

# **EFFECT OF TRADE CREDIT ON FINANCIAL PERFORMANCE OF SMALL SCALE ENTERPRISES: EVIDENCE OF ELDORET TOWN, KENYA**

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## **Abstract**

*This paper describes the relationship between trade credit and SME financial performance for a sample of 50 audited Kenyan Small and Medium Enterprise firms. It discusses on how trade credit affects three measures of financial performance namely; liquidity, profit margin and return on assets. Documentary guide was used in the study to collect secondary data and the data collected were keyed and coded into SPSS package version 20. Analysis was conducted using both inferential and descriptive statistics specifically mean and standard deviation. Inferential statistics where Pearson correlation coefficient to determine the degree of relationship while Multiple regression model was used to test the hypotheses. Findings indicated that trade credit positively affected liquidity, profit margin and return on assets. The results appear to be consistent with pecking order theory by SMEs in pattern of using trade credit instead of other external source of finance.*

*Keywords: Trade credit, liquidity, profitability, return on assets, small and mediums enterprises*

## INTRODUCTION

Trade credit is dynamic. Researchers have realized trade credit as the most important alternative to bank loans as a source of external funding in the SME sector (Demirgüç-Kunt and Maksimovic, 2001). Moreover, several authors have demonstrated how trade credit provides a safety valve for firms facing idiosyncratic liquidity shocks (Wilner, 2000; Boissay & Gropp, 2007; Cunat, 2007). Rodríguez (2006) argued that through trade credit, suppliers can reduce the transaction costs associated with the liquidation of each individual commercial exchange.

In Kenya, most of the firms are young and small. According to Ferrando and Mulier (2012) small and young SMEs are more likely to be financially constrained, and hence they rely more on the trade credit channel to manage growth. However, to our knowledge very few studies have shown Trade credit relationship with financial performance of SME. In addition, these studies have only been conducted in developed countries, where methodologies used cannot be applied in developing countries like Kenya.

This paper addresses the above gap in the literature by analyzing the role of trade credit on SMEs financial performance, thus shed some additional light on the robustness of their results.

## GROUNDING THEORY

Trade credit has been indicated to be an important source of finance for SMEs, particularly to those SMEs with difficulties in obtaining external funding via credit institutions such as Banks. Recently, trade credit in the form of accounts payable and receivable of euro area non-financial firms have moved broadly in line with the business cycle. This confirms the typically procyclical pattern of accounts payable and receivable, as they are closely linked to the exchange of goods and services and hence, to economic activity (Ferrando & Mulier, 2012). However, for developing countries this cycle has not been observed.

Studies have concluded that SMEs with low credit worthiness are likely to be more financed by suppliers, where liquidation is more likely to occur. Thus, high interest rates associated with trade credit reflect the fact that low quality firms choose this type of financing from their suppliers (Rodríguez, 2006).

In their study Fisman and Love (2003) investigated the relationship between trade credit substitutability for institutional financing and the overall development of the financial sector. They found that in countries with poorly developed financial markets, industries that use more trade credit grow relatively faster. Similarly, Boissay and Gropp (2007) in their study concluded that firms that are confronted with a liquidity shortage (shock) try to overcome this distressed situation by passing on one fourth of the shock to their suppliers by taking more trade credit.

Sola et al., (2012) in their study found a positive linear relationship between trade credit and firm performance derived from the fact that the benefits associated with trade credit surpass the costs of vendor financing. Furthermore, the effect of receivables on firm profitability differs depending on certain firms' characteristics. According to the financial motive for trade credit, larger and more creditworthy firms will extend trade credit to their smaller customers thus increasing firm's sales and generating an implicit rate of return. In this sense, we find unconstrained firms, e.g., larger and more liquid firms obtain higher returns on receivables as compared to smaller and less liquid firms. The operational motive for trade credit predicts that firms with variable demand will extend more trade credit than firms with relatively stable demand.

Bougheas et al., (2009) indicated that more production is related with higher cost of production which for a given amount of liquidity in a firm operating with more trade credits. They concluded that for a given liquidity, an increase in production will require an increase in trade credit. In contrast, Boissay and Gropp (2007) argued that firms that are facing liquidity try to pass on one fourth of the stock to their suppliers through trade credit in order to overcome this distressed situation.

Also, Cunat (2007) argued that fast growing firms may finance themselves with trade credit when other types of finance are not sufficiently available. Moreover, Petersen and Rajan (1997) revealed that firms with high profit margins, i.e. those that would benefit most from making additional sales via price discrimination, indeed have higher accounts receivable. More recent, Bougheas et al., (2009) argued that accounts receivable are important for the performance of inventory management

Finally, Ferrando and Mulier (2012) argued that firms provide more trade credit to customers that are in temporary distress. This also enhances their sales, since otherwise the distressed customer would not be able to buy the goods. Firms will however only offer additional trade credit when they believe there is a future surplus of having a long-lasting relation with that customer (Cunat, 2007).

