

THE LATE PAYMENT OF TRADE CREDIT FOR SMALL AND MEDIUM-SIZED ENTERPRISES (SMES)

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ABSTRACT

This paper explores the literature on late payment of trade credit from a global perspective. Late payment of trade credit is a long-standing problem and is not isolated to one country (Pike, Cheng, & Chadwick, 1998). Poor credit management practices and being undercapitalised are two of the major concerns for small business as they feel powerless to do anything about their debtors' late payments (F. Chittenden & Bragg, 1997; Peel, Wilson, & Howorth, 2000).

The data for this paper was collected from a questionnaire on cash management practices in 2000 which included a question about the effects of late payment of trade credit on small businesses in a regional area of Australia (the Mid North Coast of New South Wales). The sample of small businesses was from manufacturing, construction and service industries. The database used to collect the names and addresses of the businesses was the Business Enterprise Register which is located at Southern Cross University, Coffs Harbour and contains over 13,000 businesses.

Pike and Cheng (2001) note that there is limited research in the main determinants of late or non-payment. Peel and Wilson (1996) found that there was a dearth of both theoretical and empirical small business research relating to cash management practices which encompasses late payment of trade credit. The paper outlines possible remedies, with legislation a starting point to finding a solution to the problem.

INTRODUCTION

The problem of late payment of trade credit has existed for a number of decades (Bates, 1971; Bolton, 1971; Wilson, Watson, Singleton, & Summers, 1996). Bates (1971) found from an 1954 Oxford Survey that creditors and debts exceeded 50 per cent of net assets, with small businesses being 23.2 per cent for creditors and 35.3 for debtors, compared with 18.6 and 24.2 percent respectfully in public companies. In comparison Wilson et al (1996) report from their 1994 survey that "on average it was found that 52 per cent of all invoices were actually paid late (after the due date) and 44 per cent of companies reported that such late payments caused them a significant problem and they were sensitive to late payment".

The credit squeeze of 1969 in Bristol (UK) saw small business advancing credit and the West of England Engineering Manufacturers Association made the statement "extended

credit by delaying payment of its bills to the small business” and the position was summed up in the following manner, "The typical small manufacturer is now facing a situation in which large customers are taking extended credit at a time when his own bank manager is compelled to refuse normal bank facilities"(Bates, 1971). Wilson et al (1996) stated that “trade credit often fills the finance gap, particularly for the smaller business that finds itself credit rationed from the banking sector”.

Whilst the Bolton Committee (1971) added to the debate by reporting that the vulnerability of small businesses during periods of "credit squeeze" exists when larger enterprises and government bodies could use their greater power to delay payment to small enterprises. The late payment problem is not confined to one country "... we were told that it is often serious in Japan, for example, and that there the Ministry of International Trade and Industry has powers to intervene on behalf of small firms with legitimate complaints of delayed payment by large customers, and to enforce payment (Bolton, 1971)".

More recently Perry (1995) reported that the slow-down of economic activity in Europe over the past two years has resulted in slower receivables and financial difficulty for many businesses; and extending credit to businesses in the U.S.A from another country is not without risk. The International Credit Executives (ICE) reported that foreign affiliate trade receivables resulted from the following: excessive past dues, repetitive and large bad-debt write-offs; unusual extended credit terms situations; lack of adequate credit controls; and insufficient credit checking and credit information (Perry, 1995).

Whilst small businesses may suffer from their debtors not paying, they may benefit from making late payments to their own suppliers. The Bolton Committee (1971) claimed that “many firms grant credit in a haphazard fashion and have slow and irregular collection of debts”. The Bolton Committee (1971) goes further by stating that small businesses “on occasion neglect for weeks on end to submit bills for work completed or goods delivered and fail to take advantage of discounts for prompt payment of accounts thus failing to appreciate the effect by paying a very high rate of interest for the credit they are taking”. To continue the argument that this is happening today, from a UK small business experience suppliers have not efficient invoicing system, nor do they check credit worthiness of the clients which is seen by not having clearly established and agreed credit terms prior to sales for monitoring payment patterns (Wilson et al., 1996).

