The late, late show

GRAHAM BUCK SURVEYS THE LATE PAYMENT LANDSCAPE IN EUROPE.

Executive summary

- Late payments are the bane of many small and medium-sized businesses. What's more, the problem appears to be getting worse as larger companies force their suppliers to play a waiting game.

That well-worn phrase "Your cheque's in the post" may be heard less often in this era of electronic transactions, but the problem of business customers failing to pay up on time has not gone away. If anything, it is growing worse.

The latest research from credit report agency Experian, issued in July, showed that UK companies on average take 61 days to pay their suppliers. The figure represents a rise of nearly two days since November 2006 and is the highest since the firm began recording payment patterns – now based on 435,000 companies – back in 1998. The worst culprits by far are larger companies, which typically take 81.5 days to pay up, compared with 61.3 days for medium-sized companies and 60.2 days for small companies.

This latest data supports similarly gloomy findings from credit management company Intrum Justitia. Its own report, issued in May, surveyed 1,000 companies and found a worsening casualty rate, with more suffering solvency problems because customers were failing to settle their bills promptly. Its research found that 30% of respondents were suffering a liquidity squeeze because of late payment, against 23% in a similar survey three years ago. A further 15% of companies said late payments were jeopardising their future, compared 11% in 2004.

The data, part of a wider survey of 6,500 companies in 25 countries, suggests that the UK ranks worse than many other European countries in the time taken for customers to pay. What's more, Intrum Justitia's figures suggested an average time of 51 days for payments to be made in the UK, but Experian put it at 61 days.

Whichever figure is more accurate, each contrasts with British companies' typical request that payment be made to them in no more than 30 days. Small businesses and new enterprises, which have lower credit limits than larger companies and lack the resources to pursue outstanding payments, are hit hardest by the time lag between this target and the actual payment period.

According to the Intrum Justitia data, companies in Germany, Europe's largest economic power, ask for payment within 31 days on average and wait 46.5 days, while those in Norway fare best and wait, on average, no more than 26.4 days for payment.

British companies also stand a slightly higher risk than the European average of not being paid at all. Those in England and Wales write off an average 1.9% of debt compared with the European average of 1.8%.

The situation appears to be worsening in this country despite legislation aimed at relieving pressure on suppliers' cashflow caused by the commercial pressures exerted by buyers. The Late Payment of Commercial Debts (Interest) Act 1998 gives business a statutory right to claim interest from other businesses for the late payment of commercial debt, and the EC's Late Payment Directive, which came into effect in August 2002, enables them also to claim reasonable debt recovery costs.

But relatively few companies make use of either, and Gordon Brown was recently urged to accelerate new rules for tackling late payments in the construction sector – a contributing factor in the late opening of the new Wembley Stadium and a threat to the timetable for Olympics 2012 building projects.

EXTENDED PAYMENT TERMS A more worrying development for smaller businesses is that a number of major companies not only pay late, but have been actively forcing through extended payment terms that oblige their suppliers to wait even longer. The trend is putting a squeeze on smaller suppliers according to the Forum of Private Business (FPB).

The FPB has been tracking moves by big companies to make alterations to their payment terms that are detrimental to smaller businesses. The latest to be added to its 'name and shame' list is Belgian brewing giant InDev, which, in May, changed payment terms for many of its suppliers from 30 days from the end of the month of invoice to 60 days.

The FPB's adviser on late payment, Paul Gregory, recommends that smaller businesses address late payment – which he describes as "nothing but delayed theft" – in their contracts. He says that the extended credit terms that big companies attempt to foist on suppliers contrast with the much shorter periods in which they expect their own invoices to be paid. Late payments may also set off a ripple effect, with suppliers responding by themselves delaying payments to others.

Gregory says that any contract that fails to include a "substantial remedy" for late payment is likely to be invalid and struck down by the courts. However, resorting to court action is a hazardous undertaking for small companies, which face substantial costs if they do not win their case.

A corporate policy of squeezing suppliers too tightly can sometimes backfire. Catering giant Compass in 2004 provided a well-publicised example of the unexpected consequences. The group adopted a particularly aggressive stance with its suppliers, which led to financial problems at key supplier Peter's Food Service. Compass was forced to pump funds into the business in an ultimately unsuccessful attempt to keep it afloat, with Peter's chilled food distribution arm eventually salvaged by food company Brakes.

The episode persuaded Compass to reduce the time taken to pay its suppliers and distributors from 90 days to 60 days, resulting in an additional cash outflow of £100m on top of a £13m hit to profits. The move received an unfriendly response from the City, where the group's shares were sharply marked down.

WIDESPREAD ACROSS EUROPE The problem is widespread enough across Europe to concern Brussels. A report prepared for the European Commission and issued last year, *Review of the effectiveness of European Commission legislation in combating late payments*, declares that extended payment periods prevent Europe's small to medium-sized enterprises (SMEs) from making "adequate and timely investment in research and development, technology and the labour force". They also create "risks and market distortions" that undermine the ability of SMEs to take advantage of the single market.

There are some 30 billion to 40 billion invoices issued each year in Europe, of which up to one billion result in default and become debt collection cases. The report supports long-held claims that late payment is the cause of one in four European corporate insolvencies, leads to annual losses of €23.6bn and the disappearance of up to 450,000 jobs each year. The report also finds that 32% of SMES participating in its survey raise their prices to factor in the cost of late payment, while 26% accept grossly unfair conditions.

When suppliers need to pay within 30 days but their customers only pay them within 90 days, the resulting imbalance represents a significant extra cost of doing business. This is the cost of extra working capital – known as the payment period working capital cost (PPWCC) or marginal cost – needed to compensate for the difference between the payment periods. The PPWCC does not take into account the cost of financial uncertainty created by late payments, which may force a company to provision extra working capital at the expense of growth, employment or innovation.

THE TREASURER'S STANCE So how should a treasurer approach this controversial issue? Their aim is to maximise cash, which means delaying payment is good and getting money in early even better.

Attempts to extend payment terms will ultimately result in a hike in the unit cost of the product or service being bought. The treasurer can help establish the 'sweet spot' – namely, the best balance between cash on the balance sheet (if you don't pay up, you're cash-rich) and the point where the profit and loss account begins to suffer as delay pushes up the unit price.

A number of factors must be considered to find where this sweet spot lies and bridging the two. This is determined by the cost of funds for both the supplier and the buyer and there are underlying commercial considerations. For example, once the purchasing company has established the new payment terms, it will work on getting the product or service cost reduced, which involves some tough negotiating.

Although treasurers can help in bridging the gap between the two parties, it's outside their sphere of activity to be actively involved in negotiations between buyer and supplier. But treasurers are increasingly involved in other areas by virtue of their growing levels of responsibility for the company's supply chain and working capital ratios. The latter are often regarded as value drivers for the business – for example, net days paid stock, which shows that the stock is often sold by the company before it has paid its supplier's invoice.

The recent downturn in the credit markets comes as companies are attempting to reduce their number of suppliers and squeeze out savings, forcing longer payment terms on those they do retain as a *quid pro quo* for more business.

The issue of late payments is likely to move even further centre stage in the coming months if, as seems likely, we have entered a more volatile period. For small suppliers, the outlook is worrying with an already tight squeeze set to intensify.

***The Treasurer* is planning further articles on this subject and would like to hear from treasurers on payment practices on both sides of the fence. Contact us at the email address below.**

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