ACCA

Getting paid: lessons for and from SMEs

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ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

Founded in 1904, ACCA has consistently held unique core values: opportunity, diversity, innovation, integrity and accountability. We believe that accountants bring value to economies in all stages of development. We aim to develop capacity in the profession and encourage the adoption of consistent global standards. Our values are aligned to the needs of employers in all sectors and we ensure that, through our qualifications, we prepare accountants for business. We work to open up the profession to people of all backgrounds and remove artificial barriers to entry, ensuring that our qualifications and their delivery meet the diverse needs of trainee professionals and their employers.

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Published as part of ACCA's contribution to the UK Government's Finance Fitness Campaign, this report brings together the experiences of business owners and managers as well as credit and finance professionals in businesses large and small, from the supplier's as well as the buyer's side.

It finds that there is only so much government can do to protect small firms from abusive credit terms and late payment, but also a great deal that businesses can do for themselves.

Getting Paid: Lessons for and from SMEs

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GET PAID!

The findings of this report have provided the basis for *Get Paid!,* a short guide to avoiding late payment jointly published by ACCA, Experian, the Forum of Private Business and the Institute of Credit Management (ICM) as part of the UK Government's Getting Paid on Time Day on 6 February 2012.

'It is hugely important that all businesses, particularly small firms, establish clear payment terms to ensure they get paid on time and successfully manage their cashflow. There is practical information available for businesses on getting paid that we are promoting to small firms through our Finance Fitness campaign, and this new guide published by the ACCA contains clear, helpful advice. I want small businesses to use this information and set up appropriate payment terms.'

MARK PRISK MP, BUSINESS AND ENTERPRISE MINISTER, UNITED KINGDOM

Executive summary

At one level, trade credit is extraordinarily simple – it occurs when a supplier of goods or services permits a customer to defer payment for a period of time after delivery. This simple concept underlies an enormous range of business-to-business financial arrangements that arise out of complex networks of relationships. These relationships form the principal focus of this report.

Trade credit is an essential element of the working capital or 'cash conversion' cycle. Its use in the UK is significant: around 80% of business-to-business transactions in the UK are undertaken on credit and it constitutes about 37% of total business assets (Paul and Wilson 2006).

Existing research on trade credit is not extensive and is largely quantitative, producing valuable statistical information. Using such data, researchers globally have pointed to the significant benefits that the strategic use of trade credit can bring for suppliers and customers alike. These include superior cash flow management, a source of finance, cost reduction, the building of stronger supply chains and provision of important sources of information and signalling.

Nonetheless, trade credit exposes suppliers to significant default risk, and SMEs are particularly vulnerable, by virtue of their size, if customers pay late or not at all. Given the preponderance of SMEs in the UK and their role as an engine for growth and job creation, this is an obvious matter of concern.

SME lobby groups consistently maintain that the root cause of many of those firms' problems in terms of financial stability is their late-paying larger customers. To date, the policy and professional response to this risk has been to enact legislation to increase disclosure of large companies' payment trends and to enable firms to charge late payers penalty interest. There are also a variety of self-regulatory measures such as 'prompt payment codes'. Emphasis has been given by professional associations and government to credit management training for SMEs. These measures are useful tools for combating late payment but, on their own, have proved largely ineffective (Paul and Boden 2011); late payment and non-payment continue to be severe problems in the UK.

ABOUT THE RESEARCH

This research explored the reasons why the potential strategic benefits of trade credit are not more routinely achieved by SMEs and why the solutions enacted thus far have proved ineffective. To do so, it looked at the level of the individual firm to investigate the manner in which trade credit was negotiated and controlled.

In order to investigate trade credit arrangements as an aspect of business-to-business relationships it was necessary to use an alternative to existing quantitative approaches to this subject. That is, data had to be collected on how firms and the people in them actually made these arrangements and within what sort of relationships. This meant taking a qualitative approach.

We conducted 40 semi-structured interviews (that is, interviews with fairly open questions) with credit managers or controllers in UK firms. This group comprised 15 SMEs that supplied larger firms and 25 firms that were larger customers (ie more than 250 employees) of SMEs. The firms were from a variety of sectors. We had intended to conduct 15 interviews in each size grouping, but some firms miscategorised themselves as SMEs when we contacted them. As this is qualitative work this imbalance is not considered problematic and we have used all available data. The interviews were recorded and transcribed; the transcripts were then analysed using a manual coding system. Initial findings were presented at a workshop attended by credit managers and controllers from a variety of firms and feedback from that was also treated as useful data.

Qualitative work of this nature gives insights that quantitative work cannot, and the two methods therefore complement each other. In particular, this approach has, in this instance, allowed insights into the realities of trade credit relationships, offering the prospect of enabling them to work better.

KEY FINDINGS

The desirable framing principles of 'good' trade credit relationships, where both parties achieve mutual benefit, were deemed by the respondents to be equity, ethical business conduct and sustainability. That is, sound relationships were seen to be those where there is no abuse of power by one party, where all parties behave in an ethical manner and where the overall objective is sustainable business and business relationships.

The external environment in which firms operate was found to affect their capacity to build and sustain such relationships. The sector in which the firms were situated is a key factor; the characteristics and practices of particular sectors set the framework for these business relationships. Statutory and non-statutory regulatory devices designed to combat late payment are also part of the business environment although, as the results showed, they are not particularly influential. And finally, the current economic climate in the UK has had a profound impact on how trade credit relationships work.

The ways in which both supplier and customer firms organise themselves internally, together with their attitudes and behaviours, are absolutely central to how well they negotiate and controll trade credit given to or taken from their business partners.

Firms in the sample that took a more strategic approach, seeing trade credit as an important business opportunity rather than a simple debt-collecting function, reported far fewer late payment problems than their counterparts. These strategically inclined firms had taken steps to organise their trade-credit function carefully. On the supply side, the management of credit was 'mainstreamed' within the firm: credit managers took part in making key decisions and their colleagues understood and respected the value of their work. These firms tended to have clearly articulated policies and had arranged their affairs so that these were enforceable. The firms had well-trained and experienced credit management staff who exhibited a clear commitment to their work and an understanding of their role in the business.

On the customer side, the results showed that even strategically oriented firms tended to have less of an appreciation of the value to the firm of being a 'good customer' and this had consequential impacts on the attention paid to prompt payment. Even so, they still tended to be better payers (in terms of adherence to payment agreements) than their less-strategic counterparts.

Not all these firms met the principles of equity and ethical behaviour, and may thereby have been undermining their prospects for maintaining sustainable relationships: some were fairly aggressive, using their organisational ability and clear strategic goals to maximise their own financial position, whatever the cost to their business partners, often exploiting weaknesses found on the other side. These firms experienced fewer late payment issues, but were not prompt payers themselves.

A range of intra-firm characteristics are associated with the mitigation of late payment risk and with being 'good payers'. These positive firm characteristics then play themselves out successfully in relationships with partners in their supply chains. That is, well-organised firms (whether customers or suppliers) with a strategic orientation are able to negotiate and control trade credit very effectively, reducing risks and generating strategic advantages from using trade credit. The unethical and inequitable behaviour of large firms towards SMEs was, in some instances, deemed to be problematic by respondents. Nonetheless, there was confidence among respondents that, if suppliers enter into these relationships well-organised and resourced with the right skills and attitudes, then adverse consequences could be averted.

RECOMMENDATIONS

Approaches towards mitigating late payment problems, such as regulation, self-regulation and disclosure requirements, can be useful tools for firms but cannot ever constitute a comprehensive answer because trade credit relationships are so complex and heterogeneous. Importantly, the answer to late payment cannot lie in simple exhortations to, and injunctions on, large customers to pay SMEs on time.

Rather, late payment represents the failure of trade credit relationships. The best way of addressing these failures is by exploring the ways in which both customers and suppliers can be encouraged, educated, trained, incentivised and organised into maintaining better relationships that mitigate the late-payment risk. To be effective, however, such an approach needs to be grounded in sound evidence and to offer a robust framework for reconfiguration of business relationships. The start of such a tool is proposed in this report.

There is no 'magic bullet' to the problem of late payment, nor any particularly easy answer. There is no single solution, no template for all businesses to follow, because businesses are so different. Moreover, imposing a single model might prevent some firms from realising some of the strategic benefits already identified.

The report concludes by suggesting instead that there is an important new role here for accounting professionals to champion better trade credit relationships by helping their clients or firms enter into these arrangements in a healthier and fitter condition.

1. Introduction

At one level, trade credit is extraordinarily simple – it occurs when a supplier of goods or services permits a customer to defer payment for a period of time after delivery. As is often the case in life, simplicity ceases here. In reality, trade credit is constituted by a 'variety of heterogeneous, unilaterally determined systems and arrangements' (Paul and Boden 2008). To a significant extent, trade credit makes trade possible – it is an essential component of the cash conversion cycle.

Moreover, the flows of trade credit are very big. They are greater in volume than the flows of short-term bank credit in nearly all developing and industrialised countries (Guido 2003). In the UK, trade credit constitutes about 37% of total business assets (Paul and Wilson 2006) and around 80% of business-to-business transactions are undertaken on credit. Trade credit is therefore highly significant but, simultaneously, it takes place at the margins of business activity – it is not the core purpose of any business to give trade credit.

Unfortunately, these often-essential arrangements can go awry. Although firms may have sound strategic reasons for granting trade credit (Paul and Boden 2008), the time lag between sales and payment may give rise to late payment or default (ie non-payment). In short, customers may not pay on time, or even at all. In the case of some goods and almost all services it is not possible to recoup the debt by recovery of what was supplied. Consequently, arrangements which might apparently be calculated to give the best mutual benefit to supplier and customer may, in fact, reflect information or power imbalances and can yield inequitable outcomes. Suppliers might not be sufficiently knowledgeable to optimise their trade credit position or have the expertise or capacity to manage trade credit to their own best advantage. Power asymmetries may mean that suppliers are exploited, perhaps to the point where customers' behaviour becomes unethical.

Trade credit therefore represents a significant area of risk, both to individual firms and to the wider economy. Because of the economic significance of UK SMEs – they account for nearly 60% of all jobs and GDP in the UK (BIS 2011) – their working capital management practices can have repercussions at a macroeconomic level (Chittenden and Bragg 1997). Despite its size and risk significance, this virtually unregulated and largely informal financial market has grown organically and has low visibility. The large number of both suppliers and customers operating under a diverse range of arrangements exacerbates market complexity (Paul and Boden 2008).

Because of tight cash positions and/or competitive pressures, SMEs are particularly reliant on the use of trade credit to attract customers and ensure liquidity (Paul 2010). In times of recession in particular, 'small businesses bear the brunt of the credit squeeze' (Wilson 2008) and in the current economic circumstances SMEs may have to offer even more generous credit terms to win business, further increasing their risk exposure.

The combination of high reliance on trade credit and the central place that this occupies in the cash conversion cycle means that SMEs are particularly vulnerable when trade credit goes wrong and customers either pay late or default entirely. Such risk factors are exacerbated by the fact that an SME may not have a suitably sophisticated capacity to manage trade credit well, in terms of either numbers of specialised staff or their expertise. And, because they may have a weaker market position, SMEs may be poorly situated to negotiate optimal trade credit deals. These factors – reliance on trade credit, the centrality of trade credit to the cash conversion cycle, deficiencies in skills or capacity, and a weaker market position – may all combine to make trade credit a particularly risky area for SMEs.

The problem of the vulnerability of SMEs to late payment or non-payment of trade credit has been addressed by a variety of policy measures, including statutory provisions such as late payment interest laws, self-regulation such as codes of conduct, and business support in the form of enhanced training for SMEs. The current scale of trade indebtedness to SMEs suggests that these measures have had only limited impact. The European Commission reported in 2009 that SMEs had twice as many trade debtors as large businesses and they granted, or 'rather [were] forced to grant' an interest-free loan of £29 billion to their counterparts (European Commission 2009). Similarly, BACS has revealed that UK SMEs were owed £33.6 billion by November 2011 (BBC News 2011).

We have described trade credit elsewhere (Paul and Boden 2008) as a 'Cinderella subject' for research – that is, an issue whose importance is not fully appreciated. This may be because it does not sit 'neatly' within any core disciplinary research area and is relatively neglected by researchers, accounting academics in particular. Consequently, trade credit, especially with regard to

SMEs, has not received the attention it really deserves given its micro- and macroeconomic significance.

Much of the work that has been done on trade credit tends to be positivistic, concentrating, albeit usefully, on collecting largely quantitative data relating to the size and extent of trade credit practices. Such work is excellent for answering 'what?' questions, but yields little understanding as to 'why?' That is, such data and knowledge cannot adequately explain the operation of trade credit as a business practice or set of relationships – what works and why, what goes wrong and where, and how these risks can be mitigated. One of the premises of the research reported here is that this relative absence of nuanced understanding of the 'communities of practice' (Lave and Wenger 1998) around trade credit means that attempts to resolve the problems of late payment and default, whether by statutory, self-regulatory or business support means, are destined to be insufficiently informed and effective.

This study therefore took a different and more critical approach, exploring the complex array of interlocking factors that constitute real-life trade credit arrangements and relationships in order to develop a rich picture of why they are as they are. The aim was to mitigate the lack of detailed and nuanced understanding, in the research literature, of actual factors in the relationships between SMEs and customers, especially the larger ones, which undermine the effective bargaining position of the smaller partners.

In addressing such questions it is tempting to follow dominant thinking and to assume that relative customer–supplier size is the sole determining factor of the nature of trade credit relationships. It may be that such assumptions are grounded in the nature of the quantitative data collected by much research to date: relative firm size is an easy thing to capture in quantitative data. Indeed, simple size may matter, but this, we reasoned at the start of this project, was unlikely to be the end of the story. The issue of the imbalance in size needs to be nuanced in the light of other factors such as the nature, structure and historical practices of the market in which the trading occurs and the supplier's position within that; the nature of the particular products or services supplied and their importance in the supply chain; and the relative skills, capacities and competences of the supplier in handling trade credit issues.

Accordingly, the aim of this project was to identify, in the UK context, the factors that influence the late payment of trade debt to SMEs by larger firms and, using the insights gained, to consider how late payment problems might be mitigated. To do this, respondents were asked three key questions. First, how are trade credit arrangements actually negotiated between SMEs and their larger customers? Secondly, how are they managed? Thirdly, what information is exchanged and on what basis? The aim here was develop a rich picture from qualitative data of actual practices and the reasons for them. This, as far as can be ascertained, has not hitherto been systematically undertaken in the UK or possibly elsewhere.

The second aim was to explore the extent to which these actual practices of SMEs were consistent with the largely normative, rational theories that seek to explain trade credit. It is important, further, to be able to explain the reasons for any divergence between theory and practice, so that each can inform the other. In particular, this investigation of practice and its relationship to theory should extend and develop the theoretical understanding of this very varied business activity.

The third aim was to explore the actual effectiveness of current measures to tackle late payment problems, be they statutory, regulatory or related to skills training and, beyond that, to address the reasons why such measures might not be entirely effective and to consider how their efficacy might be improved. Thus, this project had at its heart a very real agenda of providing new research insights that could assist in the development of new policies and practices to mitigate late payment problems.

