Research report 133

SMEs, Financial Reporting and Trade Credit: An International Study

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1. Introduction

1.1 BACKGROUND TO THE STUDY

This study investigates the value of the financial statements of small and medium-sized enterprises to trade creditors and trade credit intermediaries, including credit rating agencies and credit insurers. The research focuses on small and medium-sized unincorporated and incorporated enterprises, referred to here as SMEs. The study is set in the context of the increased internationalisation of smaller firms and growing international convergence of financial reporting requirements.

The economic importance of SMEs, especially in developing economies, has been widely documented. Not only do SMEs provide an increasing share of turnover in the private section in most economies, but many jurisdictions regard them as vital sources of innovation, growth and new jobs. As discussed in the individual country chapters, definitions of 'small' and 'medium' vary from place to place. Since SMEs make a significant contribution to all economies, however, definitional issues are of minor importance. Against this background, many governments have developed favourable policies towards SMEs in order to lower barriers to their development. Two areas, in particular, have been singled out for attention – access to finance and financial reporting.

Many studies have identified a 'finance gap' where SMEs find it hard to obtain finance at the start-up stage and beyond. Although various initiatives and incentives have been used to encourage financiers to invest in equity and to lend to SMEs, generally the take-up levels have been disappointing. It is hard for lenders to overcome the high costs of assessing and monitoring SME investments in comparison with lending for property purchases, for example.

Existing and potential investors, lenders and creditors are widely considered to be the primary users of published accounts (IFRS 2010). Investors in large companies are generally external shareholders who delegate authority for managing the business to the directors. By contrast, investors in most small and medium-sized private companies are owner-managers (Page 1984; Carsberg et al. 1985; Collis 2003 and 2008). Although there is some literature on the users of the financial statements of small and medium-sized companies, the main focus is on lenders, and little is known about the information needs of suppliers, other trade creditors or third parties, such as credit rating agencies and credit insurers. Moreover, the use of the financial statements produced by unincorporated entities by trade creditors is a notably under-researched area.

There has been a concerted push to reduce the perceived burden of regulation faced by small businesses. As regulation has increased, small businesses and their representatives have complained that new regulation in many fields such as health and safety, employment and financial reporting impinge unfairly upon smaller businesses. Where such regulations impose costs that have a fixed element, or there are economies of scale in complying with them, there is substance in such complaints as larger competitors are able to spread additional costs over a larger volume of activity.

At the same time, the public benefit of small businesses' compliance with regulations is less than for larger entities; SMEs bear a higher relative cost of regulation for a proportionally smaller social benefit. As shown in Chapter 4, section 4.1, there has been a programme of reduction in the financial reporting requirements for small companies in the EU and in the specific requirements of nations such as the UK, Finland and South Africa. In 2012 the EU proposed new rules that would exempt micro-entities[1] from most of the requirements of financial reporting (EU Parliament and Council, Directive 2012/6/EU). Implementation of the directive would mean that micro-entities did not need to report full accounts to their members, file financial statements for public inspection or comply with accounting standards in important respects. A substantial reduction in the amount of financial information available about small companies could have two effects. At the level of individual micro-entities, companies that chose to use the exemptions could find it harder to gain trade credit and/or bank finance. At the systemic level, the reduction of information about the SME sector might increase information costs and uncertainty in granting credit and finance so that the financing costs of all SMEs rise to some extent.

The focus of this report lies at the intersection of these two elements of policy. The majority previous studies on the finance gap for small business have been directed at the provision of bank loans and, to a lesser extent, equity; yet, not all businesses borrow from banks and fewer still seek outside equity. Trade credit is another source of finance that is widely used and has many advantages for small businesses. Trade credit is usually costless or at least cheap; it is self-liquidating in the sense that most purchases of supplies on credit are generally for inventories which subsequently provide the funds to pay the supplier. Trade credit, therefore, expands with the business. Studies in various countries have found that trade credit used by the small business sector is of the same order of magnitude as bank borrowing (Berger and Udell 2006; Forbes 2010; Paul and Boden 2011).

According to Berger and Udell (2006), although trade credit is extremely important to SMEs, it has received much less attention than commercial bank lending, which provides only slightly more credit to SMEs. Trade credit provides a cushion during credit crunches, monetary policy contractions or other events that leave financial institutions less able or less willing to provide small business finance. Since only a limited number of SMEs have access to loans from financial institutions, trade credit may often be the best or only available source of external finance for working capital. Previous research has tended to oversimplify the institutional framework by dichotomising SMEs into transparent and opaque firms and suggesting that lending to opaque SMEs is uneconomic for big banks. Instead, Berger and Udell (2006) argue that alternative institutional structures could be set in place to improve credit availability for SMEs.

1. Micro-entities are defined as those that satisfy two out of three conditions: balance sheet total <€350,000, net turnover <€700,000, average number of employees <10.

Many of the procedures and processes associated with the other lending technologies appear to be used in underwriting trade credit (Wilner 2000). Credit scoring and similar quantitative techniques have long been a part of the underwriting process used by credit managers. Financial statements are analysed as part of the underwriting process for larger accounts. Previous research shows that financial information is one of the primary measures used to assess the capacity of a business to effect payment of credit (Kwok 2002). Although the generation and effective use of financial information are essential to accessing funds from external sources, loan officers tend to use full financial statements rather than relying on cash flow information alone.

A study of entrepreneurs and bank managers in Italy (Howorth and Moro 2006) found that a bank's lending decision is often based on the evaluation of the customer's financial statements and/or the provision of collateral and/or a credit rating score. These three technologies are grounded on hard facts and available public information.

'Soft' information, such as ethics and trust, social capital (relationships, networks), is also important in the lending process. Ethical perception of the borrower plays an important role in reducing agency problems such as moral hazard and adverse selection. Since the information needs of lenders and creditors are similar, these findings suggest that a combination of 'hard' and 'soft' information might also be important in the decision to grant trade credit to SMEs. In this report the term 'hard information' is used to mean sets of information, such as financial statements, court judgments and credit ratings, that are formally produced and transparent in the sense of being accessible to a range of users. The term 'soft information' is used to mean informally produced information that depends on personal opinion and experience and that is opaque, ie not widely accessible. 'Soft' information includes information internally produced by a business that is not accessible to other businesses, such as a customer's payment history.

This report addresses corporate reporting and access to finance issues, which are two of ACCA's main strategic themes. Trade credit has been recognised in a number of surveys and research publications, from both a UK and global perspective, as an important source of finance for SMEs (Forbes 2010; ACCA/CBI 2010). Although it is known that published financial statements play a significant role in the determination of the credit decision, previous research has tended to accept the user-needs framework (IFRS 2010) based on the economic decisions made by the users of the financial statements of large, listed companies (mainly investors). Little research has investigated the use of the financial statements of smaller entities in the context of trade credit and the customer/supplier relationship. The researchers have not found any study that has investigated the needs of the users of the financial statements of unincorporated entities as a basis for making comparisons with small, unlisted companies.

1.2 PURPOSE OF THE STUDY

The purpose of this study is to address these gaps in the literature by providing empirical evidence of the value of the financial statements of unincorporated and incorporated SMEs in the context of trade credit decisions that support customer/supplier relationships. The specific aims of the study are to investigate the following research questions.

- What are the main sources and types of information used by the case study SMEs when making trade credit decisions?
- How is the information used?
- What are the international similarities and differences in the findings in the context of institutional factors?

This report contributes to current knowledge of the processes involved in the credit decision and identifies what information is used and by whom. The findings from this research should be used as the basis for further development of ACCA's policy with regard to:

- access to finance – trade credit is recognised as a major source of SMEs' short-term finance
- financial management – the promotion of effective financial management practices in relation to trade credit decisions in the context of customer-supplier relationships
- financial reporting – the contribution of knowledge about users of the financial statements of small companies and small unincorporated firms, and their needs.

The recognition and importance of these policy developments will be evidence-based, which is an important issue for the government, the accountancy profession and other stakeholders. The international dimension of the research will mean that ACCA will be able to develop policies based not only in the UK but also in some of the countries where overseas members are based. The findings should contribute to ACCA's reputation with international bodies such as the IASB, IFAC and the World Bank.

1.3 STRUCTURE OF THE REPORT

The next chapter explains the research design and methods chosen for collecting and analysing the research data. Separate chapters for each country then describe the institutional setting and the findings from the country-level analysis. The final chapter presents a cross-country analysis and discusses the contribution of the research to increasing understanding of the information used by SMEs when making trade credit decisions and by credit rating agencies and credit insurers when making credit rating decisions.

2. Methodology

2.1 INTRODUCTION

It is widely held that quantitative approaches provide limited information on the relative usefulness of different sources of financial and other information used for decision making, whereas a qualitative approach can yield rich insights (Collis and Hussey, 2013).

2.2 RESEARCH DESIGN

To examine some of the international differences, this study focuses on the following countries:

- In Finland very small, non-publicly accountable companies can choose to publish slightly abridged accounts based on Finnish GAAP that also meet the requirements of the tax authorities, and that are exempt from audit.

- In the UK private companies that qualify as small can publish an abbreviated statement of financial position only (and notes thereto) that is based on the Financial Reporting Standard for Smaller Entities (FRSSE). Moreover, the full accounts they must provide for shareholders are generally exempt from statutory audit. On the other hand, private companies that qualify as medium-sized can publish a separate version of abbreviated accounts that contains more information than the version for small companies. Medium-sized private companies cannot use the FRSSE, however, and the full accounts provided for shareholders must be audited.

- In the US small and medium-sized private companies are not obliged to publish financial statements or have their accounts audited. Nevertheless, when companies prepare accounts for tax purposes they can choose to have them audited, ask for a review or ask for a compilation report (the last two options provide lower levels of assurance than an audit).

- In South Africa small private companies are obliged to publish financial statements based on the IFRS for SMEs; an audit exemption was proposed in company law provisions in 2010.

This choice of countries allows data to be collected from:

- Europe (where the UK represents an early adopter of little GAAP and Finland a late adopter of the concessions available under the EC Fourth Directive) as well as Africa and North America

- developed economies (Finland, the UK and US) and an emerging economy (South Africa). Appendix C reports on research undertaken in Thailand in order to provide additional findings on emerging economies.

The research data were collected via a number of in-depth, semi-structured interviews in each country:

- interviews with two unincorporated small entities providing trade credit

- interviews with two small private companies providing trade credit

- interviews with two medium-sized companies providing trade credit

- one interview with a credit rating agency and one interview with a credit insurer.

To address the problems of access to a suitable sample, and of cultural and language barriers, the interviews were conducted and analysed by local academic researchers in each country. The entities were selected using snowball sampling, which is a technique based on networking and is appropriate in a study where generalisation is not the aim (Collis and Hussey 2013). The majority of interviews were conducted face-to-face, and the rest by telephone.

The interview schedule (see Appendices A and B) included some closed questions to collect demographic data at the start of the interview, but the majority of the questions were open ended. Some questions incorporated critical incident technique (Flanagan 1954) to focus the interviewee's attention on a recent defined event. This helps the interviewee express an opinion about a memorable experience rather than give a general impression of events or an opinion based on vicarious knowledge. Because the primary goal was to obtain empirical insights, cues given by interviewees were followed in more depth by using ad hoc prompts and probes. Thus the interviews were designed to leave room for unforeseen issues to emerge.

The interview schedule was developed and tested with two small firms and a credit rating agency in the UK, before its wider adoption in the study. The questions addressed a number of areas relating to the information gathering processes involved in business-to-business credit decisions. It covered the types of information needed by SMEs providing trade credit and by credit rating agencies and credit insurers. It also explored the purposes for which the information is needed and the sources of information used.

The interviewees were given information about the nature and purpose of the research in advance and permission was asked to record the interviews. In the majority of cases, permission was granted. The researchers offered to provide a copy of the interview transcript for the participant's approval and a copy of the research report. The interviewees were made aware that the report would include anonymous quotations and neither their names nor the names of their organisations would be associated with any of the information provided.

Following the advice of Miles et al. (2013), a thematic approach was taken to the analysis of the research data. This entailed identifying the themes that emerged from the interviewees' responses and subsequently grouping them into categories that share a common characteristic. The first stage of the analysis took place at the country level and this is reported in Chapters 3 to 6. The second stage was to conduct a cross-country analysis to form new integrated patterns (see Chapter 7, section 7.9).

2.3 INTERVIEWS IN FINLAND

The interviews with the Finnish SMEs were conducted between May and November 2012 with the owner-manager or business controller of each business. In addition, the head analyst from a credit rating agency and two senior managers of a credit insurer were interviewed. The SMEs represented a variety of industries. The participating credit rating agency is well established in the country. The credit insurer is a not-for-profit government-owned organisation, which can take somewhat higher risks than a private credit rating agency. It operates with credit risks related to non-EU transactions where the other party of the business relationship is a Finnish entity. Table 2.1 provides a summary of the participants in Finland.

2.4 INTERVIEWS IN THE UK

The interviews with the UK SMEs were conducted between January and December 2012 with the owner-manager. In addition, the business development director from a credit rating agency and the underwriting consultant of a credit insurer were interviewed. The SMEs represented a variety of industries. The participating credit rating agency is a large, well-established company. The credit insurer specialises in the timber, construction and retail sectors and holds approximately 5% of the credit insurance market. Table 2.2 provides a summary of the participants in the UK.

2.5 INTERVIEWS IN THE US

In many industries, the issues of personal liability and involvement of personal assets mean that a large proportion of small entities are registered as a limited liability company (LLC) or other corporate form. It was not possible to identify any unincorporated small business that received trade credit or offered credit to customers. The following quotation from one of the interviewees explains the reasons.

I mean in this country, you know, the potential to lose everything you own if you're not incorporated is so significant that I would have to say it's pretty uncommon to find a business that's not incorporated, especially in an industry that deals with people's healthcare and the law suits.
(Owner-manager of small medical devices company)

Four interviews with incorporated SMEs in the US were conducted between September 2012 and January 2013. One of the interviewees was a certified public accountant (CPA) and the other three were involved in making trade credit decisions in their respective companies. Interviews were also conducted with the senior vice-president responsible for data analysis from a credit rating agency and the president of a credit insurance broker. Table 2.3 provides a summary of the participants in the US.

2.6 INTERVIEWS IN SOUTH AFRICA

Interviews were conducted with six business owners and one credit rating agency in South Africa. All the interviews were conducted in November 2012. Table 2.4 provides a summary of the participants in South Africa.[2]

2. The first of the unincorporated entities listed in Table 2.4 operates in Alice, Eastern Cape, which is one of the smallest and poorest provinces; the second entity is located in Johannesburg, Gauteng, which is the wealthiest and largest province in South Africa. The first and second of the small companies in the list operate in the wealthy, populated cities of Johannesburg and Cape Town respectively. The first and second of the medium companies in the list operate in Cape Town and Roodepoorte, Johannesburg respectively.

Table 2.1 Participants in Finland

Firm	Main activities	Number of employees	Audited accounts?	Interviewee
Small unincorporated entity A	Real estate refurbishment	1	No	Owner-manager
Small unincorporated entity B	Events management	2	No	Owner-manager
Small private company A	Interior design	2	No	Owner-manager
Small private company B	Textile import agent	3	Yes	Owner-manager
Medium-sized company A	Kitchen furniture manufacture	480	Yes	Business controller
Medium-sized company B	Business services	70	Yes	Owner-manager
Credit rating agency	Credit rating	–	–	Head analyst
Credit insurer	Credit insurance	–	–	Head of export credit and financial manager

Table 2.2 Participants in the UK

Firm	Main activities	Number of employees	Audited accounts?	Interviewee
Small unincorporated entity A	Building services	1	No	Owner-manager
Small unincorporated entity B	Structural engineering and surveying services	1	No	Owner-manager
Small private company A	Online training publications	8	No	Owner-manager
Small private company B	Engineering recycling	3	No	Owner-manager
Medium-sized company A	Manufacture of power decorating and cleaning products	160	Yes	Group financial controller
Medium-sized company B	Engineering	125	Yes	Managing director
Credit rating agency	Credit rating	–	–	Business development director
Credit insurer	Credit insurance	–	–	Underwriting consultant

Table 2.3 Participants in the US

Firm	Main activities	Number of employees	Audited a ccounts?	Interviewee
Small private company A	Medical devices manufacture	8	No	Owner-manager
Small private company B	IT security systems	40	No	Owner-manager
Medium-sized company A	Healthcare services	500	Yes	Vice-president of finance
Medium-sized company B	Ice machine manufacture	250	Yes	Senior vice-president of sales and marketing
Credit rating agency	Credit rating	–	–	Senior vice-president of data analysis
Credit insurance broker	Credit insurance	–	–	President

Table 2.4 Participants in South Africa

Firm	Main activities	Number of employees	Audited accounts?	Interviewee
Small unincorporated entity A	Hair pieces and products	1	No	Owner-manager
Small unincorporated entity B	African clothes and bags	2	No	Owner-manager
Small private company A	Catering supplies	15	Yes	Owner-manager
Small private company B	Nature guides and tours	18	Yes	Owner-manager
Medium-sized company A	Retirement homes	417	Yes	Director
Medium-sized company b	Textiles	250	Yes	Director
Credit rating agency	Credit rating	–	–	Official

3. Findings from Finland

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3.1 INTRODUCTION

As Finland has been a member of the European Union (EU) since 1995, the regulation of financial reporting is aligned with the requirements of the Fourth Company Law Directive (78/660/EEC) and other accounting directives issued by the European Commission. In Finland there is a strong alignment between financial reporting and tax reporting. Financial statements are the basis for tax filings, and financial reports of all limited liability companies are transferred by tax authorities to a public record. Niskanen and Niskanen (2006: 84) describe Finland as an environment where the payment systems are highly developed. This is supported by the European Payment Index 2012 (Intrum Justitia 2012), which shows that Finnish firms are the most prompt payers of trade credit in Europe and, therefore, Finland has the lowest payment risk profile in Europe.

