Financial Management of Trade Credits in Small-Medium Sized Enterprises

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ABSTRACT

This paper reports the findings of an empirical investigation on the trade credit management practices in UK small and medium sized enterprises (SMEs). The study involved interviews with owner/managers in 20 SMEs, a postal survey with responses from a further 236 companies, and desktop analysis of an extensive database comprising the financial accounts of 10,000 UK SMEs. The findings show that although short-term financial management practices improve as companies grow there is scope for the owner-managers of small businesses to strengthen their trade credit management in order to reduce costs and enhance business performance. Moreover, they have to consider more financial options.

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INTRODUCTION

Small and Medium Sized Enterprises (SMEs), however they are defined, constitute the vast majority of all enterprises. Such firms, the majority of which are family controlled, make a major contribution to private sector output and employment, and this contribution appears to be increasing over time. However, while the rate of new enterprise formation has increased in recent years, there appear to be relatively few examples of UK companies which have sustained growth to a position where they are a major international force (Storey, 1994).

The problems, both internal and external, facing small businesses have been the subject of increasing interest. Since the Bolton Report in 1971, there have been a number of surveys and studies of the growth constraints experienced by smaller firms (for example, Soufani 2002, ACOST 1990, Aston Business School 1991, Cambridge Small Business Research Centre (CSBRC) 1992). The CSBRC (1992) survey concluded that the two most important constraints for all firms relate to matters of finance. Due to diverse financial as well as non-financial and behavioural factors (Poutziouris et al., 1998) small businesses rely more heavily on short-term funding, and this makes them more sensitive to macro-economic changes (Michaelas et al., 1998). Under such circumstances, businesses have to strive for more efficient working capital management and especially the management of accounts receivable and payable, which make up the largest proportion of working capital needs in small firms.

Peel and Wilson (1996) indicate that if the financial/working capital management practices in the SME sector could be improved significantly, then fewer firms would fail and economic welfare would be increased substantially. Yet, even though the importance of sound financial and working capital management is recognised, theoretical and empirical work on the area has been very minimal.

This paper examines the accounts receivable and accounts payable management practices of UK SMEs. The paper explores how the adoption of the trade credit management practices is associated to size, industry classification, organisational characteristics, and firm performance. It is hoped that the results of the research will assist policy-makers, educators and enterprise support agencies (including financiers) to identify the requirements of, and specific problems faced by, SMEs. Furthermore, by providing an overall picture of the trade credit management practices of UK SMEs, companies could use the results of the study to assess the appropriateness and effectiveness of their own practices.

EVIDENCE ON THE WORKING CAPITAL PRACTICES IN SMES

The management of working capital in SMEs, and particularly the smaller firms, has been reported to be inadequate by researchers across both sides of the Atlantic. Although, empirical work on working capital practices of US SMEs has been extensive (see McMahon & Holmes, 1991 and McMahon et al., 1993 for a review) empirical research on the working capital practices of UK SMEs has been less acute (Bolton, 1971; Peel and Wilson, 1996; Wilson, 1996, Jarvis et al., 1996; and Chittenden et al., 1998; Singleton and Wilson, 1998, Soufani 2002 are notable exceptions). The Bolton Committee were critical of many aspects of the financial management of small firms, reporting that information was often so poor that management frequently learnt of an impending crisis only when the annual accounts appeared, or following an urgent call from the bank manager. In fact, a study conducted by the chartered Institute of Management Accountants in the UK (CIMA,

1994) revealed that 20 per cent of businesses (most of which were smaller firms) that failed did so as a result of bad debts or credit poor management.

Wilson (1996) examine the credit management practices adopted in UK SMEs and found a strong connection between good credit management practice and aspects of company performance. For example, Wilson (1996) reports a strong relationship between efficiencies in managing the cash cycle and profitability. Wilson (1996) shows that those firms with late payment problems were typically reliant on short-term finance and were generally poorer in terms of credit management practice. Similarly, Singleton and Wilson (1998), argue that although late payment is a concern for all small firms, some of them manage it better than others. They find that firms with formal credit management procedures are better in managing late debt. These businesses tend to use longer term finance compared to businesses that have bigger late payment problems and use various forms of short term finance to fund working capital needs (Singleton and Wilson, 1998).

Peel and Wilson (1996) analyse the postal questionnaire responses of 84 small firms and conclude that a relatively high proportion of small firms in their sample use quantitative capital budgeting techniques, and review various aspects of the companies' working capital. On the other hand, Jarvis et al. (1996) interviewed 20 small firms and indicated that 'best practice' models advocated by the finance literature are not necessarily appropriate to small firms and alternative approaches may be viable, even though these alternative approaches may be unorthodox in the eyes of academics. They conclude that financial management practices in small businesses are driven by the motivations of owner-managers which tend to be ignored in the literature.

Given the proportion of SMEs in our economy and their continual quest for more efficient use of resources in order to remain competitive, there is a definite need for more information on the methods used by small firms to accumulate and allocate their scarce working capital resources.

Data and Methodology

This study examines the financial management and working capital practices of SMEs and to provide practical information to policy-makers, financiers, academics and most importantly business owner/managers.

The study involved interviews with owner/managers in 20 SMEs operating in the North West of England, a postal survey with responses from a further 236 companies from across the UK, and desktop analysis of an extensive database comprising the financial accounts of 10,000 UK SMEs over a period of ten years, 1988-1997, (all data was taken from Lotus OneSource Database on UK firms). All sample firms were privately held companies with less than 250 employees. Of these firms, 39% have less than 50 employees, 37% employee 50-99 staff, with the remaining 24% employing more than 100 staff.