The rest of this report is structured as follows. Chapter 2 provides a brief review of the literature on trade credit from the academic, policy and business professional domains. Chapter 3 explains how this study was structured and undertaken and gives basic demographic information about the respondents. This research work enabled the development of a simple model that assisted analysis of the data generated. This is presented and explained in Chapter 4. Chapters 5, 6 and 7 set out data and analysis relating to the three major elements in that model – the external business environment, the suppliers of trade credit, and the users of trade credit, respectively. Chapter 8 pulls all the data and analysis together and identifies reasons why trade credit relationships may fail, resulting in late payment. This is followed by a short summary in which a new approach to dealing with late payment is proposed.

2. Trade credit – the story so far

Much of the existing academic research on trade credit is in the quantitative and positivistic tradition – it seeks to identify and quantify the extent of trade credit. On the basis of such findings, and using neoclassical economic assumptions, this literature asserts the beneficial potentialities of trade credit for both suppliers and customers. This chapter illustrates what is known about trade credit from previous research and sets out existing theorisations about its use.

2.1 WHAT IS TRADE CREDIT?

The word 'credit' takes its origin from the Latin verb *crédere*, meaning to believe or trust. So trade credit means, literally, to have trust that a promise or contract between two parties will be honoured as agreed. Thus, if sellers supply goods or services and allow a specified or non-specified time to elapse between delivery and payment, they are granting trade credit and trusting that the customer will honour the contract. Problematically, customers do not always honour their promises: they may delay payment beyond what is agreed or acceptable to the supplier, or even default.

Granting trade credit creates a current asset that has to be financed by the supplier. This may be done through internally held cash resources, debt-finance or trade credit from their own suppliers further upstream in the supply chain (Paul and Guermat 2009). Customers may well appreciate the economic value of trade credit as a source of finance and use it to fund their purchases in whole or in part. Tesco, the major UK supermarket chain, operates a business policy of selling goods supplied to it significantly in advance of meeting its trade credit liabilities. Thus, some customers may be able to finance their entire inventory at the expense of their suppliers. When bank lending to firms is in short supply, as it is currently in the UK, trade credit may be seen as an attractive substitute for other, more formal, forms of financing (Atanasova and Wilson 2003). Of course, firms may simultaneously buy and sell on credit, making them both trade credit borrowers and lenders. This may significantly complicate the treasury management of their net credit position. Both trade debtors and trade creditors should be managed as part of the overall working capital management; both can have a direct impact on a company's cash situation, affecting profitability, liquidity and solvency.

2.2 SIZE AND SIGNIFICANCE OF TRADE CREDIT IN THE UK

On average, trade credit accounts for 30% to 40% of most firms' total assets (Paul and Wilson 2006; Wilson and Summers 2002). Similarly, Wilson reports that, in the UK, 'stocks and flows of trade credit are typically twice the size of those for bank credit' (Wilson 2008:20) and limited companies' debtors exceed £53 billion, constituting up to 45% of their total assets (or 65% of current assets). Such extensive use magnifies the inherent risks of late payment or default associated with trade credit. Risks to SMEs may be commensurately greater, as they tend to have fewer cash resources with which to defend themselves from such exposure.

2.3 THE REASONS FOR GRANTING TRADE CREDIT

The level of risk inherent in trade credit, especially for SMEs, begs the question as to why it is used so extensively. Theory offers a number of possible explanations (for a more extensive discussion on this, see Paul and Boden 2008).

For many firms, especially SMEs, survival and prosperity depend on whether they have the capacity to stay competitive by retaining their existing customers and attracting new ones, and trade credit is one of the available tools to help achieve target sales. Suppliers may offer financially advantageous credit terms, which can assist customers and thereby help to build long-term and sustainable relationships (Petersen and Rajan 1994; Ng et al. 1999; Wilson and Summers 2002;). Hence, trade credit may be an important element of pricing policy.

Authors such as Schwartz and Whitcomb (1978) and Lee and Stowe (1993) argue that the motivations to grant trade credit go beyond this because non-financial firms are not in the business of providing finance to their customers, but of selling them goods and services. Theories based on research findings suggest that there is a complex array of reasons for the existence of trade credit, including: market imperfection/asymmetric information, transaction costs, price discrimination, and finance. Each set of theories is discussed in turn below

Asymmetric information theory

Sales and purchases between firms frequently involve complex decisions, encompassing such considerations as logistics, supply chain management and security, pricing, capital and other commitments, technical and other investments and so forth. For instance, a commitment to a major new customer may involve capital outlay to produce customised goods, or the abandonment of other customers deemed less profitable or otherwise desirable. Suppliers' uncertainty over customers' creditworthiness and financial health adversely affects their ability to make reliable selling decisions (Smith 1987; Lee and Stowe 1993). Likewise, when buyers face uncertainty about prospective suppliers or their products, they cannot confidently make the best purchasing decisions (Long et al. 1993; Pike and Cheng 1996).

Trade credit can be used to mitigate such information asymmetries because it can give buyers sufficient time to investigate and assess the quality of the product and its value for money, paying if and when they are satisfied (Smith 1987). In a competitive market, buyers might select suppliers who offer credit because this signals sellers' confidence in the quality their products or services. Trade credit can therefore be seen as an implicit guarantee of product quality (Long et al. 1993; Lee and Stowe 1993).

Conversely, by using trade credit, suppliers can gather valuable information about customers' financial health by monitoring payment patterns (especially around issues such as the uptake of discounts for early payment) (Ng et al.1999). Suppliers can also use credit periods to signal high and consistent product quality or long-term presence (Petersen and Rajan 1997; Paul 2010).

Transaction costs theory

Combining the supply of goods and finance from one source can generate cost advantages by reducing transaction costs (Mian and Smith 1992). Further, when transactions take place on credit, the timing of payments is more controllable, enabling firms to improve their cash-flow forecasts and simplify cash management, thus reducing costs. Better knowledge of customers' behaviour gained from experience leads to more accurate forecasts, reducing the need to carry large amounts of cash, and consequently decreasing the cost of holding precautionary cash balances (Pike and Cheng 2001). The financial unpredictability that can exist in cash-based businesses, which may be due to temporal fluctuations in sales, can be reduced through more prudent use of trade credit. According to the terms offered, suppliers may have a better idea about exactly when customers are likely to settle their bills (Schwartz 1974; Ferris 1981; Smith 1987). For customers, accumulating bills from one supplier and paying them simultaneously reduces transaction costs.

Price discrimination theory

Sellers may want to vary their overall prices from time to time to meet fluctuating demand. Suppliers can manipulate product price much more easily through varying the credit terms offered to different customers than they can through straightforward open price alone (Meltzer 1960; Schwartz and Whitcomb 1978; Mian and Smith 1992; Petersen and Rajan 1997).

Even more subtly, there is a difference between offering credit terms and actually enforcing them. Suppliers may, on a discretionary basis, allow a customer to pay after the agreed date without a penalty, or they may vary their two-part terms (a discount for early payment) and offer higher discount rates to selected customers or even allow them to take an unearned discount (Schwartz and Whitcomb 1978). Thus, giving longer credit than that agreed or increasing the discount rate offered is effectively the same as reducing the price of a product or service. In such circumstances, trade credit can be seen as a purposive element of companies' pricing policies.

Finally, trade credit can permit the pricing of products on a risk basis. That is, all customers may be offered the same price, but credit terms may be used to discriminate between customers depending on the perceived level of risk that they represent (Schwartz 1974; Crawford 1992; Petersen and Rajan 1994, 1997).

Financing theory

When non-financial firms offer credit they play an intermediary role, obviating the need for buyers either to use their own money or to obtain finance from their banks to pay for their purchases. Customers' buying power may not be evenly distributed, owing to firm size, reputation, the nature of their assets and of their product, high financial costs and so on (Wilson and Summers 2002). Customers rationed by financial institutions tend to turn to trade credit as a generally cheaper way of accessing short-term funds (Paul 2010).

Consequently, financially sound suppliers who have relatively easy access to external funds tend to play such intermediary roles, financing their customers' stock through trade credit (Schwartz 1974). Trade credit can therefore work as a facilitative process in that firms that are able to borrow do so and pass on the benefit to those that do not have access to funds in the same way (Emery 1984, 1988; Chant and Walker 1988; Elliehausen and Wolken 1993; Petersen and Rajan 1997).

Existing research therefore suggests four principal advantages of trade credit, explaining its use. First, it can ease information asymmetries in situations where buying and selling can be fraught with deficits in knowledge about the other party. Second, it can facilitate efficient treasury management, allowing more cost-effective handling of cash flows for both suppliers and customers. Third, it can be an effective yet subtle way of changing prices and, importantly, discriminating between customers without signalling anything to markets. And finally, trade credit can ease finance flows in specific sectors. These factors together give some indication of why trade credit might be a valuable tool for business. Nonetheless, as will be explained later in this chapter, these theories may well not constitute a comprehensive explanation for the existence and extent of use of trade credit. Rather, they might, to some extent, be seen as *ex post* rationalisations of practice.

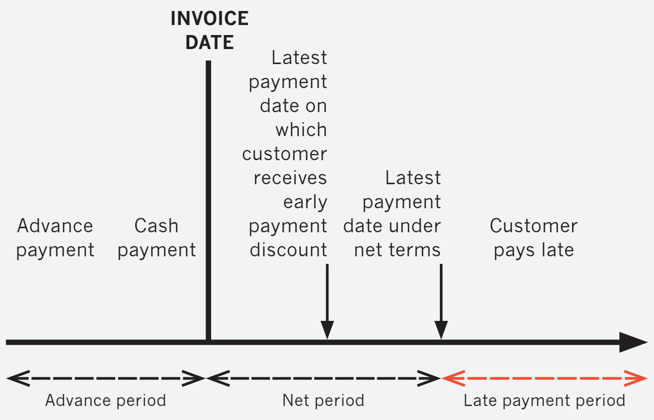
2.4 LATE PAYMENT AND SMES

For most firms, especially smaller ones, extending trade credit can, in theory at least, be an important strategic or competitive tool, playing a role in capturing new business, building supplier–customer relationships, signalling product quality, reputation and financial health, and in price competition and price discrimination (Paul and Boden 2008). Having explained how and why, in theory at least, trade credit works and the reasons posited for its use, we turn now to the question of late payment.

Late payment has two aspects. First, and most obviously, it is the situation that arises when the terms of the trade credit agreement are breached and payment is delayed beyond the agreed date or there is a partial or complete default. There is also a second and more subtle aspect: when power asymmetries are such that the terms of the trade credit agreement unfairly disadvantage the supplier. Thus, large customers might be technically in compliance with prompt payment codes, in that they pay by the agreed date, but that agreed date might be one which has been set as a result of their unfair power advantage. This is arguably, in effect, late payment because the terms set reflect power imbalances and cannot be assumed to be optimal or even ethical. Unfortunately, neither research nor policy to date have been successful in tackling this second aspect of late payment.

The determination of payment dates is illustrated in Figure 2.1. This shows the relationship between credit terms and time.

Figure 2.1: Credit terms scheme



Source: Wilson et al. 1996

SMEs make up 99.9% of all UK enterprises, of which 99.3% are small businesses (that is, they have between 1 and 49 employees). These SMEs make a big contribution to the economy. The most recent official statistics (BIS 2011) show that SMEs provide around 59.2% of jobs in the private sector and represent around 48.7% of private sector turnover – in 2010 this was £1,562 billion, a significant proportion of which was on credit.

For such smaller firms, financing, supplying and managing trade credit can cause particularly serious cash-flow and other funding difficulties. Late payment of commercial debt has often been cited as a factor that precipitates financial distress and/or constrains growth among smaller firms in particular (CMRC 2003). For firms with weak bargaining positions, enforcing credit terms can be a particular problem (Paul and Boden 2011).

SMEs may find the cost of financing, monitoring, chasing, collecting or writing off bad debts unaffordable (Paul 2007). A survey conducted by Barclays (Barclays Local Business 2008) shows that the time spent chasing late payers constituted 'more than four million wasted working hours or 544,640 wasted working days' in 2008. In 2007 the credit agency Experian examined 435,000 companies and found that the late payment problem had hit a new high, with large firms 'now taking 81.5 days to pay their bills (against 78.5 in 2003), 21.2 days more than small companies' (Experian website). In similar vein, the Forum of Private Business (website) argues that 'it seems to be almost endemic that the SMEs will have to wait for large customers to pay them' and reported that, in 2008, 88% of small firms claimed that the worst payers are large businesses.

Such common difficulties are likely to be exacerbated in times of recession and especially when bank credit is in short supply (Wilson 2008). For some businesses, trade credit is the only way to access short-term finance and it is often found to be 'crucial for firms that are running out of bank credit' (Burkart et al. 2006). In the current period of financial distress, SMEs may have to offer even more generous credit terms to win business and, as sales stagnate, their larger suppliers tend to delay payments for as long as they can get away with it. With banks curtailing credit lines to many firms, customers are turning to trade credit as a readily available source of funds, putting off payment for as long as possible. Although trade credit may alleviate short-term funding difficulties for customers, it may also create casualties among the SMEs that are the bedrock of the economy.

Indeed, the magnitude of current late payment and default issues appears to be severe. Paul (2010) shows that 77% of companies in her sample paid up to two weeks late and over 40% of larger firms always paid late. Peel and Wilson (1996) claim that around 66% of the slowest payers are large businesses and Pike and Cheng (2001: 1017) report that 'often the guilty parties are alleged to be large, ruthless companies, unsympathetic to the financial pressures on smaller suppliers and customers'. The Institute of Directors reports that '95% of all those experiencing worsening payment flows are having these issues with large and medium-size businesses' (website). In a 2011 report, the Federation of Small Businesses reports that 4,000 small businesses had collapsed because of late payment (FSB 2011). In 2008, the Credit Management Research Centre at Leeds University showed that the number of county court cases involving companies chasing overdue debts had risen sharply and that:

> *firms are under pressure…given that the majority of businesses in the UK are small to medium enterprises which are already struggling with tighter bank lending policies, the prospects for a significant rise in corporate insolvencies is now a reality as the late payment of commercial debt continues to increase.* (CMRC 2011).

Thus, the common UK habit of paying suppliers late in order to improve customers' working capital positions can be seen as inefficient, detrimental to SMEs and potentially extremely costly for the economy as a whole.

2.5 TACKLING THE PROBLEMS

Attempts have been made to tackle actual (as distinguished from effective) late payment in the UK by a variety of statutory and self-regulatory measures. Arrangements have also been made to provide enhanced training for SMEs on how to manage trade credit effectively (Paul and Wilson 2006). Legislative provisions to combat non-payment/late payment include statutory interest under the Late Payment of Commercial Debts (Interest) Act 1998, amended in 2000 and 2002; and the European Union Directive 2000/35/EC. This EU Directive will be replaced with new measures in 2013, covering not just business-to-business transactions but also business-to-government dealings – governmental organisations are reported to be the worst payers in Europe (European Commission website 2009). These pieces of legislation give suppliers the legal right to collect interest at fairly punitive rates on trade debts paid late.

Self-regulatory measures include voluntary codes of conduct. The most recent of these is a Prompt Payment Code, administered by the Institute for Credit Management on behalf of the Department for Business, Innovation and Skills (Prompt Payment Code 2011). Such self-regulatory devices attempt to alter the behaviour of larger customers by eliciting public commitments to ethical and fair behaviour.

Finally, there have been a variety of schemes that aim to provide enhanced training for SMEs in handling trade credit. The Institute for Credit Management has been active here, and a number of higher education institutions now include trade credit in their curricula. Even so, trade credit remains largely absent from the syllabuses of professional accountancy training.

