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Risk management in a buying group setting

– A case study of an administrating company in a buying group

Bachelor Thesis

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Abstract

Background and problem: The consumer electronics industry is changing and so is the role of the distributor. During the last couple of years actors within the industry have seen a change in market conditions. With increasing globalization resulting in borderless markets, consumers wield greater power in their negotiation with the producers. As manufacturers seek out opportunities of rationalizing the supply chain in order to meet consumer demands, the distributor's role is threatened. In this regard, Company A has shown great attentiveness and in order to survive has formed a buying group on a distributor level. This constellation presents many opportunities for the members but also numerous organization oriented risks. More specifically, Company A has experienced problems related to the method of payment that is used when doing international trade. As Company A and the buying group have experienced a surge in growth they are also faced with the probability of further future development. It has therefore become apparent to Company A that they are in need of an evaluation, addressing the current situation and entailing possible suggestions of alternative methods of payment. In order to manage the risks related to the international order placing process, the company has taken an interest in the implementation of Letter of Credit as a method of payment. **Method of research:** The thesis is based on a case study of the administrating company in the buying group. The research is based on qualitative interviews with staff at the company, bank associates and trade finance experts. **Purpose:** The thesis main purpose is to identify and evaluate risks related to the business concept with focus on payment methods. The secondary purpose is to evaluate the use of Transferable Letter of Credit as alternative payment method. In this thesis we started out by identifying three risk areas relevant to the business concept of the company. These areas were organizational risk, supply chain risk and competitive cost risk. In the context of these risk issues we have evaluated the possibility of implementing the use of Transferable Letter of Credit as a risk minimizing payment method. We have concluded that the company is exposed to various risks and for the company to be able to expand one needs to more efficiently manage these risks. Furthermore our evaluation of the possibility to implement Transferable Letter of Credit as payment method indicates that the organization with its complex structure is not applicable to this solution. **Subjects for further study:** As mentioned before the company needs to manage their risks related to the international payment method more efficiently. We suggest that one evaluates the organization and the members of the group in order to reach a higher degree of homogeneity. Furthermore one needs to evaluate other possible solutions for the international payment process.



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1. Introduction

Under this heading we will present the reasons why we have chosen the subject. Furthermore we will explain the problem that we will examine but also the delimitations and purpose of the thesis.

1. 1 Background

1.1.1 New market conditions for suppliers

About 10 years ago the implementation and utilization of Internet on a worldwide scale altered the competitive environment for all industries on all markets. With new technology, better communication possibilities and borderless trade opportunities within the European Union, consumers are in control. Even though the market has changed drastically, many actors have not. Within the consumer electronics industry there have been very few changes in the way business is performed for the last 20 years. The industry is famous for its distributor structure with major companies having independent representatives on the European markets.

With increasing awareness and consumer power the industry has been experiencing shrinking margins and greater pressure from the consumers. It is now possible for a consumer within the European Union, to buy the same product from a number of different suppliers in a multitude of European countries. In combination with the shrinking margins manufacturers are starting to question the traditional role of the distributor. Can one motivate the increasing cost that the distributor with its demand for margins adds to the final price the consumers have to pay? With the increased mobility and shortened distances within the European Union, is it necessary for a major manufacturer to have one independent distributor in each and every country instead of having one European distributor? These are the kinds of questions that arise and with the recent development, many distributors will need to motivate their existence, sooner rather than later. Mr. Bengt Erntsson, an industry expert employed by the industry organization, CE Konsumentelektronikbranschen, supports the scenario described above.

With this development in mind a rather small distributor on the Swedish Market, in this thesis referred to as Company A, decided that they needed to respond to the changes in the market. The company realized that the traditional role of the distributor is obsolete and in order to survive a new strategy and business plan had to be formed.

1.1.2 Company A

The consumer electronics industry has changed. Over the years one has gone towards an organization where production is outsourced to low-cost countries and focus is on research and development. Manufacturing of high quality consumer electronics has been liberated, enabling any actor on the market to purchase products under an own brand. Though this development Company A saw an opportunity to produce their own product under their own unique brand. In order to reach the volumes needed to start the production the company used



their extensive network of distributors and formed a buying group. The group is a co-operation between distributors all over Europe and Australia. What is unique about this buying group is that it is on distributor level and that it has the extra dimension of the own brand.

The definition of a buying group presented when performing a search on Google is the following: “The banding together of several dealers to purchase items in bulk at reduced rates.” Through our research it has become increasingly clear that the most common type of buying group is one when dealers or retailers pool their strength to negotiate better conditions with distributors. In fact, there have been no records what so ever of any buying group formation on distributor level. Even so, the purpose is the same one has only taken the concept one step higher up in the supply chain. “A purchasing group usually provides additional power to the members of the group in their negotiations with suppliers. Consequently, members should get more favorable conditions than those they would have obtained individually.”¹ This definition is applicable to the buying group in which Company A is the administrator.

Company A acts as an administrator for the group and consolidates the orders of the individual group members into one order that is sent to the manufacturer. For this, the company gets 3 – 4 % to cover costs and an additional 2 percent profit. The general idea is that by doing so, the individual members of the group reap the benefits that the substantial volume order generates in form of lower prices. The effect that the increased total volume has on the price should be greater than the commission that Company A charges for their services. Furthermore, the members get the additional positive effect that the unique brand generates in form of the security of being the distributor of a product that they play a part in developing. The whole concept is as far as the company knows unique for this industry.

Company A’s business strategy is to charge the members for the services one performs connected to the final delivery of the products to the members. This business strategy is depending on the group, without the group there would be no need for an administrator. Thus in order for Company A to be able to do business, the members of the group has to trust the Company and be willing to pay for its services.

1.1.3 Trade conditions

In International trade within the consumer electronics industry it is custom to use one of the following two ways to pay for orders, TT (Telegraphic Transfer) in advance or Letter of Credit. In the case with Company A and its buying group, traditionally one has been using the former of the two. Using TT in advance means that the group has to pay 30 % of the order value in advance and the remaining 70 % before the order is shipped from the manufacturer. This payment method is involving great risk as there is no insurance that the group will receive its order if the manufacturer for some reason should void the order because of for instance bankruptcy. An event like this could have great implications on the individual members of the group but also on the group as a whole, as it might loose its credibility.

¹ Nollet, J. and Beaulieu, M. “Should an organization join a purchasing group?” Supply chain Management: An International Journal Volume 10 · Number 1 · 2005 · 11–17



Letters of Credits is a far more secure way of paying, as it requires the goods to be delivered before the payment will go through to the seller. With the use of an L/C, the seller is also guaranteed payment by the buyer's bank. The problem is the high cost and the administrative difficulties that are connected to this kind of payment method. As mentioned before the buying group has traditionally been using TT in advance but has since the start experienced heavily increased order values and anticipates even greater increases in the future. This will implicitly lead to greater risks and therefore one has turned its focus towards the usage of L/Cs.

1.1.4 Relevance

Company A's business strategy represents a great example on how a company anticipates a drastic change in the competitive environment of the industry and acts on it pre-emptively. Through an alteration of the traditional role of a distributor the company has parried possible future changes in the external factors that might threaten the company's survival. Now the company is struggling with a problem that is relevant for all actors on the international market, how to most efficiently and to the lowest possible risk pay for international orders.

The implication of secure payment routines is a method to manage risk connected to a company's organization. For a company acting as the administrator of a buying group on a distributor level there are numerous of risks connected to the organization. There are several actors connected to the company that indirectly is exposed to an increased risk when a company insufficiently addresses these issues. Company A is in the middle of an intricate supply chain, interdependent with their financiers, owners, suppliers and members of the group.

The financier's interest in how Company A manages its business risk is clear. Primarily they want to protect their investment but also be the provider of the services required to secure payments. The owners of the company need to discuss what level of risk that is acceptable. The most fundamental part of this discussion is related to the relationship risk/cost. From the owners perspective this aspect of the discussion is central in order to determine how and to what extent actively manage the business risk. The members of the group are concerned with their supply chain being optimized and dependable. It is also in the supplier's interest that the company one does business with has an effective low-risk organization.

In this context Company A provides an interesting object to study. There are a multitude of actors in a close-knit network depending on each other. By studying Company A, who is currently the centre point of this network, implicitly this means studying the other actors as well. With this intricate organization structure in mind there are numerous of interesting issues to address related to the problems that are occurring.

1.2 Problem discussion

In the current situation Company A uses a payment method known as TT in advance. This method has been used since the group was formed in 2001. The group's administration management has been exploring alternate payment methods as they feel that with the group's



growth and development, TT in advance is becoming obsolete and not meeting the needs of the group. In the consumer electronics industry it is custom to use one of the two following payment methods when doing trade on the international arena: TT in advance or Letters of Credits (L/Cs). The former of the two is the one currently in use but today there are wishes to start using the latter instead. From here on we will discuss the different problem areas more thoroughly and the effects that they have on the payment method.

Company A's business idea is in many ways great but it is also connected to a number of problems. We have identified the key driver of these problems as being related to the core of the business idea. Company A acts as the administrator of a buying group with the goal to consolidate orders to reap the benefits that substantial volume orders generates. In our research we have identified problems of three kinds that can be related to this issue. These are complications that arise through organization risk, supplier risk and cost risk related issues. These problems are applicable to a number of different functions in the group. In this thesis we have limited our research to address the connection to the payment method that the company uses.

1.2.1 Organizational risk

The process from the point when an order is placed with one of the individual members to the point when the goods are delivered is complicated. First Company A sends out a forecast sheet to the members of the buying group. On this sheet the members are to indicate their orders for the next 3 months. The same month that the order that is to be placed three months later is set, the company can decrease their predetermined order by 50 percent. The month after the order is placed this maneuver ability has decreased to 25 percent and the final the same month as the actual order is placed the member has the opportunity to decrease its order by 10 percent only.

TT in advance is a common payment method in the consumer electronics industry. In Company A's case the condition one has with ones suppliers are the same that the Company As administrator of the buying group has to inflict on its members. Today these conditions stipulate that as an order is placed, 30 percent of the order value has to be paid in advance. In practice this means that Company A has to raise this money from all of the members participating in the consolidated order, before this order can be placed with the manufacturer. Then before the order is shipped from the manufacturer the remaining 70 percent is due for payment.

Company A does not experience the first step in this process, which is to collect the 30 percent prepayments, as a problem. If one member fails to present the 30 percent one simply voids their order and proceeds with the rest of the group. Indirectly this kind of behavior could present a problem if it means that the critical order volume is dependent on that all members participate. The real problem occurs when a member fails to pay the remaining 70 percent before the delivery. If Company A cannot present the whole sum to the manufacturer the goods will not be delivered. Even though the part not paid for might be insignificant, it still leads to the whole batch not reaching the group members. Thus the whole group will suffer from not receiving their orders even though only one member failed to pay for their share.



In the short-term perspective this problem can be dealt with in one of two ways: First, the manufacturer sends the major part of the batch and holds the quantity for which payment has yet to be made. This implicitly means that the manufacturer places the remaining quantity in a warehouse, and thus interest is due. The other way is for Company A to pay for the goods and then either settle the matter with the member of the group to whom the batch belongs, or to sell the goods among the members of the group. This alternative has a negative impact on Company A's liquidity. Depending on the magnitude of the order the effect might be more or less severe. However, neither of the ways presented above is a solution to the problem but a mere quick fix to solve the problem short-term.

1.2.2 Supply risk

When paying for something in advance, one is exposing oneself to the risk that the supplier might keep the money without delivering the goods ordered. There are several ways to decrease this risk and protect oneself. The easiest and most important one to cover is to know the other part that you are in business with. For Company A this means actively visiting the suppliers and taking part in the process in order to nurture a good relationship. This however, does not cover all the risks; even the most trained eye can be deceived.

The greatest risk that Company A exposes itself to be the one mentioned earlier. The worst-case scenario would be if the remaining 70 percent is paid and before the goods are shipped, the manufacturer goes bankrupt. A scenario like that would have implications both on individual member level but also on buyer group level. Depending on the nature of the order and the individual member, an order loss can have varying impact. A possible indirect effect that this might have on the group as a whole is a loss of reliability. If something like this happens the purpose of the group could be lost. It is reasonable to say that with the historical trend that shows great increases in the order volumes since the start of the project, these issues' importance will increase.

1.2.3 Competitive cost risk

Through our interviews with staff members on key positions it has been clear to us that due to the slimmer margins in the industry, all additional costs that the consumers does not see as value adding are a problem. This means that in order to stay competitive in the industry one has to be as cost efficient as possible. The collection of the orders and payments is a complicated process that requires time and resources that ultimately are charged the consumers. To use TT in advance as payment method also becomes a problem if Company A has to act as financier when group members fail to pay for their deposits or orders. The risk issues that arise through competitive cost issues are when the company fails to meet the target costs set by the consumers as a result of inefficiency in the organization. In a low-margin industry known for its fierce competition, being unable to meet the demands of the customers related to costs is unacceptable, and a great risk to a company's business.

