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FEGReG Working Paper 10/02

Giving credit where it's due – but no more: an ethical analysis of trade credit

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Giving credit where it's due – but no more:
an ethical analysis of trade credit

Abstract

In spite of its commercial importance and signs of some concern by some commentators, trade credit has not been subjected to serious ethical analysis. This is especially important in the current financial crisis, given that credit from banks is in short supply, leading to increasing pressure on trade credit. In addition to identifying trade credit as a topic of ethical significance, this paper develops an analysis of the ethics of trade credit grounded in an understanding of its purpose. Making a distinction between "operating" trade credit and "financial" trade credit, it provides an account of the maximum period for which it is appropriate for one company to delay payment to another from which it has purchased goods or services. This has implications not only for companies that take credit but also for external commentators who seek to rate companies according to their speed of payment. The responsibility of suppliers not to extend excessive credit, and thus act as a quasi-bank, also follows from the analysis developed.

Giving credit where it's due – but no more: an ethical analysis of trade credit

INTRODUCTION

In spite of its importance, finance rarely appears in writing on business ethics (Boatright, 1999; 2008), and with the intellectual "capture" of finance by financial economics (Whitely, 1986), ethics is also given little consideration within finance literature (Prindl & Prodhan, 1994). Thus few mainstream financial topics have been analyzed adequately from an ethical perspective. Some have barely been addressed at all; one such topic is trade credit.

In addition to the direct effects of recession upon their operating cash flow, firms are usually affected by difficulties in securing funds from credit institutions during times of economic crisis (see, for example, Demirgüç-Kunt, Detragiache & Gupta, 2006; Eichengreen & Rose, 1998; Kaminsky & Reinhart, 1999). What is unusual is that the current general economic problems are consequences rather than causes of the credit crisis – a crisis which has called into question the integrity of the banking system (cf. Cowton, 2002). The resulting financial stresses impact upon firms' use of trade credit, thus exacerbating and highlighting issues that are always present but generally neglected, at least in the academic literature. This paper identifies and explores trade credit granted by a supplier firm to its business customers as a topic for ethical consideration.

Trade credit is the provision by one firm to another of goods or services in the expectation that payment will be received at a later date. The delay between the provision of goods or services on the one hand and payment on the other amounts to the extension of a loan by the supplying company to it customer, and like any loan, it entails the risk of delayed payment or even default. As will be outlined and discussed below, although it is not always recognized in such terms, the payment behaviour of the purchaser towards the supplier possesses ethical dimensions; so too, it will be argued, does the behaviour of the supplier.

The aim of the paper is to establish the case for exploring trade credit in ethical terms and to develop a framework for thinking about the ethics of trade credit practice by tightly coupling the granting of trade credit to the underlying provision of goods and service used by a purchasing firm in pursuit of its business. The paper is structured as follows. The first main section provides an overview of how trade credit has been discussed, including some recent concerns that have become apparent on the part of some policy makers and other commentators. The second section then sets out the basic argument of the paper regarding an ethically sound approach to trade credit, focusing on the simple situation of two firms transacting with one another, where the second firm (the business customer, a retailer) makes its sales on a cash basis. The third section discusses various implications and possible limitations of the analysis. Finally, the conclusion summarizes the principal elements of the argument and highlights the contributions of the paper.

AN OVERVIEW OF TRADE CREDIT

The purpose of this section is to provide a non-technical overview of the principal strands in the discussion of trade credit.

Trade credit is a major source of financing for the corporate sector and plays an important role in the external financing of companies (Elliehausen & Wolken, 1993; Ng, Smith & Smith, 1999; Wilson & Summers, 2002; Stern & Chew, 2003; Van Horne & Wachowicz, 2001). The use of trade credit by non-financial firms is not new; trade credit has long been one of the most important forms of financing in the US economy (Seiden, 1964). However, in the US, the amount of outstanding accounts payable (that is, money owed by companies to other companies) increased by four times during the period 1990 to 2000, reaching a total of $3,758 billion ($10^9$) (Statistical Abstract of the United States 2003, http://www.census.gov/). In 2003, trade credit was used by 60% of small US businesses, (http://www.census.gov/epcd/www/smallbus.html), rising to more than 85 percent of the largest firms (*Federal Reserve Bulletin*, "Financial Services used by Small

Businesses: Evidence from the 2003 Survey of Small Business Finances,"[1] A182/A183, available on http://www.federalreserve.gov).