The number of enterprises in Finland increased by 40% during the period 2000 to 2007, but since then has remained fairly stable with some 318,951 enterprises in 2010. Small companies with fewer than 50 employees represent 99% of small enterprises and play a very important role in the Finnish economy. In 2010, the total sales revenue attributable to small companies was EUR 358.9bn and the number of jobs provided by small companies rose by approximately 11% between 2000 and 2010 to a total of 1.4m (Statistics Finland 2012).

The main themes identified from the interviews in Finland are examined next.

3.2 MAIN THEMES FROM THE INTERVIEWS IN FINLAND

3.2.1 Use of the financial statements

Revenue and changes in revenue were generally perceived as an important indicator of a firm's potential for profitable business. The owner-manager of the small textile import company participating in the study had a Master's degree in accounting and was in the process of handing over his family business to the third generation. In his view, most items in the financial statements of a small business are affected by the preferences of their owners. Some owners pay themselves a decent monthly salary, whereas others only take minor expenses from the business; some take dividends from the firm's retained earnings, while others build up retained earnings in the company. Therefore, he considered revenue a more reliable indicator of success than profit, as revenue is not affected by the owner-manager's policy regarding his or her financial rewards. He argued that the revenue figure can show whether the company is growing and whether it is able to maintain its position in market. Although the owner-manager of the small interior design company explained that he is not very knowledgeable about the financial statements, his view was that the most relevant information was that about revenue and liabilities.

In financial statements I might have a look at the profit for the period, but quite often the profit is close to zero. Net sales [revenue] are informative for a couple of consecutive years. In case of a larger financial risk I might ask a third party for a credit report. I might look at the pattern of inventory levels in consecutive years. If there are large changes in inventory levels, it gives me an impression that they have manipulated profit. In reading the financial information of small businesses, it is crucial to pay attention to the owner-manager's pay and rewards because they greatly affect all the other financial statement items, apart from net sales and gross profit margin. Revenue and gross profit margin are the line items where the owner-manager's decisions about his or her remuneration are not reflected.
(Owner-manager, small company, textile import agent)

My financial statement literacy is not very good, but I think that the important parts of the financial statement are the net sales and liabilities.
(Owner-manager, small company, interior design)

3.2.2 Use of payment default reports

Although the owner-managers of the two small companies recognise that payment default reports are a timely source of information about serious liquidity problems of current or potential trade partners, they rarely or never use them. On the other hand, the two medium-sized companies use payment default reports as a standard operating process with all new customers.

We are not interested in the financial statements of our customers. Other information is much more important when we assess the credit risk – in particular, the registered payment defaults are timely signals of serious liquidity problems.
(Owner-manager, small unincorporated entity, events management)

We check the financial statements when it seems necessary, but this is not a systematic procedure for all new customers because financial statement information is never up-to-date. The most up-to-date source of information is a customer's potential payment defaults. Payment defaults are quickly updated on the payment default registers.
(Business controller, medium-sized company, kitchen furniture manufacture)

3.2.3 Length of the business relationship

In general, it would appear that the interviewees were hesitant to start a new business-to-business relationship if it seemed to be a one-time transaction only. Interviewees perceived it burdensome to put their time and effort to such a venture.

Credit sales comprise 95% of our total sales. All new customers are set a prepayment before we organise the first delivery of kitchen furniture.
(Business controller, small unincorporated entity, kitchen furniture manufacture)

I haven't had a project for a customer who I would not know either personally or indirectly through someone I know. It is very common that I have various projects with the same customer.
(Owner-manager, small unincorporated entity, real estate refurbishment)

I try to operate with long-term customers only. I avoid one-time customers. It doesn't make sense to use a lot of time in

negotiations with one-off customers.
(Owner-manager, small company, textile import agent)

The hesitance about engaging in short-term business relationships seems to relate to the fixed costs, which include time-consuming information gathering and relationship building where the supplier of goods or services cannot leverage the investment in the initial customer relationship over a longer period. Another reaction to opaque riskiness profiles of new business customers is that (established) companies are not willing to carry as much risk as they normally carry in trade transactions. Instead they shift the business risk completely or partially to their new customer. The business controller of the kitchen furniture manufacturing company explained that if they perceive their new customer is risky, they do not start the production of the order until the full payment has been received and paid into the bank. If they consider the new customer is less risky, they require the prepayment immediately before the delivery.

3.2.4 Age of the business

In the early years, most new businesses struggle to survive. Research in various countries shows that small firms are most vulnerable to failure during the first five years (for example, Milne and Thomson 1986; Storey 1994). Dawitt (1983) estimates that 55% of new companies fail within the first five years of incorporation and 81% within ten years. The propensity of young firms to end up in a distressed situation compared with older, more established businesses with a long history places relatively new firms in a less favourable position when negotiating trade contracts and terms. For example, the business controller of the kitchen furniture manufacturing company explained that his firm is critical of newly established companies. The owner-manager of the events management business explained that her last business customer is well known and been operating in the region for a long time, a fact that puts the customer in a low-risk category in her mind. In addition, the head analyst of the credit rating agency who participated in the study revealed that the age of the business is a factor in their credit-risk rating model. These views suggest that small businesses consider long tenure to be a factor that improves their risk tolerance of the credit customers.

Our last customer company is well known in this region of Finland. The fact that it is so established and has been operating for such a long time makes us feel that there is very low risk of it not settling its debts in due time.
(Owner-manager, small unincorporated entity, events management)

If our potential customer is a newly established small company, then we are much more critical towards it compared with a more established and bigger company.
(Business controller, medium-sized company, kitchen furniture manufacture)

In our credit rating model we include profitability, liquidity and solvency measures, together with trade payment behaviour, number of years in operation and industry affiliation as non-financial measures.
(Head analyst, credit rating agency)

3.2.5 Organisational behaviour

Reputation is of utmost importance for those engaged in financial transactions. The interviewees suggested that globalised ways of working in trade credit markets may have raised a demand for broader understanding of reputational damage in business 'ecosystems'. Furthermore, they suggested that ethically behaving companies try to avoid persons or companies that suffer from reputational problems such as serious environmental damage, involvement in bribe issues or other unethical behaviour.

I try to follow the company's reputation. We strive for continuous trading with the same customers. It's easy to operate with the same customers. I monitor the buying and paying patterns of the customers. I share information with a group of colleagues by telephone. In the telephone calls we share our experiences. I also visit retail shops and look at what kind of selling items they have there and discuss with the retail shop personnel. I ask them how the last week has been and try to get an understanding of whether things are OK. It is much easier to get important information from lower-level personnel. Top management and professional buyers do not reveal information as easily as lower-level staff. Owners and top managers would not reveal their difficulties.
(Owner-manager, small company, textile import agent)

Nowadays, our credit insurance contracts include a clause that the customer does not appear on any black list. If any of the key parties in trade relationships that we intend to insure have been involved with issues that compromise their good reputation, we are not going to offer credit insurance. Such reputational problems include serious environmental issues, bribes and the like.
(Head of export credit, credit insurer)

3.2.6 Relationships and trust

The interviews with the owner-managers of small companies provided evidence of the importance of behavioural factors on the part of the customer in a trade credit relationship, especially the extent to which the customer pays attention to and shows professional interest to the supplier. For example, the owner-manager of real estate refurbishment business explained that he does not examine the financial statements of potential customers, nor does he check the past payment defaults. Instead, he attaches a lot of weight to personal meetings with the potential customer. If the customer looks reliable, pays careful and professional attention to the project plan and shows flexibility in the negotiation, the owner-manager considers him/her a low-risk customer. In his opinion, the customer signals a higher risk profile by behaviour characterised by a lack of time, ignorance or arrogance towards the owner-manager, and a lack of interest in the financial situation of the owner-manager. He highlighted the fact that as a sole proprietor, he must pay his own salary, collect debts and settle payments, and sometimes flexibility is needed on the part of the customer.

I place a lot of weight on customer's reactions in the first meeting when we discuss the draft contract. If the buyer pays a careful attention to the project and shows expertise and flexibility when we negotiate, it gives me the feeling that this will be a low-risk project. If the customer shows ignorance or

arrogance or is restless, I consider him as a risky customer. I rarely check the credit history of potential customers. I haven't done it in the last couple of years. I've never asked to see the financial statements of the customers.
(Owner-manager, small unincorporated entity, real estate refurbishment)

I've never asked for financial information or any credit reports. I've only had minor bad debts during the two decades of my operations. I am not aware of what credit insurance means and have never been involved with such. However, I have given some financial information, including assurances that tax payments have been done properly when there have been so-called public offers – that is, competitions organised by public sector institutions.
(Owner-manager, small company, interior design)

Our most recent new supplier relationship started four years ago. From the very beginning it was based on mutual trust. Financial statements, credit reports or any other formal documents did not play any role when it started, and neither have they been necessary in our trade relationship since then.
(Owner-manager, small unincorporated entity, events management)

I pay close attention to the potential buyer's sentiments. I am interested about the vision of the future. My sense of trust is increased when managers answer quickly. If they do not answer the difficult questions, but lose them somewhere in the response, I feel uncertain about the potential customer. What matters is the general impression. It is made by all kinds of things and nothing in particular, such as how they pay attention to me and whether they seem to be in a hurry.
(Owner-manager, small company, textile import agent)

When I invoice [for a credit sale], *mutual trust is the key. If I invoice a small business, I almost feel that I'm invoicing the person who runs the business. The relationship is very personal and it's all about mutual trust. In particular, if I have had prior work history with the customer, he or she might feel very uncomfortable if I asked for financial information: it would introduce an element of suspicion. It would destroy the atmosphere and work against the good relationship. I have never asked for financial information in any way.*
(Owner-manager, small company, interior design)

3.2.7 Importance of trade credit as a source of finance

Although trade credit is expensive if it is not repaid promptly, it may be a crucial source of funding for a fast-growing business. The owner-manager of the business service company explained that occasionally his company runs out of cash. In such a situation he has always received a helping hand from their suppliers in the form of extended payment times. He described this mutual willingness to help each other as a tradition in Finland.

In a fast growing and employee intensive business like ours, we face funding constraints and problems continuously. One of the reasons is that creating a business from scratch requires upfront investment…Even though our business is healthy, we made losses in the first years of operation and our balance sheet ratios still look quite bad, creating problems with access to bank funding…If our company runs out of cash, I sometimes pick up the 'phone and call some of our suppliers and explain the situation and our need for delayed payment time. In this country we have a tradition that a friend is not left alone in trouble. It is extremely rare that a 'phone call would not lead to a longer payment term for our trade payables.
(Owner-manager, medium company, business services)

This flexible approach by suppliers to easing short-term liquidity problems through extended trade credit can be interpreted as co-operation in the interest of supporting a continuing relationship that is important to both parties.

There is some evidence that companies tend to use their negotiating power for their own benefit (for example, see Porter 1998). The current research suggests that the relative sizes of the customer and supplier, and the growth aspirations of the latter, play a role in trade credit decisions.

I think that large companies are using small firms as their banks and exploiting their negotiation power. For example, one large company that is my customer requires a 60-day payment term for its payables. It means that when I start to work for them I normally submit my first invoice 30 days after I have started and will only get the first payment to my bank account three months after I have started the work. It feels very unfair.
(Owner-manager, small company, interior design)

We have to accept the trade credit terms of a large customer…We had a large UK customer that settled its trade credits whenever it wanted without showing any respect to the agreed trade terms. It was common that the settlement was made six months late…Overall, we don't turn down an important business deal because of unfavourable payment terms required by a customer. We can't afford that because we're a company that is growing fast and needs all available deals that have a sufficient profitability level.
(Owner-manager, medium-sized company, business services)

The owner-manager of the above business service company was able to overcome the company's short-term liquidity problem by selling its trade receivables to a factoring firm.

3.2.8 Availability of data on the internet

When the interviewees explained their normal procedures for gathering information supporting trade credit decisions, they often mentioned the internet. It seems that search engines can quickly identify the home pages of the target company and assist in creating the first impression of its credibility.

I always check what kind of website the potential customer has. It gives a good first impression of customer's credibility.
(Owner-manager, medium-sized company, business services)

We normally do some generic internet searches, but we do not look at social media pages. We visit the home pages of those companies that are the main parties of the business relationship where credit insurance would be used.
(Head of export credit, credit insurer)

3.3 DISCUSSION

The findings from the interviews with SMEs in Finland suggest that there are three main influences on the trade credit decision: formal and report-based information; 'soft' information; and contingency factors. For the formal and report-based information, registered payment defaults constitute the most common piece of information used. In such decisions payment defaults were generally considered as a highly reliable measure of serious liquidity problems. The interviews showed that these default reports were requested for all new customers in the two medium-sized companies, which each had 50 to 250 employees. Smaller firms were aware of the availability of payment default reports, but they used those only occasionally. Small companies seemed to avoid risky customers by relying on a variety of 'soft' forms of information, such as the reputation of the customer and that obtained by observing certain behavioural patterns in customers: the attention paid by the customer to the supplier, answers given to questions by the customer, the flexibility and expertise in the subject shown to the supplier in the contract negotiation.

Changes in revenue were seen as important indicators of a small company's ability to operate successfully. The time for which a company has been operating and the estimated length of the trade partnership were considered to be risk-decreasing factors for trade credit. The relative size of supplier and customer appeared to be an important contingent factor that affected the terms of trade credit. This pattern reflects how negotiating power is used to advance the interest of the more powerful party. In contrast to this use of negotiation power, was the use of personal communication between the owner-managers to resolve short-term liquidity problems that can arise in fast growing small and medium-sized companies. It would appear that the availability of online data considerably improves the speed and efficiency with which SMEs can collect information for making credit decisions about existing or potential customers. Table 3.1 provides a summary of the key themes that emerged from the interviews.

Table 3.1: Finland, summary of the main themes

Description	Formal report-based information	'Soft' information	Contingency factors
Revenue as a success indicator	✓		
Payment defaults as indicators of risk	✓		
Length of the business relationship	✓		
Age of the business	✓		
Organisational behaviour	✓	✓	
Relationships and trust		✓	
Cash flow management/credit control		✓	
Size factors and economic power			✓
Availability of internet data			✓

4. Findings from the UK

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4.1 INTRODUCTION

From a users' perspective, there is very little evidence about how suppliers and customers of SMEs in a business-to-business relationship use the published financial statements in credit decisions. In the UK, companies register their annual reports and accounts at Companies House, but there is no record of who accesses these reports. Empirical evidence (Collis 2008) shows that the directors of SMEs in the UK believe that the main users of their published accounts are suppliers and other trade creditors, credit rating agencies and competitors, followed by the bank/lenders and customers.

Although some of the previous literature is somewhat dated, it is useful in building up a picture of the impact of regulatory relaxation of financial reporting requirements for SMEs in the UK. The abbreviated accounts option was introduced in the UK in 1981 and this allows qualifying small companies to register an abbreviated balance sheet and notes only, instead of the full statutory accounts. Morris and Omrod (1990) conducted a survey of credit analysts and credit managers and found that when a small company filed full accounts, these financial statements were the most important source of information for assessing credit risk. When a small company filed abbreviated accounts, although approximately half the missing information could be found from other sources, the cost of locating that missing information was high.

A second development in the UK was the introduction of the audit exemption option for qualifying small companies in the UK in 1994. Initially, the size tests were set at a lower level than for the abbreviated accounts option, but in 2003 the UK government conducted a consultation on raising the thresholds to the EU maxima. As part of their regulatory impact assessment in 2003, the DTI conducted a survey of members of the Institute of Credit Management (the largest professional credit management organisation in Europe). The survey found that as a result of the previous increase in the audit exemption threshold in 2000, small companies' credit ratings were changed, additional security was required, credit limits were reduced or cancelled, credit became more expensive, more work went into assessing the companies' creditworthiness and further references were required, causing delays. The survey results also show that 64% of respondents would adjust the credit ratings of companies that took up audit exemption if thresholds were raised to the EU maxima.

More recently, a survey by ACCA and CBI (2010) identified suppliers as the most important creditors of SMEs and Wilson (2008) reports that trade credit is twice the amount of short-term bank lending. In one sense, therefore, all small businesses providing credit to their customers are lenders, and consequently they are taking some risk in the process. The ACCA/CBI survey in 2010 suggests that day-to-day practice of credit management in small businesses is far from perfect, often relying on poor information and methods, but concludes that it represents a reasonable compromise in the light of limited resources and the need to maintain valued commercial relationships. During the current economic crisis, managing cash flow was found to be more critical to survival in small firms than it is in buoyant conditions and there is greater need for SMEs to improve their management of trade credit in an environment where credit risk is increasing. The survey also found that the published financial statements play a significant role in the management of trade credit in SMEs.

Research by Kitching et al. (2011), which included interviews with banks, commercial credit rating agencies and credit insurance companies, confirms that abbreviated accounts offer limited insights into the financial performance and position of a company, and that other information is needed to assess credit risk. It is likely that the directors of small companies are aware of this because some file voluntary full accounts that have been audited on a non-mandatory basis to improve their credit rating (Collis 2003; Marriott et al. 2006). A UK study of 5,139 small companies filing full accounts (Lennox and Pitman 2011) provides evidence that low-risk companies attract upgrades to their credit rating when they signal their favourable borrowing characteristics by choosing voluntary audit.

