

# Exploring the necessity of prompt payments for companies<sup>1, 2</sup>

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## ABSTRACT

Late payment remains one of the biggest issues for companies. In 2016, a research shows that 60% of businesses must wait 60 days for being paid and nearly half (47%) say some invoices require 90 days to be honoured. This problem is source of exasperation and sometimes a real pain for companies. It is time for businesses to act and encourage prompt payment. Therefore, the objective of this paper is to examine the causes of delayed payment, appraise the effect of this issue and find alternatives to solve it. The Multi-Attribute Decision Making tool, composed of non-compensatory and compensatory method, was employed to compare the alternatives and define the ranking order of the most suitable solutions. The result is that Payment period terms, Interest charges, and debt recovery are essential to avoid delays in payment and in a lower level the use of early discount payment.

**Key words:** prompt payment act, required payment date, recovery debt, interest charge, cash flow, discount

## INTRODUCTION

Late payment constitutes a real scourge in the business world. It represents one of the causes of business failure especially for small businesses. Late payment is defined as a debt service that arrived after the date of the payment was due or after a grace period for the payment has passed. In the United-Kingdom, late payments of small-and-medium sized represented £44.6 billion in October 2017. The problem is that delayed payments lead to cash flow issues. In fact, trade body R3 discovered in 2016 that late payment for goods or services was a main reason in 23% of corporate insolvencies. Besides, it involves a lot of time and money for corporate to pursue those who don't pay. According to Bacs Payment Schemes Limited, the total bill of small

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business in England for chasing represents £2.16 billion. Moreover, the most regrettable thing is that 74% of firms consider that late payment is a reality of corporate life to deal with and it will never change. This issue is not only the case of England, it affects most of the world. Other members of the European Union and America have to cope with the problem of the on-time payment. Atradius insurance company made a survey in the United-States, Canada, Mexico and Brazil in 2015 and revealed that 20% of the value of their Business-to-Business awaiting payments is more than 90 days past deadline. What is more, the late payment disturbs more than the direct suppliers whose is affected by the lack of cash flow. Indeed, this issue spreads to the supply chain increasing the risk for the buyer and degrading the local and global economy. Conversely, rapid payments help to develop firm's purchasing power and production. It allows the company to save money by avoiding costly chasings. It facilitates also the relationships between suppliers and customers. On the whole governments, laws and corporates have to combat the culture of late payment in order to obtain some business and economic benefits.

This is why the purpose of this paper is to:

