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Interest on late payments

All businesses have a legal right to claim interest from late-paying customers.

The statutory right to interest, introduced under the Late Payment of Commercial Debts (Interest) Act 1998, applies to all contracts agreed after 7 August 2002. Late payments create cashflow problems and expose businesses to the risk that they will not be paid.

This briefing covers:

- Who can charge interest on late payments.
- How to decide whether or not to claim statutory interest.
- How to calculate how much interest to charge.
- How to claim what you are entitled to.

1 Who can charge interest?

The statutory right to charge late-paying business customers interest applies to contracts which do not already include their own arrangements for 'substantial' interest. The right was introduced in three distinct phases.

1.1 Small businesses have been able to claim interest from large businesses and the public sector on contracts agreed since 1 November 1998.

1.2 On contracts agreed since 1 November 2000, small businesses have been able to claim interest on late payments from **other small businesses**.

1.3 All businesses and public sector bodies have been able to claim interest on late payments for sales agreed from 7 August 2002.

- All organisations also have a right to claim reasonable debt-recovery costs. Creditors can claim an extra £40 for debts of up to £1,000, £70 for debts from £1,000 up to £10,000, and £100 for debts of £10,000 or more.

Consumers remain unaffected by the law.

2 The rate of interest

2.1 The law gives you the right to charge interest at the Bank of England **base rate plus eight per cent**.

- For example, if the base rate is four per cent, you could charge interest at 12 per cent.

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By comparison, a business overdraft is typically charged at two to three per cent over base rate.

2.2 Rates for calculating interest are fixed for **six-month periods**.

- The base rate on 31 December will be used for debts becoming late between 1 January and 30 June. The rate in force on 30 June will be used from 1 July to 31 December.
- To find out the base rate, call the Bank of England's Public Enquiries Unit (020 7601 4878) or visit www.payontime.co.uk.

3 Should you charge interest?

Although the rate of interest is high, the total amount of money involved may only be a few pounds. Think what charging interest and costs might do to your relationships with your customers.

3.1 Consider how **customers** are likely to react.

- Determine if late payment is limited to a few of your customers, or if most of your customers pay late.
- Ask front-line employees (eg in sales) for their opinions.

3.2 Assess the effectiveness of **your credit control system**.

- If you are ineffective at collecting money owed to you, customers may strongly object to being asked to pay interest and debt-recovery costs.
- See **Credit control** for information on creating a credit control system that is appropriate to your business needs.

What difference does it make?

Under the law, company finance directors who have made a habit of taking extra credit from suppliers to improve cashflow may have to think again.

A There will be **less free credit** to be had just by paying slowly.

- The 'base rate plus eight' formula means money 'borrowed' by delaying payment will be more expensive than overdraft money from the bank.

B **Attitudes** towards late payment should change for the better.

3.3 Find out what **other businesses** in your industry are doing.

- Your trade association may be able to provide advice.
- Ask your customers if their other suppliers charge interest on late payments.

3.4 Remember that it is **not compulsory** to charge interest on late payments or debt-recovery costs.

- You retain the right to define your own terms and conditions. But customers cannot impose a contract denying you 'substantial' interest on late payment. And in the absence of any specific payment terms, the Act will apply.
- You can only claim the costs under the Act if you claim the interest under the Act. If you do not claim interest, or you claim it under a contractual provision or the provisions of a different Act, you cannot claim the costs.

See **Managing your cashflow**.

4 When is a payment late?

Under normal circumstances, you will have agreed with your customer when payment should be made.

4.1 A payment is late if it is made after the last day of the **agreed credit period**.

- Agreements may be verbal or in writing. Verbal agreements are harder to prove.

4.2 If there is **no agreed credit period**, the law sets a default period of 30 days.

- You can charge interest 30 days after you delivered the goods or provided the service, or 30 days after you notified the purchaser of the amount of the debt — whichever is the later.

To notify the purchaser of the amount of the debt, you should ideally send an invoice. But any other form of notification would do, including a phone call — though that might be difficult to prove if there is a dispute.

4.3 Where a **standard practice** on payment has become established, this is accepted — in the absence of any other agreement — as the credit period.

- For example, if the purchaser usually pays

you on the last Friday of the month after the month in which you send your invoice, this is when the credit period will end.

4.4 The **exact wording** of your agreement will determine when interest can start.

- If you have agreed on part payments triggered by the completion of part of the work — for example, finishing the foundations of a building — interest will start running from the day after you have reached that milestone.
- This is not the same as an advance payment or an instalment (which is not tied to a specific milestone). Interest on these starts the day after the goods are delivered or the whole job has been finished.
- Small and medium-sized enterprises, with up to 250 employees, can ask representative bodies — such as the Federation of Small Businesses and the Forum of Private Business — to go to court on their behalf to challenge grossly unfair contract terms used by purchasers which may affect their ability to recover interest on debts.

The clock ticks on

Claims for interest do not have to be made straight away.

