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THE ROLE OF SELLER FIRM CHARACTERISTICS ON 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. The study uses Eritrea as a case study and delves into the types of trade approaches firms use (cash, credit, and/or both), how they apply their approaches and why they opt for those approaches. The study specifically focuses on the effects of size and age of seller firms to use trade credit and the possible reasons for selling on cash and credit. On the aspect of trade credit, it also includes the maximum number of credit period in days, and actions taken if customers do not pay within the credit period. Implications of these findings and future research directions are discussed.

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

INTRODUCTION

Firms may be financed by their suppliers using trade credit rather than by financial institutions. Firms need finance to operate and make short-term and long-term investments. Finances can be generated internally by retaining profits or funds obtained externally through the injection of capital or getting credit (or loan) from financial or non-financial organizations. The first option is more difficult and expensive for small and new firms (Coleman, 2003; Wilner, 2000), as it is the case with most of the business firms in Eritrea, because it requires successful business

operation. The second option is neither easy for these firms because it requires trust of the lender. Moreover, the generation of financing power by building up trust may relatively be easier in the short-term than generating it internally. Most firms in the developing world and specifically in Africa and by default in Eritrea are small (in terms of capital base and sales/profit) and therefore presumably getting problems of external financing both in the short and in the long-term. This problem could be solved by trading on properly applied credit terms (Coleman, 2003). Yet, previous research has given little attention to trade credit determinants in the developing countries, like Eritrea. However, the prevalence, use and influence on trade practice of these characteristics 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 trade credit used by the business firms in Eritrea.

Basically, there are three ways through which business firms sell their goods and services: on cash, credit, and both. This study therefore answers the following research questions using Eritrean firms:

1. What are the sales and purchase policy used by the business firms in Eritrea?
2. To what extent they sell their goods and services on cash and why?
3. To what extent they sell their goods and services on credit and why?
4. To what extent they sell their goods and services on cash and credit and why?

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. 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. According to the size in number of employees, firms are grouped into three categories: small size firms (with less than 10 employees), medium size firms (with 11-50 employees), and large firms (with more than 50 employees). Likewise, according to the size of sales, firms are grouped into three categories: small size firms (with sales less than ERN 15,555,000), medium size firms (with sales ranging b/n ERN 15,555,000 & 46,665,000, and large size firms (with more than ERN 46,665,000). On the basis of the five year average total investment in assets, they are also grouped into three categories: small size firms (with less than ERN 21,216,000), medium size firms (with ERN ranging between 21,216,000 & 63,648,000), and large size firms (with more than ERN 63,648,000). According to their age, the firms are grouped into three categories: Young (with less than 10 years since establishment), medium (with age ranging between 11 and 50), and old (with more than 50 years old).

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.

FINDINGS

Data that has been collected using questionnaires, interviews and archival records are analysed. The primary data collected using questionnaires and interviews are used to study the approaches of trade credit used by the Eritrean firms. The secondary data collected from financial statements are used to study the implication of the managerial approaches particularly on liquidity and profitability. The findings are presented as follows:

Table 1: Sales Policy

Sales policy on cash/credit					Sales policy on proportion of cash and credit		
Cash On Delivery	Cash Before Delivery	Cash only	Credit	Both cash & credit	More cash	More credit	Equal
32(32%)	6 (6%)	38(38%)	0 (0%)	62 (62)	60 (83%)	11(10%)	5 (11%)

As shown in Table 1, relatively more firms (62%) sell both on cash and credit and 38% sell only on cash (on or before delivery). Out of the 62 firms that sell both on cash and credit 83% sell more on cash, 10% sell more on credit and only 7% said they sell equally on cash and credit.

Table 2: Trading on cash

Characteristics of customers buying on cash (sellers' responses)				
New	Old	Small	large	Liquid
73 (31%)	51(22%)	42 (18%)	22 (9)	47 (20)

Table 2 also portrays that 31% of those who buy on cash are new customers, 22% are old (long relational experience) customers, 18% are small customers, 20% of those who buy on cash are liquid and 9% are large customers.

Table 3: Possible reasons for selling on cash

Selling on credit is not necessary	Offering credit is not customary	It is difficult to identify trustworthy customer	others
17 (19%)	21 (24%)	28 (31%)	23 (26%)

As shown above, Table 3 reports the reasons why firms sell only on cash, 32% of them said because it is difficult to identify trustworthy customers, 24% of them said because offering credit is not customary, 19% of them said they sell only on cash because selling on credit is not necessary, and 26% of them said because of other reasons.

Table 4: Trading on credit

Characteristics of customers buying on credit				
New	Old	Small	large	Liquid
2 (2%)	57 (57%)	5 (5%)	26 (25%)	15 (14)

Table 4 discloses that 54% of those who buy on credit are old (long relational experience) customers, 25% of them are large customers, 14% of them are liquid customers, 5% of them are small customers, and 2% of them are new customers.

Table 5: Possible reasons for selling on credit and maximum number of credit period in days

Reasons for selling on credit				Number of credit period in days				
To increase sales	To create customer confidence	Both	Other	10	30	60	90	90
10 (13%)	25 (33%)	28 (37%)	13 (17%)	9 (12%)	35 (48%)	13 (18%)	5 (7%)	11 (15%)

According to Table 5, 33% of them sell on credit to create customer confidence, 13% of them to increase sales, 37% of them to increase sales and create customer confidence and 17% of them for other reasons. Further, Table 5 reveals the maximum number of credit period in days that firms offer to your customers. 12% of them said 10 days, 48% of them said 30 days, 18% of them said 60 days, 7% of them said 90 days, and 15% of them said other.