1.2.4 Problem formulation

Company A's background presents an interesting opportunity to investigate a problem that to our knowledge has not been addressed yet. During our research the problem formulation has been evolving. During our first meeting with the president of the company we got a general



idea of the areas we wanted to research. As our knowledge about the company and the subject has been evolving, our problem formulation has become more precise and specific. In this thesis we are going to focus on explaining risks that Company A is exposed to. Through our research we want to investigate possible ways to minimize risk in international payment with focus on the risks that arises in a buying group organization. The object for our research is Company A and the questions to investigate will be:

- What are the risks threatening the business concept connected to the payment method used today?

What one from the company's side wants to investigate is whether there is an alternative way to do business that can increase efficiency, simplify the administration process and reduce risks. As mentioned before, it is custom to use either TT in advance or L/C as way of payment in the industry. Since there is a feeling that the current method insufficiently meets these requirements, one is interested in investigating the possibility to use L/C instead. However, changing payment method from the method currently in use, TT in advance, to start using Letters of Credit is connected to a number of obstacles.

- Which are the alternative payment methods that can be used to minimize risk, and are they applicable to Company A?

1.3 Purpose

The main purpose for this thesis is to illustrate the risk that Company A is exposed to in the context of its business concept. Our interviews have presented us with interesting findings regarding the different products related to international payment methods. Thus our secondary purpose will be to present and discuss alternative payment methods for risk minimization.

1.4 Scope of limitations

In this paper we have chosen to restrict our research to only identify and explain drivers of risk related to organization, supply and cost. Implicitly this means that we will not try to solve any problem or implement any possible solution.



2. Method

Under this heading we will present and explain the process that has led to the production of this paper. All the steps we have taken in order to deliver the final product that is constituted by this thesis will be discussed.

2.1 Method of research

2.1.1 Case study

The company that has been acting as the research object for this study has requested that the actual name of the company will remain undisclosed in this thesis. Therefore we will refer to the company as Company A. Furthermore we will not publish the names of the staff members that we have interviewed but only publish their titles.

This thesis stems from a meeting with the manager of Company A that was conducted in early April 2006. During this meeting we discussed a possible field for study that could be performed with Company A as the example. Company A is in a unique position, according to the manager one is the only administrating company of a buying group on a distributor level. The company's business is intriguing but connected to numerous problems related to the organization and business strategy. It became clear to us that a pressing issue for this company was risk management related to international trade. The company is the centre point of an intricate network of buying group members, financiers and suppliers. Through this meeting we saw an opportunity to use Company A with its unique situation as the object of study for a case study on risk management related to international trade.

2.1.2 Data collection

The material collected for this thesis consists of two types of data, secondary data and primary data. As the investigation in this thesis is conducted through a case study, the importance of primary data is substantial. The primary data consists of empirical material collected through interviews of a qualitative nature. The qualitative interview approach was chosen as we considered the information relevant to the study to be of such nature. In order to understand the risks that the company exposes itself and the other parties of the group to we needed to thoroughly understand the underlining risk-driving factors. In order to get the needed insight we conducted longer and more thorough interviews. The interviews have been conducted with people relevant to the buying group of which Company A is the administrator. People of key-positions at Company A, bank associates and trade finance experts were the objects interviewed.

The theoretical framework will serve as a frame of reference to which the empirically gathered data can be compared. This framework will consist of secondary data such as articles and literature. The sources for information regarding the secondary data are article databases, library catalogues, financial reports, product brochures produced by Nordea Bank and web-based resources. The secondary data collection has mainly been a focus on the use of



published articles and literature as we consider these sources more reliable than web-based resources. In order for a book or article to be published by a recognized publisher it will have to undergo scrutiny regarding quality and reliability. Thus we consider the usage of these resources as a guarantee regarding the quality of the resource. Web-based resources however can be considered less reliable as they are of a more insecure nature.

Regarding the financial statements and the product brochures produced by the bank, we have discussed the problems related to subjectivity. When one uses material of a more commercial nature there is always the risk of it being biased. In this case we deemed the information presented by the trade finance department of Nordea Bank as credible after the interview. Regarding the financial reports of Company A the same issues were discussed as a financial report in many ways can be considered a marketing tool. Company A however, is not a publicly traded company and is owned to a 100 percent by the board of directors. Under the circumstances we deemed the information feasible, even though the contents of a financial report can be interpreted in more ways than one.

2.1.3 Theoretical framework

In order to analyze the results that we have gathered from our empirical research we need a framework to compare the results to. This framework consists of a compilation of generally accepted theories relevant to the issues that constitutes the subject for the thesis. We have chosen our theoretical framework to focus on risk management, as this is the central issue of the problem formulation. We start in general terms regarding the definition of risk and its different types. To continue we go more in depth on the issues relevant to the problem formulation. The focus will be on organizational risk, supply risk and competitive cost risk.

Organizational risk deals with issues related to the company's growth. We will present generally accepted theories related to growth management and the risks related to different phases in a company's development. Supply risk addresses the problems that occurs related to the supply chain. Company A's current supply situation is extremely intricate and thus interesting to study. Under supply risk we will present the thoughts concerning supply chain related risk issues presented by recognized researchers. Competitive cost risk is the risk that companies with small margins might suffer from. As mentioned before the consumer electronics industry is experiencing decreasing margins and therefore we will present the relevant thoughts on the subject under this heading. In order to grasp the magnitude of the risk related problems we use the information in the theoretical framework to understand Company A's current situation.

2.1.4 Interviews

When conducting interviews numerous different possibilities need to be considered. One can choose from conducting interview via telephone, letter, e-mail and in person. We considered all these methods and decided that the use of personal interviews would be the most suitable. As the research is based on a case study we deemed it important to form a closer relationship with the people relevant to the research. This is important in order to in depth understand the whole situations so that a thorough analysis can be conducted. The interviews have been of a qualitative nature with the ultimate goal to provide with a multifaceted visualization of the current situation in the company.



Our initial knowledge of the subject of risk management and object of the case study is limited. As a result of these conditions the interviews have not been standardized to any extent. Before each interview we have sent the interviewee information about the subjects that we want to discuss in order to enable some preparation from the interviewee. In order to be able to present the empirical material as unbiased as possible the interviews were taped, thus adding to the validity of the material.

As the empirical study has been evolving and our theoretical knowledge has deepened the questions for the interviewees have become more specific and precise. Furthermore the development of the problem discussion has made it necessary to contact interviewees for complementing information regarding issues that has arisen from other interviews and the theoretical research.

2.1.4.1 Delimitations of interviewees

As have been mentioned before there are a number of parties that constitutes the network in which Company A is the center. We have appreciated the different actor groups as the following: supplier, Company A, buying group member (distributor), retailers and financiers. The main focus of this study is the risk that Company A exposes itself to as a company with the business plan to be the seller of administrator services to members of a buying group. Furthermore we are illustrating the risk that the individual members are exposed to as a result of the risk that Company A is taking. Lastly we focus on the credit risk that the financiers are exposed to relate to the total risk of their investment, in this case the business risk of Company A. The interviews with the trade finance experts are also a source of information regarding the possibilities for Company A to implement an alternative payment method.

As we have chosen not to in depth investigate the risk that the suppliers are exposed to, or the risk of the retailers, these parties are not represented among the interviewees. The risk elements that the individual purchasing group members are exposed to originates from the processes related to the suppliers and Company A. Consequently we have chosen not to include this party in the empirical data collection. One could argue that this is necessary in order to fully understand the magnitude of the risk and the impact a possible event could have on these members. However, the purpose of this thesis is not to visualize these issues but to shed light on the risk issues that are linked to international trade and how one can manage them.

2.1.4.2 Selection of candidates

The aim of the interviews is to get an overall impression of the risk that is related to Company A in its international trade activities. In order to acquire this information we deemed it important to interview various members of the staff in Company A, the company's bank associate and trade finance experts from two Swedish commercial banks, Handelsbanken and Nordea. The selection process regarding the personnel on the company was based on our appreciation of which people that would be of interest derived from our interview with the manager of the company. The manager could provide with a general understanding of the problem but in order to get more specific information two additional interviewees were picked based on their specific expertise. In order to validate the background information



regarding the development of the consumer electronics industry, we contacted an industry organization. One of their experts concurred with the picture presented by the company, thus we feel confident that the relevance of the thesis is high.

Regarding the capture of the financiers perspective we contacted the company's associated bank's deputy branch manager with the help of Company A's manager. Through this interview we got important information on a financier's perspective on the company's business strategy and organization from a risk perspective. As a complement to this view we contacted trade finance experts of two commercial banks. With its history of international trade the region around Gothenburg Sweden provide a good environment for companies in this situation. As a result of this the commercial banks in this region are specialized in trade finance and have a long history of providing with different trade related services.

The banks that we contacted were Handelsbanken and Nordea. Handelsbanken is the bank that Company A currently is in business with and with the help of Mr. Martin Johansson we got a contact on the trade finance department with insight in related issues. In order to prevent the empirical data to be to one sided regarding the financier perspective we decided to contact another trade finance department on at a competing bank. To provide with further information we interviewed Johan Löfqvist and Katarina Benkel of Nordea Trade Finance in Gothenburg. The reason as to why we chose to contact Nordea was that through our experience working for the company we have come to consider the bank a reliable source. Furthermore Gustaf Persson one of the writers of this thesis could establish a contact with two of the departments trade finance experts.

2.2 Empirical material and analysis

The results from the interviews will be presented under the following headlines: Company A, Handelsbanken and trade finance expertise. Under the headline "Company A" we will summarize the important points that have been derived from the interviews with the three members of the staff. Under "Handelsbanken" the relevant information from the bank associate of Company A at Handelsbanken is presented. The results from the interviews with the trade finance experts from the two commercial banks we visited are presented under "Trade finance expertise".

The analysis will be based on the risk issues presented in the problem formulation. The same issues are addressed in the theoretical framework and the empirical research. Each of the three risk aspects will be analyzed according to the relevant theory and results from the empirical study. We will compare the results from our interviews with the theoretical framework. The discussion regarding the material will be conducted through a compilation of the results from the interviews. By gathering the different views that the interviewees represent we will map out the different aspects concerning risk that is connected to Company A.

Risk management is a general term and therefore focus is on risk related to a company's growth phases and supply chain risk. Company A has experienced a rapid growth during the last couple of years and one is expecting even greater growth in the near future. Even though one has experienced this growth within sales, the internal growth or the organizations development have not seen the same growth. We have identified this as one of the three most



important sources to risk for Company A. The other two main drivers of risk related to Company A and the buying group is supply risk and competitive cost risk.

The second part of the discussion will be of the suitability of the use of transferable Letters of Credits as ways of alternative payment methods for the company. In this section we will discuss the input concerning alternative payment methods that we got from the interviews and discuss it from Company A's perspective. The empirical input will be based on trade finance books and material provided by the trade finance experts. The analysis will continue with an evaluation of Transferable Letter of Credit as a possible payment method for Company A, and whether it is fact applicable to the organization.

In the conclusion we will apply the reasoning conducted in the analysis part to our problem formulation to see if we in fact have answered the questions asked in the beginning of the thesis. Under this heading our thoughts regarding the findings and its applicability to Company A is also discussed more thoroughly. In conjunction with the conclusion we will present recommendations for further study. These recommendations will be based on our opinion regarding possibilities for the company on which areas concerning alternative payment methods that could be of interest to the company.



3. Theoretical framework

Under this heading we present a compilation of relevant research conducted on the issues relevant to our study. The focus will be on general risk discussion that will be narrowed down to more specific areas.

3.1 Risk in general

Over the last couple of decades the focus on risk has been more evident due to the fact of negative impact when making a risky decision in a world of globalization. When talking about risk and its expression, there are numerous examples and types of risks to be found depending on the situation. Therefore it can be said that aspects of risk appear differently depending on the situation surrounding it. Considering this fact, examples of risk can be the likelihood of losing invested money, the risk concerning hiring wrong people or being less effective. These risks are all from the companies' perspective. Risk can also be considered uncertainties for people, missing out on a child's growing up, or losing one's good health².

The theory- writer Mill proposed in 1848 the difference between a manager and an entrepreneur is the entrepreneur's ability to take risks. From this point on risk has become one of the concepts most intimately associated with entrepreneurship. Examinations of conventional economic theory show that the term entrepreneur is noticeable only by its absence. If studying neo-classical or mainstream economic theory, the entrepreneur is viewed as someone who co-ordinates different factors of production, but the importance of the entrepreneurs as a risk taker are not defined within these theories. Hence, the entrepreneur is viewed in a skewed light and therefore lacks importance within the theoretical discussion.

