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On the Ethics of Trade Credit: Understanding Good Payment Practice in the Supply Chain

Christopher J. Cowton¹ · Leire San-Jose²

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Abstract In spite of its commercial importance and signs of clear concern in public policy arenas, trade credit has not been subjected to systematic, extended analysis in the business ethics literature, even where suppliers as a stakeholder group have been considered. This paper makes the case for serious consideration of the ethics of trade credit and explores the issues surrounding slow payment of debts. It discusses trade debt as a kind of promise, but— noting that not all promises are good ones—goes on to develop an analysis of the ethics of trade credit grounded in an understanding of its fundamental purpose. Making a distinction between “operating” trade credit and “financial” trade credit, the paper provides an account of the maximum period for which it is appropriate for one company to delay payment to another from which it has purchased goods or services. The concern of commentators and policy makers that companies should not take too long to pay their debts is affirmed, but the understanding of what timely payment means is significantly finessed, with one conclusion being that, if debts have not already been settled according to acceptable standard terms of trade, cash should pass quickly back along the supply chain once the customer in the final product market has paid. The analysis has implications not only for companies that take credit but

also for external parties that seek to rate companies or set regulations according to speed of payment—an approach that is shown to be misleadingly simplistic, albeit well intentioned. A corresponding important responsibility for suppliers, not to extend excessive credit (and thus act as a quasi-bank), also follows from the analysis developed. Having provided a novel analysis of an important business problem, the paper then discusses some of the related practical issues and makes suggestions for further research.

Keywords Trade credit · Creditors · Purchasing · Supply chain · Suppliers · Promise-keeping

Introduction

In spite of its economic importance, finance has featured relatively rarely in writing on business ethics (Boatright 2008; Hendry 2013), and with the intellectual “capture” of finance by financial economics (Whitely 1986), ethics is also given little consideration within finance literature (Prindl and Prodhan 1994). Thus few mainstream financial topics have been analysed adequately from an ethical perspective. Some have barely been addressed at all; one such topic is trade credit, in spite of late payment being “one of the most commonplace problems of business ethics” (Sorell and Hendry 1994 p. 140). This paper seeks to remedy that lacuna.

Trade credit is created when a supplier provides goods or services to another firm in the expectation that payment will be received at a date in the future. Instead of payment in cash or near-cash, the goods or services are supplied “on credit”, usually with an invoice that specifies the payment terms (e.g. payment to be received within 30 or 60 days). This amounts to the extension of a loan by the supplying

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company to its customer. Like any loan, it entails the risk of default or delayed payment; and it is not uncommon for some customers to take longer to pay than indicated in the payment terms. As will be explained below, although it is not always recognised, the payment behaviour of the purchaser (trade debtor) towards the supplier (trade creditor) possesses ethical dimensions and should be analysed in such terms. Although it is less intuitive, it will be argued that the behaviour of the supplier with regard to the provision—particularly the over-provision—of trade credit also has ethical implications.

The aims of the paper are to establish the case for analysing trade credit in ethical terms, to highlight some initial considerations, and to develop a framework for thinking about it by grounding the granting of trade credit in the underlying provision of goods and services used by a purchasing firm in pursuit of its productive activities. The paper is structured as follows. The first main section provides an overview of how trade credit has been discussed in other literature (particularly finance and economics), as well as some recent concerns that have become apparent on the part of some policy makers and other commentators. The second section sets out some initial thoughts about how trade credit might be considered in ethical terms, particularly as a promise between two firms. The third section then develops a more fundamental, complementary analysis regarding an ethically sound approach to trade credit. The fourth section discusses various implications and possible limitations of the analysis. Finally, the conclusion summarises the principal elements of the argument, highlights the contributions of the paper and makes some suggestions for further research.

An Overview of Trade Credit

The purpose of this section is to provide a non-technical overview of trade credit: first, in order to demonstrate its importance and thus provide a *prima facie* case for its ethical consideration; and second, to provide sufficient background for the analysis that follows.

Trade credit is a major source of external financing for companies (Ng et al. 1999; Stern and Chew 2003; Horne and Wachowicz 2001). Using a sample of large traded non-financial firms of the G-7 countries, Cuñat and Garcia-Appendini (2012) observed that trade credit taken (accounts payable) represents, on average, a sizeable 11.5–17 % of total assets. The use of trade credit by non-financial firms has long been one of the most important forms of financing in the US economy (Seiden 1964). However, in the US, the amount of outstanding accounts payable (that is, money owed by companies to other companies) increased by four times during the period

1990–2000, reaching a total of \$3,758 billion (10⁹) (Statistical Abstract of the United States 2003, <http://www.census.gov/>). In 2003, trade credit was used by 60 % of small US businesses, (<http://www.census.gov/epcd/www/smallbus.html>), rising to more than 85 % of the largest firms (Federal Reserve Bulletin, “Financial Services used by Small Businesses: evidence from the 2003 Survey of Small Business Finances,”¹ A182/A183, available at <http://www.federalreserve.gov>). The situation is similar in other developed economies. In Australia, trade credit owed by Australian businesses (both listed and unlisted corporations) is estimated to have been over \$80 billion in March 2013, which accounted for around 8 % of their total liabilities (Fitzpatrick and Lien 2013). Kohler et al. (2000) estimate that 55 % of the total short-term credit received by UK firms during the period 1983–1995 took the form of trade credit, and it is generally accepted that more than “80 % of daily ‘business to business’ transactions are on credit terms” (Wilson and Summers 2002). Trade credit is used by both small and large companies. In 2007, trade creditors owed small firms in the UK a total of £48,666 million (FAME² Database). The total amount of trade creditors for a sample of 200 FTSE firms (representing approximately 85 % of UK stock market capitalisation) is over £400 billion. Around 80 % of limited companies extend trade credit to customers, which has increased 5 % in the post-recession period; and up to 90 % of companies receive credit from suppliers, which has increased 8 % in the post-recession period. For many small companies trade credit is the only source of external finance (Wilson 2014).

