

Prompt Payment

Your guide to getting paid on time

This guide to effective credit management has been prepared by ACCA for owners and managers of small and medium sized enterprises.

The booklet offers practical and sensible advice on how firms could protect themselves against late or non-payment of their bills.



Supporting small business

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Introduction

Research has suggested that 80% of small companies do not have any formal policy with regard to the credit which they offer their customers. Most do not even agree proper credit terms with their customers¹.

That the degree of attention given to credit management is so low may be for a variety of reasons. Some firms may consider that they do not have the time or the staff resources to give much attention to aspects of credit management. Others may feel that, in a highly competitive business climate, to demand strict payment conditions of a prospective customer might prevent them from clinching a contract. Others still might take the trusting view that, once the product or service has been delivered in accordance with the agreement between buyer and seller, it is a largely straightforward question of converting the debt receivable into cash.

Whatever the reasons why individual firms do not pay enough attention to credit management, it is worth noting that late and non-payment are widely regarded as being major causes of insolvency. It is also worth considering that, at any one time, an estimated £20 billion is owed to British businesses in overdue debts².

¹ Credit Management Research Group, Bradford University

² Federation of Small Businesses

The purpose of this booklet is to stress the importance of sound credit management to the financial health of the smaller business, and to offer some outline guidance to firms on how they could protect themselves against the late or non-payment of their bills. For more detailed advice on tightening up your own credit procedures and techniques, you should consult your accountant.

The importance of effective credit management

Although a firm which has provided goods or services to a customer has a legal right to be paid for having done so, this is, of course, far from being as good as having the cash in the bank. The regularity with which unsecured trade creditors lose out in liquidations testifies to this. Businesses need to have effective credit arrangements to ensure that amounts which are legally owing to them are paid sufficiently promptly to enable them to meet their own obligations and to make a profit.

Firms need to look upon a business contract as only the means to an end, the end being to actually receive the agreed transaction price, preferably within an agreed payment period. Attention paid to minimising the risk of late or non-payment at the outset could save a business much trouble and expense later on.

Where a customer fails to pay a debt on time, the selling firm is not able to make use of the money owed to it in order to meet its own cash flow obligations. This may oblige it to borrow money - and to pay interest on that borrowing - in order to fund its continuing overhead and working capital needs. If a customer fails to pay completely, the work undertaken to provide the product or service will have been wasted and the selling firm may end up receiving no financial compensation for its efforts at all. If the customer becomes insolvent and goes into liquidation, the chances of the unpaid trade creditor receiving a dividend will be slim.

Why is it so important now?

On 1 November 1998, the Late Payment of Commercial Debts (Interest) Act starts to come into effect. The new law, when fully in force, will give businesses the right to receive compensation, in the form of statutory interest, for debts which have not been paid by the contractually agreed date (or, where there are no clearly agreed payment terms, within 30 days of the delivery or performance of the goods or services or the date of delivery of the invoice, whichever is the later). This rule will apply even if there is no provision for interest or payment dates in the contract or the applicable conditions of sale.

In introducing this measure, the Government's intention is to tackle the unfairness of the situation whereby sellers are used, effectively, as a source of free working capital. At the same time, it hopes that the threat to debtors of being made to pay additional interest charges will achieve the wider aim of bringing down actual payment periods (which, in the UK, currently average 49 days).

Under the new law, a business which is overdue with a payment to its creditor will become liable to pay interest on that overdue debt at a statutory rate of interest, which is, initially, 8% above base rate. The unpaid creditor will be entitled to take the late payer to court in order to recover both the invoiced amount and the associated interest. If a debtor pays your bill late, but fails to pay the associated interest, then you will be entitled to pursue the interest separately. Amounts due under these rules will be claimable by a creditor at any time up to 6 years after they fall due for payment.

The provisions of the Act are being introduced in stages. Initially, the right to claim statutory interest is only enforceable by 'small' businesses against larger businesses (including public authorities). For this purpose, a 'small' business is one which had 50 or fewer employees, on average, over the financial year prior to the year in which the contract was made. Thus, if a large company or a public authority is overdue with its payment to a small business, the latter will be entitled to enforce its right to claim interest on that outstanding debt.