The definition of risk suggested from the "Oxford English dictionary" is: possibility of bad result.³ Furthermore, the suggestion of definition for: taking a risk: to decide to do something even though you know it may have bad result, and finally risk-taking: the practice of doing things that involve risks in order to achieve something. All of the definitions above put focus on the negative, dangerous and unpleasant outcomes that might arise when involved in a project.

Miller and Friesen express a definition of taking a risk, which has a direct relation to a business-risk.

"The degree to which managers are willing to make large and risky resource commitments - i.e. those which have a reasonable chance of costly failures"⁴

² Blombäck, A. "Growth and risk-taking behavior in SMEs" Parajett, Sollentuna 2000

³ "Oxford English dictionary" Oxford university press 1996

⁴ Miller, D. And Friesen, P. "Archetypes of strategy formulation" Management Science 24/1978 p. 923



The last definition illustrates how the term risk entails an evaluation supported by the perception of an opportunity, which means a possible loss or gain⁵.

“The degree to which the commitments are made must also relate to how much you are prepared to risk losing in order to get the chance to gain the preferred outcome (or more). The risk should thus get bigger as the as the perceived possibility of the desired outcome gets lower.”⁶

3.1.1 Risk discussion - within the literature

Taking the risk perspective one step further, the theorist Knight defines the term risk equal to actions of an entrepreneur. The entrepreneur is an individual who is willing to take a risk to reap the reward and profit that come with the uncertainty and the uninsurable risk-taking. What's more, profits can only erupt from the opportunity that comes with the uncertainties surrounding changes. If changes are fully predictable, rewarding opportunities are not possible. From Knight point of view there was a significant distinction between risk and uncertainty.⁷

“Risk exists when we have uncertain outcome but those outcome can be predicted with a certain degree of probability” (Deakins p. 12)

The connection between risk and an entrepreneur is strong according to David Deakins, but in the literature an entrepreneur is often expressed as a risk taker but not a gambler. This is a questionable theory; though a gambler is often well aware of the risk, he is also very calculating when taking chances. Therefore it is possible to argue that there's little difference between the entrepreneurs who calculates his financial risk against the gambler who is well aware about the odds of success. As a result, the author defines the attempts to enter a business as doing a form of calculated gambling, which means the entrepreneur can minimize the risk, but there is always an element of luck involved.

Deakins supported Knights beliefs in the entrepreneur as a risk-taker. However, Knights view of risk being a subset of uncertainties was not supported of Deakins. The reason for this was Knights believes that events, which are truly uncertain, could not by any means predict the possibility of occurrence or degree of probability. With support of the insurance industry Deakins argues that uncertainties can be predicted with a degree of probability. Insurance companies have higher premiums in the inner city because of the probability of damages. A entrepreneur is able to do the same identification in his or her business, what risks comes with the trade? The question he has to ask is. Can we handle the risk or do we have to transfer the risk to insurance. His answer to this question is:

“A successful entrepreneurs is someone who can minimize risk either through the limitation of his or her financial stake or by reducing the degree of uncertainty, so that they can calculate accurately and decisions can be made with more reliability” (Deakins p. 10)

⁵ Blombäck, A. "Growth and risk-taking behavior in SMEs" Parajett,Sollentuna 2000

⁶ Blombäck, A. "Growth and risk-taking behavior in SMEs" Parajett,Sollentuna 2000 p. 20

⁷ Knight, F.H., "Risk, uncertainty and profit" Boston : Houghton Mifflin Company, 1921



3.1.2 Different types of risk

For Deakins it was like for Knight, important with risk taking, but Deakins believed that one must be able to assess which risk to accept. Depending on the nature of the project, all risks should be taken under consideration, weather to accept the risk or to reduce the risk through risk management, or transfer risk through insurance.⁸ To sum up some of Deakins thoughts; risks can appear in different ways, but his conclusion is that risk taking is fundamental in the daily work of an entrepreneur. As presented previously it becomes obvious for Deakins that to be able to succeed one must be able to identify the risk. Most discussions in business literature concerning risk in a business refer to the imminent danger of losing money.⁹ This type of risk is commonly referred to as financial risk.

“Risk can be defined as the likelihood that a new venture will fail to reach satisfactory sales, profit or ROI target”¹⁰

For an entrepreneur running a business, the dangers of financial risk taking does not stop there. Adjacent to the financial risks, here are several other risks that need to be accounted for.¹¹ This means that an evaluation must result in the outlining of the entire business cycle, facilities, locations, customers, suppliers and organizational charts. A business must look beyond the risk concerning financial investment and understand risk related issues concerning the daily business. Examples demonstrating this could be a non-developed organization, the lack of strategies and the know how of implementation. These are all potential obstacles that could hinder further development. Price water house Cooper illustrates how to categorize risk into several different areas¹².

- Financial risk
- Commercial risk (involves relations to customers and suppliers)
- Strategic risk (involves acquisitions, disposals, new markets, products etc)
- Operational risk (involves system and people within the organization)
- Technical or physical risk.

S-E Johansson adds to the discussion the significance of categorizing risk into different areas. He sheds light on the central issue of risk concerning the financial structure of a business. The model he uses to portray the risk classifies the risk into three categories¹³.

- Business risk: is a risk that is measured by the spread I return on investment. This kind of risk can be referred to as the investment-, product-, price- and market politics alongside the strategies and organizational management, with the exception of the financial politics.

⁸ Deakins, D. "Entrepreneurship and Small Firms" Second edition, McGraw hill (1999)

⁹ Blombäck, A. "Growth and risk-taking behavior in SMEs" Parajett, Sollentuna 2000

¹⁰ Fishburn 1977 in Dickson & Gilierano 1986

¹¹ Blombäck, A. "Growth and risk-taking behaviour in SMEs" Parajett, Sollentuna 2000

¹² Price water house Coopers www.pwc.com/rms

¹³ Johansson S-E, Runsten, M. "Företagets lönsamhet finansiering mm", 2005 Studentlitteratur, Lund. (SEJ)



- Total risk: is referred to as the spread in return on equity. This is dependant upon the total business politics including the financial politics.
- Financial risk: the difference between the business risk and the Total risk can be referred to as the financial politics or financial risk. This risk correlates to the spread in debt ratio,

S-E Johansson's analysis and model is to a large extent based upon numbers and financial reports. Price water house Cooper chose to define risk into four different categories. The perspective of Blombäck is as follows: to be able to assess and structure issues around risk one must specify and distinguish the types of risk very narrowly. These distinguished types are presented below.

“1. The financial risk perspective includes the pure financial aspects of growth and what control the company has had over financial commitments. Has the company borrowed money or did it use retained earnings? Has the firm been placing money in fund or stock or otherwise invested money in “out of operation activities” strictly in order to make profit?

2. The strategic risk perspective regards how the firm has developed strategically. That is, no longer term commitments and major changes. This might include new products or markets, merges, acquisitions, or even selling the company.

3. The operational risk perspective regards risk in the daily operations. For example by increasing operations or diversity into new areas, affirm might tie capital in machines or people where there is no certain future but only limited projects. Related to this is also uncertainty in projects, where a firm might accept a project without knowing the exact outcome of it as well as extensive reliance on a few key-persons.

4. The social risk perspective might appear when one or several of the above three risk types have been realized. This type of risk is not completely separated from financial aspects when concentrating on the organization since the relations being considered in the end might be what lead to income and profit. Still, it is separated from direct or intermediary financing since it concerns a third party (at least) outside the firm's control.” (Blombäck p. 28)

3.2 Stages of growth

The constantly changing economic environment in the world puts great tension on the owner/management of a small business.¹⁴ In the literature many theorists argue that growth of a business can be classified into various stages, each with a set of problems, which a business encounter when growing. In order to pass on to the next stage of growth the firm has to deal with these problems. The model drawn up by Jim Dewhurst illustrates the firm as a behavioral unit, whose focus of activity changes in systematic and predictable way.

The model consists of 4 distinctive phases, each with different economic magnitude and aims and each presenting the owner/manager with different problems for further growth. This model in many ways simplifies the appearance of a growing firm; one can argue that a firm

¹⁴ Dewhurst, J. & Burns, P. "Small Business Management" 3rd edition, Mackays of Chatham (2000)



does not grow in a process in a linear fashion.¹⁵ The model does not take into consideration different types of businesses and their particular obstacles. Nevertheless the model gives us an understanding of the growth process and an insight on how problems at each stage should be managed. Dewhurst classifies phases with underlying problems under four headings.¹⁶

- Management style and organization
- Organization structure
- Accounting problems and finance problem
- Funding

The theorist Michael Murphy portrays a similar model of growth. He describes a business journey through a series of five stages¹⁷. Depending on the size of the company one can determine at what stage the business is at. Size in these terms can be measured in terms of sale, in total assets or in the number of employees. The theory explains that for a firm to pass on to the next stage it has to encounter a crisis situation. The idea of each new stage in a firm's life cycle is preceded by a crisis, is built upon the belief that as it grows so do the demands upon its resources, system and control. The crisis will erupt between transitions of stages. The magnitude of the crisis stands in correlation to how well the business can provide sufficient resources to pass into the next stage. Insufficiency within any of the key issues provided by Dewhurst often results in a crisis. Michael Murphy has added four more heading to Dewhurst previous ones, some being similar to the original ones and some being newly created.¹⁸

- Management role/Style
- Organization structure
- Market research
- System and Controls
- Sources of finance
- Cash generation
- Major investments
- Products

3.2.1 Stages

Below is a description of the five steps of the ladder theory, putting focus on the different obstacles that need to be taken care of prior to further growth.

3.2.1.1 Inception

As the first step, *Inception* puts focus on generating profit and coping with administrative demands. Furthermore, obtaining customers is emphasized as well as structuring an economic model for products. The firm is likely to be unstructured; no specific market-research analyses

¹⁵ Murphy, M. "Small Business Management" Pitman publishing (1996)

¹⁶ Dewhurst, J. & Burns, P. "Small Business Management" 3rd edition, Mackays of Chatham (2000)

¹⁷ Murphy, M. "Small Business Management" Pitman publishing (1996)

¹⁸ Murphy, M. "Small Business Management" Pitman publishing (1996)



have been conducted. The source of finance for most businesses is often friends or the owner. (Murphy 1996)

3.2.1.2 Existence and survival

During this step it is crucial for the manager to have a clear picture of the entire business. At this point he has the role of coordinating various tasks and at the same time supervising the employees. As formal management is put on the back burner, the main task for the entrepreneur is to build a network of customers¹⁹. At this point developing the special features of the product offered will be the foremost valuable mission. Cash flow is the major control imperative. (Murphy 1996)

3.2.1.3 Consolidation and control

This is the phase when the owner/manager is proving that he can obtain repeated sale and that business is making sufficient profits. Cash flow remains crucial but new budgets and targets will start to set. Organization remains simple. If the business is to stay at this level then some basic financial, marketing and production control systems must be structurally anchored.²⁰

3.2.1.4 Control and planning

As the business with growth potential moves on to the next step crucial decisions need to be taken concerning the owner/managers aspirations to capitalize upon this. If this is the case, improving control and assessing resources as well as recruiting, developing and delegating to staff is essential. In this phase the manager/owner needs to formulate a strategy involving ways of exerting better control over the growth process. (Dewhurst 2000) Preparing to recruit and developing ways of delegating to a larger extent than before is also of utmost importance, as the growth of the company will require a more formalized structure. It is important at this point continuing as a risk-taker, always searching for new market opportunities.²¹

3.2.1.5 Expansion

This phase means rapid expansion. In order to make this happen there must be adequately competent staff in place, their roles clearly defined and their activities properly coordinated. In many cases business are facing premature expansion, which can lead to failure because of lack of organizational skills. At this point it is crucial for the business to have strong management and to acquire this, actors within the professional management sphere start to emerge. For businesses that are unable to shift their organization towards a more sufficient and efficient organization, reason to sell out to a larger firm, who will put in the professional staff to manage this important expansion, can come in to consideration. This move towards greater control will necessitate a more formal system. (Dewhurst 2000)

¹⁹ Dewhurst, J. & Burns, P. "Small Business Management" 3rd edition, Mackays of Chatham (2000)

²⁰ Dewhurst, J. & Burns, P. "Small Business Management" 3rd edition, Mackays of Chatham (2000)

²¹ Murphy, M. "Small Business Management" Pitman publishing (1996)



3.3 Risk management

The chairman of the board at Company A told us that he had always been a gambler. If you are unwilling to take risks, you might as well put your money in a bank. It is simple market theory that there is a correlation between return on investment and risk. The key is to determine which level of risk one is willing to take and to what price.