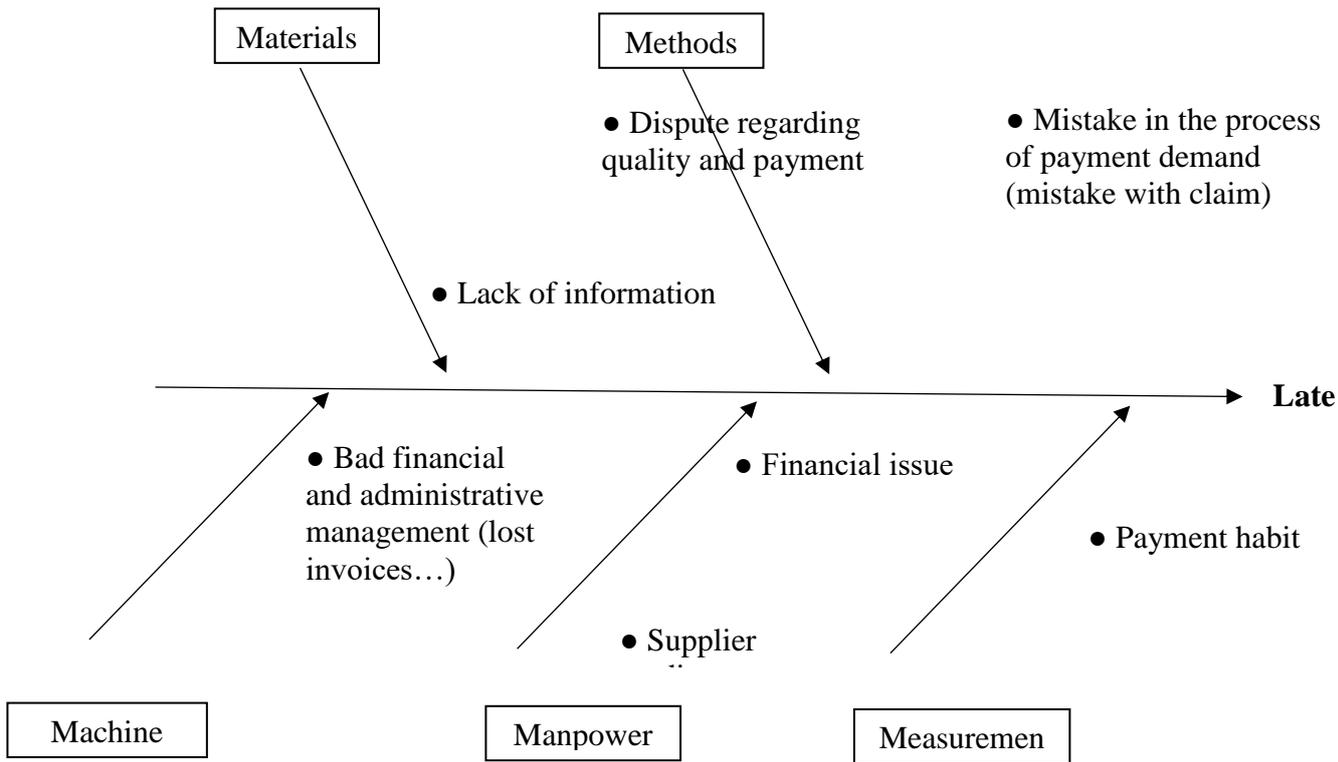
- 1) Understand the root causes of late or delayed payment
- 2) Assess what the impact of this is, especially on small businesses
- 3) Identify solutions to this problem

## **Methodology**

### **Root causes late payment**

Before starting to resolve this issue, the most important thing is to identify and understand the causes in order to treat efficiently and for good the delayed payment.

There are many various causes which lead to the fact that some businesses don't pay on time. Some stem for owners and some derive from contractors. We can represent the most common by a fishbone (see next page).



For contractors:

- Lack of information. In the contract created into the parties, the contractor not specifies clearly the information regarding the payment instructions. The date of, procedure of payment and any fees (in case of delay) are not present in the contract.
- Mistake in the process of requiring payment. For example, in some sectors like the construction contractor has to establish claim (that are validated by owners) after he carried out the work in order to collect payment from the owner. But sometimes the claim is not correct because of some mistakes (in forms, procedures...) coming from the contractors.

For Owner:

- Financial issue. Debtor is experiencing hard time period and he can't make any payments.
- Bad financial and administrative management. For example, it is sometimes difficult for the owner to monitor and treat the payment because the financial department is badly organized. Or, the invoice can be lost, the person in charge of the treatment is not here, etc.
- Supplier grading. The contractor is not considered as a priority in comparison to other suppliers.

- Disagreement regarding quality or amount of invoice. Client can express that the work was not carried out as expected or the amount not matches the work done by the contractor.
- Payment habit. Some sectors are known for making delayed payment do to receivables and operational customs. It is the case of construction, manufacturing...

### **The consequences of delayed payment, especially on small businesses**

Overdue payments affect individual company and the global economy. The need to solve this phenomenon becomes a fundamental economical concern. Late payments have negative effects on the competitiveness, profitability and especially cash flow of companies. It is small businesses which suffer the most of this issue. For some of them it threatens even their survival with bankruptcy. Late payments is not only about waiting but it represents also a real cost for smalls companies. In fact, spent time in chasing payment, administrative charges, make loans are expensive. Small businesses must cope with financial issues which impact their investment and the employment and consequently the growth of the organisation. Also, the lack of cash flow conducts them to pay late their supplier. This leads to decrease productivity, and global development. This client default spread along the supply chain and can affect financial and political institutions. Moreover, delays in payment affect the credit score of companies and can constitute an impediment for business opportunities. Therefore, it is fundamental to find some alternatives to ensure prompt payment.

