

# The Economics of Corporate Trade Credit in Europe

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## Chapter 1

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### The role of trade credit in corporate activity

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# 1 The role of trade credit in corporate activity

## 1.1 Theoretical aspects of trade credit

The idea of financing business activity through trade credit was developed and cultivated by merchants and manufacturers as early as Antiquity (Cheng and Pike 2003). Nowadays, trade credit is so common and quotidian that its role in enterprise operation is often not recognised. It has become an element inscribed in the functioning of business entities, which is reflected in their reporting. Meanwhile, entrepreneurs assess trade credit in various ways, i.e. from very negative opinions to convictions of its positive role in entity development (Nowak 2014).

The mechanism of trade credit, however, invariably remains the same: the customer receives the goods it can trade, whereas the payment for those goods is made at a later date (Cuñat 2007). An agreement defined as such requires its parties to enter into a mutual relationship. Historically speaking, these relations were built based on a trust relationship between the merchant and the buyer, meaning the trust in the other party fulfilling the agreement and making the payment within the agreed time limit.

The Hammurabi Code contains provisions meant to protect the merchant<sup>1</sup> against the buyer's dishonesty. There are even letters that were exchanged between the parties to a trade agreement in ancient Mesopotamia, indicating one of the parties' dishonesty, which forced the other party to seek a solution to the problem, based on the legal structures existing at the time. Just as in the present day, this correspondence calls for payment and presents the prospect of lodging a complaint about the dishonest customer on the part of the claimant (Oppenheim 1967). Over the centuries, the legislative bodies, as well as the entrepreneurs themselves, have developed various tools meant to protect the parties to an agreement. Nevertheless, the formation of a bond of trust between merchants and buyers has remained unchanged. This bond connects the two parties in such a way as to have the capital provider receive the payment for it in the amount agreed and within the time specified (Smith 1977). Without trust in the buyer's integrity, no agreement would have been concluded.

The way businesses are run has changed over the centuries, new capital raising mechanisms were introduced, and the very idea of capital has also been modified. Trade credit was a form of financing the merchants' activity or meeting any other

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needs associated with the functioning of the so-called squires who were receiving ground rent on their land resources (Smith 1977). In this case, the certainty of payment for the ‘goods’ received was important as well. That is how A. Smith noticed that some landowners had to get into debt by pledging their property in order to settle their debt. The act of paying off the merchants and artisans enabled further use of the products that allowed one to lead a lavish life.

The increasing number of entities using trade credit resulted from the development of both the countries and the societies regulating the rules of trading and debt recovery. The role credibility, the collateral held, and the ability to pursue debts constituted the basis for the granting of both cash and commodity loans (Smith 1977).

The Industrial Revolution changed the way goods were manufactured. In the period preceding the Industrial Revolution, goods were produced for direct sale; thus, the role of inventories was limited. The emergence of mass production increased the role of inventories, while maintenance thereof at a higher level became an operational requirement. As a result of the process described, trade credit became a convenient form of finance and method for increasing inventory levels (Brasch 1972). After the Industrial Revolution, trade credit financing began to be widely used in business-to-business (B2B) relations.

When defining the essence of trade credit, attention should be given to the agreement that initiates the process associated with the purchase of a good or service. This agreement is concluded between the enterprise producing specific goods (the lender) and its customer, i.e. the enterprise using the goods purchased for its own production, resale, or for the performance of a service (the borrower), and thus stating the demand for these goods. Simultaneously, the seller agrees to defer the payment for the goods or services sold. The sale of a good, service or product takes place at a different time than the payment of the amount due for that good, service, or product. One of the parties (the borrower) is obliged to pay the agreed amount in the future, within a strictly defined date, while the other must have confidence that the payment will be made (Adams, Wyatt, and Kim 1992). Trade credit is thus a special type of short-term loan that binds both time and the traded goods’ value.

Throughout the duration of as well as while fulfilling a trade credit agreement, the exchange and the payment processes are split in time (Costa and Habib 2021). If the trade credit becomes marketable, it can be treated as a substitute for money (Ferris 1981). For many business entities, this is one of the main short-term sources of business activity finance, which, in many cases, replaces working capital loans (Atanasova 2007). Conversely, business entities that experience problems obtaining capital from credit institutions use trade credit as a ‘last resort’ source of finance (Fisman and Love 2003). The essence of trade credit is presented in Figure 1.1.

Trade credit can take two forms, depending on its source, i.e. supplier credit and credit from the recipient. In the first case, the seller delivers the goods or services and receives the payment with an agreed upon delay. The second case, however, involves prepayment, i.e. the buyer finances the seller.

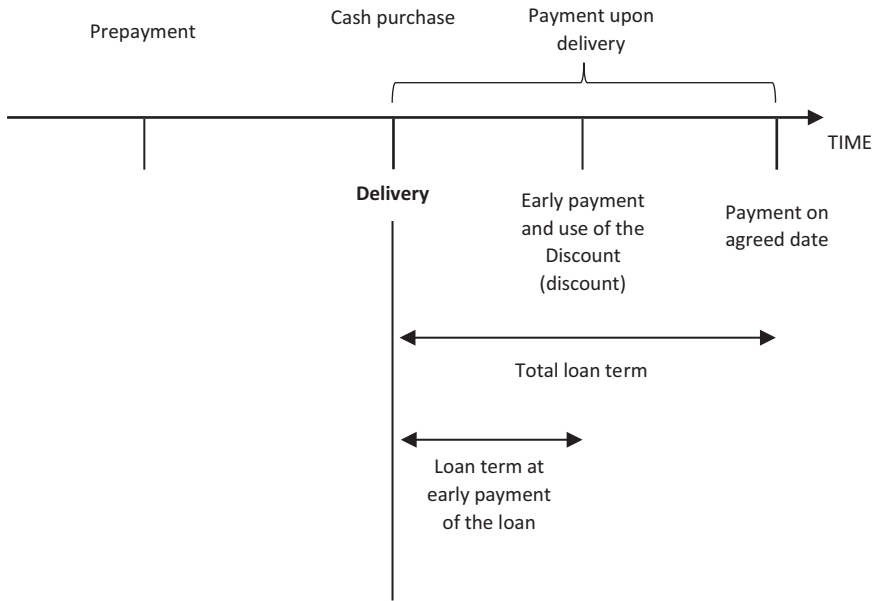


Figure 1.1 The essence of trade credit. Source: own elaboration based on: Ng and Smith (1999).

A classic trade credit agreement usually specifies the discount rate percentage, the discount's validity period, and the date for the payment of the full order value. For example, a manufacturer offers the customer a trade credit of EUR 10,000, under the '3/10, net 30' terms, which means that the ordering party can pay EUR 9700 (with a 3% discount) within 10 days or the full amount within 30 days.

The profit resulting from prompt payment of the receivables constitutes the discount. The cost of resigning from the cash discount and making the full payment within the deferred date can also be specified. This is called the trade credit cost and it allows comparison of the trade credit offer with the cost of a loan from a financial institution. The cost of resignation from the discount ( $Cr$ ) can be calculated using the following formula:

$$Cr = \frac{Cd}{1 - Cd} \cdot \frac{360 \text{ days}}{Cp - Dp} \quad (1.1)$$

where:

$Cd$  – cash discount;

$Cp$  – credit period;

$Dp$  – discount period.

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A seller who offers trade credit to his contractors should implement specific internal procedures to minimise the risk associated with granting trade credit and, in the event of late or payment, enforce any amounts due. This process should consist of at least five steps (Mian and Smith 1992):

1. assessment of the risk associated with granting trade credit to a potential customer;
2. decision to sell and grant credit, including establishment of the credit terms;
3. decision regarding the method of financing the receivables prior to maturity;
4. decision regarding the method of receivables collection;
5. in the event of the borrower's failure to pay the amounts due – a decision regarding the method of covering the loss.

Appropriate arrangement of the sales process, including assessment of the risk resulting from granting trade credit, begins another process, the next stage of which entails a decision (or lack thereof) to sell with deferred payment terms. One important element, before concluding the agreement, entails negotiating the credit terms, particularly the credit duration. Conclusion of an agreement specifying the terms constitutes the next steps. Following the sale, the crediting entity must manage its liquidity in such a way as to prevent the deferred payment sale from disrupting the company's financial situation. After the receivables are collected, this cycle can be repeated and, depending on the level of the trade credit risk and the buyer' (borrower's) needs, the terms of both the credit and the sale might be changed. This process is presented in Figure 1.2.