As from 1 November 2000, the right to claim statutory interest on overdue debts will be extended to small firms as against other small firms. Finally, as from 1 November 2002, any business will be entitled to claim statutory interest against any other business. In all cases, the law will only cover contracts entered into on or after the relevant commencement date.

On the face of it, these transitional arrangements are helpful to the small business. Small firms often complain that they are the victims of the late payment practice of larger companies and public authorities, which in turn harms their ability to meet their own obligations. In this way, late payment is seen as having a knock-on effect throughout the economy.

At the same time, however, the new legislation is something of a double-edged sword for small firms in that, as well as having this new right to claim interest from their

The new Act provides firms with new challenges. In order for them to be in a position to assert their new rights to claim interest from debtors, they will need to ensure that they maintain and act upon detailed records of amounts owing to them. Where they have the legal right to claim statutory interest, they will need to consider whether it is worth their while and in their interests to actually do so. Most importantly, only by improving their incoming cash flows will small firms be able to ensure that their own debts are paid promptly, thus reducing the chances of their becoming liable themselves in due course.

debtors, they will, in due course, become liable to statutory interest themselves if they fail to pay their own debts on time. This may be the last thing that a cash-strapped small business feels it needs. In view of this, small firms need to give serious thought to how they can enhance their credit management procedures both in order to profit from their new legal rights and to defend themselves against possible future liability.

Awarding credit

Every one of us who has a credit card account will know that we are given a credit limit. This is not something which is set indiscriminately but after a careful investigation by the company concerned of our earnings, existing financial commitments and credit history. The credit card company will make an assessment, on the basis of its findings, of the amount of credit it feels it can offer us while minimising the risk to it of the non-payment of our periodical bills.

In the competitive world of business, firms will invariably find that if they do not offer credit, they will not find people willing to do business with them. Clearly, giving customers time to pay after delivery of the product or service is part and parcel of how business deals are done.

This being said, for a business to offer similar credit terms to each and every prospective customer, with no assessment of the latter's likely ability or preparedness to pay, and on time, makes little sense and exposes a business to continuous cash-flow risk. Just as the credit card company will conduct an investigation into an applicant member's creditworthiness, a business can do the same in respect of a prospective customer and frame its approach to the award of credit accordingly.

How much time and effort you decide to spend on investigating the creditworthiness of any prospective customer will depend on the relative financial importance of the deal concerned. If the customer's debt is going to be material in terms of your cash flow and solvency, you will need to take more care in the assessment of his/her creditworthiness than if the contract is for a less significant amount. Take extra care in awarding large amounts of credit where you are over-dependent on a single or a small number of customers.

Carrying out reasonable checks on creditworthiness will enable you to form a view as to the terms that you will feel able to offer a prospective customer.

A business can carry out the following initial checks of creditworthiness:

Annual Accounts

If your prospective customer is a limited company, its annual accounts will be filed at Companies House. These can be inspected either by visiting one of the Companies House search rooms, or through a specialist agency, or by means of the on-line system

operated by Companies House. If the company is 'small', its accounts may not provide a great deal of detailed information on its performance, but the company's file will still reveal potentially useful information about its shareholders, capital structure and debt obligations. If the prospective client is a public company or a 'large' private company, its accounts will include a statement of its policy regarding payment practice - this could include its adoption of BS 7890, see below - and a figure for the 'average number of days' that it took to pay its debts during the period covered by the accounts.

BSI Standard on Prompt Payment (BS 7890)

A number of business organisations have co-operated to develop a statement of best practice covering the various procedures involved in planning, negotiating and completing commercial transactions. If the customer has adopted the standard, then you may take some comfort from the fact that it has given a public commitment to comply with best practice on these issues.

Credit Agencies

These can provide you with a status report on any named business based on published information, e.g. the firm's annual accounts, charges on its assets and court records. An agency will also be able to recommend a credit rating for the business concerned. Bear in mind, though, that such statements do not constitute a confirmation of creditworthiness.

