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# The Role of Credits and Bank Guarantee Letters in Financing Trading Companies

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## Abstract

*Banks provide businesses with a multitude of bank instruments which may be used to finance and develop the business of entrepreneurs. Of these, credit and guarantee instruments are the most commonly used.*

*This paper aims to identify financing alternatives to classical loans so that businesses can carry out their work by attempting to outline the impact of credit instruments as well as of guarantee instruments used at trading company level on economic and financial indicators and on cash flow. The achievement of this approach is useful in the relationship between entrepreneurs and banks, so that the most suitable bank instruments can be used to develop the business in a changing business environment.*

**Key words:** economic and financial indicators, bank guarantee letters, bank credit, cash flow, bank instruments
**J.E.L. classification:** G21, G32

## 1. Introduction

Access to financing is essential for the development of trading companies, the most important direct sources of external financing for SMEs being credit lines, bank loans and leasing.

According to a survey conducted at EU level and published on November 30$^{th}$, 2016, for 9% of SMEs in the EU, the main concern is the access to financing, the percentage of companies expressing concerns about access to financing declining from 16% in 2009 to 9% in 2016.

Collett et al. (2014) have directed their research to highlight the impact of indebtedness on companies in times of crisis. Other researchers (Lawless, 2013) analysed alternative financing sources, so companies can record an economic growth and secure their cash flow.

The purpose of this paper is to highlight the importance of credits granted to companies, but also of guarantee instruments to business development in an environment subject to change and increase in cash flow.

After a review of the scholarly literature, the paper presents the research methodology, detailing the way we identified the analysed enterprises, the software used and the judgment for their choice, the data collection and processing method, followed by the data analysis and interpretation, the calculation of the main economic and financial indicators, the determination of the cash flow and the enunciation of conclusions.

## 2. Literature review

There are a diversity of types of credit to finance businesses, among which the most used are: credit line, credit for temporary stock financing, credit for seasonal stock financing, overdraft credit, operating global credit, discount credit, export pre-financing credit, investment credit, refinancing credit.

Unlike credits, bank guarantee letters, sui generis guarantee instruments do not involve cash availability and are found in a variety of fields and obligation relationship. They can take the form of tender guarantee in public procurement proceedings by which, for example, it is guaranteed the solvency of the tenderer; the contract performance bond whereby the risk of the proper fulfilment or non-fulfilment of the contractual obligations is protected; the maintenance letter to ensure the beneficiaries against the risk of incurring repairing costs during the warranty period; the bank guarantee letter for payment (of the price or advance); the credit guarantee and counter-guarantee letter, etc. (Cioc, 2000).

As a rule, the guarantee letter is issued by a bank, thereby it irrevocably and unconditionally undertakes that in case the principal debtor fails to fulfil their obligations by the due date and under the conditions assumed under the contract (concluded between the principal debtor and the guarantee beneficiary), to pay the guarantee beneficiary the amount expressly indicated in the contents of the bank guarantee letter.

The bank guarantee letter is a means of facilitating transactions concluded between parties between which there is no required cash availability or there is no guarantee of honouring the mutual obligations, representing an instrument to guarantee contractual obligations.

It is worth mentioning that bank guarantee letters reduce the risk of international transactions between professionals, being an efficient and simple instrument that confers on the beneficiary the certainty that the business partners will fulfil their obligations assumed under the concluded contracts.

The outbreak of the international economic crisis has led to a sharp decline in the financing sources and liquidities of entrepreneurs, with severe consequences on their performance, but especially on the relationship with the business environment. Under these circumstances, numerous studies in the scholarly literature belonging to researchers or international bodies have focused on the use of alternative sources of financing (Lawless, 2013).

Capital is an indispensable element of the business and plays an important role in the general protection of credit institutions against the risks to which they are exposed. In this respect, the size and especially the structure of capital are essential in determining the risk profile of credit institutions. In line with the requirements of the Basel III Agreement, the quality of the capital base and new standards in liquidity management are required to strengthen banks' ability to absorb shocks, avoiding the use of public funds for recapitalization, with beneficial effects also targeting consumers, investors or governments. Medar (2011), Dănilă (2012), Egami & Yamazaki (2013) concluded that there should be close ties between business and banking environments, so that, in the long run, sustainable and effective crediting can be ensured, based on financial capital, with effects on the increase in the enterprise performance and the development of the entire business environment.

In 2013, Brigo highlighted that a better understanding of the credit risk is the starting point for finding alternative financing solutions. At the same time, Joseph (2013), Gaganis et al. (2010), concluded that, if used with caution, credit can create wealth, and Castro (2013), Alessi et al. (2014) concluded that understanding the credit risk is the best way to use credits.

The aim of the research conducted in recent years has been to reduce indebtedness and increase cash flow at entrepreneurial level. Thus, it has been demonstrated that the regional background is of great importance in the formation of the entrepreneurial capital (Drakopoulou and Hynes, 2012; Kibler, 2013), but the resource shortage is easier to be financed by innovative companies that have ties with casual experienced entrepreneurs, having relations with external partners (Fitjar et al., 2013).

