



(REVIEW ARTICLE)



Trade Credit and Earnings Quality: Financial Reporting Credibility as a Determinant of Supplier Financing

Ahmed Bazan Chisthi *

Department of Engineering Management, Christian Brothers University.

World Journal of Advanced Research and Reviews, 2026, 29(02), 1439-1442

Publication history: Received on 17 January 2026; revised on 25 February 2026; accepted on 27 February 2026

Article DOI: <https://doi.org/10.30574/wjarr.2026.29.2.0455>

Abstract

Trade credit is traditionally explained as a response to financial constraints, information asymmetry, and relational contracting. However, less attention has been devoted to how the quality of financial reporting influences supplier credit decisions. This paper develops a conceptual framework linking earnings quality to trade credit availability and terms. Building on foundational theories of informational advantage and credit substitution, the analysis argues that suppliers rely not only on private transactional information but also on publicly observable accounting signals when determining credit extension. High earnings quality reduces uncertainty, enhances credibility, and facilitates more favorable credit terms, whereas low reporting quality increases monitoring costs and tightens supplier financing. Integrating insights from trade credit theory and accounting research—including recent evidence that suppliers differentiate between accounting-driven and real economic losses—the paper positions financial reporting credibility as a central determinant of trade credit dynamics. The framework offers testable implications using publicly available accounting measures and opens new avenues for empirical research at the intersection of accounting and corporate finance.

Keywords: Trade Credit; Earnings Quality; Suppliers; Financing Options; GAAP Loss vs Real Loss

1. Introduction

Trade credit represents one of the most pervasive forms of short-term financing in corporate practice. Suppliers routinely allow buyers to delay payment for goods and services, creating accounts payable and accounts receivable that often exceed short-term bank borrowing. While trade credit originates in operational transactions, it performs significant financial and informational functions.

The dominant literature explains trade credit through informational advantage, substitution for constrained bank lending, and relational contracting. Suppliers may possess superior information about buyer quality relative to banks, enabling them to extend credit efficiently. Financially constrained firms substitute trade credit for formal debt. Long-term supplier relationships motivate flexible repayment during temporary distress. These explanations have substantially advanced understanding of trade credit behavior. Yet a central question remains underexplored: How does financial reporting quality influence trade credit?

Suppliers observe both private operational information and public financial statements. When evaluating credit risk, they must interpret earnings performance, cash flow patterns, and balance sheet strength. The credibility of these accounting signals affects uncertainty and monitoring costs. If earnings are volatile due to aggressive accounting or opaque reporting, suppliers may tighten credit terms. Conversely, transparent and high-quality financial reporting may facilitate more generous credit.

* Corresponding author: Ahmed Bazan Chisthi

This paper develops a conceptual framework linking earnings quality to trade credit availability and contractual terms. By integrating accounting theory with trade credit research, it positions financial reporting credibility as a critical determinant of supplier financing decisions.

2. Foundations of Trade Credit Theory

The earliest formal analysis of trade credit is provided by Schwartz (1974), who argues that suppliers possess a monitoring advantage relative to financial intermediaries. Suppliers observe order frequency, delivery patterns, and inventory flows, enabling them to assess creditworthiness at lower cost.

Petersen and Rajan (1997) empirically demonstrate that financially constrained firms rely more heavily on trade credit, supporting the substitution hypothesis. Meltzer (1960) earlier suggested that trade credit redistributes liquidity during periods of tight monetary policy. Demirgüç-Kunt and Maksimovic (2001) extend this perspective cross-nationally, showing that trade credit plays a larger role where financial systems are less developed. Fisman and Love (2003) link trade credit to industry growth in constrained environments.

Contractual and relational perspectives further deepen understanding. Ng, Smith, and Smith (1999) show that trade credit terms embed incentives and risk-sharing mechanisms. Biais and Gollier (1997) formalize trade credit in credit rationing models under asymmetric information. Wilner (2000) and Cunat (2007) emphasize relational contracting and implicit insurance, demonstrating that suppliers may extend flexible credit to preserve long-term relationships.

Collectively, these studies establish trade credit as a mechanism shaped by information, financial constraints, and relational incentives. However, they generally treat financial reporting signals as background conditions rather than primary determinants.

3. Earnings Quality and Information Asymmetry

Earnings quality reflects the extent to which reported accounting numbers faithfully represent underlying economic performance. High-quality earnings are persistent, transparent, and supported by strong accrual quality. Low-quality earnings may involve aggressive accruals, income smoothing, or opaque disclosures.

In credit markets, information asymmetry plays a central role in determining financing terms. Lower information asymmetry reduces risk premiums and enhances credit access. While trade credit theory emphasizes suppliers' private informational advantages, public financial reporting remains a key signal of buyer health.

Recent evidence reinforces this connection. Hossain et al. (2025) demonstrate that suppliers differentiate between accounting-driven losses and real operating losses when extending trade credit. Firms reporting losses due to accounting treatments—such as expensing intangible investments—receive more favorable credit relative to firms experiencing genuine operational distress. This finding suggests that suppliers do not rely solely on headline profitability but instead interpret the composition and credibility of accounting signals.