The process of receivables collection constitutes an important element associated with the administration of the trade credit granted. Depending on the subject, it takes a more or a less formalised form. Possible costs associated with the collection of the above-described receivables should also be taken into account during

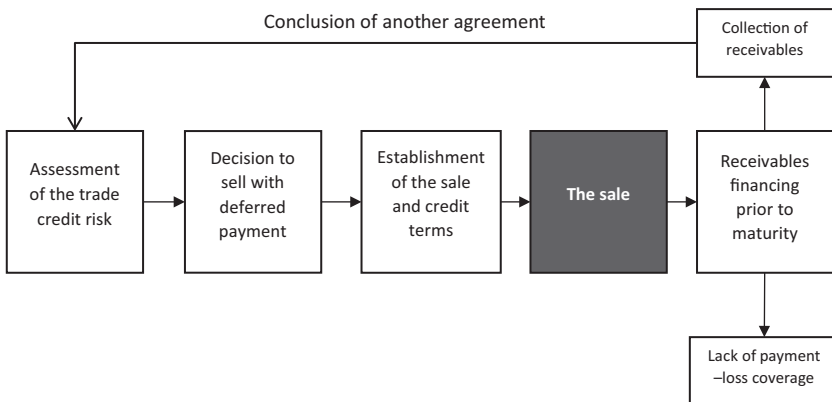


Figure 1.2 Trade credit administration cycle. Source: own elaboration.

this process. It might happen that, despite the fact that the risk assumed in relation to the granting of trade credit to a given contracting party is acceptable and thus payment for the goods is anticipated, this payment does not take place, which forces the creditor to cover the loss incurred.

Three different, but not mutually exclusive, currents justifying the use of trade credit can be found in the literature (Cheng and Pike 2003):

1. economic models;
2. marketing models;
3. tax-based models.

One of the theories based on the financial aspects of trade credit use was developed by Schwartz (1974). In his theory, he indicated that entities that can obtain capital at a relatively low cost offer trade credit to entities that otherwise would have to incur the higher costs of obtaining capital from financial institutions. This model assumes that stronger and financially more stable producers will offer credit to their smaller and financially less secure customers. Attention is drawn to the role of trade credit, which enables the flow of finance from financial institutions, through entities that do not experience problems with obtaining such financing, to entities with weaker possibilities of obtaining capital from financial institutions.

Marketing models show that trade credit is an operational tool which, when used by companies in situations of uncertain demand, can either allow selling price fluctuations, in order to enable the market to clear itself of ineffective entities as a result of these fluctuations, or alter production, as to match the demand. Selection of the first or the second option is costly for enterprises, which results either from the high price of information retrieval or from the high cost of manufacturing under production volume fluctuations. In order to reduce these costs, entities can increase inventories or lengthen the purchase queues by extending the delivery periods. Trade credit lowers the effective price paid by the borrowers, i.e. the price paid by the buyers at nominal value (Alchian 1969; Emery 1987). In such a case, the duration of the credit period constitutes an additional element affecting purchasing decisions. It is all the more significant since just a mere price reduction can cause imbalance on a given market and start a price war that could end up being harmful to all entities operating on that given market. That is why trade credit, as a less radical and more flexible instrument, constitutes an important sales-shaping tool (Fabbri and Klapper 2016).

Another model, pertaining to the tax burden, was developed by Brick and Fung (1984). In their model, the payer companies profit on high tax brackets by offering trade credit to business entities that have lower tax brackets. Buyers, therefore, only prefer trade credit when their tax bracket is lower than that of the sellers'. Otherwise, they can use the financial institutions' offer to benefit from the tax shield effect. Nevertheless, they prefer to cash purchase the goods at a lower price, using discounts. What is more, sellers with tax brackets below the average cannot offer trade credit within a given industry. The Brick and Fung model described

indicates that entities that consider the trade credit granting optimal will not find any tax advantage in it either.

Depending on the method of bookkeeping (cash accounting versus accrual accounting), trade credit exerts an economically justified impact on the level of taxation (Brick and Fung 1984). Enterprises seeking ways to minimise tax liabilities are willing to make deferred payment purchases in order to reduce the tax burden in a given period, without any cash outflow.

The literature presents a number of different motives behind granting and taking trade credit. These motives often overlap, increasing both the supply and the demand for this form of agreement. The theories describing the financial benefits associated with business activity financing via trade credit indicate the advantages resulting from the raising of capital through trade credit (financing advantage theories of trade credit) (Schwartz 1974). This theory highlights the trade credit's cost-related advantage over credit institutions, which the enterprises operating on a common market encounter. The financial motive pertains to the perception of trade credit as a form of financial service. Financing obtained in this way is of key importance for micro and small business entities as well as for those in an inferior financial situation. For these entities, the cost of short-term liability acquisition can be lower than the cost of external capital acquisition. If trade credit balances assume positive values, they can constitute the source of financing the borrowing entity's assets (Haley and Higgins 1973). Owing to the non-financial advantages, the lender (seller) is willing to forego the financial income associated with granting credit. Financial companies may be disinterested in crediting the buyer since goods are of less value to them than to the firms operating in the market. These enterprises have a competitive advantage over financial institutions, which pertains to three aspects (Petersen and Rajan 1997; Cheng and Pike 2003):

1. advantage in the retrieval of information about the borrower's financial situation (information asymmetry);
2. the advantage resulting from the limited supply of given goods in a given market (market power);
3. the advantage of asset recoverability and lower cost of capital.

The advantage of the retrieval of information regarding the borrower's financial situation results from the broader and quicker capabilities of determining the contractor's financial situation (Smith 1987). This aspect is subject to the impact of the structure of orders, which, when increasing, can indicate the borrower's increased turnover (Petersen and Rajan 1997). The buyer's inability to benefit from early payment discounts can be a symptom of its problems with financial liquidity and its poor access to financial markets. A prompt payment discount policy entails transaction costs that help identify the customers experiencing cash flow issues and signals the need for stronger monitoring and control (Cheng and Pike 2003). Financial institutions also collect information about the borrowers' financial condition, but it is the suppliers who may be able to obtain such

information faster and at a relatively lower cost, since this information is obtained in the course of normal business activity (Petersen and Rajan 1997).

Research so far indicates the existence of information content that results from the level of the trade credit granted, which is of value for financial institutions, as it allows supplementation of the information on enterprises. The actual availability of supplier trade credit can therefore facilitate institutional finance (Agostino and Trivieri 2014). Credibility, which in the eyes of the contracting party translates into the granting of trade credit to the counterparty, might improve their creditworthiness for banking institutions.

One additional value for the seller, resulting from frequent contact with the buyers, entails the development of bonds and positive relations that allow the formation of long-term business relationships. By examining the contracting parties financial situations, suppliers simultaneously develop relations with the buyers, which can translate into increased sales in the future.

The second form of information asymmetry results from the inadequacy of the information available on the product markets, where the seller (lender) has a fuller picture of the quality of the goods offered and shipped, compared to the customer (borrower). The credit period offers an opportunity to reduce this asymmetry. The buyer (borrower) can carry out quality control of the product purchased during the payment term. In a sense, trade credit signals product quality (Cheng and Pike 2003). In the time preceding the payment, the buyer, in the event of discovering product defects, can negotiate a price reduction or return the products without incurring the risk of losing money.

Information asymmetry can affect the choice of trade credit bidirectionally. In the first case, sellers who do not have proper market stature and reputation when selling their products can offer extended payments as an effective guarantee of the quality of the products sold (Ng and Smith 1999). This is particularly used by newly established enterprises or those offering products whose quality checks require a longer time (e.g. advanced technology) (Deloof and Jegers 1996). A given trade credit's terms allow the buyer to test the quality of the product received and express its opinion through its payment practices (Ng and Smith 1999). The seller (lender), by offering a long-term loan, can signal its stable market position, and thus provide potential customers with information that the product offered is of proper (often high) quality.

If a given buyer does not meet the payment deadline agreed upon, the seller (lender) can seize the goods previously delivered. The more durable the goods delivered, the more solid the assurance securement; hence, the credit granted may be greater. The financial institutions granting loans can also seize their debtors' assets, but in order to cash in the assets acquired as such, they must incur higher transaction costs than those the seller would bear as a lender. This results from the fact that suppliers already have sales networks for their goods; thus, the acquisition and resale costs are lower than those of a credit institution. In parallel, attention should be drawn to the existence of differences in the volume of the above-described suppliers' advantage over financial institutions. This advantage varies depending on the type of goods the supplier sells and on how much the



customer transforms these goods in the course of their own sale. The fewer goods end up being processed by the buyer, the greater the supplier's advantage over financial institutions in terms of the search for an alternative buyer (Petersen and Rajan 1997).

When the number of sellers in a given market is limited, the alternatives for the buyer are limited as well. The risk of future deliveries being cut off is therefore motivating, especially when the recipient is just one of the seller's many customers. For the borrower, however, the threat of future financing and delivery withdrawal can have an immediate impact on business activity (Petersen and Rajan 1997). In such a market, adherence to the agreed deadlines is crucial for the sellers' survival and, at the same time, constitutes an argument in negotiations.

Research also highlights the role of the buyer's share in a given seller's sales. The greater the supplier's share in the retailer's sales, the more likely it is to grant the retailer trade credit and finance its purchases more broadly (Chod, Lyandres, and Yang 2019). The competitive urge constitutes an important element affecting the decision to grant trade credit. This applies in particular to companies that still need to secure a good market position, as well as entities that sell in countries with under-developed banking systems. Entities that have gained a competitive advantage and occupy a monopolistic position on given markets, in contrast, sell fewer goods or services with deferred payment (van Horen 2005).

