TRADE CREDIT: A REAL OPTION FOR BOOTSTRAPPING NEW VENTURES (SUMMARY)

Doug Bosse
University of Richmond, dbosse@richmond.edu

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SUMMARY

TRADE CREDIT: A REAL OPTION FOR BOOTSTRAPPING NEW VENTURES

Doug Bosse, University of Richmond, USA

Principal Topic

Trade credit is a common form of bootstrap financing among small firms. Trade credit refers to an agreement between the firm and a supplier where the supplier allows the firm to delay payment. This study views trade credit through a real options lens from the small firm’s perspective. Receiving trade credit that provides a discount for early payment creates a real option that directly affects the small firm’s cost of capital. Imagine Firm A pays its full balance on the tenth day and enjoys a two percent discount on the value of the exchange. Its competitor, Firm B, delays payment beyond the discount period therefore incurring a 36 percent annual cost of capital [360 days / 20 days = 18 times/year without discount; 18 x 2% = 36% discount missed on annual basis]. Given the difference in cost of capital incurred by these firms it is interesting that small firms often do not take the trade discounts they are offered. This dramatic affect on small firms’ cost of capital raises the central question that motivates this study: under what conditions do small firms exercise their real option to defer payment and, therefore, forego trade credit discounts when they are offered?

The hypotheses examined in this study are derived from real options theory. In this context, theory predicts the option to defer payment to suppliers is more valuable – and therefore more often chosen – when uncertainty about cash flow is highest.

Method

The 1998 Survey of Small Business Finances (SSBF) constitutes a representative sample of the five million small businesses operating in the United States as of year-end 1998. Given the research question guiding this study, we examine data on the 728 firms in the SSBF that were offered a trade discount. Regression techniques test the hypothesized relationships between uncertainty and the decision to forego trade discounts.

Results and Implications

We seek to explain common managerial behaviors regarding bootstrap financing in the form of trade credit discounts. Based on their inherent impact on cost of capital, these behaviors have tremendous influence on the growth and survival of small and entrepreneurial firms. We hope our results will enable managers and scholars to better anticipate the effect of various sources of uncertainty on small and entrepreneurial firm financial performance.

CONTACT: Doug Bosse; dbosse@richmond.edu; (T): 804-287-1922; University of Richmond, Richmond, VA 23173.