A purchasing group depends on trust; it is the cornerstone of the cooperation. In this context risk management is extremely important. Some companies are perceived as less risky than others. Many times these companies can reap the benefits that this perception generates. For example it is reasonable to argue that a company seeming less risky than another will get better terms from its financiers, suppliers and customers, everything else equal.²²

In her article, Tchankova discusses the importance of risk identification as the first part of risk management. According to her, managers must ask themselves the following questions:²³

- How can organizational resources be threatened?
- What adverse effect can prevent the organization from achieving its goals?
- What favorable possibility can be revealed?

It is important to seek answers to these questions both in the internal environment and the external environment. As the article implies, seeking answers to these questions is the most fundamental part of risk management. Even so, it must also be considered as the most important part of the process as it forces management to scrutinize the organization, searching for liabilities. Risk management is closely connected to cost. As mentioned before a central question in the discussion is how much risk one is willing to expose oneself to, what the possible gains this could generate and to what costs.

Financial institutions have made it their business to accept the risk of other actors and depending on the level of total risk, charge accordingly. In this context it is important to explain what a bank can and cannot do regarding internal and external risk. A bank or another financial intermediary can play a part in handling external risks such as fluctuations in currencies. What a bank cannot do is to handle the risk that arises from inadequate internal operations.

²² Funston, R. and Galloway, D. "The challenges of enterprise risk management" Balance Sheet, Vol. 8 No. 6, 2000

²³ Tchankova, L. "Risk identification – Basic stage in risk management" Environmental Management and Health, Vol. 13 No. 3, 2002



“The process of analyzing exposure to risk and determining how to best handle such exposure.” This is the definition of risk management as presented by the webpage investorwords.com. In order to handle risk, first one has to identify and classify the risk element. According to Tchankova there are four different basic elements:

- Sources of risk
- Hazard factors
- Perils
- Exposures to risk

In the article, *sources of risk* are explained as follows: “Sources of risk are elements of the organizational environment that can bring some positive or negative outcomes.”(Tchankova p. 292) “A condition or circumstance that increases the chance of losses or gains and their severity.” (Tchankova p. 292) This is how the term *hazard* is defined. *Hazards* that a company can be exposed to be for example management choosing to cooperate with a supplier and than that the goods delivered are of poor quality. A situation like this exposes the company to a great deal of risk regarding to what extent one will be able to sell the goods and the negative effect it might have on the perception of the brand etc.

“Peril is something that is close to the risk and it has negative non-profitable results.” (Tchankova p. 292) Peril is something that causes losses that are unpredictable. Furthermore a part of the definition of peril according to Tchankova is that peril does not include a positive meaning, peril always causes losses. Issues of peril for a company could be failure of the distribution network or an industrial accident at the manufacturer of the goods, ultimately leading to a loss with no positive effects on the business as a whole, what so ever.

Resources exposed to risk are the objects that will be affected by the risk event. In the service industry for example, many times the human capital is the most important resource. This resource might also be exposed to the most risk as events not seemingly closely connected to this issue, might have indirect negative effects on this resource. In the following sections we will proceed to discuss risk with focus on risks that occur when a company is in a growth phase. Later on the theoretical discussion will be narrowed down to focus on the supply chain management risk.

3.4 Supply chain risk

The supply chain represents the flow of materials, information, and finances as they move in a process from supplier to manufacturer to wholesaler to retailer to consumer. Many organizations are looking to supply chain optimization as means of gaining significant competitive advantages.²⁴ As mentioned in the definition supply chain management is becoming an increasingly important factor for competitive advantage. Companies are forced to continuously evaluate and improve their supply chain in order to stay efficient. According

²⁴ <http://www.balancedscorecard.biz/Glossary.html>



to Nollet and Beaulieu the most common reason mentioned regarding why to be a part of a buying group is “looking for more advantageous contractual conditions”.²⁵

According to Jüttner, the simplest degree of complexity concerning a supply chain structure consists of three parties: a company, a supplier and a customer. The author continues: Risk in the supply chain centers around the disruption of flows between organizations. These flows relate to information, materials, products and money. They are not independent of each other but are clearly connected.²⁶ As the supply chains become more and more intricate the risk factors become increasingly important. In a supply network the parties are depending on each other to play their part. This interdependence requires every party to excel in their performance because a negative event in one of the parties will affect the whole network. Thus, the more parties involved in a supply network, the greater the total risk. An example of this used by Jüttner is the chassis manufacturer UPF Thompson. The company was a supplier to Land Rover and due to insolvency in UPF Thompson in 2001; Land Rover had to face the possibility of having to suspend production of the Discovery Jeep.

According to Panelli, Upton and Zsidisin there are numerous risks that can be realized within a supply chain. Selections of these risks are:²⁷

3.4.1 Business risk

Business risk encompasses the financial dimensions of the supplying party. One must assess these risks by trying to judge the possibility that the supplier might end up in financial hardship. According to the authors, supply risk becomes imminent when a buyer-supplier relationship is entered into and the purchasing party has a higher degree of reliance on that particular supplier. When assessing business risk, one has to look at the financial stability of the company. For instance, a supplier with good relationships to its financiers or a possible parent company might be considered less risky than a company without these kinds of connections.

3.4.2 Disasters

A company’s supply risk is closely linked to the organizational features that constitute the company’s business strategy. For instance, companies in different industries can be exposed to the same kinds of risk but the severity of the risk varies depending on how it is perceived by the company. For a company in the high-tech industry, risks related to quality, design and legal issues are important. In the same way, the administrator company in a buying group is exposed to other risks. For instance, in a purchasing group it is important with homogeneity and common interest among the members so that effectiveness is not reduced.²⁸ In the same way that a company in the high-tech industry has to be concerned with risks related to their

²⁵ Beaulieu, M. and Nollet, J. ”Should an organization join a purchasing group?” Supply chain Management: An International Journal 10/1 2005 p. 11

²⁶ Jüttner, U. “Supply chain risk management – Understanding the business requirements from a practitioner perspective” The International Journal of Logistics Management Vol. 16 No. 1, 2005

²⁷ Panelli, A., Upton, R. and Zsidisin, G. “Purchasing organization involvement in risk assessments” Supply Chain Management: An International Journal

²⁸ Beaulieu, M. and Nollet, J ”Should an organization join a purchasing group?” Supply Chain Management: An International Journal, Vol. 10 No. 1 2005



particular industry, the buying group administrator can see risks related to heterogeneity and hidden agendas among the members. Examples of supply risks that can be related to the organization are cost and supplier. “Competitive cost risk is determined by target costs from the customer.”²⁹ Supplier risk related to cost is becoming increasingly important in industries that are experiencing lesser margins and a rising pressure from consumers, for instance the consumer electronics industry. In the article the authors continues to define supplier risk as follows: “Supplier risk means assessing and choosing suppliers of good financial health and manufacturing in politically stable or low-risk natural disaster areas.” (Panelli, A., Upton, R. and Zsidisin, G p. 189)

3.4.3 Supply risk assessment and management

There has been little research conducted on supply chain risk assessment and management compared to risk assessment and management in general. The research that has been conducted has focused on for instance trading with several parties as a measure to limit ones dependence to one supplier. In their article about risk mitigation in an aerospace supply chain, Malzahn, Pankaj and Whitman explains the risk assessment process. “The goal is to determine the root cause or the source of the undesirable/desirable event. Furthermore, it facilitates identifying the direct and indirect impact.”³⁰ This process is difficult if it turns out that the most severe impacts that a company is facing is related to indirect factors rather than direct ones. The indirect impact of risk is usually more difficult to assess, as it is harder to identify the specific implications and its costs. Panelli, Upton and Zsidisin continues to that supply risk assessment can involve the establishing of loss potential, identifying potential losses, understanding the likelihood of potential losses, assigning significance of losses and appraising overall risk.³¹

Regarding supply risk management the general idea is to ensure that the supply chain runs smoothly in order to secure the flow of products to the company. This process is depending on a successful identification of risk, the assessment of those risks so that one knows what risk to prioritize and than the action of countering the risk. According to the article supply risk management can be divided into two activities, process improvement and buffer strategies. Process improvement focuses on risk reducing activities such as forming strategic alliances to in order to encourage an increase in the communication between buyer and supplier. This might result in decreased risk related to transactions and an increased trust between the parties. In their article: *Managing supply risk with early supplier involvement: a case study and research propositions*, Smith and Zsidisin discusses the positive effect Early Supplier Involvement (ESI) can have on a buyer-supplier relationship. According to the authors companies can engage in ESI activities in order to decrease the risk of supplier failures. These failures can include quality problems, supplier insolvency and product introduction delays.³²

Risks can be managed but not entirely eliminated. However, through effective identification, assessment and management, the impacts of risks can be decreased.

²⁹ Panelli, A., Upton, R. and Zsidisin, G. “Purchasing organization involvement in risk assessments” *Supply Chain Management: An International Journal* p. 189

³⁰ Malzahn, D., Sinha, P. R. and Whitman, L. E. “Methodology to mitigate supplier risk in an aerospace supply chain” *Supply Chain Management: An International Journal* Vol. 9 No. 2 2004 p. 159

³¹ Panelli, A., Upton, R. and Zsidisin, G. “Purchasing organization involvement in risk assessments” *Supply Chain Management: An International Journal*

³² Smith, M. E. and Zsidisin, G. A “Managing supply risk with early supplier involvement: a case study and research propositions” *Journal of Supply Chain Management*, Fall 2005 Issue (9/22/2005)



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4. Letter of Credit Explanation

This chapter contains a brief explanation of the nature of Letter of credit.

In order to understand the discussions of this paper in their entirety it is fundamental to be able to grasp the nature of the Letter of credit. It is therefore recommended that the reader study appendix 1, which will give the reader a profound knowledge of the practice and technicalities surrounding the Letter of Credit. It will present the different types of credit, advantages and disadvantages concerning the Letter of Credit for the seller and buyer. Furthermore, it will explain the risks of the credit and the foundation of which the credit is built upon.

Addressing this material is the first step of an evaluation meant to show the needs that are to be taken under consideration when implementing a Letter of credit. A number of criteria regarding risk, advantages, and disadvantages need to be fulfilled and estimated in order to follow through with an implementation. The outcome of the evaluation will demonstrate which type of credit that is most preferable.

4.1 The foundations of Letter of Credit

It is believed that the use of the letter of credits was first introduced in the 18th century. Since the start, letter of credits has evolved a lot over the years and not until recent years have users been able to see the final product with the adoption of UCP 500³³. The UCP 500 works as a set of standardized rules for the practice of Letter of credits all around the world. The last version of UCP 500 was revised January 1st 1994 and banks seldom see credits, which are not in accordance to these rules. The definition of the UCP 500 is as follows.

“The Uniform Customs and Practice for Documentary Credits, 1993 Revision, ICC Publication N 500, shall apply to all Documentary Credits (including to the extent to which they may be applicable, Standby Letter(s) of Credit), where they are incorporated into the text of the text of the Credit. They are binding on all parties thereto, unless otherwise expressly stipulated”³⁴

A Letter of credit is an arrangement whereby a bank that acts according to instructions received from a customer (the applicant), commits itself to pay an amount to a third party (the beneficiary) against that party's presentation of stipulated documents complying with the terms and conditions of the credit.³⁵

³³ Nordea “Documentary credits” January 2006, published by Nordea

³⁴ ICC Uniform Customs and Practice for Documentary Credits, Publication No 500 (the UCP 500) article 1

³⁵ <http://www.nordea.lv/sitemod/default/index.aspx?pid=68602>



5. Empirical material

Under this headline the results from the empirical study will be presented. The material will be structured under the following headlines: Interviews at Company A, Interview with Handelsbanken Stenungsund and finally Interviews with Trade Finance experts. The data will be presented as summaries of the interviews where only the relevant information will be used. Under each headline information regarding the interviewees and their relevance to the study will be briefly summarized.

5.1 Interview with Handelsbanken Stenungsund

The following empiric material is created from an interview held by the financial manager of the Stenungsund Branch Office, Martin Johansson. The material gives an illustration of the problem surrounding company A from the Bank's point of view. It will shed light on the urgent difficulties around the business concept that is a consequent of rapid growth. Furthermore, will it give a description over the role Handelsbanken is playing when serving company A, where centre of attention is the development of new solutions and the business concept. The conclusions taken from this material are to serve as prim support for the larger analyze.

As coordinator of Company A's cash flow Handelsbanken also grants loans for further development of the business. The coordinator role entails acting as a transfer point from which money is transferred and collected from each individual member before it is sent as payment to the manufacturer. Before granting a loan it is crucial for Handelsbanken, as a loan-granting agent, to be able to make a full analysis of the company's financial state. This means that due to the size and time of maturity, the company must fulfill a certain point of standard of this analysis to meet further loan granting. The analysis consists of an evaluation over the companies, strength, weakness, opportunities and treads, where the focus is set on future development. In terms of Company A's business concept, Handelsbanken has found it to be interesting and they believe that the company is able to increase steadily in size over the next couple of years. However, in growing as a company it will need to evaluate and almost certainly improve in capital and change the routines of the daily administration. This analysis is done with support of the ladder theory, which describes a company's steps and critical point when evolving from a small size company to a large size company.