Summing up, trade credit is one of the earliest forms of enterprise finance via external capital. It evolved over centuries, contributing to the development of various enterprises. Nowadays, the significant role this form of finance plays by enabling the broader use of external capital and constituting the only source of such capital for many entities is also being observed. What is more, the sellers recognise the role of trade credit and its usability for market positioning, by increasing the sales and expanding the sales markets for the products offered. The manner in which an enterprise's receivables and payables are shaped, therefore, constitutes an element of enterprise management.

## **1.2 Receivables and payables management**

Enterprise management has been undergoing constant changes in recent years, which result from the progressive disappearance of the trade barriers existing between various economic entities. It manifests itself in the simplification and acceleration of the raw material and product exchange, which has been affected by the political changes and the development of transport systems. The disappearance of trade barriers, which is currently being observed, favours the conclusion of trade agreements, while the role of trade credit becomes an important issue. Another force impacting enterprise management is the dynamic development of ICT, which has accelerated the process of information exchange among market participants, decreasing, but not eliminating, the existing information asymmetry. These changes have contributed to the emergence of the need to systematise the methods of management, including receivables and payables management in enterprises.

Griffin (2015) described management as ‘a set of activities (including planning and decision-making, organising, leading, and controlling) directed at an organisation’s resources (human, financial, physical, and information), with the aim of achieving organisational goals in an efficient and effective manner’. In the definition cited, efficiency means utilisation without unnecessary waste, while effectiveness refers to operating successfully. Management, therefore, entails the process of setting the goals to be achieved, organising the resources needed to fulfil those objectives, and controlling the results obtained.

The above-cited definition of management indicates that the managerial personnel’s task is to effectively utilise a given organisation’s resources. Mahoney, Jerdee, and Carroll (1965) recognised management as a cyclical process consisting of the following stages: planning, organising, leading, and controlling. This process is illustrated in Figure 1.3.

The process of enterprise management deals with activities that are defined as planning, organising, leading, and controlling. A synergy of all these elements determines the effectiveness of the decision-making processes taking place as a part of the company’s business activity. Similarly, the process of receivables and payables management takes the form of a cycle, which should be adjusted in the event of deviations.

Planning is the process of setting the objectives and defining the tasks which must be undertaken to achieve them. It entails decision-making regarding the directions of the organisation’s activity, as well as strategy conceptualisation, including the definition of strategies for both raising the capital and granting trade credit to its customers. Strategies entail the prediction of the future arrangement of the conditions under which an organisation may find itself, as well as the selection of the measures to be undertaken to achieve its goals.

Organising is the process of tasks assignment, resource allocation, and coordination of individual persons’ and individual groups’ activities. It involves the

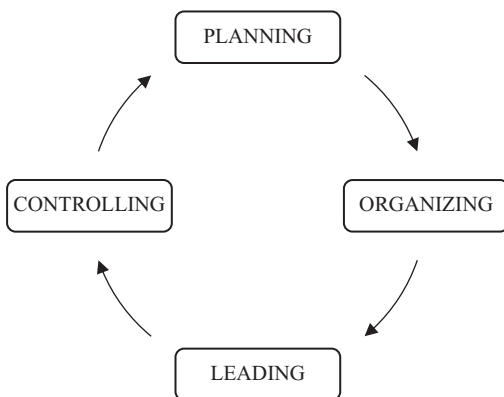


Figure 1.3 Stages of the management process. Source: Mahoney, Jerdee, and Carroll (1965).

performance of activities that are aimed at interlinking the various activities executed by the members of an organisation into more or less permanent sets of actions. This function is performed through the development of the organisational structures defining the team activities and describing the division of labour, both in terms of managerial and executive activity.

Leading is the process of increasing employees' engagement in the achievement of the objectives planned. It involves the induction of the subordinates' appropriate attitude towards the tasks entrusted to them.

Controlling entails the measurement of the effectiveness of the tasks undertaken. It involves a comparison of the proceedings or the results associated with the activities carried out with a given benchmark, i.e. a comparison of the state achieved with the objective planned.

Receivables and payables management constitutes an important element affecting trade credit management in an enterprise. A properly selected strategy constitutes the primary element that allows the development of an appropriate system of receivables and payables management. Three main credit strategies can be found in the literature (Neveu 1985):

1. conservative strategy;
2. aggressive strategy;
3. flexible strategy.

A company deciding on a conservative strategy reduces the credit terms and selects short periods of trade credit or adopts immediate payment for the goods sold. This way, it minimises the risk of losses resulting from non-payment.

An aggressive strategy aimed at sales volume maximisation is characterised by long-term payments for the products or services sold. Another important aggressive strategy element involves adequate and, at the same time, delicate debt collection (Patterson and Wejer-Kudelko 2018).

Enterprises implementing a flexible strategy manoeuvre the two previous strategies quite freely, depending on their internal and external situation. A flexible strategy allows an entity to react to the changing business conditions and adjust the policy of granting trade credit in such a way as to increase sales volume or attract new contractors during the periods of its ability to finance the contracting parties via trade credit, or as to allow the entity to make sales with shorter or immediate payment, in a situation of its deteriorating liquidity.

Irrespective of the lending policy selected, enterprises should introduce adequate management systems for the trade credits granted, which would enable appropriate formulation of credit policies, the monitoring of potential customers, and the conclusion of agreements. A proper trade credit management system should additionally allow the determination of acceptable risk levels, equipping the sales personnel with clearly defined rules regarding the conclusion of agreements with deferred payment terms.

An enterprise's system of trade credit management should consist of five stages, which begin with credit policy building, followed by the collection of

relevant information about its environment and the contracting parties. The next step should entail the development of rules and procedures for the conclusion of deferred payment contracts. The two subsequent stages involve the monitoring and collection of unpaid receivables. This cycle is presented in Figure 1.4.

The first step in the development of an efficient credit management system should involve the formulation and definition of the credit policy that the business entity intends to apply. This policy should attempt to determine the level of acceptable risk and the measures to prevent it (e.g. via the use of factoring or trade credit insurance). An entity's credit policy should fit into its general financial policy towards enterprises enjoying a strong and stable financial situation, and as such it can be more aggressive (Patterson and Wejer-Kudelfko 2018). Developing entities, which increase their level of sales, have also been observed to apply more aggressive trade credit granting policies by maximising the sales volume (Summers and Wilson 2003).

The next stage involves the collection of information which should be broken down into two basic categories, namely:

- information on the industry in which the entity operates; and
- information on the financial standing of the contractors.

First, it is necessary to establish the trade credit granting rules and terms adopted in the entity's competitive environment. If the principles adopted in the credit policy formulated differ from those adopted in the environment, a redefinition of the assumptions adopted should be considered. The potential customers should then be evaluated and categorised.

The third stage should serve to translate the credit policy into specific rules and procedures that the entity shall apply to the contractor groups. Properly designed procedures and adequately-developed databases containing information on the contractors' situation should support the personnel during the conclusion of agreements with the recipients and simultaneously minimise the risk of error or corruption. It is also important to adapt the procedures and rules to the changing business environment conditions in such a way as to enable the flexible conclusion of agreements, in line with the strategy adopted.

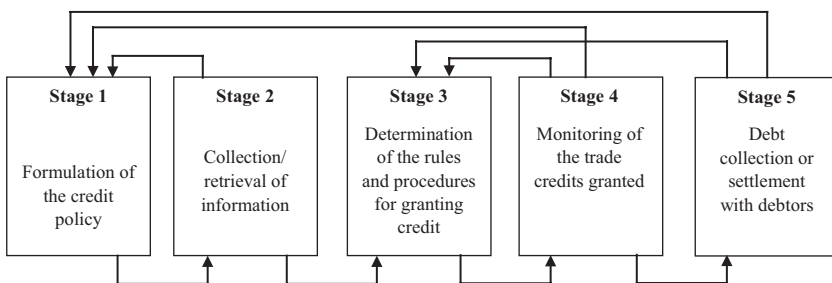


Figure 1.4 Trade credit management system in an enterprise. Source: own elaboration.

Each entity should build a debt monitoring and recovery system. As in the third stage, in this stage it is important to adequately adapt the procedures and rules to the changes taking place in the entity's both internal and the external environment so as to support the personnel in the process of debt monitoring and recovery. Clear and transparent rules should facilitate debt collection and recovery, and thus make it more effective.

An adequate trade credit policy should allow the design of transparent procedures for the use of adequate debt collection tools. These tools should be put to use in the fourth stage. Information about any existing non-repayment or payment delays should be entered into the customer database on an ongoing basis, as not to increase the amount of the credit granted to entities with reduced reliability. To minimise bad debt, an evaluation of the contractors and an assessment of their repayment ability should be carried out. Based on a given contractor's situation, the methods of debt recovery and agreement renegotiation (extension of term, interest) or settlement should be selected.

One important element interrelated with receivables management entails the development of the management system in such a way as to have it eliminate, with appropriate flexibility, the problems associated with the fraud or corruption resulting from, e.g. the business partners' unethical behaviour (Mroczek, Trąpczyński, and Więcek 2013). This is particularly important for the companies that are developing and expanding their sales markets. Enterprises that decide to exploit corrupt activities in a new market can incur higher costs of operation in the long run (Doh et al. 2011). The existing corruption pressure exerted by business partners can affect the agreements concluded, thus contribute to the crediting term extensions or even to the conclusion of agreements with entities that are in an unstable financial situation, which does not augur payment for the liability contracted.