#### **A. Feasible Alternatives & attributes**

There are several alternatives to increase on-time payments. The following are the most used in contracts: Payment period, Interest charges, debt recovery costs, discount clause, suspension clause, termination of the contract.

Term of period payment, interest charge, and debt recovery are promoted by the prompt payment act. This code encourages best practices in term of prompt payment between businesses and institutions. Besides, it important to know that other means apart from contract terms which can be used to improve prompt payment such as client investigation, cash flow projection, online payment...

In order to analyse and compare alternatives it is necessary to select some appropriate attributes which are: Cost, Satisfaction, Level of risk, ease of justification, relationship between parties, degree of certainty to obtain payment.

## B. Development of the feasible alternatives

-Payment period: It is important to specify the payment period in advance and include it into clauses of payment. The client will know the number of days to carried out the payment for the work done by the supplier. Business can establish payment period according to their capital conditions and the type of company. The following payment period are frequent in payment terms: Net5, Net10, Net30, Net60, Net90 (payment has to be done in 90 days from the invoice date). If the payment term is short it increases cash flow of contractor rapidly and lead to a positive working capital.

-Interest charges: Any companies can demand interest if clients don't pay on time. It is based on the Late Payment of Commercial Debts (Interest) Act 1998, and amendments established in 2000, 2002 and 2013. This right can be claim for transactions in business and public-sector clients but it can't be set up for transaction with customers. It is preferable that interest fee be present in the payment terms. If it is not the case, contractor can use the statutory right. The interest starts to take effect at the end of the agreed credit period. Each country, state, sector has its own regulations which define how calculate rate of interest. For example, in England, people have to use rates which are defined for six-month periods (1st January to 30 June and 1 July to 31 December) in order to determinate the interest. Then for the assessment of the interest the regulation requires to add up 8% to the bank of England base rate which is the reference rate.

-Debt recovery costs: Contractors can ask for a compensation from debtors according the amount of the debt which has been not paid.

The compensation entitlement varies in accordance with the size of the debt:

Size of unpaid debt	Sum to be paid to the creditor
Up to £999.99	£40.00
£1,000.00 to £9,999.99	£70.00
£10,000.00 or more	£100.00

(source: <http://payontime.co.uk>)

-Discount clause: Contractor can ensure to reduce the amount of the payment if debtor pay before the deadline. It is frequent to have a discount on the invoice of 1% or 2% if the debtors pay before 10 days. If debtor pay after this 10 days he has to give the original total amount of the bill. The discount established depends on sector criteria, the competition (which discount competitors apply or not?) and if the debtors make a prompt payment the last time. Discount provides benefits to both parties because it speeds up the payment (thus, increase the cash flow for the business) and reduce the amount of the bill for the debtors. However, there are

also some drawbacks. In fact, it happens that clients not inform the contractor that they decide to pay after the discount deadline. Sometimes, clients can also benefit from the discount even if they pay still late. It will affect the benefit and cash flow of the contractor.

-Suspension clause: The suspension clause enables the contractor to interrupt his work temporarily if payment is not due. This clause is particularly present in construction contract. It avoids the need to undertake the definitive end of the contract. However, contractor must not take advantage of the suspension clause and absence of this specific term in contract may conduct to agreement violation and a repudiatory breach of contract. Thus, it can be a risk for the contractor if he interrupts the work incorrectly.

-Termination of contract: This clause is stronger than the suspension clause. It involves that contractor cease his work in a definitive way because employer fail to make payment. Breach of contract for non-payment requires that the settlement must be considered as the main point of the agreement. As the suspension clause, the terms regarding termination and its justification must be clearly express on the contract. There is also the risk to pay instead of collecting because termination can be wrong (don't respect the termination requirements) and contractor has to pay damages to the employer for breach of contract. Specific conditions are required to terminate the contract. For example, the contractor has to show that he lost benefit that he expected.

