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THE ROLE OF BUYER AND BANK RELATIONSHIPS ON BUYER TRADE PRACTICES: THE CASE OF SMALL BUSINESS FIRMS

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ABSTRACT

This study assesses the trade practices used by firms in developing countries using Eritrea as a case. The study specifically focuses on the effects of short term bank financing on buyers' trade approaches. It examines ***what*** *types of trade approaches the buyer firms use (cash, credit, and/or both). Then it studies if these approaches are influenced by the existence of buying firm and bank relationship (as measured by* ***availability and need for bank loan, terms of bank loan, reason for not getting bank loan and availability of other sources of short term financing****). As a result, the role of banks and buyer firm relationship has been verified. The research has revealed that, firms with positive response to the* ***existence*** *of financial institutions that provide short term financing buy more on both cash and credit compared to those that said "no". Furthermore, the firms who get short term bank loan buy more on both credit and cash compared to those who said that they do not get bank loan. Finally, the findings of this paper sustain the concept that, buyer firms with better relations with banks rely less on trade credit and more on short term bank loan (Petersen, Rajan 1994). The paper offers insights to executives of companies to govern the buyer-bank relationship in order to diversify and expedite short term financing using the bank option. Implications of these findings and future research directions are discussed.*

KEYWORDS: *Trade, cash, credit, firms' characteristics, buyer firm, banks, developing countries, Eritrea.*

INTRODUCTION

Generally, the dual business objectives of firms are the profitability objective - creation of value to investors by increasing revenues/cash inflows and deceasing costs/cash outflows on one hand and the liquidity objective - controlling the risk of liquidity on the other. One of the major tools that help in the achievement of these objectives is a policy of trade credit. Trade credit helps to create value to investors by increasing revenues but potentially exposes business firms to risk of liquidity because it may decrease cash inflows by postponing cash collection to the future (NG et al., 1999).

The use of trade credit depends upon the prevailing characteristics of the firm, the product and the environment. Firm characteristics include (a) firm's own characteristics; (b) inter firm linkages with suppliers and customers and (c) firm bank relationships. Researchers have found out that the characteristics of firms have different applicability in both developed and developing countries. Considerable research has been conducted to assess the trade credit determinants including firm and bank relationships (e.g., Pike et al., 2005; Marotta, 2005; McMillan & Woodruf, 1999; Deloof & Jegers, 1996). Yet, previous research has given little attention to trade credit determinants in the developing countries, like Eritrea. However, the prevalence, use and influence of buyer firm and bank relationships on trade practice on Eritrean business firms, is yet to be researched. So far as the researchers' knowledge is concerned, there has been no research made with an objective to find the motive, the extent nor the types of influence of buyer firm and bank relationships on trade practice in the business firms in Eritrea. Basically, there are three ways through which business firms, trade (sell and buy) their goods and services: on cash, credit, and both. This study, therefore answers the following research questions using Eritrean firms:

1. What are the trade practices used by buyer business firms in Eritrea?
2. Does firm bank relationship influence buyers' trade approaches?

THE RESEARCH METHODOLOGY

For this study, we have followed Bouma and Atkinson (1995) proposal. They propose an outline of three phases in the research process. The first phase requires a researcher to clarify the issues to be researched and select a research method. In this phase the researcher has to select, narrow and formulate the problem to be studied, select the research design, design and devise measures for variable, set-up tables for analysis and select a sample or the units of analysis. The second phase concerns the collection of data about the research question, summarizing and organizing the data. The third and final stage relates to the analysis and interpretation of data including relating data to the research question, drawing conclusions, assessing the limitations of the study and making suggestions for further research.

MEASURES

Drawing on the literature review and guided by the research framework, first the variables/concepts considered relevant to the study have been identified, defined conceptually and operationalized. The second step was the preparation of the questionnaire and execution of a pilot study on 10 respondents (firms' managers). A pilot study was done in order to test whether [a] the questionnaire would enable us to gather the desired data, and [b] the respondents understand the concepts and measurements. After conducting the pre-test or pilot study and making all necessary adjustments, 200 questionnaires were distributed to the respondents.