According to the Global Economic Crime Survey 2020 (PwC 2020), 30% of enterprises worldwide encounter corruption and bribery, while 35% encounter abuse committed by customers. Considering the problems resulting from the fraud committed by customers, which arise from unfair trade practices and are attributable to, inter alia, the corruption of the employees responsible for the conclusion of sales agreements or deferred payment contracts, which the customers do not intend to fulfil in a timely manner, trade credit granting entities should develop appropriate internal-control tools aimed at minimising the chances of employee corruption. These procedures should incorporate separation of duties as well as double verification of contractors, which would support the employees in the decision-making and reduce the likelihood of corruption activity.

The corruption and fraud occurring during the conclusion of deferred payment contracts undoubtedly have a negative impact on entities' financial results, although the detrimental long-term impact of such activities should be indicated as well. The decrease in employees' motivation, which may translate into a decrease in the level of sales and, consequently, lead to a loss of market position, are particularly unfavourable.

The construction of trade credit granting procedures and rules should also incorporate appropriate tools for the verification of potential buyers. The conclusion of

an agreement should be proceeded by a collection of information. At this stage, employees should also be equipped with a set of procedures facilitating the collection and specifying the scope of the data that should be used before the conclusion of a deferred payment contract. This should minimise the conclusion of agreements with insolvent or dishonest contractors.

Just as in the case of receivables, payables management should take the business entity's strategy into account. The establishment of a link between receivables management and the entity's liabilities can support a wide variety of enterprise needs. When an entity's receivable cycle is shorter than the payables cycle, credit may be used, which can finance various needs. The payables management strategy should support the entity's purchasing decisions but also interact with its capital building strategy more broadly.

The key aspect in payables management is to maintain financial liquidity without incurring any outlays for the acquisition of the means of payment for timely repayment of liabilities. Both receivables and payables management should be carried out jointly in such a way as to have the receivables fund the payable outflows. In order to minimise the interest costs that are used to finance activity and repay liabilities, entities should strive to minimise cash gaps. To avoid cash gaps, an entity can, on the one hand, shorten the receivables collection cycle and, on the other hand, extend the terms of liability payment.

Moreover, in a sale or a purchase involving a currency other than the entity's currency, currency risk should be considered in the process of receivables and payables management. The fluctuating exchange rates, as well as the cost of foreign currency transactions, can affect the actual value of a given transaction. Entities should pay attention to the existing risks associated with the fluctuating exchange rates and modify their contracts in order to minimise the possible losses resulting from exchange rate differences.

Summing up, receivables and payables management in an enterprise constitute an important element impacting its situation. When structuring their receivables and payables, enterprises shape it in such a way as to maximise the sales levels on one side and minimise the costs of raising capital on the other. The best way to measure the adopted credit policy's effectiveness is to achieve a high level of timely repayment of receivables (Hoggett et al. 2016). Minimisation of the risk resulting from an entity's structure should be counteracted through appropriate procedures for the assessment of contractor reliability. At the same time, for an entity to be able to extend the terms of liability repayment and thus finance its activity via trade credit, it should increase its credibility. The primary element associated with the increase of this credibility is the timely payment of liabilities.

### **1.3 The role of trade credit in the economy**

The history and the role of trade credit are associated with the development of industry and trade (Brasch 1972). The magnitude and the significance of this form of sale result from the development of markets where goods are exchanged. As mentioned in previous sections, deferred payment sales, as well as the so-called

trade credit purchases, are both subject to impact by a number of factors. These factors can be internal, i.e. the receivables and payables management strategy and policy or the sales strategy, as well as external, i.e. those resulting from the availability of other competitive forms of finance.

The use of trade credit in business entities depends on various factors, such as the country of operation, the industry, or the enterprise size. As indicated in Section 1.2, enterprises determine and manage the levels of receivables and payables autonomously. The scale of trade credit use also depends on the business cycle and affects enterprise behaviour, including the extent of trade credit granting and trade credit purchases.

The role of trade credit in the functioning of enterprises is related to the share of this form of financing in the companies' assets. The share of trade credit in the total assets of the enterprises operating in the European Union countries is varied. The largest share was that of Romania (the median for the period from the second quarter of 2018 to the third quarter of 2020 was 13.2%) and Bulgaria (the median for ten quarters was 11.76%), as well as Lithuania (the median was 9.80%). Conversely, the countries with the lowest share of trade credit were Luxembourg (the median of 0.12%), Great Britain (0.50%), and Greece (0.74). Simultaneously, a lower level of credit financing was observed in the countries of the so-called 'old' EU, compared to the level observed in the countries which joined the European Union at a later time. This may indicate lower availability of financing sources for developing enterprises in these countries. Detailed data in this regard is presented in Table 1.1.

The differences in the trade credit's share in the total assets indicate various entity-affecting factors existing within the sphere of financing. Both the internal and the external factors shaping the share of this form of finance are discussed in the further part of the work.

One of the factors affecting the volume of trade credit supply and demand is the occurrence of turbulence in the financial markets. The collapse of institutional finance is forcing companies to seek alternative forms of finance. As Petersen and Rajan (1997) indicate, trade credit can fill in enterprises' capital gaps and become a relatively important source of finance. Entities with access to finance sources redistribute these resources to disadvantaged companies through trade credit (Petersen and Rajan 1997; Fisman and Love 2003). Capital redistribution is possible when stronger entities have access to funds. During a deep crisis, for instance, advantaged enterprises can also experience a deficiency or lack of finance sources, which may result in these entities' inability to transfer this capital to other companies (Love, Preve, and Sarria-Allende 2007). According to Love, Preve, and Sarria-Allende (2007), an increase in the level of trade credit at the peak of a financial crisis results from an increase in bad debts. The level of trade credit then gets reduced through write-downs. This situation may persist even for several years after the financial crisis.

Enterprises experiencing a difficult financial situation can replace institutional sources of finance with trade credit (Atanasova 2007). The dependence associated with an entity's situation and its replacement of financial debt with trade

Table 1.1 The share of trade credit in total assets of enterprises by European Union country distribution (in %)

GEO/TIME	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3
Belgium	3.39	3.25	3.63	3.41	3.64	3.33	3.51	3.54	3.21	3.36
Bulgaria	11.76	11.59	11.54	11.67	11.76	12.12	12.04	12.07	11.92	11.63
Czech Republic	7.41	7.32	7.32	7.22	7.24	7.20	7.23	7.07	7.06	7.11
Denmark	1.40	1.39	1.48	1.44	1.36	1.33	1.34	1.39	1.36	1.27
Germany	3.41	3.41	3.36	3.34	3.21	3.20	3.16	3.10	2.81	2.86
Estonia	8.02	8.06	7.83	7.87	7.55	7.42	7.80	8.00	7.29	7.09
Ireland	3.80	3.90	4.12	3.67	3.65	3.63	3.57	3.55	3.15	3.14
Greece	0.70	0.69	0.73	0.72	0.77	0.75	0.76	0.79	0.76	0.74
Spain	3.90	3.93	4.01	3.92	3.91	3.85	3.84	3.70	3.26	3.40
France	2.90	2.88	3.02	2.88	2.84	2.82	2.88	2.92	2.76	2.75
Croatia	5.83	5.70	5.67	5.70	5.63	5.54	5.61	5.71	5.58	5.70
Italy	5.03	4.93	4.84	4.74	4.68	4.61	4.66	4.69	4.44	4.52
Cyprus	4.06	4.02	4.06	4.05	4.04	4.05	4.02	4.12	4.04	4.02
Latvia	6.39	6.11	6.59	6.78	6.73	6.33	6.43	6.75	6.21	5.88
Lithuania	10.76	10.50	9.82	10.24	9.98	9.77	8.88	9.51	8.70	8.45
Luxembourg	0.11	0.12	0.12	0.12	0.12	0.12	0.12	0.12	0.12	0.12
Hungary	6.29	6.29	6.81	6.80	6.76	6.58	6.23	6.16	5.36	5.28
Malta	7.05	7.00	6.98	6.86	6.74	6.68	6.66	6.62	6.50	6.53
Netherlands	0.95	0.96	1.02	1.00	0.98	0.92	0.96	0.93	0.84	0.86
Austria	1.77	1.80	1.93	1.98	1.97	1.96	1.98	1.98	1.84	1.82
Poland	5.99	6.26	5.99	6.17	5.98	6.09	5.94	6.05	5.10	5.44
Portugal	4.09	4.07	4.08	4.02	3.94	3.92	3.90	3.89	3.65	3.65
Romania	13.09	12.80	15.80	15.68	15.83	15.32	13.16	12.73	12.41	12.52
Slovenia	7.89	7.96	7.66	7.90	7.71	7.53	7.18	7.18	6.48	6.60
Slovakia	6.84	6.72	6.67	7.00	6.68	6.57	6.56	6.41	5.76	6.23
Finland	2.56	2.54	2.55	2.39	2.42	2.39	2.52	2.44	2.35	2.33
Sweden	1.75	1.71	1.89	1.79	1.78	1.71	1.69	1.70	1.59	1.52
United Kingdom	0.50	0.51	0.51	0.52	0.50	0.48	0.50	0.46	0.45	No data

Source: own compilation based on Eurostat 2021.



credit constitutes an important factor affecting levels of this form of finance. Nonetheless, an increased share of trade credit in the entities with difficult financial standing can contribute to declines in their financial results (Molina and Preve 2012). Entities use trade credit only when other sources of financing are unavailable to them (Molina and Preve 2012).