Handelsbanken's analysis of Company A illustrates a company that has doubled in size over the last years. The turn over is believed to reach over 270 million this year, which means an increase in turn over with over 400 percent since the beginning. The bank perceives great potential in Company A and the growth prognosis for the turn over is assumed to reach 500 million in two years. This rapid growth will, according to Handelsbanken lead to the point where steps up on the ladder from being a small size company to entering the next level as middle size company. This point will be achieved when Company A is closed to 500 million in turn over. The ladder theory explains that problematic issues that arise when a company is growing and has reach the point where it will enter a new level. When entering into a new level a company must improve its capital structure, management and organization and address the problems that occur in reaching a critical point of the ladder. The reason why the banks analysis puts focus on each of the ladders critical points is due to the fact that experience has shown that when a business grows to a certain size the risk will greatly increase. The



evaluation of Company A has shown that the company's organization does not demonstrate the control over its cash flow, orders and business partner required to climb to the next step.

The bank's analysis and former experience indicates that when a company grows, showing close to 500 million in turnover, a critical point is reached. This entails bringing new competence to the table, thus being in charge of supervising the financial cash flow and financial structure on a daily basis. The bank looks positively on the progress of company A. However the lack of administrative control greatly contributes to the administrative risk. Having fairly low margins, constituting about 3% of the turn over, makes supervision of increasing order volumes and members more important than ever. Due to the low margins, this in essence increases the risk as the turn over consistently ads up.

To administrate the future cash flow it will be crucial to start looking at times of credits for members as well as manufacturers along with the possibility of working with the interest rate. If the company can improve its administration and develop a deeper financial thinking, the bank will decrease its risk concerning the structure of the company and open up for larger credit capacity. The ability to finance the company's growth with credits is vital for promoting expansion. Therefore it will be fundamental for the company to reduce all possible risks in order to gain a larger credit capacity.

The organization and management risk previously discussed can be classified as an operational risk. An enlargement of the company's turnover will therefore increase the operational risk, which in turn can be related to more people involved in the business and larger order volumes. Due to the nature of the risks, involving members putting in larger amounts of money prepaid at every order occasion, the demands of the participating members will automatically become more challenging. The fact is that the entire business concept relies on the executing of payment from member to Company A to manufacturer, with the aim of bringing back goods. Therefore it is of high priority to lower the operational risk and hence develop the business further.

From Handelsbanken's point of view further expansion of the company must be financed partly by their own means and partly by the bank in the form of loans. Currently the banks analysis reveals that Company A does not have the financial capacity for further loan granting. But if the operational risk is to be reduced along with a satisfying profit growth the capacity for loan granting will open itself up even more. In aiming to lower the operational risk for Company A, the banks suggests finding a solution to making sure the payment from distributor to Company A to the manufacturer is securely carried out. In order to do so Company A needs to present a solution that is adaptable to all the members of the group. This can be problematic due to the fact that all members of the group are financially different in terms of maturity and strength. If these problems are not to be solved major obstacles will stand in the way of additional development. Facing these problems has lead some group members to argue that the increased risk will lead to greater cautiousness. In the future they can become unwilling to increase the value of the orders simply because it implies losing more money because of the risk of involved with the prepaid system.

One possible solution to the problem associated with a steadily increasing operational risk could be the implementation of practicing Letter of credits. The use of Letter of credits is suggested to a company that is involved with international trade with a country where the



current payment methods are risky. This kind of solution would without doubt result in lower margins, though the increased order volumes will probably compensate for these costs.

The implementation of Letter of credit is suggested by Handelsbanken because of the fact that it lowers the risk associated with the transfer, thus transferring the sellers risk from the buyer to the buying party's bank. This means a lowered risk for all of the concerned participants.

According to Handelsbanken, the concept of an international buying group can be problematic when trying to implement Letter of Credits, because of the differences of European banks. Company A's buying group consists of western countries as well as Russia, Turkey and countries of the former east block. The variety of countries can be an obstacle when implementing Letter of credit. Handelsbanken's lack of trust as well as cooperation issues is a result of some of the countries having underdeveloped markets. This fuels certain amount of cautiousness when engaging in business within the constellation. Prior to practicing Letter of Credit within the group Handelsbanken must evaluate the possibilities of the countries accounted for, focusing on the risk concerning that country's particular bank.

5.2 Interviews with trade finance experts

The following empiric material is created from two interviews held by specialist at the trade finance department Nordea and Handelsbanken's Trade finance departments. It will focus on the risk-situation and consequence that arises when Company A is involved in trade with many different parties. Through a investigating discussion held by the specialist, an exploration of the possibilities of implementing some sort of trade-insurance that can be helpful to lower the risk in Company A is made. The empiric material will present three different types of bank instrument used for this purpose. Main focus will be put on the possibilities of Letter of credit and complication that follows surrounding an implementing in Company A.

A direct consequence of an increase in turnover and company size is a higher business risk.

One of the risks is related to the enlargement of order size. The bank's suggestion on how to face an increasing trading risk is to employ some sort of insurance. The bank provides many different types of insurance to secure these kinds of situations.

A firm when making trade with a unknown business partner, or trading with a politically and economically unstable country most commonly uses Letter of Credit. Company A's business involves over 19 countries, some of them belonging to the former USSR, the East-block and China. The other countries in the buying group are western with the exception of Turkey. The concerned countries have all reached different stages of financial maturity level and also differ in terms of being politically stable.

For a Swedish bank using Letter of credit as security can cause problems. The lack of confidence towards some countries presents several risks with using Letter of Credit. The analysis demonstrates concern towards such countries as Russia, Turkey and the former east block. In general the banks of these countries demonstrate poor cooperation and lack of trust towards each other as well as western banks. The former East-European countries exemplify this perfectly. Most of the banks are small and local without a global network.



To consider using Letter of Credit the trading partners must have some form of financial relation with the bank or have a earlier record of using Letter of credit. If the western banks were to cooperate they would exposed to tremendously large risks. Therefore, to minimize this risk surrounding local banks, Swedish banks suggest that one must use a larger and more reliable bank with a former history of Letter of credit. Though this may seem troublesome this is not always the case. In fact, the bank proclaims to have worked with Letter of credit in all these countries; it basically just comes down picking the right bank to cooperate with.

The concept of the buying group described previously is, according to the bank, very interesting. Never before has such a problem been faced, concerning the consolidation and securing orders from 16 different countries. Issues concerning this arise when the value of a placed order is higher than the acquired credit facility can provide. Thus, the gathering of orders from many distributors results in higher order volumes which compromise security. In this kind of situation, the bank is not willing to secure the traded good with a Letter of credit. Because of the insufficient credit facility of Company A an implementation of letter of credit will be impossible as it would be a risk filled endeavor.

A possible solution of the problem would be to collect credit facility information from each of the members. This will provide the security that is necessary when creating the Letter of Credit. But with this new inconveniences will arise. In determining the specifications of the securities, what should be accounted for and what should be disregarded? If one were to find a solution the implementation of a transferable Letter of Credit would be the preferable way to ensure security. To enable this it is of most importance that the distributors themselves construct an individual Letter of credit containing stipulation of their share. To qualify for adequate security measures the distributors must encircle specific information regarding, unite quantities, price, time of deliver and so forth.

Furthermore, to serve as a security for the combined order the individual Letter of Credits, have to be transferable. This would theoretically mean that the individual Letter of credits could be assembled and converted in to one final Letter of credit that is able to secure the entire order. This is where the first problem transpires; because the bank has no prior experience of working with this large amount of transferable partners the order in which the final Letter of credit is to be assembled is basically untreated territory. In general this procedure is reversed, namely starting with several manufacturers constructing a transferable Letter of credit for the buyer. In the case of Company A, the process commences with the buyer composing a transferable Letter of credit and ends in the hands of the manufacturer.

This way of doing it will ultimately lead to problems. Firstly, issues connected to the actual practice of the transfer can arise at any time and secondly, the rules surrounding the legitimacy of the Letter of credit are not to be sidestepped. Concerns regarding the latter are addressed by following the rules stipulated in the UCP 500 “world agreement”. In attempting to make a transferable credit in the fashion described above all of the transferable Letters of credit from the distributors need to be specified along the lines of the UCP 500.

Because of these very explicit set of rules this, unfortunately, brings about a colossal amount of administrative work. Because the individual Letters of credit need to be converted and assembled, the final result, that is the large compilation of these, should serve as one document. This document consists of information regarding the orders specified in the earlier



Letters of credit, consequently increasing the risk of uncertainty concerning the proper validation of the final Letter of credit. The bank is therefore at risk, and with a higher risk comes a higher price. Repercussions are also to follow in the subsequent steps; after shipment has been carried out and the Letters of credit are to be cashed in, the path must be traced back the same way. This means that the compilation Letter of credit has to be divided in the same parts originally assembled. The specification of these must be accurate in accordance with the shipping document and original Letter of credit. With every step of the way, the bank is increasingly at risk and is very likely to end up in a situation too strenuous to handle. It is for that reason safe to say that the bank would be better off in considering a different risk-decreasing alternative.

One possible solution to how to secure the Letter of credit towards the manufacturer could be a form of standing credit facility within each of the distributors. This credit facility would serve as insurance for the final Letter of credit and has to be accessible but reserved for this reason only. This means that Company A is able to strength its financial situation and are considered credit worthy, which is a necessity when implementing a letter of credit.

The fundamental nature of the business idea is built upon trust, and a situation with a standing credit facility within the distributor would be a further development of this idea. In a situation of low credit facility, the solution of having credit facility within each distributor could prove to be problematic, because to be trust worthy Company A must come up with a solution of how to exploit the credit facility equally in each of the distributors. An answer to this problem could be to exploit the facility share wise in correlation to the quantities ordered from each of the members. Nevertheless, to be able to do this, the bank will need to make a complete investigating of all the members and in doing so, focusing on the financial state and potential future development of each member. Finally, specifying this agreement in legal documentation is highly necessary but will take a substantial amount of time to complete.

Back-to-Back credit is another product that can be taken under consideration for Company A. This credit works largely in the same way as a transferable Letter of credit and has the same purpose. The difference between them is that a back-to-back credit is not specified as an instrument in the UCP 500, which in turn means that it does not hold the same amount of legal justification. Consequently, there are risks involved with back-to-back credit. Therefore, it can be proven problematic when investigating the options of satisfactory credit for this purpose.

5.3 Interviews at Company A

The interviews conducted at the company were with the following persons: The Sales Manger, The Head of operations and The Chairman of the Board. The Sales Manager was interviewed twice with focus on his general understanding of the company's situation with regards to both internal and external aspects. Furthermore he possesses valuable information regarding the members of the group through his role as sales manager. The Head of Operations provided more in-depth information about the internal organization of the company. Finally the interview with The Chairman of the Board provided with valuable information regarding the companies risk management discussions.



The business strategy of Company A is to be the administrating company in an international buying group on a distributor level. This role requires that Company A efficiently manage the operations concerning the consolidation process of the group member's individual orders. The whole purpose of the consolidation of orders is to reach the critical volume required in order to attain greater margins. Consequently this means that the pooled order is dependant on the individual orders. Thus the concept is dependant on the order placing process running smoothly. The co-operation is a loosely connected network, built around trust from the members and old relations between many of the individual member companies and the founder of the company, also The Chairman of the Board

Over the last three years Company A has seen an increase in turnover of more than 400 percent.³⁶ In the same time order volumes have been increasing constantly and are predicted to rise even further. According to the company's projections of the order volumes in 2006, one estimates an total value of 30.3 million US Dollars in comparison with 19.4 million the year before. The company's strategy to increase volumes over the next years is to add more countries to the group and try to increase sales volumes. With the previous year's development regarding sales volumes and increasing number of members, Company A has a good growth potential. With increasing order volumes and a greater number of members in the group, the administration function of the group will have to develop further in order to cope with the new circumstances.

Currently the company manages the consolidation process by collecting indications of orders 3 months in advance and then as the actual order date approaches, the individual member's scope for changes in order value decreases. As mentioned before the current payment method requires the whole value of the order to be paid in advance to the manufacturer. This is done in two steps, first 30 percent of the order value as the order is placed and then the remaining 70 percent before the order is shipped. For the administrating company this presents two possible problems.

The first problem occurs in the first step of the process when the prepayment is due. At this point Company A must collect the money from all the members participating the order before the consolidated order and the prepayment can be made. Should one or more members not be able to pay for their order a problem does not necessarily occur. If possible, the easiest way to deal with a situation like that would be to exclude the member from the order and proceed without this party. The problem occurs if the consolidated order is dependant on this individual order to reach the critical volume.