As can be seen from the data, sample firms represent the larger SME population, and in a way smallest firms are under-represented (only 6 per cent of sample firms have less than 20 employees). It could also be argued that companies which responded to the postal survey are the ones which are more interested in working capital management and possibly have better working capital management systems than non-respondent firms. Thus, if anything, working capital practices in the smaller firms (less than 20 employees) could be expected to be even less sophisticated than what the results presented in this study suggest. Thirty percent of sample firms are in manufacturing industry, 19% are construction companies, wholesale traders constitute 17% of sample firms, another 19% are business services companies. The remaining 15% have been classified as ‘Other’ business activities. Figure 1, presents a breakdown of the database of sample firms by employment size and industry.

Figure 1: Breakdown of SMEs Database by Size and Industry

MANAGEMENT OF ACCOUNTS RECEIVABLE (TRADE DEBTORS)

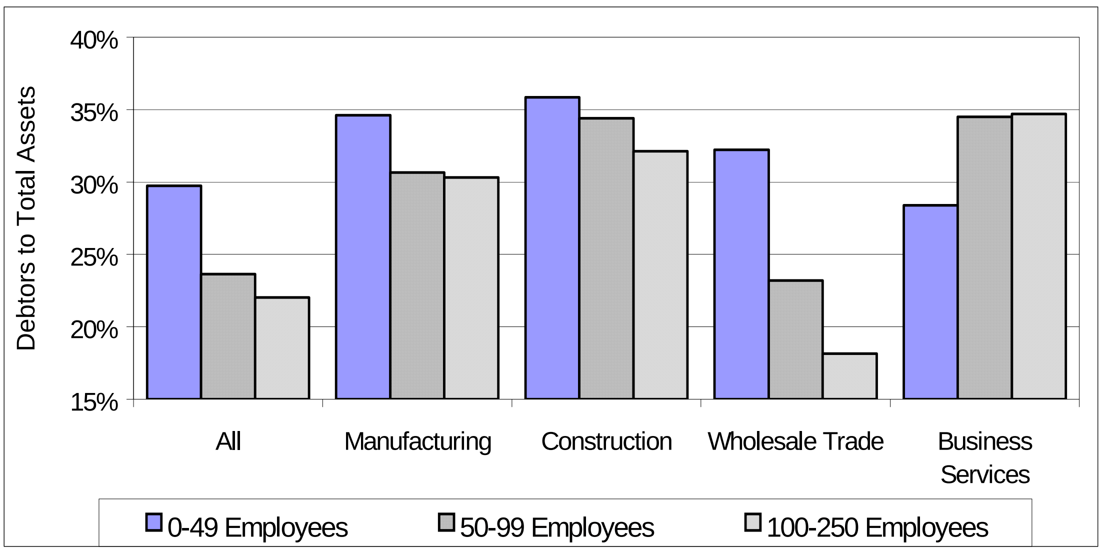
Credit Policy in UK SMEs

Trade credit is one of the most important sources of short-term finance used by businesses, and especially small firms, and as shown below, it represents a substantial part of business assets and liabilities. In fact, more than 96 per cent of the respondent firms indicated that they provide credit to their customers. On average 91 per cent of daily business transactions in sample firms are on credit terms (note that the retail sector is excluded). Trade debtors are one of the main assets on most corporate balance sheets. Utilising a database comprised of the financial accounts of 10,000 private SMEs over a period of eleven years (1987-97)[1], we estimate that trade debtor's represent 28% of total assets in UK SMEs.

[1] All the data was collected from the Lotus OneSource Database on UK Firms.

As can be seen in Figure 2, the ratio of debtors to total assets differs significantly across industries and across size bands, being as high as 36 per cent in smaller construction firms and as low as 18 per cent in larger wholesale trade businesses. It is very interesting to note that in all of the four sectors examined the ratio of debtors to total assets is higher the smaller the firm, except in the business services sector, where the opposite is true.

Figure 2: Ratio of Debtors to Total Assets in UK SMEs



With debtors constituting almost one third of the total assets of small firms, the management of accounts receivable is paramount to the survival and success of every business. Yet, only 36 per cent of small firms have a fully documented credit policy, with another 41 per cent having a partially documented policy. In 22 per cent of respondent firms, credit policy is either purely verbal or non-existent. Nevertheless, a good credit policy is one where there are clearly defined procedures and where customers know the rules. Debtors who are experiencing financial difficulties will look to do business with, or try to delay payment to, companies known to have poor or relaxed credit granting and collection procedures. However, as we shall she below, credit management in UK SMEs falls behind best practice and the results of this study suggest that there is a space for improvement.

Credit Management Activities in UK SMEs

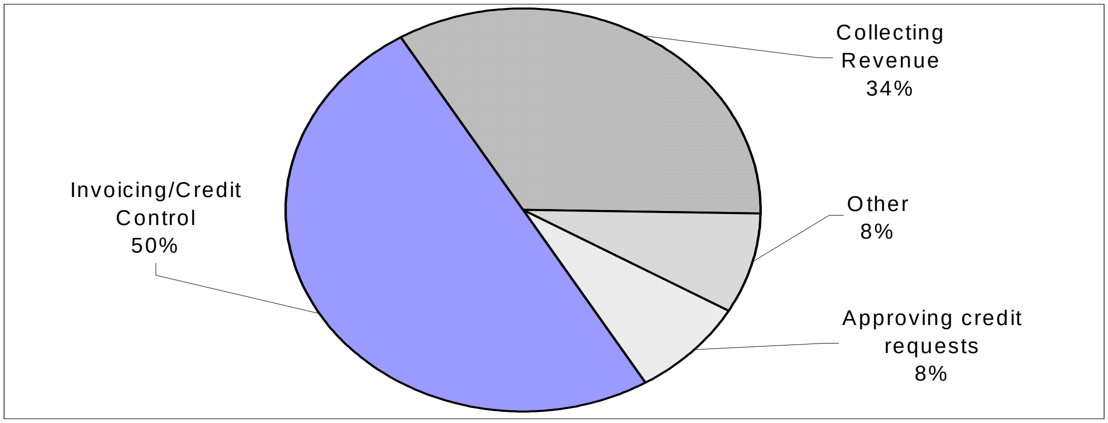
On average, 45 per cent of the respondent firms have a full-time credit officer. Larger companies, with more than 100 employees, are more likely to employ a full-time credit officer (54 per cent) than smaller businesses (42 per cent). Figure 3 illustrates that full-time credit officers are more common in the wholesale trade sector compared to the construction and business services sectors. This may be because profit margins in wholesaling businesses are relatively small, and as a result good credit management is of paramount importance.