The main themes identified from the interviews in the UK are examined next.

4.2 MAIN THEMES FROM THE INTERVIEWS IN THE UK

4.2.1 Use of financial statements

Neither of the owner-managers of the two unincorporated businesses used the financial statements of existing or potential customers when deciding whether to give credit, although one of them was a qualified accountant. Nevertheless, both were confident that their customers would pay their debts, primarily because they know their customers personally or because their customers had been introduced by someone they know personally. The owner-manager of one of the small companies also had an accountancy background, but even he did not examine the customers' financial statements when making credit decisions. In this case the reason was not because he knew the customers personally, but because he knew them by reputation (the firm's main customers were professional bodies). This will be considered more closely in the next section.

A very different picture emerged in the case of the two medium-sized companies. Both relied heavily on the published financial statements when making credit decisions. As in Finland, cash emerged as an importance concept.

I'm looking at where the asset value is…What's the cash position? Is there any money being taken out? If it's part of a bigger group, are they sweeping it clean every year and taking it out? Is anybody putting any money into it? What kind of liabilities are in there? I'm not really interested in the stock values because you can kid an auditor you've got £2m worth of stock if you want to. You know, it's so easy to manipulate, it's untrue. So I'm really looking at cash, debtors and creditors…You wouldn't want to manipulate your creditors and it's hard to manipulate your debtors. Some people do manipulate the debtors by putting false invoices in, so you've got to be wary of that. If you're being audited it's hard to fiddle the cash really because the cash is cash.
(Managing director, medium-sized company, engineering)

The above interviewee considered audited accounts to be important, but was conscious that there are some boundaries to the assurance and the accounts should not be considered wholly reliable because the figures can be manipulated. Nevertheless, he found the audited accounts useful for making credit decisions about new customers and for monitoring existing customers for credit-control purposes.

Cash was also cited by the owner of the second medium-sized company interviewed as the most useful information in the financial statements of customers. Even so, it was clear that other signals were also being picked up, such as the availability of the accounts and how quickly they are filed at Companies House.

I'm interested in the two- to three-year cycle…I'm also interested to see if they've reported early or late and I don't like it when they're late…Bad results take a long time to file; good results get filed quickly…One example [that raised concern] is [customer A], which is owned by a family trust from Jersey and they've got another company that we sell through called [customer B]. Although they're trading in the UK, they haven't filed any Companies House documents and I don't know how they've got away with it…I spoke to their accountant and he said they don't have to…I was unsure enough to actually then ring Companies House and say, 'Is that right?'…[In the end] I asked for a letter of support from [customer A], so we've got a letter signed by [finance director] guaranteeing the debts of this other company. So we will do more than just a credit agency check, but it's not that normal.
(Group financial controller, medium-sized company, manufacture of power decorating and cleaning products)

Continuing the timeliness theme, the above interviewee suggested that financial statements would be more useful if companies had to file them more quickly. He argued that businesses are assessing each other for credit purposes and sometimes the amounts are quite considerable. Reducing the filing period would support credit sales and was the *quid pro quo* for the privilege of limited liability.

There seems to be reluctance among the UK interviewees to ask customers for copies of their financial statements.

I wouldn't ask them. When it's your customer I think it's a bit insensitive when that information is already available at Companies House for the sake of £1.
(Group financial controller, medium-sized company, manufacture of power decorating and cleaning products)

The above interviewee was prepared to talk to the customer if he had any queries after looking at the financial statements, because sometimes the explanation was simply that there had been a change of ownership, either as a takeover or because one of the partners had moved on. His main objective was to assure himself that the customer was a going concern. The managing director of the other medium company interviewed summed up the sensitivity of the situation by saying:

I prefer to do it round the back door rather than the customer thinking, 'Why's he asking for that? What's the matter with him?
(Managing director, medium-sized company, engineering)

The financial statements were accessed through Companies House or credit rating agencies.

Listed companies are required to publish their statutory report and accounts on their websites and ease of access to this and other financial information on the internet is one of the major innovations in recent years.

The biggest change has probably been the internet as a delivery tool, but what hasn't changed is the data and that data is dependent upon fundamentally Companies House hard data.
(Business development director, credit rating agency)

4.2.2 Use of credit rating reports, credit insurance and invoice finance

The interviewees tended to be risk averse and use a variety of methods to determine the creditworthiness of new customers. The managing director of the medium-sized engineering company is a qualified accountant who uses the financial statements together with information supplied by credit insurers and invoice discounters to provide a framework for making credit decisions.

All of our customers are given credit at some point. If it's the first transaction, we may go pro forma. We may ask for a Visa transaction [credit card], *depending on who it is, what it is, etc, and then build up some confidence. If they're using the tools we've got available to us – if we've got that confidence straightaway – fine, we'll give them credit straightaway.*
(Managing director, medium-sized company, engineering)

The group financial controller of the medium manufacturing company also has a formal system for collecting information.

We have an information form…We want to see a letterhead from the company…We want to know who they are, their main contacts…we even ask for their VAT number, but I never check that one…[The credit decision] *is based on the credit rating agency report and the volume of trade that we're going to do. So I ask the question straight back to the salesman, 'Is this a customer we want long term?' We also factor through [name of invoice factor] and anybody over £10,000 we check ourselves. Then we put through to the bank for them to check as well.*
(Group financial controller, medium-sized company, manufacture of power decorating and cleaning products)

The credit decision is not so fast for new overseas customers. This is mainly due to the lack of credit-rating information about foreign companies.

[Name of credit rating agency] *is getting quite good within parts of Europe – and you can now do the States – but I've used them as a third-party house to do an assessment on [name of customer] in Australia.* [Because] *I could wait a week for a decision to come back, in the meantime, I go off and find*

what I can on the internet. I usually find the company's results somewhere there and then assess whether I think they're a strong enough company. The sales team have already done a fit analysis and they like this company. They've been out there and met them, they've been to Australia to try and increase distribution, I then come along slightly later and say, 'Well you shouldn't have visited them' or 'You should have visited them'. That decision was two-and-a-half times the limit I would have approved and it then had to go to the board because that goes above my pay grade.
(Group financial controller, medium-sized company, manufacture of power decorating and cleaning products)

None of the small unincorporated entities or companies used credit insurance or any form of invoice finance. One of the unincorporated entities interviewed told us that his application for invoice finance was rejected because he was a one-person business**.** One of the medium-sized companies uses credit insurance as a part of a framework of credit-control mechanisms to reduce the risk of non-payment. This may be a reflection of the interviewee's professional accountancy background and past experiences in the industry

Well, we have credit insurance in place…I've only had that in for the past 12 months…It's one of those things where you're grateful you've got it if anything happens, but it's costing. I've got a very good deal with it, but we don't really need it – it's a nice safety factor that I'm prepared to pay a little bit of money for at this point in time, but ask me in five years and I may have changed my mind.
(Managing director, medium-sized company, engineering)

The same interviewee explained the role of invoice finance and credit insurance in his credit control framework using one his large corporate customers as an example.

So what I've got negotiated with [name of bank supplying the invoice finance] *is we raise an invoice to* [name of customer] *and at the point when we raise it, we've got 120 days that we can draw down and borrow on that and I only really have to worry about* [name of customer] *after those 120 days. Also I've got credit insurance whereby…*[they] *should start paying us that money at that point in time…So at the point where the invoice financing on that money drops off and I can't borrow on that invoice anymore, I've got credit insurance that should be paying up at that point in time.*
(Managing director, medium-sized company, engineering)

This interviewee provided further insights into his experience of using credit insurance.

What we find with credit insurance with [name of credit insurer] *is that they're very, very quick to withdraw credit from anybody that's got any bad news and that's their downfall because they really are de-risking their position so rapidly… The credit insurer reviews the portfolio of customers on value…Anything not reviewed, they give £7,500 cover, providing there's history of previous payments…We'd get the money from the insurer if they went bust.*
(Managing director, medium-sized company, engineering)

He also uses the credit insurers to give an opinion about the riskiness of giving credit to a customer

Say someone wants £50,000 credit; I would send it to [name of credit insurer] for an opinion. They may offer cover of only £30,000; the other £20,000 is a commercial decision by me. Is it a show stopper? If it's not, I just get a feel about whether they are vibrant [such as] *is the car park full? If the amount is very big, we use progress payments to hedge against the debt.*
(Managing director, medium-sized company, engineering)

Maintaining the company's credit rating is very important to this interviewee and he was conscious that it was important to file his accounts at Companies House as early as possible.

4.2.3 Business drivers

Not surprisingly, SMEs tend to have a smaller range and volume of products and/or services than large firms. This means SMEs need a high level of knowledge about customers and the market, which enhanced the interviewees' confidence in making credit decisions.

Knowledge is everything. Understanding of your potential customer, knowledge of the industry, the feeling…and it's a gut feeling sometimes…The only area we've found where it's a bit more risky – where everyone's really at each other's throats – is the construction industry.
(Managing director, medium-sized company, engineering)

In some cases, business drivers are an important influence on the credit decision for corporate customers.

We're a sales and marketing-led business and it is all about distribution, so that's where rational thought and reason can go out of the window [with regard to giving credit]*. We have to go on a hunch, and the hunch* [in this example] *is that this company is a good fit. This territory, being south of the Equator, takes us out of seasonality and the volumes they can deliver fit the longer term strategy…I said, 'I'm saying no, but I understand all of the above' and then refer to the board and tell them that if they want to make this decision, these are the risks.*
(Group financial controller, medium-sized company, manufacture of power decorating and cleaning products)

The above interviewee pointed out that sometimes his advice about the risks was ignored and, on one occasion, the sales and marketing team got it wrong and the company lost a significant amount of money when the corporate customer went into liquidation.

4.2.4 Relationships and trust

The interviews revealed that most customers were either of long standing or resulted from word-of-mouth marketing and recommendations. These informal networks featured prominently as a source of new customers.

I get most of my work through word of mouth – primarily, local informal networks of individuals who know each other and presumably are satisfied customers in terms of quality and/or price.
(Owner-manager, small unincorporated entity, building services)

I don't get many big companies ringing up. The reason I'm doing the work for [large customer 1] *is because I've been doing work for* [customer 2] *and there's a lift consultant there who recommends all the lifts. We've been working together… I was in* [name of an apartment block] *talking to the estate manager [and she said], 'Oh, we've got to do our lifts. Do you know anybody?' I said, 'I know this firm – he does all the work for* [customer 2]*. Give him a call and see what he can do.' He comes down, gets the job and they're impressed – it's good. So he thought, 'Oh, right, I've just got engaged to do this job in* [large customer 1] *and they need an engineer. So I've recommended him, he's recommended me and we got a job each out of it…. That's how it works.*
(Owner-manager, small unincorporated entity, structural engineering and surveying services)

Developing personal relationships lies at the heart of networking, as illustrated in the following quotation.

Well, with supplying them [existing customers] fairly regularly, you speak to them on the' phone and visit them regularly… and you find that if a new customer comes in, it's usually because they've been speaking to somebody and he told them to give us a ring…So we've never advertised in 20 years.
(Owner-manager, small company, engineering recycling)

Although there has been a marked increase in mistrust in UK society generally in recent years (Jackson 2009), there is considerable evidence that trust plays a key role in the decision to give credit to customers. Trust appears to be more important than formal sources of information where the financial knowledge of the owner-manager is not sufficient to use such sources effectively or formal sources are not available. The unincorporated businesses and small companies in the study tended to have only a few business-to-business customers, but relationships with such customers sometimes extended over a significant period of time, which allowed trust to develop. It was clear that trust was a feature of both sides of the relationship, as illustrated by the following quotation.

It's mutual trust because this client I've known for 30 years… He trusts me to do his work honestly in terms of time spent, whether I do it as a time charge or I give him a lump sum quote; and I trust him to pay me for doing it.
(Owner-manager, small unincorporated entity, structural engineering and surveying services)

A different example of trust was given by the owner-manager of a small online publishing company where 70% of the customers are not-for-profit professional bodies, which typically promote ethical codes of conduct for their members and their own activities. This gave him confidence about being paid and receiving the payment on time. In a similar vein, the managing director of the medium-sized engineering company had customers in whom he had considerable confidence.

We also do plaques, unfortunately for bereaved and people like that, but the best payers of all are the vicars…[They] *have got a conscience…In all the years we've had brass foundries, I've never had to chase a reverend for his money!*
(Managing director, medium-sized company, engineering)

Trust appears to be one of key factors in relationships with customers and suppliers. One interviewee suggested that in some cultures the concept of honour is an integral feature of trust.

If you put it in percentage terms, 50% to 60% of the overall decision process is down to trust and having a relationship with the person…[Citing a large customer where credit insurance wasn't forthcoming]*, we met the guy who's the vice-president in Japan,* [name of contact]*, and we've been out drinking with him. It's all a matter of honour with the Japanese. It's not what it says on paper; it's about eye-to-eye contact, etc. and having an understanding…We've been doing this for 20 years with them and it all works – it's always worked out right.*
(Managing director, medium-sized company, engineering)

4.2.5 Credit terms

The small businesses in the study were providing services or adding value to bought-in goods and none of them offered formal credit terms to their customers and clients. Credit card payments, however, were popular and acceptable alternatives. The experience of one of the owner-managers of an unincorporated business, who used to give customers 30 days from the date of invoice, explains he gave this up because the actual credit period could be a good deal longer.

I give credit insomuch as I give them few days to pay the invoice. When I started there was a 30-day thing on the invoices and then I suddenly realised that 30 days is [actually] *40 days or 50 days, so I've now got it down to 7 days.*
(Owner-manager, small unincorporated entity, structural engineering and surveying services)

The owner-manager of the small unincorporated building services firm does not give a formal credit period and if a job is worth less than £2,000, he gets payment as soon as the work is done. For jobs worth more than £2,000, he agrees a series of stage payments, with the last payment (the most risky) representing his profit/wages. This allows him to recover his costs before the job ends. In the case of the small engineering recycling company, the owner-manager required payment in advance for jobs worth more than £5,000. The other small unincorporated business owner also uses stage payments to finance his working capital and as a mechanism for credit control on larger contracts.

When I send out a fee proposal, I would say this is going to be 20% in advance and then monthly invoices or one-half of it now and the other half when we finish. So I do that in a fee proposal and generally that works – but then I have the advantage that if they don't pay the first invoice, they certainly don't get the rest of the work!
(Owner-manager, small unincorporated entity, structural engineering and surveying services)

For one of the medium-sized companies, the motive for stage payments is getting cash in.

We have had some very big contracts. We do control how much money someone owes us, not because we have a

concern about whether they might ever pay us, but because we just need to get the cash in…So we're quite keen to agree milestones within a project. Our whole approach to managing a project is designed to say there will be this initial scoping and the price for that is X and we will invoice you at this point and then there will be a stage one, stage two, stage three, stage four invoices that will come out. Sometimes…how shall I explain this? Imagine that we scope a piece of work that has an initial prototype or whatever and then there are five chunks of it left. We say, 'Okay, we'll do the five chunks. It'll take five months and we'll invoice you for each one at the end of the month' and we put the dates in. Then the client doesn't deliver to us the content we need in order to do the work…In some cases we'll still raise the invoices and say, 'Look, we'll do the work when it comes in, but I have people sitting here waiting for that and I can't just not invoice you' and they'll say, 'That's fine, we don't mind paying as long as you say you'll do it'.
(Managing director, medium company, engineering)

Thus, the size of the contract affects the credit decision and whether stage payments or payment in advance is required. This emphasises the importance of getting invoices out to customers in a timely manner. The customer's payment history with the supplier and good credit control appear to be important factors when making credit decisions about subsequent orders.

We rely on payment history. If an existing customer came on and placed large orders and there was still money outstanding, I would expect that money to be paid before we went ahead.
(Owner-manager, small company, engineering recycling)

[In a recent case] I had a guarantee of a payment date for their existing debt, and we usually ask for that. It's a very simple question, 'OK, this is how much you're owing. Are you going to pay it on the due date?' And I have a very good credit controller who manages our debt on our ledger…she manages the debt so well, I can't remember what the percentage was, it's something like 0.8% is overdue and, given the size of the invoicing that we do, it's remarkable we achieve that and we do it by just nagging and insisting on due dates.
(Group financial controller, medium-sized company, manufacture of power decorating and cleaning products)

4.2.6 Cash flow management and credit control

The size of the firm and the nature of the business were reflected in the extent of monitoring and control of trade receivables. The evidence suggests that any customer exceeding the credit period would receive a telephone call immediately.

Yeah, we monitor because we've a relatively small amount of customers…Some come on every month, some every three months or six months. I mean, obviously, when an account is outstanding longer than 60 days, I simply get on the 'phone and give them a ring and chase them up…We probably do an average of 40 invoices per month, so it's relatively easy to keep your eye on that.
(Owner-manager, small company, engineering recycling)

Credit terms are 60 days in this business…When an account is outstanding longer than 60 days, I simply get on the 'phone and chase them up. They don't seem to mind a bit of a kick and I think they expect it.
(Managing director, medium company, engineering)

The above interviewee preferred to get the person in his organisation who had taken the order to ring the project manager in the customer's firm, rather than the finance director, who is used to deflecting such calls. In the interviewee's experience, the project manager in the customer firm would then speak to his managing director, who would invariably override the finance director and pay the overdue amount. This highlights the importance of personal relationships and networking in credit control. The problem of late payment for small businesses has been addressed in the UK by legislation, which was recently updated by the Late Payment of Commercial Debts Regulations 2013.[3] Although large entities have the economic power to dictate the credit period to their small company suppliers, the owner-manager of one of the unincorporated small entities acknowledged that there were compensations.