The requirement to reduce corporate indebtedness, the business financing, and the cash flow generation has prompted international bodies to focus their attention more on bank guarantee letters.

Unfortunately, during the period from 1999 to 2009, bank management did not give due importance to bank guarantee letters, preferring an infusion of funds into the economy amid the economic growth.

## 3. Research methodology

For the purpose of the research, we have selected 40 companies operating in the field of manufacturing and whichduring the period from 2013 to 2017 used credit instruments and guarantee instruments provided by banks for carrying out the activity. The specificity of the activity of the selected companies for the research is industry, due to the complexity of the crediting and guarantee instruments used in this field.

Within the 43 selected companies, 22 entrepreneurs who financed their activity by credits and 18 entrepreneurs who secured their business using bank guarantee letters were identified.

In the design of the research we used the software DIAFIN and RISC.ev., both being some of the most complex educational software, by which a dynamic analysis of the main economic and financial indicators and the cash flow can be performed.

In order to perform the analysis, we used the data reported in the annual financial statements for the period 2013-2017, submitted by the trading companies subject to research. On the basis of the accounting information entered in the annual financial statements, we were able to calculate the main economic and financial indicators and cash flows, after which we generated their average mean by the two groups of entrepreneurs studied.

## 4. Findings

Starting-up a business often involves risk-taking, usually underlying the success or failure of a business. When talking about a bank credit, we refer to a short, medium or long term commitment, whether it is an operating or investment credit.

Bank credit is the most well-known source of business financing, but it may be a costly choice for start-ups, as there are quite stringent rules in granting the financing, and companies have to meet several conditions, which many times prove to be difficult to be met by small businesses or businesses not having yet a history.

In order to get a credit from the bank, the company will have to come up with real guarantees worth at least the amount of the credit. These guarantees are represented by real estate, equipment, passenger vehicles owned by the company or the entrepreneur who is willing to put them as a mortgage or pledge in favour of the bank in order to obtain the financing. There may, however, be other types of guarantees other than those listed, such as: guarantee funds, re-re-guarantee, guarantee letters from other banks, etc. By means of bank guarantee letters, these funds guarantee companies wishing to obtain repayable credits.

Using the DIAFIN and RISC.ev software, the main economic and financial indicators for the analysed companies were calculated, averaging the indicators by the two groups of studied entrepreneurs, as shown in Table 1 and Table 2.

Following the processing of the end-of-year financial statements for the 22 companies that financed their activity through credits, a synthetic financial situation was drawn (table no. 1). Please note that the average values of the indicators for the 22 analysed companies are shown in the table.

*Table no. 1 Abridged financial statement of the 22 companies that financed their activity during the period from 2013 to 2017 using bank credits*

| Indicators | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|
| Sales of commodities + Income generated by assets (thousand lei) | 5170 | 4135 | 3446 | 2061 | 1183 |
| Ordinary operating profit/loss (thousand lei) | 520 | 470 | 413 | 225 | 99 |
| Profit (loss) before payment of interest and profit tax (thousand lei) | 567 | 501 | 455 | 268 | 154 |
| Net operating profit/loss (thousand lei) | 420 | 386 | 309 | 138 | 73 |
| Added value rate (%) | 23.8 | 21.1 | 20.8 | 18.1 | 22.1 |
| Net return on sales (%) | 14.0 | 15.1 | 12.1 | 11.3 | 12.3 |
| Net financial return (%) | 66.3 | 74.8 | 73.3 | 128.7 | 68.1 |
| Interest coverage (no.) | 12.2 | 11.1 | 10.0 | 7.8 | 1.7 |
| Total of debit entries (thousand lei) | 3071 | 2456 | 2047 | 961 | 792 |
| Equity (thousand lei) | 624 | 509 | 416 | 106 | 106 |
| Total liabilities (thousand lei) | 1901 | 1596 | 1353 | 854 | 684 |
| Total financial liabilities (thousand lei) | 761 | 598 | 507 | 150 | 104 |
| Current liquidity (%) | 75.9 | 64.3 | 50.1 | 46.0 | 34.1 |
| Immediate liquidity (%) | 37.1 | 26.1 | 25.1 | 21.1 | 17.2 |
| Current solvency (%) | 160.5 | 152.8 | 150.2 | 111.5 | 114.7 |
| Overall indebtedness (%) | 303.3 | 312.1 | 323.7 | 798.0 | 639.1 |
| Financial indebtedness (%) | 120.9 | 116.4 | 120.8 | 140.1 | 97.1 |
| Net working capital (thousand lei) | -136 | -140 | -38 | -151 | -189 |
| Working capital requirement (thousand lei) | -96 | -159 | -112 | -141 | -158 |

*Source:* author processing

Following the processing of the end-of-year financial statements for the 18 companies that secured their transactions through bank guarantee letters, an abridged financial statement was drawn (table no. 2). We mention that the table shows the indicator average values for the 18 companies analysed.