Here there is no cash flows so NON-COMPENSATORY method

Attributes	DOMINANCE (PAIR WISE COMPARISON)					
	Payment Period	Interest charges	Debt recovery costs	discount clause	Suspension clause	Termination of contract
Cost	Better	Better	Better	Better	Better	Worse
Satisfaction	Better	Better	Better	Better	Better	Worse
Level of Risk	Better	Better	Better	Equal	Worse	Worse
Ease of Justification	Better	Better	Better	Better	Worse	Worse
Relationship between parties	Better	Equal	Equal	Better	Worse	Worse
Degree of certainty to obtain payment	Equal	Equal	Equal	Worse	Better	Better
<b>DOMINANCE</b>	<b>YES</b>	<b>YES</b>	<b>YES</b>	<b>YES</b>	<b>MAYBE</b>	<b>NO</b>

**C. Acceptance criteria of the feasible alternatives**

According to the last chart, we identify four potential alternatives (in green) which have the most correct attributes: payment period terms, Interest charges, Debt recovery costs and discount clauses. Then, in the next part of the paper we will carried out a deeper comparison among these four alternatives to understand the rank order.

Attributes	DOMINANCE (PAIR WISE COMPARISON)					
	Payment Period	Interest charges	Debt recovery costs	discount clause	Suspension clause	Termination of contract
Cost	Better	Better	Better	Better	Better	Worse
Satisfaction	Better	Better	Better	Better	Better	Worse
Level of Risk	Better	Better	Better	Equal	Worse	Worse
Ease of Justification	Better	Better	Better	Better	Worse	Worse
Relationship between parties	Better	Equal	Equal	Better	Worse	Worse
Degree of certainty to obtain payment	Equal	Equal	Equal	Worse	Better	Better
<b>DOMINANCE</b>	<b>YES</b>	<b>YES</b>	<b>YES</b>	<b>YES</b>	<b>MAYBE</b>	<b>NO</b>

**FINDINGS**

**A. Analysis and comparison of the alternatives**

In this part, we will analyse potential solutions found with the non-compensatory model by using the compensatory model. In fact, this method allows us to rank this alternatives with a ratio scale which is more appropriate for a comparison.

The first step is to transform each alternative in a “base1” as we can see on the below chart. This represents the scoring model.

Attributes	Cost				Satisfaction			Level of risk		
	Free	Low	Medium	High	Low	Medium	High	Low	Medium	High
Dimensionless value	1	0,67	0,33	0	0	0,5	1	1	0,5	0

Attributes	Ease of justification			Degree of certainty to obtain payment			Relationship between parties		
	Low	Medium	High	Low	Medium	High	Poor	Good	Excellent
Dimensionless value	0	0,5	1	0	0,5	1	0	0,5	1

Attributes	Payment Period	Interest charges	Debt recovery costs	Discount clause
Cost	1	0,8	0,8	0
Satisfaction	1	1	1	0,7
Level of Risk	1	0,8	0,7	0,5
Ease of Justification	1	0,7	0,7	0
Relationship between parties	1	0,6	0,6	1
Degree of certainty to obtain payment	0,5	0,8	0,7	0
<b>TOTALS</b>	<b>5,5</b>	<b>4,7</b>	<b>4,5</b>	<b>2,2</b>

The final step involves several stages. First, attributes are ranked according to their significance and the total ranking sum (21). This sum enables to weight each attribute according to their ranks. The ranking of attributes is: Degree of certainty to obtain payment > Level of risk > Ease of justification > Cost > Satisfaction > Relationship between parties. The method is the “Additive Weighting Technique”. Thanks to this method we can determine the best alternative, in other words the one whose the score tends toward 1.