Bank references

A prospective customer should be willing for you to approach his/her bank for assurance as to his/her creditworthiness. It should be borne in mind, however, that the bank's duty is to its customer and it will not volunteer information which might reflect adversely on him/her. For this reason, approaches to banks should be phrased in direct, specific terms, and information forthcoming from this source should be treated with caution.

Personal references

If you have not dealt with a prospective customer before, you may be able to obtain useful direct or second-hand information from business contacts in the area or from references from past or existing suppliers. When considering a customer reference, bear in mind that only satisfied customers are likely to be invited to provide you with a reference.

Personal visits

In order to get a 'feel' for the reliability of the prospective customer, you may find it helpful to visit the firm's premises in order to meet with its managers and judge its operations and resources at first hand. For large orders, this will be highly desirable.

Public Registers of Bankruptcy and IVAs

You may check whether any individual is bankrupt or has entered into an individual voluntary arrangement (IVA) by using the relevant search facilities maintained by the Insolvency Service at its Birmingham office. Checks may be made in person or in writing (but not over the telephone). The contact details appear in Appendix 1. The particular significance of bankruptcy is that it is an offence for a bankrupt to obtain credit of more than £250 without disclosing his/her status.

Setting payment terms

In order for any contract to be enforceable in law, the intention of the contracting parties must be clear. This applies to credit terms as much as to any other aspect of the transaction. Accordingly, it is in the interests of both parties that there is agreement on how and when payment is to be made, and that each side understands and accepts all the terms which are to apply to the sale.

Among the features which a seller may consider applying to a transaction are the following:

Discounts

Offering a discount from the normal sale price for payment up front or after a specified period is commonly seen as a potentially useful promotional device. Before offering discounts, however, sellers will need to weigh up the advantages of achieving early or prompt payment against the disadvantages of receiving less than the standard sale price.

Payment in advance

Clearly, this is the ideal solution for all transactions, but impractical in most cases. It is precisely because of its unattractiveness to most potential customers that selling firms will usually insist on such terms only when they consider that they are faced with a substantial risk of non-payment, for example when the buyer is suspected of being insolvent.

Retention of title

It is a well-established principle of commercial law that, where a sale transaction is entered into, ownership of the item being sold is transferred not necessarily when the item is delivered but *when the parties to the transaction intend it to be transferred*. It is therefore open to the selling party to assert its right to retain ownership of the goods concerned until such time as certain conditions are met.

If you are selling goods which are easily identifiable as separate items, then it makes sense to insist on a retention of title (ROT) clause in the conditions of sale. Under a valid ROT clause, a buyer does not become the legal owner of the item that he/she has acquired until he/she has performed his/her obligations under the contract of sale, which will invariably mean paying the agreed purchase price in full.

Where a buyer has not paid the agreed price, then it is open to the seller to identify the goods in respect of which he/she has retained title and remove them from the buyer's premises. This rule will still apply where the buyer goes into liquidation or receivership.

ROT clauses represent a legitimate and enforceable protection for a selling firm, which may be incorporated in a contract whether or not the seller suspects that the purchase price may not be paid in full. To be effective, however, clauses must be properly worded and legal advice on the drafting and enforcement of a clause is highly advisable. Since the retrieval of ROT-protected goods depends on them being identifiable by the true owner, clauses can only be applied to goods which are capable of being conclusively identified as having been delivered by the seller. For this reason, goods delivered as raw materials for the purpose of being processed cannot be effectively covered.

Guarantees

Sellers who, although prepared to offer credit to a prospective customer suspect that full payment may not be forthcoming, may decide to insist that the debt be legally guaranteed, either by an individual buyer personally or by a third party. Note that a company which is 'limited by guarantee' does not offer its creditors any sort of guarantee that their debts will be paid.

Continuing credit

If you offer a continuing credit facility to a regular customer, you should be prepared to impose a limit on the account, and to restrict further credit to that customer until the sum outstanding on the account has been paid.

Make sure that, at the conclusion of negotiations, it is clearly understood what conditions are to apply to the transaction. This is particularly relevant where, as is common, both buyer and seller have standard conditions of business. You as seller should be prepared to insist that the buyer accepts your own terms, and that this is confirmed in writing. Lastly, make sure that the invoice which you deliver to the customer is clear, accurate and contains all the relevant information regarding the transaction. Remember, if the invoice is inaccurate, the customer will not pay it and delays in rectifying the error could prove costly to you.