The second and more serious problem arises when the actual order has been placed and one of the members fails to pay the remaining 70 percent when it is due. This means that the whole order could be delayed as the manufacturer might hold the shipment until payment is made in full. Implicitly this creates cost in form of interest charged by the manufacturer for holding the products in storage. Indirectly it could damage the group as the shipment will be delayed and this could create frustration among the members in the group. In this kind of situation the administrating company might act as a bank, stepping in and disbursing for the goods. This however has a negative effect on the company's liquidity.

³⁶ Financial statement of company A, 2004; 2005



As mentioned before the greatest risk that the members of the group and Company A as administrator exposes them to is, should it be so that the manufacturer fails to deliver after the entire payment has been made. This risk increases as the order volume grows and thus the money paid in advance also increases. With today's payment method the only way one can counter this risk is to have a close relationship to the manufacturer and actively taking part in the whole process, from the order being initially placed, to the final product is being delivered. According to the head of operations, this is how the company works with these issues today.

The Chairman of the Board pointed out the fact that the organization structure creates both possibilities as well as threats. The fact that there are no written agreements between the members of the group and Company A creates benefits through flexibility. However, it presents a problem as the possibility to control the group by enforcing some rule or regulation is small. Furthermore, the current method when the members pay the full amount of the order in advance to Company A is based on trust. Even though many of the members have to give credits to the retailers that buy the goods, the members still pay for their orders full in advance. One big threat to the business concept according to The Chairman of the Board would be if an event occurred that would indirectly hurt the credibility of the concept and the trust, which is the foundation that the buying group is resting upon.



6. Analysis/Conclusion

Under this headline we will discuss and analyze the material that we have gathered throughout our research. The analysis will be based upon the empirical material and theoretical framework.

6.1 Analysis

6.1.1 Risk

The discussion will be held in accordance to the three risk areas that we established earlier in the paper, which were: organizational risk, supply risk and competitive cost risk. First each issue will be dealt with separately in this section and then later on be discussed more thoroughly in the analysis

6.1.1.1 Organizational risk

The buying group has seen a steadily increasing order volume since the concept was introduced in 2001. Like every company in a growth phase, the buying group is exposing itself to a greater business risk than a similar actor in a stable phase is. A company that exposes itself to greater business risk has all the more incentive to balance this out with a lower financial risk. As companies grow the need for efficiency and risk minimization in the internal structures becomes more important.

In the theory there are thorough discussions concerning the relationship between company growth and increased risk. Risk related to growth occurs as a company is between two phases. Without efficient risk management the possibility for a company to enter the next growth phase will be hindered. Should the company be able to enter the new phase without sufficient risk management practices, the outcome could be disastrous. (Dewhurst 2000) Company A has seen continuous growth over the last years and one is expecting and aiming for an even greater development in the future. The phase that the company is currently in is the so-called “Planning and control phase”. However, with the results from the empirical study and the theoretical framework one can predict that the company is getting closer to entering a new growth phase. We believe that Company A is on the verge of entering a new phase, in this case it is the “Expansion phase”. (Dewhurst 2000) In order for a company to be able to enter the expansion phase there are several issues that needs to be addressed, for instance the development of efficient administration, an issue that is highly relevant for Company A. If the company wants to see a continuous expansion of the group, minimizing the risk will be an important issue to address.

Through our research it has become clear to us that the risk related to the intricate network of financiers, suppliers, group members and the administration company, is a pressing issue. In his article, *Influences on Member Commitment to Group Purchasing Organizations*, Doucette discusses the importance of trust and satisfaction among the members in a group purchasing organization. Doucette writes: “To be successful at obtaining favorable purchase terms, a



GPO must be able to foster and maintain the commitment of its members.”³⁷ This discussion is crucial for Company A as its business is depending on being able to provide the members with their services as the administrating company.

For Company A their business concept is the main source of risk in accordance to the theory. There are most definitely positive aspects related to the business strategy. Through cash management operations one is able to make money on the pre-payments gathered from the individual members of the group. Furthermore there is the aspect of being able to increase margins through volume purchasing.

The company is dealing directly with the manufacturer as a representative for a buying group. Company A by itself is dependant on the strength of the group to be able to reach the critical volume needed to deal directly with the manufacturer. This means that the company is dependant on the success of 23 independent actors for its business to run. Another source of risk for Company A is the order process used today. The company pays the total value of the order in full in advance without any guarantees from the manufacturer.

6.1.1.2 Supply risk

A supply chain stretches from final consumer in one end to primary supplier in the other end. A purchasing group adds an intricate network as another an additional party in this chain. The more parties that are depending on each other’s ability to perform, the greater the total risk for the individual parties in the network.

The current situation that Company A is in is that one pays the suppliers in advance. This means that there is no guarantee that the goods actually will be shipped according to arrangements. Today the company works with a form of crude Early Supplier Involvement (ESI) activity. According to the company’s management the biggest mistake a buyer can make when doing business in the consumer electronics industry is not to actively investigate and form a personal relationship with the supplier. By actively visiting the supplier’s production facilities and personal relationships the company so far has been successful in minimizing the risk of supply failure.

For Company A the risks are related to the buying group structure and administration rather than to for instance quality. Another important factor that is discussed in the theoretical framework is supplier risk. All the parties below the supplier in the supply chain are depending on the supplier to perform according to agreement. If the supplier turns out to be insufficiently meeting the needs for quality, financial strength etc. the whole network will suffer for it.

If we start with the supply chain risk related issues, we can clearly see that a buying group creates a more complicated supply network compared to a more orthodox supply structure. In this stage it is important not to get the terminology confused. When talking about supply risk we mean the risk related to the processes involved in getting the finished goods to the final

³⁷ Doucette, W. R. “Influences on Member Commitment to Group Purchasing Organizations” *Journal of Business Research* 40:1997 p. 183



consumers. This should not be misinterpreted as supplier risk. Supplier risk is in our given context the same; independent on whether the supply network is intricate or simple. The supplier risk is the risk that Company A exposes itself and its customers to when they decide to do business with a supplier. Supplier risk plays an important role in the total risk that constitutes the consolidated supply chain risk.

According to the management of Company A the worst-case scenario related to the risks one is exposed to would be to lose a whole order. The total order value is paid advance before the goods are shipped meaning that should the supplier not deliver the goods one would lose the total value of the consolidated order. This aspect of the supply chain risk would be related to supplier risk. However, since the company merely acts as the administrating company in the buying group, a lost order would mean that 23 individual parties would receive neither their ordered goods nor their money paid. Company A is depending on the members of the purchasing group to place their orders with the Company and pay for the goods in advance. An issue like this could negatively impact willingness among the members to increase or even order at all which in turn would lead to the concept not serving its purpose and Company A standing without a business. If you apply the same scenario to a more orthodox supply chain this problem would not occur as it would be possible to insure the order through a Letter of Credit to a greater extent than for Company A.

6.1.1.3 Competitive cost risk

Competitive cost risk is an interesting issue for Company A in the context of the shrinking margins of consumer electronics industry. According to the management of Company A, the main reason as to why the purchasing group organization was founded was to generate greater margins on purchases. Our meeting with Company A's business associate confirmed our thoughts regarding the correlation between risk and cost. However, this relationship is a two-sided coin.

One aspect is the fact that companies considered more unnecessary risk-taking generally receive harsher financial terms. Harsher financial terms mean higher interests on loans and credits. Furthermore the cost for buying financial services and products will also go up. The other side of the coin deals with the aspect of the fact that the more one wants to lower one's risk, the more it will cost. For Company A to be completely insured and protected, thus having 0-risk, it would cost a fortune.

According to the theory competitive cost risk is related to not being able to present the consumers with their desired price, when another actor on the market can. (Panelli, A., Upton, R. and Zsidisin, G. 2000) The individual members of the buying group of which Company A is the administrator are buying the services of the company because they believe that doing so will improve their margins. If however, increased cost related to financiers perceiving Company A a risky investment and thus inflicting harsher credit terms could decrease these margins, and therefore negatively affect the concepts attractiveness. The catch 22 of the situation is that whatever means the company will take to manage the risk will also lead to increased costs and tighter margins.

Regarding the competitive cost risk there is a catch-22-situation. If the company will not actively manage their risk they will most likely have problems to expand the business as the



risks become more substantial for the members. From a member's point of view one would start to consider the co-operation within the group a more high-risk venture than before. When taking higher risks, the risk-taker agrees to the possibility of losing money and in return expects a higher return on one's investment. In this case this would mean that the members expect to make better margins by using the group's strength and pool the purchases for the individual members. However, since the members pay the total value of the goods ordered in full, a perception of the venture to be of higher risk might fuel a discussion on better credit terms. Better credit terms for the buyers mean harsher terms for the seller, in this case Company A.

The paradox is the issues that can be qualified as competitive cost risk. Competitive cost risk is related to target costs set by consumers on the open market. In this case these consumers are the suppliers and the seller is Company A. If one cannot guarantee a better price and thus higher margins than other actors, there will be no one wanting to buy the goods. The members of the group are willing to accept a higher level of risk with the hope of making better margins through volume purchasing. If Company A decides to start actively managing their risks related to the organization it will cost more money, more money that ultimately the consumers will have to pay. As the costs go up the margins go down and the concept of buying as a group through an administrating company becomes less attractive. This is competitive cost risk and it is something that Company A will have to consider before deciding how and to what extent to manage their risk. Evidently it seems that ultimately both risk issues are related to the business concept and the organizational structure that comes as a part of it.

6.1.2 Alternative payment method

Company A is in a delicate situation. Voices have been raised from members of the group and their bank that the current method of payment insufficiently meets the needs concerning risk and financing issues. Combined with the wish from Company A to find an alternate way of payment there are strong incentives to investigate what possibilities there are.

The problem is to secure the individual members payments to Company A, then secure the consolidated order placed with the supplier for the whole group's sake. A Letter of Credit from a member to Company A would indeed eliminate the risk that the individual member is faced with when paying in advance. However, to be able to gather 23 Letters of Credits from possibly 23 different banks in the same number of countries and then transfer these credits to one consolidated is not a possibility. A transferable letter of credit, if practically possible to implement, would solve the risk related problems related to the securing of orders from suppliers. The members would stand without the risk of losing their prepayment, as the supplier would be getting paid until the goods would be delivered to the final destination.

The interview we have conducted with members of Company A indicates that even though they are the administrator and driving force in the group, the members are a force that has the opportunity to push for their own agendas. It has become clear that more and more members of the group are interested to shift from TT in advance as way of payment, towards the use of L/C. One argument that these members rely heavily on is the possibility to use credit instead of payment in advance. There are clearly incentives that support the implementation, but as



have been shown there are many obstacles that have to be overcome before this can be realized.

In our research we have identified two obstacle drivers. When identifying these drivers we have tried to determine which issues can be considered syndromes and which issues that are the actual problems. The core problems that we call the obstacle drivers are related to parties that have key positions in the solution of the problem. These obstacle drivers are the following: Insufficient internal structure in the administrating company and heterogeneity among the group members. From here on we will continue to discuss these problems more thoroughly.

6.2.2.1 Obstacle driver 1 – Insufficient internal structure in the administrating company

Through the discussion with Martin Johansson, deputy branch manager at Handelsbanken in Stenungsund it became clear that there are some administrative difficulties connected to Company A that needs to be addressed in order to be able to successfully implement a solution. The problem as it is today is can to some extent be related to the buying groups structure. The buying group is an informal cooperation between independent distributors in different countries. In the same way that there are pros such as less bureaucracy and flexibility, there are cons such as unclear structure and which obligations the members have to the group.

This is a major problem to the implementation of L/C in the group in the way that this requires that the order procedure becomes more reliable and efficient. In order to consolidate the individual letters of credits the administrating company has to collect transferable L/Cs from all members and present these to their bank. With the business plan that the group has, late payments are a reality. These issues are related to how the routines that the administrator has to inflict on the group members in order to have an efficiently functional organization.

Company A charges the individual members a commission on the orders that they place, thus it lies in the company's interest to maximize order volume. Since the start this has been the trend and the company has done exceptionally well. When focusing so heavily on the external business development, it is easy to forget the need for an efficient internal organization that can handle this expansion. With the ambition to link more countries and to increase volumes, the administrative problems of the Company Are not going to decrease; they are more likely to increase. With the wish from members of the group and financiers to decrease risk in the concept through the change of payment method, the company will soon be under pressure to address these issues. Since the suppliers of the service demand that the administration and internal structure are perfected before they can supply the service, it will be impossible to implement the service until this is done. The company will have to form a policy concerning the order placement that is adaptable to the implementation of L/C as way of payment.