So, trade credit is widely and heavily used by companies to support their business operations (Brennan et al. 1988; Meltzer 1960; Petersen and Rajan 1997). It enables them to receive necessary supplies in advance of receiving payment for their own products, thus helping to support their production processes and economic activity. However, it puts a strain on suppliers’ own financial resources because goods or services are produced and provided without, at least for a time, receiving cash—and, as business wisdom has it, “cash is king”. Nevertheless, for better or worse, many suppliers judge it worthwhile to grant credit in order to generate their own revenue and profits; it is a crucial aspect of supply chains.

There are many economic studies that explain and test, theoretically and empirically, what influences how much

¹ The SSBF provides the most comprehensive information on the patterns of credit use by small businesses and their providers for 1987, 1993, 1998 and 2003. The 2003 survey is the last to have been conducted.

² FAME, Bureau van Dijk database contains information for companies in the UK and Ireland. FAME contains information on 3.4 million companies, 2.8 million of which are in a detailed format (<http://www.bvdep.com>).

trade credit is taken by companies. These studies focus on how it can help a company to increase sales (Brennan et al. 1988; Emery 1987; Meltzer 1960; Petersen and Rajan 1997; Schwartz 1974), enabling it to gear up production in advance of the receipt of monies owed, and hence supporting growth (Cuñat 2007; Petersen and Rajan 1997). Studies also examine the use of trade credit as a substitute for bank credit, particularly when the latter is difficult to come by (Gertler and Gilchrist 1994; Jaffee 1969; Nilsen 2002; Schwartz 1974). As in previous downturns (Smith 1987; Walker 1991), the current economic recession engendered by the banking crisis will be putting pressure on trade credit, tempting companies to take longer to pay their suppliers—to the detriment of these businesses (suppliers) that are not always included in the list of a firm's stakeholders, “but deserve to be” (Sorell and Hendry 1994 p. 138). Part of the reason for this effect is that, in addition to the direct impact of recession upon their operating cash flow, firms are usually affected by difficulties in securing funds from credit institutions during times of economic crisis (see, for example, Demirgüç-Kunt et al. 2006; Eichengreen and Rose 1998; Kaminsky and Reinhart 1999), which encourages or tempts them to delay paying their trade debts. In one study, only 39 % of companies in the European countries studied paid promptly, and 3.3 % of companies delayed payment more than 90 days beyond the agreed due date (CRIBIS 2013).

The practice of delaying payment accords with conventional commercial wisdom and is reflected in some of the ways in which trade credit is described in finance and corporate financial management textbooks. Trade credit has been variously described as a “spontaneous source” of funds (Block and Hirt 1994; Gitman 1988), “an easy financing form” (Stern and Chew 2003; Horne and Wachowicz 2001), “informal” (Arnold 2005; Gitman 1988; Weston and Copeland 1992), “accepted practice” (Pike and Neale 1993), and “liberal extension of money” (Horne and Wachowicz 2001). It is generally assumed that the norm is for trade debtors to take a long time to pay, particularly in industries such as manufacturing (Atrill and McLaney 2002). Some financial texts suggest that purchasing companies should aim to stretch the credit period offered by suppliers (McMenamin 1999). Gitman et al. (1976, pp. 169–170) confirm that a basic cash management strategy normally applied is to pay accounts payable as late as possible without damaging the firm's credit rating and supplier relationship.

Such practices raise ethical issues. Delay (or, even worse, default, the possibility of which tends to increase with delay) in paying by customers, especially major ones, can have severe, if not fatal, financial consequences for suppliers, which in turn has repercussions for their own suppliers and other stakeholders, such as employees.

Concern has been voiced by some commentators, particularly in relation to small firms (Barrow 2006; Dalton 2007; Hodgetts and Kuratko 2001; Sihler 2004). This is probably a worldwide concern. For example, large businesses in China are more likely to delay payment to small businesses (CRIBIS 2013).

Small businesses are particularly vulnerable to the problems caused by late payment especially with large corporate customers who can use their market position to dictate their own payment terms. Many large firms use their small-firm suppliers as a bank—taking, what is in effect, an interest-free overdraft (Ryan 2008 p. 373).

The UK is one country in which such worries have led to several policy initiatives. For example, for a period from 1997³ it was mandatory for large firms in the UK to disclose in their Annual Reports (Directors' Report) the number of days taken to pay their suppliers. This was calculated by dividing the trade creditors (accounts payable) figure outstanding at the end of the financial year by the aggregate amount invoiced by suppliers during the year (not visible in the published accounts). This gave a more reliable estimate than the ratio traditionally calculated by financial analysts, where cost of sales or even total revenue are used as proxies for the amount invoiced by suppliers. The figures were used for the Payment League Table, which was developed as a “helpful tool” for suppliers, in a joint venture between the Institute of Credit Management (ICM), the Credit Management Research Centre (CMRC) and Credit Scorer Ltd.

Further regulations were introduced in the UK in 1998. The Late Payment of Commercial Debts (Interest) Act sought to encourage purchasers to pay on time by granting suppliers the right to claim interest on overdue accounts. Previously, businesses were only able to claim interest on late paid debts if it was included in the contract, or if they pursued the debt through the courts and the courts awarded interest. Similarly, in 2000, Directive 2000/35/EC of the European Parliament and of the Council on Combating Late Payment in Commercial Transactions was published in the Official Journal L 200. This Directive was aimed at dealing with the problem of late payment, with a focus on helping small and medium enterprises (SMEs). If the customer does not pay on the day fixed in the contract (or, if the date or period for payment is not fixed in the contract, within 30 days of receipt of the invoice or receipt of the goods or services), the debtor is obliged to pay “penalty interest”.

