RELATIONSHIP BETWEEN CORPORATE DEVELOPMENT AND SHORT-TERM CREDIT DYNAMICS

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Abstract:

It is an established fact all firms need, for achieving long-term development, long-term financing sources – most important being, among them, retentions and bank loans; but, long-term development is definitely not possible if the firms' experiences in meeting its financial leverage, i.e. in maintaining and bolstering its liquidity. This is no minor benchmark: liquidity of a firm is nothing less than its ability to meet its obligations without selling/mortgaging its fixed assets – indispensable to long-term development. Putting it in another light, long-term finance sources cannot replace short-term ones, i.e. short-term credit, especially if firm´s economic cycle is adaptable/adapted to – or even designed for – using as a rule short-term financing. Furthermore, a basic route to long-term development, a sustained increase in sales volume, needs a good use of short-term credit.

Key words: financing sources, trade credit, debt

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Introduction

The financial structure of a company is the sum of all financing sources that participate to the setting of a firm's composition (Tirole, J. (2006), p.118; Stancu, I. (2003), p.643) of capital invested in the company, and thus to:

- Financing current activity of the company;

- Financing the (extensive) of the company.

It's necessary to outline, from the very beginning, that the financial structure of a company, cannot be confused with the capital structure of the company – as happens sometimes in the literature; in fact, capital structure of a company is the (main) component of the financial structure due to the fact that:

a. the company's capital structure includes only long term financing sources (Brealey, R.A., Myers, S.C., Allen, F. (2014), p.54);

b. in addition, the financial structure of the company includes both long term and short-term financing sources.

The reason for which the trade credit is a distinct component of the financial structure - instead of being "absorbed" as part of "Credit" - e.g. "Short-term credit" - needs including in this paper, an explanation, one built of several arguments.

Firstly, due to the fact that, on average and in market economies in general, trade credit may be considered an ideal tool – e.g. free for financing – literature distinguishes two components of trade credit, the first being free, while the second it isn't - and, technically, cannot be – free (Ehrhardt, M.C., Brigham, E.F. (2011), p. 670):

- free trade credit

- costly trade credit.

The first component of trade credit refers to what constitutes trade credit transactions that were conducted within the discount period, and the second component comprises trade credit transactions conducted outside the discount period.

Consequently, trade credit becomes expensive - which is not mandatory, ineffective or inefficient, when the cost of contracting and using is higher than the other sources of financing investment projects.

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Furthermore, technically speaking, the trade credit is (Ehrhardt, M.C., Brigham, E.F. (2011), p. 789) a debt assumption generated by the selling goods or services of a company on credit (e.g. to another firm), registered debt:

a) in an account receivable from the supplier or

b) in an account payable (debt) by the purchaser.

From this point of view, it’s obviously that this type of credit, the trade credit, is significantly different from the short term bank credit, by the fact that it not only supports or finances, daily productive operations - or generally short term, but it is literally one of the manifestations form of this activity.

And this, all the more, at least in a market economy, as trade credit is designed to function in together with the company production cycle itself - including, and especially, by calibrating it, in principle, at least, to maturity commercial credit, calculated according to period driven by sales cycle of goods (Dobrotă, N. *et al.* (1999), p.146).

There are, of course, short-term lending limits, beyond which it becomes inefficient, if not absolutely useless: in a market economy, at least, the credit process, of any type, cannot finance investment projects, e.g. long-term investment for development a business of a company; in return, however, the same short-term lending process - i.e. trade credit - is indispensable production cycles normal course of business.

These remarks are very precious for our approach of critical analysis for the determinants of a company's financial structure, because it outlines one of the most important determinants of its functions, namely the designing of desired financial structure of the firm characteristics (materialized as such of) the structure and activity of the company.

Thus, till now, has been expressly outlined in the literature, one of the objective conditioning that leads to the necessity of investigating the ways for realizing the desired financial structure (i.e. desired, ultimately, by the firm's shareholders) of the company, the need to choose between (Tirole, J. (2006), p.141):

(I) the total payment to investors, mainly in the form of a fixed amount predetermined to creditors

(II)the same payment, also mainly, in a more flexible manner to shareholders.

In this field, the determinants of the financial structure of a company are (and will be) identifiable by management of any firm, as the first effect of daily performing of undertaken management processes to ensure the company operation itself - in other words, for and through its short-term dynamics – in the process of developing the firm’s development strategy - which means, for its long-term dynamics.

Regarding the calibrating perspective for the short-term company’s functioning, and therefore of financial structure, the need to choose between creditors and shareholders, as an absolute majority of firm’s investors, is (in economic terms) satisfied by reliance on short-term loans - including trade credit.