In Australia the same happens as seen from interviews conducted about payment issues... one-third of the small firms reported that their trade suppliers had been pressing for payment; had severely cut the period allowed for payment; or had introduced charges or penalties for late payment. Most of the small firms affected in this way had either been unable or unwilling to adopt similar procedures with their customers. In fact, some had been obliged to allow customers a longer period in which to pay their accounts when their suppliers were imposing more onerous credit terms than previously (Johns, Dunlop and Sheehan, 1989).

Problems with trade credit generally, and debtors in particular, are likely to vary from industry to industry. (Bolton, 1971) found that:

..as between small and large firms in similar trades it appears that there is no great difference in the use of trade credit: manufacturers, small or large, are net givers of trade credit and their ratios of debtors to turnover are not dissimilar; for non-manufacturers, a category dominated by the retail trades, debtors and creditors are more nearly equal.

Wilson et al (1996) found that the industry sectors in the UK that experienced the most severe problems from late payment of trade credit were:

- Construction
- Textiles, Leather, Clothing, Shoes
- Timber, Furniture

Yet the industries that considered credit terms to be important were:

- Metal and metal goods manufacturing
- Engineering
- Construction (Wilson et al., 1996)

It is not only industries but government departments which add to the problem by paying late and this was covered by the Bolton Committee (1971) that reported:

The public sector offers better prospects of improvement, and it is possible that a lead given here would have some effect in private industry. We were told that central Government departments themselves have a bad reputation in this connection, as well as nationalised industries and public authorities, and we therefore discussed the matter with Treasury. In the case of the departments, we are entirely satisfied that deliberate delay of payments does not occur. The number of payments is immense and occasional mistakes inevitably happen, but prolonged and serious efforts have failed to produce a single valid case of deliberate delay. This is as it should be; departments have no liquidity problems and there is strong pressure to clear bills quickly. The average time taken is between one and three months, depending on the size and complexity of the contract. Some of the nationalised industries however (which do have liquidity problems) appear to be less conscientious; their average payment period is three months, but longer delays are not uncommon. Local authorities, particularly their public works departments, have also been heavily criticised, and the Federation of Building Trades Employers suggested to us that their internal audit procedures inevitable cause delays in payment of accounts.

Credit management

The standard of credit management in the UK amongst small businesses is very poor (Bolton, 1971). Some of the reasons for small business failure has been the result of poor or careless financial management (Berryman, 1983; Peacock, 1985). Pike and Cheng (2001) cited the Society of Practitioners of Insolvency that said “unsecured nature of most trade credit arrangements generates significant corporate exposure to the delinquency risks of slow payment and debt default. This is compounded when many businesses operate on the principle of ‘pay when paid’ thus exacerbating the late payment problem (Howorth & Wilson, 1999).

McMahon et al (1993) report that problems with regard to payment by debtors can arise not only from the bad practices of debtors but also reflect poor credit management on the part of the business which is extending the credit. Phillips (1996), a senior manager from Ernst & Young stated that “Rather than paying attention to credit management only when confronted by a major bad debt, organisations must recognise that credit risk management warrants the attention paid to any other area of operations”.

Johns et al (1989) found that “the reduced availability of net trade credit can also have an important effect on the financial structure of small companies and that small business, rather than larger business, has tended to suffer from this problem for two reasons:

- There has been less expert control over trade debtors of small business
- Small firms have less market power than larger firms”.

Howorth and Wilson (1999) found from their case studies that some firms are more sensitive to credit management than others from two extremes; those who suffered from the late payment and those who controlled it. Howorth and Wilson (1999) found that “sensitivity to late payment was reduced in businesses with long-term financial stability and by having a good knowledge of when payments could be expected, enabling cash flow to be planned”. When good credit management procedures exist the actual late payment was less.

