Chapter 7

Transition Firms

7.1. Introduction

In the previous chapter we started the empirical study by describing and analysing the internal and external working capital operations and levels of the government owned firms. In this chapter, we continue with regard to firms in transition to privatisation. This section (7.1) introduces the chapter. Section 7.2 presents a firm’s overall working capital management issues. Section 7.3 covers the internal management of working capital levels and operations. Section 7.4 presents external working capital management, including firm-supplier linkages and firm-customer linkages. Section 7.5 winds-up the chapter with conclusions.

The objective of this chapter is to help us answer question 2(b) of this research study: “How do manufacturing firms in the process of transition to privatisation in Eritrea manage their internal and external working capital”? Specifically, the objective of the study presented in this chapter is to investigate how a typical firm in transition to privatisation manages its (a) internal and (b) external working capital operations and levels and then to compare this with other transition firms.

With this objective in mind, we approached the managers of Keih Bahri Tannery and studied its internal working capital management, its supplier linkages with Asmelash Hides and Skins Wholesale and its customer linkages with Selamawit Shoe Factory. We have selected Keih Bahri Tannery because it represents a typical firm in transition to privatisation and it was also possible to get responses of its main supplier and customer. A comparison is also made between the working capital management of Keih Bahri Tannery and other four firms in transition, namely - Asmara Textile Factory, Lalmba Sack Factory, Sembel Household Utensils Factory and Dahlak Shoe Factory.

7.2. Overall working capital management

This section presents the transition firms’ background information on issues related to the overall working capital management, including historical background, organizational structure, objectives of working capital management and constraints to achieve the objectives as well as the role of working capital management in creating value. We start with a background information on Keih Bahri Tannery (section 7.2.1) and then present a comparative analysis of the firms in transition to privatisation (section 7.2.2). For detailed information on the overall working capital management issues, refer to Appendix 7.1.

7.2.1. Background information

Historical background of Keih Bahri Tannery  According to its general manager, Keih Bahri Tannery was established in 1946 by an Italian investor under the name of “Conceria Baldini”. It started by producing semi-processed hides and fully finished
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leather for both the local and foreign markets. Its original capital is estimated to be around 1.6 million Ethiopian Birr. In 1975 the Ethiopian government nationalised the factory and did not make any capital investment thereafter. According to its general manager, at present the factory produces 30% for export and 70% for the local market. Upon independence the foreign market in Ethiopia was totally lost. However, since 1993/94 the local and other foreign markets increased so much that at the moment demand is above its production capacity. According to the interview conducted with the firm’s general manager, Keih Bahri Tannery’s overall performance in terms of volume of sales, production capacity, number of employees and market has increased after independence. Under the Ethiopian government, the factory was producing to fill its quota as determined by the then Ministry of Industry while at present it produces on order basis and the incoming orders are enough to make the factory operate at its full capacity. However, the manager says there are some bottlenecks with regard to the investment in machines and maintenance, as a result of which a large liming drum is not functioning. The factory cannot repair this because the cost amounts to a capital expenditure that the factory is not allowed to make in this period of transition to privatisation.

Organisational structure Keih Bahri Tannery’s organisational structure is composed of the general manager, who is responsible to the privatisation agency, NASPPE (National Agency for Supervising and Privatising Public Enterprises) and other managers responsible to the general manager, including heads of quality control, finance and administration, marketing and operation. The NASPPE controls the overall managerial policies pending its privatisation. According to the general manager’s opinion, he is only partially empowered to make decisions regarding working capital levels of investments and financing, as well as operations of production, purchasing and sales. Along with the commercial manager he is also responsible to investigate and assess the market and apply appropriate marketing strategy. The financial manager controls the firm’s financial operations and reports to the general manager periodically. The general manager reports to the NASPPE periodically.

Firm policy and constraints Keih Bahri Tannery’s financial manager believes that the objectives of the firm include mainly decreasing costs, remaining liquid and generating profit. According to the firm’s general manager, Keih Bahri Tannery has no long-term objectives because it is in the process of privatisation. He said that: “The new owners have to bother about their long-term objectives”. During the interview the financial manager also stated that, “We do not have a well planned approach of managing working capital levels and operations due to lack of managerial policy and being in transition to privatisation. Given this shortcoming we try to fully operate the factory, increase sales volume, decrease costs by minimising capital tied-up in receivables and inventories, generate profit and remain liquid”. According to the general manager, what hinders the firm from achieving its objectives is the lack of investment in fixed assets, production capacity, skilled labour and the process of transition to privatisation. As Appendix 7.1 indicates working capital investment, short-term financing, fixed capital financing, product demand and markets are not constraints. The general manager said that: “We can’t produce as much as we want to sell because the machines are old, slow and often out of function. We cannot invest in major repairs because we are instructed by the government that long-term commitments are not allowed since the firm is expected to be privatised”.