- A** A supplier has **six years** in which to make a claim for interest on late payment, as long as trading terms were agreed and the customer was duly notified when interest began to accumulate.
- The six-year claims period is the same throughout England, Wales and Northern Ireland, but the period is only five years in Scotland.
- B** Businesses may still make claims for interest **after they have stopped** supplying goods or services to a particular purchaser.
- The only way for purchasers to be sure of avoiding future claims is to pay bills on time.
 - Liquidators and receivers acting in connection with a business can also pursue ex-customers for interest on late payments, going back up to six years.

5 Calculating the interest

Calculating the interest due is a straightforward, step-by-step process.

5.1 Calculate what the interest would be for a **full year**, by multiplying the amount owed by the total rate of interest (base rate plus eight per cent).

- For example, if the debt is £1,000 and the base rate is 4.5 per cent, then the annual interest would be $£1,000 \times 12.5 \text{ per cent} = £125$.

5.2 Calculate the **daily interest** by dividing the annual interest by 365.

- For example, the daily interest on this £1,000 debt is $£125 \div 365 = 34\text{p}$.

5.3 Calculate the **interest due** by multiplying the daily interest by the number of late days.

- For example, if the £1,000 debt were paid 30 days late, you could charge $34\text{p} \times 30 = £10.27$.

5.4 If there is no specific agreement to indicate otherwise, any **part payment** will go towards reducing the interest before it starts to be applied to reducing the original debt.

- For example, if you received payment of £1,000 in respect of the £1,010.27 now being charged, the amount outstanding would be £10.27 of the original debt. Interest on the £10.27 would continue to accrue.

5.5 The amount outstanding changes on a daily basis. Be **practical**, as payer or payee, about settling the debt.

- For example, agree that if the debt is paid within one week, then no further interest will be charged.

5.6 Your **VAT** position is unaffected. You charge interest on the gross amount of the debt (including any element of VAT), but you do not pay VAT on this interest.

Nor do you pay VAT on any debt-recovery costs you claim.

- In the example in **5.1** (above), the original £1,000 debt may be made up of £851.06 plus £148.94 VAT.

➡ Call the DTI for a free copy of 'The Late Payment of Commercial Debts (Interest) Act 1998: A User's Guide' (020 7215 5000).

6 How to claim interest

If you decide to start charging interest on late payments, you need to make provision for it as part of your routine credit control system.

Even if you do not usually intend to collect interest, draw attention to your rights in a revised 'terms and conditions' statement. It may encourage customers to start paying on time.

6.1 Notify each customer in writing. State that you will charge interest on late payments as you are entitled to do by law.

- Contact habitual late payers to discuss how the system will affect them. Explain that their late payments cost you money.

6.2 Ensure that your customers understand and agree to your **payment terms**.

- State the agreed payment date on each of your invoices.
- The invoice should clearly state your new terms and conditions, and that you intend to exercise your right to charge interest on late payments.

6.3 Inform customers when interest begins to accumulate. Give the following information:

- The original invoice number.
- What account the bill is for.
- How much is owed.
- The extra amount of interest the customer will owe you each day.
- To whom the payment should be made.
- Payment instructions.

6.4 Present the customer with a **final bill** once the interest and the original amount that was due have been paid.

- The final bill should specifically mention the number of days that interest has been charged for and the base rate that was used in calculating the interest.

7 What if a customer objects?

Despite the law, your customer may be unwilling to pay interest on late payment — but they cannot 'opt out' of doing so. In the interests of customer relations, try other ways of obtaining your money before considering legal action.

7.1 Make it clear that you would prefer to come to an **agreement** regarding the debt.

- If you cannot reach agreement with your customer, you can follow several approaches to obtain the money.

7.2 Consider applying pressure by placing this customer on a **stop list** until the debt has been paid. (See **Credit control**).

7.3 Consider **selling or passing the debt** (or part of it) to a third party, such as a debt collection agency (see **Debt recovery**).

- The purchaser of the debt can use the courts to obtain payment of the debt and the interest.

If you sell or transfer a debt, you must inform your customer in writing that it has been assigned to a third party.

7.4 You may ultimately want to pursue your claim for the original amount and interest through the **court**.

- Your claim will be helped if you can provide written evidence that you delivered the goods or completed the job, and that the customer was satisfied.
- If you have legal expenses insurance, this should encourage a non-payer to pay up when threatened with legal action. See **Suing** for more information on how to pursue a case.

8 Further help

Further advice on claiming and paying interest on overdue invoices is available from a number of sources.

8.1 Your **accountant** or financial adviser should have an understanding of the legislation and how it could affect your business.

8.2 Check with the **Better Payment Practice Group** (www.payontime.co.uk).

- The website offers an online interest calculator and you can submit through the site questions on late payment that experts will answer.

8.3 Your local **Business Link** can offer advice, or visit www.businesslink.org.

8.4 Check with the **Small Business Service** (www.sbs.gov.uk/finance/latepayments.php).

Further help

There are other Directors' Briefing titles that can help you. These briefings are referred to in the text by name.

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