Wilson et al (1996) found that good credit management practices and credit terms results from 76 per cent of respondents from a Forum of Private Businesses (FPB) on their products and ranked their importance:

- 43 per cent had a formal credit policy
- 41 per cent had a credit application form
- 65 per cent checked the credit worthiness of customers before allowing credit
- 28 per cent used credit reference information (19 per cent on line)
- 39 per cent categorise customers according to solvency risk
- 58 per cent categorise customers according to late payment risk

Chittenden et al (1998) adds to the debate that 62 per cent of respondents subscribe to a credit agency to obtain information about potential customers with only 58 per cent requiring credit applications to be completed on new customers. Some of the results indicate that poor credit screening practices exist in small businesses especially when the comment was made that “We give credit to anybody who asks for it. It is as simple as that (F. Chittenden et al., 1998)”. To add to the problem Chittenden et al (1998) found that on average only 45 per cent of small businesses have a full-time credit officer.

Possible remedies to the late payment of trade credit problem

The Bolton Committee (Bolton, 1971) suggest the only recourse to law is:

“penal clauses” - say, the charging of 1 per cent per month interest on delayed payment - to be ignored by companies secure in the knowledge that they will not be taken to court. An alternative remedy which has been suggested to us is the wider use of bills of exchange, which would fix a date for repayment and prohibit, except by negotiation, any extension of the credit period. Such bills could be discounted, thus providing the creditor with working capital more quickly than would otherwise be the case. We put this forward for consideration: it seems to us to have possibilities, but of course requires negotiation with the debtors. It is also administratively cumbersome when there are a large number of relatively small individual transactions.

The Bolton Committee suggested an alternative way of dealing with the problem in the form of bills of exchange. Whilst this particular financial instrument may not be relevant, it does raise the question of alternative ways of avoiding direct confrontation with

customers. One way of doing this is to use factoring. However, similar problems arise with factoring, and other devices, such as with legal proceedings in that there are some fixed costs involved which impact disproportionately on small businesses. Also, alternative approaches may require a higher level of financial management skills than many small business owner-managers possess (Hutchinson & Drever, 1998).

Both the Bolton Committee in the UK and the report by the Small Business Advisory Council on Finance for Small Businesses in Australia suggest that small businesses are at a disadvantage in their dealing with large businesses and government agencies as mentioned earlier. There needs to be two important provisos to this observation. First of all both these reports attribute at least part of the blame to poor management practices on the part of small businesses and secondly, the data are based largely on anecdotal evidence (Hutchinson & Drever, 1998).

Again, the Bolton Committee provides a useful starting point in answering this question the late payment of trade credit problem. The Committee's recommendation was that government could, indeed, play a very direct role by ensuring that departments under government control followed best practice with regard to the payment of its creditors. Prompt payment by government bodies would itself remedy a significant proportion of the problem since, although the government sector is shrinking and many small businesses do not deal directly with government, government departments still account for a very high proportion of economic activity (Hutchinson & Drever, 1998). Unfortunately there is no empirical literature to support this claim except for what Bolton as said in the past.

Government legislation

United Kingdom

Bolton Committee (1971).. believed the Government should ensure that in all contacts carried out by private industry on the Government's behalf, the main contractor is required to observe the payment terms of any contracts with sub-contractors. The United States Government achieves this by stipulating that for certain contracts the main contractor will not be paid until he can demonstrate that all sub-contractors have been paid. Hutchinson and Drever (1998) noted that the role of government could be extended further by using its contractual powers with large private contractors. The Bolton Committee points to the US government as an example of this and since then the US Prompt Payment Act of 1988 has provided small businesses with a right to interest on overdue payments by federal authorities but there is little empirical information available on this matter.

In the UK there were a number of papers that considered the late payment bill issue. The Department of Trade and Industry (1997a) had a consultation paper in the UK that introduced a statutory right to claim interest on late payment of commercial debt, exercisable, initially, by small business against all large enterprises, including public sector organisations.