The size of the late payment and default problem in the UK suggests that these measures have proved quite ineffective (Paul and Boden 2011), although, of course, the counterfactual is unknown. It is known, however, that firms that sign up to a code do not pay faster than those who do not sign up, including firms that are listed on the well-known ethical index FTSE4Good (Cowton and San-Jose 2009). In similar vein, use of statutory interest provisions appears to be at very low levels; Paul (2010) reports that nearly 75% of respondents never or rarely charge interest on late payment and only 38% make their customers aware of their rights to charge interest when communicating their credit terms and conditions.

Measures that attempt to mitigate the worst effects of late or non-payment may be largely ineffective because SMEs, being the weaker partners in the supply chain, are unable to exercise their statutory rights or enforce codes of conduct (Paul and Boden 2011). Or it might be that they are simply unable, for a variety of factors, to manage their trade credit effectively.

The problems created by trade credit for SMEs, and the very real risks that it poses to their profitability and existence, suggest that it is not working as the existing theories, outlined above, suggest. Late payment of trade debts is associated, inter alia, with the relative power positions of suppliers and customers, especially where the customer is in a monopolistic or oligopolistic position (Paul and Wilson 2006). That is, large dominant customers generally exert greater power over smaller suppliers in very competitive input markets. The existence of such behaviour cuts across theoretical models, which suggest that firms have a mutual self-interest in cooperating on trade credit rather than attempting to 'do each other down'. Plainly, there is something else going on here, yet in the research literature there is a lack of detailed and nuanced understanding of actual factors in the relationships between SMEs and their larger customers that may undermine the effective bargaining position of the smaller partners.

Current financial conditions and the significance of trade credit for individual SME performance and the wider economy suggest that there is a significant policy need for better-informed research to address these issues. Better understanding of the processes of negotiating and managing trade credit could help SMEs to engage with it more effectively.

2.6 LIMITATIONS OF PREVIOUS RESEARCH

Research on trade credit to date has been primarily quantitative and not extensive (Ng et al. 1999; Paul and Wilson 2006; Paul and Boden 2008).

One cause of this neglect, both in terms of research focus and commercially, is that trade credit does not coincide precisely with any specific academic or management expertise domain. Rather, it encompasses financial accounting, financial management, management accounting and indeed treasury functions generally (Paul and Boden 2008).

Current research-based knowledge on trade credit is, in the main, predicated on two types of theory and evidence, often used in tandem. First, there is a body of positivistic evidence collated from firms' responses to questionnaires. This is factual and almost exclusively quantitative. It can be used to paint very detailed pictures of the amount of trade credit and its relative distribution. On the other hand, it can reveal little about why such patterns exist, and only a limited amount about what their consequences are.

Second, there are normative assumptions about firms' behaviour, generally based on neoclassical economics, which are used to interrogate and explain such quantitative data. Because of the limited nature of the quantitative data and the normative assumptions on which the theory is based, the insights derived are useful but are unlikely to be able to provide a truly comprehensive understanding (Paul and Boden 2008). In particular, these data and the theories built around them tend to conclude that trade credit is not used optimally by suppliers – that in some sense they are 'failing'. It can provide no insights as to why this theoretical potential of trade credit is not consistently realised.

Schaeffer (2002: ix) argues that trade 'credit is part science, part art, and part gut-feel. The trick is to get the right mix'. This suggests that there are extensive human and social interactive factors at work in trade credit – subjective factors that are not accessible via the existing research and theorisations. This lacuna in understanding is potentially problematic because what little knowledge is available has come to inform policy, statutory provisions and professionals' practice.

3. Methodology of the study

The gap in understanding identified in the conclusion to Chapter 2 prompted us to design our project to collect qualitative data and, employing rigorous analysis, to offer the prospect of an enhanced understanding of trade credit practice. The study sought to investigate detailed descriptions of trade credit through 'thick description' and thereby aid the development of evidence-based policy and practice in the area.

In particular, it is important to recognise the nature of the relationships within and between suppliers and customers, how these are acted out and what power balances are at play. How do structural factors (such as sector, product, etc), expertise, experience, knowledge, and perception of market position, affect trade credit practices?

This chapter explains the qualitative approach taken to the research questions and the precise methods, a series of semi-structured interviews, used to collect data. It then gives details of the sample of interview respondents and outlines the analytical approach and the themes used to interrogate the data.

3.1 RESEARCH APPROACH

As explained above, most research on trade credit to date investigates meta-level patterns by means of large-scale quantitative surveys (Paul and Boden 2008). While excellent at mapping current and quantifiable situations and trends, such approaches have only weak potential for explaining why such patterns exist and, indeed, the seeming failure of regulatory measures to mitigate late payment. Indeed, as is also explained above, such approaches may lead to rationalisations of the propensity of firms to offer trade credit that are based on normative heterodox economic arguments, rather than being evidence-based in a more grounded way. Such explanations may therefore be misleading if used in isolation.

In contrast, the qualitative approach for this project helped to capture the rich texture of the 'part science, part art, and part gut-feel' (Schaeffer 2002: ix) that constitutes trade credit. Qualitative data, arguably, allows one to understand the social, human, organisational and interactive factors that determine actual trade credit practice. The interview method for collecting the information needed to answer the research questions allows access to deeper understandings not only of policies and practices, structure and organisation but also of underpinning behaviour, attitudes, negotiations and relationships. So, unlike quantitative data, information acquired from direct interaction with the respondents involves interpretative techniques that translate terms by their meaning, not their frequency.

A primary goal in producing such a rich picture of actual practice is to inform policymakers seeking to make evidence-based policy. This requires a detailed and rich qualitative picture of the ways in which trade credit arrangements are actually negotiated and managed by firms. This would help to shed light on why rational theories of larger trade debtor behaviour have only a weak explanatory power, as well as why current regulatory regimes have not been effective. This may help in the further development of strategies and policies to deal with the problems that trade credit can cause. Although this study is UK-based, proving this approach should enable its use in different socio-economic settings.

3.2 METHOD

The data for this project were collected via a series of interviews with relevant individuals within a range of SMEs and larger companies, details of which are provided below. As we were investigating the relationships, primarily, between SME suppliers and their larger customers, it was important to capture both partners' stories. In the larger firms, the respondents were generally dedicated trade credit managers or controllers. In SMEs they tended to vary from credit managers or controllers to the owner-managers themselves, in the case of some micro-firms. That said, and as is made clear below, data were also collected on how suppliers and customers behaved when the trade credit supply role was reversed (that is, for instance, when suppliers also took credit themselves).

Participants were recruited via a process of snowball sampling (Heckathorn 2002). That is, our contacts and networks were asked to invite participants, who were then asked to nominate further, suitable individuals. The initial respondents were extremely willing and helpful in arranging contact with further potential respondents within their professional networks.

The primary contact route was through the Institute of Credit Management (ICM), the professional body for credit managers in the UK. Additionally, members of the

European Credit Professionals were contacted and recruited.

While there were no difficulties in recruiting the necessary numbers of respondents, this method made it much easier to identify suitable individuals to approach for interview in larger firms because SMEs tend to have less substantial networks of contacts around this issue: SMEs are less likely to employ credit management professionals. This points to a very real need to ensure that the 'unheard voices' of SMEs, the majority of UK firms, are listened to and understood, and that the knowledge gained is translated into effective action.

One-off semi-structured interviews of between one and two hours were held with each of these respondents. Most of these were face-to-face, some by phone. The interview topic lists (one for larger firms and one for SMEs), which were piloted during the first five interviews and then refined, explored:

- basic firm demographics (size, market position, sector attributes and practices regarding trade credit, organisation of the trade credit function, etc).
- the strategic use made of trade credit (if any)
- the firm's attitudes and approaches towards, and issues with, trade credit negotiation and management
- the extent and nature of late or non-payment problems experienced by the respondent firm
- late payment policy implementation
- the firm's understanding of business ethics in this context
- the firm's own payment behaviour (whether an SME or a larger firm)
- the effect of relative market position on firms' ability to exercise desired trade credit management approaches
- firms' views on current theories of trade credit
- respondents' perceptions of the efficacy of current statutory and self-regulatory arrangements.

Beyond the topic list, respondents were encouraged to discuss other aspects that they thought were important, relevant to their sector and/or of interest to their specific case. Any issues that emerged from the discussion (and not included in the original topic list) were incorporated into subsequent interviews when judged to be relevant. A good example here is the issue of staged payments on large projects undertaken by construction companies. Thus the research was to some extent guided by the interests, concerns and expertise of the respondents.

All respondents and their firms were guaranteed complete anonymity. The research was conducted under a strict ethics protocol. This may have contributed to a quite remarkable degree of frank disclosure by the interviewees, who were very cooperative and open about issues that otherwise would be confidential to their companies. Indeed, there was almost universal enthusiasm for the subject by respondents, who appeared to find it a relief that their views and experiences were being heeded. This confirmed the initial premise that there was 'more of a story' to trade credit than that revealed by the existing positivistic quantitative research.

The researchers' own impact on research participants must be acknowledged. One of the benefits of qualitative research of this type is the development of a relationship between the researcher and respondents. Arguably, interviewees responded positively to the interviewers' involvement, enthusiasm and expertise in trade credit. This meant that interviewees 'opened up' and engaged in lively discussion, debate and reflection. The majority of the participants reported that the interview process made them think about credit management in general in a different way and, in turn, this enabled the issues to be viewed through a much wider lens.

Following the interview stage, initial findings from the project were presented at a specially organised event to which all respondents were invited, at the ACCA headquarters in London. The presentation was followed by a sustained discussion among the participants and ourselves as researchers and led to further valuable insights that have informed the drafting of this final report.

Consequently, this qualitative data collection approach arguably yielded a depth of understanding of many aspects of trade credit management and processes. It maps factual empirical data on the firms' trade credit performance and management with the firms' own narratives of their experiences, problems and issues. This allows interrogation of those aspects of the power relations and practices of SMEs and their larger customers that cause late payment problems and, consequently, the finding of suitable possible solutions.

3.3 SAMPLE

The sample of interviewees was drawn from 15 SMEs that have larger customers and 25 larger firms that use SMEs as suppliers. This unequal sample size reflects the fact that it was generally easier to recruit larger firms. As this is a qualitative rather than a quantitative study, this imbalance is not viewed as problematic. There were 40 interviews in total, ceasing when the rate of return of new data began rapidly diminishing. Table 3.1 shows the number and sizes of the firms involved in the study.

Table 3.1: Profile of the respondents: size of companies classified by number of employees

Size (by number of employees	Number of companies	% of companies	Cumulative total
Micro (<10)	5	12.5	12.5
Small (10–49)	4	10.0	22.5
Medium (50–249)	6	15.0	37.5
Large (>249)	25	62.5	100
Total	40	100	100

The smallest SME had just one employee, while three of the larger firms each had around 10,000 employees. The original plan was to interview 15 SMEs and 15 large companies. In practice, one problem was that firms that claimed, or appeared, to be SMEs were in fact subsidiaries of large parents or members of significant groups. These were classified according to group size. In a sense this is a somewhat arbitrary process – both because these are not always helpful categorisations but also because smaller parts of larger groups may be able to exercise reasonable autonomy in areas such as the management of trade credit. In the end, and perhaps ironically, these size distinctions did not matter as much as we originally thought they might. As is explained in subsequent chapters, this project showed that the management of trade credit was also contingent upon a whole range of factors independent of size. No matter how large companies are, there are always others larger and more powerful than themselves – as one respondent put it, 'there is always a bigger fish in the sea'. This is not a concern, but a real insight into what goes on in the field.

As this was an initial study, it concentrated on a small number of sectors. Choice of these was determined, to some extent, by the nature of the snowball sampling technique adopted. Table 3.2 provides details of the sectors in which the 40 respondents were situated.

Table 3.2: Profile of the respondents: companies classified by sector

Sectors	Number of companies	% of companies
Services	10	25.0
Construction/building/engineering	13	32.5
IT/software	8	20.0
Food/drink distribution	4	10.0
Others (publishing, electronics, promotional goods, manufacturing/distribution)	5	12.5
Total	40	100

Nearly one-third of the interviewees belong to the construction sector. This sector, by its nature, has complex supply chain issues often involving long time periods. This generates very complex trade credit management needs in response to frequently intractable problems. The complex supply chain relationships meant that respondents in this sector were a very generative source of further contacts under the snowball sampling approach – this is an industry where credit managers network extensively with each other.

Originally, service sectors were specifically excluded as being too complex to deal with and as presenting markedly different characteristics from those of the suppliers of goods. In fact, after (by accident) we came across one service company, we realised that the information collected gave us an insight which, though different from that obtained from the goods-based sectors, was of great interest and utility in the study. For instance, what can a supplier do when an advertisement has been placed in a publication but the customer decides not to pay for this service because it was not what was required in terms of wording, timing, positioning, etc?

Information technology/software companies constituted the third biggest group of respondents, with eight interviews in total

3.4 ANALYSIS

All the interviews were taped, with the respondents' consent. These recordings were then transcribed to facilitate analysis. A manual two-stage analysis protocol was used for this.

First, the basic demographics of each firm were mapped in a single database. This included details of the company's name, size, sector, type of activities it is engaged in, size and nature of the credit function (its position in the company), credit terms and condition, whether or not the company has a credit policy and credit limit, and any particularities of the company.

Second, a manual thematic coding technique was applied to the transcripts themselves. This involved the initial identification of broad themes, derived from impressions gained from the interviews. The data from each transcript were manually coded, with cross-references entered on a grid with respondents on one axis and the themes on the other. Reading the transcripts and coding the themes allowed additional ones to emerge, which extended the code frame. That is, the data were allowed to 'speak for themselves'. This approach allowed us to get 'close' to the data. This technique reflects a standard method of qualitative data analysis for relatively small numbers of interviews. The eventual themes were divisible into two groups.

The first group relates to internal issues that were under effective control by respondent firms and that companies could control and quite possibly address themselves. These themes were as follows.

- Policies and practices among both those who extend and those who use trade credit: this included trade credit terms and credit decisions (number of days granted, credit limit, credit insurance, factors that influence credit terms and conditions, existence of credit policy) as well as policies on paying creditors.

- Perception of credit granting/use: this theme concerned issues such as whether trade credit was perceived as a financial or marketing tool, a way of building long-term relationships with customers or as a source of finance.

- Importance of the credit function: that is, the importance given to the credit function within the firm, including such matters as whether it was a standalone department/section or part of another department such as sales, finance or even marketing. This theme also covered such matters as full or partial trade credit outsourcing.

- Relationship between sales and credit staff: this theme included the possible conflicts of interest that can exist between the credit and the sales departments/sections and how these were resolved.

- Late payment issues: this included evidence of the extent of late payment, use of statutory interest, the profile of late payers, risk-assessment methods used and whether any analysis of the reasons for late payment was undertaken.

- The perceived added value of the trade credit function within supplier firms, especially among senior management.

The second group of themes relates to issues that were exogenous to the firms. These themes were as follows.

- Power position: this included the relative bargaining power position of SMEs vis-à-vis larger customers but size was not the only determining factor here.

- The effect of the current adverse economic climate.

- Regulatory environment: this theme explored the extent to which both suppliers and customers engaged with the regulatory environment, principally through use of either late-payment interest or codes of good practice.

- Sector characteristics: this theme concerned the extent to which there were sector norms or conditions that determined trade credit relationships.