The situation is similar in other developed economies, such as the UK. Kohler, Britton & Yates (2000) estimate that 55% of the total short-term credit received by UK firms during the period 1983 to 1995 took the form of trade credit, and it is generally accepted that more than "80% of daily 'business to business' transactions are on credit terms" (Wilson & Summers, 2002: 319). Trade credit is used by both small and large companies. In 2007, trade creditors owed small firms in the UK a total of £48,666 million (FAME Database[2]). The total amount of trade creditors for a sample of 200 FTSE firms (representing approximately 85% of UK stock market capitalization) is £434,447 million.

So, trade credit is widely and heavily used by companies to support their business activity (Brennan, Maksimovic, & Zechner, 1988; Meltzer, 1960; Petersen & Rajan, 1997). However, it puts a strain on suppliers' resources because goods or services are produced and provided without, at least for a time, receiving payment.

There are many economic studies that explain and test, theoretically and empirically, why trade credit is used. These studies focus on how it can help a company to increase sales (Brennan, Maksimovic, & Zechner, 1988; Emery, 1987; Meltzer, 1960; Petersen & Rajan, 1997; Schwartz, 1974), enabling it to gear up production in advance of the receipt of monies owed, and hence supporting growth (Cuñat, 2007; Petersen & Rajan, 1997). Studies also examine the use of trade credit as a substitute for bank credit, particularly when the latter is difficult to come by (Gertler & Gilchrist, 1994; Jaffee, 1969; Nilsen, 2002; Schwartz, 1974). As in previous downturns (Smith, 1987; Walker, 1991), the current economic recession engendered by the banking crisis will be putting pressure on trade credit, tempting companies to take longer to pay their suppliers.

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[1] The SSBF provides the most comprehensive information on the patterns of credit use by small businesses and their providers for 1987, 1993, 1998, and 2003. The 2003 survey is the last to be conducted.

[2] FAME, Bureau van Dijk database contains information for companies in the UK and Ireland. FAME contains information on 3.4 million companies, 2.8 million of which are in a detailed format (http://www.bvdep.com).

This practice of delaying payment accords with conventional commercial wisdom and is reflected in some of the ways in which trade credit is described in finance and corporate management textbooks. Trade credit has been variously described as a "spontaneous source" (Block & Hirt, 1994; Gitman, 1988), "an easy financing form" (Stern & Chew, 2003; Van Horne & Wachowicz, 2001), "informal" (Arnold, 2005; Gitman, 1988; Weston & Copeland, 1992), "accepted practice" (Pike & Neal, 1993), and "liberal extension of money" (Van Horne & Wachowicz, 2001). It is generally assumed that the norm is for trade debtors to take a long time to pay, particularly in industries such as manufacturing (Atrill & McLaney, 2002). Some financial texts suggest that purchasing companies stretch the credit period offered by suppliers (cf. McMenamin, 1999). Gitman, Forrester & Forrester (1976: 169-170) confirm that a basic cash management strategy normally applied is to pay accounts payable as late as possible without damaging the firm's credit rating and supplier relationship.

Such practices raise ethical issues. Delay (or, even worse, default, which tends to increase with delay) in paying by customers, especially major ones, can have severe, if not fatal, financial consequences for suppliers, which in turn has repercussions for their own suppliers and other stakeholders, such as employees. Concern has been voiced by some commentators, particularly in relation to small firms (Barrow, 2006; Dalton, 2007; Hodgetts & Kuratko, 2001; Sihler, 2004).

> Small businesses are particularly vulnerable to the problems caused by late payment especially with large corporate customers who can use their market position to dictate their own payment terms. Many large firms use their small-firm suppliers as a bank – taking, what is in effect, an interest-free overdraft. (Ryan, 2008: 373)

In the UK at least, such worries have led to several policy initiatives during the past decade or so. For example, since 1997[3] it has been mandatory for large firms in the UK to disclose in their Annual Reports (Directors' Report) the number of days taken to pay their suppliers. This is calculated by dividing the trade creditors (accounts payable) total at the end of the financial year by the aggregate amount invoiced by suppliers during the year. This should give a more reliable estimate than the ratio

