The EU's Late Payment Regulation and its potential impact

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Why is the European Commission proposing this late payment regulation? and what potential consequences are there?

On 12th September 2023, the European Commission, part of the executive of the European Union, took initial steps to combat late payments in commercial transactions in Europe. This proposal would revise an existing directive from 2011 and aims to "bring fairness in commercial transactions, increase the resilience of SMEs and supply chains, foster a more widespread use of digitalization, and improve the financial literacy of entrepreneurs."[1]

Currently, the existing directive lays down a payment term of 30 days in B2B transactions. However, this can be extended to 60 days or more "if not grossly unfair to the creditor". In practice, the absence of an effective maximum payment term and the ambiguity in the definition of "grossly unfair" in the directive has led to a situation whereby payment terms of 120 days or more exist.

The new proposal for a regulation streamlines the current provisions and introduces a single maximum payment term of 30 days for all commercial transactions, including B2B and transactions between public authorities and businesses. This term will be the same across the EU. The freedom of contract is preserved since parties can negotiate any payment term as long as it does not exceed 30 days. The proposal does not affect shorter payment terms laid down in national legislation, to ensure legal certainty.

Defining late payments

Firstly, what is a 'late' payment? Strictly speaking, it means that a buyer (debtor) makes payment to its supplier (creditor) after the invoice due date, which in turn should reflect the amount of days after the invoice is issued that is commercially agreed between the parties for payment to be made.

Sometimes these late payments can be the result of operational inefficiencies or errors on the part of the buyer, and at other times they can be caused by companies who deliberately hold onto payment beyond agreed terms to boost their own cash flow at the expense of the supplier. In either instance, the supplier is left financing the working capital of the buyer.

A related issue is what the commercially agreed amount of days should be between the invoice issuance and due dates.

A 'late' payment can also be a situation where a buyer uses its leverage resulting in the supplier agreeing to an unreasonably long amount of time between the invoice issuance date and the invoice due date, even assuming the buyer pays on the due date.

In this instance, it can be argued the payment is not late at all. However, if a small supplier has to wait, after issuing an invoice to be paid by a large buyer, up to six months or more then it is reasonable to conclude that the smaller supplier has an undue amount of strain placed upon them.

The European Commission supposes that one of the root causes of late payments is due to this asymmetry "in bargaining power between a large or more powerful client (debtor) and a smaller supplier (creditor). This often results in suppliers having to accept unfair payment terms and conditions."[2]

This asymmetry has led to a lot of public discussion over recent years regarding payment terms (otherwise known as trade credit) between businesses, and particularly how large corporations can hold smaller firms to ransom for carrying the working capital needed to support a product or service.

It can be argued that large corporations have a moral obligation to ensure dealings with all their suppliers, particularly SMEs, are managed fairly. After all, most large corporations didn't start out as large corporations, but rather once were SMEs themselves who had grown and benefited over the years with the support of their suppliers.

The new regulation aims to better protect creditors from their debtors. Thus the new rules propose to make the payment of interest automatic and compulsory until payment of the debt. Contrary to the current directive, under the new proposal, the creditor cannot waive its right to claim interest for late payment. A contractual provision or practice to the contrary would be unfair, and therefore null and void of any legal effect.

The creditor is therefore relieved from the burden of claiming the payment of interest, which becomes an automatic obligation of the debtors when they pay late.

The burden late payments present

It has been estimated that 10% of invoices issued in commercial transactions around the world were not paid on time (or written off as bad debt), costing the global economy $1 trillion every year.

Payment timing and late payments are a challenge for all businesses, though particularly for small businesses, across the globe. It is an issue that Taulia is particularly conscious of – and one that we are helping to solve for businesses worldwide.

Taulia's Supplier Survey in 2023 found that late payments are on the rise, while fewer customers are paying early. The survey found that 50% of companies are being paid late, compared with only 3% being paid early, on average.

During the pandemic, more businesses took action to protect their supply chains by paying suppliers early. Our survey found that this trend has now reversed, with businesses once again taking steps to protect their own working capital.

Payments may be made late for a multitude of reasons: operational inefficiencies, buyer error, or cash flow concerns. Variance in the value of cash is a common consideration for businesses, and it is one particularly of concern during the inflationary surge that has developed since mid-2021.

Research commissioned by Taulia in late 2022 highlighted the challenges businesses are most commonly facing, with 42% of respondents considering the impact of inflation to be one of the top concerns for 2023. Similarly, 50% of respondents believed that the current high inflationary environment would last until at least 2024, perhaps even up to the end of 2024.