All three managers (general, financial and commercial) of the firm believe that the strict government regulations on the privatisation process are the virtual points of reference for the management of the firm at the moment. The regulations that refer to working capital management include restricting the firm from buying or selling on credit for more than three months. The managers say this rule is to ensure that when the firm is privatised there will be no uncollected receivables or unpaid debt transfer from the government to the new owners. The firm is also advised not to collect large inventories of both materials and finished goods. As it is the case with the government firms, Keih Bahri Tannery is permitted to transact on account both purchases and sales only with fellow government and transition firms and cash balances cannot be invested in profitable ventures or deposited into interest bearing bank accounts. With regard to cultural factors the general manager said that: “The ultimate suppliers of raw material skins and hides are the rural farmers. Culturally, the farmers differentiate their animals by engraving a sign on their skin with hot iron, which also shows the wealth of the farmers. This affects the quality of the skin during production. The Ministry of Agriculture is trying to convince the farmers not to do this, but it is a culture and not so easy job”.

The role of working capital management on value creation Before getting into more specific issues on working capital management we asked the general manager a question on the role of working capital management on value creation. He said that: “The only job that we are doing at the moment is, managing working capital levels of investments and financing as well as related operations of purchasing and selling”. The firm’s financial manager also believes that overall working capital management has a pivotal role to play on value creation, particularly in increasing sales by managing cash, receivables, inventory, sales of finished goods, purchase of materials and trade payables can help to achieve objectives of value creation. The financial manager also believes cash management can help in decreasing costs.

7.2.2. Overall working capital management issues - Comparison of transition firms

Here we want to know if the transition firms reveal similarity or have a material difference on the overall working capital management, particularly with respect to the policy of working capital management, constraints in achieving firm objectives and the factors determining firm objectives.

Firm policies and constraints The financial managers of the transition firms responded that their working capital management policy is tailored towards, decreasing costs thereby generating profit and to remain liquid. However, only two out of the five transition firms responded that their working capital management aims at increasing sales.

Regarding the constraints in achieving firm objectives, the transition managers response to interview questions indicate that the factors which are constraining firm objectives are government regulations referring to the transition process have a direct effect on the working capital investment. Except for Sembel House Hold and Dahlack Shoe Factory, fixed capital investments, production capacity and availability of labour are considered to be constraints for of the firms. The transition firms responded
differently to the question regarding the factors that determine their working capital levels. All except Asmara Textiles Factory agreed that seasonality of sales is the most important factor, which affects the working capital levels. In addition to this while credit policy and availability of credit is relevant for Lalmba Sack Factory, Dahlack Shoe Factory and Keih Bahri Tannery reported that sales growth is also important factor. Asmara Textiles Factory reported that availability of credit, price levels of inputs and operating efficiency affect the levels of working capital most.

**The role of working capital management in the value creation** All managers of the transition firms are of the opinion that overall working capital management has an important role for value creation. Keih Bahri Tannery and other transition firms responses show that working capital management is important for the purpose of increasing sales by managing trade receivables, inventory, sales of finished goods, purchase of materials and trade payables. Unlike the financial manager of Keih Bahri Tannery who was not sure whether managing working capital items could reduce costs, the other managers believed that managing inventory, sales of finished goods and purchase of materials could decrease costs.

### 7.3. Internal working capital management

This section covers Keih Bahri Tannery’s internal working capital management, which is divided into levels and operations. Working capital levels refer to investments in cash, inventories and receivables (section 7.2.1) and financing (7.2.2). Working capital operations include purchases (section 7.2.3) and sales (section 7.2.4). For detailed information on internal working capital management of transition firms, refer to Appendix 7.2.

#### 7.3.1. Managing working capital investments

Here, we discuss the managers’ responses to questions on how the firm manages its working capital investments on cash, receivables and inventories. The objective is to study if Keih Bahri Tannery applies efficient value creating methods of managing working capital investments. First, we describe and analyse that of Keih Bahri Tannery and then we compare the outcomes with the other firms in transition to privatisation.

##### 7.3.1.1. Cash management

In this section we study if Keih Bahri Tannery creates value by managing cash balances, collections and payments. Therefore, we asked questions regarding the motive of holding certain balances of cash levels, purposes for cash forecasts and forecasting approaches, purposes and approaches in preparing cash flow statements as well as approaches of controlling cash payments and collections. For detailed information on cash management, refer to Appendix 7.2.1.1.

**The motives of holding cash balances** According the financial manager, Keih Bahri Tannery’s only purpose of holding cash is to make regular predetermined payments (transaction purpose). It has no other specific purpose such as to make
unforeseen investment opportunity (speculative purpose), to pay for unforeseen transactions (precautionary purpose) or as a guarantee for bank loans. According to the firms financial manager, Keih Bahri Tannery pays and collects cash through the bank and mostly has a moderate cash surplus.