[3] SI (Statutory Instrument) 1996/189.

traditionally calculated by financial analysts, where cost of sales or even total revenue are used as proxies for the amount invoiced by suppliers. Using this information, the Payment League Table has been developed as a "helpful tool" for suppliers, showing which companies are the best payers.[4]

Further regulations were introduced in 1998. The Late Payment of Commercial Debts (Interest) Act sought to encourage purchasers to pay on time by suppliers the right to claim interest on overdue accounts. Previously, businesses were only able to claim interest on late paid debts if it was included in the contract, or if they pursued the debt through the courts and the courts awarded interest. Similarly, in 2000, Directive 2000/35/EC of the European Parliament and of the Council on Combating Late Payment in Commercial Transactions was published in the Official Journal L 200. This Directive is aimed at dealing with the problem of late payment, with a focus on helping small and medium enterprises (SMEs). If the customer does not pay on the day fixed in the contract (or, if the date or period for payment is not fixed in the contract, within 30 days of receipt of the invoice or receipt of the goods or services), the debtor is obliged to pay "penalty interest". Claiming and receiving such interest in practice tends to be challenging, but these legislative initiatives are symptomatic of a concern about trade credit payment practices.

Large UK companies are also required to disclose their policies on the payment of trade creditors and to state whether they follow any code or standard on payment practice, and if so, provide the name of the code or standard and information about how to obtain copies of the code. So far, there have been three such codes widely available in the UK. The first was "The Prompt Payers' Code". Developed by the Confederation of British Industry (CBI), it started operating in November 1991. During its period of operation between 1991 and 1997, the Code was signed voluntarily by 1000 firms, most of them limited companies. In 1997, the CBI Code was superseded by the "The Better Payment Practice Code", developed by the government's Department of Trade and Industry (DTI). Again, this code is voluntary and more than 1000 firms signed it between 1997 and 2008. More recently, in

[4] This table, available at http://www.paymentleague.com, is a joint venture between the Institute of Credit Management (ICM), the Credit Management Research Centre (CMRC) and Credit Scorer Ltd.

December 2008, the third UK payment code appeared, supported by the Institute of Credit Management (ICM) on behalf of the government's Department for Business, Enterprise and Regulatory Reform (BERR) – the now defunct successor to the DTI. The "Prompt Payment Code" is another voluntary payment code, focused in a direct way, not only on information and paying bills, but also on helping to increase the speed of payments to smaller companies.

These various initiatives briefly described above are designed to encourage "better" behaviour by companies in dealing with their suppliers. The purpose of reviewing them is not to provide a comprehensive account of their content and effectiveness, but rather to establish that there are signs of 'worrying' about trade credit in ways that have ethical overtones or would benefit from ethical analysis.

In conclusion, this section has sought to accomplish three things: first, to show that trade credit is an important commercial practice; second, to show that conventional wisdom regarding the taking of trade credit – as reflected in financial management texts, for example – is, at best, amoral; and third, to note that there have been signs of concern on the part of some policy makers and other commentators. These three factors imply that trade credit is *prima facie* a practice worthy of serious ethical analysis. The next section attempts to develop such an analysis.

THE ETHICS OF TRADE CREDIT BETWEEN BUSINESSES

It might be contended that the granting of trade credit and the payment of trade debts is simply a matter between the two contracting parties; it is open to the supplier and purchaser to agree mutually acceptable terms of trade and equally open to them to seek legal redress in civil, rather than criminal, law if the other party does not perform according to the contract.[5] However, it will be argued below that there are two sorts of respects in which ethical, if not legal, considerations should be brought to bear:

[5] By way of contrast, consumer credit which, in its various forms, involves a private individual acquiring, or obtaining the use of with a commitment or option to acquire, a consumer good is subject to significant regulation. It is an area fraught with risks for the unwary private individual, and governments in many nations have constructed regulatory mechanisms to protect them.

first, because of the nature of the relationship between the two parties; and second, because of the possible impact of this relationship on third parties.

