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Legislate or educate?

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On the 20th October 2010, the European Union voted in favour of a new Directive to combat late payment in commercial transactions within the EU market. This Directive will replace the existing Directive 2000/35/EC.

The scope of the European Commission and Parliament is to change the present business culture - that of paying late for the supplies of goods and services received.

The new Directive does not only apply for business-to-business transactions but also for business-to-government dealings. The government departments and governmental organisations are cited as the worst payers in Europe and this piece of legislation may assist suppliers to get paid from the government after 30 days.

When this Directive will be transposed into every EU State's legislation both public and private sectors would have to pay their bills for goods and services provided by their trade suppliers by not later than 30 days. Nevertheless, in business-to-business transactions, the Directive allows credit to be extended up to 60 days if both parties agree. However, extending credit beyond 60 days is only permissible if ***"expressly agreed"*** by the creditor and the debtor in the contract of sale and provided that it is not ***"grossly unfair"*** to the creditor. This provision is aimed to protect SMEs that in many cases are forced to agree on longer credit terms, especially when they deal with bigger firms.

For the public-to-business payments, the general deadline is also 30 days. If the payment periods are to exceed 30 days, this has to be ***"expressly agreed"*** and ***"objectively justified in the light of the particular nature of the contract"***. This new Directive allows Member States to choose a payment period of not more than 60 days for public entities providing healthcare.

In case of late payment, suppliers will be entitled to 8% plus the ECB intervention rate as late payment interest from their customers. Interest charges will come into effect 30 calendar days from date of invoice or supply of goods/services. Suppliers are also eligible to claim a minimum of €40 to compensate for the expenses incurred to recover past-due money from the trade customer.

Other implications in this Directive relate to 'Retention of Title' of goods and an obligation on all EU Member States to ensure that an enforceable title will be obtained, irrespective of the amount of the debt, within 90 calendar days of the lodging of the creditor's action or application at the court.

At face value, this piece of legislation may seem plausible. However, I find it difficult to believe that it will be effective, let alone a good tool to change the present late payment culture of Europe.

Firstly, the existing legislation of every EU member state should support this Directive. Every members state should have adequate legislation relating to Retention of Title and the judicial system should allow a supplier to obtain an enforceable title within 90 days irrespective of the amount of debt; secondly, standardising the credit terms does not work in practice. This may also send a wrong message to the business community since this principle goes against any good credit management practice.

Credit terms should be determined flexibly by the supplier, according to the cost of money at time of granting credit (the opportunity cost of granting credit); the level of competition in the industry or market (the harsher the competition, the better credit terms); the cost of the product at point of sale; and the specific risks involved in granting credit.

An English veteran in the credit industry recently said that *"The implication of the EU directive is that the shorter the credit period the better. And that flies in the face of much of what businesses know to be the case: i.e. that longer credit periods can give you a competitive advantage, can show faith in trusted customers, and especially at this time, can give buyers the time they need to finance their purchases."*[1]

[1] Mr Simon Groves

The EU Commission acknowledges that the Late Payment Directive 2000/35/EC was ineffective and in my opinion, the new Directive will also be unsuccessful. Culture takes time to change and the best recipe to change culture is by means of education. The business community needs to be educated when it comes to granting and extending credit. Investing in credit management training programmes that focus on good customer services, synergy between the sales and the credit functions, competition, sound cash flow management and long-term profit is the key for the success of firms in today's business world.

The people working in the field of credit management should be trained and skilled to analyse the credit worthiness of their prospective credit customer in a profitable manner and be relevant to today's market needs. Firms should be encouraged to make more use of efficient and reliable Credit Management Information Systems provided by third party sources, which information helps them take profitable and relevant credit decisions. Forming part of Credit Circles is also advisable in order to act proactively.

Good credit management practice insists that trade creditors should always present a credit agreement to their customers. These agreements should detail the credit terms and the conditions of sale and should be duly signed by both parties – as the Italian saying goes *' Patti Chiari, Amicizie Lunghe'.*

The credit practitioners should also strive to issue invoices which are properly dated and addressed; accurate; complete; and informative, providing good description of goods/services. An invoice should be a simple document requesting payment for goods /services provided and it should not include any advertising clutters. It should be issued on time and any disputed invoices should be settled promptly by the supplier to the benefit of both parties. No supplier should expect to get paid if invoices are not issued clearly, accurately and timely!

One of the main concerns for many businesses is the managing of past-due accounts receivables or overdue accounts, as they are commonly referred to. Statistics show that approximately 40% of the total Assets of a firm relate to Accounts Receivables and hence this asset requires good protection. But how skilled and knowledgeable in this subject are the employees managing such a critical liquid asset?

Skilled credit practitioners would know how to listen to their customers and get to know their customers and the reason/s for paying late. Categorizing overdue customers according to the reasons for paying late would then help to focus the limited resources where it pays most. Thus, ensuring sound cash flow and securing long-term profit, while encouraging existing customers to continue buying at a profit to the supplier.

Having a skilled team of credit practitioners would also benefit from long-term working relationship with customers, gaining and sustaining competitive advantage in the market whilst being more successful in the collection of dues.

Trained credit staff would also strive to be flexible, to innovate and to improve their systems and procedures to ensure better customer service. The credit function is a peoples' function and it is people and people-driven processes that are the real source of sustained competitive advantage – which is the name of the game in today's business!

Although legislation may sometimes help businesses as a last resort, good credit management practices should always prevail as it is the recipe for business success.

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He obtained his MBA from Henley Management College, Member of the Chartered Institute of Marketing (UK), and Fellow of the Chartered Institute of Credit Management (UK).

He has contributed with intuitive workshops and presentations addressed to various business people worldwide. Josef is a regular contributor of business articles to business press.