6.2.2.2 Obstacle driver 2 – Heterogeneity among the members

It would be naïve to think that the members of the group would have the same financial culture, financial strength and experience using L/C. Even so, had it been so many difficulties could have been avoided. The buying group is a rather loosely connected assembly of independent companies that as the CEO of company put it are “stars in their own market”. These companies differ from each other on a number of factors, which makes it hard to implement a “one fits all” – solution. Furthermore it has been clear from our interviews with the staff at Company A that an implementation more or less has to be a policy shift, i.e. it has to be consequent and apply to all members and all orders. In order for this to be possible there has to be a consensus among the members that this is the way to go.

The buying group has members established on immature markets. This constitutes a problem in the implementation of L/C as it requires cooperation between banks. If the administrating company’s bank considers the L/C put out by a bank on an immature market as a greater risk, the cost will go up. In some cases the administrating bank might require the individual member to use a different bank if they determine that the members bank insufficiently meet their risk requirements.

As the members also vary in size it is reasonable to presume that their financial situation and strength varies as well. This might be a problem if it means that some companies will have difficulties getting a letter of credit from their bank. The L/C is as implied in fact a credit, which means that before the bank agrees to guarantee the seller payment, they will need to have some sort of collateral or security. If the order that the member places with Company A is substantial in volume in relation to the total turnover of the company, the bank might consider it a great risk and either refuse or demand a high risk premium. This problem can to a greater extent be linked to the over all commitment the member has to Company A and the brand. If this business only represents an insignificant part of the total turnover of the members, they might not be as motivated to participate in any major alterations of the group’s business strategy. Since the implementation is dependant on a consensus agreement among the members in the group, it might be hard to motivate an implementation with the lesser-committed members.

6.3 Conclusion

With this thesis we set out to identify risks and threats to business concept related to the payment method used today. As a complement to this problem we also investigated alternative methods of payment that could be used in order to more efficiently manage said risks. Through our research it has become quite clear that in the current situation Company A and the purchasing group is exposing oneself to numerous risks related to the international trade activities that one is participating in today. Furthermore we believe that if this risk is not efficiently managed, the future for the concepts is uncertain to say the least. This conclusion is based on the results that we have compiled through our research in combination with the information based on the theoretical framework. The risks are significant individually and combined they constitute a hinder to great to overcome easily. Even so, our research has



presented us with some interesting subjects worthy of further study. These will be discussed further in the following section of the paper.

The three parties that all play a crucial part in this equation are as mentioned before the administrating company, the individual members of the buying group and the bank. In order to manage the risks in Company A, all of these actors will have to participate in the process. The greatest threat to the concept is the organizational structure of the buying group. Company A is depending on its members in order to turn a profit and without efficiently managing the relationships and securing continuity in the group, Company A will not prosper.

It has become clear both from previous research conducted on the issue but also from the management of the administrating company that in a buying group environment, managing relationships is crucial. In the current situation the business is depending on the personal relationships that the manager and the chairman of the board have with the customers in Europe. We believe that nurturing close business relationships is crucial for any successful company involved in trading. However, we also believe that with the structure of the buying group as it is today, the concept is too heavily depending on these relationships to function.

It would be interesting to see how a negative effect such as an order being voided by the manufacturer due to insolvency would affect the purchasing group. It is our belief that Company A would be able to avoid the direct implications of the event even though it might cause some problems. The indirect effects might be harder to identify and thus harder to counter. An event like the one previously described might cause the members of the group to doubt whether the arrangement is safe enough. Indirect risks to the concept like these are hard to pick up and left unaddressed might jeopardize the credibility of Company A as the administrator.

Company A is in a delicate situation. They are in the middle of two strong forces that both have to be dealt with successfully in order for the concept to prosper. In the current situation the group's orders are too insubstantial to be used as leverage in the negotiations with the suppliers. Before the volumes become big enough for Company A to be able to negotiate better terms with the suppliers, the group has to adjust to the terms inflicted by the supplier. The retailers to which the goods are sold pressure the members of the group. This far the members have been ok with paying for their goods in advance, even though the retailers most definitely demand credit, this might shift. The question is what effects that would have on Company A in their current state of administration.

When we first visited the manager of Company A he told us that there are two possible ways to pay for international orders in the consumer electronics industry. He described the system used today, TT in advance but also the alternative as being L/Cs. The alternative that he wanted to investigate was the use of a transferable letter of credit. In our research we have found that it will be extremely hard to implement a change from TT in advance to the use of transferable L/Cs. This conclusion is based upon our estimation of the organization structure, the effect it would have on the business and whether it would solve the risk related problems.

As mentioned in the analysis, a successful implementation if practically possible with all administrative difficulties set aside, would indeed affect the risk related to securing the



orders successfully. However, the question whether the total effect would be positive is another issue. The costs for lowering this aspect of the total risk would be too great when taking the competitive cost risk in to consideration. With this in mind we have concluded that the use of a transferable L/C as a method to decrease the overall risk related to payments is not a possible solution in the current situation.

The heterogeneity of the group in combination with the loose structure makes it hard to form a consensus around a decision. Some of the members neither have the enough practical experience working with this kind of product, nor the financial possibilities to use L/C as payment method. With the current administrative problems related to the placing and payment of orders, an alteration has to be unanimous. Company A is the administrating company in the group and is the driving force behind the group. However there are several parties involved, all with different priorities.

We set out to identify and explain the risks that are threatening Company A's business concept. We did not believe that our findings would tell us that the main source of risk for the company is the organizational structure. We believe that in order for Company A to be able to take calculated risks that can make the difference in a fiercely competitive market, one has to start managing the fundamentals. Implementing a new payment method, develop the organization structure within the group, these are only two suggestions of issues that needs to be addressed in order for the company to be able to reach the goals one has so highly set for oneself. This is crucial a company so heavily depending on trust from their group members and financiers.

Implementing a new payment method for the international orders is a step in the right direction if one decides that to manage risk is something that the company needs. However, the alternative presented by the management, transferable Letter of Credit, is not the solution. We believe that this instrument is too crude to sufficiently be applicable to the intricate trade structure that the buying group constitutes. If the worst-case scenario is to loose an order and the prepayment entirely, one might have to divide the problem into two parts. First make sure that the consolidated is insured and securely delivered to Company A, then find ways for the individual members to secure their individual claim.

To summarize our conclusion we would like to make clear that even though we have identified numerous risks of varying severity, Company A has not yet experienced any greater effects related to these issues. Up till this day the one has successfully managed the business with entrepreneurship and experience in order to minimize the risks. We believe that this is as great a recognition that any management could get, proving that one has good instincts. In the theoretical framework we started out by explaining the connection between being an entrepreneur and being a risk taker. The founder of the company is truly an entrepreneur and most definitely a risk taker. However, there is a difference between being an entrepreneur and being a person taking risks in their business, the entrepreneur just like the gambler always takes calculated risks.

By using personal relations and ESI (Early Supplier Involvement) the management has successfully steered the company out of harms way. Based on strong entrepreneurial skills and great instincts this has been possible. As the company is on the verge on entering a heavy expansion these factors will be extremely important for the long-term success but will they be



enough? In our opinion the answer to this question is no. Based on the information collected and the gathering of previous studies related to the material, we believe that a more active risk management activity is needed.

6.5 Subjects for further study

An alternative that the experts at Nordea presented was a sort of credit guarantee agreement between the intermediate bank and the individual member's banks. This would implicitly mean that the members would be proportionality responsible for the risk, should the intermediate bank not get paid. A possible solution could be that the individual member's freezes money in their respective bank as security for the order. This however has a negative effect on the liquidity in the companies. With this kind of arrangement it is up to the intermediate bank to evaluate whether they can comply with the risk that this involves.

Another possibility to explore would be so-called back-to-back credits. This solution is very similar to that of a transferable Letter of Credit. The difference is that with a back-to-back credit there are two independent credits in use instead of the one that is the case with a transferable L/C. This type of solution is not mentioned in the international rules concerning documentary credits, the UCP 500. This means that one can side step a lot of bureaucracy that in our situation would present a hindrance. On the other hand the fact that it is not included also means that this kind of product is not considered a proper security. As a result the requirements and conditions are much harsher for this kind of product. Even though this is a theoretical solution and that many companies use it, in our situation it could be hard to implement. In practice most banks would be reluctant to act as intermediate party unless the company in the middle, in this case Company A, proves to be financially strong enough to present a security for the whole credit.

If company A is to consider going through with the idea of some form of integrated credit facility, the aim would be to give company A stronger financial capability. The first move in this process is an evaluation of all the distributors in the buying group. We believe that there might be problems that can be traced back to the variation in financial-maturity level within the member group. The evaluation will therefore focus on the distributors financial state, future development and bank contacts. The buying group consists of 23 countries and to be able to go through with a solution all the countries must have sufficient funds and agree upon the terms of the idea. It is therefore of great importance that all the members run financially stable businesses with the capacity to share some of its credit facility to strengthen Company A's business. To know the future development and plans for each distributor will also be of significant value, because as mentioned before, the solution of the problem depends on an agreement that all the members can agree upon.

As a result, Company A must be able to evaluate what the future holds for the distributors in terms of financial stamina. If not, the entire business idea will fall. As illustrated in the empiric material, the members are from many different parts of Europe. Therefore, investigating a potential collaboration between the Bank and the distributors is vital. In some cases the investigation could indicate that it is not possible to cooperate with a certain distributor's bank and to be able to follow through, this means switching to a bank able to collaborate with the Swedish one. Furthermore, the investigation could show that the distributors are not capable to meet the standards of financial capability and potential future



development. If this were the case, one would suggest the replacement of this distributor for another better-suited member that meets the criteria.

We believe that the company could benefit from further evaluating alternative payment methods that better suits the organization. In the long-term perspective it will be important for the company to evaluate the organization structure and its members in order to more successfully administrate and manage the business.

6.6 Quality of results

The research that we have conducted has been in the form of a case study. We chose this method as we thought that it would be interesting to illustrate a phenomenon that to our knowledge has yet to be covered. This phenomenon was exemplified through a case study of the only company that to our knowledge is the administrator of a buying group on a distributor level. The problem with using a case study as method of research is that it is hard to generalize. One needs to discuss whether this one case could be descriptive of the reality.³⁸

In the literature the discussion regarding validity and reliability when doing qualitative research is entwined. When discussing the one you are more or less discussing the other. In qualitative research validity and reliability is connected to collecting the right material in order to present a feasible interpretation of the object studied.³⁹ Our empirical research is based on qualitative interviews. According to Bryman, in qualitative interviews one can start with loosely formulated subjects that one wants to cover in the interview.⁴⁰ We started our interviews by being quite specific in order to form an opinion regarding the situation in Company A. The following interviews were based on findings that we discovered along the way. In accordance to Bryman we went from being general to more specific as the research continued.

In their book *Att utreda, forska och rapportera* Eriksson and Wiederstam-Paul discusses validity as the research method's possibility to evaluate what one intends to evaluate.⁴¹ In this context we believe that performing a case study as research method is the appropriate way to study our research object. Since the company that we use to exemplify our problem is the only actor in the similar situation a case study provides with important information regarding the problem. One important issue that needs to be discussed in this context is subjectivity. As mentioned before the interviews have been unstructured and flexible in order to let the interviewee give their view of the issues addressed. Davidsson and Patel discuss the importance of validity in qualitative research as way to ensure feasibility. It is important to counter subjectivity when transcribing the interviews.⁴² We tackled this problem by discussing the interviews thoroughly in order to make sure that we had understood the interviewee.

³⁸ Bryman, A. "Kvantitet och kvalitet i samhällsvetenskaplig forskning" Studentlitteratur Lund 1997

³⁹ Patel, Davidsson "Forskningsmetodikens grunder" Tredje uppl. Studentlitteratur Lund 2003

⁴⁰ Bryman, A. "Kvantitet och kvalitet i samhällsvetenskaplig forskning" Studentlitteratur Lund 1997

⁴¹ Eriksson, Wiederstam-Paul "Att utreda, forska och rapportera" 7e uppl. Liber 2001

⁴² Patel, Davidsson "Forskningsmetodikens grunder" Tredje uppl. Studentlitteratur Lund 2003



In this context we believe that we have been consequent with acknowledged research methodology and stand by the quality of the research. However, this thesis is based on the information provided by one company that to our knowledge is the only one of its kind. Therefore further study regarding our field of research will be necessary. Given the circumstances we believe that the information presented in this thesis is valuable and in a descriptive manner illustrates the problems related to our object of research, an administrating company in a buying group on a distributor level.