A cross-sectional survey research method is chosen as a preferred method for our research using exploratory and descriptive study approaches. Our survey generalizes the trade practice used by all business firms in Eritrea from a sample of 200 firms at Zoba Maekel. We have preferred the survey approach due to its advantage over economy, speed of data collection and its advantage in identifying attributes of a population from a small group of individuals (Creswell, 1994).

We distributed questionnaires to 200 firms (from the manufacturing, service and merchandising business sectors) of which 100 were sellers and 100 were buyers. In addition to the questionnaires, data has also been collected from the firms' financial statements of five years (2004 to 2008). All respondents returned the questionnaires (100% response rate). The 200 firms (sample) were randomly selected from the 2205 firms of the Central Zone, provided by the Ministry of Industry and Trade (MoTI, 2010). The Central Zone is the most industrial region of the country.

Firms' managers were asked to give us their opinions on their trade credit policy and practice. For example, managers are asked (a) what trade approaches they use (cash or trade credit or both) and (b) how they apply their approaches or (c) why they do not apply otherwise. Most questions provide a number of alternative answers and end-up with "others" so that the managers input their own reasoning. In administering questionnaire, data collectors were properly selected in that they all had a minimum of diploma in accounting with very good grade in working capital management. Second, they were given orientation on the objectives and data collection approaches. Third, they were given official letters introducing the researcher and the data collector. Fourth, they contacted each respondent personally or by telephone. On the appointment date the data collector hands over official letters that identify the researcher and data collector. The data collector then explained the objective of the study and how the respondent can fill in and then submit the questionnaires. This may take around 30 minutes. At least one reminder call is made by the data collector a day before the date of the appointment. When collecting the questionnaire about 15 minutes is taken to explain questions that the manager may have and appointment made for the conduct of interview. Upon collection, the questionnaire is imputed to the data summary sheet and notes of inconsistencies or unfilled questionnaires taken.

Our main objective was is to find out if the buyer firms' relationship with the banks in the form of - credit rationing influence the use of trade credit. As a proxy to measure the firms' relationship with the banks we used the managers' opinion on the availability of bank loans. If the answer is "yes" to availability of bank loans, we asked if the bank loan is for short or long term and if the answer is "no" how they solve their short term financing problems. In other words, as a proxy to obtain and measure information we used the managers' opinion: First, on the firms' trade practice, (if they trade on cash, credit or both). Second, information on the firms' availability and need of bank loan, terms of financing bank loan, otherwise reason for not using bank loan and availability of other alternative sources of financing short-term deficits. Finally, we assessed if the second is influenced by the first. Conceptually, we expected that buyer firms with better relations with banks rely less on trade credit and more on short termbank loan (Petersen, Rajan 1994). Moreover, buyers can reduce cost of financing short term borrowing if they are not credit rationed. They can borrow from banks and pay during trade credit discount period, thereby taking advantage of the relatively lower bank interest rate and therefore trade more on credit than on cash.

FINDINGS

Table 1: Availability of Bank Credit (credit rationing) vs trade credit

Do you get bank loan	No of firms	Cash only	Credit only	Both
Yes	15(15%)	1(6%)	0	14(94%)
No	85(85%)	33(39%)	2(2%)	50(59%)

As indicated in table 1, we asked the firms "whether they get bank loan or not". All the 100 firms responded to the question and 85% said "no" they do not get and 15% said "yes" they get bank loan. As the table indicates, 94% of those who said "yes", buy both on credit and cash and 15% buy only on cash. From the firms which said "no" 59% buy both on credit and cash and 33% buy only on cash basis.

