The economic impacts of late payment

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Abstract

This short paper presents an overview of existing evidence about the impact and consequences for companies who are paid later by their customers than agreed terms. It sets out evidence on the causes of late payment, impacts of late payment on companies and the economy and concludes by setting out potential policy responses.

1. Introduction

Research in 2016 into access to finance in the oil & gas industry[2] identified that many supply chain companies were being affected by late payment (defined as being paid by their customers later than agreed terms). Following this, further research was carried out to better understand the extent and impact of late payment for the wider economy.

2. The extent of late payment practices

A range of evidence highlights that late payment is an ongoing and, in many cases, worsening issue for SMEs. For example:

- Scotland had the highest level of late payment in 2015 (67% of companies affected) ahead of Northern Ireland at 66%, England at 62% and Wales at 59%[3].
- The total late payment debt across UK business in 2015 was estimated to be £26.3 billion (Scotland's share would be approximately £1.8bn), an average of £32,185 for SME's who said they are affected[4]. One in four SMEs say if this figure reached £50,000 they would have to declare bankruptcy[5].
- Late payment was a 'big problem' for 10% of all Scottish SME employers in 2015, and a less significant problem for 33%[6]. Figures for the UK as a whole are similar (14% and 31% respectively[7]).
- Medium sized (49%) and small businesses (44%) in Scotland were more likely to have had a problem with late payment than micro-businesses (42%)[8].

[1] *Scottish Enterprise is Scotland's main economic development agency*
[2] *Oil and Gas Finance Market Gap Analysis (March 2016)*
[3] *Bacs Payment Schemes Limited*
[4] *Bacs Payment Services Ltd, £26 billion owed in late payments – but this won't get worse under Brexit , say smaller UK businesses (2016)*
[5] *Bacs Payment Schemes Limited*
[6] *Scottish Government (2015) 'Small Business Survey Scotland''*
[7] *Small Business Survey, Department for Business, Innovation & Skills (2015)*

- Average payment time has increased since 2008 with small businesses (with turnover under £1m) waiting 71 days on average, compared to 48 days for large (£500m+ turnover) businesses[9].

There are also variances across sectors. Late payment was a greater problem in manufacturing (51% of SMEs), construction (66%) and business services (55%) compared to other sectors[10].

3. The impact of later payment on SME's

The European Commission found that in the UK, 30% of businesses indicated that late payment had links to subsequent redundancies (compared to 35% of businesses in Germany; 28% Spain, 25% in France)[11]. The study also found **late payment has a negative impact international exports** as many businesses surveyed felt international activity was risky both due to the frequency of late payment and how to manage any cases that arise.

Late payment also forces many affected businesses to focus on 'day-to-day' activities rather than longer-term plans for growth and expansion[12]. Research has shown that **the longer companies wait for payment, the lower the level of investment they make.** A month delay in being paid would reduce capital spend by 1.2%, and could lead to reduced profitability for as long as five years thereafter[13].

There is evidence that **late payment is linked to an inability to access affordable finance**[14]**,** due for example to an inability to demonstrate to lenders a clear cash flow (this is an issue Scottish oil & gas companies have reported[15]).

Other consequences for businesses of late payment highlighted by research include[16] [17]:

- time (with cost implications) having to be spent chasing invoices
- paying their own suppliers late
- increased borrowing/use of overdrafts
- difficulty paying bills like energy, rate and rent
- directors reducing their salary to keep cash within the company