*Table no. 2 Abridged financial statement of the 18 companies securing transactions during the period from 2013 to 2017 using bank guarantee letters*

| Indicators | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|
| Sales of commodities + Income generated by assets (thousand lei) | 4901 | 4310 | 3209 | 1915 | 1217 |
| Ordinary operating profit/loss (thousand lei) | 469 | 327 | 307 | 196 | 122 |
| Profit (loss) before payment of interest and profit tax (thousand lei) | 486 | 350 | 327 | 210 | 131 |
| Net operating profit/loss (thousand lei) | 409 | 294 | 275 | 177 | 110 |
| Added value rate (%) | 20.2 | 18.1 | 17.9 | 21.0 | 20.0 |
| Net return on sales (%) | 12.1 | 10.2 | 13.0 | 9.8 | 11.3 |
| Net financial return (%) | 67.4 | 50.7 | 53.7 | 44.5 | 38.6 |
| Interest coverage (no.) | 38.9 | 27.2 | 25.1 | 23.5 | 15.9 |
| Total of debit entries (thousand lei) | 3417 | 3215 | 2610 | 1112 | 903 |
| Equity (thousand lei) | 598 | 569 | 503 | 390 | 279 |
| Total liabilities (thousand lei) | 1811 | 1619 | 1210 | 708 | 509 |
| Total financial liabilities (thousand lei) | 109 | 126 | 97 | 55 | 61 |
| Current liquidity (%) | 159.1 | 156.2 | 169.1 | 146.1 | 136.4 |
| Immediate liquidity (%) | 100.2 | 96.1 | 79.0 | 71.1 | 67.1 |
| Current solvency (%) | 187.6 | 197.5 | 214.6 | 155.9 | 176.2 |
| Overall indebtedness (%) | 301.5 | 283.2 | 239.2 | 180.3 | 181.1 |
| Financial indebtedness (%) | 17.3 | 21.2 | 18.4 | 13.3 | 21.1 |
| Net working capital (thousand lei) | -147 | -97 | -101 | -137 | -113 |
| Working capital requirement (thousand lei) | 119 | 146 | 86 | 57 | 104 |

*Source:* author processing

The analysis of the two tables reveals that a series of indicators (the current result for the year, the sales of goods, the result before the payment of interest and profit tax, the net result for the year) registered a significant decrease both among the companies financing their business by bank credits, and companies that secured their transactions through bank guarantee letters. However, the evolution of these indicators is not influenced by the two banking instruments, which is why this study does not intend to deepen their analysis.

It is worth noting that the net financial return has a better level for companies that have financed their business through bank credits, while the value of the interest coverage indicator is better for companies that have secured their transactions through bank guarantee letters.

Also, the companies that secured their transactions through bank guarantee letters registered a positive working capital requirement for the entire analysed period, unlike those who financed their activity through bank credits and registered a negative working capital. This is due to the fact that in the case of the companies that secured their sales by guarantee letters, the banks have fed their current assets if the selling companies did not make the payments in due time.

The regularity with which companies using bank guarantee letters have collected their receivables from clients has determined positive cash flow values for these trading companies.

Positive cash flows were also due to the fact that the supplying companies used the advance payment guarantee letters issued by banks as veritable financing instruments because they financed their businesses with the advances received from the beneficiary companies. Beneficiary companies have also been confident that they would get their advances back if supplying companies would not honour their obligation to deliver the products.

Performance bonds issued by the banks of the supplying companies in favour of the beneficiary companies represented a counterweight to the payment guarantee letters issued by the banks of the beneficiary companies in favour of the manufacturing companies. In this way, the beneficiary companies were confident that the supplying companies will fulfil their contractual obligations in the amount and by the deadlines stipulated in the commercial agreements (Firică, 2011)

## 5. Conclusions

The credit risk involves the bank assuming the risk that, at the due date, the client will not be able to pay up its obligations to it. To this end, through its specialists, the bank needs to form a prudent opinion on the actual possibility of repaying the credit, and it must consider not only a first source of reimbursement for the payment of the obligation, but also a possible secondary source of recovery of receivables.

The crediting activity is based on the viability of business plans and on the ability of debtors to generate income and, respectively, liquidities, which is the main guarantee and source of credit repayment and interest payment, provided that their cash flow be assigned to the bank and run through the accounts opened with it.

The bank guarantee letter is the document by which a bank, namely the guarantor bank, will irrevocably commit to pay a certain amount of money to a beneficiary, if the principal debtor fails to do so. Through this *bank guarantee letter*, the beneficiary will always have the opportunity to claim the amount of money owed by the principal debtor. If the debtor fails to comply with the terms and conditions of the contract, then it is the bank that will have to pay the beneficiary the amounts of money entered in the guarantee letter.

The use of bank guarantee letters secures business contracts between companies, the main result being the generation of positive cash flows, which allows entrepreneurs to resort to bank credits to a lesser extent.

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