Claiming and receiving such interest on the part of suppliers tends to be challenging in practice, but these

³ SI (Statutory Instrument) 1996/189.

legislative initiatives are symptomatic of a concern about trade credit payment practices. More recently, in the case of England, Wales and Northern Ireland, changes to legislation tabled at European level have resulted in The Late Payment of Commercial Debts Regulations 2013, introduced on 16 March 2013. If no payment terms are agreed, the default period is 30 days. However, payment terms must not exceed 60 days unless both parties agree and the extension is not grossly unfair. In the case of the public sector, payment must be made within 30 calendar days of receiving an invoice. Achieving such a target would be a challenge in some countries. For example, in June 2014 the European Commission opened a formal infringement procedure against Italy because of its failure to comply with the Late Payments Directive, which orders governments to reduce payment delays to no more than 60 days; and in Spain some regions were taking about 300 days to pay for pharmaceutical suppliers in 2011–12.

At an earlier point in time, large UK companies were also required to disclose their policies on the payment of trade creditors and to state whether they follow any code or standard on payment practice, and if so, provide the name of the code or standard and information about how to obtain copies of the code. This disclosure requirement is no longer required, but initiatives such as a code to deal with trade credit still exist. So far, there have been three codes widely available in the UK. The first, launched in November 1991, was “The Prompt Payers’ Code”, developed by the Confederation of British Industry (CBI). During its period of operation between 1991 and 1997, the Code was signed voluntarily by 1000 firms, most of them limited companies. In 1997, the CBI Code was superseded by the “The Better Payment Practice Code”, developed by the government’s Department of Trade and Industry (DTI). Again, this code was voluntary, and more than 1000 firms signed it between 1997 and 2008. More recently, in December 2008, the third UK payment code appeared, supported by the Institute of Credit Management (ICM) on behalf of the government’s Department for Business, Enterprise and Regulatory Reform (BERR)—the now defunct successor to the DTI. This “Prompt Payment Code” is another voluntary payment code, focused in a direct way, not only on information and paying bills, but also on helping to increase the speed of payments to smaller companies. Also in 2008, the Payontime initiative (www.payontime.co.uk) was launched to build on the work of the Better Payment Practice Campaign, which had been established by the UK government in 1997 in partnership with leading business organisations. More recently the Prompt Payment Code has been strengthened and promoted strongly by the CBI, though a survey by the Federation of Small Businesses in 2015 suggested that small businesses do not place much confidence in it, with traditional excuses

for late payment (e.g. invoice lost or did not arrive) still prevalent (see Governance and Compliance May 2015, p. 6).

The various initiatives briefly described above are designed to encourage “better” trade credit behaviour by companies in dealing with their suppliers. The purpose of reviewing them here is not to provide a comprehensive account of their content and effectiveness, but rather to establish that there are clear signs (regulations, codes, league tables) of “worries” about trade credit that have ethical overtones and would benefit from ethical analysis. In particular, there is evidence of a desire to protect SMEs from poor payment practice by more powerful, larger companies.

In conclusion, this section has sought to accomplish three things: first, to show that trade credit is an important commercial practice; second, to show that conventional wisdom regarding the taking of trade credit—as reflected in financial management texts, for example—is, at best, amoral, and perhaps immoral; and third, to note that there have been clear signs of significant concern on the part of policy makers and other commentators. It may also be suggested that, if suppliers matter as a stakeholder group—either in themselves or as the embodiment of a network of indirect stakeholders—then trade credit matters, since it affects their ability to survive and flourish. These factors imply that trade credit is a practice worthy of serious ethical analysis. The next section begins to develop such an analysis.

The Ethics of Trade Credit: Initial Considerations

It might be contended that the granting of trade credit and the payment of trade debts is simply a matter between the two contracting parties; it is open to the supplier and purchaser to agree mutually acceptable terms of trade and equally open to them to seek legal redress in civil, rather than criminal, law if the other party does not perform according to the contract.⁴ However, it will be argued below that there are two respects in which ethical, and not only legal, considerations should be brought to bear: first, because of the nature of the relationship between the two parties; and second, because of the possible impact of their relationship on third parties. Moreover, the authors are not aware of any justification, in the business ethics literature, for a general presumption that business-to-business (B2B)

⁴ By way of contrast, consumer credit which, in its various forms, involves a private individual acquiring, or obtaining the use of with a commitment or option to acquire, a consumer good is subject to significant regulation. It is an area fraught with risks for the unwary private individual, and governments in many nations have constructed regulatory mechanisms to protect them.

relationships should not, or cannot, be subject to ethical analysis. Indeed, the practical concerns and public policy initiatives described in the previous section are inconsistent with such a presumption.

The policy initiatives that imply a concern over one company taking too long to pay another company for goods or services supplied hint at a useful distinction. First, a company might take longer than contracted to pay its supplier. Of course, this entails a legal breach of contract. However, in most cases it is not worthwhile going to law because of the expense of doing so and, where further custom is hoped for (the norm in B2B relationships), because of the risk of damaging future commercial activities between the two companies. Such considerations have undermined initiatives to permit suppliers to charge interest on overdue accounts. Nevertheless, whether or not legal redress is considered appropriate, late payment does seem to imply, at least, a moral philosophical opening. As MacLagan (2012) notes, in his exposition of *prima facie* duties, W.D. Ross explains that they usually involve others who stand in some sort of relation to us, such as ‘promisee to promiser’ or ‘creditor to debtor’ (see Dancy 1991). Indeed, the position of being a debtor can be seen as a particular form of promise, an undertaking to pay a sum of money (to a creditor). As Bronaugh (1997 p. 521) comments, ‘Someone who eschews promising could not make business contracts or deal in credit’.