The existing variety of factors affecting the trade credit supply, in particular the uncertainty resulting from the risk of crises or even the risk of deterioration in the contractor's financial situation, is of particular importance when it comes to the global economy, as contract-concluding entities operate on often radically different financial markets, encountering legal or cultural differences.

Deferred payment sales carry a risk for the seller, which is associated with non-payment on the date agreed upon. It is thus particularly important to minimise the sales risk inherent in international contracts. Designation of a counterparty that will pre-finance the transaction is of key importance here. The conditions in the country of the goods' origin, as well as those in the country of destination, both affect the form of the contracts concluded (Hoefele, Schmidt-Eisenlohr, and Yu 2016). The payment agreements concluded between international trade partners should therefore be arranged in such a manner, as to compensate for the differences in financial costs and, at the same time, enable enforcement of various national legal standards (Hoefele, Schmidt-Eisenlohr, and Yu 2016).

Entities make the granting of a loan depending on the level of risk (Hodgman 1960). In order to reduce the risk, they strive to minimise it through a variety of tools, which include the following:

1. credit limits;
2. credit scoring;
3. reverse credit;
4. structured trade credit;
5. transaction insurance;
6. factoring;
7. prepayment.

The establishment of a limit on the credit granted to customers is one of the primary instruments used in trade credit management. It is particularly important to set such limits for the customers with whom the entity concludes first-time agreements (Patterson and Wejer-Kudelko 2015). The establishment of a credit limit should entail the identification of so-called high-risk customers, which involves consideration of the customer's payment history and analysis of its financial situation. Deteriorating financial results, delays in repayment, or any information on the creditors' claims should reduce the limits. With regard to the method of entity evaluation, the most commonly-used mechanism of credit limit determination involves an assessment carried out by an analyst who supports the persons responsible for the sales affiliated with a given contractor (Scherr 1996).

Credit scoring (also used to assess natural persons' creditworthiness) is meant to determine whether a given company can pay off its obligations. Banks and

FinTech companies in particular try to introduce risk measurement methods, to minimise the costs of the loans granted (Butor-Keler 2020). Initially, credit scoring was associated with the banking industry and was used in loan application acceptance (Nosslinger, Guther, and Thonabauer 2004). As a result of technological development, credit scores became advanced predictive models. Nowadays, various scoring institutions use neural networks, decision trees, and random decision forests. The continuous development of the above-mentioned methods, in search of the best scoring assessment tools, should be noted here (Przanowski 2015).

Entities take the following factors into account when making scoring assessments:

1. payment history;
2. duration of the company's debt;
3. debt structure;
4. industry risk;
5. enterprise size.

From the perspective of the enterprises willing to grant trade credit, the main advantage of credit scoring entails its point-related nature falling within specific ranges, e.g. from 0 to 100, which expedites and facilitates the decision-making, especially in international trade. It does not, however, exclude the risk associated, in the event of non-payment.

Reverse credit and structured trade credit are other tools that can secure the seller's liquidity and improve its financial flows, and consequently reduce the risk associated with deferred payment sales. These instruments are an alternative to traditional credit and are mainly used in cross-border trade of goods involving high-value contracts. These methods have a major advantage – the transfer of cash from a financial institution prior to the shipping of goods; the financial institution receives payment for the loan as soon as the counterparty makes payment.

Another tool to minimise the risk associated with trade credit is credit insurance. As per Jones's definition,

trade credit insurance (also known as credit insurance, business credit insurance or export credit insurance) is an insurance policy and risk management product that covers the payment risk resulting from the delivery of goods or services. Trade credit insurance usually covers a portfolio of buyers and pays an agreed percentage of an invoice or receivable that remains unpaid as a result of protracted default, insolvency or bankruptcy. Trade credit insurance is purchased by business entities to insure their accounts receivable from loss due to the non-payment of valid debt by debtors. It can also be expanded to cover losses resulting from political risks such as currency inconvertibility, war and civil disturbance, confiscation, expropriation and nationalisation.

(Jones 2010)

The functioning of trade credit insurance is presented in Figure 1.5.

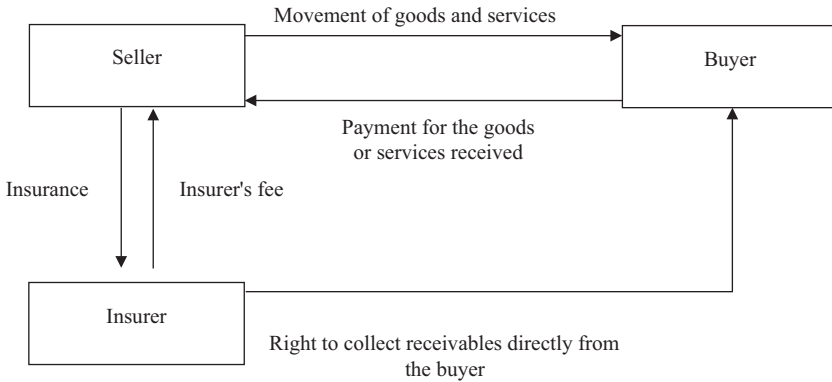


Figure 1.5 The functioning of trade credit insurance. Source: Jones (2010).

The history of trade credit insurance policies begins with the British Commercial Insurance Company. During the Interwar Years, Western Europe developed and adopted the insurance makeup that is still currently used, in which the insurers are entities acting on behalf of the state (Funatsu 1986) (entities whose main task is to support and secure exports) or commercial entities (Jones 2010).

Insurance companies across the world provide protection in the event of non-payment or significant payment delays. Numerous insurance entities offer products covering the political risk associated with export as well as the emergent trade blockages resulting from legislative changes in the counterparty's country. Depending on the contract concluded (insurance policy), the insurer can:

1. pay compensation on any unrealised payment;
2. pay compensation to the largest recipients whom the insured treats as key contractors;
3. pay compensation to the contractors (groups) specified by the insured party, when:
  - a. an objective selection criterion occurs;
  - b. it is indicated by the insured.
4. cover individual transactions with insurance;
5. pay compensation in the event of exceedance of the damages limit specified in the contract for:
  - a. one contractor, or
  - b. an entire group of recipients.

As a rule, insurers cover the existing short-term commercial and political risk for up to one year, though usually from 90 to 180 days. State-supported insurance policies offer a longer term of up to five years, but they constitute a small part of the trade credit insurance market (Jones 2010).

When concluding an insurance contract, the insurer sets the credit limits and the conditions for concluding the agreement, e.g. the maximum payment period. The insurance entity can reduce or even cancel the insurance limits in the event of a deterioration in the buyer's financial situation, or in the event of a political or legal change; the changes made apply to future operations and do not pertain to previously covered transactions (Jones 2010).

In order to motivate entities to implement careful sales management and appropriate selection of contractors, policies, as a rule, do not provide full coverage of the risk incurred; most contracts cover 85% to 90% of losses (Jones 2010). The premiums, on the other hand, are calculated based on the loss ratio and the annual turnover of the entity wanting to ensure its sales and, in the case of a new policy – based on the turnover forecast (Jones 2010).

Factoring is another tool reducing the risk caused by extended payment terms. The seller forwards the sales documents (often only selected ones) to the factor, who then pays the funds to the seller's account. The contractor, however, is obliged to pay the amount for the product or service to the factor's account.

The use of the tools described is varied in the European Union countries. In the years 2016–2019, enterprises used prepayments for products or services, although, in the period addressed, these prepayments decreased by 11 percentage points (pp). Almost one-third of entities did not use any payment security tools. Detailed data on this aspect is presented in Figure 1.6.

The above-mentioned tools for reducing the risk associated with granting trade credit constitute elements improving the seller's situation. Due to the FinTech industry development, simultaneous development of tools supporting deferred payment sales and reducing payment backlogs should be expected.

The development of the tools limiting the risk associated with deferred payment sales should contribute to the broader use of trade credit, especially in sales transactions in emerging markets. Simultaneously, the growing ease of access to seller-supporting tools contributes to the commercial exchange between ever-smaller economic entities. The development of financial and insurance services, as well as the emergence of entity-supporting IT tools, will continue to contribute to the development of trade and the elimination of dishonest contractors.

#### **1.4 Trade credit functions**

Acquisition of financing sources is one of the management's primary tasks. Limited access to external sources of financing can contribute to the weakening of the competitive position, which can translate into an interruption or even discontinuation of a business entity's development and expansion (Nowak 2014).