They [the large customer] *are the worst payers in the world, but on the other side of the coin they're the best because they say they won't pay you for 42 days, but on the 42nd day, it's straight into the bank account.*
(Owner-manager, small unincorporated entity, structural engineering and surveying)

One of the interviewees maintained that it was easier to obtain payments from trade debtors because the business made and sold tangible products. He is a qualified accountant and compared his engineering business with an accountancy practice trying to collect payments from clients.

[An accountant's clients] *can't see all the time it takes to produce or audit a set of accounts; they just see the end product, which is ten pieces of paper. So they struggle in themselves to actually want to pay the £10,000 fees, whereas for our customers – they can actually see what they're getting – there's a product there and it makes it a little bit more of a priority payment than people in the service sector. So I do see how people in the service sector struggle!*
(Managing director, medium-sized company, engineering)

The size of the firm and the nature of the business were reflected in the amount of trade receivables at the end of the year. In the medium-sized companies, the longer length of the credit period given by their suppliers than the credit period they gave to their customers was influential in determining the difference between trade payables and trade receivables.

3. The legislation allows a supplier to claim interest and debt recovery costs if another business is late paying for goods or a service. If no payment terms are agreed, the law says the payment is late after 30 days for a public authority; for a business-to-business transaction, it is 60 days after the customer gets the invoice or after delivery of the goods or services (if this is later). Compensation is £40 for amounts under £1,000; £70 for amounts £10,000 and £100 for amount over £10,000.

Receivables only represent 60 to 90 days and the payables can run between 90 to 120 days, so you're probably seeing four months against three months.
(Business controller, medium-sized company, manufacture of power decorating and cleaning products)

None of the businesses had needed to write off significant bad debts in recent years. In the case of the unincorporated entities the reason for the lack of bad debts was good knowledge of their customers and close relationships.

Maybe it is because I've got a fairly small client base – no bad debts because it's a small number of customers who have been around for ages.
(Owner-manager, small unincorporated entity, structural engineering and surveying services)

I've only had two bad debts in 30 years.
(Owner-manager, small unincorporated entity, building services)

In the case of one of the small companies, a bad experience over ten years ago had nearly made the company insolvent and had led to the tighter credit control procedures they have adopted since then.

My largest customer is on about 45 days and I actually ring them and go round and get the cheque off them…It's in the region of £30–40k per month they owe, so we don't allow that to go any further than 45 days.
(Owner-manager, small company, engineering recycling)

4.2.7 Importance of trade credit as a source of finance

As previously mentioned, many of the interviewees had enjoyed long relationships with some of their customers and suppliers. The following is a comment of from an owner-manager of a medium-sized company who was talking about the trade credit it received and the importance of being an established company.

I know we're called [name of company], *but* [division 1], *which is one of our divisions, has been around for 160 years, [division 2] has been around 80 years and* [division 3] *has been around 100 years. It does help having those names in there…it does help someone: 'Oh, they've been around for a long time. You don't have to worry about them'. If we were a new company and we'd only been trading 12 months, I would imagine it would be a completely different conversation I'd be having with you then than this one.*
(Managing director, medium-sized company, engineering)

None of the small businesses had been asked to supply financial statements or other information by their suppliers. The managing director of the medium-sized engineering company was aware that some of his steel suppliers used credit rating agencies to check his company's credit rating. The group financial controller of the other medium-sized company also expected new suppliers to check the company's credit rating. The following quotation captures the two-way nature of the checking process.

Well, they [new suppliers] *ask for the usual – the accounts. They'll ask some rude questions, which we just don't answer. We just sort of encourage them to take a credit check on us. We monitor ourselves on credit checks…In terms of a new supplier coming on board, that's usually a major decision with purchasing…and I'll credit score that company to make sure that they're creditworthy.*
(Group financial controller, medium-sized company, manufacture of power decorating and cleaning products)

There was some evidence that SMEs in the UK take pride in paying their suppliers on time.

Around Sheffield, which has got a lot of small industry, a lot of the smaller customers do pay up very promptly. It might be the wife that does the payments or it's a small office, and they do take pride in being prompt and regular in making their payments…. We don't have to chase them.
(Managing director, medium-sized company, engineering)

4.2.8 Availability of data on the internet

As in the Finnish study, several of the interviewees among the UK SMEs mentioned the importance of the speed with which SMEs can collect data for making credit decisions about existing or potential customers. In the UK, access to financial statements of public and private companies is available via the Companies House website, for a small fee. In addition, credit rating agencies provide the financial statements and credit ratings to subscribers online, and large and small businesses provide potentially useful information on their websites. The following quotation from the group financial controller of the medium-sized manufacturing company illustrates a typical search for information that will be useful in assessing the credit risk for a new customer.

If they've got a website, we want to have a look at that. We want to know who they are…Basically I can check them from their name…but to make sure I don't make a mistake, I want the registered number…I can check them usually within five minutes.
(Group financial controller, medium-sized company, manufacture of power decorating and cleaning products)

The London, Edinburgh and Belfast *Gazettes* are an important source of insolvency information for banks, credit reference publishers, specialist private sector organisations and others. If a company goes into liquidation, it is published in the relevant *Gazette* the following day.[4]

4. The *Gazettes* are the official newspapers of record for the UK. They record and disseminate official, regulatory and legal information in print, online and electronic formats.

4.3 DISCUSSION

As in Finland, the three main influences on the trade credit decision in the UK are: formal and report-based information; 'soft' information; and contingency factors. The main formal sources of information are the financial statements and data supplied by credit rating agencies and credit insurers. The customer's assets and the overall cash position were considered as important indicators of trade credit risk for those larger SMEs in the study that analyse their customers' financial statements. In most cases where trade credit was given, however, greater reliance was placed on the customer's trade credit rating and/or credit insurance. Interviewees using these formal sources of financial information to assess new and existing customers were able to use online sources. Some reported that they also found useful information on the customer's website. This greatly improves the speed and efficiency of processing orders involving trade credit decisions.

Trust is a significant feature of the trade credit decision, and this was apparent even in the small unincorporated entities where the credit period was very short (typically, payment on invoice). This stems from the importance of 'soft' information arising from personal relationships and networking and the length of the business relationship. In larger SMEs, it also included organisational behaviour such as the payment history. The relative size of supplier and customer appears to be an important contingent factor that affects the terms of trade credit, reflecting the economic power of large customers. In practice, prompt personal communication between the business and the buyer in the customer organisation to resolve late payment issues seems to be effective in avoiding potential liquidity problems. As in Finland, the availability of online data considerably improves the speed and efficiency with which SMEs can collect information for making credit decisions about existing or potential customers.

Table 4.1 provides a summary of the key themes that emerged from the interviews in the UK.

Table 4.1: UK, summary of the main themes

Description	Formal report-based information	'Soft' information	Contingency factors
Assets and liquidity as risk indicators	✓		
Credit rating as risk indicator	✓		
Organisational behaviour	✓	✓	
Relationships and trust		✓	
Cash flow management/credit control		✓	
Business drivers		✓	
Size factors and economic power			✓
Availability of internet data			✓

5. Findings from the US

Andrew Holt, Metropolitan State University of Denver

5.1 INTRODUCTION

The US Small Business Administration (SBA) defines a small business as one that is independently owned and operated, is organized for profit, and is not dominant in its field. Depending on the industry, size standard eligibility is based on the average number of employees for the preceding twelve months or on sales volume averaged over a three-year period. Title 13, Code of Federal Regulations, part 121 (13 CFR 121) sets out the thresholds for each sector in the North American Industry Classification System (NAICS). On the basis of these criteria, the SBA has established the following common size tests for a small business:

- average employees not exceeding 500 employees for most manufacturing and mining industries, and
- average annual receipts (total income plus cost of goods sold) not exceeding $7m for most non-manufacturing industries.

Although these are the primary size standards for most industries, there are many exceptions, both between and within industries. As a result, to help small business owners assess their small business status and assess whether they qualify for government loan programmes, the SBA has established a Table of Small Business Size Standards, which is matched to the NAICS of each industry (US SBA 2012).

Adopting the definition of a small business as an entity with up to 500 employees, small firms represent 99.7% of the business population, provide 50% of jobs in the private sector and contribute more than 50% of non-farm private gross domestic product (Kobe 2007). In 2010, there were approximately 27.7 million small private businesses in the US (US Department of Commerce: Census Bureau 2012). According to ACCA (2013), there has been an increased focus on support for small businesses in federal policy since the economic recession. Measures have included increasing the export of small firms' products and services, and policies to assist start-ups by women, military veterans and ethnic minorities.

In contrast to the UK, where the majority of small businesses are unincorporated, the vast majority of small businesses in the US are one of the following four types of limited liability entity:

- corporation
- limited liability corporation (LLC)
- limited partnership
- limited liability partnership.

The LLC is the most popular and can be formed with a single member (a person or a corporate body). It does not issue shares but members contribute capital in the form of cash or other assets, which may be quantified into membership interest or units (ACCA 2013). An LLC must file a tax return (IRS form 1065), which requires information relating to gross sales, cost of goods sold and gross profit, and the accounts can be prepared on a cash or accruals basis. The majority of LLCs are owner-managed and taxed as sole proprietorships (Hope et al. 2011).

The Securities and Exchange Commission (SEC) requires that public companies with more than $10m in assets and more than 500 owners must produce periodic financial statements that are prepared in accordance with US GAAP. Unlike many other countries, however, the US has no statutory requirement for public accountability from private companies, other than companies operating in certain regulated industries such as financial services. Furthermore, there is also no statutory requirement for a privately held company to provide an external review or audit of its financial statements. Therefore, the majority of small private businesses have no financial reporting requirements other than the completion of annual income tax returns. Nonetheless, certain private companies may be required to produce audited financial statements to meet demand from lenders, bonding companies, regulators and other bodies (AICPA 2011). Where financial statements are demanded, preparation may be required in accordance with US GAAP or an alternative special purpose reporting framework. Financial statements prepared in accordance with a special purpose framework apply a definite set of logical criteria to all material items within the financial statements; examples include tax, cash, modified cash and statutory bases of accounting.

As a direct result of the unregulated nature of financial reporting by private companies in the US, little is known about users and uses of their financial statements. Allee and Yohn (2009) argue that, apart from firm size and demand from external shareholders, there may be many other factors that determine whether a small business produces financial reports on a voluntary basis. One such factor may be the reliance on trade credit for purchases, especially as trade credit normally represents a substantial fraction of corporate liabilities (Petersen and Rajan 1997). In 2003, the Federal Reserve Board conducted the National Survey of Small Business Finances among 4,240 small businesses in the US and found that 60% used trade credit, an incidence of use that exceeded all other forms of financial services apart from the use of normal bank accounts (Federal Reserve Board 2005). Use of trade credit varied with firm size, increasing from about one-third of the smallest firms to more than 85% of the largest firms. Young firms were less likely than others to use trade credit, and its use was most common among firms in construction, manufacturing, and wholesale and retail trade (Mach and Wolken 2006).

Allee and Yohn (2009) used data from the 2003 NSSBF to test the importance of trade credit in the production, use and sophistication of financial statements produced by 4,004 small privately held businesses. Their results show a positive correlation between the use of trade credit and the production and use of financial statements, which is consistent with the notion that US suppliers may demand financial statements for assessing the client firm's creditworthiness and to facilitate the monitoring of that firm. They conclude that 'firms with audited financial statements benefit in the form of greater access to credit' (Allee and Yohn 2009: 1).

The main themes identified from the interviews in the US are presented next.

5.2 MAIN THEMES FROM THE INTERVIEWS IN THE US

5.2.1 Non-public disclosure of financial information

All the interviewees in the US were of the opinion that a private company should have the right to keep its financial statements free from public scrutiny. In their view, public disclosure of financial information could potentially aid competitors and harm a company's future prospects.

We're a privately held company. [We] *won't volunteer anything…*[We] *never show and tell.*
(Owner-manager, small company, medical devices manufacture)

They were prepared to give their financial statements to the bank, but not to customers or suppliers unless there was a specific request.

No, absolutely not – in fact, we make them beg [for copies of our financial statements].
(Vice-president of sales, medium-sized company, ice machine manufacture)

The owner-manager of the small medical devices company thought the provision of financial statements to customers, suppliers or other public bodies would be unusual in the US.

Who's going to give you their financial statement? I don't think it's going to happen. I think that if you're a bank – if you're a lending institution – obviously, they have ready access. I mean they're going to get your financial statements, but business-to-business – I've never heard of such a thing.
(Owner-manager, small company, medical devices manufacture)

None of the four SME interviewees said they would voluntarily provide copies of their financial statements to suppliers. Interviewees at both the medium-sized businesses said that supplier requests for financial statements depended on both the size of the order and the size of the supplying organisation. The vice-president of finance for the medium-sized medical services company explained that the company's larger suppliers did request copies of the financial statements when an order or credit limit was over $100,000. According to the vice-president of sales for the medium-sized ice machine manufacturer, such requests would be for audited yearly financial statements, with vendors repeating requests for this information every three to five years.

5.2.2 Credit terms

All the interviewees acknowledged that allowing customers and clients a period of trade credit was a normal part of doing business in their industry.

98%, almost all our customers receive credit…I don't know anything about how business is done anywhere other than in the States…People are quick to extend a little bit of credit to anybody that wants it because everybody wants to believe in the American dream and that people can start a business and make it work. So everybody that I know, including us, we're willing to take small risks with just about anybody…The only ones that we wouldn't extend credit to were the ones that we had personal knowledge that their payment history was bad and as a small company we couldn't take the risk.
(Owner-manager, small company, medical devices manufacture)

While all the companies have standard contractual payment terms (15, 30 or 45 days), larger customers often demand longer terms.

There are some very large corporations that bully you into very long terms. You have a 30-day term which is a standard term you're using, but they may bully you into 60 or 90 days.
(Owner-manager, small company, IT security systems)

In general we tend to be of greater flexibility with larger customers.
(Vice-president of sales, medium-sized company, ice machine manufacture)

One company allowed negotiation of the credit period in order to attract new business, especially from larger customers.

It could be negotiated if a facility were to say, 'Our current vendor gives us 60-day terms and we're only willing to do 60'. And it's based on the size of the contract because in some cases large chains do have 60-day terms.
(Vice-president of finance, medium-sized company, healthcare services)

The above company included a standard 30-day payment period in any long-term contract for service. Any new customer in a relevant line of business would be granted credit terms on their first order with the company without a credit check.

Whether or not they're in our industry, basically they're in our wheelhouse of business, so if they're an assisted living, if they're a skilled nursing facility, if they're a correctional facility and they're a valid business, so that's all they really have to have in order to initially be granted credit, meaning we'll send them a bill for services that they've ordered.
(Vice-president of finance, medium-sized company, healthcare services)

This company never ran a credit check on new customers or asked them to supply copies of financial statements. One of the reasons was that the company had a policy of never turning down business because it supplied services to long-term care facilities occupied by elderly patients. Therefore, the owner-manager's policy was never refusing a call for service in case it could potentially harm patient care.

In the case of the two small companies and the medium-sized healthcare services company, the interviewees explained that they would eventually stop servicing a company that did not pay. Because all three companies were supplying essential services and products that clients and customers could not do without, non-paying customers were very scarce.

Most of what we sell are the wound devices and they [the customers] *have disposables that can only be used with our product and have to be ordered from us – so we hold all the cards.*

(Owner-manager, small company, medical devices manufacture)

Well, you know, you're selling yourself and your knowledge and architecture, so it's like, if they don't pay you, they don't get it. So after 30 days, if you don't get paid, you quit supporting them and then they'll be in a heap of trouble. When you're in there and you start to get going they can't let go. They really need the support so they have to pay. They don't have a choice but to pay.
(Owner-manager, small company, IT security systems)

5.2.3 Use of credit rating reports, credit insurance and invoice finance

It is clear from the interviews that the types of information used to justify trade credit decisions vary. Furthermore, the information that SMEs use to determine an individual trade credit decision sometimes varies according to who the customer is, the relative size of a customer's order and competitive concerns.

The owner-manager of one of the small companies runs an online credit check on new customers before supplying products.

We only perform a [Dun & Bradstreet] *check on new customers. No request for financials.*
(Owner-manager, small company, medical devices manufacture)

The online credit check information is part of the business information report supplied by Dun & Bradstreet (D&B). The D&B credit scoring system was used by all the interviewees and PAYDEX (D&B's payment performance index) was the main source of information regarding trade credit decisions in both small companies and the medium-sized medical services company. D&B's business information reports were routinely used by all three SMEs for:

- verifying the existence of a registered business
- limiting risk exposure when making daily credit decisions
- identifying a company's payment patterns
- analysing financial trends and the overall strength and stability of a business
- researching possible fraud by reviewing the firm's business standing.

As one interviewee explained:

Every vendor that participates in D&B reports everybody that pays them. So D&B does all the work for a small business. As a small company you don't have the resources to go out and analyse someone's credit ratings and the whole point of D&B is that it does it for you. Every company that I've ever worked for ran a D&B check on everybody they extended credit to – I don't know anybody that didn't – so that's my personal experience. It's like an industry standard, and quite honestly, as a company that's extending credit you would also be very cognisant of what your D&B rating is… If they [a customer] didn't have a D&B report, we'd put them on a very, very short leash because it generally means they were a small start-up company and we would watch their payables and our receivables very closely. Most of our customers have good Dun & Bradstreet ratings. I mean, as an industry, healthcare pays pretty well, so, you know, we didn't take on any high risk customers that I'm aware of. If you don't have a D&B rating they just won't give you credit. So pretty much everyone we did business with had a D&B rating, they would participate. It is voluntary, but only kind of voluntary. It's voluntary from the standpoint that it's not mandated by the government. It's not voluntary… in terms of whether companies would extend your credit. Probably that was our biggest indicator.
(Owner-manager, small company, medical devices manufacture)

It is clear that information from online commercial credit rating databases, such as that offered by D&B, is a key input in trade credit decisions involving SMEs. In an interview with the vice-president of data analysis at a credit rating agency, the interviewee revealed that a vast proportion of its requests for credit checks are for smaller businesses, rather than large public companies.