Prompt payment can thus be viewed as a case of keeping a promise, the fulfilment of a “positive duty” from a deontological perspective (Davis 1991 p. 216). In a culture where late payment is the norm, it might even be viewed as meritorious behaviour—though that would seem to devalue the moral status of the original “speech act” (Austin 1962) that is the promise. On the other hand, late payment can be viewed as a case of breaking a promise or agreement, which from the angle of most moral theories is considered wrong (Sorell and Hendry 1994). The degree of moral censure associated with such behaviour might depend on the context. Indeed, in certain circumstances, perhaps where there is some unforeseeable change of severe or catastrophic proportion, late payment might even be justified or at least defensible. Such a situation might include a sudden downturn in the economy, collapse of demand for a particular product or the trade debtor, if it supplies businesses in turn, having difficulty collecting payments due from a major trade customer. Sorell and Hendry (1994) make the point, though, that this should also tend to entail the creditor firm acknowledging its ability and willingness to withstand the delay, rather than such delay being merely presumed by the trade debtor and not communicated. For example, the trade creditor might, if not out of loyalty, make a conscious business decision that it is better to wait longer for payment in order to help its customer and so

protect future trade with it. Such a decision might entail actions on the part of the trade debtor, such as the provision of appropriate information on its financial position and prospects. The trade debtor should also not take longer to pay than is necessary; it would be unfair to take advantage of the generosity, or calculated benevolence, of the trade creditor. In other words, the debtor should or can, if appropriate, be positively released from its obligation.⁵ Such considerations resonate with debates on promise-keeping more generally (Bronaugh 1997). Nevertheless, the analysis developed in the next section serves to define a maximum period beyond which the firm should not agree to grant credit.

Second, however, there is a further dimension to promise-keeping to be considered. Not all promises are good promises. What is wrong—such as a contract killer undertaking to carry out a murder—cannot be turned into a moral obligation by the making of a promise (Bronaugh 1997). While the promise to pay a debt would not seem to fall foul of this problem, it might still have morally undesirable characteristics. For example, a third party (e.g. an existing creditor) might be adversely affected by a reckless agreement between the two parties.⁶ However, the most pertinent issue is that, where there is an asymmetry of power involved in the setting up of the promise or bargain, the terms might not be good for the less powerful, more vulnerable promisee. There might be a presumption that such circumstances are unlikely in B2B relationships; after all, the supplier has agreed to the deal, so would be presumed to be better off with it than without it. However, that is not to say that the deal is equally beneficial or fair to the two parties involved.

It will be recalled that the policy initiatives referred to in the previous section were first enacted in the context of small companies’ relationships with larger—and hence presumed to be more powerful—companies. It is interesting to note that Hawksorth (1991 p. 219) refers to the Social Responsibility Committee of The Boots Company producing a booklet in which it stated that it was the policy of the Company to ensure that “There is no abuse of economic power in dealing with a smaller concern”—which implicitly recognises the potential for such abuse to take place. In addition to delaying payment beyond the agreed date, this might be through demanding unreasonable terms of trade, such as an unusually long period of credit and thus taking what is, in effect, an interest-free overdraft (Ryan 2008). In recent times, some powerful UK retailers have attracted significant criticism for unilaterally forcing

⁵ See Sorell and Hendy (1994, pp. 141–143) for more complex considerations.

⁶ The protection of creditors is an important area of company law (see Cowton 2012).

suppliers to accept worse terms of trade, including longer payment periods. Thus promptness is not the whole story; a company might pay promptly but “too slowly”. This possibility is implied by The Late Payment of Commercial Debts Regulations 2013 in the UK, cited earlier, which state that payment terms must not exceed 60 days unless both parties agree and the extension is not grossly unfair—from which it may be inferred that there is the real practical possibility of a “grossly unfair” agreement over payment terms. Thus, beyond the issue of promise-keeping, there arises the question of whether the agreement is fair to both parties, with a particular initial concern—given what has gone before—for the supplier.

One way of opening up this issue philosophically would be to build on the tradition of a just or fair price (or some other perspective on justice or fairness), where the number of days’ trade credit becomes part of the consideration of what it means for a purchaser to act fairly or justly towards a supplier. Price is, after all, just one of the terms of trade, albeit a very important one.

Justice can, in general terms, be viewed as being concerned with whether each gets what he or she is due (Hooker 1995). In one sense, highly relevant to this discussion, it is concerned with who gets the benefits and the burdens (Sankowski 2005). While the application of justice, in its full sense, or manifold senses (Sankowski 2005), to a corporation might be problematic, “commutative” justice—which concerns the fairness of wages, prices and exchanges—seems to be appropriate (Solomon 1993). In particular, when both parties are corporations, they are on a level justice playing field.⁷

One practical way of judging fairness is to see how a party treats the various other parties it deals with. One approach would be to compare the debtor company’s behaviour towards one supplier with its behaviour towards other suppliers; this might expose, for example, that it pays small suppliers more slowly than large suppliers. Such information might be accessed via credit rating agencies (CRIBIS 2013). If such information isn’t available, an alternative approach would be to compare a company’s payment behaviour with that of other firms—the kind of comparison that payment league tables purport to perform. However, while both forms of comparison might be of some help in forming a judgment on a particular firm’s behaviour, they are necessarily relative. This entails two problems. First, it provides no objective benchmark for what the payment behaviour *should* be. Perhaps a relatively quick payer is just “the best of a bad bunch”. Second, the

analysis developed below demonstrates that a simple comparison of payment days has significant shortcomings unless it is related back to the underlying supply chain processes—on which a more satisfactory account of appropriate payment periods can be built. Therefore, although this section has already yielded some valuable insights into the ethics of trade credit, the next section takes a step back to ask more fundamental questions about trade credit and to develop an argument that specifies what the maximum period of trade credit should be allowed to be. Any bargain outside this period would, we argue, be a bad one.