We then mapped this thematic analysis against the company profiles to discern patterns/trends in experiences, paying particular attention to the dyadic nature of these business-to-business relationships. Thereafter, we compared actual practices within these relationships with theories about them from the existing, largely positivistic, literature in order to discern any deviations and seek explanations for these. An evaluation of the extent to which, current regulatory and/or management approaches to mitigating late payment problems are effective and why, was then undertaken.

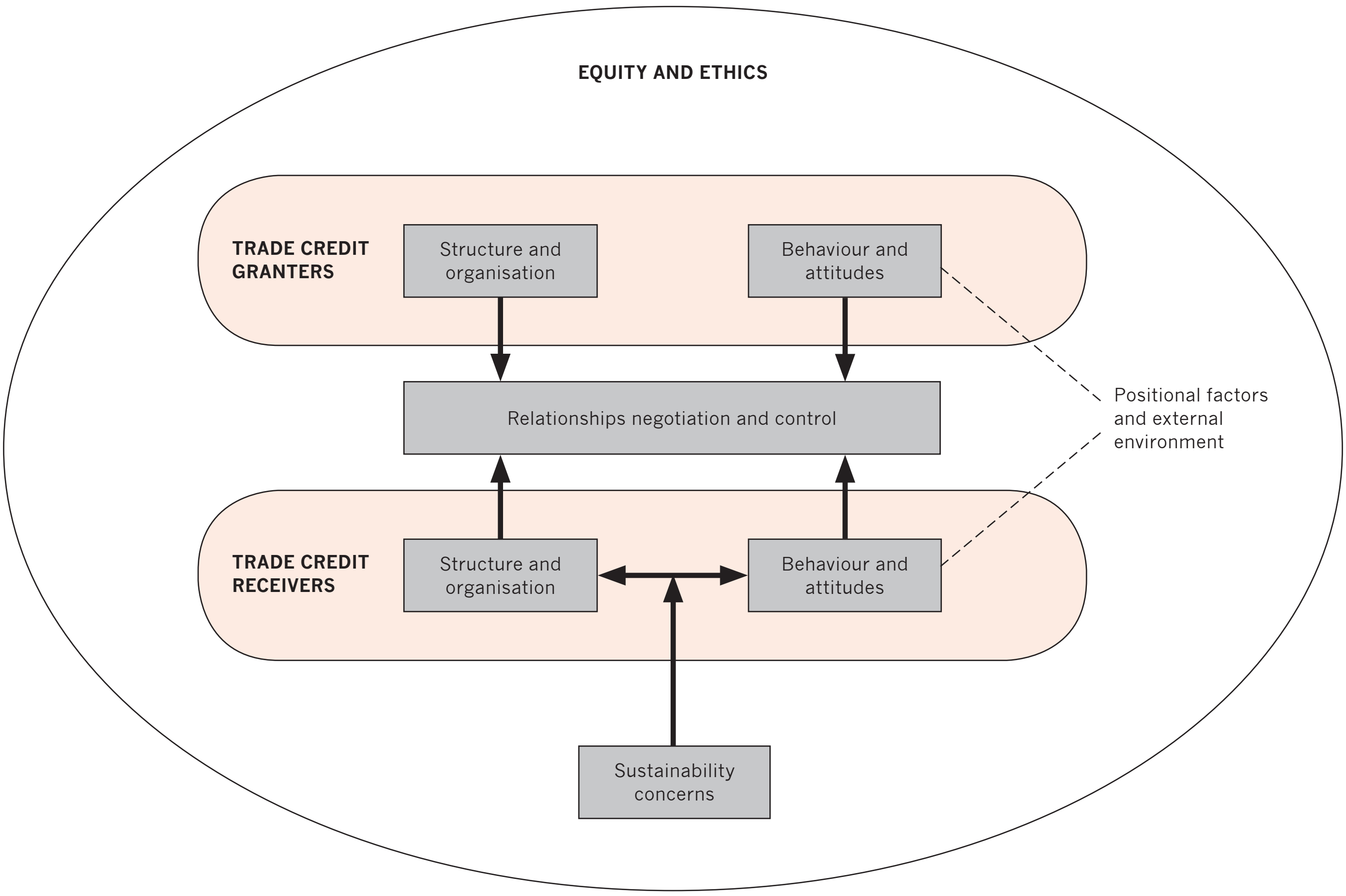
On the basis of these findings, we have then attempted to develop detailed guidance and recommendations for policymakers and SMEs as to how late payment problems might be mitigated.

4. A CONCEPTUAL ANALYTICAL MODEL

The initial analysis of the interview data led to the formulation of a model through which to conceptualise the relationships inherent to trade credit management. These relationships are represented diagrammatically in Figure 4.1. This conceptualisation allows a considered organisation and presentation of the analysis of the findings.

Informing this model are three factors that should arguably underpin mutually beneficial trade credit arrangements. These are: equity, ethics and sustainability.

Figure 4.1: A conceptual analytical model of trade credit relationships



First, with regard to equity, trade credit arrangements will be economically efficient, and therefore mutually beneficial, for suppliers and customers only if they are fair. That is, neither party to these relationships should engage in behaviour, activities or arrangements that exploit either their power-base or any weaknesses or disadvantageous position of the other side. This applies equally to customers and suppliers. Examples of unfair trading might include 'capturing' a supplier by becoming its dominant customer and then insisting on inequitable trade credit terms such as demanding longer payment periods, knowing that a captive supplier will have little option but to comply, even if this is to its detriment.

Second, relationships should be ethically founded. This is clearly related to equity – firms on either side of the relationship need to behave with propriety, for instance, by honouring payment arrangements unless they literally cannot. The ability to be 'an awkward customer' should not lead to unethical behaviour.

Finally, sustainability means that trade credit arrangements must be constructed and conducted in such a way that they do not compromise the capacity of either party to continue as a going concern, or the ability of the business relationship to endure.

Within this framework of equity, ethical behaviour and sustainability, a three-step process was used to examine trade credit relationships through: external environment, intra-firm characteristics and inter-firm relationships.

4.1 EXTERNAL ENVIRONMENT

In looking at the external environment in which such firms operate, factors were considered that might shape the demand for and the supply of trade credit, and its qualities and characteristics. Three parameters are of particular interest in this environment. First, there are sector-specific characteristics that might affect the organisation and conduct of trade credit. Research evidence points to the influence of such specific habits or routines on trade credit outcomes (Fisman and Love 2003). For instance, some sectors (such as construction) have long production times and complex value chains.

A second important aspect of the external environment is the existence of any statutory or self-regulatory regimes designed to control or affect trade credit practice. Of interest here are the ways in which such measures are perceived to influence trade credit practices, especially in any sector-specific ways.

The third interesting aspect of the external environment is the macroeconomic factors, especially during the current 'credit-squeeze'. This is because of evidence in the literature of the use of trade credit as a substitute source of finance during periods of restricted bank lending (Schwartz 1974; Atanasova and Wilson 2003; Fisman and Love 2003).

4.2 INTRA-FIRM CHARACTERISTICS

This research covered two aspects of the internal organisation of both suppliers and recipients of trade credit. The first was the need to map and analyse the internal structural or organisational arrangements that were put in place either for the control of trade credit or for paying debts. The reasons for this are that firms exhibit extremely heterogeneous arrangements with regard to trade credit. The research evidence to date suggests that certain forms of structure and organisation are more effective than others in achieving desirable trade credit practices (Mian and Smith 1992; Smith and Schnucker 1993; Ng et al. 1999; Wilson and Summers 2002; Paul 2010). Therefore, there is existing evidence that such characteristics are important and we wanted to document and analyse these.

Of interest in such organisational arrangements are the size, expertise and hierarchical position of the trade credit function, and these issues raise the following questions.

- Was there a trade credit department and how much staff resource was devoted to trade credit?
- What expertise did staff dealing with trade credit have and were they trained for this work?
- Perhaps most crucially, where did the trade credit function 'sit' with the firm – was it relegated to a low-status back-end activity or was it, at the other extreme, a high-profile strategic function?
- What arrangements did the users of trade credit make for the appropriate payment of trade debts and what did this reflect about their attitudes to suppliers?

Second, alongside structures and organisational arrangements, this qualitative approach gave us the opportunity to explore respondents' attitudes towards and behaviours around trade credit – business outcomes are, of course, contingent upon far more than formal organisational arrangements. That is, beyond formal arrangements and policies, we wanted to interrogate how people did their jobs, and with what sort of thinking, and how these factors affected trade credit outcomes. Of special interest here was how those responsible for trade credit interacted with their colleagues, and how this affected their capacity to be effective within the organisation.

The next step was to bring these structures/organisational arrangements and behaviours and attitudes together. We were especially interested in how less-than-optimal organisational factors or behaviours might be overcome by individual actions and practices or the strength of formal arrangements. This produced, for both trade credit suppliers and their customers, a rich picture of the condition they were in when entering the trade credit field.

4.3 INTER-FIRM RELATIONSHIPS

Finally, having mapped how both suppliers and users of trade credit are organised and behave, we then examined how these partners interacted in their trade credit relationships. That is, we were interested in how all these intra-firm aspects of both suppliers and users combined in negotiated relationships – how was trade credit controlled and agreed? This aspect is pivotal.

4.4 SUMMARY

The model provides the basis for a framework of analysis of the qualitative data and group discussion results. In the remainder of this report this model is used to set out the analysis and findings in four principal chapters. Chapter 5, which follows this, discusses the external environment. Chapter 6 looks at the suppliers of trade credit, while Chapter 7 addresses those customers who make use of it. Chapter 8 brings all this together and discusses the relationships between suppliers and users. This is followed, in Chapter 9, by a discussion of the way forward.

5. The external environment

This chapter looks at the first part of the conceptual model – the external environment that affects and shapes trade credit practices. Three key factors were discernible: sector-specific characteristics, statutory or self-regulatory regimes designed to control or affect trade credit practice, and macroeconomic factors, especially the current credit squeeze. Each of these is discussed below.

5.1 SECTOR-SPECIFIC CHARACTERISTICS

The sample was divided between firms in construction/building/engineering (13 firms); services (10 firms), information technology/software (8 firms) and food/drink distribution (4 firms).The remaining five firms were spread across publishing, electronics, promotional goods, and manufacturing/distribution.

The construction sector was particularly interesting because it tends to deal in specific contracts tailored towards customers' requirements. This means that trade credit arrangements have to reflect that. With the sizeable and long-term commitments implied by major construction contracts, staged payments tend to be used. The work needs to be certified by an architect (usually) before the payment can be released. Because of the nature of the contracts, one trade credit manager explained, suppliers tend 'to operate unofficially on a pay-when-paid clause, which is double the risk' – the supplier becomes exposed to upstream supply chain risk; that is, its customers have to be paid before the supplier can receive any cash. This makes the construction industry particularly vulnerable to domino-effect collapse of payment chains. These constraints and the long timescales of construction projects mean that while most other industries cite 30 days as the credit norm (even if they do not adhere to this), most construction companies cite 60 days as the norm. As one respondent put it, 'we measure ourselves in line with the industry rather than in line with our terms'.

The service sector respondents also displayed interesting characteristics. Once a service has been provided on credit, if customers delay payment or default, it can be very complicated if not impossible to retrieve the service, solve disputes or even prove, in some instances, that the customer was at fault. Companies in this sector claimed that they were particularly vulnerable to opportunistic behaviour by customers.

Many IT/software companies are in a powerful position to dictate terms and conditions because they sell products and services that are key to their customers' production processes. One (large) respondent company explained that its credit terms are 30 days across the board with no negotiation – this company is the market leader and has market dominance. Another extremely dominant supplier, however, said it had 'very flexible credit terms' – most of its products are tailored to its customers' specification and this is mirrored by the credit terms and conditions offered. As the credit manager put it: 'the credit manager's job is to say yes to everything, then find the best solution for the terms and conditions'. This firm never said 'no' to a customer's credit request, but incorporated a premium in the final price of the product to reflect the cost and risk of the credit. This made the customer's credit limit 'totally irrelevant'. In this company the credit manager was very proactive, exercising a great deal of discretion in making credit decisions. Of course, in IT, customers often become locked into the product or service (and change can be expensive) so the strategic use of trade credit in this way can help build a sustainable customer base.

5.2 REGULATORY MEASURES

The study identified two types of regulation designed to mitigate late payment issues – legislation for statutory disclosure and interest charges, and self-regulatory codes of good practice. In the last 15 years many attempts have been made by the UK government and the European Commission to mitigate late payment hazards, especially to protect SMEs (Paul and Boden 2011). These measures often come as the result of lobbying by bodies representing the interests of SMEs. The first government intervention was through amendment to company law in 1997, requiring UK public limited companies to disclose their payment policies and credit days in their annual financial reports.

The Conservative government in power until 1997 bucked the European trend and favoured self-regulation over legislation. This policy shifted in 1997 when the incoming Labour government enacted a series of Commercial Debts (Interest) Acts. Under the 1998 Act SMEs were given the right to charge large companies and public sector organisations interest on invoices paid late. Legislation introduced in 2000 allowed small companies to charge other small companies interest on late payment and in 2002 these rights were extended to all firms. Under this legislation, firms are allowed to charge administration fees and interest at up to 8% over the standard bank rate on late payments (Paul and Boden 2011). A European

Directive in 2000 (2000/35/EC) also created statutory interest rights and this will be replaced with strengthened regulations in 2013, under which business-to-government dealings will come within the interest provisions.

In addition, there have been efforts led by government to promote self-regulation by business. There has been the establishment of the Best Practice Group on late payment, a British Standard for Payment, a Prompt Payment Code (Prompt Payment Code 2011) and calls the for the 'naming and shaming' of late payers.

Available evidence suggests that these legislative and self-regulatory measures have had little impact, doing little to affect late payers' behaviour. In particular, late payment interest rights are not widely exercised, largely because firms fear losing customers as a result (Paul and Boden 2008, 2011). A recent study conducted by Graydon, one of the leading credit and risk intelligence companies (Graydon 2011), found that only 48% of UK credit managers believed that the EU Late Payment Directive will make a difference to the problem of late payment in Europe.

Among the respondents to this study we found very little faith in self-regulatory codes and little use of statutory interest. The SMEs were wary of the consequences of jeopardising the relationships they had built with their larger customers by pressing for late payment interest. Further, most smaller firms lacked the administrative capacity to add late interest – this was a software issue with invoicing systems. Where interest was contemplated, threatened or used, it was only when the relationship had collapsed beyond repair – generally when legal action was being considered or actually taken for debt recovery. Some respondents did report that interest was a potentially useful tool but that it was far from a magic bullet to solve the problems of late payment that they were experiencing. The company law disclosure provisions relating to trade credit were not cited by any firm, large or small, customer or supplier, as affecting its trade credit choices.

5.3 MACROECONOMIC ENVIRONMENT

General adverse macroeconomic conditions are likely to affect trade credit and late payment in two principal ways: a general downturn slows down payment, increasing late payment; and firms suffering from a credit squeeze may decide to make more use of trade credit to finance their businesses, just as suppliers may be running short of cash because customers are paying late or later and their own access to bank finance may be diminished.