Figure 3: Full-Time Credit Officers in UK SMEs

Pearson Chi-Square = 9.480, Significance = 0.050

Figure 4 presents a breakdown of the total time devoted to accounts receivable (debtors) in UK SMEs. It can be seen that 84 per cent of the total time spent on managing accounts receivable is consumed by invoicing and collecting revenues. Only 8 per cent of total credit management time is devoted to approving credit requests and negotiating and agreeing terms.

Figure 4: Breakdown of Total Time Devoted to Accounts Receivable



It could be argued that small firms are not proactive in their credit management activities, as they spend significantly less time and effort on 'pre-delivery' activities, i.e. on activities that occur before the delivery of goods/services. Respondents were asked to rank the importance of different credit management activities on a scale from 1 to 5, where 1 = Not Important and 5 = Very Important. As can be seen in Table 1, 'pre-delivery' activities are rated as less important than 'post-delivery' activities, i.e. activities that occur after the delivery of goods/services.

Table 1: Importance of Credit Management Activities

Credit Management Activity	Importance 1=Not Important, 5=Very Important			
	All Firms	Firm with no late payment problems	Firms with late payment problems	T-Statistic
Pre-Delivery Activities				
Checking customers' ability to pay	3.94	4.43	3.81	-3.610**
Negotiating payment terms with customers	3.38	3.70	3.30	-1.751*
Checking orders against credit limits	3.23	3.27	3.15	0.364
Post-Delivery Activities				
Collecting revenue in line with agreed terms	4.27	4.28	4.30	-0.074
Administering sales ledger	4.21	4.05	4.15	0.466
Resolving disputed invoices	4.10	4.04	4.35	-1.796*
Chasing overdue payments	4.57	4.55	4.73	-2.378**

*/** statistically significant at 90/95% level.

Evidently the most important credit management activity in small firms (on a scale form 1 to 5) is chasing overdue payments followed by collecting revenue in line with agreed terms. In fact, when asking a similar question to a sample of SMEs Wilson (1996) found that 33% of time devoted to credit management is spent on chasing overdue payments with a further 24 per cent of the total time spent on collecting revenue in line with agreed terms. However, the need to undertake this action could be the result of poor credit screening practices. If the sales effort is to be directed towards those customers yielding the highest returns, the credit management must asses the quality of both its existing and potential customers (Pike et al., 1998).

Respondents were asked to indicate what factors they consider in deciding to grant or refuse credit to new or existing customers. As can be seen in Table 2, the most important factors determining credit decisions are: the firm's credit history, knowledge of the owner/manager, the customer's type of business, credit agency reports and trade references.

Table 2: Factors Determining Credit Decisions

Factor	Importance 1=Not Important, 5=Very Important			
	All Firms	Firm with no late payment problems	Firms with late payment problems	T-Statistic
Firm's credit history	3.96	4.24	3.91	1.762*
Knowledge of owner/manager	3.46	3.79	3.38	1.703*
Customer's type of business	3.29	4.21	3.01	0.928
Credit agency reports	3.27	3.44	3.23	-0.077
Trade references	3.13	3.60	3.01	-3.234**
Size of the firm	2.84	2.87	2.86	-2.616**
Age of the firm	2.81	2.69	2.87	-0.786
Bank references	2.68	3.25	2.51	-1.997**

*/** statistically significant at 90/95% level.

Information regarding customer creditworthiness is available from various sources. A strong credit policy should provide clear guidance on when, where, what and how much information should be acquired. Approximately 62 per cent of the respondent firms subscribe to a credit agency to obtain information about potential customers. However, the volume of information purchased is very low. On average, credit agency fees amount to 0.02% of turnover.

Nevertheless, as can be seen in Table 2, firms with no late payment problems appear to pay more attention to credit agency reports, trade references and bank references compared to businesses that experience late payment problems. Moreover, although 84 per cent of small firms provide their customers with their terms and conditions, only 58 per cent of the respondent firms require that new customers complete a credit application. Credit application forms are particularly popular in the wholesale trade industry (in 95 per cent of the firms) but relatively unpopular in the construction industry (used by 25 per cent of the firms).

Additionally, 83 per cent of small firms do not formally categorise customers into different risk categories. Furthermore, as can be seen in Table 3, only 41 per cent of the respondent firms assign credit limits to all customers, while 20 per cent of small firms do not assign credit limits to any of their clients. Credit limits on customer accounts appear to be more popular in the manufacturing and business services industries although these differences are not statistically significant.