The Ethics of Trade Credit: A Fundamental Perspective

As stated at the beginning of this paper, trade credit involves one company supplying goods or services to another without receiving any money in return at the time of delivery. This looks like a loan; the supplier has done work but the money it is owed at that date will—hopefully—arrive later, while the business customer is enjoying the benefit of goods and services without, at this point, having paid for them. Financially, the purchaser is in the same situation as if it had borrowed money from the bank and bought the goods or services using the funds obtained; it just owes the money to the supplier rather than the bank. Indeed, the interchangeability of trade credit and bank finance, as covered in texts on financial management, was referred to earlier in this paper. However, there is an important difference. In contrast to other forms of finance, trade credit is provided by companies within the supply chain that are trading with each other. Unlike equity finance provided by shareholders or loans provided by banks, for example, the granting of trade credit does not add to the sum of finance within the supply chain; it is a zero sum game, with the granting of trade credit (a non-cash current asset) being exactly matched by a current liability. Nevertheless, this collaborative arrangement means that companies can undertake production before a consequent retail sale is made, thus facilitating trade and industry (Brennan et al. 1988; Meltzer 1960; Petersen and Rajan 1997)—ultimately to the benefit of the supplier too, assuming the debt is paid.

Thus suppliers can be seen as taking part in a joint enterprise with their business customers. Suppose the purchasing company/debtor is a supermarket that sells to the final consumer on a cash basis. The supplier provides goods to the retailer, whose role is to get the supplier’s product to market. Once the final consumer pays, then a sum of money becomes available to pay the supplier, with the balance remaining with the retailer to pay its other costs

⁷ In contrast, if it is contended that corporations’ ontological status means that they do not have rights (“substantive justice”: Hooker 1995), the assessment of fairness or justice as between an individual and a corporation is a more complex matter.

and generate a margin. Not only can this be seen as a joint enterprise, but imagine if the supplier were vertically integrated to the final consumer market—it would still have to wait until the final consumer paid before it had the money earned by its efforts.

This scenario demonstrates that it is reasonable for the business customer to take trade credit while both it and its supplier wait for a sale to be made, and cash received, in the final product market (here, the supermarket). However, once the cash is received, the supplier should be paid immediately; there is no longer any justification for taking the trade credit, and to hold the money back is to forcibly borrow the money due to the supplier, with implications for financial positions within the supply chain. This analysis thus argues that the trade credit period can justifiably be as long as, but no longer than, the period taken to receive the money from the final consumer. At that point, the rewards of the joint enterprise should be shared between the collaborators in accordance with the terms of an appropriate agreement between them. If the supplier is not paid by that point, the position moves from one of real or “operating” trade credit to one of “financial” trade credit.⁸ Moreover, rather than there being a collaborative endeavour under way, the continued taking of trade credit can be viewed as exploitative; the business customer is hanging on to the supplier’s money simply because it can. If a trade debtor wishes to have more cash in its possession, it should go to a bank or similar source of funding. There are several reasons for this: banks have, or should have, greater expertise in granting credit than suppliers and are better diversified; providing finance is their *raison d’être* as a business, and they are regulated accordingly; and, assuming the purchasing company is not being merely opportunistic, more working capital would be provided to the supply chain where it is apparently needed (cf. the zero sum game between supplier and purchaser).

We would also suggest that the position we have described sets the limit for a just or fair bargain regarding trade credit. Solomon (1993) comments that traditional ethics is concerned with the nature of promises and other obligations etc., and he notes that this fits well micro-ethics in business—which he characterises as the rules for fair exchange between two parties.

What is peculiar to business micro-ethics is the idea of a fair exchange and, along with it, the notion of a fair wage, fair treatment, what counts as a “bargain” and what instead is a “steal”. Aristotle’s notion of

‘commutative’ justice is particularly at home here (Solomon 1993).

We would suggest that for a company to delay payment to its supplier after it has received payment for the products in which the supplier’s goods have been incorporated is unfair. To withhold money beyond this date is indeed—to use Solomon’s term—a “steal”, albeit a temporary one.

In a departure from other concerns about business customers taking too long to pay, though, this analysis also implies an ethical responsibility for the supplier. The point is this: if a supplier chooses or agrees (rather than is forced) to grant credit beyond the period when the final customer pays, then the supplier is going beyond the parameters of the joint productive enterprise. For any “excess” period of “financial” trade credit the supplier is, in effect, acting as a bank rather than a commercial partner. As explained earlier, suppliers are often viewed as a direct alternative to banks. Yet, as the recent financial crisis has reminded us, banks are special institutions, with peculiar risk characteristics when compared with mainstream businesses. Going back to at least the nineteenth century, this has led to banks being subject to special forms of control. Insofar as supplying firms act as banks (Ryan 2008), though, they are not subject to such controls. We suggest that acting as a banker without the appropriate powers or oversight is wrong. For this reason, it is also unacceptable even for a buying firm to compensate a supplier for expected (too) slow payment by paying a higher price—if the payment period extends beyond our critical period. While the additional revenue might be welcome to a supplier, and it might be considered fair as between the two parties, on our account it is an inappropriate action, amounting, in part, to the payment of interest for financial capital.