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Appendix

Appendix 1 - Types of Credits

All Letter of credit around the world are created along with the UCP 500 standardized rules. In using the UCP 500 rules the paper is perceived as more legitimate and also assures the buyer and seller in receiving payment and goods. If done correctly and in accordance with UCP 500 banks are more or less obligated to pay if the document can be correctly presented⁴³. Further more, when examining the possibility to implement a Letter of Credit one must decide what type of credit is to be used. A Letter of credit can be divided into the following types:

- Revocable- irrevocable
- Unconfirmed- confirmed
- Credit available payment – credit available by negotiation
- Sight credit – usance credit
- Import credit – export credit

These different categories can be combined as required⁴⁴. For instance, you may issue a usance export credit, irrevocable and unconfirmed, and it can either be a credit available by payment or a credit available by negotiation. Depending on the type of transaction between the buyer and seller a suitable Letter of credit for this purpose is created. Each type of credit holds its own advantage depending on what intention the buyer and seller is to agree upon. However, all Letter of credit holds similar features regarding the advantages, disadvantages and risks that come with the implementation. Following the above stated evaluation in connection with the specific order and payment method, A feasible credit will be determined through the above measured evaluation along with the nature with the specific order and risk involving the payment⁴⁵.

The general rule is that an advantage for one party may be a disadvantage for the other, therefore putting focus on the importance of the evaluation, as it constitutes a ground for the entire process. As a consequence, it will be pivotal to identify the advantages and risk before making a final decision whether or not to use a Letter of credit, and not to forget to assess the probability of risks to come.

Advantages, disadvantages and risk

The statement below outlines some of the most important advantages, disadvantages and risks related to the use of Letter of Credits. This presents the fact that the buyer takes the greatest risk and gets most of the disadvantages. However, it is important to note that fraud in Letter

⁴³ Nordea “Rembursen i praktiken” published by Nordea

⁴⁴ Nordea “Documentary credits” January 2006, published by Nordea

⁴⁵ Nordea “Rembursen i praktiken” published by Nordea



of credit transactions is fairly rare. If the case were otherwise, the documentary credit instrument would not be used to a large extent that it is today⁴⁶.

Advantages for the buyer

- The seller is entitled to receive payment only against presentation of the documents stipulated
- Normally, payment is not to be effected until the buyer's bank has received the documents.
- It might be easier to obtain a credit facility under a documentary credit than an ordinary loan.
- Increased possibility to obtain discount or finance from the exporter.

Disadvantages for the buyer

- Commitment to pay for documents according to the terms of the credit, regardless of the condition of the goods.
- He cannot demand a reduction in price or better terms, once the credit has been issued.
- A credit facility under a documentary credit can only be obtained from a bank if the buyer is creditworthy.

The buyer's risk

- No guarantee of receiving the goods ordered. Only certainty of the seller's presentation of the stipulated documents.

Advantages for the seller

- Security for obtaining payment for the goods delivered.
- Payment will be effected in an agreed date.
- Sight credits: against presentation of documents.
- Deferred credits: at maturity.
- Security against amendment or cancellation of an order without the exporter's consent.

Disadvantages for the seller

- There may be extra work involved in connection with the preparation of the documents stipulated in a credit.
- Delay in receiving the documentary credit may cause problems in observing an agreed time limit for dispatch of the goods.

The seller's risk

- Documents not fulfilling the stipulations of the credit can be refused.
- The credit is not better than the bank that has a payment undertaking.

⁴⁶ Nordea "Documentary credits" January 2006 , published by Nordea



Conventional Letter of credit

When issuing a Letter of credit an agreement in the form of an application is made up between the buyer and seller. This application specifies all the details and information concerning the Letter of credit. The Letter of credit that is later to be issued by the bank is based upon this written information, specified in the application between the buyer and seller. Therefore, it is very important that the applicant has knowledge of all the details that may influence the terms and conditions of the Letter of credit. In the proceeding process the issuing bank will issue the credit and send it forward to the beneficiary's (the seller) bank (advising bank). In the normal situation the next step for the bank is to advise the seller about the credit. The seller will examine the credit and if the information and details are met according to the agreement, the seller will arrange for shipping⁴⁷.

After the shipping has taken place, the seller will receive the transport documents (for instance bill of lading) and examine and confirm that all the additional documents stipulated in the credit are accurate. The seller will then present the document to the beneficiary bank, and if it appears to be correct the seller will receive its payment. This document is then to be passed forward to the issuing bank (The buyer). The issuing bank will examine the document and ensure that the terms and conditions of the credit have been met. If the document contains the right stipulated details the bank will pass on the document to the applicant against payment. At the time of the arrival of the shipped goods, the buyer will present the necessary document to the shipping company. The buyer is now free to take the goods through customs.

Transferable Letter of Credit

In some cases the beneficiary of a Letter of Credit is not the producer or final seller of the goods. The beneficiary may be asked to provide some form of security for the producer or the final seller¹. The beneficiary is operating as a company in the middle, with producers on one side and ultimate seller on the other. The beneficiary is then the one most often asked to issue the credit. If the beneficiary is incapable or unwilling to persuade his bank to issue the requested documentary credit on his own behalf, it might be a possible idea to use the Letter of credit from the ultimate buyer as security. This action is referred to as transferable Letter of credit⁴⁸.

Article 48 b

“a credit can be transferred only if the issuing bank expressly designates it as transferable. Only the nominated bank may transfer the credit. In freely negotiable credits a bank authorized to make the transfer must be specified. Article 48 c states that a bank is authorized to transfer a credit, nevertheless, has no obligation to do so. Some banks are only prepared to transfer credits that are available at their counters. Some banks even require the credit to be confirmed by them”. (Documentary credits p. 40)

⁴⁷ Nordea “Remburser i praktiken” published by Nordea

⁴⁸ Nordea “Documentary credits” January 2006, published by Nordea

The picture below illustrates the creation procedure of a Letter of credit.

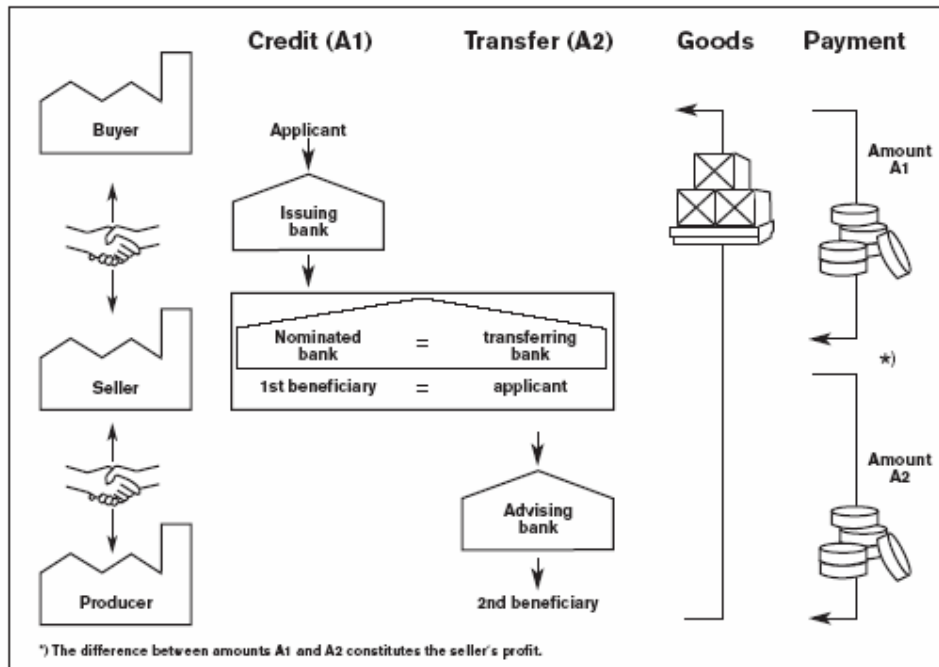


Figure 5

(Documentary credits p. 40)

A bank will normally transfer credits for their customers if they are sure that the underlying commercial transaction is sound and acceptable. In contrast to a standard Letter of Credit, the transferable Letter of credit is different in the way that the beneficiary acts, that is as the applicant during the transfer. A similar change is emerging within the banks, the nominated bank of the credit becomes the “issuing bank” for the transfer⁴⁹.

UCP 500, article 48, strictly regulates the structure of the transferable Letter of credit. The terms and conditions of the credit must not be changed in any way, with the following exceptions.

“Article 48 h

- The amount of the credit and the unit price, if any, may be reduced.
- The date of expiry, the date or period for shipment and/or for presenting documents (according to article 43 a) may be changed to an earlier date or reduced.
- The percentage for which insurance cover is to be affected may be increased to the effect that it covers the sum insured for the first beneficiary’s invoice.”⁵⁰

⁴⁹ Nordea “Remburser i praktiken” published by Nordea

⁵⁰ ICC Uniform Customs and Practice for Documentary Credits, Publication No 500 (the UCP 500) article 48h



Appendix 2 - Interviews

Interview material – Company A

20060331 – Göteborg

Interview with The Sales manager of Company A

Could you give us your opinion on the traditional role of the distributors today?

- What is the current development in the industry?
- You told us before that you felt that the role of the distributors were threatened, why do you feel this way?

What is a buying group?

- How is it organized?
- Explain the relationship between the members of the group?
- Are there any legal contracts stipulating the relationships?

Could you elaborately and in as much depth as possible describe Company A's business strategy in response to the changes in the industry?

What are the strengths and weaknesses of this strategy?

Can you identify any problems related to the arrangement?

What is your opinion on the concept's success?

Do you have any opinion on how the project is perceived by the other members of the buying group?

From another member of the buying group's point of view, which are the most likely problems/risks do you think?

What risks does the company take when acting as the administrator of orders within the buying group?

- Describe the contracts between Company A and the members of the buying group concerning cancellation/late payments.
- Describe the contracts between the buying group and the manufacturer regarding cancellation/late payments, cancellation/late deliveries?



20060418 – Stora Höga

Interview with The Head of Operations, Company A

In this interview we focused on the interviewee's opinion regarding the organizational structure of the company and the issues related to the consolidation and placing of orders.

Questions that we asked:

What is your opinion regarding the company's business concept?

What is your opinion regarding the organizational structure in the company focused on over all risk and expansion possibilities?

As elaborately as possible, please describe the order process from beginning to end.

With focus on order volumes, how has the buying group's development been?

What is your opinion on the future development?

Regarding order volumes, is there a minimum volume that needs to be reached in order to place an order, and if so is the consolidated order close to the minimum level?

What problems arises when members fail to pay for their orders, and how do you deal with them?

What is you opinion on the suppliers' thoughts regarding the different payment methods?

What is your opinion on TT in advance compared to L/C?

How do you discuss risk issues in the context of cost and margins?

20060510 – Stora Höga

Interview no. 2 with The Sales manager of Company A.

During this interview we focused on the vision and goals of the company and the organizational structure of the buying group?

What are the expansion goals for the coming years?

Do you see any risks issues related to this process? For instance do you see a risk in adding new members to the group?



In the expansion, do you see a problem in the heterogeneity among the members?

What are the pros and cons with the relatively loose organizational structure?

20060510

Interview with The Chairman of the board, Company A

During this interview we focused on the organizational structure of the company and the risk related to this.

What are the strengths and weaknesses of the business concept?

How has the concept been evolving from the beginning?

In your opinion is the company exposed to greater risks now than before?

What are the greatest risks that the company is exposed to?

How would a possible negative event affect the company?

What is your opinion regarding the payment methods used today? Are they sustainable?

Interview material – Handelsbanken Stenungsund

20060420 - Stenungsund

Interview with Mr. Martin Johansson, Deputy branch manager, Handelsbanken Stenungsund

In the interviews we wanted to focus on Handelsbanken's view of Company A's business concept and the relationship between the bank as financier and Company A.

Questions that we asked:

What is your opinion regarding the company's business concept?

What are the strengths and weaknesses of this concept?

Are you familiar with the issues related to the international trade processes in the company?

What is your opinion regarding the method of payment in use today?

What is your opinion regarding the risks related to the business?



How does the risk affect the company's possibilities to develop?

In your opinion, what would it take for the company to be able to go ahead and expand the business?

Interview material – Trade finance experts

20060425 - Göteborg

Interview with Mr. Johan Löfqvist & Katarina Benkel, Nordea Trade Finance Göteborg

What is your opinion regarding the payment method currently in use in Company A?

What is your opinion regarding the applicability of Transferable Letters of Credits on Company A's business concept?

How would you solve the problem with the international payment process?

What would it require of the company in order to solve the problem?

What would it require of the buying group?

In your opinion, with the context of the industry that the company is in, would it be practically possible from a cost perspective to solve the problem?

20060427 - Göteborg

Interview with Trade Finance Associate at Handelsbanken Trade Finance, Göteborg

What is your opinion regarding the payment method currently in use in Company A?

What is your opinion regarding the applicability of Transferable Letters of Credits on Company A's business concept?

How would you solve the problem with the international payment process?

What would it require of the company in order to solve the problem?

What would it require of the buying group?

In your opinion, with the context of the industry that the company is in, would it be practically possible from a cost perspective to solve the problem?



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