The policy initiatives described in the previous section suggest a concern over one company taking too long (however determined) to pay another company. They further suggest a useful distinction. First, a company might take longer than contracted to pay its supplier. Of course, this entails a legal breach of contract. However, in most cases it is not worthwhile going to law because of the expense of doing so and, where further custom is hoped for (the norm in business to business relationships), because of the risk of damaging future commercial activities between the two companies. Nevertheless, whether or not legal redress is considered appropriate, late payment does seem to imply, at least, a moral philosophical opening in terms of promise keeping, with the various elements that would normally go into such a discussion. Thus prompt payment can be seen as a case of keeping a promise, perhaps meritoriously, while late payment can be seen as a case of breaking a promise – perhaps, in certain circumstances, with some justification or at least defense.

However, there is a further dimension to this. Not all promises are good promises. A "bad" promise might be kept, but that is not necessarily a good thing, in particular where there is an asymmetry of power involved in the setting up of the bargain. Although there might be a presumption that such circumstances are unlikely in business-to-business relationships, the policy initiatives referred to in the previous section were first enacted in the context of small companies' relationships with larger companies, and commentary from a small business perspective has referred to large companies taking too much credit. This might be through demanding unreasonable terms of trade, such as an unusually long period of credit. Thus a company might pay promptly, but "too slow". One way of opening up this issue would be to build on the tradition of a just or fair price, where the degree of trade credit taken becomes part of the consideration of what it means for a purchaser to act fairly towards a supplier. This could be done by comparing the purchasing company's behavior towards one supplier with its behavior towards other suppliers; or, more widely, to compare its payment behavior with that of other firms – the kind of comparison that the figures disclosed in UK directors' reports, or the ratios traditionally calculated from financial accounts, permit. However, while the latter appears to have some initial attractions,

including practicability, the analysis developed below suggests that it has significant shortcomings. Rather than simply comparing financial statistics, the analysis takes a step back to ask more fundamental questions about trade credit and to build an argument that attempts to specify what the period of trade credit *should* be.

As stated at the beginning of this paper, trade credit involves one company supplying goods or services to another without receiving any money in return at the time of delivery. This looks like a loan; the supplier has done work but the money it is owed at that date will – hopefully – arrive later, while the business customer is enjoying the benefit of goods and services without having, at this point, paid for them. Financially, the purchaser is in the same situation as if it had borrowed money from the bank and bought the goods or services using the funds obtained. Indeed, the interchangeability of trade credit and bank finance, as covered in texts on financial management, was referred to earlier in this paper. In effect, the supplier is acting as a banker to the purchaser. Yet – as the present financial crisis has reminded us – banks are very special institutions, with peculiar characteristics when compared with mainstream businesses. Going back to at least the nineteenth century, this has led to their being subject to special forms of control. Insofar as supplying firms act as banks – providing, as noted earlier, vast amounts of credit to other businesses – they are not subject to such controls.

One reason for this is that suppliers can be seen as taking part in a joint enterprise with their customers. Suppose the purchasing company is a shopping mall retailer that sells to the final consumer on a cash basis. The supplier provides goods to the retailer, whose role is to get the supplier's product to market. Once the final consumer pays, then a sum of money becomes available to pay the supplier, with the balance remaining with the retailer to pay its other costs and generate a return. Not only can this be seen as a joint enterprise, but imagine if the supplier were vertically integrated to the final consumer market – it would still have to wait until the final consumer paid before it had the money earned by its efforts. Business is normally like this; costs are incurred in the expectation of subsequent revenue.

This scenario demonstrates that it is reasonable for the business customer to take trade credit while both it and its supplier wait for a sale to be made in the final product

market (store). However, once that sale is made, the supplier should be paid immediately; there is no longer any justification for taking the trade credit, and to hold the money back is to forcibly borrow the money due to the supplier. This analysis thus argues that the trade credit period can justifiably be as long as, and no longer than, the period taken to receive the money from the final consumer. At that point, the rewards of the joint enterprise should be shared between the collaborators – in this simple case, the retailer and the supplier.