The inappropriateness of suppliers acting as providers of financial capital is reinforced if stakeholders are considered. Given that a supplier’s stakeholders (such as employees, its own suppliers and local community) can be adversely affected if it has a major customer default or delay significantly on payments, then it can be argued, generally, that suppliers are under an obligation not to grant trade credit inappropriately. That would include not granting credit recklessly (e.g. to a customer that is unlikely to pay), but it would also include, per the analysis here, not willingly granting credit beyond the period justified by the joint enterprise implied in getting its products to final market. In addition to the argument made earlier regarding asymmetry of power, this is the second respect in which a bargain might not be a good one, even though made willingly between two parties, since it can lead to an increased risk of undesirable consequences for third parties by involving the supplier in an inappropriate activity, namely acting like a bank. If a supplier has reasons to

⁸ This distinction, of our own devising, mirrors the conventional distinction in finance between operating leases and finance leases. It also resonates with, but finesses, Ryan’s (2008) reference to taking trade credit being like having a free overdraft.

grant, or is forced to grant, credit for a period longer than our analysis would support, we suggest that it should seriously consider factoring its invoices (i.e. selling its debts to a finance company).

This analysis thus places an ethical duty on the buying company not to take trade credit beyond a certain period of time but it also suggests that suppliers should endeavour to avoid being complicit in such actions. None of this implies that a company is under an obligation *not* to pay more quickly than the deadline our analysis implies; we provide an outer limit or constraint. Nor does our analysis rule out some argument that firms *should*, in some circumstances, for some reasons (such as established business custom), pay more quickly than the outer limit that we have established conceptually. However, while the analysis resonates with policy concern about taking too long a period of credit, it both identifies a responsibility for suppliers and ties the understanding of an (in)appropriate trade credit period to the underlying business process rather than referring only to some pan-economy standard such as 60 days.

Thus we have argued that the granting and taking of trade credit is, up to a certain point, an acceptable, or indeed good,⁹ practice, but that after that point it is ethically dubious. Rather than attempting to justify some arbitrary number of days' credit, the argument has sought to ground an understanding of the maximum appropriate credit period in the underlying economic processes which justifiably give rise to it. In the following section, we identify and comment on some possible objections to our analysis, including some practical issues, and then go on to suggest what the contributions of the paper are.

Discussion

In the previous sections we have sought to establish the importance of trade credit as an issue warranting the attention of business ethicists. We grounded the justification of the practice in an understanding of the joint productive exercise that exists between buyer and seller and, indeed, within the supply chain. Recognising that the granting of trade credit often entails various problems and tensions, especially where the buyer possesses considerable power within the relationship, our initial exploration of the issues focused on the notion of delayed payment as a kind of broken promise, when and how a promise might be broken or amended, and the importance of an agreement being fair in the first place. The various public policy initiatives to which we referred earlier in the paper provide

economy-wide stipulations or recommendations of what a generally 'fair' maximum payment period might look like—60 days, for example.

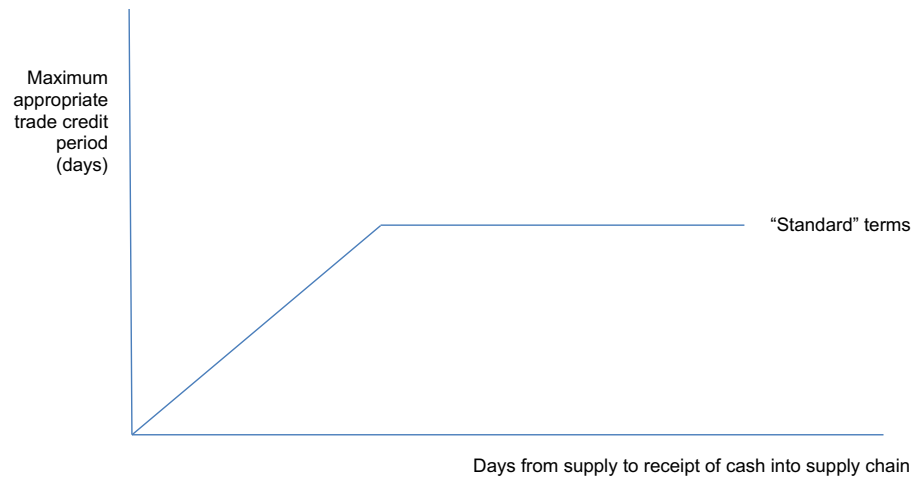
However, returning to an understanding of the purpose of trade credit grounded in the joint productive exercise between creditor and debtor, there are circumstances in which an arbitrarily set payment period is too long, entailing suppliers acting as quasi-banks in supplying not only goods and services but also “financial” rather than merely “operating” credit. Such a situation is most likely to occur towards the top, or consumer-facing end, of the supply chain. This element of our analysis has particular pertinence to suppliers' relationship with B2C (business to consumer) firms such as supermarkets, which have notably high stock (inventory) turnover and tend to generate cash within a week or two of receiving supplies, particularly in food retailing. Yet not only do supermarkets tend to take longer than this to pay, but there have been recent high profile examples of supermarkets changing their policies to move payment dates further back—even though they have not been at imminent risk of bankruptcy and against a background of a continuing drive to increase stock turnover rates.

Figure 1 portrays the two elements of the maximum payment period.

Figure 1 shows the relationship between days taken from point of supply until cash is received into the supply chain and the maximum period of trade credit to be allowed. In many cases—particularly towards the bottom end of a supply chain—we would support a standard period that is considered reasonable and fair, as has been advocated in various recent policy initiatives. This would form the basis of terms of trade between companies, unless there were good reasons to vary these (see earlier comments about fair bargains and promise-keeping). However, trade credit should be constrained to the provision of “operating” credit, which dominates the standard terms where the period between supply and cash entering the supply chain is shorter than the standard terms—hence the upward sloping segment of the constraint line towards the left-hand end of the x-axis.