Table 3: Percentage of Companies Assigning Credit Limits

	Manufacturing	Construction	Wholesale Trade	Business Services	All
To all customers	46%	24%	59%	31%	41%
To some customers	41%	34%	33%	38%	39%
Not at all	13%	41%	8%	31%	20%

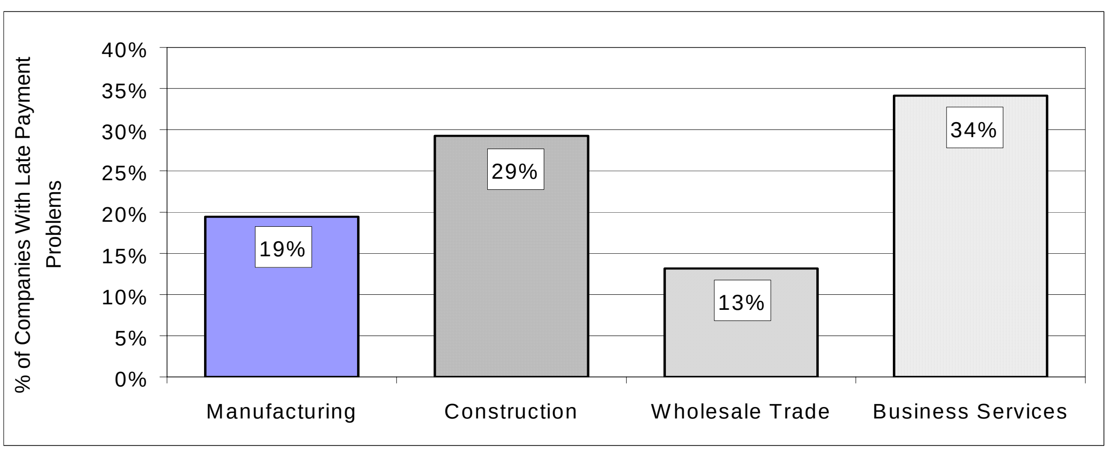
Pearson Chi-Square = 1.598, P = 0.809.

It is evident that some small firms pay less attention to ‘pre-delivery’ activities. Consequently, on average 90 per cent of the requests for credit from prospective customers are accepted. In the words of one of the owner/directors interviewed: *'We give credit to anybody who asks for it. It is as simple as that’* (Manufacturing company; 48 employees). However, it is important that businesses focus on 'pre-delivery' activities of negotiating and risk screening rather than simply collection. As can be seen in Table 2 above, '*pre-delivery' activities are regarded as more important in firms with no late payments problems compared with firms facing serious problems with overdue accounts'*. In a similar investigation, Wilson (1996) found that companies that spent more than 35 per cent of total credit management time on activities that occur in the early part of the cash cycle and before the delivery of goods or services had: a greater proportion of sales paid on time (75% compared to 62%), a lower bad debts as a percentage of sales (1.35 compared to 2.4%); and lower average debtors days for same credit periods (41 days compared to 46 days).

The Problem of Late Payments

Late payment of trade debt is a continuing problem for businesses across all sectors in the United Kingdom. In fact the issue of late payment has provoked a great deal of press comment and parliamentary interest in recent years. Respondent firms indicated that, on average, less than 50 per cent of their customers settle their accounts on time, without having to be chased. In fact, 25 per cent of small firms face either serious or very serious late payment problems. As can be seen in Figure 5, late payment problems are more serious in the construction and business services industries.

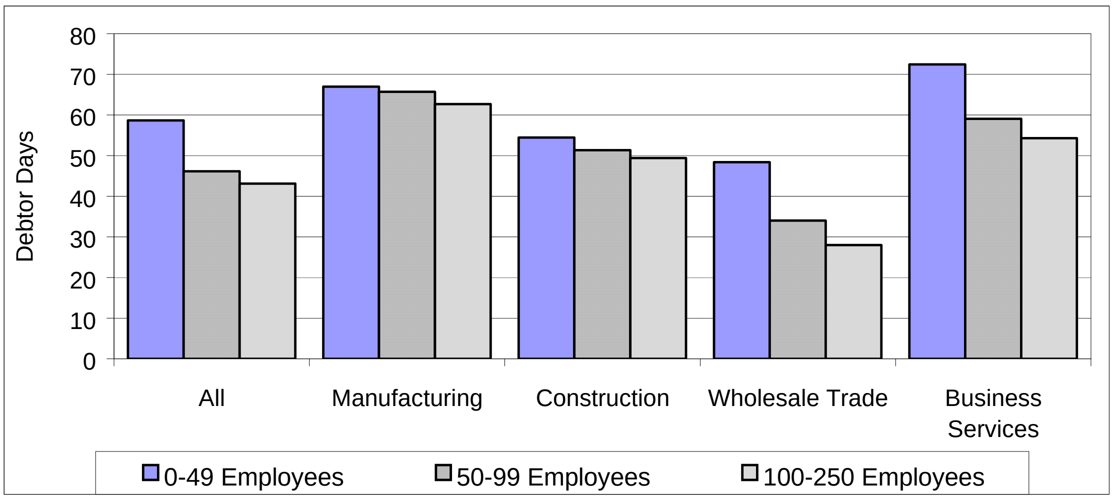
Figure 5: Late Payment Problems Across Sectors



Pearson Chi-Square = 10.090, P = 0.039.

Based on the database of the 10,000 UK SMEs mentioned above, we estimate that average debtors days in these businesses amount to 54 days. However, as shown in Figure 6, debtors days are significantly higher in the manufacturing and business services industries compared to construction and wholesale trades.

Figure 6: Debtor Days across Industries



It is also very interesting to observe that debtors days are higher the smaller the firm in all industries. This could be the result of better credit management practices adopted by larger firms. Alternatively, it could be because smaller firms have a lower asset base relative to their size, or offer more credit to their customers as part of their marketing strategy when compared to larger counterparts.