On the one hand, this analysis places an ethical duty on the buying company not to take trade credit beyond a certain period of time. This duty could, in principle, be "called in" by the supplier. Certainly, the implication of the argument is that it is unfair for the buyer to take credit beyond the point where it receives payment. On the other hand, in tying the appropriate trade credit period to the underlying business process, the analysis suggests that there may be ethical implications for the supplier too. The point is this: if a supplier chooses or agrees to grant credit beyond the period when the final customer pays, then the supplier is going beyond the parameters of the joint enterprise and for the "excess" period of credit it is, in effect, acting as a banker rather than a commercial partner. Thus the position moves from one of real or "operating" trade credit to one of "financial" trade credit.[6] Given, first, that banks are subject to special regulations, and, second, that the supplier's stakeholders (such as employees, its own suppliers and local community) can be adversely affected if it has a major customer default on its payments, then it can be argued that suppliers are under an obligation not to grant trade credit inappropriately. That would include not granting credit recklessly, but it would also include, per the analysis here, not granting – or at least seeking not to grant – credit beyond periods justified by the joint enterprise implied by getting its products to final market. This is the second respect in which a promise might not be a good one; though made willingly between two parties, it leads to an increased risk of undesirable consequences for third parties.

[6] This distinction, of our own devising, mirrors the conventional distinction in finance between operating leases and finance leases.

Thus we have argued that the granting and taking of trade credit is, up to a certain point, an acceptable, or indeed good,[7] practice, but that after that point it is ethically dubious. Rather than attempting to justify some arbitrary, perhaps conventional, number of days' credit, the argument has sought to ground the appropriate credit period in the underlying economic processes which give rise to it. In the following section, we identify and comment on some possible objections to our analysis and then go on to suggest what the contributions of the paper are.

DISCUSSION

In the previous section, the argument sought to ground an ethical understanding of trade credit in the "real" (as opposed to purely financial) underlying business processes. Yet it might be objected that the approach is not "realistic". Many practical details have not been mentioned or fully dealt with. Given that this paper is a first to attempt to treat the ethics of trade credit in a systematic manner, this is not necessarily a major problem. Our objective has been to lay the groundwork for future discussion. Nevertheless, we will mention a few practical issues and sketch some outline responses.

First, the example discussed in the previous section concerns only a dyadic relationship, whereas in practice a supply chain can have many links. However, the principle argued for above remains the same. Once money enters the supply chain, it should pass quickly along it. When company *x* receives payment in the final product market, it should pass an appropriate sum of money to its supplier, company *x-1*; which, as a purchasing company, should pass a share of that money on to its supplier, company *x-2*; and so on. Goods might move slowly along the supply chain, but the money, once it has entered the supply chain, should flush back virtually instantaneously, without hindrance.

Second, the analysis seems to entail two particular complications when compared with current standard practice. It seems to suggest that prior to setting the terms of

[7] Other things being equal, the encouragement of economic activity is taken to be a good thing.

trade regarding settlement of an invoice, the parties to the deal will need to forecast when cash will be received, and this is usually uncertain – though the degree of uncertainty will vary. In an ideal world, there would be no need to set a period of credit since, as explained, cash would simply be received and a share passed on immediately, through the supply chain. However, being more pragmatic, what follows from our analysis is that the credit period should be set with some regard to the underlying business processes, for example with only a short period of credit granted when the transaction is temporally close to the final receipt of cash. Similarly, taking the case of a retailer again, different products will sell more quickly. Instead of the ideal of passing on money as soon as it is received, a retailer could undertake to pay based on its average inventory turnover period (assuming cash sales); a longer period would not be justified. Or it could take a more sophisticated approach and base its payment policies on the average inventory turnover for particular classes of goods; this would more closely approximate the ideal.

Third, the examples so far have tended to assume the provision of goods for onward sale. However, some goods (e.g. stationery supplies) to not enter the production or distribution process but rather support them. In these cases they are not incorporated directly in sales in the final product market. Similarly, many services have a somewhat ambivalent relationship to identifiable activities further along the supply chain. However, it should still, in principle, be possible to analyze the way in which a firm uses bought-in services and other goods to support its activities, whether the purchasing firm is a manufacturer, retailer or – itself – a service provider. From an understanding of the firm's use of services in its own business, it should be possible to derive suitable measures or proxies to indicate whether it is using trade credit to facilitate its own sales (legitimate) or as a more general source of finance (illegitimate).

Finally, a more general possible objection to the "realism" of the analysis is that the it is not "realistic" in what it expects companies to do; they will not adopt the ideal practice advocated or even change in the direction implied by it. This is a familiar charge against normative business ethics, or indeed against any ethical analysis that finds practice wanting in some respect. In the context of business ethics, this often entails explicit or implicit assumptions about the way competitive markets function.