The Department of Trade and Industry (1997b) response paper on the Government's Green Paper had over 3,500 copies circulated in the UK to a wide range of public and private sector organisations, with over 490 responses on the introduced legislation to provide a statutory right to claim interest on late payment of commercial debts (Wynarczyk, 2000). The UK Government's Bill was introduced in December 1997 and received Royal Assent in mid 1998. The rate of interest has been set at the official dealing rate of the Bank of England (the base rate) plus eight 8 per cent, which is the same rate that small businesses are able to borrow from the banks (Wynarczyk, 2000).

The legislation is called The Late Payment of Commercial Debts (Interest) Act 1998 and is phased as follows:

- for the first two years - 1 November 1998 to October 2000 – small businesses (those with fewer than 50 employees) are to be able to claim interest from large businesses and the public sector on debts incurred under contracts agreed to after that date
- the right to claim interest will be extended from 1 November 2000 to 31 October 2002, so that small businesses will also be able to claim from other small businesses on debts incurred under contracts agreed after that date
- from 1 November 2002, all businesses and the public sector will be able to claim interest from all businesses and the public sector on debts incurred under contracts agreed after that date (Wynarczyk, 2000).

One outcome from the legislation by Brun-Rovet and Meehan (2002) states that the penalties for late payment may favour big business. In the UK an estimated 10,000 businesses fail due to cash flow problems and the legislation for late payments would act as a deterrent to those contemplating to act “it’s pointless taking a customer to court for late payment because of the time involved, and because you’re unlikely to keep their custom (Brun-Rovet & Meehan, 2002).

Another outcome has seen that there is no excuse for the delay of payment beyond the agreed (or statutory) terms. Therefore the basics of credit management has been conducted through the Better Payment Practiced Group (BPPG) to educate a growing number of SMEs to develop credit policies that will help them overcome any problems they have with late payment of trade credit (Anonymous, 2003).

Wynarczyk (2000) states “that the legislation introduced by the UK Government to combat the problem of late payment is having very little impact on speeding up outstanding debts owed to small business .. and remains a major and acute problem in 1999, becoming as endemic as business failure itself”.

Australia

In 1998 a report was prepared for the State Government of New South Wales, Australia on the issue of late payment of trade credit and whether such legislation should be introduced at State or Commonwealth level. It would appear to be highly problematic to introduce it on a State-wide basis given that many small businesses will have customers outside the State (Hutchinson & Drever, 1998). However in 1999 the ‘Building and Construction Industry Security of Payment Act’ was passed at State level and from early 2000 this new law in New South Wales reformed the way that contractors, subcontractors, consultants and suppliers in the State’s construction industry get paid (“Building & Construction Industry Security of Payment Act," 1999).

Furthermore in 2001 the Commonwealth introduced the late payment of trade credit known as ‘Payment of Commercial Debts (Interest) Bill 2003’, which has had its second reading and was adjourned on 6 March 2003. It penalises late payment of commercial debts by Commonwealth government agencies and large corporations to small business in relation to contracts for the supply of goods and services (The Parliament of the Commonwealth of Australia, 2002).

Currently in Australia debts outstanding can be recovered under the Credit Act, Trade Practices Act, Corporations Law and Petty Sessions. In addition, legal action can be taken to enforce the conditions of a contract, which could include the right to interest in the event of late payment, subject to the validity of the contract and providing that any such conditions are not themselves in contravention of any legislation (Hutchinson & Drever, 1998). Most of the references to these Acts and the impact of each piece of legislation can be located on the Australian Securities and Investment Commission website.

In addition, Hutchinson and Drever (1998) noted that the Department of Workplace Relations and Small Business reported that the Australian Competition and Consumer Commission (ACCC) has expanded its services and activities for small business. One of the key factors is making the legal system more accessible for small business by ensuring enforcement bodies are in a position to assist these firms when a dispute arises. "It is no good having stronger legal rights for small business if they can't be adequately enforced or if access to remedies is beyond reach of small business (Federal Government Fair Trading Statement, 1997)".