Most of our customers are not going to do business with IBM for example, regardless of what the credit report says, but with small businesses they don't know anything about, or only have limited pieces of information about. So our supply of credit-risk business, 80% of our active requests come in for small businesses, or should I say smaller businesses.
(Vice-president of data analysis, credit rating agency)

Although three of the SMEs used D&B services extensively, the vice-president of sales for the medium-sized ice machine manufacturer doubted the value of D&B's rating service for evaluating SMEs in his company's line of business.

We don't place large stock in D&B. The value of Dun & Bradstreet for the smaller, independent companies is not a lot.
(Senior vice-president of sales, medium-sized company, ice machine manufacture)

For the above company, the high dollar value of each order and its relatively small customer base of only 150 clients meant that financial statements, rather than information about a customer's credit rating, were the primary source of data when determining trade credit decisions.

We look at their audited financial statements first and foremost and base their creditworthiness on that.
(Senior vice-president of sales, medium-sized company, ice machine manufacture)

The company further protected itself from potential bad debts by factoring 65% of its trade receivables through an independent third party.

None of the companies used credit insurance for domestic sales and explained that their national suppliers very rarely required credit insurance before granting trade credit. Where large amounts of international credit sales were offered, credit insurance was sought. The owner-manager of the small medical devices company recalled one instance of having to take out credit insurance to bond an order with a Chinese supplier because it represented 90–180 days of raw materials.

None of companies recalled receiving requests for financial statements or other supporting information from overseas suppliers seeking credit insurance.

5.2.4 Relationships and trust

In many instances, the interviewees acknowledged that they relied on instinct when determining whether to grant trade credit to customers.

Me and my partner we're not so good on finances, so we've been trusting a lot, but we've never been burned yet either.
(Owner-manager, small company, IT security)

The owner-manager of the small medical devices company recalled granting credit of $500,000 to a customer without requesting a copy of the customer's financial statements. In this company, trade references are requested as standard on the order form, but not taken up before granting credit.

5.2.5 Credit history of the owner

While traditional sources of information were primarily used in determining most trade credit decisions, where the customer was an SME the personal credit history of the principal shareholder was an important source of information for assessing credit risk.

So typically our customers, even when they're incorporated, it's one person who owns them. So we'll do a credit check on that individual, on that principle.
(Vice-president of sales, medium company, ice machine manufacture)

One of the reasons why the owner-manager's credit history is important is because many of the owners of SMEs personally guarantee the line of credit for their firm. The credit rating agencies and credit insurance underwriters participating in the study both explained that they sometimes use consumer credit data when assessing small businesses.

There are products on the marketplace that blend commercial and consumer data. So take an owner of a single-person company and take their personal credit history as well as their commercial credit history. We don't currently do this in our credit scores but other companies do. The information about how they pay their American Express card is very valuable.
(Senior vice-president of data analysis, credit rating agency)

As a result of the blending of commercial and consumer information in assessing credit risk, the distinction between the payment records of the SME business and of its owner(s) is removed. Such blended information was directly used with trade credit decisions only by the medium-sized ice machine manufacturing company. The other three companies interviewed routinely used credit-scoring information from commercial data providers. Thus, blended data were likely to have informed trade credit decisions either directly or indirectly.

5.2.6 Providing information to credit rating agencies

It was apparent from the interviews with the four companies that the two small companies and the medium-sized healthcare services company tried proactively to manage the information that credit rating agencies supply about companies' payment histories. These three companies supplied information to the D&B credit reporting agency about their payment records.

To D&B we supplied information to show that we were in good standing. That's voluntary information you give to them because then they can look you up and say, 'Oh, this is a good company' and you get a higher rating.
(Owner-manager, small company, IT security systems)

We report openly to D&B – absolutely. They'll send you a form to report to them…They do receivables and payables and you report what your payment terms are and how quickly you pay and the people that pay you.
(Owner-manager, small company, medical devices manufacture)

We have a log-in for D&B and we pay fees to manage our account. So we receive alerts and I actually received some today – actually I think eight different companies or something accessed our credit report – and it [the alert] tells us the industry they were from. And so we give them information on our accounts payable in order to improve our rating because in some cases the people that are reporting or the companies that are reporting may skew our rating negatively.
(Vice-president of finance, medium-sized company, healthcare services)

Yes, our vendors report on us. We purchase oxygen and so certain larger companies report to D&B on us based on how quickly we've paid the invoices according to the due date. And that impacts our credit rating, but they don't have the whole picture. So some of our largest vendors who don't report, we report the information on their behalf to improve our credit rating. We report it on behalf of ourselves, but we report how we're paying our vendors. So it's typical only if your report is impacted negatively by something somebody's reporting and we manage our credit rating proactively. So we don't allow our credit rating to be poor. So we wouldn't be denied credit for our D&B report, but it's possible if you don't manage it. We generally update it if it's necessary. So if our credit rating drops we receive an alert and so if we receive an alert that our credit rating's then negatively impacted, then we access the account.
(Vice-president of finance, medium-sized company, healthcare services)

The reporting of payment records to the D&B was an important factor in deciding which suppliers would be paid first by this company.

Yeah, based on the amount and the industry and who you think may be reporting because you develop information over time to make a decision on which vendors are reporting and which vendors aren't and it absolutely impacts our decision to pay those vendors. So it's in the best interests of the vendor to report to D&B because they're going to get paid first because we're not going to want a negative credit report.
(Vice-president of finance, medium-sized company, healthcare services)

In contrast to the other three companies, the medium-sized ice machine manufacturer did not report information about its payment record to any credit reporting agencies. This could be partially explained by the company having access to only a very small pool of potential suppliers and customers that seldom changed over time. As a result, the company focused on managing its relationship with its current vendors and customers rather than reporting its payment history to credit rating agencies.

5.2.7 Providing information to suppliers

For the two small businesses and the medium-sized healthcare services company, information from D&B's databases was routinely used by new and existing suppliers when making a decision to offer trade credit or a line of credit.

They're going to go on D&B. I'm assuming they're doing the same thing we're doing and they're going on D&B and say, 'Oh well, these guys are paying pretty well'.
(Owner-manager, small company, medical devices manufacture)

One interviewee had experienced the granting of credit without the supplier requesting any prior information, but found that large suppliers asked for trade references.

On the payable side we send financial information, we send trade references to our vendors. We deal with customers who run our D&B all the time and they're very large corporations who would say you would not be allowed credit, we're turning you down as a customer.
(Vice-president of finance, medium-sized company, healthcare services)

Only where credit lines exceeded $100,000 a month did this company receive requests to see copies of the company's audited financial statements.

It's based on the amount of credit that we're requesting. So if it's a very large credit line, meaning over $100,000 a month, they request our audited financial statements. If it's under $50,000 a month, they'd just get a credit information sheet from us with our trade references and our Dun and Bradstreet number. Then they'd run our D&B history and call our references to set up the credit limit – and there've been instances where they are very, very strict on the credit limit that's set and, in order to increase our credit limit, we'd also have to send our audited financial statements… We don't give our monthly financial statements to anybody other than the banks. So our lenders are the only ones that receive our internal unaudited financial statements.
(Vice-president of finance, medium-sized company, healthcare services)

Where large suppliers requested copies of the financial statements, they typically preferred to receive audited financial statements, although the interviewee was unsure whether audited accounts were essential.

Some of our largest vendors ask for financial statements every year on a schedule. They don't require that they be audited in order to give us credit as far as I know, but we've always had audited financial statements. So we don't have any vendors that say if you can't produce audited financial statements we won't give you credit or do business with you. They also call our bank as a reference as well. So on our information sheet for vendors it lists our banker, our banking relationship and our trade references.
(Vice-president of finance, medium-sized company, healthcare services)

New large suppliers to the other medium-sized company also routinely request copies of the company's audited financial statements and trade references.

They prefer audited [accounts] *and trade references – those are the two primary sources of information.*
(Senior vice-president of sales, medium-sized company, ice machine manufacture)

The owner-manager of one of the small companies also had experience of requests from certain large suppliers for copies of financial statements, although such requests diminished once his company had established a payment track record.

I've been asked for that…Before we start business with a supplier they absolutely ask for financial statements. It's 50:50. I mean, when you were smaller it was…harder. Then you grow and then it gets easier...it was a $6m-a-year business and you can imagine how much hardware. We bought millions and millions every year of hardware and the vendor of course wants to sell as much as possible so they give us better terms and stuff, but when we started we had no credit so it was very hard and it was upfront. It's hard to get started. It's a no-win situation.
(Owner-manager, small company, IT security systems)

At the medium-sized healthcare services company, new suppliers usually ask for additional information, such as trade references, before giving trade credit. Its existing suppliers do not ask for trade references owing to the relationship they have built up with the company.

Because we're established, we're a good credit risk and we pay our bills. So we've established a relationship with them and so they're going to be more understanding.
(Vice president of finance, medium company healthcare services)

Similarly, interviewees at the two small businesses stated that existing suppliers would judge additional requests for trade credit on the basis of their company's payment history record, and would not make further requests for trade references or financial statements. Nevertheless, existing suppliers to the medium-sized ice machine manufacturer request updated copies of the company's financial statements every three to five years, together with additional information should the company undergo any major structural changes, such as a change in ownership.

The last couple of times I can think of, they wanted to know actually more about the transaction of our new ownership. They wanted to know what the structure was.
(Senior vice-president of sales, medium-sized company, ice machine manufacture)

5.3 DISCUSSION

It is normal practice for all the SMEs participating in the study in the US to provide trade credit to their customers and clients, but only one of the businesses requests a copy of the customer's audited financial statements. The other three companies rely on formal information provided by a credit rating agency or operate on trust without any credit checks in order to secure new business. In most instances, the SMEs used credit rating information from a commercial rating agency as the primary factor in trade credit decisions. As in Finland and the UK, 'soft' information such as personal relationships and the customer's payment history was also considered.

It would appear that the nature of an SME's business and the size of the sales order play a key role in shaping the types of information routinely used in trade credit decisions. With regard to trade credit from suppliers, it would appear that requests for the SME's financial statements were more likely if the order value is significant, the SME has a short credit history or the supplier is a large dominant company. The majority of the SME interviewees indicated that the financial statements are not the primary determinant of most trade credit decisions in their company or in their industry sector. As in Finland and the UK, the availability of online data considerably improved the speed and efficiency with which SMEs can collect information for making credit decisions.

Table 5.1 provides a summary of the key themes that emerged from the interviews in the US.

Table 5.1: US, summary of the main themes

Description	Formal report-based information	'Soft' information	Contingency factors
Credit rating as risk indicator	✓		
Database payment history as risk indicator	✓	✓	
Owner's credit rating as risk indicator			
Relationships and trust		✓	
Size factors and economic power			✓

6. Findings from South Africa

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6.1 INTRODUCTION

Many governments throughout the world focus on policies that support the development of SMEs. In South Africa, the National Small Business Act of 1996 uses the total number of paid employees, the total annual turnover and the total gross assets (fixed property excluded) to define enterprises by size. For example, according to the *Government Gazette of the Republic of South Africa* (2003), definitions for the number of employees are:

- <5 employees for a micro-entity (also five for the agriculture sector)
- 5 to 20 for a very small enterprise (10 for the agriculture sector)
- 21 to 50 for a small enterprise (11 to 50 for the agriculture sector)
- 51 to 200 for a medium-sized enterprise (51 to 100 for the agriculture sector).

The unemployment rate in South Africa is 25.5% (Statistics South Africa 2012). One of the best ways to address unemployment is to leverage the employment creation potential of small businesses and to promote small business development (FinMark Trust 2006). Abor and Quartey (2010) estimate that 91% of formal business entities in South Africa are SMEs, and this category accounts for approximately 57% of GDP and 61% of jobs. The small business sector is expected to be an important vehicle for addressing the challenges of job creation, sustainable economic growth, equitable distribution of income and the overall stimulation of economic development in South Africa (Maas and Herrington 2006). Despite the economic contribution of SMEs, the failure rate is much higher than that of larger organisations. SMEs in South Africa fail at a rate of between 70% and 80% (Adeniran and Johnston 2012). The National Credit Regulator (NCR 2011: 7) points out that South Africa has one of the lowest SME survival rates in the world.

One of the major problems is access to sources of external finance (Maas and Herrington, 2006; Herrington et al. 2009) and the majority of SMEs depend on funding from the owner, family and friends, which is often inadequate for survival and growth (Carpenter and Petersen 2002). The availability of alternative finance, such as trade credit, could provide a boost to growth and survival of SMEs.

Venture capitalists are mainly interested in SMEs with exit options. Shane (2008) contends that venture capital provides only a small proportion of the equity funding for SMEs in the US. Venture capital funds are not interested in providing the small amounts of funding sought by many SMEs. According to the South African Venture Capital Association (2008) there are at least 65 venture capital funds in South Africa controlling a total of R29bn with an average investment size of R15.4m. Venture investment with an SME focus is, however, approximately R1.1bn, which is just under 4% of the funds. This indicates that the availability of venture capital is limited for SMEs. The lack of access to external equity makes many SMEs dependent on bank loans and overdrafts and suppliers' credit.

Commercial banks and trade creditors hesitate to grant credit to SMEs. The National Credit Regulator (NCR 2012) estimates that South Africa has between 2.4 million to 6 million SMEs, of which some 20% are registered with Companies and Intellectual Property Commission (CIPC) and have a bank account. Of the formal SMEs, fewer than 100,000 (27%) successfully apply for and receive funds from the formal financial sector. Almost half of SMEs are not registered and hence are operating informally, and some 85% of these do not have access to the financial markets. In practice, access to trade credit is limited for SMEs, especially new ones. FinMark Trust (2006) provides evidence that only 2% of new SMEs in South Africa are able to access bank loans and that the use of suppliers' credit for new SMEs is virtually non-existent.

A report by Forbes (2010) contends that credit is crucial for South African SMEs. Overall, the top forms of debt financing that South African SMEs use today are secured bank overdraft (31%), trade credit (31%) and business credit cards (30%). Financial institutions are now more careful in approving funding as they need to conform to the provisions of the South Africa National Credit Act 34 of 2005, which strictly stipulate the prerequisites for credit granting (responsible lending). Trade credit is particularly important for medium-sized enterprises in South Africa. These three methods are also the main debt vehicles South African businesses intend to seek over the next two years. This suggests that while access to trade credit might be very limited for new SMEs, overall the use of trade credit has improved for SMEs in general.

According to the Republic of South Africa Close Corporations Act 69 of 1984 and the Companies Act 71 of 2008, close corporations and companies are required to prepare annual financial statements complying with applicable accounting standards (ie they must be audited or independently reviewed). Since 1 December 2012, companies must comply with full IFRS or the IFRS for SMEs.[5] Close corporations and companies are also required to file annual returns to the Companies and Intellectual Property Commission (CIPC) within 30 business days from the anniversary of the date of incorporation. If an entity fails to do so, CIPC will assume that it has ceased trading or that cessation is planned in the near future. Non-compliance with annual returns may lead to deregistration. Companies that are required to be audited must submit a copy of their financial statements with the annual return. CIPC currently waives the requirement for

5. Companies with a public interest score of less than 100 do not have to comply with any particular standards (Company Regulations 2011, 4c).

financial statements to be filed for close corporations. CIPC will give notice on its website when such financial statements must be lodged with an annual return.

The South African Revenue Service (SARS) requires any company or any close corporation (CC) that becomes liable either to pay any normal tax or to submit a return of income under the terms of section 66 of the Income Tax Act No. 58 of 1962, (the Act) to register as a taxpayer under the terms of section 67 of the Act. The South African Revenue Service requires sole proprietors and companies to keep records as they are liable to pay turnover tax.

The National Credit Regulator (NCR) has responsibility for the registration of credit rating agencies in South Africa. According to the Credit Bureau Association, there are five full members (Compuscan, Experian, TransUnion, XDS and CPB) and five associate members (AccountAbility, Credit Data Online, LexisNexis, Tenant Profile Network and Inoxico) of the association. Credit rating agencies obtain information from individuals and businesses. Subscribers, such as lenders and suppliers, can use the credit ratings produced to evaluate lending and credit risk.

The three major credit insurers in South Africa are Credit Guarantee Insurance Corporation, Coface and Lombard insurance. These firms issue credit insurance to suppliers in trade credit transactions. Credit insurance gives the supplier (trade creditor) the confidence to explore higher risk business opportunities and reduces the risk of non-payment. The credit bureaux and credit insurers use the financial statements of the debtor or potential debtor (if available) as part of the information set used to issue credit reports.

The main themes identified from the interviews in South Africa are presented next.

6.2 MAIN THEMES FROM THE INTERVIEWS IN SOUTH AFRICA

6.2.1 Use of the financial statements

None of the SMEs participating in the South African study used the financial statements of customers when making trade credit decisions.