The role of trade credit and the related process of designing the best possible trade credit policy depend on whether the entity is the seller (lender) or the buyer (lender) (Zhou and Zhou 2013). Trade credit should be considered with regard to two basic aspects:

- 1) raising capital for the borrower;
- 2) impact on the lender's sales volume.

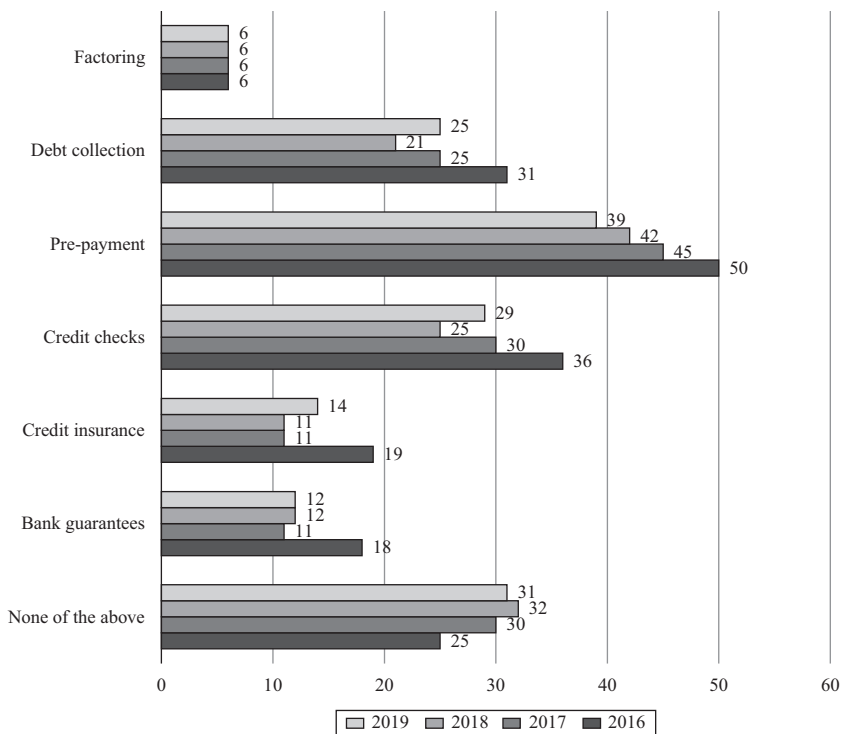


Figure 1.6 Delayed payment minimising tools used by enterprises operating in European Union countries (% of enterprises). Source: Intrum AB (2019).

Enterprises can pursue other goals in reliance on trade credit, such as:

- 1) tax optimisation (Brick and Fung 1984);
- 2) facilitation of institutional financing (Agostino and Trivieri 2014; Ferris 1981);
- 3) identification of risky customers (Smith 1987);
- 4) cost reduction (Emery 1987);
- 5) reduction of product quality risk (Cheng and Pike 2003; Deloof and Jegers 1996);
- 6) influencing the demand for the products offered (Blazenko and Vandezande 2003);
- 7) development of relations with the environment, in particular, provision of information on the financial condition and its perspective (Summers and Wilson 2003; Ng and Smith 1999).

Acquisition of external financing is dependent on the business entity’s size and its life expectancy. Entities run by natural persons (entrepreneurs) are in a particularly difficult situation. In this group, acquisition of external capital is possible

through a bank loan or a trade credit only (Huyghebaert, Van De Gucht, and Van Hulle 2007). If enterprises have limited access to the financial market, trade credit is the only source of access (Fisman and Love 2003), replacing working capital loans (Atanasova 2007). One additional factor affecting the acquisition of financing via trade credit entails entity localisation, either within an urbanised area or outside it (Yazdinejad and Jokar 2019).

During periods of increased sales, entities will strive to increase the cost of purchasing goods, so as to minimise the public-law liabilities. It is particularly visible in the entities applying the accrual principle, where cost recognition is not the same as the outflow of cash. Trade credit constitutes a form of tax optimisation in these entities. Extension of the liability payment term, with a simultaneous quick collection of the receivables, enables allocation of financing for investments improving various aspects of entities' functioning.

Having information on the borrower's situation, the lender can determine the risk of the borrower's insolvency (loan default) (Ng and Smith 1999). Financial entities may base their financing granting decisions by making use of the seller's information, which can help mitigate credit rationing (Biais and Gollier 1997). Trade credit can, therefore, constitute a positive signal for banks, confirming, in a way, the financial situation of the entity applying for financing (Agostino and Trivieri 2014). This role of trade credit is extremely important from the borrower's perspective, as it increases its chances of obtaining additional finance. This is particularly important in the case of micro and small enterprises, which have fewer opportunities for raising capital. Financial entities, in turn, have problems with the acquisition of reliable financial information regarding a given entity's solvency; trade credit helps reduce this information gap.

When an entity is facing problems with the demand for the goods produced and sold, it may use trade credit to equalise the cash flows in order to reduce the costs incurred, such as the cost of warehousing or the cost of adjustment to production volume changes in the assortment manufactured (Emery 1987). What is more, an entity increasing the level of trade credit can stimulate the demand for the products offered, thus increase its revenues (Blazenko and Vandezande 2003).

Trade loans can also constitute a form a long-term customer retention strategy. It is particularly important at times of economic fluctuations, which affect the levels of sales (Jacob 1994). Trade credit helps to maintain good relations with the recipients, and thus encourages them to stay. It also facilitates the entity's survival during turbulent periods of economic downturn. Empirical research confirms the impact of these relationships, especially when it comes to granting credit to producers, whose acquisition generates higher costs for the seller (Summers and Wilson 2003). As Jacob (1994) indicates, enterprises that are building relationships with buyers and are willing to adjust their terms of sale to the buyers' capabilities, including those within the sphere of trade credit, benefit economically. As Summers and Wilson (2003) indicate, enterprises reward their contractors' loyalty by extending the trade credit and lowering its cost.

Trade credit can also constitute a form of securing the receivables (Cheng and Pike 2003). With regard to debt security, the features characterising the goods

offered play an important role, e.g. in a situation when the buyer is not able to resell, the seller can then claim a return of the goods and resell them to another reliable customer (Summers and Wilson 2003).

Business entities seeking additional capital to support their development opt for trade credit to achieve this goal. As presented in the previous sections, business financing via trade credit depends on many factors; nevertheless, its pro-development function, concerning the borrowers, can be indicated. Entrepreneurs' behaviour during a possible crisis must be given attention. For the purpose of enterprise behaviour analysis, Polish enterprises operating during the period of various problems emergent due to the COVID-19 pandemic will be described. Like most countries, Poland also introduced a lockdown on 16 April 2020, which slowed down the production by nearly 25%, compared to April 2019. During that time, numerous enterprises from many industries had to adapt to the conditions resulting from supply chain interruptions and the drastic drops in sales.

Polish enterprises showed an increase in the volume of short-term receivables, which was then suppressed during the first COVID-19 lockdown. As a result of the general uncertainty, entities decreased the level of receivables. Simultaneously, the level of receivables from suppliers decreased, while short-term loans increased. During the crisis caused by the COVID-19 pandemic, enterprises sought financing from financial institutions mainly. The aid granted to enterprises, in the form of an abandoned collection of social security contributions and extensive subsidies aimed at maintaining jobs, is not without significance. These trends are presented in Figure 1.7.

Receivables management under uncertainty forces entities to undertake actions aimed at minimisation of various risks, e.g.

- a) risk of bankruptcy;
- b) risk of loss of contractors;
- c) risk of loss of credibility.

The key is to reduce the level of liabilities by repayment and non-incurrence of new ones. Entities that experienced declining liquidity due to the problems resulting from the changes in the environment (such as during the lockdown introduced in the first quarter of 2020) used short-term credit financing. In the case of the entities described, the role of trade capital clearly comes down to increasing external capital, but only under favourable conditions in the enterprise's environment.

The role of trade credit primarily depends on whether a given entity acts as the borrower or the lender. One particular role of trade credit entails its use as a tool for raising capital and mitigating the information asymmetry in the financial market. Lenders, in turn, use trade credit to increase the demand for the products offered. Trade credit's role in the development of long-term relations with contractors, which allow mitigation of unfavourable market trends, is not without significance either. This is of particular importance during crises or during an economic slowdown, as in the case of the COVID-19 pandemic.