Interest on Late Payments

As from 1st November 1998 small firms in the UK have been able to claim interest on late payments by large businesses (to be more precise and from 1st November 2000 they have been able to claim interest from other small businesses) . Incorporating the right to charge interest on overdue accounts in the credit terms and conditions can help reduce and finance overdue debts. In fact, 43 per cent of respondent firms indicated that they incorporate the right to interest on late payments in their credit policy. This percentage is higher the larger the company. This may suggest that smaller firms have not got the bargaining power those larger firms' posses. Nevertheless, only 2 per cent of the respondent firms presently charge interest on overdue payments. These firms usually charge interest at the rate of borrowing plus a certain percentage; 3 per cent.

Credit Insurance

Bad debt risks can be reduced and transferred to a third party by purchasing credit insurance. However, the risk has to be high enough to warrant the insurance premium. In fact, only 23 per cent of small firms have credit insurance cover. Table 4 shows that the percentage of firms using credit insurance increases as the firm grows larger.

Table 4: Credit Insurance Cover in UK SMEs

	Number of Employees			
	0-49	50-99	100-250	All
% Using credit insurance	18%	22%	35%	23%

Pearson Chi-Square = 5.915, P = 0.052.

Credit insurance policies purchased by small firms cover, on average, 68 per cent of their credit turnover. Again, insurance cover as a percentage of credit turnover is higher amongst larger firms.

Figure 7: Credit Insurance Cover as a Percentage of Credit Turnovers

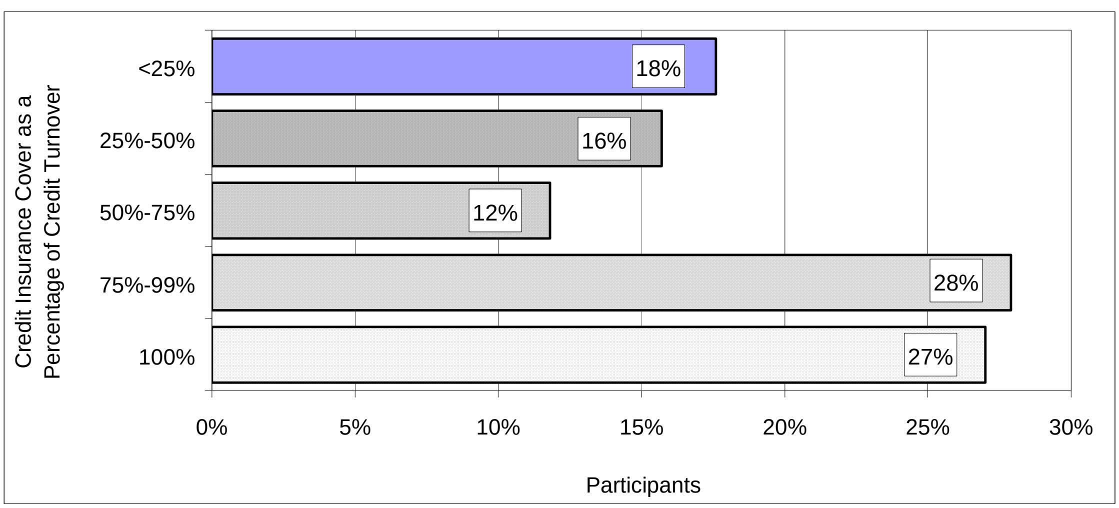


Figure 7 show that 27 per cent of small firms that have credit insurance have insurance policies covering 100 per cent of their credit turnover. Furthermore, average credit insurance fees in small firms that have an insurance policy amount to £20,000 or 0.28 per cent of insured turnover.

MANAGEMENT OF ACCOUNTS PAYABLE (CREDITORS)

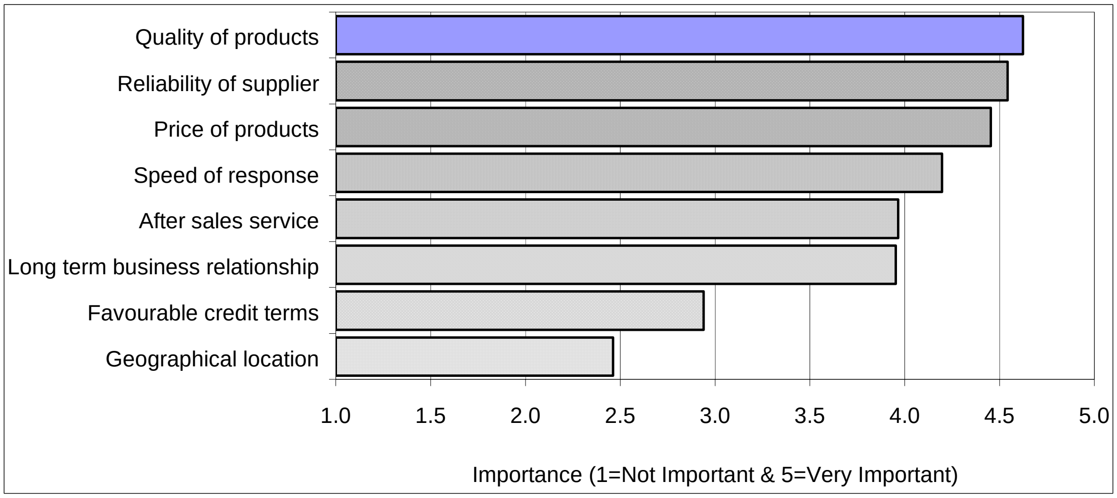
Choosing Suppliers

Careful choice of suppliers is very important because this will determine the quality and reliability of goods and services purchased as well as the credits terms on which these goods/services are bought. This is especially important when it is considered that, on average, 93 per cent of all purchases in small firms are obtained on trade credit. In fact, 25 per cent of small firms buy all of their inputs on trade credit.