In this way – in the sense described above – short-term financing of the company is, in principle, viable, given the payments to the creditors can or even have to be made at a (pre) determined maturity.

We can conclude, therefore, that financial structure of a (relatively) strong company, that act - or might act - in an oligopoly must adjust development strategy in the long term, and implicitly the financial structure taking into account the following preconditions:

1. maintaining sales volume at a (sufficiently) high level;

2. (acute) necessity of increasing profit size – in long-term.

At microeconomic level, these conditionings could be considered as manifestations of a determinant of a company's financial structure, namely the strengthening of a dominant market position on the basis of intensive use of short-term lending – and especially trade credit.

Regarding trade credit, in its quality of essential financing source for operations of the company, and simultaneously of advantageous form of short-term lending, some observations will clarify the (potential) role of commercial credit in making financing decision, by analyzing factors that influence the efficient use of this form of lending.

Thus, for the beginning, it must be stressed that, especially in a hostile environment from financial perspective, commercial credit can be an indirect solution for financing investments at microeconomic level, i.e. by preserving the financial funds of the company to be used later to finance investments, funds that would otherwise be destined for short term financial needs.

Results obtained

In addition, in practice, the proportion of firms that use trade credit, in modern market economies, from the entire range of investment funding sources, is circumscribed by the following characteristics (*The Use of Trade Credit by Businesses* (Reserve Bank of Australia - September Quarter 2013), p.1):

I. trade credit can be used as a tool for operationalization the *price discrimination*

II. trade credit can be used by companies in order to verify the quality of acquisitions before paying for them

III. this type of loan is at the same time, an important source of external financing for companies that are not listed on the stock market (Ibid, p.2).

Price discrimination, is, on the one hand, accessible practically only to large companies, and in particular those companies that act as monopolies (Mankiw (2006), p. 326). On the other hand, trade credit will be conducive to a company, in the context of practicing price discrimination - from the point of view of financial engineering, of practicing it by its creditors - if the monopoly that play or could play the role of lender (Ibid., p. 328) in the trade credit mechanism:

1.will face a high mobility of sold product / products in multiple markets – connected to each other (Ibid., p. 327- *Exempli gratia*, through e-commerce is possible to acquire a cheaper product from a foreign market than directly from the Romanian market);

2.will have difficulties in the ability of measuring the debtors desire / possibility to pay a given price;

3.fails to decrease the price size down to the marginal cost price.

At least equally important is the observation of the fact trade credit is of the outmost importance for unlisted companies in their need to finance themselves - and not only for the latter.

It is, thus, a *directly* advantage for companies that benefit from holding such shares, the fact that companies that issue such securities have a good financial situation; in other words, it is a direct advantage obtained by an *indirect* way.

Cost quantification of (using) different financing sources is carried out according to two fundamental criteria regarding the structure and operation of those sources, namely:

- Source of funding resources, that decide calculation the value of one of the two types of costs of the financing sources use, respectively:
  1.The **cost** of financing sources using that do not come from the company's investors, but from its stakeholders and from:
    - a.Banks (in this case, by granting short-term loans)
    - b.Suppliers and, possibly
    - c.Employees

  2.The **capital cost** of financing sources provided by firm's investors (e.g., shareholders and banks - by granting long-term loans)
- The *lifetime sources* of financing (Ibid., p. 342) according to which is calculated:
  1.The **cost of** short term **debt** - contracted to finance the (current) activity of the company and as such, being outside the scope of permanent sources of financing

  2.The **capital cost** of long-term financing sources used to finance the firm's investment

In summary, for the components of financial structure of the company that, on the one hand, are made available by the stakeholder and, on the other hand, represent, in principle, the foundation of firm's (current) financing activity is calculated the cost of using, whereas for the elements that compose the capital structure – in strict terms – is quantified the cost of capital (of using for financing investments at the microeconomic level).

1.The cost of financing sources contracted by the company and used by this in short-term, or, more clearly, the cost of short-term financing is high, i.e. short-term financing is expensive - for company - basically, when is used mainly, being high, at least the relative cost of this type of funding.

The mainly using of short-term financing sources will not be used typically for any company, but only in cases tell them, 'special', as we shall demonstrate below.

On the one hand, generally in any market economy, the cost of financing sources borrowed and used by the company in the short term is relatively high - that is, non- negligible - big enough to endangering the existence itself of the company, by bankruptcy risk materializing, given the following economic and financial circumstances (Ehrhardt, M.C., Brigham, E.F. (2011), p. 703):

(1)Firstly, short-term loans (especially those granted by banks) are generally riskier than long-term loans;

(2)Secondly, a firm that borrows financial funds of sensible sizes in the short term - from any source whatsoever - is likely to fail after the (sudden) outburst of a recession, given following effects of recession will substantially affect the company:

a.The company will find very hard to meet its obligations towards its creditors;

b.The company will not be able to obtain an expansion /extension of the loan (e.g., in short-term).