Nearly all firms in the sample had had an adverse experience of the current economic climate. Even those that have not suffered much from late payment were finding that some customers were insolvent. This was particularly marked among the construction companies: as one respondent put it 'overdues are going up and sales dropping off the edge of the cliff'. Unsurprisingly, many were, consequently, experiencing financial difficulties themselves, evidenced by shedding staff and/or cutting wages. As customers were losing the ability to pay, trade credit was growing. One respondent said 'where it took one phone call before to get debt in, [now] it's taking five'. A significant number of respondents (81%) reported an increase in late payment. Some thought that a few customers were using the economic downturn as an excuse to hang onto their cash for longer. Those respondents who used credit risk insurance had seen premiums increase.

Ironically, some firms were doing better because the particular circumstances of the downturn had changed spending/domestic habits to their advantage. Some respondents were repositioning their businesses out of the areas that involved trade credit and therefore carried the risk of default.

There was evidence of a variety of diverse responses to these exogenous business factors. Some firms were extending credit terms to assist customers while others were being more careful about the customers to whom they extended credit and were generally tightening credit control by limiting available credit or refusing accounts altogether. Firms' responses depended on sector and customer base. There was a move by some towards more e-invoicing, which was seen as reducing customers' opportunity to claim that they had not received the bill. In contrast, other firms were not investing in their trade credit function but, rather, letting credit managers go and outsourcing to debt collectors. While this may save money in the short term, it reduces the potential to use trade credit proactively for strategic advantage. Some firms were working proactively with customers to ease them through hard times, while some larger firms were pressing for longer payment terms; this stresses suppliers yet further.

6. The suppliers of trade credit

This project investigated two interrelated aspects of suppliers' characteristics – the arrangements and organisations in place for managing trade credit and, on the other hand, the behaviours and attitudes of those dealing with aspects of trade credit within the firm. This chapter considers each in turn and then discusses how they come together.

6.1 ORGANISATION AND STRUCTURE OF SUPPLIERS

The way in which a supplier is structured and organised to deal with trade credit is clearly of central importance to its successful operation. Ideally, the credit function should be an integral part of a firm's overall strategic management, and the involvement, at an early stage, of credit managers/controllers generates the opportunity to avert late payment issues. Previous research indicates that, where trade credit is poorly organised or relegated to a subordinate position in firms, this can lead to suboptimal trade credit management, to the detriment of the business (Howorth and Wilson 1999; Paul and Wilson 2006).

Three aspects of the organisation and structure of suppliers are considered here: trade credit policies, trade credit terms and the position of the trade credit function in the firm.

Trade credit policies

A credit policy is an internal company guide that states clearly the different steps that the firm should follow when taking credit decisions. Ideally, these should encompass every stage, from the time a customer asks for credit to the settlement of invoices. If a credit policy is used proactively, it can contribute to internal organisation efficiency and the sophistication of the credit management processes. A policy that is designed as part of the firm's overall goals can be used as a powerful strategic tool to build and sustain long-term relationships with customers and can influence corporate performance in the long term. A clearly documented credit policy not only effectively guides credit management decisions, but can also be designed to accommodate internal/external changes, creating room for creativity and development (Paul 2010). It is often asserted that where credit policies are well embedded in companies' missions, this leads to a consistent approach to dealing with customers and optimal trade credit management (Kaplan 1967; Bass 1991; Wilson et al. 1995).

Existing research indicates that firms often lack trade credit policies and that, even when they are drawn up, they are frequently more aspirational than actually implemented (Wilson et al. 1995; Pike and Cheng 2001; Paul 2010). This is because few companies appreciate the importance of having clear credit policies that are effectively communicated to all parties involved with the credit decisions, directly or indirectly, both within and outside the company.

The respondent group revealed a wide degree of variation as to whether or not there was a codified trade credit policy. Some firms had extensive written policies, which detailed every step of the credit decision process. This suggests that they had, at some point, given very careful consideration to trade credit, but it did not guarantee that such reflexivity was sustained or that the policy was in fact implemented. Other respondents had a set of practices that had become custom and habit. In small firms this might not necessarily be problematic, as communication chains will be much shorter and so formal codification is likely to be less essential. Indeed, in a number of small companies, in particular, because of the alignment of interests and high degree of organisational control by the owners, the absence of a formal written credit policy did not impede efforts to manage this function effectively. As one respondent put it, 'the credit decision is taken by the whole team, the use of common sense...'. Such an informal, organic approach might not, however, result in reflexive, careful consideration of what the policy should be – formulating a formal policy is likely to lead to a close focus on the issue. A third group of respondents had no credit policy, written or informal, and could not see the point of having one.

Among the SME respondents specifically, just five had a written credit policy. One company argued that a credit policy would be limiting as, 'everything regarding credit is completely flexible and negotiable'. Another firm said that, although they had a detailed credit policy, it was used very flexibly. In a further instance, a representative of a company that had a very detailed credit policy said it was 'completely ignored and not used at all'. Another credit manager admitted that, although the firm had a credit policy, it was 'very much out of date and no one is interested in it'. This situation was evident in another firm where the credit policy was 'consistently ignored'. A construction company's credit manager pointed out that because of the nature of their business, every contract is different and thus 'a credit policy would be useless'. This firm risks not engaging reflexively with trade credit issues. At the other end of the spectrum, one respondent said that, not only did they have a credit policy, but also that it was 'applied to the letter'.

In contrast, among the 25 larger firms, 16 had some form of written policy. This difference might be reasonably anticipated – larger firms will always almost tend to have more formalised methods of dealing with such areas. Even so, it was somewhat surprising to discover that 9 of the 25 larger firms had no form of written policy at all. The relatively long communication chains in these firms raise questions as to how any control is maintained over the operation of trade credit.

As well as size, there are sector-specific factors that appear to influence whether or not suppliers have trade credit policies. For instance, respondents in the food and drink sector tend to deal with a very large number of customers and are usually cash rich. Consequently, the emphasis of activities tended to be on collecting overdue accounts, and so policies were less in evidence. Some companies in the construction and service sector argued that, owing to the unique nature of their contracts – goods or services designed to satisfy very specific customer needs – credit policies would be too inflexible. One firm said that 'every deal is looked at on its own merit' and another that trade credit decisions are 'decided by marketplaces'.

When it came to the content of those policies that were codified in some way, some very detailed credit policies attempted to specify every step in the credit-granting processes.

> *I won't send you the entire document. It's about 500 pages. This has been drawn up between our worldwide directors, PricewaterhouseCoopers and our internal audit team, so what that details is guidelines on Account Receivable policies such as invoicing values, deal values, payment terms, customer credit line approval limits, early payment discount approval and so on.* (Large firm, IT sector).

Companies that did not have a very formal credit policy were able to describe some kinds of 'operating procedure' or 'guideline' used to help make credit decisions. One credit policy of only one page provided very general guidance; in these circumstances any non-routine credit decisions were at the discretion of the credit managers or senior management, the 'credit policy' therefore being described as a 'guide not a diktat'. Even among the 16 who did have a document that they could name as a 'credit policy', one described it as really just 'brief procedures' and a further two had only very short policies of around one to two pages.

Trade credit policies were also frequently allowed to become outdated, thereby increasing the prospects of their being rendered ineffective and likely to be ignored. When asked' do you actually look at [your credit policy]? Do you follow it?' one interviewee responded:

> *Generally yes, as I said it does need updating because so much has happened... Just to give you an indication, where I look and think I'm not doing my job because it's been 2007 since it was updated. The other [branch's] credit policy has not been updated since 1999.* (Medium-size firm, construction sector).

And one large-firm trade credit manager told us that 'I [can] put my hand on [my] heart and say that I don't know where our credit policy is'.

Of course, having an appropriate, well-thought-through and up-to-date credit policy is one thing, using it effectively and positively is quite another. Of the five SMEs with a written policy, one said that it was 'constantly ignored' and another firm described how its policy was so out of date that it was not usable. This meant that just three SMEs both had and used a distinctively articulated policy. Among the larger firms, one firm had a written policy but did not actually use it.

Where policies did exist, interviews addressed the issue of the relationship between policies and practice, and especially asked about the flexibility of these and the circumstances in which terms and conditions varied. This is because the credit function involves or affects not just credit managers and controllers but also almost every other function within the company, including such areas as sales, marketing, and finance. All these functions should, ideally, be knowledgeable of and aligned with the firm's credit policies. For instance, one of the respondent SMEs was a fast-moving advertising business. This meant that the sales team could not always consult the credit controller over business taken on credit. Sales team members not 'on board' with credit policy within the firm might process sales contrary to the objectives of the credit controller – and because this was a fast-service sector this situation could not be redeemed. Hence, when trade credit policy is not embedded in the structures of the entire firm then credit managers and controllers have their work cut out for them. One large-firm respondent noted that he frequently ended up 'chasing some of our project managers more than we actually chase the client for payment'.

By virtue of the way some firms were organised, credit decisions could end up being taken by personnel outside any designated trade credit function, especially by sales team members. An unwritten or poorly articulated/ organisationally embedded policy could lead such decision making to be in breach of overt or implied parameters – staff might simply ignore the rules. This could result in late payment, default and disputes.

> *Sales sometimes try to make offers of extensions without getting the official authority...deals with the customer to 'hold' the price...that does not filter down the line and creates disputes.* (Large firm, food/drink sector)

To be effective, trade credit policies need to be supported from the very top of the organisation and carry the authority of senior directors.

> *I've tried to do something which is probably slightly out of the ordinary. I mean we looked at one [credit policy]...a lot of people who take the policy and have it very much as either something which then becomes a manual...and that's one thing which is quite...valid, the only problem with that is nobody reads it, um, what you need to do...and this is my approach, is you have a credit policy which is signed by the CEO. So that everybody can see...this isn't a credit policy coming from the credit manager for the senior manager, credit management or whatever I am, this is actually coming from the CEO and the executive.* (Large firm, construction).

Interestingly, the survey showed an inverse relationship between the status or position of the trade credit function within the firms and the absence of a written credit policy. Where there was no codified policy, the credit manager or controller tended to deal largely with routine, mundane back-end activities and the credit function was seen as a non-core activity. In contrast, where there was a formally articulated policy it often offered evidence of serious attention to trade credit and could provide, as one interviewee put it, 'force to the arms of those who manage trade credit, both within the company and with customers'.

Finally, the effectiveness of even formal trade credit policies will be inhibited if they are not effectively communicated to customers. Clear communication avoids ambiguity, misinterpretation and misunderstanding that can affect relationships: often 'customers are not clear about the credit terms and condition so tend to pay at their convenience'. This is discussed further in subsequent chapters, but it is important to note here that if the organisation of the firm does not ensure the adequate communication of policies to customers then problems of late payment are likely to be exacerbated.

Credit terms

Beyond policies, stated or implied, firms providing trade credit need to define their credit terms. These cover such matters as payment dates, discounts for early payment and penalties or interest charges for late payment. Credit terms should, in theory at least, represent the expression of a range of business and economic decisions around such matters as cash flow, transaction costs, pricing policy and business strategy with regard to winning and keeping customers (Wilson 2003). Existing research suggests that terms will be heterogeneous between sectors because they can be contingent upon particular structural characteristics and habits (Paul 2010). For instance, the construction sector embodies very long lead times that predictably involve a sharing of project financing costs throughout the supply chain via long trade credit periods. Therefore, credit terms are generally expected to exhibit a high degree of heterogeneity.

Indeed, survey respondents did show a significant amount of heterogeneity. The normal trade credit term offered in the UK is, on average, 30 days. In practice, this can vary enormously for many reasons. The term offered can be 30 days from the beginning of the month, middle or end of the month, from invoice date, or from dispatch. Most companies in the sample cited 30 days as being their norm. Yet their credit terms were marked by significant variability from seven days to, in one extreme instance, 180 days. Terms set tended to be variable and to respond to individual circumstances. Some of the bases for variations were:

- the amount sold (large and small firms in the construction, service and manufacturing sectors)
- the specific customers and negotiations (large firms in construction and distribution)

- whether the customer was based in the UK or not – with longer terms for non-UK customers (large firm in the IT sector)
- the time at which work is certified (large construction firms)
- in response to competitors' offers (small firm, distributor of construction materials)
- short periods (14 days) of rolling credit (large food and drink wholesaler)
- longer periods for large customers (small and large firms in the service sector and construction sector)
- long periods of more than 90 days for key customers (small and large firms in engineering)
- a term of seven days, but an acceptance of payment within 30 days (small companies in service and consultancy sectors)
- a variation of between 10 and 120 days depending on the specific deal (large firm in the service sector, medium-sized firms in manufacturing and distribution).

There was also some variation between different sectors, with some having significantly longer credit periods than others. For instance, most of the construction companies in the sample cited 60 days as their norm. Nonetheless, for larger contracts the term depended on when the work was certified. Thus variations are due to structural attributes of this sector.

Thus, there was evidence of a fair degree of internal flexibility in setting trade credit terms. In a well-organised trade credit supplier such heterogeneity may be the product of a proactive and reflexive engagement with the needs of the business (such as cash flow, pricing policies, transaction costs or competition for customers). One would not expect the organisational aspects of such work to be highly codified or formalised in SMEs – in such small enterprises this level of organisation may be more evident in the 'feel' or 'attitude' that the key decision makers have for their business. Alternatively, in the poorly organised firm, such variability may arise because the trade credit supplier has lost control of its own terms, either through mismanagement or because of the power position of its customers.

The firms with high levels of trade credit routine, followed systematically with little complication, tended to have the most uniform trade credit terms. This suited some firms, generally those that had an appropriate sort of customer base. For instance, one interviewee was owner-manager of a very small firm supplying promotional goods for corporate events. It set very tight terms and got to know its customers well. This firm always rang a week before the due date to make sure that the customer had no issue with the goods delivered. If there were any issues, they were quickly resolved within the credit terms limit. The firm did not hesitate to put customers on 'stop' if the payment was late, or to take recovery action if debtors persisted in non-payment. It always charged statutory interest if matters went as far as this.

Such efficient systems were also evident in large companies, particularly in construction firms with large customers. For such firms credit terms are very hard to fix in advance owing to the nature of their business and the long timelines. These firms had, however, developed 'cradle to grave' terms with enough flexibility to accommodate their heterogeneous projects. Their terms and conditions very clearly stated the right to charge interest on the late payment. These firms tended to have proactive credit managers who reported directly to senior management. This sense of organisation and firm boundaries tended to affect customers, with whom they had long-term relationships – there was a clear basis for business.

Some suppliers were very flexible in their approach to credit terms as a result of a deliberate policy to manage these for business advantage. For such respondents, the way in which terms were set varied according to the pattern of their customer profile. Hence, trade credit terms would vary according to such factors as amounts of repeat business, size of orders and customer concentration. Using trade credit flexibly to attract and/or retain customers or to build long-term relationships needed better and more closely monitored trade credit management structures. Many of the interviewees reported that this had become even more important with the economic crisis. One medium-sized company in the distribution sector set itself monthly sales targets and adjusted credit terms to assist with meeting these objectives. The general economic situation meant that firms were paying particular attention to customers' credit rating, often demanding cash on delivery if the customer's profile did not match the risk deemed acceptable.

There was some evidence that the variability in trade credit terms was not the result of good organisation but of adverse power asymmetries where customers were, effectively, setting their own terms. In particular, customers who were major retailers tended to use their bargaining position to dictate their own payment terms, leading one small supplier to state that the 'big bully boys dictate payment terms'. This was evident generally.

> *They* [retailers] *are the ones that push the hardest for extended terms...the most annoying ones are like Tescos, the blue chip organisations, they have the ability to pay on time, they have large cash resources but for whatever reason they choose to pay very slowly...they have the power...sometimes it gets abused.* (Large firm, service sector).