Figure 8 shows that the most important factors determining the choice of suppliers, in order of importance, are: quality of products, reliability of supplier, prices of products, speed of response, after sales service, and long term business relationships. Quality of products and reliability of supplier, price and speed of response were also found to be the four most important factors determining the choice of suppliers in the Wilson (1996) study. It is very surprising to observe that favourable credit terms are not considered as important factors when choosing suppliers.

We can see that the average score for favourable credit terms is below 3, which is the middle ground between 'Not Important' and 'Very Important'.

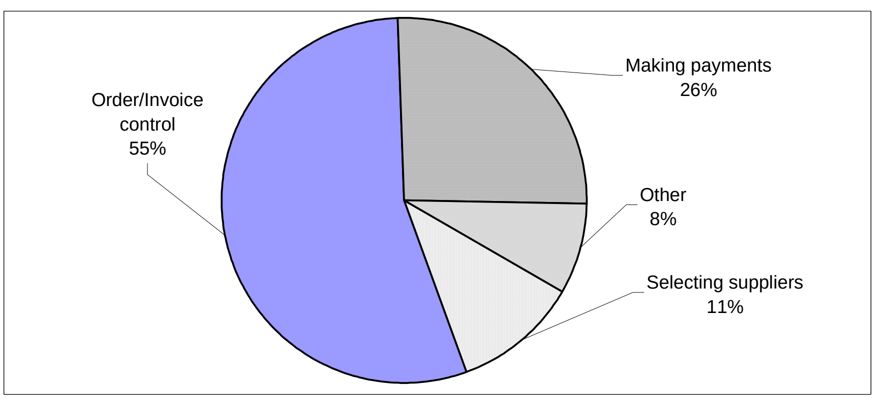
Figure 8: Factors Determining Choice of Suppliers



Managing Accounts Payable (Creditors)

Figure 9 presents a breakdown of the total time devoted to managing accounts payable (creditors) in UK SMEs.

Figure 9: Breakdown of Total Time Devoted to Accounts



As with the management of debtors, the focus of attention in the management of creditors is on 'post-delivery' activities. These include order and invoice control (55 per cent of total creditors management time), and making payments (25per cent of the total time). On the other hand, total time devoted to 'pre-delivery' activities, notably selecting suppliers, amounts to 11 per cent.

However, as shown in Table 5, companies that spend 25 per cent or more of total time devoted to managing accounts payable to selecting suppliers, enjoy, on average higher creditors days. This may suggest that by spending more time on selecting their suppliers smaller firms can improve their cash-flow cycle.

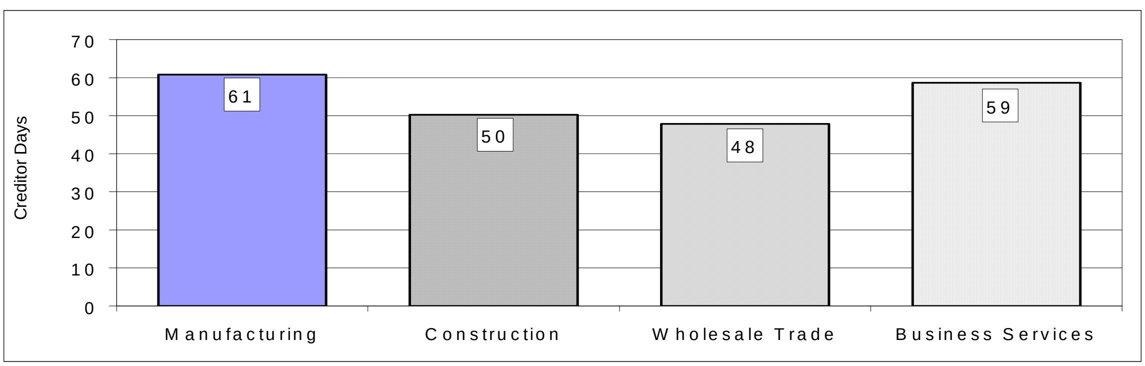
Table 5: Time Devoted to Selecting Suppliers and Creditors Days

	Less than 25% of time devoted to selecting suppliers	More than 25% of time devoted to selecting suppliers	T-statistic
Creditors Days	44 days	64 days	-3.447*

* Statistically significant at 95% level.

As shown in Figure 10, creditors days appear to be lower in the wholesale trade (48 days) and construction (50 days) compared to manufacturing (61 days) and business services (59 days) sectors.

Figure 10: Creditors Days across Sectors



F – Statistic = 4.112, P = 0.002

Trade Discounts

The natural reaction of small businesses suffering from late payments from their customers is to delay payments to their suppliers. In fact, 62 per cent of the respondents indicate that they tend to delay payments to suppliers on a regular basis. This percentage is higher in larger firms which possibly have more power over suppliers. Three quarters of the larger businesses (more than 100 employees) delay payment to creditors, compared to 35 per cent of the smaller firms.

However, paying bills late (unauthorised trade credit) is the most expensive form of business finance. The analysis of the responses suggests that the average discount rate offered by suppliers is 3% with an average discount period of 20 days. The most frequently cited cash discount is 2.5 per cent within 30 days. Based on the database of 10,000 SMEs discussed above we find that average creditor days in UK SMEs is 53 days.