I don't really check financial information because most of my clients are big…I check their business operations on the internet.
(Owner-manager, small company, nature guides and tours)

Both medium-sized companies in the study have established processes to comply with necessary regulations attendant on their categorisation as medium entities. They both benefit extensively from the financial knowledge and business expertise/acumen of their proprietors, which translate into proper and accurate bookkeeping, annual auditing of financial records, and other evidence of good financial management. Nevertheless, they base their trade credit decisions on instinct rather than any careful analysis of financial reports.

6.2.2 Relationships and trust

The interviewees from the two small unincorporated entities explained that they award trade credit to their customers on the basis of long-term relationships and the ability to repay. No information is required from customers in order to grant them trade credit. The two small companies also base their decisions to grant trade credit on personal recognition, relationships and trust, without requesting their customers to supply any financial reports or other documents. In fact, the company in Cape Town deals with distant/overseas customers whose identities and creditworthiness are difficult to verify. The importance of industry competition makes it essential to make trade credit decisions quickly, with a high degree of flexibility.

All my customers are individuals and sole proprietors…I give credit because I want to sell my goods and other people in the business also grant credit. For small firms, I must know his place of business and have an idea of how he conducts his business by visiting his business…For individuals, I look at the financial capability or status. Is the person working? Where is he/she working?
(Owner-manager, small unincorporated entity, hair pieces and products)

Nobody asks for financial information – it's not important. I want to know and trust the person. I want to know his business address…[Referring to a recent credit sale] *I did not request financial information. I have been selling goods to her on credit and she always repays. There is trust between us.*
(Owner-manager, small unincorporated entity, African clothes and bags)

Financial information is not important. Trade experience, bank reference and past account relationship with the customer are often used… [I also use the] *credit report and trade reference.*
(Owner-manager, small company, catering supplies)

[With an existing customer] *financial information is not important.* [I use the] *past account relationship with the customer, reputation and repayment history.*
(Director, medium-sized company, textiles)

The decision to grant credit in the medium-sized textile company is informed by the global competitive pressure from low-cost producers, but more importantly by foreign exchange exposures that are peculiar to each economy. The business holds the largest part of its trade credit in the US and the UK; only a very limited portion is held in South Africa.

The proportion of credit sales is considerably higher in the unincorporated entity in the poorer location (70%) than in the business in the wealthier metropolis (30%). This may reflect the fact that communal connections are stronger in smaller communities than in big cities. The owner-managers of both the small unincorporated entities acknowledged the negative impact of bad debts on the potential growth of their businesses, but the incidence of the bad debts is not strong enough to pose a threat to the survival of either business.

There was some evidence that a large credit sale makes the owner-manager more cautious.

I'm very careful about granting big credit to a customer. I have to really know the person well and must have been trading with the person for some time and I know the person's repayment history. For small customers, I can still grant credit, even the person is new, but it is going to be a small amount.
(Owner-manager, small unincorporated entity, hair pieces and products)

Credit insurance and credit checks and credit reference are critical.
(Owner-manager, small company, catering supplies)

6.2.3 Cash flow management and credit control

Cash flow management is vital in any business and monitoring trade receivables is a key part of credit control, even in the smallest business. The following comment highlights the importance of networking and relationships in the business community.

I monitor to see whether they pay as agreed – both small and large customers. I do not ask for a credit check or financial information. At times, I can get information from other business owners that a particular business is not paying back.
(Owner-manager, small unincorporated entity, hair pieces and products)

In the case of the small catering supplies company, the owner-manager monitors the customer's cash position by asking for the customer's bank statement. As in the other countries, the evidence suggests that any customer exceeding the credit period would be chased up promptly.

First, I go to his trading place to ask for payment. If he cannot pay instantly, we fix another payment date – I grant more time. If he does not pay, I write to him to request for payment. If he does not, I take him to the small claims court.
(Owner-manager, small unincorporated entity, hair pieces and products)

A letter is sent to the customer to ask for payment…Only three customers have defaulted.
(Owner-manager, small company, catering supplies)

6.2.4 Importance of trade credit as a source of finance

The owner-managers of the small unincorporated entities did not consider that their access to credit was affected by their (lack of) knowledge of finance. Neither of them had to provide financial statements as a prerequisite for trade credit. Although, the value of the trade credit that they have enjoyed is relatively small, their access to trade credit does not depend on the size of the order, as suppliers largely award trade credit on personal recognition basis. None of the companies taking part in the study had been asked to supply financial information to suppliers providing trade credit. It would appear that the assessment of credit risk when suppliers grant trade credit to SMEs is also based on non-financial factors.

No financial information [was required by a new supplier]. *I was introduced to him by a colleague. He asked for my business address* [and] *we had a general discussion about my business.*
(Owner-manager, small unincorporated entity, hair pieces and products)

No financial information was required [by a new supplier], just the trading address and ID.
(Owner-manager, small company, catering supplies)

In the case of the two medium-sized companies, both benefited from trade credit from their suppliers, but the amount of credit granted had decreased since 2008 owing to dwindling business confidence and the high number of business failures.

6.2.5 Access to finance

The two small companies were incorporated at almost the same time and they both recently financed some critical business assets through financial institutions. While suppliers grant trade credit on a personal recognition basis, financial institutions require audited financial statements, business registration and other financial and non-financial reports. Financial institutions request information on the creditworthiness of the proprietors from a credit rating agency (TransUnion), to ascertain their payment record and to assess the likelihood of repayment.

I give financial statements and trading address to the credit rating agency. A form that contains a request for information is filled.
(Owner-manager, small company, catering supplies)

6.2.6 Findings from the credit rating agency

According to the interviewee from one of the leading credit rating agencies, 80% of the agency's South African revenue is generated from 20% of its clientele, which are mainly financial institutions. The agency processes more than 2.5 million credit information requests (customer credit rating) every month. To service this level of activity they have more than 60 million items of information in their database.

To arrive at a credit rating, the agency uses both the Credit Providers Association (CPA) model and non-CPA models. With the former, most decisions are based on financial considerations, especially an assessment of the ability of the customer to repay the credit (this consideration applies equally to both corporate and individual customers). The assessment uses financial statements and derived financial ratios, such as liquidity, income, turnover, profitability and distress ratios. The agency also makes use of the monthly payment history of the client. The non-CPA considerations include items such as demographic information, court judgment/default data, enquiry data, frequency of payment, history/background information and, for individuals, career progression/job security. For both CPA and non-CPA considerations, the credit rating agency inputs the customer data into the model, analyses the data, and makes a recommendation to the financial institution or the individual person that requested the analysis.

Where the information supplied is considered insufficient, the credit rating agency sometimes requests additional information. This happens mostly in the case of a new business or a new entrant to the job market without a credit history. In this instance, the credit rating process is based on the demographic profile, geographical location, job security and career potential of the customer (non-CPA model).

6.3 DISCUSSION

The evidence from the interviews in South Africa, unlike those in the other countries, shows that none of the SMEs uses information from the financial statements and only one of the interviewees (the owner-manager of a small catering supplies company in a city location) mentioned the use of credit reports. Instead there was a heavy reliance on 'soft' information, with trust playing a significant role. This stemmed from personal relationships and networking, reputation of the owner and the length of the business relationship. Apart from the name and address of the business, 'soft' information also includes bank and trade references and previous payment history (for existing customers). Participants in the poorer and smaller communities appeared to give more trade credit and suffer from a higher incidence of bad debts than those in the wealthier, more populous cities.

Although none of the SMEs uses financial information when making trade credit decisions, it was noted that information such as audited accounts, transaction history and other account books/records is needed when seeking access to finance from institutional lenders. The study found that one participant (the owner-manager of the small catering supplies company) gave a copy of the company's financial statements to a credit rating agency. Financial institutions rely heavily on the credit reports generated by credit rating agencies when assessing lending risk and credit rating agencies use both models based on financial information and non-financial models in the process. In contrast to the other countries, in South Africa there little mention of the use of the internet in connection with data gathering for making trade credit decisions and a much greater emphasis on tacit knowledge. Only the small nature guides and tour company, which has large international clients, checks customers' websites for information about their business operations. This suggests that access to the internet is a major contingency factor in South Africa. Table 6.1 provides a summary of the key themes that emerged from the interviews in South Africa.

Table 6.1: South Africa, summary of the main themes

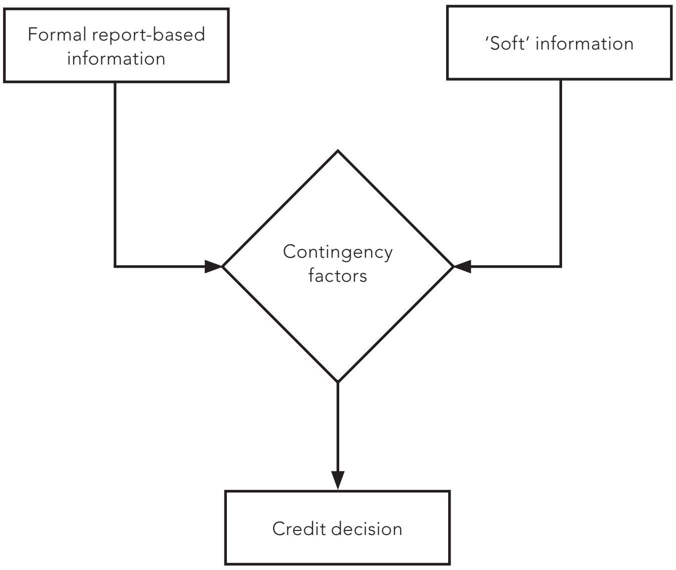
Description	Formal report-based information	'Soft' information	Contingency factors
Credit rating as a risk indicator	✓		
Payment history as a risk indicator	✓	✓	
Relationships and trust		✓	
Availability of internet data			✓

7. Discussion and conclusions

7.1 INTRODUCTION

Previous research in Italy (Howorth and Moro 2006) indicates that the bank lending decision is often based on the evaluation of the SME's financial statements and/or the provision of collateral, and/or credit rating score, together with 'soft' information such as ethics, trust, relationships and networks. The evidence provided by this study suggests that similar types of information are used for making trade credit decisions in SMEs in Finland, the UK, the US and South Africa. There appear to be three main influences on the trade credit decision: formal and report-based information; 'soft' information relating to social capital; and contingency factors (see Figure 7.1). The contingency factors dictate the extent to which hard/formal information versus 'soft'/informal information is used.

Figure7.1: Contingency factors determine how 'hard' and 'soft' information is used in credit decisions



The discussion that follows is based on further analysis of the country-level findings. This is achieved by synthesising the concepts and categories that emerge from the interviews in each country chapter. Despite the intentionally diverse social and economic conditions represented by the case countries, a surprising consistency of themes emerges:

- the importance of economic conditions
- the importance of trade credit
- the role of transaction technologies
- use of cash and cash management
- the role of information and information intermediaries in SME lending and trade credit
- the importance of trust.

7.2 IMPORTANCE OF ECONOMIC CONDITIONS

The research took place during the worldwide pause in growth following the global financial crisis that started in 2008. The impact on small business has been twofold: recession has caused difficulties in maintaining or expanding turnover for some companies and financing has been squeezed because banks are unwilling to lend, suppliers are reluctant to grant credit and customers have taken more credit by deferring payment.

In all the countries it was found that small business played a similar role in the economy. SMEs are numerous in each country and together account for a significant proportion (one-third to one-half) of the private sector. This is enough to matter in whatever way it is measured, so that definitional issues are of little consequence and SME policy is worth worrying about in each economy. SMEs everywhere seem to account for a greater proportion of employment than they do of GDP. There are a number of reasons for this. Many SMEs are in relatively low technology, low capital-investment businesses so that few of them have highly paid employees. Secondly, because of their flexible needs, they employ many part-time workers and hire and fire as needed, although with the growth of zero-hours contracts many larger businesses are trying to emulate this flexibility.

Much has been made of the role of SMEs in job creation and growth. The nature of this study does not allow it to make a large contribution to the debate, but it is clear that, without access to appropriate finance, business expansion is a problem for SMEs in each country. The high rate at which SMEs are created and also disappear is a factor everywhere and it affects their ability to borrow and obtain credit. Credit risk is the fundamental driver that determines the structure of transactions but different businesses have different methods of dealing with it in different environments.

7.3 IMPORTANCE OF TRADE CREDIT

Not all SMEs give or receive trade credit, although even labour-only businesses usually undertake work in advance of being paid at the end of the week or the end of the month. As noted in the introduction, trade credit is about as important as bank lending as a source of finance in the SME sector. In some of the case study countries it is more important; in others it is a bit less important.

Trade credit has some characteristics that make it an important complement to bank lending and in some cases it can also be a substitute. Trade credit is potentially accessible to many SMEs although some of them may not need it. It can be a cheap form of finance if suppliers extend it without onerous terms, on the other hand there can be hidden costs to using it if early settlement discounts are forgone. Trade credit terms vary from industry to industry and from place to place. In the US, for example, generous early settlement discounts seem to be common (Cole 2011). Elsewhere, in some industries, differential pricing may occur, so that suppliers recoup the cost of credit by higher prices. Nevertheless, credit is often cheaper than bank borrowing as a form of finance. As noted in the introduction, trade credit has other advantages. For example, it is a flexible form of credit that tends to expand with the volume of business and it has a capacity for absorbing unexpected shocks.

7.4 IMPORTANCE OF FINANCIAL STATEMENTS

The findings of our individual country studies show that where small entities contract only with other small entities, relationship-based credit relationships are most important. Small entities rely on trust, personal knowledge and reputation. When medium-sized and larger entities contract with each other and with small entities, however, information derived from financial statements becomes an important part of the transaction technologies used in the SME sector. This is not to say that the contracting parties are, in all cases, physically consulting financial statements, but the information they contain has been processed, analysed and accumulated with other information. The use of such information is not necessarily obvious to the SME to which it relates. Owner-managers may not be aware of the extent to which the availability of trade credit and the terms offered to them by suppliers depend on their willingness to make financial statements available for inspection, the amount of information disclosed and whether the financial statements are audited.

Where direct use of financial statement data was made, it was not used uncritically. Respondents in different countries remarked that the inventory figure could be manipulated and was not to be relied on. Figures for cash, investment and distributions (by way of dividends or owners' pay) were of more interest, as were turnover and turnover growth. Credit reference agencies and insurers made more extensive use of financial statement information. Accounting ratios were calculated and factored into the agencies' proprietary scoring models to arrive at credit scores and recommended levels of credit.

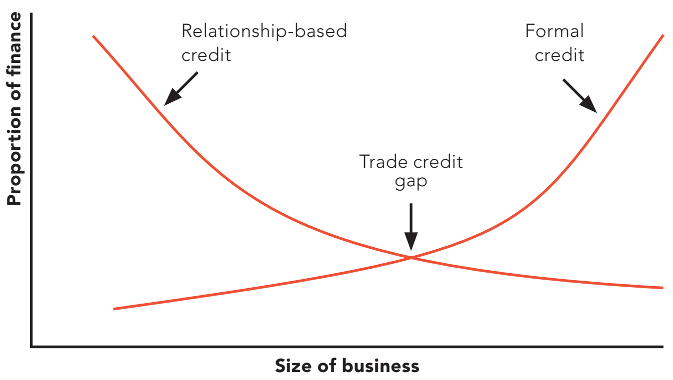
7.5 TRANSACTION TECHNOLOGIES

One of the most interesting and significant findings of this study is the way in which finance transactions differ across the case countries. Berger and Udell's way of looking at these transactions (2006) is helpful in explaining the present findings. The smallest and most informal businesses have relationship-based (opaque) finance in all forms. Equity comes from the owners, their family and their friends. There is little loan finance and trade credit is relationship-based. For larger businesses the transparency model describes their financing. Equity and loan finance are acquired through formal processes. Financial statements, that may or may not be audited, and well-researched credit reports together with other information are used in the granting and receiving of trade credit. It is in the intermediate and transitional stage that SMEs become more complicated and where the institutions in place in the economy have most potential for stimulating growth by removing barriers to expansion (Beck and Demirguc-Kunt 2006).

Figure 7.2 shows how relationship-based trade credit and formal credit may develop for SMEs. For new or very small businesses the only trade credit available is relationship based. As the business expands it needs more trade credit and the proportion of the financing it needs exceeds the amount that can be obtained through relationship networks. Larger businesses have grown to the point where trade credit can be obtained from formal sources because the businesses are transparent. Such a business has a track record, a payment history, a credit rating and financial statements. At an intermediate size, it may be that the businesses have outgrown their access to relationship-based credit, but have not yet become able to replace it with formal credit, giving rise to a 'trade credit gap'.

One way of filling such a gap is to increase the possibility of obtaining formal credit by becoming more transparent. In particular, the business can make available credible financial statements that contain the information required to access formal credit. In practice, however, financial statements are only effective if a mechanism for making them available to users exists.

Figure 7.2 The trade credit gap



The country studies in this report show how different solutions have arisen in the form of transaction technologies and use of information to mitigate trade credit gaps. For example, in Finland, although there is some evidence of use of small company financial reports, information on payment defaults is of most interest to granters of credit. In Finland, information on payment default is easily accessible. In a larger economy, such as the UK, it is harder to access comprehensive payment default information directly, so that credit rating agencies have a role in collating the information and incorporating it in their credit reports.

Use of deposits and pre-payments is one response where there is both lack of trust and inadequate formal information. Search for non-financial information by use of trade references or other sources is another. Personal guarantees and/or bank guarantees are also widespread in some countries. The internet is a relatively new and widespread source of information, as are mystery shopping, discussions with low level staff and use of indicators such as the fullness of car parks, which the present study shows are used for inferring customers' business strength.