Of course, the quality of a credit management system depends not only on the credit policy formulation and on setting appropriate terms, but also on the firm's ability to enforce those terms successfully. Enforcement needs to be understood in a nuanced way – sometimes suppliers of trade credit may decide to act flexibly and exercise their discretion when enforcing terms. This can lead to the overt renegotiation of terms or to giving customers tacit consent to extend the credit period beyond the due date without a penalty or to take early payment discounts that have not been earned. The motivation for this exercise of discretion may be customer retention or providing a 'helping hand' to a particularly valued customer in difficult times. Many firms reported that if they value a customer and it has financial difficulties, they do everything to help it get through. Some even said they would help customers with advice on cash management and on how to get paid themselves by their customers. In contradistinction, failure to enforce terms (whether flexibly approached or not) may be the result of an adverse power relationship between customers and suppliers that has been poorly managed by the latter.

And, of course, some firms are just hopelessly badly organised in setting trade credit terms. The credit controller of one large, market-dominant company in the distribution sector spent most of his time chasing unpaid bills but collecting very little, as customers were not even made aware of the credit terms in the first place. Most of the credit decisions were taken by the sales department:

> *many depots just agree to deliver without going through the credit department, so there no check, no credit agreement...it's all done on...well, goodwill...verbally, which is useless.* (Large firm, distribution).

Among the respondents, the degree of organisation exhibited around the setting of trade credit terms varied. Some fully understood the importance of keeping on top of terms and their enforcement. As one interviewee put it, 'we have to be on the ball and we cannot afford any bad debt, [the] credit manager has lots of power in decision making'. Nonetheless, the perception that large customers have of their smaller suppliers is summed up by this senior manager in a large construction firm.

Now, most of small and medium enterprise businesses, they don't have written contracts [specifying trade credit terms], *they don't go through all of this, the professionalism that they put to the administration bears no relationship to the professionalism of the product that they produce at the end of the day. It is a weakness. The one thing that I would say is the SME sector in this industry... in this country is actually the architect of most of its own problems.* (Large firm, construction).

Position of the trade credit function in the firm

Policies and practices aside, we looked at the actual role and position of the trade credit function within the organisational structure of supplier firms. This, arguably, will have an impact upon the ability of the firm to set and enforce appropriate and beneficial trade credit policies and terms. There is a distinction between firms where trade credit is, essentially, a debt-collecting function and those where it is seen more as a higher-status 'management' or 'control' activity. Credit managers or controllers (in the former) are those who are proactively involved with the 'front-end' activities such as establishing credit policies, negotiating contracts and risk screening. These credit managers tend to be more proactively and directly engaged with customers from the outset of any contract.

To investigate this, we looked at factors such as the number of employees working in the trade credit function, those to whom they report (ie their structural position in the firm's hierarchy) and the extent of professional qualifications, such as how many were members of the Institute of Credit Management.

One of the respondents, a large construction company, had a whole trade credit team which formed part of the finance function, with the credit manager reporting directly to the head of finance. The credit manager was very much involved in the decision making on contracts from the very beginning, at the risk assessment stage.

> *Credit management is held in quite high esteem within…I think quite a lot of it is down to the approach that we've taken, which is to integrate what we do into the business. We're not a standalone thing. For example, there's some debate at the moment as to what my reporting line should be. At the moment I report to the financial function through the head of financial control…and to the CFO. There was and still is some debate* [about] *whether I should go into a commercial function…it's debatable actually. It depends what checks and balances you put in play. Because if you do that then all of a sudden you start looking at the influence that certain people can have.*
> (Large firm, construction)

In contrast, in some firms, trade credit was designated organisationally as a low-level service function, not mainstreamed into the company's procedures and structures. One respondent firm had a team of credit controllers and debt collectors but other departments in the business apparently considered the credit function to be a non-core activity. Consequently, the credit team was not involved strategically in decision making and its work was largely mechanical and bureaucratic – collecting information on the creditworthiness of customers, getting references, making sure customers filled in the credit application form, etc. This information was then passed on to the finance department for the decisions on credit terms – crucially away from the people who would have a sophisticated understanding of credit – and decisions were being made on strictly financial, rather than business opportunity, grounds.

> [We are] *subordinate to sales and the 'handbrake' on the business…when 'decisions on terms and conditions are taken by the top, it's a source of frustration…there is still an in-built feeling that we are there to restrict trade.*
> (Large firm in the service sector)

6.2 BEHAVIOUR AND ATTITUDES

Thus far this chapter has described and discussed largely formal arrangements for the supply of trade credit within firms – the policies, terms and conditions used and the constitution and position of the function within the organisational structure. But, of course, such factors are not the end of the story and, ultimately, critical factors for successful trade credit management tend to depend upon the ways in which people actually work within such arrangements, and how their views and attitudes shape these arrangements. There are two issues here: first of all, the view within the firm of what trade credit is – whether a debt-collection activity or an area of strategic importance beyond that. Secondly, there is the question of how people actually do their jobs in and around trade credit.

Some of the respondents reported that they use trade credit to attract customers, build long-term relationships or expand their market share. These proactive trade credit suppliers broke down into two further categories. First, there were those who used trade credit aggressively as a competitive tool. These tended to be market-dominant firms who got their customers to pay on time but tended to pay late themselves. This was seen by as 'good business practice' with a clear strategy by which, in the words of one large construction company, it 'measure[s] credit daily...so we have a positive gap... paying later than [we are] paid...so [we] have a cash balance left'. In contrast, there were proactive trade credit suppliers who sought to use trade credit in a more collaborative way, building customer relationships. Such firms, even when dominant, might accept late payment if, for instance, 'it's a route to other projects', thereby leading to more business.

Other respondents, in contrast, were more passive and considered trade credit as merely an inevitable consequence of sales. Such attitudes tended to be reflected in their organisational structures. They tended to use trade credit to 'react to what a competitor is offering the customer'. Interestingly, some of these firms tended to have a lower customer concentration, with the result that the credit controller had little rapport or relationship with customers. This tended to be used as an excuse for a reactive trade credit function. Finally, such firms tended to vest the credit decision-making capacity with the sales teams or, as one respondent put it, 'sales pick and choose who they send through [to credit managers] for approval'.

Participants were asked about the ways in which they thought the rest of their company saw credit management. Some reported that they were seen as distinctly 'non-core', often reflected in the fact that they were subsidiary to other sections, such as finance or sales. In such instances, those involved with trade credit were often debt collectors. Others claimed that they were seen as an overhead, and thus vulnerable to outsourcing to third-party providers. In the current period of economic difficulties, when companies are trying to cut costs, many reported that the credit department had suffered disproportionate reductions in staffing levels. Even so, some respondents stated that they were valued as a real source of information and expertise and that they were a sort of an internal consultancy service, assisting senior management in key strategic areas (not least of which is cash flow) and hence had become 'more important since the recession'.

Hence, the survey showed a fairly strong relationship between attitudes to trade credit and the organisation and structures adopted. In addition, it has revealed interesting detail about trade credit staff themselves. As noted above, the training of staff is frequently seen as important in shaping the general trade credit environment and here a complex, and interesting composite picture emerges. Most of the interviewees agreed that good credit management requires personal knowledge, qualifications, skills and lots of experience. This is a complex and sophisticated mix. Many workers had acquired valuable knowledge through practice: they had been doing the job for a long time and had become expert in their field. Others had a credit management qualification as well as experience; such staff tried very hard to put theory into practice to bring the credit management function, as one respondent put it, into 'this century'. Others were distinctly less professionalised in their personal ethos, happy to limit themselves to dealing with routine and prosaic tasks.

Perhaps most crucially, given the fast-moving and potentially strategic nature of trade credit, a lot was said about the importance of the personal capabilities or temperament of trade credit workers. One respondent said that the 'power of credit managers comes from their personality and how they conduct their business', while another said that there was a 'need to put [the] right people with [the] right qualification and attitude to add value to credit management'.

The combination of the organisational position of the trade credit function, the attitude that the firm took towards trade credit and the personal characteristics of trade credit staff resulted in some very interesting relationships within the firms.

Trade credit as a function can tend to sit in a sort of 'natural tension' with the sales function. Among those respondents in firms where trade credit is used proactively, this tension could be mutually beneficial and highly creative, generating business and producing competitive advantage. Alternatively, in firms with a more reactive attitude towards trade credit, there could be problematic tensions between sales and credit managers or controllers. This is because, in such cases, each has differing and competing priorities. In the latter firms, the trade credit staff tended to be most concerned with minimising late payment and bad debt, as this was what they were judged by. Their lack of vision about the possible uses of trade credit meant that they could be seen as the 'handbrake' on sales. In contrast, sales teams in such firms were concerned only with achieving the maximisation of sales, often with little regard for whether or not the revenue could actually be collected. This was especially problematic in situations where sales staff were on bonus payment systems.

Whether used proactively or passively, trade credit workers therefore have to negotiate these tensions with care and subtlety. Sometimes organisational factors helped – such as when the trade credit manager was involved from the outset in contract negotiation. This was in evidence only where customer concentration was high and therefore business was far more customised and less routine. High-volume sales to disparate groups of customers could mean that this kind of detailed involvement was not possible. The credit managers' formal position could also help – such as their reporting position in the chain of command.

Many explained that the 'power of credit managers comes from their personality and how they conduct their business' so as well as experience and/or qualifications, one needs, as many respondents argued, to have the 'right' personality to be a credit manager. The overwhelming majority of interviewees stressed that regular communication with sales and other departments that are directly or indirectly involved with the credit function (such as finance or marketing) was essential. All agreed that it is almost entirely up to the credit managers to be as active as possible in order to make their mark and gain organisational status, 'to avoid to be seen as the sales prevention department'. It is, perhaps above all, crucial that credit staff work closely with the sales team so that eventually 'sales come to understand that if we say no then there is a good reason'.

7. The users of trade credit

This chapter considers the users of trade credit – the customers of suppliers – and the part that they play in credit relationships. In a sense, the internal organisation of suppliers frequently dominates considerations of how trade credit works. This is potentially very problematic when attempting to devise novel solutions to late payment problems, as customers are ignored.

Chapter 2 noted that customers may take credit for a variety of reasons, including a need for alternative forms of finance, to manage their cash flow and to reduce transaction costs. It is very important to understand the economic significance of trade credit as a source of finance and, from choice, firms may prefer to use trade credit to fund their purchases rather than turn to bank borrowing. This is especially the case where banks are limiting their lending. Paul and Guermat (2009) find that both the level and length of trade credit demanded by UK companies are affected by the need for short-term finance, implying that trade credit is used either to complement or as a substitute for other sources of funds. Trade credit may therefore become an almost implicit source of financing.

Problematically, customers may pay late or not at all. This delinquent behaviour may take a variety of forms, from paying late, demanding or taking discounts not due, or simply not paying at all. Their reasons for this may vary. First, they may not have been invoiced or invoiced appropriately so that it is not possible for them to pay because of internal control systems. This form of late payment may be innocent or may be the result of deliberate policies to frustrate payment by using particular payment systems. Second, some may simply be too disorganised to pay on time. Third, customers may have very poor trading positions – they simply may not have the cash. Fourth, some firms may engage in highly cynical, perhaps even unethical, business practices aimed at avoiding payment. One respondent claimed that:

> *There are quite a number of major contractors who will quite openly say that one of the reasons that they are able to make profits on particular businesses is by deliberately failing small businesses that are sub-contracting to them and they know they're doing it and it's just the way... because they know then they won't have to pay anything. It happens quite regularly.* (Large firm, construction sector)

Taking trade credit can therefore be seen as an important corporate social responsibility issue, and an aspect of ethical business. Such considerations are not without hard consequences for businesses, generating very sound financial reasons for behaving responsibly; 'good' customers are valued by suppliers and will be accorded preferential treatment in the supply chain. Moreover, a poor trade debt situation is likely to generate a poor credit rating, which will then affect the prices sought by suppliers, their willingness to extend credit and the terms on which that credit is supplied. The net trade debt position of companies is an aspect of the valuation of firms and, where payment patterns are used intelligently as a source of information by suppliers, late payment sends market signals that a business is not worthy of trust. For instance, in January 2011 suppliers to HMV, the struggling retail chain, were refused credit insurance (Albert 2011).

In short, being a good customer makes business sense. This implies that two aspects of customers who take trade credit need consideration: their structure and organisation and, second, their attitudes and behaviour. Both are discussed below.

7.1 CUSTOMERS' ORGANISATION AND STRUCTURE

The way the customers' credit function is organised and managed influences their payment behaviour. Although the size of these firms plays a role in the pattern of payment, it is by no means the only factor.

With customers it is important to remember that many are also suppliers themselves. Therefore, their payment of debt should, ideally, be part of a comprehensive trade credit policy in which they proactively manage their net credit position. Paying and getting paid should be part of one well-organised process.

As explained in Chapter 6, many users of trade credit do not have a credit policy. This increases the risk that they make ad hoc credit decisions and fail to manage their net credit position. Their payment patterns may be random and unpredictable. This will have an adverse affect on suppliers and will inhibit the ability of such firms to manage their own cash flows. The respondents told us that the weaker the credit system in place, the greater the payment delays tended to be.

Nonetheless, it is not necessarily the case that those with credit policies avoid late payment. One weakness among the larger-firm respondents was that their policies frequently dealt only with their own granting of credit and collection of their own accounts receivable. These firms were therefore making ad hoc decisions when it came to paying their creditors. Many suppliers complained that larger organisations have overly complex payment processes.

> *Larger companies take longer to process paper work, everything has got to be authorised, it's not easy to find who's got the invoice and who they're in the system.* (Medium-size firm, service sector)

This is especially the case where customers outsource their payments function to third parties. Frequently, such payment centres are overseas and suppliers reported considerable frustration at trying to deal with call centres, where communication was a real issue and it was impossible to have regular contact with the same person, who would get to know the details. It appears that, in seeking efficiency gains by reducing payment-processing costs, larger firms may be losing advantage in terms of their reputation with suppliers.

Some of the respondent companies had an explicit policy of paying only when they themselves were paid, sometimes enforced via a clause in contracts. This places their suppliers in double jeopardy as potentially unknown businesses in other parts of the supply chain represent unassessable risks. Through such processes the customer's risk essentially becomes that of the supplier, but perhaps one outside their knowledge or capacity to evaluate. Even when a 'pay-when-paid' clause is not in the contractual details, some customers literally cannot pay their suppliers unless they collect the cash from their own customers themselves, with the same result.

In some respondent firms the staff responsible for payments had only a passive role, dealing with mundane tasks. In such cases, the credit function was usually part of another department and enjoyed only low status within the firm. In these firms, those staff dealing directly with suppliers' credit managers/controllers had no authority to work proactively. They could deal with the routines of processing an invoice, but could not, for instance, authorise payment or sign a cheque. Respondents claimed that some authorisation processes were made as complicated as possible – in one instance authorisation could only be given by a senior manager who signed cheques every other week. Thus, we found, those who were poorly organised in terms of their own granting of trade credit were also poor payers.

Some respondents still had a 'pecking order' payments policy. These firms would always pay their key suppliers, which frequently tended to be larger companies, first and then, depending on their own cash flow situation, pay the rest. These respondents talked about 'having a priority list' produced on a monthly basis, so a granter of credit might be told:

> *sorry but this month you are not seen as an important supplier therefore we will not be paying you, other people have debt[s] overdue that are bigger and longer than your debt...and there is little we can do about it... the global agreement is worth more than one invoice that gets paid considerably late. We have to put up with it.* (Medium-size firm, IT service).