Exhibit 1, demonstrates how a company that does not take advantage of a trade discount of 2.5/30 net 53 (i.e. 2.5 per cent discount for paying invoices within 30 days rather than 53) is effectively borrowing the money due at an annual interest rate of 41%.

Exhibit 1 -- Estimation of interest rate

Average creditors days are 53 days and the most cited cash discount is 2.5 per cent within 30 days. For any company not taking advantage of such a trade discount the interest rate equivalent is shown below.

$$\text{Interest rate equivalent} = \frac{\text{Discount \%}}{100 - \text{Discount \%}} \times \frac{365}{\text{Final Date} - \text{Discount Date}}$$

$$= \frac{2.5}{100 - 2.5} \times \frac{365}{53 - 30} = 40.7\%$$

Yet, the vast majority of small businesses are unaware of the opportunity costs of trade discounts forgone, and consequently many firms do not take advantage of this facility. Analysis of the responses suggests that, on average, 56% of small business owners/managers are not aware of the opportunity cost of trade discounts forgone.

Although, 43 per cent of the respondents indicated that all or most of their suppliers offer them trade discounts, less than 45 per cent of small businesses take advantage of trade discounts offered to them on a regular basis, while 25 per cent never (or rarely) pay suppliers within the discount period to take advantage of discounted invoices. Yet, more than 90 per cent of purchases in small firms are bought on credit, and if we consider that in the majority of cases, small firms will not take advantage of the trade discounts offered to them, enormous savings are forgone.

Small businesses should be encouraged by their financial advisors to take advantage of prompt payment discounts. This would reduce costs to small firms, but would also help in decreasing the late payment problem. Unless, a company can delay payments to its customers long enough to compensate for the opportunity cost of not taking a trade discount, it is in the company's interest to pay suppliers within the trade discount period and take advantage of lower prices. Even if a firm does not have the liquidity to pay invoices within the discount period, it is in the firm's interest to borrow money, probably in the form of short-term loans or bank overdraft, so that the business can take advantage of the trade discounts.

The question that arises now is how does a company decide when it should take advantage of a trade discount or not. In Table 6, we estimate the break-even point between the opportunity cost of trade discounts forgone and the benefits derived from delaying payments to suppliers. The break-even point will depend on the interest rate (the rate at which the firm can borrow money) and the rate of suppliers discounts.

For example if the borrowing rate of a company is 10% and it is offered a discount of 3% for invoices paid within the discount period, then unless the company can delay payment of the invoice for more than 117 days, it is in the company's interest to borrow money and so take advantage of the trade discount. If it can delay payment beyond the 117 days break-even point, then it will save money by doing so, but this could damage relationships with suppliers since this involves stretching the credit period 64 days over the average payment period in the UK (53 days).

Table 6: When Should You Take Advantage of a Trade Discount?

	Break Even Point in Days for Deciding on Borrowing to Pay Accounts Payable by the Discount Day																		
	Interest Rate																		
Discount	6.0	6.5	7.0	7.5	8.0	8.5	9.0	9.5	10.0	10.5	11.0	11.5	12.0	12.5	13.0	13.5	14.0	14.5	15.0
1	63	58	54	51	48	45	43	40	38	37	35	34	32	31	30	29	28	27	26
1.5	95	88	82	76	72	68	64	61	58	55	53	51	49	47	45	44	42	41	39
2	127	117	109	102	96	90	86	81	77	74	71	68	65	63	60	58	56	54	53
2.5	159	147	137	128	120	113	107	102	97	93	89	85	82	78	76	73	71	68	66
3	191	177	164	154	144	136	129	123	$\boxed{117}$	111	107	102	98	94	91	88	85	82	80
3.5	223	206	192	180	169	159	151	143	136	130	125	119	115	110	106	103	99	96	93
4	256	237	220	206	194	183	173	164	156	149	143	137	131	127	122	118	114	110	107
4.5	288	267	248	232	218	206	195	185	176	168	161	154	148	143	138	133	128	124	120
5	321	297	277	259	243	229	217	206	196	188	179	172	165	159	153	148	143	138	134
5.5	354	328	305	286	268	253	240	228	217	207	198	190	182	175	169	163	158	152	148
6	388	359	334	312	293	277	262	249	237	226	216	207	199	192	185	178	172	167	162
6.5	421	390	363	339	319	301	285	270	257	246	235	225	216	208	201	194	187	181	176
7	455	421	391	366	344	325	307	292	278	265	254	243	234	225	217	209	202	196	190
7.5	488	452	421	393	370	349	330	314	299	285	273	261	251	242	233	225	217	210	204
8	522	483	450	421	395	373	353	335	319	305	292	280	269	258	249	240	232	225	218
8.5	556	515	479	448	421	397	376	357	340	325	311	298	286	275	265	256	247	239	232
9	591	547	509	476	447	422	399	379	361	345	330	316	304	292	282	272	263	254	246
9.5	625	579	539	504	473	447	423	401	382	365	349	335	321	309	298	288	278	269	261
10	660	611	568	532	500	471	446	424	403	385	368	353	339	327	315	304	293	284	275

Therefore, it is clear that it is in the interest of all companies to take advantage of trade discounts, even if the company has to borrow money in order to be able to pay invoices within the discount period. Yet, when we asked small business owners whether they would be willing to borrow money to pay for invoices in order to take advantage of trade discounts, 73 per cent of the respondents indicated that they would not do so. It could be argued that current bank products such as bank overdraft and term loans are not appropriate for the financing of purchases. Perhaps, there is scope for a new financial product that will provide funds for paying creditors within the discount period.

CONCLUDING REMARKS

This report has documented the key findings of the Manchester Business School/European Regional Development Fund investigation of the trade credit practices in UK SMEs. The report has looked at how credit management systems within SMEs are set up, and how these businesses manage their debtors and creditors.