On the other hand, there are a number of strengths of short term financing sources, but only in the situation in which the economic cycle of the company is designed specifically to use, or at least to be compatible with its support of short term financing; thus, the company's activity, in such a case, will have a number of characteristics, the most important being (Ibid., p. 703):

(I)the financial funds need registration with a cyclical or seasonal rhythm - which, moreover, should be emphasized, do not need a long-term funding, due to the fact that interest rates are generally lower for the short term (banking) loans those for the long term;

(II)framing the moments in which occurs the need for financial funds in a descending trend in the short term (i.e. achieving an economic activity in the near future of which the need of financial funds decreases, following that in the future cycle of time to return at previous (high) level.

To measure the amplitude of all these financial dynamics – emphasize, in the short term - is used, most often, the called current liquidity ratio, whose calculation formula is: current assets/current liabilities.

This ratio is extremely important, due to the fact that the result of ratio above is relevant both for a supplier – i.e., if you borrow a trade credit - and for a bank – given the decision to grant a bank loan; in either of the two situations, the frame that describes the quality of credit using can be characterized in the following terms (Ross, S.A., Westerfield, R.W., Jordan, B.D. (2013), pp. 57-58):

a)the lender is in a more favorable position as the value of current liquidity ratio is higher - in this case, than 1;

b)the debtor obtained from the magnitude of the current liquidity ratio, information about both effectiveness of trade credit and the management of the business itself, given that:

i.good or high value (≥ 1) may indicate

1.a good company form the perspective of liquidity existence

2.a poor condition of the company, because of the inefficient use of liquidity and, respectively, other short-term assets

ii.a value low than 1 suggests the existence of a negative net working capital, an unusual situation for a "typical" ("average") company.

The existence or usefulness of liquidity - in this case, the financial funds obtained in the short term - for a company in terms of trade credit (where it is supposed to play the role of the debtor) can appreciate more precisely by circumscribing the value of trade credit cost.

This value is, in fact, as important as the amount of current liquidity since the current liquidity indicates the quality of the financial perspectives of the company – e.g., the future size of financial funds needs – whereas the quantification of the cost of using trade credit by the company reflects the today efficiency of investment.

Turning to the trade credit analysis it must be emphasized that ***it acts as a multiplier of the financial resources*** obtained by the firm in the short term, given the magnitude of these resources increases directly proportion to:

1. the increase in sales volume, according to the following dynamics:
   the increase in sales volume → development the production capacity of the company → the increase of company production → a new increase of sales volume
2. *the* extension of deadlines for returning the amounts (of credit period) through the operation represented by amounts received as trade credit grow even without an increase in actual sales.

Future directions to be approached

This multiplier paradigm is in itself quite daunting, because it shows further investigations are needed for determining the *true* characteristics of multiplier's mechanism; in other words, for determining whether financial resources *alone* are required to put this mechanism in motion.

This is a rather important component of the theory of trade credit. For, given what can be conceived as its closest 'relation', i.e. the multiplier found in macroeconomics – both in theory and, what is most important, in practice – it is essential to clarify what *this* multiplier, namely trade credit, is made of.

The economy possesses a number of self-adjusting mechanisms, the multiplier being one of the most important, given a *market* economy is based on spending; thus, the multiplier process 'ensures' a change in spending will generate a *larger* (in relative quantitative terms) adjustment of total expenditure, the main lever being marginal propensity to consume (MPC) (Schiller, B.R. (2003), p. 207).

MPC is, itself, the reflection of consumer behavior, whose mechanism is derived from the very structure of consumption, that is (Ibid., p. 2130):

a) autonomous consumption – i.e., consumption 'free' of *income* factors/influences;
b) induced consumption – i.e., consumption based on income factors/influences.
In our analysis, the investigation needed has the object of determining whether trade credit is a function of only sales volume, or is influenced of such factors as 'consumer' confidence – in this case, *purchaser* confidence.

Conclusions

Companies carrying out "typical" economic activities will use short term financing sources only in order to finance the (current) activity of the firm, not to finance its investments; in this case, the relative cost of short-term financing will be reduced, and, anyway, will not reach too high a level, at least not in 'average' circumstances and not against firm's own goals and interests.

On the other hand, however, it is clear a well-managed company *should* find it within its grasp to finance, through use of short-term credit and especially of trade credit, its day-to-day activities, so that short-term/trade credit *will* finance its project investments, be it indirectly.

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