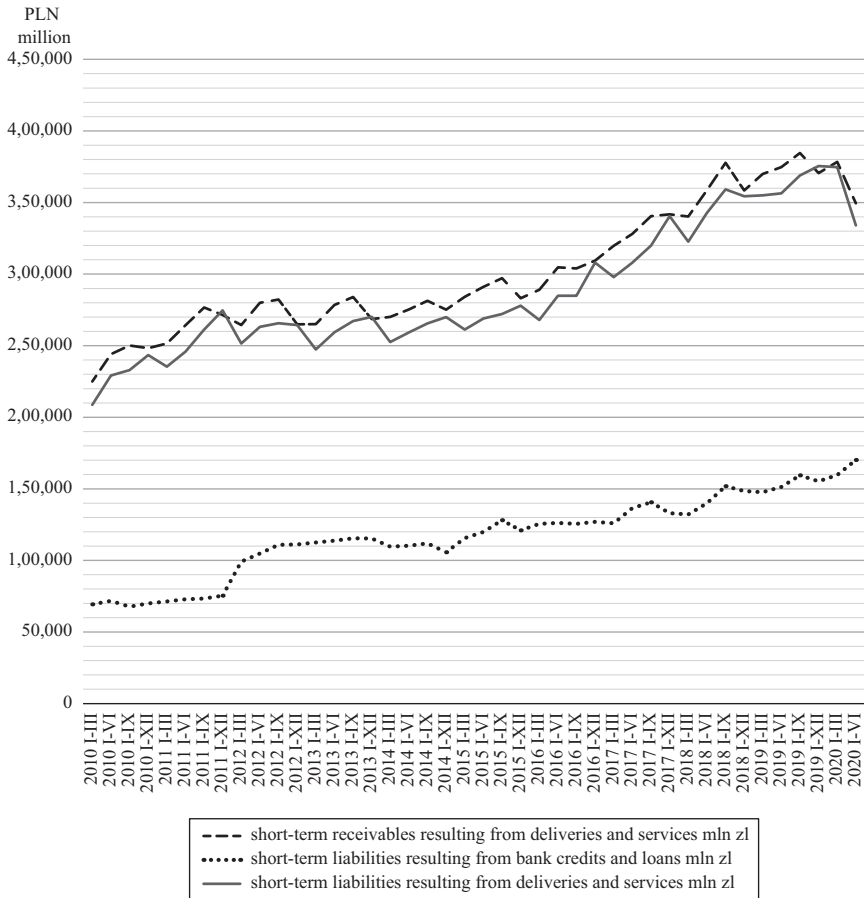


Figure 1.7 Short-term trade and other receivables, short-term trade and other liabilities, and short-term credit and loan liabilities in Polish enterprises employing 50 and over persons, in quarterly distribution during the years 2010–2020 (in PLN million). Source: own compilation based on GUS (2019).

## 1.5 Legal conditions of trade credit

Trade credit, as presented in the previous sections, plays various roles in the functioning of economic entities. Nevertheless, the contracts concluded by economic entities are not always respected by all the parties. This contributes to a number of irregularities in the business entities' functioning, including the formation of the so-called payment backlogs in particular. The occurring delays affect enterprises' financial liquidity and, consequently, can cause their bankruptcy or even generate problems for entire industries. These backlogs' impact on competitiveness and profitability is not without significance either, as it forces companies to use external financing (UE 2011).



The key elements affecting the enforcement of undisputed claims are the duration (quickness) and the costs of court proceedings. The provisions of the European Union law, therefore, include various acts aimed at facilitation of receivables recovery (UE 2011), such as:

- Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgements in civil and commercial matters;
- Regulation (EC) No 805/2004 of the European Parliament and of the Council of 21 April 2004 creating a European Enforcement Order for uncontested claims;
- Regulation (EC) No 1896/2006 of the European Parliament and of the Council of 12 December 2006 creating a European order for payment procedure;
- Regulation (EC) No 861/2007 of the European Parliament and of the Council of 11 July 2007 establishing a European Small Claims Procedure.

According to Directive 2011/7/EU of the European Parliament and the Council, in business-to-business commercial transactions, for which the payment date or period is not specified in the contract, invoices must be paid within any of the following deadlines:

- 30 calendar days from the debtor's receipt of an invoice or an equivalent payment request;
- 30 calendar days from the date of receipt of the goods or services, when the date of an invoice or equivalent payment request receipt is uncertain or when the debtor receives an invoice or an equivalent payment request prior to the delivery of the goods or services;
- 30 calendar days from the date of the debtor's receipt of an invoice or an equivalent payment request, if the invoice date falls before the date of intended goods or services acceptance or the date of the verification of the goods or services' conformity with the contract; the acceptance or the verification procedure may not exceed 30 calendar days from the date of the goods or services receipt, unless the contract expressly states otherwise and provided that it is not grossly unfair to the creditor.

The Directive also introduces a contractually set framework payment period, which cannot exceed 60 calendar days, unless the contract expressly states otherwise and provided that it is not grossly unfair to the creditor.

Article 6 of Directive 2011/7/EU additionally introduces the following tools supporting receivables recovery:

- the creditor's entitlement to obtain, from the debtor, a fixed amount of no less than EUR 40, when the interest for late payment becomes payable under commercial transactions;
- the compensation amount paid without the need for a reminder, as compensation for the recovery costs incurred by the creditor; and

- the creditor's entitlement to obtain reasonable compensation, from the debtor, for any receivables-recovery costs exceeding the fixed amount (EUR 40) and incurred due to the debtor's late payment, including, inter alia, the costs incurred in connection with the need to lawyer up or hire a debt collection agency.

The above-mentioned standards are supplemented by national acts, which clarify the national regulations and adapt them to the specificity of a given domestic market. These rules, aimed at preventing payment backlogs and excessively extended payment terms, are of particular importance in asymmetric transactions, where the creditor is an SME, and the debtor is a large enterprise. Moreover, the tax standards pertaining to both the tax on goods and services and the income taxes introduce a number of regulations that are aimed at the development of a legal and organisational framework designed to eliminate the tax advantages resulting from excessively long contractual payment terms.

The following presents the national standards adopted by the EU countries included in the study. This is meant to specify the framework standards of the European Union regulations, as well as the standards functioning in Turkey.

Belgium has adopted standards intended to shorten the payment terms of transactions involving an SME-sector enterprise as the creditor. Since 29 April 2020, companies in Belgium cannot contractually set payment terms exceeding 60 days if the creditor is an SME and the debtor is not an SME entity. The Act entered into force on 1 December 2020, and applies to new or existing contracts concluded, renewed or amended after that date (PwC Legal).

A re-examination of the general terms and conditions of trade and the B2B contract templates from this new angle will definitely be necessary in order to avoid the clauses being questioned and declared as invalid in court.

Following the revision of the Belgian standards on the prevention of late payment in commercial transactions, adopted on 2 August 2002, non-SME companies can no longer contractually impose payment periods exceeding 60 days on commercial transactions with SMEs.

These standards define an SME as an enterprise that, at the time of entering into a commercial transaction, did not exceed one of the following criteria (Advocaten, n.d.):

- an average of 50 employees annually;
- an annual turnover of EUR 9,000,000, excluding value-added tax;
- a balance sheet total of EUR 4,500,000.

In case of an absence of a payment deadline, the Act still provides for a 30-day payment period, counted from the day of (Advocaten, n.d.)

1. the receipt of a request for payment or a sales invoice;
2. the receipt of the goods or services, if no request for payment or sales invoice was issued;
3. taking possession of the goods or services in the event of an absence of such receipt.

Although Directive 2011/7/EU provides that the payment period specified in a contract cannot exceed 60 calendar days, Belgian law provides that the parties may agree on a longer payment term, as long as it is not grossly unfair to the creditor.

The German legislator adopted the Law on Combating Late Payments in Commercial Transactions (*Gesetz zur Bekämpfung von Zahlungsverzug im Geschäftsverkehr*) on 29 July 2014. The standards contained in this Act restrict the contractual freedom of agreeing on the payment period for a commercial obligation and adapt payment terms to the framework of Directive 2011/7/EU, i.e.

- payment terms of up to 60 days;
- the periods of inspection and receipt of goods or services may not exceed 30 days;
- longer terms are only considered binding for the parties to the contract if they are expressly agreed on and when they are not grossly unfair to the contracting party (Tjarks, n.d.).

Additionally, during the time of the COVID-19 pandemic, German regulations allowed small enterprises, i.e. those employing fewer than ten employees and recording annual turnovers of EUR 2 million, to temporarily suspend the performance of certain continuous contractual obligations until 30 June 2020. These companies, however, were allowed to realise monthly payments if

- the contract was concluded before 8 March 2020; and
- fulfilment of the obligation in the context of the COVID-19 pandemic would jeopardise the SME's economic basis or existence.

This means that if the conditions were met, the debtor could not delay payment until the 30 June 2020.

In Spain, the payment date in commercial operations is regulated by Act 15/2010 of 5 July amending Act 3/2004 of 29 December which was amended on 4 December 2014. Payment periods may be set for 60 days at maximum, while invoice grouping is allowed conditionally when the maximum payment term is respected.

Interest on late payment for goods and services is calculated automatically, without the need for the creditor to issue a payment date notification. Spanish law establishes a statutory rate of late payment interest, consisting of the rate applied by the European Central Bank plus 8%. The parties may agree to a lower rate, but it cannot be excessively low, i.e. not less than 70% of the statutory rate for late payment. In addition to the late payment interest, an automatic late payment compensation, in the amount of EUR 40, was simultaneously introduced.

With regard to transactions involving fresh, perishable products, the maximum payment term has been set at 30 days. This applies to products whose natural properties are preserved for a period of fewer than 30 days or which require controlled temperature conditions for sale and transport.