In the case of trade credit, the argument that the "realities" of competition leave no room for manoeuvre might go something like this: if one supplying company does not allow as long a credit period as its competitors (either in its explicit terms of business or through enforcement that other firms do not attempt to do), *ceteris paribus* it will lose out and be forced to come into line. Thus there would appear to be the possibility of a 'race to the bottom' in terms of trade credit granted. One response to this is to affirm that managers of a company have some room for agency. Lucas (1998: 59) comments: "Economic determinism is false. The iron laws of supply and demand are not made of iron, and indicate tendencies only." How much room for choice is left is an empirical question, but it is not a given that at least some companies, some of the time, cannot follow our suggestions. Furthermore, even if companies are propelled by market forces into providing financial, in addition to operating, trade credit, our analysis identifies the shortcomings of such practice and invites regulatory or other system-level reform to address the issue.

However, there are implications of our paper beyond the behavior of the companies concerned. One is that companies' payment practice should not be judged solely according to the number of days' credit they take on average. The analysis of this paper demonstrates that a commonsense focus on days' credit, which is how published "league tables" of slow (and fast) payers are constructed, is misleading. It may not be more praiseworthy (and probably is not) for a supermarket to pay suppliers in 25 days than for a manufacturing company to pay in 50 days. Compilers of such tables might complain that they are the best that can be produced, given the data available, but if the best ranking that can be produced is misleading, it is better not to produce it at all. Moreover, following from the argument of this paper, various improvements might be considered. For example, notwithstanding the problems briefly alluded to earlier, separate tables might be compiled for different types of companies, with the grouping designed to reflect different underlying characteristics regarding the movement of goods through the supply chain towards final product markets.

Finally, although this paper is normative, in the sense of setting out an ideal, it does not base its argument on abstract ethical principles but rather on an account of what trade credit is for. This account could itself be debated in more abstract moral

philosophical terms, but it is contended that the account is both reasonable and plausible – trade credit enables companies to co-operate in a joint productive enterprise and hence fulfil their functions better than if it did not exist. Fundamentally, we argue that a company should pay over the money involved when the purpose for which it was "borrowed" has been accomplished, at least where the source of the funding is not a bank; this seems to us a reasonable prima facie obligation, but not one that is voiced or followed in relation to trade credit.

CONCLUSION

Trade credit is an important commercial practice, the significance of which has been highlighted by the credit crisis. This paper is, we believe, the first in the business ethics literature to identify and explore it as a topic worthy of ethical consideration – a perspective that is conspicuously missing from the finance literature. We have outlined some of the concerns that have been voiced in business and public policy circles regarding trade credit practices, but rather than simply taking those at face value, we have sought to develop a framework that provides a firmer foundation for thinking about the ethics of trade credit. Our analysis has highlighted two particular shortcomings of an exclusive focus on speed of payment when evaluating the behaviour of business customers in paying for their supplies. First, it is important to distinguish between speed of payment and promptness (which is related to promise keeping). Second, and possibly more important, without being related back to the underlying economic productive processes involved, speed (slowness) of payment, as measured by number of days' credit taken, is a misleading indicator of the commendableness of a firm's behavior. In particular, on its own it gives no indication of whether a firm is holding onto money that it has received from its own customers, a proportion of which is due to the supplier with which it has been engaged in a joint enterprise or partnership to facilitate those sales. The other novel aspect of our analysis is to go beyond a focus on the buying firm to introduce into the picture the responsibilities of the firm supplying the goods or services and credit. These are not so much the conventional responsibilities of a bank not to lend irresponsibly – though reckless granting of trade credit is not recommended. Rather, we have argued that the responsibility of the supplying firm is not to act as a bank at all – which is what

effectively happens when a purchasing firm takes credit for longer than what we have argued is the legitimate period. To repeat our distinction, it is legitimate to provide "operating" trade credit but not "financial" trade credit. While the policy implications of this might not all be practicable given well-established commercial practices and the dominant perspective in financial circles, we would claim that this is an important insight to bear in mind when the ethics of trade credit is being considered in future.

Finally, although we have positioned this paper as a novel contribution to finance ethics, it has relevance to other aspects of business ethics too. In particular, trade credit should also be factored into ethical analyses of, and debates about, supply chain ethics.

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