Ensuring payment

As stated earlier, actually winning a contract and delivering the goods or services ordered is, as far as you the seller are concerned, only the means to the end of getting paid, and should be seen as such. You should prepare actively for the possibility of non or late-payment, and take steps to avoid that happening. The following points should be considered:

Monitoring of outstanding debts

All sellers need to keep an accurate record of the debts owed to them and of the date that they fall due for payment. Although this sounds obvious, it can be overlooked and a firm which fails to maintain accurate records will clearly not be in any position to press its customers to honour their commitments. A full record of payments due, reviewed and updated regularly, is an essential primary tool of self-protection against late payment.

At the outset you should identify a person at the customer's office with whom you can liaise regarding payment. This will enable you to make contact quickly, when you wish to, with the person who is aware of all the details surrounding your transaction and who is responsible for the despatch of your payment. Firms are sometimes reluctant to make written or telephone contact with their debtors, fearing that such action will appear hostile and thereby counter-productive. However, failure by a firm to signal its preparedness to press for payment when it is due may well be interpreted as a sign of managerial weakness and exploited by the buyer. Also, the establishment of a cordial but businesslike relationship regarding the payment of amounts due can be constructive in two respects. Firstly, it will demonstrate to the customer that your business is being managed efficiently. Secondly, by reminding the customer that the debt has fallen due for payment (or, as the case may be, will shortly fall due for payment), you ensure that your bill - which will doubtless be one of many - remains very much in the forefront of the customer's mind.

You should be prepared to chase the creditor for payment as soon as the agreed payment period has expired without your bill having been paid. Clear undertakings should be sought as to when payment will be forthcoming. Further contact should be made if these further undertakings are not fulfilled. You should also be prepared to make contact with the buyer at any time if you become aware of any information which you think might affect his ability to pay your bill.

Note that, where a debtor is experiencing cash-flow difficulties and sends you a part payment of his/her debt to you in 'full and final settlement', you will still be fully entitled to claim the remainder, even if you bank the part payment, unless you formally accept the debtor's 'offer' or if the part payment is accompanied by some fresh undertaking on his/her part.

Credit insurance

Since the risk of non-payment is and will remain a fact of business life, you can protect yourself against the risk completely by taking out credit insurance. A contact address for trade credit insurance appears in Appendix 1 to this booklet.

Factoring

Factoring can be an extremely useful, albeit expensive, facility which can be used either on a continuous or an ad hoc basis. By selling its unpaid invoices, a firm can expect to receive the invoice amount less the factor's fee, which may be up to 20% of the invoice price. A contact address for the factoring industry is included in Appendix 1.

Collection Agents

Private debt collection agents can be engaged to pursue unpaid invoices on a contingency - no win, no fee - basis. The best collection agents achieve a high success rate, which may be partly because of their specialist expertise in debt recovery and partly because of the impression which their involvement tends to make on debtors. As with factoring however, the service can be expensive, fees usually being based on a pre-determined percentage of the amount collected.

Solicitors' letters

A well-framed solicitor's letter, carrying with it the express or implied threat of legal action in respect of the unpaid debt, can prove effective in achieving the desired result without having to undergo the risk and expense of going through the courts.

Legal action

If, despite active credit management and your best efforts, a debtor refuses or is unable to pay, you may have no other option but to consider legal proceedings to recover your money.

Where the amount owed is no more than £3,000, you can choose to take advantage of the special 'small claim' procedures in the county courts. These are intended to reduce the expense and complexity of recovery action. Cases which involve debts of more than that amount can also follow a simplified procedure provided both parties agree. Small claims do not involve juries but are heard by a judge or registrar sitting alone. You do not need to be represented by a solicitor: if you decide to engage one, your costs may not be recoverable from the other party if you win your case.