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[8] Small Business Survey, Department for Business, Innovation & Skills (2015). There was no statistically significant variation between Scotland and the UK as a whole. Micro businesses are those with less then 10 employees, small businesses have 10-49 employees, medium businesses have 50-249 employees.
[9] Asset Based Finance Association, *Late Payment, An analysis by sector*, 2015.
[10] BIS (2015) *'Small Business Survey 2014: SME Employers'*,
[11] European Commission, March 2016, *'Ex-Post Evaluation of Late Payment Directive'*,
[12] Bibby Financial Services, December 2015, *Q4 SME Confidence Tracker Report*,
[13] ACCA, 2015 *'Ending late payment. Part 1: Taking Stock'*
[14] All-Party Inquiry into Late Payments in SMEs (July 2013)
[15] Oil and Gas Finance Market Gap Analysis (March 2016)
[16] Hilton-Baird Collection Services, Hilton-Baird's Late payment Survey, January 2015
[17] Bacs Payment Services Ltd (2016)

- difficulty paying staff on time.

Overall, the evidence suggests that late payment is having a negative effect on the ability of many Scottish companies to invest and grow. More evidence is needed to establish the specific links between late payment, investment and internationalisation, but evidence that does exists indicate there is a link.

4. Reasons for late payment

Whilst in some cases late payment may reflect inefficient internal processes there are cases where larger companies use their power (either explicitly or implicitly) to 'compel' smaller companies into accepting late payment as standard practice. They use their market power and financial strength to pressure smaller companies into acquiescing; or simply pay late knowing it will not be challenged because of the importance of the contract.

How larger companies exercise this power can be complex. For example, some companies build in processes to delay acceptance of an invoice, whether through overzealous queries or via deliberately complex and lengthy accounts procedures[18].

This type of behaviour becoming the 'accepted norm' can have a significant impact on the sustainability on companies in the industry, particularly if there is a reliance on single or larger customers. For example, in the oil & gas sector, many operators use exclusive contracts which limit the ability of SMEs to broaden their client base. If companies are being starved of cash due to late payment, it then becomes more difficult for them to invest in innovation and other growth plans.

A UK Parliamentary Inquiry noted that challenging late payments from larger clients was not seen as desirable as *"SMEs are reluctant to trigger a statutory right to interest fearing losing a valuable client or developing a reputation of being overly litigious"*[19]*.* In the oil & gas sector, many operators use exclusive contracts which limit the ability of SMEs to broaden their client base.

Late payment can also be due to internal financial inefficiencies as well as external factors beyond the control of the payer. Hilton Baird found the most common excuses for late payment were waiting for payment authorisation (27% of companies) and waiting to be paid themselves (19%)[20].

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[18] ACCA, 2015 'Ending late payment. Part 1: Taking Stock'
[19] All-Party Inquiry into Late Payments in SMEs (July 2013)
[20] Hilton-Baird Collection Services, Hilton-Baird's Late payment Survey, January 2015

This suggests it is addressing both internal company processes as well as culture that are central to reducing late payment.

5. Policy response and their effect

There is no specific legislation outlawing late payment in any nation. At the UK level, the Small Business, Employment and Enterprise Act 2015 came into force in 2016[21]. This introduced a requirement for large and listed companies in the UK to report on their payment practices, including making public the proportion of invoices they pay beyond agreed terms. This is then shared centrally and made publicly available, but at this point appears to have made little impact as the lack of enforcement means it has little effect on behaviour[22].

At the EU level, a Directive was adopted to reduce late payment, including a provision that companies have to pay their invoices within 60 days, unless they expressly agree otherwise (see Appendix A). However, the evaluation of the Directive highlighted that a lack of enforcement renders many initiatives toothless. It notes that *"rather than legislation, national business culture, economic conditions and power imbalances are the driving factors for payment behaviour"*[23].

As part of its commitment to support sustainable business growth in Scotland, the Scottish Government launched the *Scottish Business Pledge*[24] in 2015. One of the nine commitments for signatories to commit to (or work towards) is prompt payment. The Pledge emphasises many of the consequences of late payment on SMEs, and the benefits to companies of paying their suppliers on time, and encourages businesses to pay promptly to support the supply chain and the wider Scottish economy[25]. Benefits highlighted include:

- suppliers will be keen to work with businesses that pay on time
- avoiding costly late payment charges or compensation claims
- avoiding the costs of firefighting and strained relationships
- being able to approach suppliers and customers on confident terms and build their confidence
- being able to give a reliable service to customers because the supply chain is working effectively
- closer cooperation with suppliers can lead to more efficient delivery patterns, or new insight into alternatives for components or supplies.