As an attempt to open up the topic of trade credit to ethical scrutiny, this paper has inevitably had to make some simplifications and explore some issues to only a limited extent. Thus, in spite of grounding the analysis in an understanding of the trade credit phenomenon, it might be objected that the approach is not “realistic”. This worry about a lack of “realism” might take two forms: first, that the analysis is unduly idealistic (see below); and second, that certain practical details have not been addressed. On the second point, given that this paper is a first to attempt to treat the ethics of trade credit in a systematic manner, this is not necessarily a major flaw. Our objective has been to

⁹ Other things being equal, the encouragement of economic activity is taken to be a good thing.

Fig. 1 Maximum trade credit period

make progress but also to lay the groundwork for future discussion. Nevertheless, we will mention some practical issues and sketch some outline responses. We will then return to the issue of “idealism”.

First, a supply chain can have many links. However, the principle argued for above remains the same. Once money enters the supply chain, it should pass quickly back along it, assuming payment has not already been made and received according to “standard” terms. If we are operating in the sloping segment of Fig. 1, once money has entered the supply chain, it should pass back promptly to unpaid suppliers, without hindrance. In the era of electronic funds transfer (EFT), this is easier to accomplish than ever before.

Second, where supply is taking place relatively close to the top of the supply chain, the analysis seems to imply that prior to setting the terms of trade regarding settlement of an invoice, the parties to the deal should forecast when cash will be received at the end of the chain. This is usually uncertain—though the degree of uncertainty will vary with the particular supply chain and the point within it at which the forecast is being made. Perhaps, though, following our analysis, there should, in principle, be no need to set a period of credit since, as explained, cash would simply be received and a share passed on promptly, back through the supply chain. It would thus appear that we are suggesting that money received is “earmarked” and must be paid the minute it is received. That might be possible in some special situations, but, being more pragmatic, a suitable alternative would be to set the credit period with some regard to the underlying business process. Thus only a short period of credit should be granted or taken when the transaction is temporally close to the ultimate receipt of cash. For example, taking the case of large supermarket groups, they would not be expected to use their buying power to gain extended credit or even “standard” credit terms, but they would be expected to be among the fastest

of payers because they sell for cash (or near-cash) and have very high stock turnover (days rather than weeks). Again, though, being practical, instead of the ideal of passing on money as soon as it is received, or forecast to be received, for particular goods, a retailer could undertake to pay based on its average stock turnover period. Alternatively, closer to the ideal, different products or product categories sell more quickly than others (cf. fresh vegetables and canned vegetables, for example), so a supermarket could base its payment policies on the average stock turnover for particular classes of goods.

Third, the discussion about the sloping segment of Fig. 1 has tended to assume the provision of goods for onward sale. Similar principles would apply to raw materials or components that would be manufactured or assembled into a new product, though they might be more likely to be covered by the horizontal segment of the line. There are also purchases that are used for many different purposes (e.g. industrial fastenings in car manufacturing) or do not enter the production or distribution process but rather support them (e.g. stationery supplies). Similarly, many services have a somewhat ambivalent relationship to identifiable activities and outputs further forward along the supply chain. However, it should still, in principle, be possible to analyse the way in which a firm uses bought-in services and other goods to support its activities, whether the purchasing firm is a manufacturer, retailer or—itself—a service provider. From an understanding of the firm’s use of services in its own business, it should be possible to derive suitable measures or proxies to indicate where in Fig. 1 it is operating with a particular supplier and, in the sloping segment, whether it is using trade credit to facilitate its own sales (legitimate per this analysis) or as a more general source of finance (illegitimate).

Having addressed some of the practicalities, a more general possible objection to the analysis is that it is unduly “idealistic”, and hence not sufficiently “realistic” in what

it expects companies to do. Companies will continue to purchase supplies in accordance with conventional commercial wisdom and financial advice, taking as much credit as possible, up to the point where they begin to risk adverse consequences for themselves. They will not adopt the practice advocated here, or even change in the direction implied by it (as illustrated in Fig. 1).

This is a familiar charge against normative business ethics, or indeed against any ethical analysis that finds practice wanting in some respect—though it is difficult to imagine the value of a business ethics that was never in tension with business practice (Campbell and Cowton 2015). In the context of business ethics, this often entails explicit or implicit assumptions about the way competitive markets function. In the case of trade credit, the argument that the “realities” of competition leave no room for manoeuvre, or better behaviour, might go something like this: if a business customer does not take as much free credit or a supplying company does not allow as long a credit period (either in its explicit terms of business or through enforcement of payment terms that other firms do not attempt to do), as their respective competitors, they will lose out economically and be forced to come into line—or risk bankruptcy or managerial discipline by shareholders. It should be acknowledged that it is particularly difficult for a purchasing company to be exemplary in its payment practices if its own customers are not treating it well; Higginson (1993) recounts the story of “Barry” who is being squeezed in the middle when he wants to pay his suppliers promptly. There are several responses to this.

First, not all business is always as depicted above. Not all supply chains are tactically antagonistic in all respects, including payment terms; some are more co-operative for strategic instrumental reasons. The notion of “centralised supply chains” (Jonsson et al. 2013), in which first-order optimisation is sought, provides a good example of a context in which our overall analysis should be acceptable to participants. Good payment practices should be part of the terms of trade of partners in such a supply chain, or indeed in any supply chain where a more collaborative approach is being sought (Department for Business, Innovation and Skills 2014).

Second, while business and competition can be tough, some managers, at least, have some room for agency; their behaviour is influenced by market forces (they have to be taken into account), but it is not wholly determined by them. As Lucas (1998 p. 59) comments: “Economic determinism is false. The iron laws of supply and demand are not made of iron, and indicate tendencies only.” How much room for manoeuvre is available is a contingent, empirical question. However, it is not a given that at least some companies, some of the time, to some extent, cannot follow our suggestions—not least, in the case of suppliers,

by debt factoring or invoice discounting (i.e. selling to a third party, at a discount) some of their invoices, rather than continuing to extend “financial” credit themselves, if that is where the problem lies.