## **METHODOLOGY**

The researcher employed a descriptive research design. This study was carried out in Eldoret town. The town is among the fastest growing towns in Kenya. The town is located in North Rift region, Uasin Gishu County in Kenya. Documentary guide was used to collect secondary data from 50 SMEs whose capital structure comprised of debts financing as reflected in their audited financial statements.

Table 1. Measurement of variables

Variables	Measurement
Trade Credit Ratio	Accounts payable/total purchases (Rodríguez,2006)
Profit Margin Ratio	Gross profit/sales
Return on Assets	Net Income/total assets Michaelas (Chittenden & Panikkos, 1999)
Current ratio	Current assets/current liabilities

Pearson correlation coefficient was used to determine the degree of relationship between trade credit and financial performance. Multiple regression analysis was used to predict the financial performance of SMEs.

These regression equations are outlined below:

$$y_i = \beta_1 + \beta_1 x_1 + \varepsilon$$

Where:

$Y_i$  (i= 1.....3) = Profit Margin ratio, Liquidity and Return on Asset

$X_1$  = Trade Credit

$\varepsilon$  = error term.

## EMPIRICAL RESULTS

Findings in table 2 indicated descriptive statistics of the trade credit (independent variable) and the three dependent variables namely: profit margin ratio, liquidity ratio and return on asset ratio (ROA). Results from the Table showed that SMEs were making 61.07% of gross profit out of total sales. Liquidity ratio was highest as evidence of 0.5881. More findings showed that SME had an average of 50.28% trade credit in their total purchases.

Table 2. Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Profit Margin Ratio	150	0	3.62	0.6107	0.74898
Liquidity Ratio	150	0	3.24	0.5881	0.72115
Return On Asset	150	0	2.64	0.5023	0.66888
Trade Credit	150	0.01	3.47	0.5028	0.46159

Results showing correlation between variables were depicted in table 3. Findings revealed that trade credit was positively associated with liquidity ( $r=.230$ ), profit margin ( $r=.207$ ) and return on asset ( $r=.145$ ) in descending order. In general, trade credit was correlated with overall performance of SME financial performance.

Table 3. Correlation Statistics

	Performance	Profit margin ratio	Liquidity ratio	Return on asset	Trade credit
<b>Performance</b>	1				
<b>Profit Margin Ratio</b>	.232**	1			
<b>Liquidity Ratio</b>	.395**	.329**	1		
<b>Return On Asset</b>	.210**	.281**	0.038	1	
<b>Trade Credit</b>	.264**	.207*	.230**	0.145*	1

\*\* . Correlation is significant at the 0.01 level (2-tailed).

\* . Correlation is significant at the 0.05 level (2-tailed).

Linear regressions in table 4 showed three models each with one independent variable. Viable results were presented providing enough evidence to conclude that trade credit had significant positive effect on profit margin ratio ( $\beta=.19$ ). Trade credit also affected liquidity positively ( $\beta=.221$ ) significant at 0.05. Similarly, trade credit had positive and significant effect on returns on asset ( $\beta=.134$ ). Thus, having trade credit positively affecting the three measurements of firm performance, we can therefore infer that trade credit directly related to SME financial performance.

Table 4. Regression results

	Model 1, Dependent Variable: Profit margin ratio		Model 2, Dependent Variable: Liquidity ratio		Model 3, dependent variable: Return On Asset	
	Beta	t	Beta	t	Beta	t
Trade Credit	0.19*	2.175	0.221*	2.999	0.134	1.755
ANOVA (F ratio)	17.539		0.21		0.27	
ANOVA (Prob)	0		0.194		0.261	
R Square	0.265		12.92		8.408	
Adjusted R Square	0.25		.000a		0	

\*significant at 0.05

Dependent Variable: Profit margin ratio , : Liquidity ratio, : return on asses

## DISCUSSION OF FINDINGS, CONCLUSION AND RECOMMENDATION

Trade credit had positive effect on liquidity of SMEs. These findings are in contrast with Bougheas et al. (2009) that for a given amount of liquidity in a firm, firm tends to operate with more trade credits. Similarly, Boissay and Gropp (2007), argued that firms that are facing liquidity problems try to pass on one fourth of the stock to their suppliers through trade credit in order to overcome this distressed situation. The study is also consistent with Pecking Order Theory, developed by Myers and Majluf (1984), that under information asymmetry, firms favor internal over external financing, short-term over long-term debt and the issue of shares. This theory is relevant to SMEs because of their limited access to external capital (Holmes and Kent, 1991).

More findings indicated that SMEs with more trade credit tend to improve their profitability; this is contrary to Pérez (2012) that firms with high net profit margin probably have more liquidity since they earn more from their economic activity and thus the reason why they take less trade credit.

SME return on asset was positively determined by level of trade credit. According to Bebczuk (2004), the higher the return on asset the lower the probability of default and therefore the higher the probability of obtaining a loan.

Based on unique findings, this paper provides several insights on the effect of trade credit on financial performance on the part of small and medium enterprises in Kenya. Some provocative results that deserve further investigation are the low effect of trade credit on profit margin ratio, which scholars say is major determinants of SME performance. This study was however, limited to secondary sources for its data, thus suggesting more study like the same using primary data through the use of a 5-point likert scale.

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