There are of course many forms of assistance provided to small businesses by government both at local, state and commonwealth level. Relevant examples in the context of the issue of dealing with customers are the Export Finance and Insurance Corporation (EFIC) and recent initiatives in terms of government purchasing with two to five years repayment period for contracts valued at \$1 million to \$5 million (Hutchinson & Drever, 1998). The EFIC provides services which include export credit insurance, export finance, bonding facilities, working capital guarantees and overseas investment insurance. The more recent creation of Export Access combined with EFIC greatly helps small businesses involved in exporting when dealing with issues regarding the provision of trade credit (Hutchinson & Drever, 1998).

Recent developments in term of government purchasing such as the Supplier Development Program, the Industrial Supplies Office Network and the National Procurement Reform Principles (February 2003) make it easier for small businesses to bid for government contracts. It is to be hoped that securing a government contract means that a small business will have not to worry about late payment (Hutchinson & Drever, 1998).

Therefore it can be concluded from the legislation that whilst there do not appear to be any legal or accounting barriers to small businesses charging interest on outstanding debts (provided that any such requirements are made clear to the customer at the point of entering into the contract), in practice this does not seem to be a feasible option for most small business owner-managers because of problems of enforcement (Hutchinson & Drever, 1998).

RESEARCH METHODOLOGY

Data were collected through a postal questionnaire using 'closed' questions. The questionnaire covered a range of questions relating to credit management of accounts receivable and accounts payable and cash management. This paper is exploratory and deals with the late payment of trade credit and the literature surrounding that issue.

A database located at Southern Cross University, Coffs Harbour known as the Business Enterprise Register was used for this study. It has more than 13,000 small businesses listed in an area known as the Mid North Coast of New South Wales, Australia. The

questionnaire was mailed out to 2,000 small businesses in 2000. There were 560 returns with 352 (25 per cent) from businesses that had moved or closed their businesses, with another 208 (10 per cent) completed responses.

The survey sample closest to the present study is that of Chittenden et al (1998), conducted in the UK. Given the distance between the two countries and the changes that have taken place over the last five years it will be informative to make some comparisons between the two studies on the late payment of trade credit.

The remainder of the paper reports the findings of the study and examines empirically the arguments made in regard to the late payment of trade credit. The results of this paper adds to the literature previously mentioned which are qualitative in nature, therefore the analysis presented in the following three tables is along the lines of credit officers, the number of days for creditors and the late payment of trade credit.

RESULTS

Table 1 relates to how many small businesses have full-time credit officers in Australian SMEs. As the table illustrates the figures are very low with less than 30 per cent of businesses across the board having the services of a full-time credit officer. The result are somewhat different to what Chittenden et al (1998) reported. For small companies with less than 50 employees 45 per cent operate with a full-time credit officer in UK SMEs (F. Chittenden et al., 1998). Yet 88 per cent of small businesses operate a finance department/function within the company (F. Chittenden et al., 1998) with 70 per cent having a finance director.