The respondents seemed to reflect common understandings that very large suppliers get paid on time because they are vital to supply chains, very small invoices also get paid because they are a nuisance, while the vast majority of medium-sized invoices in the middle are the ones subject to the greatest payment vagaries.

Some sector characteristics affected payment organisation. For instance, in the construction sector work is sometimes undertaken at short notice without going through 'normal' contracting processes. This often leads to disputes and defaults. Some participants gave examples of such unpredictable work: if there is a call-out emergency, there is no time to go through the purchasing process and, as one said, 'the odds are that the £500 bill, 12 months later, you'd end up writing it off'. This supplier maintained that such was the volume of poor payment on such invoices that the firm had to increase sales by about 5% just to make up for them.

We spoke to many suppliers who considered that many of their customers had every intention of paying on time, but were simply too disorganised to do so. This was regardless of customer size – small firms often did not have the necessary ability to monitor payments, while larger customers often appeared unwilling to invest in the necessary staff and their training.

The overall picture of how customers organised themselves to pay their bills is that this is a much-neglected area. Neglect manifested itself in one of two ways. There were those who were simply disorganised, lacking the proper structures or staff or time to deal with these issues. On the other hand, there were those who had assigned a low priority to prompt payment, frequently outsourcing it to save cost and forgetting about it, or who organised payment in such a way as to deliberately, and sometimes unfairly, delay the egress of cash from their business.

There was ample evidence that credit terms are effectively set by customers, with little by way of negotiation. Many respondents reported that large companies, including big, well-known retailers, are particularly likely to exercise their power position to achieve the terms that they demand, sometimes even changing them retrospectively.

There was a sector-specific aspect to this. For instance, in the construction sector where competition is fierce, suppliers increasingly have to accept terms and conditions set by the customer or risk losing the business. This, almost inevitably, means longer payment periods and increasing late payment. In contrast, medium-sized companies are reported as generating 'excuses' to delay payment while small firms have, we were told, a tendency to bury their heads in the sand and wait to be chased. It appears therefore that there is a correlation between customer size and their sense of ability to set the credit terms that they want. This is unsurprising, but does point towards a use of power-position that may not reflect corporate social responsibility and may undermine the equity of trading relationships.

The survey shows that the bargaining power of larger companies often has a disproportionate effect on the credit terms received.

> *As a large company you are in a powerful position...in a very powerful position. Because you're big, everybody wants your custom...We can't bully certain people, like the oil industry...bitumen, cement, we can't bully those, but we negotiate with those...and we get advantageous terms and they get what they want because they get the volume.* (Large firm, construction)

Some respondents were unapologetic about their demands. One credit manager in a large firm recounted how:

> *Somebody once accused me and said, 'you're just using your power in the market', and I said, 'are you expecting me to actually apologise for that?' That is part and parcel of capitalism.* (Large firm, construction)

Overall, among the sample, the power of customers depended primarily upon sector norms, the size of orders, the extent of their repeat business and customer concentration. Large companies reported that they receive preferential credit terms from their suppliers either because of the long-term relationship or the size of their purchases. Also crucial, for small suppliers, was the extent to which their product or service was key to the customer's supply chain.

7.2 ATTITUDES AND BEHAVIOUR

Customers who use trade credit can, like their suppliers, take a proactive or reactive attitude towards its use. For both customers and suppliers, strategic use may be either designed to ease cash flows, provide finance and build business relationships and firm profile, or it may be more aggressive, designed to seize what may be an unfair advantage. In contradistinction, the users of trade credit may take a more passive approach, effectively paying little attention to this side of the management of their net credit position and treating it as purely and simply a prosaic function.

As with suppliers, those firms that managed their debts proactively had made a conscious decision to do so and had organised themselves accordingly. Sometimes this resulted in a fairly aggressive approach to suppliers, as evidenced by one large firm that explained that: 'we force other people to pay us...we pay [suppliers] late, we have to protect our cash position, pure and simple'. Such firms tended to be those that managed their net credit position well, balancing their debtors and creditors in what could sometimes be a precarious relationship. One respondent said 'I cannot pay because I have not been paid yet'. We found that if our respondents were paid late, then, to deal with the shortage of funds, they tended to adjust the terms offered to them by lengthening the payment period, rather than seeking external finance from their banks.

Firms that purchase large volumes, which tend to be bigger firms and therefore desirable customers, have the power not only to demand more trade credit but also to require favourable credit terms. If a firm is considered a key customer it is likely to be offered credit terms that are outside the 'norm'. But if firms operate in a market dominated by large buyers, all competing for generous credit terms, some use trade credit strategically to get the best terms. To achieve this, they have a policy of paying within the agreed terms (which are generous in the first place); these firms argue that this supports the suppliers' financial health and thus develops a supply chain that may help buyers to gain/maintain market dominance. Very few, however, recognised overtly that by paying their suppliers promptly they were helping to improve their own market performance. Some others still had not realised that, if they strangle suppliers, there will be less competition for their custom and the power relations in their own supply chains may become less agreeable to them.

The extent to which customers bothered to build relationships with suppliers varied, but in almost all cases less attention was paid to this than to relationships with customers. This was particularly the case with large respondents, where attention was focused on getting in cash. This points to a lack of strategic use of trade credit from the customer perspective, which, research suggests, might mean that these firms are turning their back on potential competitive advantage. Many firms did not take the view that, as customers, they should act proactively to build supplier relationships, instead blaming small suppliers' disorganisation for late payment. There was particular criticism of the capacity of small suppliers to set and enforce clear credit terms.

> *The vast majority of people who supply us wouldn't know a set of terms and conditions if it slapped them in the face... Small companies' problems relate to their lack of expertise...You have a variety of people who come into running their own business and running up bills with no training, no understanding, no professionalism, who may very well know what they're doing in terms of their own little business...in terms of the operational side of it, but couldn't understand the flow of cash through a business, if it slapped them in the face.* (Large firm, construction)

If the demand for trade credit is to be used strategically to gain and build long-term relationships with suppliers, then it is reasonable to posit that companies would examine the credit terms offered to them and review their choice of suppliers on a regular basis. Of the companies we studied, only a few frequently changed suppliers for better credit terms. Some were happy with the terms offered to them, others reported that once they have entered into a relationship with the supplier they do not review their credit terms, which means that new opportunities may be missed.

8. Trade credit relationships

The premise of this study is that trade credit is best described as the expression of a business-to-business relationship between customers and suppliers. The existing literature, described in Chapter 2, posits that these relationships have the capacity to be mutually beneficial for both parties. Such benefits include mutual financing, cost reduction, strategic business information, stronger supply chains and enhanced cash flow management.

But trade credit also comes with the potential risks of late payment and default – these relationships may go sour and the potential benefits may not be realised. In this chapter we conceptualise trade credit relationships as somewhat like a marriage: relationships that can bear very happy fruit but that have the potential to go disastrously wrong. Like marriages, trade credit relationships exist in wider contexts and have two partners who sometimes have power asymmetries. Marriages are made or broken by family circumstances, what the two parties bring to them, how they behave and whether the benefits are equitably distributed. That is, in good marriages a good environment, equity (or fairness) and ethical behaviour generate sustainability. These partnership principles are equally applicable to trade credit.

While marriages may end in divorce, trade credit relationships can end in late payment or default. That is, late payment and default are aspects of a failed business relationship. And indeed, public debate about late payment has all the same hallmarks of mutual recrimination as some failed marriages. The benefits to suppliers of avoiding late payment are readily evident. Counter-intuitively, there are also benefits for customers. Paying on time affects the reputation of firms, signals ethical practice and supports vital members of the supply chain. Customers who pay on time may also be able to manage their net credit position and hence cash flows more effectively, and win discounts for prompt payment.

This chapter first explains late payment and then describes the late payment issues reported by the respondent firms. It finishes by analysing these late payment problems in terms of what customers and suppliers said about their business environment, how they organised themselves (ie what they brought to their relationships) and how they behaved (that is, their attitudes and behaviours). This leads on, in Chapter 9, to some relationship-counselling advice in the form of suggestions for improving trade credit management in the UK.

8.1 LATE PAYMENT ISSUES

Late payment is not a homogeneous phenomenon – it may take a variety of forms and needs to be considered in the round. It may range from a straightforward delay to a complete default. But it may also take the form of partial payment, taking early payment discounts that are not due, and arbitrarily changing payment terms. In short, it is broadly defined here as any eventuality where payment does not take the form agreed. This raises the problem of what happens when suppliers are less than clear about what these terms are at the outset. Technically, if terms are not adequately expressed in a way with which the customer can comply, there can be no late payment. Nonetheless, among the survey respondents, such suppliers considered that they were being paid late.

Many of the SME respondents, in particular, reported that late payment was contributing to their financial distress and was an increasing problem. Even those who historically had few problems reported that late payment was now a growing issue for them. There was a perception that the current economic downturn is lengthening payment periods and, at the same time, these suppliers are financially stressed because of the credit squeeze. Some were, therefore, entering a vicious circle whereby they were not being paid on time because of the general economic climate, and had no access to substitute sources of working capital because of those same economic problems. Most SMEs we interviewed reported that, for the last couple of years, they have been preoccupied with business survival, placing their strategic objectives for growth and innovation on hold. These findings reflect commentary in the business press and, in situations where the UK is seeking economic growth, this is potentially extremely problematic.

Respondents were asked what they believed were the underlying reasons for late payment. Many of the respondent firms did not undertake any formal analysis of their late payment issues and were not aware of the main reasons for them, or even, most surprisingly, their extent. As one interviewee put is, ‘we don’t have an automatic visibility on the reasons for late payment’.

For those who did advance any sort of analysis, the explanations ranged from issues of structure, management and bargaining power, to geographical, cultural and sector-related issues. In reality, the reasons and issues will vary from firm to firm.

Poor organisational structures in suppliers and customers

Some firms stated that poor organisation structures in both customers and suppliers were to blame for late payment. One interviewee said '90% of late payment is due to the lack of structure'. The problems here were cited as the absence of a credit policy and a credit function with a poor position in the organisational hierarchy, meaning that it had little impact on decision making. For instance, where the credit manager was not involved at the beginning of the process, sales people could agree informal terms with customers that diverged from the normal terms. Such informal arrangements often resulted in disputes and thus payments were not received until the problem was resolved.

Mismanagement and disorganisation among suppliers and customers

This was cited as a frequent cause of late payment. On the suppliers' side, interviewees named poor systems for credit control and poor definition and articulation of trade credit terms. Many of the firms did not agree the terms and conditions of trade credit formally and consequently found it very difficult to enforce them. Larger customers often held rather disparaging opinions of the organisational competence of small suppliers, reflecting little sympathy for their plight, which was often seen as self-imposed. It was noted to us that signals of poor organisation, such as not issuing invoices promptly, could be seized upon as evidence that a supplier would not chase for prompt payment.

Abuse of power

SMEs (and, indeed, a few larger firms) tended to pin the blame for late payment on larger customers' use of their position of power in relationships. Some of these large customers did indeed see delaying payment as part of a good and strategic business practice and therefore paid as late as they could and asked for extended credit 'as part of a corporate strategy'. Large retailers, especially, were identified as bad payers, often dictating their own terms and advancing 'excuses' to reduce prices. One interviewee described a major retailer as 'just a pain; they will eventually pay and often find every reason to take deductions for reasons such as promotion, quality, quantity, breakage'. Another major high street retailer was cited by three of our participants, and described as a 'very aggressive, poor payer and unwilling to negotiate'. Smaller firms, however, were described as tending to 'slow down on payment, put their head in the sand and wait to be chased hard as opposed to coming to tell us that they've got a cash flow problem'. This possibly reflects a lack of confidence on the part of SMEs.

Geographical/cultural factors

These were put forward as one of the main reasons for late payment by the majority of respondents who deal with Europe as well as the UK. They described a clear North–South divide. One interviewee said that with 'Northern Europe you get paid, Central Europe you get paid eventually, Southern Europe[an] countries have an anti-payment culture'.

Personality and personnel issues

Aside from the organisational or structural reasons given for late payment, respondents cited much 'softer' factors, generally related to particular individuals within firms and how they behaved. One interviewee said 'most of the problem of late payment is related to individuals not sector or size, it boils down to one or two individuals who work in that organisation'. These respondents argued that if the credit managers or controllers have the skills and personality and are empowered to build a relationship with customers, perhaps meeting them at an earlier stage in the contracting process and contacting them regularly, then they can deal directly and avert problems. This needs diplomacy, communication and negotiation skills as well as resources in place, especially time, to invest in 'knowing' the customer. We found that companies that do not have the right 'soft' credit management skills are more likely to suffer from late payment. As one respondent put it, a 'lack of skill to manage credit properly, lack of resources and investment in credit staff all contribute to late payment'.

Cash flow

Cash flow problems were also cited by many respondents as a reason for late payment. In particular, many observed a sort of domino effect, where one company's payment streams depended on the payment of a firm in another part of the supply chain. Firms said that they 'don't pay because they have not been paid themselves'. This problem is particularly acute for building and construction companies with long supply chains involving many sub-contractors over extended periods. Many argued that a late payment penalty is counter-productive in the construction industry.

Capital rationing
It was noted by some larger firms that any particular industry has a finite amount of working capital and that some firms chose to attempt to maximise their accretion of this, even at the expense of business relationships, denying capital to others by demanding payment early while paying their own debts late.

Disputes over service or product quality
This was a frequently cited reason for late payment. The disputes varied greatly; specific reasons were listed by one interviewee as 'incorrect billing, quality, quantity, delivery, price, late or missing invoice, agreement on credit terms, [and] after-sales service'. Some respondents questioned how genuine many of these disputes were, the assumption being that some at least constituted little more than an attempt to gain a payment holiday.

Complex deals
Some respondents said that the chance that things would go wrong was heightened when contracts involved large numbers of business actors and there were contractual stage payments, etc. This meant that delays in one area of work by one sub-contractor, or delays in getting work certified as completed, could significantly slow payment.

Sales departments
Many respondents acknowledged this internal factor. They cited many instances where sales departments were unmoored from considerations of trade credit, failing to appreciate that sales are not complete until the goods or services have been paid for. This structural problem meant that sales staff, often motivated by poorly structured bonus schemes, would sell on credit without taking proper advice or counsel from their colleagues in trade credit. Such deals tended to generate payment problems further down the line.

Interestingly, none of our respondents cited the absence of further statutory or self-regulatory provisions as the reason for late payment although, as explained below, some did see them as potentially useful tools.

8.2 THE CAUSES OF LATE PAYMENT

Having investigated how firms constituted their organisational arrangements and structures for dealing with trade credit, how they perceived trade credit and where they thought the problems arose, we have created a typology of factors that appear to be influential in establishing sound trade credit relationships and, therefore, in mitigating late payment risks.

Policies
The existence of trade credit policies appropriate to the firm was a necessary but not sufficient condition for good trade credit management for both suppliers and customers. A policy could allow both parties to think through exactly what they wanted to achieve by either granting or using trade credit.

Some very small firms did not write their policy down, but, when asked, they were able to articulate very clearly and precisely what the policy was. For many it was evident that the policy provided an arena in which issues could be discussed and approaches honed. It cannot be known whether producing a policy led to this clarity, or whether the clarity led to the statement. Nonetheless, there was a strong positive correlation between having a very clear idea of what the firm was doing and why, and effective trade credit management. Except within some large firms, policies on extending credit were rather more carefully thought about than managing the firm's own debt.