[21] In line with EU Directive, a summary of which is included at Appendix B.
[22] All-Party Inquiry into Late Payments in SMEs (July 2013)
[23] European Commission, March 2016, 'Ex-Post Evaluation of Late Payment Directive'
[24] https://scottishbusinesspledge.scot/
[25] https://scottishbusinesspledge.scot/prompt-payment/

As of June 2017, 267 businesses in Scotland had signed up to the prompt payment element, 72% of all businesses signing the Pledge.[26]

6. Conclusions and actions

Late payment has a wide range of consequences for companies, including deferring investment and innovation plans, being unable to access finance and discouraging trading internationally, all of which act as a drag on economic and productivity growth.

Research offers insights into how companies can mitigate the effects and reduce the extent to which it is common practice, both those experiencing late payment and those adopting late payment practices. For example:

- **Increasing the innovative capacity and the quality** of the goods and services supplied to customers shifts the balance of power in the customer/supplier relationship[27]. By increasing the importance of their product or service to the customer, this empowers them to enforce prompt payment regimes, through implied withdrawal of services. Furthermore, innovative businesses are more likely to have a more diversified client base. Therefore, if any contractual relationship is beset with late payment practices, the company has other income streams to mitigate the impact.

- **Maximising other revenue streams through diversification** to prevent a heavy dependency on one particular customer or client. Diversified income streams and client bases are however, not always possible for many SMEs.

In terms of changing the behaviours of those employing late payment practices, this paper has highlighted there is no simple fix as it appears to be driven as much by conventional norms and business culture than a deliberate power play. The responses of governments in the UK and across Europe fall short of compliance, and focus on education and encouragement. There is some emerging evidence that education and encouragement is making a difference, but perhaps not at the speed desired.

[26] https://scottishbusinesspledge.scot/information/scottish-business-pledge-statistical-overview-june-2017/
[27] ACCA research found a *"superior ability"* of mid-sized businesses to withstand late payment practices by larger companies due to greater market power and diversified sources of income.

Appendix A

European Late Payment Directive

To address the growing issues caused by late payment in the wake of the financial crash, the EU adopted a Directive in February 2011 to combat this in commercial transactions[28]. This was enshrined in legislation across member states by 2013, the Directive set a minimum set of behaviours for companies, which enabled member states to go further if they deemed it appropriate.

Main provisions of the EU Late Payment Directive

- Public authorities have to pay for the goods and services that they procure within 30 days, or in very exceptional circumstances, within 60 days
- Enterprises have to pay their invoices within 60 days, unless they expressly agree otherwise and provided it is not grossly unfair
- Automatic entitlement to interest for late payment and €40 minimum as compensation for recovery costs
- Statutory interest of at least 8% above the European Central Bank's reference rate
- EU countries may continue maintaining or bringing into force laws and regulations which are more favourable to the creditor than the provisions of the Directive.

Only Sweden and Denmark went further than the Directive, introducing stricter provisions. Their legislation carried an implication that the longer the payment term is, the more likely any court will consider it to be grossly unfair. Any payment term beyond 30 days in these nations must be agreed – in writing – by both parties. Sweden also recognised the power imbalance in many of these relationships, and put into legislation that specific consideration should be given to protect the party in the weaker position in the business relationship, in any dispute[29]. To date however, there is no evidence of these additional provisions having a beneficial impact for small firms in these countries.

[28] *http://ec.europa.eu/growth/smes/support/late-payment/index_en.htm*
[29] *European Commission, March 2016, 'Ex-Post Evaluation of Late Payment Directive'*