Table 1: Full-time credit officers in Australian SMEs

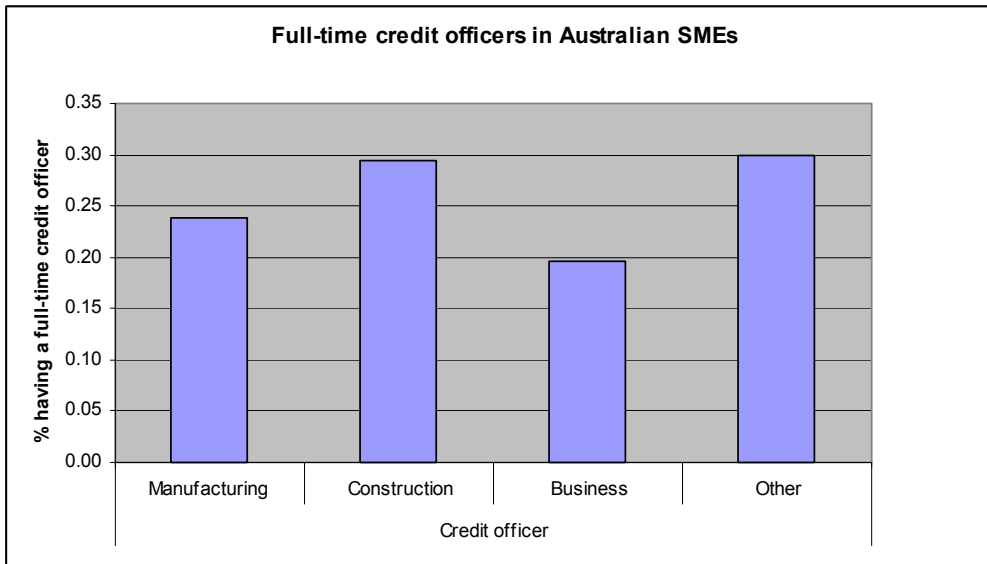
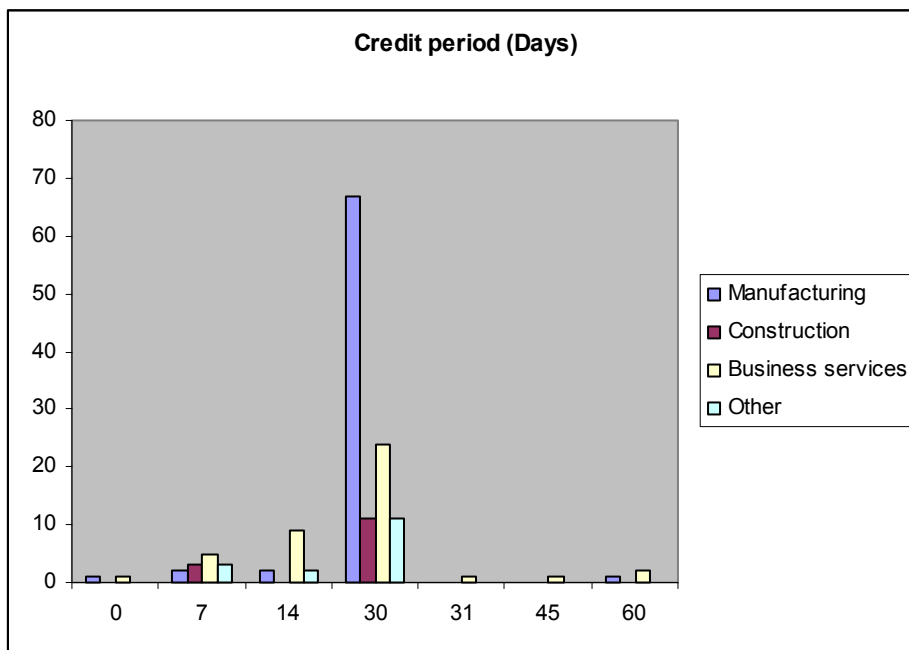


Table 2 illustrates that the credit period, in the number of days, for all industries studied is believed to be around 30 days (Pike & Cheng, 2001). The business service and manufacturing industries have credit periods going beyond the 30 days which is consistent with the literature but is inconsistent with Chittenden et al's study. Creditors days across the sectors appear to be lower in the construction industry (50 days) compared to manufacturing (61 days) and business services (59 days) sectors (F. Chittenden et al., 1998).