Small claims are initiated simply, by filling in a 'particulars of claim' form and submitting it to your local county court. You then complete a 'request' form which is used by the court to prepare the summons which is served on the debtor, who then has 14 days to reply. Thereafter, what happens depends largely on the response of the debtor. Guidance material on the operation of the small claims procedures will be available from your local county court.

Where you resort to court proceedings and win your case, you may then have to take steps to enforce the judgement order. This can be pursued via a number of different methods, such as 'garnishee' orders (where a debt owed to your debtor is compulsorily re-routed to you) and warrants of execution. Ultimately, if your judgement debt remains unpaid, you will have the right to petition for the debtor's bankruptcy or liquidation. At the enforcement stage, you will usually need to take specialist legal advice on which method is most appropriate in your particular case.

Conclusion

The immediate purpose of the new legislation on late payment is to enable creditors to be compensated for debts which are paid late. The ultimate objective is to destroy or at least to weaken the culture of late payment. Since this culture is presently so widespread and affects businesses of all sizes and in all sectors, most firms will only be in a position to pay their bills more promptly if they first achieve substantial improvements in the time it takes to collect debts owed to them. It remains to be seen whether an unpaid seller's right to recover statutory interest will be much used in practice. Many small firms can, however, improve their ability to withstand the effects of late or non-payment - and thereby put themselves in a better position to pay their own bills on time - by following the sort of procedures outlined in this booklet. If, after reading this booklet you feel that your business needs help to improve its credit management, consult your accountant.

Appendix 1: Contact addresses

Association of British Chambers of Commerce
Manning House
22 Carlisle Place
London SW1P 1JA
Tel: 020 7565 2000

Bankruptcy/IVA Search Rooms
The Insolvency Service
2nd floor
Ladywood House
45-46 Stephenson Street
Birmingham B2 4UZ
Tel: 0121 698 4000
Fax: 0121 698 4407

Dun & Bradstreet*
Holners Farm Way
High Wycombe
Bucks HP12 4UL
Tel: 01494 422000
Fax: 01494 422260

Experian*
Talbot House
Talbot Street
Nottingham NG1 5HF
Tel: 0115 941 0888
Fax: 0115 934 4905

Factors & Discounters Association Ltd
2nd floor
Boston House
The Little Green
Richmond TW9 1QE
Tel: 0208 332 9955
Fax: 0208 332 2585

UK Credit Insurance Brokers Committee
c/o BIIBA House
14 Bevis Marks
London EC3A 7NT
Tel: 020 7623 9043
Fax: 020 7626 9676

* Credit Reference Agency

Appendix 2:

Checklist for credit management

All businesses should consider devising their own policy with respect to customer credit. The details of such a policy will vary from firm to firm, reflecting differences in, for example, size and trade practice. It should, however, address the following issues:

Initial checks

- Decide what credit checks should be carried out on new customers. The range of checks to be undertaken in individual cases should take account of the materiality of the transaction concerned, both in terms of the amounts involved and of your likely dependence on the debtor concerned. You may, on this basis, be able to identify a cut-off point below which only limited checks need be made.

Insurance

- Consider taking out insurance against the risk of non-payment.

Conditions of sale

- Devise your own standard contract or conditions of sale. Consider the feasibility of inserting a retention of title clause.

Special terms

- Decide whether you are in a position to offer prospective customers incentives such as discounts.

Agreeing Terms

- On concluding a contract, ensure that all the details of the transaction are understood clearly by both sides.
- Send an invoice to the customer as soon as the goods or services are delivered.
- Make sure that your invoice states the payment details and terms clearly and accurately.

Monitoring Amounts Owed

- Keep an accurate record of all amounts owed and review and update this regularly. Your record should enable you to identify amounts due for payment at any time.

- Make sure that you have the contact details of the person whom you can approach with regard to the payment of your bill.
- Be prepared to act on any information of which you become aware that might affect the payment of your bill.
- Send written reminders to the debtor if payment has not arrived by the payment deadline. Send a further reminder and then a final demand for payment.
- Keep an eye on the payment performance of individual debtors. In particular, note any recurring weaknesses.

In case of late payment

- Decide what your position will be with regard to the use of factors and discount houses. Also, consider what your policy is to be with regard to the new statutory right to recover interest on overdue debts.