Table 2: Term of bank financing Vs trade credit

For how long do you get bank loan?	Number of firms	Cash only	Credit	Both
Short-term	9(26%)	3 (33%)	0	6 (67%)
Long-term	5(15%)	2(40%)	1(20%)	2 (40%)
Both short-term and long-term	20(59%)	6 (30%)	1 (5%)	13 (65%)
Total	**34**(100%)	**11 (32%)**	**2 (6%)**	**21 (62%)**

Regarding the terms of bank financing, as indicated in table 2, out of the 34 firms which responded to the question, 59% get both short-term and long-term bank loan, 26% get only short-term loan and 15% get only long-term loan. Comparison between the bank term borrowing and the buying policy shows that, from the short-term borrowers, 67% buy both on credit and cash and 33% buy only on cash. Out of the long-term borrowers, 40% buy both on credit and cash and 40% only on cash. From those which borrow both on short and long -term, 65% buy both on credit and cash and 30% buy only on cash.

Table 3: Reason for not getting bank loan Vs trade credit

Why do you not get bank loan?	Number of firms	Cash only	Credit	Both
Banks do not give bank loan	5(8%)	1(17%)	0	4(83%)
Do not need loan	33(53%)	10(30%)	0	23(70%)
Other	24(39%)	9(37%)	0	15(63%)
Total	62(100%)	**23 (36%)**	**0**	**42 (64%)**

As for the reason why the firms do not get bank loan (see the table 3), 53% said that they do not need bank loan, 8% said banks do not give loan and 39% said other such as: Banks have no foreign currency to lend, high bank interest rate, do not know how to take bank loan, bank regulations on taking loan is very strict and do not have the fixed asset for collateral. As table 3 indicates, when the reasons for not getting bank loan are compared to the use of trade credit, 83% of the buyers who responded that banks do not give loan buy both on credit and cash and 17% buy only on cash. On the other hand 70% of those that said they do not need bank loan buy both on credit and 30% buy only on cash.

Table 4: financing short-term deficits

How do you finance your short term financing needs?	Trade credit	Additional investment	Retaining earning	Other
Number of respondents (total 53)	17	13	14	9
Percentage (%)	32%	25%	26%	17%

As table 4 reveals, 32% of the firms finance short term needs with trade credit, 26% with retained earnings, 25% with owner's additional investment and 17% with other means such as: "borrow from relatives".

Table 5: Financial institutions that can provide short-term financing vs trade credit

Are there financial institutions providing short-term financing?	No of firms	Cash only	Credit only	Both
Yes	**15**(15%)	1(6%)	0	14(94%)
No	**85**(85%)	33(39%)	2(2%)	50(59%)
Total	**100**(100%)	34(34%)	2(2%)	64(64%)

As table 5 shows, 85% of the firms believe that "there are no financial institutions that can provide short-term financing" and only 15% said "yes". Then we checked if those managers who said "yes" to the existence of financial institutions buy on cash by borrowing from the banks. Finding show that (see table 11 again), 94% buy both on cash and credit and only 6% buy on cash only. And out of the 85 firms, who said "no", 64% buy both on cash and credit, 33% buy on cash and 2% buy on credit only.

Table 6: Source of Short-term Financing - frequency of use

No	Source of Short-term Financing	No. of firms	frequency of use- 0 - never, 1- rare, 2 - frequent		
			0	1	2
1.	Bankers' (guarantee) acceptances	49	37(75%)	8(16%)	4(9%)
2.	Accounts payable (Trade Credit)	49	20(41%)	21(43%)	8(16%)
3.	Accruals	51	35(70%)	11(22%)	5(10%)
4.	Bank overdraft	46	38(83%)	3(7%)	5(10%)
5.	Bank short term loan	49	45(92%)	3(6%)	1(2%)
6.	Secured borrowings with accounts receivable as collateral	51	46(90%)	4(8%)	1(2%)
7.	Secured borrowings with inventory as collateral	50	45(90%)	4(8%)	1(2%)
8.	Secured borrowings with guarantee of another bank customer	51	48(94%)	0(0%)	3(6%)
	Total		318(80%)	55(14%)	25(6%)