Table 6: Actions taken - if customers do not pay within agreed credit period

Give more time	Communicate orally, written, in person.	Stop selling on credit until the debt is paid	Solve the case amicably	Take the case to the court	Other
16 (18%)	22 (25%)	19 (21%)	30 (34%)	0	2 (2%)

Table 6 reports that all of them (100%) said that they never take the case to the court. Moreover, 34% of them said that they solve the case amicably, 25% said they communicate orally, in written or in person, 21% said they stop selling on credit until the debt is paid, 18% give more time. Only 2% of them said that they use other mechanisms such as telling them by telephone and then going to their work place to ask personally.

Table 7: Size in sales, number of employees, and investment vs trade credit practice

		Cash On Delivery	Cash Before Delivery	Cash only	Credit only	Both cash & credit
Size: Number of employees	Small	26 (37%)	2 (3%)	28 (40%)	0	43 (60%)
	Medium	3 (17%)	3(17%)	6(34%)	0	12 (66%)
	Large	3 (27%)	1 (9%)	4 (36%)	0	7 (64%)
	Total	32 (32%)	6 (6%)	38 (38%)	0	62 (62%)
Size: Sales	Small	20(45%)	2(4%)	22(49%)	0	23 (51%)
	Medium	1 (17%)	1 (17%)	2 (34%)	1 (17%)	4 (66%)
	Large	3 (20%)	1 (7%)	4 (27%)	0	11 (73%)
	Total	24 (36%)	4 (6%)	28 (42%)	0(%)	38 (58%)
Size: Investment in Asset	Small	17 (50%)	0 (%)	17 (50%)	0	17 (50%)
	Medium	1(11%)	2(22%)	3(33%)	0	6 (67%)
	Large	2 (20%)	0 (%)	2 (20%)	0	8 (80%)
	Total	20 (38%)	2 (4%)	22 (42%)	0(%)	31(58%)

As indicated in Table 7, when size as measured by number of employees is taken as a proxy, all 100 firms do not use the policy of selling on "credit only". Moreover, relatively more firms (62%) sell both on cash and credit and the 38% sell only on cash. Out of the 11 big firms 64% sell both on cash and credit and the remaining 36% sell only on cash. 18 firms were average in size out of which 66% sell both on cash and credit and credit and the remaining 34% sell only on cash. 71 firms were categorized as small in size out of which 60% sell both on cash and credit and the remaining 40% sell only on cash. Sales as a measure of size (see Table 7) also show that all 66 firms, which responded to the enquiry said they do not use the policy of selling on "credit only". Moreover, relatively more firms (58%) sellboth on cash and credit and the 42% sell only on cash. Out of the 15 big firms 73% sell both on cash and credit and the remaining 27% sell only on cash. 6 firms were average in size out of which 66% sell both on cash and credit and credit and the remaining 34% sell only on cash. 45 firms were categorized as small in size out of which 51% sell both on cash and credit and the remaining 49% sell only on cash. In addition, Investment as a measure of size (see Table 7) shows that all 53 responding firms do not use the policy of selling on "credit only". Moreover, relatively more firms (58%) sell both on cash and credit and the 42% sell only on cash. Out of the 10 big responding firms 80% sell both on cash and credit and the remaining 20% sell only on cash. 9 firms were average in size out of which 67% sell both on cash and credit and the remaining 33% sell only on cash. 34 firms were categorized as small in size out of which 50% sell both on cash and credit and the remaining 50% sell only on cash.

Table 8: Age (years since establishment) vs Trade Credit Practice

Age	Cash On Delivery	Cash Before Delivery	Cash only	Credit only	Both cash & credit	Total
Young	26 (37%)	2 (3%)	28 (39%)		43 (60%)	71(71%)
Average	3 (17%)	3 (17%)	6 (34%)		12 (66%)	18 18%)
Old	3 (27%)	1 (9%)	4 (36%)		7 (64%)	11 11%)
Total	32 (32%)	6 (6%)	38 (38%)	0 (%)	62 (62%)	100 (%)

As shown in Table 8, all 100 firms responded and said that they do not use the policy of selling on "credit only". Moreover, relatively more firms (62%) sell both on credit and cash and the 38% sell only on cash. 71 firms were categorized as young in age out of which 60% sell both on cash and credit and the remaining 40% sell only on cash. 18 firms are medium in age out of which 662% sell both on cash and credit and the remaining 34% sell only on cash. Out of the 11 old firms 64% sell both on credit & cash and the remaining 36% sell only on cash.

CONCLUSIONS, LIMITATIONS, AND FUTURE RESEARCH

It must be noted that trade approaches firms use are not something new but there are scarcity of studies on trade approaches firms use in developing countries and little is empirically known about the trade approaches firms use (cash, credit, and/or both), how they apply their approaches and why they opt for those approaches in developing countries. Thus, this study empirically examined the trade approaches firms use in one developing countries, Eritrea.

While this study is an important step forward in understanding the trade approaches firms use in developing countries like Eritrea, it has some limitations. First, this study was conducted in only one developing country (Eritrea) and that restricts the generalization of the findings to other developing countries. Thus, in order to generalize and validate the findings of this study, we suggest that a similar study be conducted in other developing countries. That is, additional research is needed to examine the robustness of the findings and generalizations. In spite of the above limitations, however, this study addresses several gaps [literature] in trade approaches firms use in developing countries, like Eritrea. First, this study is the first in its kind. Second, this study has examined the extent to which different firms' characteristics affect the trade approaches firms use in Eritrea, which to our knowledge has not been studied. And thus, it can be seen as an important addition to the literature on the trade approaches firms use in developing countries.

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