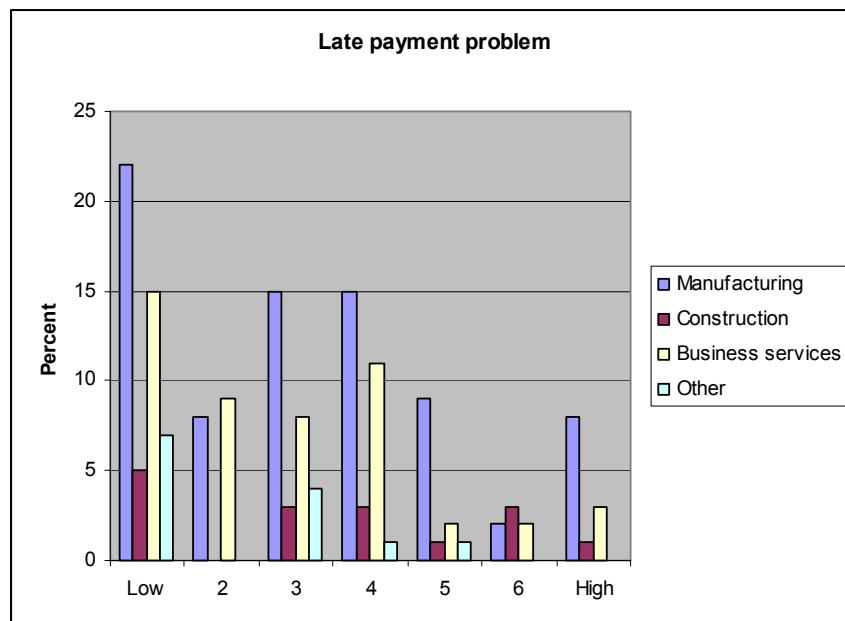
Table 2: Creditors days across sectors



A great deal of press comment and parliamentary interest in the late payment of trade credit problem has existed in Australia over the last three years as mentioned earlier. The late payment continues to be a problem for any business that uses credit facilities. In this study respondents indicated that on average 50 per cent of their customers settle their accounts on time that is without further communication or correspondence. From this study it was found that a very serious late payment of trade credit problem exists with 25 per

cent of SMEs which is consistent with Chittenden et al study. The results suggest that the late payment problem exists in the construction and business service industries and needs to be explored further.

Table 3: Late payment problems across sectors



Hutchinson and Drever (1998) list advantages and disadvantages of adopting remedies to the late payment of trade credit would appear to be:

Advantages

1. It provides an opportunity to change the culture with regard to credit management and particularly the tendency to deliberately delay payment in order to use creditors as a source of cheap finance.
2. It would undoubtedly improve the cash flow for many small businesses, either in the form of receiving payments more quickly or receiving additional money when payments are late.
3. It could be seen as "levelling the playing field" for small businesses in their dealings with large businesses and thereby reduce some of the coercive power of larger businesses.
4. It would be consistent to study and adopt legislation similar to other countries.

Disadvantages

1. It could be seen as another example of government interference in the regulation of commercial activities.
2. It may not be the best way of achieving the stated aims. There may be other, more cost-effective, ways of helping small businesses in relation to late payment. For example:
 - ensuring that government departments and those who deal with governments observe better practice with regard to prompt payment of accounts.
 - making more use of trade associations to act on behalf of their members in a variety of ways such as taking over the legal enforcement of late payments. This could be

funded by an industry levy and could be extended to cover bad debts as well as late payments. The government could have a role to play here in terms of allowing any such levies as a tax deductible expense.

3. The issue of late payment is much less serious now than it was during the period of high inflation. Whilst it is always possible that high inflation may return, low inflation reduces the urgency of this problem.
4. The extensive use of credit cards reduces the problem of bad debts and late payment for many small businesses.
5. Large businesses may still be able to use their market power by shopping around to find suppliers who are prepared to offer very long periods of credit or agree to bill late.
6. It may actually encourage delay in payment of debts if a customer finds that the statutory rate of interest is less than the cost of other financing.
7. Very importantly, it may "backfire" on small business in general and on rapidly growing small businesses in particular. To the extent that small businesses may be net borrowers rather than net lenders, the introduction of such legislation could increase the cost of an important source of funding to them.

CONCLUSION

It can be seen that there is a role for government and that this can take the form of:

1. Ensuring that those entities directly under government control follow best practice with regard to payment of debts.
2. Using its bargaining with private contractors to ensure that they follow best practice in dealing with small businesses.
3. Providing specialist facilities such as the EFIC
4. Introducing legislation which provides a statutory right to interest on overdue accounts

Consideration should also be given to alternative ways of achieving all, or most, of the objectives of such legislation by other means. These would include the greater use of government power to enforce best practice with regard to the payment of debtors and the encouragement of trade associations to deal with such problems.

Encourage the best practice of small businesses paying accounts by those entities over which it has direct or indirect control. This, in itself, could lead to a very significant improvement in the financial position of small businesses.

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