The case of the US is different from the others we studied because there is no requirement for non-public entities to publish financial statements so they are not generally available. Respondents were supportive of this position but, as interviews progressed, it became clear that financial data were released by them in a number of ways to banks and credit reference agencies. In particular, it appears that one agency (D&B) has achieved a dominant market position so that information is transmitted privately to D&B, which incorporates it into a credit score. The apparent dominance of a single agency is not surprising as the market for credit scores, where company data is not publicly available, seems to be a natural monopoly because there are fixed costs to gathering data and the marginal costs of selling it are very small.

In the other countries studied, data are publicly available, so cheaper to obtain, and the market for credit rating agencies is, apparently, more competitive.

Table 7.1 shows how information availability and the power balance between supplier and customer affects the availability of trade credit.

Some of the medium-sized firms use invoice discounting and credit insurance as both cash management and credit risk management tools. These are transaction technologies that associate third parties with the transaction. However, some interviewees consider these technologies to be worth the cost because of losses avoided and comfort.

7.6 CASH AND CASH MANAGEMENT

The maxim produced by one interviewee and echoed by others is 'cash is cash'. The point is that cash realisation is the ultimate aim of nearly all transactions, and transaction technologies that bring this forward reduce financing costs and enable the business to undertake a higher volume of business by reinvesting the cash in the business cycle. One means of doing this was to demand deposits from customers, especially when creating bespoke products, such as kitchens, that could not be sold elsewhere if the buyer failed to take delivery. This practice seemed to occur in different locations. The use of business credit cards was remarked upon in more than one country.

Generally, it would appear that large companies take advantage of their dominance to defer payment of invoices. While this presents difficulties for smaller entities, the owner-manager may consider it is worth suffering the delay because the risk that payment will not be received is low and it means that the business can grow.

Table 7.1: How relative size of supplier and customer affects trade credit decisions

	Small supplier	Medium supplier	Large supplier
Large customer	Customer demands credit and extended payment deadlines Public information (including financial statements) about customer is available	Customer demands credit and extended payment deadlines Public information (including financial statements) about customer is available	Formal credit Supplier and customer have equal market power and can negotiate using transparent information
Medium customer	Supplier has some procedures in place for assessing credit risk and uses what information is available	Partial information available and the parties have equal market power. A range of transaction technologies are available	Supplier has some procedures in place for assessing credit risk and extensive information is available for assessing credit risk
Small customer	Relationship-based credit: credit decisions are based on trust, personal relationships and reputation	Customer is 'opaque' to the supplier, who may refuse credit or impose onerous terms	'Take it or leave it': supplier has dominant position and can demand cash up front or other safeguards

7.7 TRUST, PERSONAL RELATIONSHIPS AND REPUTATION

As mentioned, when very small entities transact with each other the dominant factor determining the availability of trade credit is trust, which can be derived from the personal relationship between the two parties (eg from the pattern of previous trading between the enterprises) or from the reputations of the businesses and their proprietors, or from external qualitative factors. However, trust as a basis for trading is by no means confined to the smallest enterprises.

Trust is an efficient, low cost governance mechanism where it can be relied upon (Rus and Igli 2005; Gulati and Nickerson 2008). This study shows that trust is more likely to operate where there is a local close-knit community and qualitative information about the contracting parties, such as reputation for quality of work or ethical dealing, is available. One predisposing factor to the use of trust is the knowledge that breaches of trust will be severely punished, for example by social ostracism or loss of good reputation and, hence, future business opportunities. In more than one example, trust was found to operate across international boundaries.

Several interviewees stressed the importance of personal contact with customers and believed that they could assess the trustworthiness of customers by meeting them face-to-face. There was little experience of bad debts in trust-based credit decisions.

7.8 THE ROLE OF NON-FINANCIAL INFORMATION AND INFORMATION INTERMEDIARIES

Taken together, the different cases show the existence of a wide range of transaction technologies that can help to finance SMEs. Whichever technologies prevail in a given environment depends, among other things, on information available, on the institutions (legal framework, disclosure regulation, banks and banking traditions, etc.) and market conditions in the environment.

The interviewees used a wide range of information apart from financial information. In many cases, financial information was not available, but even when it was available, it was only part of a jigsaw of other information, both qualitative and quantitative. Much weight was attached to information about court judgments, which was regarded as timely and informative, and to information about payments to other suppliers. Personal information about the owners of businesses was sometimes used where available, and proxy information, such as the age of the business, was used to infer stability.

Information intermediaries, especially credit rating agencies, had an important role in collating information and using their expertise to analyse it. Although some very small businesses did not use credit rating agencies, their use seemed to become more widespread as enterprises got larger, although they were not used for all transactions. Credit rating agencies and credit insurers provide a useful stewardship role. For example, a powerful factor driving good behaviour among SMEs in their role as customers of other businesses is the knowledge that poor payments to suppliers will be picked up by credit rating agencies and will result in a down-grading of their credit score.

7.9 COUNTRY DIFFERENCES

In many ways the similarities amoung the countries are more remarkable than the differences. The US is an exception because of the lack of a requirement to produce public financial statements has caused a different pattern: in particular, there is an increased emphasis on credit scores. There were some differences that can best be described as cultural – in Finland, companies experiencing temporary cash flow problems could expect support from their business contacts, while elsewhere pride in prompt payment reduced cash flow problems. The emerging economies (South Africa and Thailand) differed from the others, mainly in degree rather than qualitatively. The system of trade credit appeared less developed, but these countries have many more very small businesses using relationship-based approaches than elsewhere. Even in these economies, published financial statements were used in certain situations to assist trade credit decisions.

7.10 LIMITATIONS OF THE STUDY AND FUTURE RESEARCH

The main limitation of the research is that resources constraints meant that relatively few SMEs were interviewed in each country. This does not detract from the objective, which was the generation of understanding of the importance of trade credit and the place of financial statements in the process. Nevertheless, it would be desirable to follow up the research with more extensive surveys using the concepts generated in this study to extend and refine the findings.

7.11 CONCLUSIONS

Rather than setting out recommendations from the research to parties who have not asked for them, the authors draw the following inferences from the work so far as it has relevance to different groups.

7.11.1 Lessons for SMEs

Although small businesses that trade only with other small businesses with which they have long-standing relationships are not much affected by the availability and quality of their financial statements, almost all other businesses probably are. In particular, a business that is seeking to grow may be able to improve the availability of trade credit if it promptly files full financial statements, preferably ones that have been audited. This may also be true of bank finance, although that was not part of the present research.

7.11.2 Lessons for professional advisers

Clients may not be best served by taking advantage of maximum disclosure exemptions. Unless there is reason to believe that proprietary costs (such as use of information by competitors or intrusion into owners' privacy) are high, it may be better to place full accounts on the public record. If the marginal costs of audit or some other form of attestation are not high it may be worth the cost, particularly if the client is seeking to grow or to raise loan finance. Providing more public information may help to mitigate the trade credit gap for clients suffering from it.

7.11.3 Lessons for professional bodies and business associations

Professional bodies and business associations play an important role, not only in lobbying for the interests of individual members but also in channelling their members' experience when seeking economic and institutional structures that provide collective benefits, such as environments where businesses can enter into a wide range of relationships with each other at minimum cost.

7.11.4 Lessons for regulators

The prime responsibility for maintaining and improving the trading environment by reform of institutions lies with regulators, including national governments, national and international standard setters, the EU and other bodies. Providing companies with the choice of reducing the cash costs of financial reporting may have small benefits for some, even the many, who take advantage of it. Yet individual businesses may well be better off publishing full financial statements and the possibilities for doing so need to be maintained and improved. Improving the content and availability of financial reports could help to relieve any trade credit gap that is holding back growing small businesses.

In the UK, for example, a relatively small number of potentially exempt companies publish full financial statements. The rest, mostly advised by their professional accountants, incur a small additional cost to file abbreviated accounts. On the basis of the present research, it is arguable that many of them would have better credit scores if they filed full accounts and they might achieve cheaper finance and operating costs as a result. Companies House is the repository of company reports and, with the advent of electronic filing and XBRL, there is an opportunity to encourage companies to file full information at minimal, if any, cost to the exchequer or the companies themselves. The potential improvement to the pre-existing public database in terms of both access and content could provide a useful boost to the SME sector.

In the EU, the interaction between EU rules, the IFRS for SMEs and national rules, such as the UK's FRSSE, provides potential for considerable complications that should not be allowed to entangle SMEs. Common sense requires some adaptation of EU and IFRS rules to national environments, especially for micro-entities, which do not trade much across international boundaries.

Appendix A

INTERVIEW SCHEDULE FOR SMES

Participant information
(Provide in advance but reiterate main points at the interview.)

Thank you for agreeing to take part in this international study which focuses on the financial and other information used in making credit decisions relating to SMEs in Finland, the UK, the US and South Africa. In particular, we are interested in:

- the type of information needed by trade and other creditors, credit rating agencies and credit insurers
- the purposes for which the information is needed
- the sources of information used
- other information that they would like to see in the financial statements.

With your permission, this interview will be recorded. This will reduce our need to take detailed notes and improve the analysis. We will provide a copy of the interview transcript for your approval. We may use anonymous quotations from the transcript in the research report to illustrate the findings, but the full interview transcript will not be published. We will send you a copy of the research report.

We are very grateful to you for kindly giving up your time to take part in the study. Your participation is voluntary. Unless you have given us permission otherwise, neither your name nor the name of your organisation will be associated with any of the information you provide. Your contact details will be treated in the strictest confidence and once the study has been completed, we will delete these records.

Interviewee:
Tel:
Name of firm:
Address:
Activities:
Group/company/unincorporated?
Date incorporated/started:
No. of employees last year:
Small/medium?
Accounts audited?
Trade receivables last year:
Trade payables last year:

I'd like to start by asking you something about yourself and the business.

1. Who are the main customers? (eg small, medium, large firms, individuals)
2. What is your background? (eg financial experience/ training)

   a) Do you make all the credit decisions in the business?

3. I see from the annual accounts that trade receivables exceed trade payables – is that typical of this sector?

I'd now like to focus on credit decisions made in connection with *customers*.

4. Approximately how many and what proportion of your customers are given credit?

   a) How do you decide whether to give credit?

   b) What do you take into account when deciding whether to grant credit?

   c) Does the value of the contract effect the credit decision? If so how?

   d) Are large customers dealt with differently from smaller ones?

   e) Does the form of the customer affect the decision (eg large limited company, medium or small limited company, sole trader or partnership, public body, private individual)?

5. I'd like you to think about the last time you made a decision to give a substantial amount of credit to a new customer (ie the first time from this customer).

   a) How long ago was that and how would you categorise this customer (eg size of the firm, amount of credit, value of orders/sales volume)?

   b) What financial and/or non-financial information did you request from this new customer?

   c) Did you receive any other information without asking for it?

   d) Did you look at this customer's financial statements? (Question about audit later.)

   e) Can you give some indication of the relative importance of financial information compared with non-financial information?

   f) Did you do a credit check, ask for a credit reference or ask for credit insurance?

g) Do you treat most of your new customers in this way? If not, how do things differ?
Probe: Would you have requested different information if the circumstances had been different (eg value of the order; size of the customer; if the customer was part of the community/your business network)

6. I'd now like you to think about the last time you made a decision to give a substantial amount of credit to an existing customer.

   a) How long ago was that and how would you categorise this customer (eg size of the firm, amount of credit, value of orders/sales volume)?

   b) What financial and/or non-financial information did you request from this existing customer?

   c) Did you receive any other information without asking for it?

   d) Did you look at this customer's financial statements? (Question about audit later.)

   e) Can you give some indication of the relative importance of financial information compared with non-financial information?

   f) Did you do a credit check, ask for a credit reference or ask for credit insurance?

   g) Do you treat most of your existing customers in this way? If not, how do things differ?
   Probe: would you have requested different information if the circumstances had been different (eg value of the order; size of the customer; if the customer was part of the community/your business network)

7. Do you have access to any of your customers' real-time information systems (eg e-invoicing)?

   a) If so, approximately how many and what proportion of your customers?

8. Do you monitor the financial position of your customers? If so, which customers and how? (eg to see whether they are paying within the agreed period, to ask for credit checks or to request financial information)

   a) What happens when a customer exceeds the credit period?

   b) Are bad debts a problem for your business?

I'd now like to ask you about the use of financial statements in assessing and monitoring the creditworthiness of customers.

9. Does your business examine the financial statements of new and/or existing customers? (If 'no', go to Q12.)

10. Are you responsible for examining the new and/or existing customers' financial statements?
    (If 'no', keep these questions for that person.)

    a) Does your business examine the customer's annual financial statements?
    (In some countries, check whether these are the statutory accounts.)

    b) Does your business examine the customer's periodic financial statements?
    Prompt: quarterly, monthly, other.

    c) Does your business require the financial statements to be audited? If so, which (annual, quarterly, monthly, other)?

    d) How do you obtain customers' financial statements?
    Prompt: from the public registry, from a commercial database (if so, which one?), from the customer's website, by asking the customer?

    e) What information is examined?
    Prompt: P&L, BS, notes to the accounts, other.

    f) What is the most useful information in the financial statements for assessing/monitoring credit risk?

    g) What other information would make the financial statements more useful?
    Prompt: do you ask for other financial information that is not disclosed?

    h) Do you discuss the information in the financial statements with the customer?

11. Do you have a standard format for extracting the data to be analysed?

12. Do you compare financial data for the customer with industry averages or other benchmarks? If so, what?

13. Do you do a credit check on new and/or existing customers? If so, which credit rating agency do you normally use?

    a) What information do you get?

    b) What information do you use?

    c) Do you assess the customer's performance? If so, how do you measure it?

    d) Do you assess their liquidity? If so, how do you measure this?

Before we finish, I have a few questions about when your business is buying on credit from another organisation.

14. Please think about the last time you purchased goods or services on credit from a new supplier (ie the first time from this supplier).

a) How long ago was that?

b) What financial and/or non-financial information did this new supplier request?

c) Did you give any other information without being asked for it?

d) Did they ask for your business's annual financial statements? (In some countries, check whether these are the statutory accounts.)

e) Did they ask for your business's periodic financial statements? Prompt: quarterly, monthly, other.

f) Did they ask for the financial statements to be audited? If so, which (annual, quarterly, monthly, other)?

g) Did they ask for a credit reference or ask for credit insurance?

h) Do most of your new suppliers treat you in this way? If not, how do things differ?
Probe: would you have been asked for different information if the circumstances had been different (eg value of the order; size of the supplier; if the supplier was part of the community/your business network)?

15. Please think about the last time you purchased goods or services on credit from an existing supplier.

a) How long ago was that?

b) What information did this existing supplier request?
Prompt: Financial or non-financial information.

c) Did you give any other information without being asked for it?

d) Did they ask for your business's annual financial statements? (In some countries, check whether these are the statutory accounts.)

e) Did they ask for your business's periodic financial statements? Prompt: quarterly, monthly, other.

f) Did they ask for the financial statements to be audited? If so, which (annual, quarterly, monthly, other)?

g) Did they ask for a credit reference or ask for credit insurance?

h) Do most of your existing suppliers treat you in this way? If not, how do things differ?
Probe: would you have been asked for different information if the circumstances had been different (eg value of the order; size of the supplier; if the supplier was part of the community/your business network)?

16. Do you give information to credit rating agencies, credit insurers or other organisations? If so, what information do you give to each?
Prompt: financial and non-financial.

Thank you very much for giving us so much of your time.

We will send you a copy of the interview transcript for your approval in due course.

Neither your name nor that of your organisation will be associated with any of the information you provide, unless you have given permission otherwise.

Your contact details will be treated in the strictest confidence and will be destroyed at the end of the study.

Appendix B

INTERVIEW SCHEDULE FOR CREDIT RATING AGENCIES AND CREDIT INSURERS

Participant information
(Provide in advance but reiterate main points at the interview.)

Thank you for agreeing to take part in this international study which focuses on the financial and other information used in making credit decisions relating to SMEs in Finland, the UK, the US and South Africa. In particular, we are interested in:

- the type of information needed by trade and other creditors, credit rating agencies and credit insurers
- the purposes for which the information is needed
- the sources of information used
- other information that the above entities would like to see in the financial statements.

With your permission, this interview will be recorded. This will reduce our need to take detailed notes and will improve the analysis. We will provide a copy of the interview transcript for your approval. We may use anonymous quotations from the transcript in the research report to illustrate the findings, but the full interview transcript will not be published. We will send you a copy of the research report.

We are very grateful to you for kindly giving up your time to take part in the study. Your participation is voluntary. Unless you have given us permission otherwise, neither your name nor the name of your organisation will be associated with any of the information you provide. Your contact details will be treated in the strictest confidence and once the study has been completed, we will delete these records.

Interviewee:
Tel:
Name of firm:
Address:
Activities:

I'd like to start by asking about the different types of customer you have.

1. Can you give me an estimate of the proportion of your customers that are:

    a) listed companies

    b) unlisted companies with more than 250 employees

    c) unlisted companies with 51–250 employees

    d) unlisted companies with 11–50 employees

    e) unlisted companies with 0–10 employees

    f) unincorporated businesses 0–50 employees.

2. Can you give me an estimate of the proportion of the credit reports/credit insurance you supply that relate to:

    a) listed companies

    b) unlisted companies with more than 250 employees

    c) unlisted companies with 51–250 employees

    d) unlisted companies with 11–50 employees

    e) unlisted companies with 0–10 employees

    f) unincorporated businesses with 0–50 employees

I'd now like to focus on *small and medium-sized unlisted companies.*
(Agree simple non-financial definition for ease of comparison. In Europe we will use number of employees.)