**B. Ranking of the solutions from the best to the worst**

Attributes	Step1	Step2			Payment Period		Interest charges		Debt recovery costs		Discount clause	
	Relative Rank	Normalized Weight (A)			(B)	(A) x (B)	(C)	(A) x (C)	(D)	(A) x (D)	(E)	(A) x (E)
Cost	3	3/21	=	0,14	1	0,14	0,8	0,11	0,8	0,11	0	0,00
Satisfaction	2	2/21	=	0,10	1	0,10	1	0,10	1	0,10	0,7	0,07
Level of risk	5	5/21	=	0,24	1	0,24	0,8	0,19	0,7	0,17	0,5	0,12
Ease of justification	4	4/21	=	0,19	1	0,19	0,7	0,13	0,7	0,13	0	0,00
Relationship between parties	1	1/21	=	0,05	1	0,05	0,6	0,03	0,6	0,03	1	0,05
Degree of certainty to obtain payment	6	6/21	=	0,29	0,6	0,17	0,8	0,23	0,7	0,20	0	0,00
SUM	21			1,00	SUM	0,89	SUM	0,79	SUM	0,74	SUM	0,23

As a result, this technique is a tool to make a comparison between the alternatives thanks to the ratio scale. In fact, we can observe in the chart above that the Payment period term, Interest charges, Debt recovery are largely better than the Discount clause which has a low score 0.21 whereas the other are above 0.70. If we compare payment period and discount clause we can see that payment period is 2.5 times better than discount clause. On the other hand, the difference between Payment period, interest charge and debt recovery is not so pronounced. Payment period is just 1.17 times better than interest charges, and 1.22 times better than debt recovery. It is the same case between interest charges which is 1.04 times better than debt recovery. Consequently, the ordering of the solutions is Payment Period >

Interest charges > Debt recovery costs > Discount clause. It is advised to use the first three solutions together and in a lesser extent discount clause if it is not too risky.

### **C. Performance Monitoring and post-evaluation of results**

It is important to undertake monitoring and controls to check if the alternatives chosen are appropriate to improve the prompt payment. In order to do that, it is necessary to determinate by a regularly analysis if the payment period decreases after the implementation of this terms into the contract. It the contractor and clients must control the amount of interest charges and the debt requested because they can't be overestimated. Otherwise, there is a risk of sanctions for the contractor. If there is a discount clause, there will be some strict controls to check if clients take the discount without respecting the due date. Also, check if early payment discount lead to increase cost for contractor or owner.

## **CONCLUSION**

The aim of these paper was to answer three questions:

### 1) Understand the root causes of late or delayed payment

Late payment can be due to contractors or clients. There are many reasons why people pay late. For contractors, the most frequent are the lack of information provided to the clients, and some mistakes made when they required the payment. For the owner, financial difficulties, poor administrative and financial management, the low rank associated to the contractors, the dissatisfaction regarding quality or invoice, or payment culture lead to payment delays.

### 2) Assess what is the impact of late payment, especially on small businesses

It affects the competitiveness, the profitability of the company. The main impact is that it reduces the cash flow of the company and affect their investment. The small companies suffer the most of this lack of cash flow because some of them don't have reserved cash. This issue has a consequence on their investments and employment. Moreover, this problem can be diffused through the whole supply chain and impact many other stakeholders.

### 3) Identify solutions to this problem

Terms and conditions in the contract are a fundamental key for businesses to ensure on time payment. Terms should clearly establish the payment period for any invoice. Charge interest or claim debt recovery can be also added to the terms to encourage early payment. In a lesser extent, early payment discount can also be used but it requires some investigations.

## **FOLLOW ON RESEARCH**

In this paper, the late payment issue is only tackled in terms of conditions and terms of contract. In fact, there are some other important means that can be used by companies to reduce the risk of default. For example, contractors can undertake some investigations about their clients to make sure they pay on-time. But also, they can set up an on-time payment culture or the use of online payment etc. Besides the use of terms of contract, it is required to take into consideration these other methods.

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