In addition to the nullity of a given clause, any breach of the maximum payment terms may be subject to penalties imposed by the Spanish Food Agency (AICA)(Le Quid).

In France, the payment period for commercial transactions is set at 30 days. By way of derogation, the parties may agree on a maximum period of 45 days from the last day of the invoice month, provided that this period is clearly defined in the contract and does not constitute any obvious abuse (Code de Commerce).

The French Code has also introduced specific payment terms to be respected in the following situations:

1. 30 days after the completion of delivery, for purchases of perishable food products and frozen or quick-frozen meats, frozen fish, ready-made meals, and canned food made from perishable products, excluding the purchases of seasonal products made under integration agreements concluded within the fruit and vegetable sector;
2. 20 days from the date of delivery, for purchases of live cattle for human consumption and fresh meat obtained from cattle;
3. 30 days after the end of the delivery month, for purchases of alcoholic beverages covered by the consumption rights provided for in Article 403 of the French Tax Ordinance;
4. 45 days from the end of the invoice month or 60 days from the invoice date, for purchases of grapes and must for production of wines and alcoholic beverages, which are subject to the trading rights provided for in Article 438 of the Tax Ordinance, excluding the following:
  - a) the interbranch decisions taken pursuant to the Act of 12 April 1941 on the Establishment of the Interbranch Committee for Champagne Wine; or
  - b) the interbranch agreements concluded under Book VI of the Agricultural and Sea Fisheries Code and under the mandatory provisions for all economic entities throughout the metropolitan area.
5. 30 days from the invoice date, for carriage of goods by road, rental of vehicles (with or without a driver), transport orders, freight forwarding and cargo transportation;
6. for sales carried out in the agricultural-equipment sector between manufacturers, producers and importers of agricultural equipment and specialised distribution and repair companies:
  - a) 55 days from the end of the invoice month, for greenery maintenance equipment;
  - b) 110 days from the end of the invoice month, for agricultural equipment, excluding tractors, transport and livestock equipment.
7. 90 days from the invoice date, for the sales of winter sports equipment, concluded between suppliers and companies whose activity is exclusively or almost exclusively seasonal, as well as in the event of an invoice settlement for deliveries made prior to the beginning of the sports goods season;
8. 54 days from the end of the invoice month, for sales carried out between the suppliers and specialised distributors operating in the leather sector;

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9. 59 days from the end of the invoice month or 74 days after the invoice date, for sales carried out between the suppliers, manufacturers, importers or wholesalers and specialised distributors operating in the watchmaking, the jewellery, and the jewellery and goldsmith industries, including point-of-sale, distance-sales, central-purchasing activity, which mainly deal with resale of watchmaking, jewellery, and goldsmith's products;
10. For sales carried out between manufacturers and distributors specialising in the toy trade:
  - a) 95 days from the date of invoicing a 'fixed' period lasting from January to September inclusive;
  - b) 75 days from the date of an end-of-the-year invoice issued between October and December inclusive (Code de Commerce, L441-11).

The French Commercial Code provides for sanctions for non-compliance with the payment term regulations. Administrative penalties have been set at a high level – up to EUR 75,000 for natural persons and EUR 2 million for legal persons. The authority competent to impose these penalties is the Directorate-General for Competition, Consumers and Fraud Control. Publication of information about a penalty is at the expense of the penalised (the 'name and shame' sanction) (Dentons.com).

Companies whose financial statements are subject to audit by external independent auditors publish the information on payment delays in their reports (Code de Commerce, L. 441-14 and D. 441-4). If the delays are significant, they get indicated by statutory auditors in their audit reports (Code de Commerce, 823-7-1).

The primary rule adopted in Croatia is the 60 days for B2B transactions (30 days for contracts concluded with public entities). On an exceptional basis, when trade credit can be granted for a maximum of 360 days, a written form is required. An agreement concluded for a period longer than 60 days cannot be grossly unfair to the creditor.

In addition to the interest and the EUR 40 penalty, Croatian regulations have introduced strict standards, treating late payment as an offence, for which sanctions are provided, ranging from 10,000 HRK to 1,000,000 HRK for entrepreneurs and 1000 HRK to 50,000 HRK for the company managers (TEB poslovno savjetovane).

In Italy, the basic payment period is 30 days, counted from:

1. the day of the debtor's receipt of an invoice or an equivalent payment request;
2. the day of the receipt of goods or service, if the date of an invoice or equivalent payment receipt is uncertain, or when the debtor receives an invoice or an equivalent payment request earlier than the goods or services;
3. the day of goods (service) acceptance or the day of product conformity verification, in the case of an acceptance or a verification procedure taking place; the payment term is provided for by the law or a contract, whereas the debtor must receive an invoice or an equivalent payment request prior to the date of the acceptance or the verification (CNA Parma).

The 30-day period can be extended if the contractual terms are not grossly unfair to one of the contracting parties. With regard to contracts in which one of the parties is an SME, the payment period may not exceed 60 days, as per the ordinance of the Ministry of Productive Activities of 18 April 2005. At the same time, there is no such limitation with regard to agreements in which both of the contracting parties are SME enterprises (CMS law tax future). Moreover, extensions of the payment term beyond the 60 days must be contracted in writing.

Poland implemented the 2011/7/EU provisions and, as per the applicable regulations, the payment period specified in a contract may not exceed 60 days, counted from the date of the debtor's receipt of an invoice or a bill confirming the delivery of goods or performance of service, unless the parties expressly agree otherwise in the contract and provided that the arrangement is not grossly unfair to the creditor (*Ustawa o Przeciwdziałaniu Nadmiernym Opóźnieniom w Transakcjach Handlowych* 2021).

If the debtor obligated to pay for goods or services is a large entrepreneur, and the creditor is a micro-, small-, or medium-sized entrepreneur, the payment term specified in the contract cannot exceed 60 days, counted from the date of the debtor's receipt of an invoice or a bill confirming the delivery of goods or the performance of a service (*Ustawa o Przeciwdziałaniu Nadmiernym Opóźnieniom w Transakcjach Handlowych* 2021).

Pursuant to the Polish Act on Counteracting Excessive Delays in Commercial Transactions, the amount of compensation depends on the amount of the receivable under recovery (*Ustawa o Przeciwdziałaniu Nadmiernym Opóźnieniom w Transakcjach Handlowych* 2021):

- EUR 40 – when the value of the pecuniary benefit does not exceed PLN 5000;
- EUR 70 – when the value of the pecuniary benefit is higher than PLN 5000 but lower than PLN 50,000;
- EUR 100 – when the value of the pecuniary benefit is equal to or higher than PLN 50,000.

In addition to the above-described standards, provisions were introduced into the tax on goods and services (bad debt relief – Articles 89a and 89b of the VAT Act), which allow a creditor who has not received the receivable, nor any part of it, within 90 days from the date of the payment deadline specified on the invoice (bill) or in the contract, to reduce the tax base by the value of this receivable (or its part) or increase the loss incurred.

The right to reduce the tax base or increase the loss is vested in entrepreneurs who had included the value of the claim as due income, provided that the claim has not been settled or sold prior to the date of the tax return submission.

The tax base reduction or the increase of loss are entered in the tax returns that are submitted for the tax year in which the 90-day lapse from the payment deadline occurred. The tax relief described is aimed at minimisation of the losses incurred by the seller in the event of non-payment. The above-described mechanism allows the input tax paid to be refunded.

Turkey is not a member of the European Union; thus, the Turkish lawmakers are not directly required to implement Directive 2011/7/EU. Nevertheless, both Directive 2011/7/EU and 2000/35/EC have been transposed into Turkish law. These standards have been implemented into the Commercial Code (TCC) and the Code of Obligations (TCO) (CMS law tax future). It has been assumed that the maximum payment term is 60 days from the date of the invoice or the goods (services) receipt (TÜRK TİCARET KANUNU, art. 1530). The parties can extend the time limit, provided that it is not grossly unfair to one of the contractual parties. The Turkish law provides for exceptions from contractual payment term extension, when:

1. the payee is a small or medium-sized enterprise (SME);
2. the debtor is a large-scale enterprise;
3. the recipient is an agricultural or livestock producer.

Summing up, this chapter has presented the basic legal regulations regarding the terms of liability payment. The legislation, both in individual countries, as well as in the entire area of the European Union, is intended to reduce the payment backlogs occurring in B2B transactions. The fact that contracts may be shaped quite freely, provided that they will not be grossly unfair to the creditor, should be given attention as well. Moreover, entities can use counterparty verification tools, or simply ensure the sales (the basic tools for reduction of the seller's risk are described in Section 1.3).

Both the national regulations as well as the European Union directives are intended to protect enterprises from the privileged entities' exploitation of their competitive advantage. This is particularly visible in the case of large companies, which capitalise on small suppliers, by imposing the payment terms and, in effect, treating these entities as sources of interest-free credit (Ryan 2008). Such practices raise ethical issues, as defaults may, in this case, contribute to corporate bankruptcy (Cowton and San-jose 2017). The legal norms described above are intended to limit the cases of extended terms of payment for received products or services.

## Note

- 1 Paragraphs 100–107.

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