Third, even if companies are propelled by market forces (such as the power of a major customer) into providing unreasonable terms or even financial trade credit, but cannot engage in factoring for some reason, our analysis identifies the shortcomings of such practice and invites regulatory or other system-level reform to address the issue.

Finally, not all organisations that incur trade debts are profit-seeking businesses: just as The Late Payment of Commercial Debts Regulations 2013 imply a higher standard for public sector organisations, so those—and similar—organisations might have greater potential for following the guidance implied by our analysis. It is important to remember that not all organisations are subject to the disciplines of the market. However, as noted earlier, this would involve some governmental or public sector organisations, especially in some countries, drastically changing their payment practices, which is less likely to happen during a period of austerity in public budgets.

Furthermore, again *contra* the charge of “idealism”, there are implications of our analysis beyond the behaviour of the creditor and debtor companies themselves. One is that companies’ payment practice should not be judged solely according to the number of days’ credit they take on average. The analysis of this paper demonstrates that a commonsense focus on days’ credit, which is how published “league tables” of payment practice are constructed, is misleading. It is almost certainly more meritorious for a manufacturer to pay in 30 days than for a supermarket to pay in 25 days, for example. Compilers of such tables might complain that they are the best that can be produced, given the data available, but if the best ranking that can be produced is misleading, it might be better not to produce it at all. Moreover, following from the argument of this paper, various improvements might be considered. For example, separate tables might be compiled for different types of companies, with the grouping designed to reflect different underlying characteristics regarding the movement of goods through the supply chain towards final product markets and the receipt of cash therein. In particular, it would be desirable to separate out companies that are likely to be operating in the sloping segment of Fig. 1. A similar point might be made about codes of practice or regulations such as those referred to earlier; at the very least, our analysis highlights the issue that, when they focus on the number of days’ credit, they are simplifying in a way that does not do justice to different commercial contexts.

Finally, although this paper is normative, in the sense of setting out an ideal and providing recommendations, it does

not base its arguments primarily on the “*uneasy* application of some very general ethical principles”, which tends to be problematic for business ethics (Solomon 1993, p. 354, emphasis added). Rather, it grounds the analysis in an account of what trade credit is (the Initial Considerations section) and what it is for (the Fundamental Perspective section). This is one sense in which it is a relatively “realistic” analysis.

Conclusion

Trade credit is an important commercial practice, the significance of which has been highlighted again by the recent credit crisis. Yet, even though late payment is one of the most commonplace problems of business ethics in practice (Sorell and Hendry 1994), trade credit has not featured as an element of the business ethics research agenda (Cowton 2008). This paper is, we believe, the first in a business ethics journal to identify and explore the ethics of trade credit—a perspective that is notably absent from the finance literature. We have outlined some of the concerns that have been voiced in business and public policy circles regarding trade credit practices, particularly that payment is too slow—with a particular concern for large, more powerful companies’ treatment of SMEs.

However, our analysis has highlighted two particular shortcomings of an exclusive focus on speed of payment when evaluating the behaviour of business customers in paying for their supplies. First, it is important to distinguish between speed of payment and promptness. Promptness is a good thing in the sense that it fulfils a promise, but justice is served only if the underlying bargain is fair. This might be related to a general consensus about what is fair in a particular economy or, perhaps, industry. However, in some situations, closer to the top of the supply chain, a judgement on fairness should be related back to the underlying productive processes involved, to ensure that the business customer does not take advantage of trade credit beyond the point at which it receives cash for the relevant sale. From this, it is clear that speed (slowness) of payment, as measured by number of days’ credit taken, can be a misleading indicator of the commendableness of a firm’s behaviour.

A further novel aspect of our analysis is to go beyond a focus on the buying firm to introduce into the picture the responsibilities of the firm supplying the goods or services on credit. These are not so much the conventional responsibilities of a bank not to lend irresponsibly (Cowton 2002, 2010)—though reckless granting of trade credit is not to be recommended or even condoned, because of the damage such behaviour can do to the interests of shareholders and other stakeholders. Rather, we have argued that

the responsibility of the supplying firm is to endeavour not to act as a bank at all—which is what effectively happens when a purchasing firm takes credit for longer than the maximum legitimate period in the slope segment of Fig. 1. To repeat our distinction, it is legitimate to provide “operating” trade credit but not “financial” trade credit.

Given that this paper is positioned as an initial sustained contribution to the ethics of trade credit, it has not been possible to consider all the relevant issues in depth, and the topic would repay further research. Further conceptual argument might challenge or extend our arguments, thus refining our discussion. For example, might a supplier ever be considered to have a positive duty to provide trade credit? When might it be acceptable for a trade debtor to delay payment, on what grounds and with what corresponding responsibilities? What are the ethical issues relating to debt factoring and invoice discounting? What further insights might the literatures on justice and fairness or on promise-keeping furnish? What information should companies be required to disclose about their payment practices? How might all this work through in different supply chain contexts? In addition to conceptual work, case studies of particular firms and supply chains would be helpful too. More systematic empirical research in this under-researched area is also needed. Possible projects might include determining whether some firms (e.g. generally more “responsible” ones) are more likely to pay on (good) time and investigating whether policy initiatives or tools (e.g. codes of payment practice) are effective in encouraging good payment behaviour.

Finally, although we have positioned this paper as a novel contribution to finance ethics, it has relevance to other aspects of business ethics too. In particular, trade credit should be factored into ethical analyses of, and debates about, supply chain ethics and responsibilities to suppliers and their stakeholders. It should also be considered as part of the terms of trade alongside the issue of fair or just prices where the transaction is between businesses rather than, according to the traditional focus, between businesses and consumers.

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