The use of trade credit is widespread in the small business sector. Almost all business transactions are on credit terms, with debtors representing one quarter of the average SMEs' assets, with creditors equivalent to 11 per cent. However, credit management in smaller firms falls behind best practice. In spite of the importance of trade credit, the majority of SMEs do not have a documented credit policy. Credit screening appears to be very basic, especially in smaller firms, and consequently more effort and time is devoted to 'post-delivery activities': collecting revenue, chasing overdue payments, making payments to creditors. It has been shown, however, that firms that spend more time on 'pre-delivery activities': approving credit requests and choosing suppliers, are less likely to experience late payment problems and also enjoy higher creditors days.

Late payment is a continuing problem for small firms. It has been shown that less than fifty per cent of customers settle their accounts on time, with one quarter of small businesses facing either serious or very serious late payment problems. The natural reaction of small businesses suffering from late payments from their customers is to delay payment to creditors. However, paying bills late (unauthorised credit) is the most expensive form of business finance. Yet, the majority of small business owner/managers are unaware of the opportunity costs of trade discounts forgone, when delaying payments to suppliers.

It was explained that it is in the interest of all companies to take advantage of trade discounts, even if the company has to borrow money in order to be able to pay invoices within the discount period. Yet, the majority of the respondents indicated that they would not be willing to do so. Perhaps there is scope for a new financial product that will provide funds for paying creditors within the discount period. This could help reduce costs in small firms, but would also help in decreasing the late payment problem in the economy.

POLICY AND MANAGEMENT IMPLICATIONS

It is apparent from the above discussion that there is plenty of opportunity for improvement in the financial management practices of UK SMEs. Small businesses should be encouraged by their advisors to become more proactive in their credit management practices. There is scope for improvement in the credit screening practices of small firms, which in the long run, will save money and time. Better credit management planning could also facilitate the higher utilisation of trade discounts which can save large amounts of money.

Although it is the responsibility of business entrepreneurs to familiarise themselves with best practice, and arrange for the implementation of such practices, business advisors and government policy can play an important role in encouraging and facilitating such developments.

Financial institutions are also in a good position to encourage best practice in small firms. It has been discussed that although small firms can benefit by taking advantage of trade discounts, even if they have to borrow money in order to pay suppliers within the discount period, very few small business owner/managers would be willing increase their borrowings for this purpose. In this context small business owners' reservations about using external finance represent a self-imposed financial barrier.

Perhaps, there is scope for a new financial product that will provide funds for paying creditors within the discount period. In some cases, the inventory purchased could be provided as security. This would take the form of reverse - factoring, where in this case the factor would not provide money for debtors-sales invoices but for creditor- purchase invoices. Furthermore, the finance house could also provide purchase negotiation advice that could yield better terms/prices. Ultimately, small businesses could also possibly outsource part of their purchasing department/function to the finance companies that will be in a better position to negotiate better terms/prices for their clients.

In addition, factoring companies could, perhaps, use this knowledge about the advantages of taking trade discounts to offer a service to their clients that would reduce customer payment periods and, by managing their clients' purchase ledgers, apply the additional cash collected to obtaining the maximum trade and cash discounts from suppliers. This could increase the average (but not the total) amount advanced against factoring contracts as cash receipts would immediately be applied in payments to suppliers to capture the best cash discounts. The factoring house, familiar with, and in control of cash collection for customers, would be able to negotiate on behalf of their factoring customers for cash discounts and improved purchasing terms that fit in with the observed payment patterns of customers. For the factoring house this will yield a fee for outsourcing the management of the purchase ledger and a higher level of borrowing (and therefore higher interest charges).

APPENDIX : The Factoring Solution for Growing Small Firms

The following business case can highlight the different issues addressed above with regard to the potential benefits of working capital management using factoring or the invoice financing option as a financing choice for smaller enterprises.

Case Study - "Ela-Kids" *

A second generation entrepreneur (Mr Youngo), in line with his family tradition started his own company – "Ela-Kids" to manufacture and trade children's Caps, Gloves and Socks. The entrepreneur identified a number of outlets for his products in the form of two large department stores and a number of retail outlets in big shopping centres.

The key issue in the start up phase was the availability of finance. Mr Youngo had a few thousands pounds to start-up his company which was incorporated in the year 2000 but did not have enough working capital to accelerate growth via producing new designs and channelling his products to new markets . He approached the bank and requested a loan (more specifically mixture of overdraft and term debt facility) to fund the working capital cycle, central to its early growth agenda. The bank was not prepared to take the risk since the start-up company – a spin out of a struggling family firm - has not yet established a business track record of sales and orders. Moreover the owner-manager had limited financial management expertise which has been jeopardising working capital efficiency. His approach to late payment was to delay extensively payment to trade creditors – often overlooking generous trade discounts

Mr. Youngo was then recommended to a factoring company where after a brief meeting an agreement was in place: the factoring company would extend up to £50,000 pounds provided the entrepreneur secured some orders from his potential customers, and then, as sales materialized and trade credits were offered the factoring company would forward money against invoices. This placed the business extension of credit on a self liquidating basis as if it was selling for cash. The company has grown since 2000 to become a thriving small niche-enterprise with annual sales of £850,000 per year.

Mr. Youngo indicated that the role of the factoring option at the start up phase of the business was certainly very critical, without over-looking the importance of other elements such as quality of the product, pricing tactics and quality customers, and his effective marketing strategy. The winning marketing mix, made the factoring option used at the early stages of the business start-up feasible and effective.

*The company wishes to remain anonymous

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