Overall as the research findings indicate (see table 6) majority (75% - 94%) of the firms said that they never use any of the 9 sources of short term financing. Relatively, trade credit, accruals and Bank overdraft are used to some extent the other sources of short term sources of short term financing are not used. The most frequently used source of short-term financing is Accounts Payable (Trade Credit) where 43% of the firms use it rarely, 42% never use it and 16% use it frequently. For accruals 22% of the firms use it rarely, 70% never use it and 10% used frequently. Bank overdraft 7% of the firms use it rarely, 83% never use it and 10% used frequently. The remaining 5 sources of short term finance are almost never used.

DISCUSSION

The main objective of this study was to examine the extent to which buyers' trade practice, (trade on cash, credit or both), is influenced by buyer firm and bank relationship. We have used managers opinion on the availability and need for bank loan, terms of bank loan, reason for not getting bank loan and availability of other sources of short term financing to measure buyer firm and bank relationship. To that end, we performed a number of analysis (Tables 1-6). The findings of this study suggest that, the vast majority of the findings were in line with previous studies (e.g., (NG, 1999), Pike, Cheng, Cravens, Laminmaki, (2005).

The findings exposed that most of the respondents believe generally that there are "no" financial institutions providing short-term financing. However, firms with positive response to the existence of financial institutions that provide short term financing buy more on both credit and cash compared to those that said "no". The firms who responded that they get bank loan buy more on both credit and cash compared to those who said that they do not get bank loan.

We found that the firms who said they can borrow from banks buy more on both credit and cash compared to those who said have no option of borrowing from banks. This finding strengthens the concept that firms that get bank loan for the short period buy more on both credit and cash compared to those that said do not get bank loan. They can borrow from banks and pay during trade credit discount period, thereby taking advantage of the relatively lower bank interest rate and therefore trade more on credit than on cash. This implies buyers reduce cost of financing short term borrowing if they are not credit rationed. The findings on the reasons for using (not using) bank loan shows that those that said Banks do not give loan buy more on both credit and cash compared to those who said that they do not need bank loan.

Conceptually, we expected that firms with better relations with banks rely less on trade credit and more on short term bank loan (Petersen, Rajan 1994). In line with this, if there are no financial institutions that can provide short-term financing, buyers will have to buy more on credit.

CONCLUSION, STUDY IMPLICATIONS AND FUTURE RESEARCH DIRECTIONS

We started the search study by reviewing literature that researchers and academicians disclosed in their writings. The result of the literature review was the conceptual framework and theoretical expectations from which the data collection survey questionnaires and interview were designed.

Little is empirically known about the trade approaches firms use, how they apply their approaches, why they opt for those approaches and if the buyer trading approaches are influenced by firm and bank relationship and cooperation in developing countries. This study empirically examined the trade approaches firms use in one developing country, Eritrea. We have used managers' opinion on the short term bank loan - availability, need, terms, reason for not getting and availability of other sources of short term financing, to measure firm and bank relationship and cooperation.

The research has revealed that generally buyers believe, there are "no" financial institutions providing short-term financing. However, firms with positive response to the existence of financial institutions that provide short term financing buy more on both cash and credit compared to those that said "no". Furthermore, the firms who get short term bank loan buy more on both credit and cash compared to those who said that they do not get bank loan.

Conceptually, buyer firms with better relations with banks rely less on trade credit and more on short term bank loan (Petersen, Rajan

1994). Moreover, buyers can also reduce cost of financing short term borrowing if they are not credit rationed. They can borrow from banks and pay during trade credit discount period, thereby taking advantage of the relatively lower bank interest rate and therefore trade more on credit than on cash.

The research shows that buyer firm and bank relationship is weak and therefore business firms in Eritrea have scarcity of sources of short term financing. Findings on the frequency of use of other sources of short term financing, such as bankers' (guarantee) acceptances, bank short term loan, secured borrowings with guarantee as collateral of accounts receivable, inventory and other bank customer is also very weak.

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