	Small	Medium	Large
Finland	0–50 employees	51–250 employees	> 250 employees
UK	0–50 employees	51–250 employees	> 250 employees
US	0–500 employees		> 500 employees
South Africa			

3. What non-financial information do you use to assess credit risk in small and medium-sized unlisted companies (incorporated SMEs)?

    a) What non-financial information do you use and how do you obtain it?

    b) How do you use it?

    c) How does this non-financial information for a small or medium-sized company differ from that of a large company?

4. What financial information do you use to assess credit risk in these small and medium-sized unlisted companies?

   a) Do you use their financial statements? If so, which financial statements?

   b) How do you obtain them?

   c) What information in the financial statements do you use for assessing credit risk?

   d) Do you supplement the information from the financial statements with other financial information? If so, what and how do you obtain it?

   e) How does the information you use from the financial statements for a small or medium-sized company differ from that for a large company?

5. Is there any information that is not currently disclosed in the annual financial statements of small and medium-sized unlisted companies that you would find useful for credit rating/credit insurance purposes?

6. Is there any information in the annual financial statements of small and medium-sized unlisted companies that you consider is irrelevant for credit rating/credit insurance purposes?

I'd now like to focus on *unincorporated* small and medium-sized enterprises.

7. What non-financial information do you use to assess credit risk in unincorporated small and medium-sized enterprises?

   a) What non-financial information do you use and how do you obtain it?

   b) How do you use it?

8. What financial information do you use to assess credit risk in *unincorporated* small and medium-sized enterprises?

   a) Do you use their financial statements? If so, which financial statements?

   b) How do you obtain them?

   c) What information in the financial statements do you use for assessing credit risk?

   d) Do you supplement the information from the financial statements with other financial information? If so, what and how do you obtain it?

9. Do you ever go back to small and medium-sized companies or unincorporated small and medium-sized enterprises to get more information? Do they ever contact you to query their ratings?

10. Do you know whether credit insurers/credit rating agencies (*delete as appropriate*) use your credit reports?

Thank you very much for giving us so much of your time.

We will send you a copy of the interview transcript for your approval in due course.

Neither your name nor that of your organisation will be associated with any of the information you provide unless you have given permission otherwise.

Your contact details will be treated in the strictest confidence and will be destroyed at the end of the study.

Appendix C: Research in Thailand[6]

Sutthirat Ploybut, Portsmouth University
Michael Page, University of Portsmouth

C1. INTRODUCTION

Thailand is an attractive case to study in relation to SMEs, financial reporting and trade credit, owing to its forthcoming integration into the ASEAN Economic Community in 2015, when it will join existing members Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore and Vietnam. Joining the single market will remove barriers to the movement of goods, services and labour, which will allow for greater flexibility for all Thai firms, including SMEs (AEC 2012). As in other countries, SMEs play a significant role in the economy of Thailand.

According to the Office of Small and Medium Enterprises Promotion, at the end of 2010 there were 2.91m SMEs in Thailand, of which 99% (2.89m) were small firms (OSMEP 2011). The manufacturing sector was the most important, with SMEs providing 32.3% of GDP in 2010, closely followed by the services sector (31.6%) and the trade and maintenance sector (28.2%). As shown in Table C.1, SMEs accounted for 76% of jobs in the period 2005–8, and around 30% of exports. This illustrates the reliance of the Thai economy on SMEs and the opportunities offered by international trade.

Table C1: Economic contributions of SMEs in Thailand 2005–8 (%)

	2005	2006	2007	2008
Percentage of total enterprises	99.53	99.61	99.62	99.69
Percentage of total jobs	76.06	76.57	76.00	N/A
Percentage of gross domestic product (GDP)	39.60	38.90	38.20	37.90
Percentage of total exports	29.70	29.10	30.10	28.90
Percentage of total imports	32.40	32.70	29.83	29.80

Notes

1. The share of GDP was estimated from SMEs in the non-agricultural sector.

2. In 2008, there was an adjustment of the database used to estimate the number and employment of SMEs, so the figure for employment is not available.

Source: OSMEP 2009.

C2. FINANCIAL REPORTING

The official definition of SMEs is available in the 2000 SME Promotion Act, but for statutory financial reporting purpose, the legal form of business is used as the main criterion for specifying the extent of financial reporting obligations; all limited liability entities are required to prepare and publish financial statements. Almost all limited liability entities (99%), whether companies or registered partnerships, are small and medium-sized entities (OSMEP 2009).

In Thailand, preparation and publication of general-purpose financial statements is required for statutory financial reporting. Financial reporting requirements are largely determined by legal forms. All limited liability entities, eg companies and registered partnerships, regardless of their size, are required to prepare and file their annual financial statements with the Department of Business Development (the Registrar's Office) and these published financial statements are available for public inspection.

In the past, the same set of accounting standards was applied to limited liability entities, regardless of their size. To ease reporting burdens for SMEs, in 2002 Thai national standard setters adopted one set of accounting standards, with some exemptions for SMEs. This different level of reporting was not, however, based on the size of entity; instead, the legal form of a business was employed as a criterion. Only limited liability entities other than public companies were allowed to use the option of the accounting standard exemption. Examples of exempt accounting topics are cash flow statements, consolidation of financial statements and related-party disclosures. In 2009, a separate set of accounting standards for non-publicly accountable entities was proposed and was implemented for the financial reporting period of 2011. Again, no size test is adopted in this simplified framework for financial reporting.

With regard to filing requirements, non-public companies are not required to prepare and file consolidated financial statements or cash flow statements. Statutory audit is compulsory for companies, but an audit exemption is given to small registered partnerships, which are defined in the Accounting Act 2000. These statutory filing and audit requirements have not changed since 2002. Finally, under Thai accounting regulations, the preparer of accounts of a company or registered partnership (internal or external accountant) is required to have a specified minimum level of educational qualification and practice.

6. The research reported in this Appendix formed part of a PhD thesis (Ploybut 2012) and is augmented by additional interview data. The PhD research included surveys of SME owner-managers and covered trade credit and other topics.

According to the Accounting Act (B.E. 2543, 2000), the statutory financial statements must be prepared annually in accordance with the 'facts and accounting standards'. Thai Accounting Standards, issued by the Federation of Accounting Professions, are thus mandatory for accounting and financial reporting by all business entities that are subject to statutory reporting. Nonetheless, business entities other than public companies are allowed to depart from certain accounting standards such as impairment of assets and preparation of a cash flow statement. Most SMEs qualify for the exemption because of their legal form.

Thai accounting standards setters decided to develop local GAAP standards for SMEs. In March 2010, the exposure draft on Thai Financial Reporting Standards for Small and Medium Enterprises was released. In this proposal, the IASB's International Financial Reporting Standard for SMEs (IFRS for SMEs) and the Financial Reporting Guidelines for Small and Medium-sized Enterprises (SMEGA) Level 3 of the United Nations Conference on Trade and Development (UNCTAD) were identified as guidance for its development (FAP 2010). Measurement, recognition and disclosure were substantially simplified. For example, there was no requirement for impairment assessment of assets, all leases except those for hire-purchase were treated as operating leases, and any changes in accounting policies did not require adjustment of prior amounts.

A year after its first release for public discussion, the new standard was introduced in May 2011 with the new title of Thai Financial Reporting Standards for Non-Publicly Accountable Entities (TFRS for NPAEs), which reflects its scope of applicability. Non-publicly accountable entities, regardless of size, can choose to adopt it. There were in fact significant changes between the final draft and the initial proposal, especially in measurement and recognition

The Accounting Act (B.E. 2543, 2000) requires companies and registered partnerships to have their accounts audited by certified public accountants. Small registered partnerships with issued capital, total assets and turnover of less than £100,000, £600,000, and £600,000, respectively (THB 5m, 30m, and 30m)[7] are, however, exempt from the audit requirement. Notably, for taxation purposes these small partnerships are still required to have their financial statements audited either by tax auditors who are licensed by the Revenue Department or by certified public accountants.

A company's auditor, appointed each year at the shareholders' annual general meeting, is required to examine the books of account of the company in accordance with generally accepted auditing standards, and to give an opinion on the financial statements, as to whether the accounts present fairly the financial position and results of operations for the period under audit. At present, there are no specific auditing standards or guidelines issued by Thai Auditing Standards Board of the FAP for auditing small companies' accounts. The Board believed that the existing auditing standards could be used with the audit of all sizes and types of business but auditors were recommended to use the guidelines of the International Federation of Accountants – International Auditing Practice Statements No. 1005 – The Special Considerations in the Audit of Small Entities (Srijunpetch 2009).

C3. METHODOLOGY

The research in Thailand focused on a sample of unlisted private limited liability entities (companies or registered partnerships) in the non-financial sector. The study adopted a mixed methods approach, which entailed collecting and analysing both qualitative and quantitative research data. Face-to-face interviews were held with directors or managers of SMEs, users and other stakeholders, with the findings then analysed thematically using a grounded theory approach (Strauss and Corbin 1998). In addition, a survey of SMEs was conducted using web-based and paper-based questionnaires with a statistical analysis of the resulting data.

C4. FINDINGS

A4.1 Use of trade credit by Thai firms

Empirical evidence shows that trade credit is an important source of external finance for Thai firms. A survey of 1,043 Thai firms by the World Bank (2006), for example, revealed the use of trade credit to finance the firms' investments and working capital: on average, among those questioned, 2% of fixed-assets and 12% of working capital were financed by trade credit. Evidence from a survey by Sarapaivanich and Kotey (2006) shows that around 33% of 407 small and medium-sized entities in the trading sector used trade credit as a source of finance for funding the business. In the present study, an analysis of the balance sheet structure of 272 SME annual accounts filed with the Thai Department of Business Development for 2007 shows that larger SMEs have higher levels of trade credit. In medium-sized entities, trade creditors, on average, accounted for 22% of total assets compared with 8% for small entities and only 0.18% for micro-entities. This suggests that larger SMEs tend to offer trade credit to their customers. Micro-entities had little or no receivables in their annual accounts, whereas receivables in small and medium-sized entities presented around 11% and 16% of total assets respectively.

C4.2 Credit reporting agencies

For the trade credit market, commercial credit information about local and foreign business entities can be obtained from credit rating agencies, such as International Research Associates Co Ltd (INRA) and Business Online Public Co Ltd (BOL), in partnership with Dun & Bradstreet. According to the 2011 annual report of BOL, several information sources are gathered and used to develop the company's database and services. For instance, business registration information and financial statements of Thai businesses are obtained from the Department of Business Development, Ministry of Commerce, and businesses' payment information is collected from a customers' payment information exchange programme, ie participating companies provide payment information about their debtors to BOL. Credit reports provided by the credit rating agencies can be accessed via online services.

7. £1.00 is approximately equal to 50 baht

Sample credit reports are available on the websites of BOL (www.bol.co.th) and INRA (www.inra.co.th). At over 15 pages in length, the reports contain a variety of information about a business entity including incorporation details, business operations, and information about a company's management. A summary of a company's financial statement information is also provided, together with a financial ratio analysis. Another important piece of information contained in the report is a credit rating score. As shown in the sample reports on BOL, the levels of financial strength and creditworthiness of a company are indicated by the D&B rating. Assessment of financial strength is based on the company's net worth and the credit rating score is calculated from various factors, for instance, management experience, business age, and financial condition. The report also provides a credit risk index (CRI) to facilitate credit decisions and credit management. There are six levels of credit risk, ranging from CRI 1 (minimal risk) to CRI 6 (high risk). This assessment takes into account a variety of information about a business entity, for example, business registration information, financial statement data, history of trade credit payments, business operations and management, and public records information.

Some banks also provide a credit assessment service. For instance, Export and Import Bank of Thailand (EXIM Thailand) offers a business risk assessment report on overseas buyers for Thai exporters. The report includes the following information: (1) name, address, business line, establishment, number of employees, (2) trend in buyer behaviour (3) payment records through EXIM Thailand (if any), (4) credit ranking by EXIM Thailand, and (5) comments from an EXIM Thailand analyst, such as the appropriate level of credit and terms of payment (EXIM 2012).

The National Credit Bureau (NCB) has played a major role in supporting banks' lending decisions. It gathers information from member financial institutions, which is then used to inform lending decisions. The bureau has access to a range of information derived from customers' bank accounts that is not available to other credit rating agencies and is therefore not available for trade credit decisions.

C4.3 Trade credit insurance

In Thailand, trade credit insurance is offered by several commercial banks and insurance companies (for example, Kasikorn Bank, EXIM banks and Samaggi Insurance). In practice, such credit insurance services seem to focus on cross-border transactions (Ploybut 2012). BOL's annual report for 2011 shows that financial institutions are the company's main customers. EXIM Thailand, for instance, is a major customer for credit information on overseas business entities.

C4.4 Trade credit practice

The following discussion is based on the findings from interviews with four representatives of small business, two owners and two accountants, together with an interview with a professional accountant who services small business clients. The focus of the interviews was on information sources used in the firms' decisions about trade credit. Also, the results from a questionnaire survey of SMEs and interviews with several groups of SME stakeholders, including SME directors/managers, are incorporated in the discussion where relevant.[8]

According to the interviews with the owners of small businesses, credit sales are normally not granted to new customers. Initially, sales transactions are conducted on a cash basis or with an advance payment. After the trading relationship between the firm and a customer has been established for a period of time and the firm has gained some knowledge and experience with the customer, the firm may extend trade credit to that customer. Some supplier companies require their credit customers to provide them with bank guarantees.

A director of a small manufacturing firm indicated that the decision to extend credit to a customer depended mainly on previous experience of the customer's payment behaviour. The documents often required from customers for credit application included legal documents, such as business and VAT registration documents, but there was no requirement for financial statements or bank statements, for instance. Instead, information about existing customers would be gained from visiting customers' premises and asking other suppliers.

Some companies might pursue information about the financial position or creditworthiness of their customers by other means. For example, they obtained financial information about their customers through customers' published accounts available on the public record,[9] by checking themselves, asking their accountants to check it for them or asking other businesses or banks about their customers' financial status. No small company directors reported undertaking further investigation of customers' creditworthiness by using a service from credit rating agencies. An interviewee who is an auditor mentioned that some customers asked her to check financial information on their potential business partners in the database of the Department of Business Development. She paid attention to the information about the board of directors, profit figure, name of auditor, etc so as to assess the reliability of the business.

8. In the last quarter of 2011, a web-based survey of SMEs was conducted, which produced 188 usable responses. In addition, 20 semi-structured interviews were held with SMEs, users, and other stakeholders.

9. This refers to the Companies in Thailand Database provided by the Department of Business Development, Ministry of Commerce. Apart from business registration information of business entities, the database provides the financial statements of a business for several years but in an abbreviated format. Financial statement ratio analysis of a business entity and of industry information is also available in this online service. The public can have access to this database.

In larger entities, the procedure begins with requesting information from new customers applying for trade credit. This often includes financial statements, VAT and registration documents, company profile (information about registered capital, product and services, type of business), dealing banks and bank accounts, and other information about terms of payment and contact. Further information is then collected from other sources before analysing and making the credit decision.

One of the accountants interviewed indicated that financial statements were required only from a customer that was a public company. For credit applicants that are non-public companies, financial statements would be obtained indirectly by the finance department through the public database of the Department of Business Development. Besides, further information about customers can be obtained by making a visit to customers' premises or factories, carrying out interviews with customers, or receiving information from trade associations. Nevertheless, some customers, such as those who were not in a good financial position, may be asked for a bank guarantee for purchasing on credit.

Similar information requirements when making a credit application are found from the interview with a CFO of a medium-sized company.[10] He said that financial statements were requested from new customers, regardless of their type of business. In addition, the firm would check the credit reports of new customers further through an online database provided by the credit rating agency, BOL. Apart from a company profile, financial statement information for the past several years, financial ratio analysis and a suggested credit limit are shown in this database. For monitoring credit customers, the firm used customers' payment history and credit information. As regards extending the amount of trade credit, existing customers would be required to submit their financial statements.

The findings from the interviews with the owners of four small businesses and a professional accountant suggest that trade credit practices of Thai firms vary significantly among businesses. Some companies rely on their own ways of obtaining information to support the assessment of creditworthiness of potential or existing customers, while others follow more systematic procedures: obtaining information from trading partners and other sources, analysing such information and then making the trade credit decision. Private information and knowledge of trading partners gained through trading relationships, so-called 'soft' information, seems to be an important source of information that small business owners use for making credit decisions. The use of financial statement information and other information sources, such as bank references and credit information reports, in credit decisions was found in larger SMEs.

Similarly, the results from a survey of SMEs and interviews with SMEs, users and other stakeholders in 2011 suggest that at least some SMEs use financial statements for trade credit purposes.[11] For instance, approximately 10% of 188 respondents reported using their accounts for trade credit, and identified trade creditors as important users of accounts. Likewise, two SME directors interviewed mentioned sending their annual accounts to their suppliers and obtaining financial statement information about their customers or suppliers via public records. Information sources that the survey respondents considered important for deciding to extend credit to their business customers were (in order of importance): payment history of the firm, references from banks and business partner's financial statements.

C5. CONCLUSIONS

Trade credit is not much used by very small businesses in Thailand, but as business size increases so does the use and granting of trade credit. Small businesses rely on informal systems and relationship-based credit decisions whereas larger businesses use more formal processes. None of the smaller businesses interviewed used credit information reports but some of the larger businesses did. Both large and small businesses used financial reporting information filed in the Department of Business Development database.

10. The company is a subsidiary of another business and has annual turnover around 2,000m baht.

11. The majority of respondents to the survey had an annual turnover over 5m baht and 50 or more employees.

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