Suppliers' policies were fairly useless when unused or not communicated either to other parts of the firm or to customers. The customers who articulated their policies best were those who attempted to set their own trade credit terms with their suppliers – they had a policy about what they paid and when, and were generally keen to enforce that on suppliers.

Suppliers who lacked a clearly articulated policy seemed to be in a weak position. Not only did they not have a clear vision of what they were attempting to achieve, but they also ran the risk of signalling disorganisation to a possibly predatory customer and, indeed, of being in a weak negotiating position if the customer did have a clear policy on credit terms. Only larger customers benefited from having such policies on payment – as desirable clients they were in a position to negotiate hard.

Policies therefore, in essence, set the initial parameters of the contractual relationship, laying down some ground rules. These positions could be, and with the best policies were, flexible and subject to negotiation.

Internally, policies helped those in the trade credit function to establish their position within the firm. This meant that they could set up protocols and decision-making routines that took trade credit into proper account. Policies helped to raise the profile of the trade credit function and provided, *in extremis*, a good rule book. Again, good policies were flexibly implemented but they provided the basic ground rules within which the firm could organise itself.

Policies therefore help firms, whether supplier or customer, to think through their position on trade credit, to organise themselves effectively internally to achieve their aims, and to assist them in being assertive in their external business relationships. An absence of policies often led to a very reactive approach to trade credit, internal disorganisation and the emergence of a very weak power position vis-à-vis business partners in the supply chain. These factors, our respondents noted, were associated with late payment.

Credit terms

The setting of credit terms allows suppliers to mitigate the risk to the firm of advancing credit and to maintain a reasonable degree of control over cash flow.

The ways in which the respondents did this varied. Some were very far from proactive in setting terms and communicating them to customers. Others had very fixed terms, an approach that generally suited companies with wide customer bases (and therefore high numbers of transactions). Yet others adopted extremely flexible approaches, tailoring terms to specific customers. This latter method could work effectively only when the trade credit function was particularly well integrated into the firm, allowing credit managers and controllers to be part of decision-making processes from the outset.

Among customers, a proactive approach to credit terms can assist in maximising the potential advantage of taking credit. Customers may choose to negotiate terms, ensuring that they are favourable and indeed possible for them to meet. At the very least, the proactive customers in our sample factored credit terms into their management of their net credit position and paid careful attention to the cash flow forecasts that arose as a result.

The failure of suppliers to set terms frequently appeared to result in late payment issues, and some customers were unapologetic about taking advantage of this, being of the view that such suppliers were authors of their own misfortune. Likewise, customers who took advantage of their power position to demand inequitable terms could become what we have called ‘effective late payers’ – they might be technically compliant but their abuse of power might result in an unfair contract that could threaten suppliers’ existence. The least problematic relationships appeared to result from the clear and unambiguous setting of terms from the outset. In some sectors these are non-negotiable; in others they are entirely negotiated, but reflexively so.

Setting terms is one thing, enforcing them another. Sometimes departure from terms happens as a result of negotiation between the parties. This can be mutually beneficial. A number of respondents noted that SMEs appear less willing to negotiate when they cannot pay, whereas their creditors would prefer early contact rather than having to pursue aged debt. It follows, therefore, that one aspect of enforcement is good communication and mutual respect and this can mitigate late payment problems.

Positioning trade credit organisationally

If customers are to honour their agreements and pay on time then they need appropriate arrangements for doing so. Likewise, where payment is late and no divergence from the terms has been agreed, suppliers need effective organisation for the pursuit of debt. This brings us to the question of organising the credit function.

Regardless of firm size, both customers and suppliers need to make appropriate arrangements for negotiating and then either paying or monitoring and chasing trade debts. Where the organisation was weak, evidenced by a lack of policy or the failure to agree credit terms, then the result tended to be late payment.

The position of the trade credit function in the firm’s hierarchy was most important. The supplier firms in the respondent group with fewest trade credit problems were also the ones where the function was ‘mainstreamed’, often with the credit manager reporting to a senior manager of the firm. As such, trade credit was hard-wired into the decision-making routines of the business. This was sometimes hard to achieve as the benefits of trade credit can be somewhat opaque. Nonetheless it could be achieved even in SMEs. In one respondent firm, the owner-manager's wife chased the overdue debt – getting money in was not seen as a peripheral activity to be undertaken by a junior member of staff.

Beyond this, the trade credit function had to be properly constituted, with the ability to monitor debt and take appropriate action. Among the respondents, the best-organised firms were proactive in such matters – for instance, ringing up customers a week before payment was due.

Some customers had organised trade credit for prompt payment while others were either wilfully or otherwise disorganised. Larger customers tended to have complex payment processes, which could considerably slow payment, and this may have been deliberate. Many firms did not place a priority on meeting their obligations on time and failed to set up effective organisational arrangements to achieve this. The use of overseas payment centres, contactable only through a call-centre process, was typical of this, as were arcane payment approval processes. Such disorganisation compounded late payment. Some firms might revel in this, keeping their cash for longer. Nonetheless, arguably, such behaviour cannot be efficient in the long term and is no substitute for fairly and properly agreed trade credit terms, which should work to mutual advantage. Disorganised systems are ones that, by accident or design, promote late payment.

Intra-firm structural characteristics can also promote late payment. A number of respondents pointed to tensions between sales and trade credit. In some, sales staff were rewarded through bonus schemes linked to orders placed, not payments made. This created significant late payment issues as the sales staff were not mindful of payment issues. In one large firm this was overcome by delaying the payment of sales bonuses until payment was received – in this instance the sales staff then 'pestered' the credit manager to chase up payments. Thus, simple organisational changes such as this can do much to mitigate late payment issues.

And, of course, the trade credit function has to be adequately resourced. At its simplest, this means having sufficient and well-trained/qualified staff. There were a variety of surprising current moves, such as shedding credit control staff or outsourcing the work to what were, in effect, debt collection agencies. One large firm, for cost-saving reasons, sent out invoices by second-class post. In contrast, other firms were reducing late payment problems by investing in technology such as e-invoicing, which reduces the capacity of customers to maintain that the invoice has not been received. The failure to resource trade credit adequately exacerbates late payment problems, especially if customers become aware, as they generally do.

Attitudes and behaviour

Of course, structures and organisational arrangements are one thing, the attitudes and behaviours of the people who staff them are another. Two quite contrasting attitudes towards trade credit emerged in the course of this study and neither was particularly associated with large firms or SMEs. On the one hand, some firms trade credit was a Cinderella function, unrecognised and not respected. Trade credit was seen as a menial, back-room activity, often equated with debt collection. This approach flowed through into such organisational attributes as lack of a clear policy, the poor articulation of terms, and a trade credit function with lowly organisational status and few resources. These firms, almost invariably, had problems with late payment and/or did not pay on time.

In contrast, some firms appeared to model 'best practice' in this area. Their skilled and motivated credit managers saw the possible competitive advantages of the effective management of trade credit and had acted accordingly. These companies fell into two sub-categories. One placed great emphasis on equitable and ethical trading for sustainable business partnerships. These firms both paid on time and had few late payment issues and those that they did have, they appeared to manage assertively and effectively. The other group was also inspired by the potentialities of trade credit and saw the advantages of it, but these firms tended to be larger, were more aggressive and worked less in a collaborative mode with partners. They also tended to have fewer late payment problems, and managed those that did have well, but they might be deemed to be not quite such good customers. These were the firms that used their superior organisation and market position to exploit suppliers through their relationships with them. They tended to create late payment problems.

Beyond such strategic approaches, the staffing of the trade credit function itself was also an important 'soft' factor. Among suppliers, most respondents agreed that the best trade credit staff were not only skilled but also personally committed and capable of working proactively. Some credit managers whom we met were superbly networked, building effective relationships within their firms and with customers. They told us that they knew their customers because their customers' risks were *their* risks. They used these relationships to ensure that their payments were prioritised. As one respondent put it, 'people collect money from people'. Varying by sector, they described techniques such as always knowing a named person in the customer organisation, and their phone number. A number decried the increasing use of email reminders for overdue debt (a cost-saving measure), pointing out that phone calls were more personal and more effective. In contrast, and in firms with sometimes severe late payment problems, there were reactive individuals who took a distinctly 'backseat' approach to their task.

Within firms, where trade credit managers were active in communicating with colleagues, getting them 'onside' and able to understand the value of their work and working alongside, rather than in opposition to, sales, then there were commensurately fewer late payment problems. As one would expect, the opposite is also true.

8.3 SUMMARY

Late payment (including effective late payment where there is technical compliance but on terms perceived as unfair) is the product of trade credit relationships that have not worked well. The reasons for such failures are heterogeneous. Like a failed marriage, late payment is rarely the fault of only one party. Late payment appears to be mitigated when both suppliers and customers have clear policies, engage with credit terms and are effectively organised. Generally, such characteristics are accompanied by attitudes and behaviours that recognise the strategic potential of trade credit and where staff are committed, innovative and enthusiastic. Beyond that, as in any relationship, effective trade credit management and the mitigation of risk depend upon fair and honest negotiation.

It was not always easy for the SMEs in the sample to negotiate such relationships in competitive environments, especially where some large customers are not committed to fair and ethical trading. Even so, there were examples of SMEs that were achieving just this. These were the well-organised firms with a clear strategic view of trade credit and staffed by some excellent workers. The professionalisation of the trade credit function appeared central to such negotiating skills. As one respondent noted, the 'power of credit managers comes from their personality and how they conduct their business'.

9. Conclusions and recommendations

Great fleas have little fleas upon their backs to bite 'em,
And little fleas have lesser fleas, and so ad infinitum.
(Augustus de Morgan, 19th-century mathematician)

Trade credit offers significant advantages to both customers and their suppliers. Beyond merely winning sales and sustaining the customer base, the potential benefits to suppliers include the communication of product information to customers, the building of enhanced customer relations and improved financial management, especially of cash flows. For customers there are benefits too, including the financing of inventory holdings, cash flow management, implicit product warranties and the strengthening of supply chains. The problem for business is to ensure that the benefits are realised while avoiding the hazard of late payment.

The provision of trade credit is an extremely widespread practice in the UK; such are the amounts of trade credit granted that it might almost be thought of as a sort of shadow, unregulated banking sector (Paul and Boden 2008). As implied by the verse above, the nature of supply chains is such that firms may well be both suppliers and customers. This means that some firms assume very complex trade credit positions. Trade credit can therefore be seen as a very large series of heterogeneous bilateral business-to-business relationships that are, strictly speaking, financial but are in fact about trading.

Existing research on trade credit is largely quantitative and has concentrated on developing a series of metrics through the use of postal questionnaires. As was explained in Chapter 2, this research has done much valuable work in both mapping the situation and in theorising the potential benefits of trade credit. Nonetheless, while quite a lot is now known about the extent of late payment (the signifier of the failure of these relationships), there is less understanding of why it happens. That is, not enough is known about why these relationships fail, denying firms the potential benefits that are so carefully theorised.

Problematically, the various measures introduced to combat late payment in the UK are, almost universally, acknowledged not to have been a 'magic bullet', and late payment persists (Paul and Boden 2008). These measures are arguably the product of both the normative theorising by previous researchers and highly effective lobbying by groups representing SMEs. It is not that the measures are inherently wrong, or even wrong-headed – our respondents reported that they could be a useful tool in the trade credit armoury – rather, they fail to get to the heart of late payment because they are not grounded in an understanding of how it arises.

This suggests that examination of actual practice is necessary, and this was the focus of this project. This qualitative piece of work has had the advantage of sustained personal engagement with a range of credit managers and controllers. As with all qualitative work, it does not purport to be statistically significant, but rather to give insight in some considerable detail into how trade credit works, or does not, in a range of companies.

As noted earlier, on the ground, trade credit consists of a series of highly heterogeneous business relationships. Those relationships are also highly dynamic. They are shaped by a myriad factors, including the external environment, the organisation of firms, the attitudes and behaviour of people in firms and the dynamics between customers and suppliers. Each relationship has its own peculiarities and, therefore, their failures are also extremely specific to context. This diversity makes resolving late payment issues problematic and a 'one size fits all' solution unlikely.

The common discourse on trade credit is that late payment arises because of abusive behaviour by large companies towards smaller suppliers. Indeed, this was the original starting point of this project. Although abuse of power related to size does undoubtedly exist, it would arguably be a mistake to seek to address late payment by concentrating solely on the reform of large-customer behaviour. All firms, whether small or large, experience late payment problems and these do not occur solely between large and small firms and nor is the problem always in the direction commonly supposed. That said, SMEs constitute the overwhelming majority of businesses in the UK and do suffer disproportionately greatly from late payment compared with larger firms. Even so, it has to be contemplated that this may not always be entirely the fault of their larger customers.

This report identifies a range of reasons for late payment (see Chapter 8), only one of which is the relative power of large customers over small suppliers. It takes two to create a problem and, we conclude, the best way of addressing the failure of these business relationships is by exploring the ways in which both customers and suppliers can be encouraged, educated, trained and organised into better relationships that mitigate the risk of late payment. To be effective, however, such an approach needs to be grounded in sound evidence and to offer a robust framework for the reconfiguration of business relationships.

This will be a considerable and complex task. Because trade credit relationships are heterogeneous, so must their reconfiguration be. There is no single solution, no template for all businesses to follow, because businesses are so different. Moreover, imposing a single model might prevent some firms from realising some of the strategic benefits already identified.

Instead, we conclude that the way forward may lie in the development of an evidence-based trade credit operating framework with which to aid/guide all firms in the configuration of these relationships. If trade credit is a business process, then it needs to be properly and specifically designed to fit the firm. In line with findings from the survey, especially those in Chapter 8, this might include protocols for identifying, in the case of both customers and suppliers:

- the specific trade credit characteristics of the firm's sector and the environment in which it is operating
- the firm's ethical stance on payment
- if/how the firm wishes to use trade credit strategically and proactively and, if so, what its objectives are
- an appropriate credit policy
- the terms on which the firm wishes to engage with trade credit and how these will be determined and negotiated
- how the trade credit function in the firm will be resourced and structured and where it will sit in the hierarchy (if there is one)
- how trade credit will be positioned within the firm, having special regard to potentially competing areas such as sales
- the firm's attitudes towards trade credit and the kind of people it wishes to employ in this function, having regard to the relational nature of the work
- the use the firm will make of regulatory devices such as statutory interest, and
- in sum, how it will engage with customers and suppliers as part of its business relationships.

The task is also made complex by the fact that trade credit is granted by non-financial organisations that are not in business to offer finance but to sell goods and services. Moreover, most of those businesses are SMEs. As such, while they may be excellent at making and selling goods and services, they get rapidly out of their area of expertise when granting credit. Unlike other functions in a company, where roles and tasks are specific, trade credit management tends to suffer from somewhat more fuzzy boundaries. Trade credit staff are becoming increasingly professionalised, particularly through the work of bodies such as the Institute of Credit Management. It may be that these extremely varied, mostly small firms need a strong source of advice and assistance. In conclusion, we suggest that there may be scope for an enhanced role for the accounting profession here in assisting either the accountants' clients or, for management accountants, their firms, to build effective, equitable ethical and sustainable business relationships to mutual advantage.

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