In an inflationary environment, such as that we have seen of late, the value of cash is greater in the present than it will likely be in the future, potentially leading buying businesses to hold onto their payments for increasing periods of time. This may well have led the European Commission to act on late payments now.

Are there benefits to a variance in payment term lengths?

While shorter payment terms can aim to reduce the cash flow burden on smaller businesses, there are organic reasons for variance in payment terms via negotiation.

One such example is that industries may not operate at similar time frames and therefore require adaptation when it comes to making payments.

With mining, for example, the development of a deposit into a mine requires five key steps: exploration, discovery, development, production, and reclamation. This process can be extensive.

Consequently, the cash conversion cycle in such an industry can be lengthy, and place strain on the cash flow of mining companies. Trade credit from the suppliers to the mining business can help to significantly reduce the cash flow burden, meaning the miners can wait to pay out for necessary supplies closer to the time that they will receive payment from their customers.

Similarly, the production of components for manufactured goods can often take place thousands of miles from where they are finally purchased and delivered, resulting in a transport period that can last days or weeks. Upon arrival, the goods must be inspected to ensure that they comply with the specifications ordered. This is usually referred to as the three-way match, where the purchase order, invoice, and goods receipt are compared prior to approving the payment of the invoice.

Typically the buyer would not wish to make payment for goods it has not confirmed are satisfactory compared with what was ordered. Inevitably there will be a period between the supplier producing the components/goods and the buyer being able to receive those goods, sell them onward, and receive payment that needs to be financed.

There are various documentary trade instruments that can be used to mitigate these risks and provide financing to the parties involved, however, these can be expensive and many firms with an established trading history prefer to deal with this on an open account basis where trade credit is offered and received between them.

Another reason for varied payment term lengths is competition. In many cases, businesses use payment terms strategically to differentiate their offering from that of a competitor. For a business operating in a crowded industry where the specification, volume, price, and quality are similar amongst peers, having the ability to offer longer payment terms to differentiate their offering and win customers is important.

Potential consequences of the legislation

It is important to make clear that this regulation would only affect contracts based in the European Union. Consequently, there is concern that the European Commission's plans could inadvertently raise prices and encourage more business outside of the EU, where firms would not be bound by these regulations and would have greater freedom to negotiate more flexible commercial arrangements.

Payment terms legislation can vary quite widely between countries. Taulia's International Payment Terms Database can elucidate the term differences between countries around the world.

In reducing payment terms, there will also likely be a greater burden elsewhere in the supply chain. For instance, if large corporations are required to pay their suppliers sooner, then those corporations may renegotiate pricing to account for lower financing by trade credit.

Available working capital is a necessary element for each of the parties in the chain in producing any product. Taking the current state where payment terms of differing lengths are negotiated between businesses to manage their working capital, and moving to a state where payment terms are standardized to 30 days would see a very significant shift in the amount of working capital the different players would need to finance, and the overall cost is likely to be shifted from one party to another as a result.

Whoever ends up carrying the additional working capital will have to look at their end-to-end business model including levels of borrowing, debt structure, procurement contracts, and inventory management practices to ensure that their business remains strong and attractive for its shareholders/investors.

Considering the asymmetry between large and small businesses today, if contractual payment terms were capped at 30 days, one could argue that some smaller companies may not need to borrow as much and therefore could fuel their growth at a lower cost.

What's next?

Currently, this regulation remains a proposal. It is facing opposition from businesses, which may cause it not to pass or it may change it in substance prior to passing.

One particular issue stems from European businesses that consider it a substantial disadvantage in comparison to their non-EU competitors. Nick Lakin, head of corporate affairs at Kingfisher, said "It does not come for free. It puts the cost somewhere else in the value chain [...] This would ultimately have consequences for consumers in terms of product availability, choice, and price."[4]

If the regulation does come to pass, its implementation is also likely to be a gradual process given the significant impact it will have on companies.

Having a well-developed working capital strategy during this period and beyond will be vital. Taulia is well-positioned, as a complete working capital management solution, to support businesses regardless of economic cycle or regulatory environment.

Sources:

1: European Commission: Questions and Answers: Late Payment Regulation

2: European Commission: Questions and Answers: Late Payment Regulation

3: Taulia: Supplier Survey 2023

4: Financial Times: EU payment rules shake-up will prompt price rises, retailers warn

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