If suppliers are sensitive to nuanced accounting distinctions, broader dimensions of earnings quality should similarly affect credit decisions.

4. Conceptual Framework: Earnings Quality as a Determinant of Trade Credit

The proposed framework rests on three mechanisms linking earnings quality to trade credit. First, higher earnings quality reduces uncertainty about future cash flows. Suppliers extending credit effectively provide short-term financing based on expectations of repayment. Persistent and transparent earnings enhance confidence in buyer solvency, lowering perceived default risk.

Second, reporting credibility reduces monitoring costs. When financial statements are reliable, suppliers require fewer additional verification procedures. Lower monitoring costs make credit extension more efficient and may translate into longer payment terms or larger credit limits.

Third, earnings quality influences relational trust. Trade credit often depends on implicit trust within ongoing supplier relationships. High-quality reporting signals managerial integrity and reduces concerns about opportunistic behavior. This reputational channel complements informational mechanisms.

Conversely, low earnings quality increases perceived risk. Aggressive accruals, restatements, or opaque disclosures may trigger supplier caution. Credit terms may shorten, discount windows may narrow, and monitoring intensity may increase. These dynamics suggest that financial reporting credibility operates alongside private informational advantages in shaping trade credit outcomes.

5. Implications for Trade Credit Terms

Beyond credit volume, earnings quality may influence the structure of trade credit contracts. Ng, Smith, and Smith (1999) demonstrate that payment terms reflect negotiated incentives. High-quality reporting firms may secure more favorable discount terms or extended payment periods. Relational contracting theory suggests that suppliers reward trustworthy buyers with flexibility. If reporting transparency enhances trust, firms with stronger earnings quality may experience greater contractual adaptability during temporary liquidity stress.

Furthermore, suppliers facing limited information about distant or new customers may rely more heavily on public financial statements. In such cases, earnings quality becomes even more central to credit decisions.

6. Broader Implications for Accounting and Finance

Integrating earnings quality into trade credit theory enriches both accounting and finance literatures. For accounting researchers, trade credit provides an alternative outcome variable through which to assess the economic consequences of reporting quality. For finance scholars, incorporating reporting credibility deepens understanding of informal credit markets.

The framework also suggests that improvements in disclosure standards and audit quality may indirectly influence working capital dynamics. Stronger reporting regimes could facilitate trade credit expansion by reducing uncertainty within supply chains.

Importantly, empirical tests of these ideas do not require proprietary transaction-level data. Publicly available accounting measures—such as accrual quality, restatement frequency, earnings persistence, and audit quality—can be linked to observable trade credit proxies, including accounts payable ratios and payment cycle metrics.

7. Conclusion

Trade credit has traditionally been framed as a substitute for bank finance and as a response to informational asymmetry mitigated by suppliers' private knowledge. This paper extends that view by positioning earnings quality and financial reporting credibility as central determinants of supplier financing decisions. Drawing on foundational trade credit theory and recent accounting evidence, the framework argues that high-quality financial reporting reduces uncertainty, lowers monitoring costs, and enhances relational trust, thereby facilitating more favorable trade credit terms. By bridging accounting and corporate finance perspectives, the analysis opens new avenues for research on the informational foundations of informal credit markets.

Future empirical work can examine whether firms with stronger earnings quality receive more generous trade credit, particularly in settings where private information is limited and public financial statements play a larger role in credit evaluation.

References

- [1] Biais, B., & Gollier, C. (1997). Trade credit and credit rationing. *The review of financial studies*, 10(4), 903-937.
- [2] Cunat, V. (2007). Trade credit: suppliers as debt collectors and insurance providers. *The Review of Financial Studies*, 20(2), 491-527.
- [3] Demirgüç-Kunt, A., & Maksimovic, V. (2001). *Firms as financial intermediaries: Evidence from trade credit data* (Vol. 2696). Washington, DC: World Bank.
- [4] Fisman, R., & Love, I. (2003). Trade credit, financial intermediary development, and industry growth. *The Journal of finance*, 58(1), 353-374.

- [5] Hossain, J., Bhuiyan, J., Rahman, A., & Dao, M. (2025). Accounting-Driven Losses and Trade Credit. *Accounting & Finance*.
- [6] Long, M. S., Malitz, I. B., & Ravid, S. A. (1993). Trade credit, quality guarantees, and product marketability. *Financial management*, 117-127.
- [7] Meltzer, A. H. (1960). Mercantile credit, monetary policy, and size of firms. *The review of Economics and Statistics*, 429-437.
- [8] Ng, C. K., Smith, J. K., & Smith, R. L. (1999). Evidence on the determinants of credit terms used in interfirm trade. *The journal of finance*, 54(3), 1109-1129.
- [9] Petersen, M. A., & Rajan, R. G. (1997). Trade credit: theories and evidence. *The review of financial studies*, 10(3), 661-691.
- [10] Schwartz, R. A. (1974). An economic model of trade credit. *Journal of financial and quantitative analysis*, 9(4), 643-657.
- [11] Wilner, B. S. (2000). The exploitation of relationships in financial distress: The case of trade credit. *The journal of finance*, 55(1), 153-178