**Cash budgeting and control** According to the financial manager, the management of Keih Bahri Tannery does not prepare cash budgets. He said: “*We do not have the tradition of preparing cash budgets. However, we prepare other items of a master budget including materials purchases and usage, sales and production requirements.*” The firm prepares cash flow statements using the receipts and disbursements method because it is a requirement by the government, which it uses to control cash payments and receipts but not to control liquidity or to long-term needs. The firm hedges a possible cash shortage by having an agreement with the bank for overdraft facility. According to the firm’s financial manager cash for working capital purposes is guaranteed by the overdraft agreements. He stated that: “*We do not have a policy of minimum cash balance because the bank overdraft serves as a safety measure when cash is needed in excess of our internal resources.*”

**Managing cash payments and collections** Keih Bahri Tannery controls its cash payments using the voucher system, that is, by approving for expenses before payment is made. It also uses other three control mechanisms - using checks sequentially numbered, which are controlled and accounted regularly, preparing the bank reconciliation by someone other than the one involved in cash collections and payments and using a petty cash system. As a policy of speeding-up cash collections, the firm sells only on cash. The factory controls cash collections by depositing receipts at the bank on a daily basis and by separating duties for sequential cash operation, handling and recording. The financial manager believes that the firm has no problem in managing cash collections and payments. Therefore, it does not make agreements with the bank like borrowing at short notice, extending outstanding loans or extending outstanding trade credits.

**Concluding remark** The firm has surplus cash flow from its operations but because of a lack of investment opportunities and managerial empowerment, it does not value creating approaches of cash investment and financing. The motive of holding cash is only to take care of regular cash collections and payments. So we observed that the firm has efficient control measures against unauthorised cash payments and collections. The firm does not prepare cash budgets and therefore performance evaluation of cash operations is not done. Therefore, as the financial manager stated, the management of Keih Bahri Tannery’s cash management has very little do with achieving firm objectives.

### 7.3.1.2. Inventory Management

The objective of this section is to know if Keih Bahri Tannery creates value by managing its materials and finished goods inventory balances. Therefore, we asked questions regarding if and how it determines inventory costs and values, formulates and implements its inventory planning and control. For detailed information on inventory management, refer to Appendix 7.2.1.2.1 for materials inventory and see to Appendix 7.2.1.2.2 for finished goods inventory.
Materials inventory management As per the financial manager’s opinion, Keih Bahri Tannery’s primary policy in the management of materials is to safeguard against inventory shortages, to minimise the holding costs and the purchase ordering costs. The factory has no major problem of co-ordinating its materials inventory management with its suppliers. According to the firm’s commercial manager, Keih Bahri Tannery has well co-ordinated firm-supplier linkages. This linkage has enabled it to almost eliminate both inventories of materials and finished stock. During the interview the commercial manager stated that: “We have suppliers all over Erirrea. These suppliers buy raw animal skins from farmers. We provide these suppliers with preservative chemicals like salt and with means of transportation by periodically sending vehicles to pick-up the raw materials from their place. When the materials arrive at the factory, the production process starts immediately so there is no raw materials inventory in the factory”.

According to the firm’s financial manager, the inventory reflected in the balance sheet refers to an import from the Sudan, which the firm is not using. He said: “In 1991 there was shortage of raw materials in Erirrea and we imported inferior quality raw materials from Sudan and some of this raw materials is still in the inventory. We are not using it because we are getting better quality raw materials from the local market at present”. The firm’s major cost of holding inventory of materials is the cost of physical deterioration. The opportunity cost of capital invested or interest on capital tied-up, cost of power, costs of handling, security and record keeping are very small. Overall, the commercial manager believes that this cost of holding inventory of materials is very small amount. Applying the economic order quantity in order to keep only the minimum level required reduces the level and costs of the important items.

Keih Bahri Tannery selectively controls the physical movement of materials inventory on the basis of cost and not criticality in case of shortage, usage rate or scarcity in the market. It uses average cost (not first-in-first-out or last-in-first-out) approach to determine the cost of materials issued to production and remaining in inventory. Therefore, inventory of materials is valued in the balance sheet on the basis of cost (not on cost or market whichever is lower or market-replacement cost).

Finished goods inventory management According to the firm’s financial manager, Keih Bahri Tannery produces mostly on the production order of customers so it does not hold much inventory. It does not use selective inventory control bases like costs, usage or sales rate and criticality in case of shortage. The average cost technique is mostly used to determine the cost of goods sold and in inventory. The firm values the finished goods inventory in the balance sheet at cost. Cost or market whichever is lower and market value are not used for inventories valuation purposes.

According to the financial manager of Keih Bahri Tannery, the firm has no reason for holding finished goods inventory and does not forecast its finished goods production and inventory requirements. The yearly average level of finished goods inventory is less relevant and the costs of holding inventory of finished goods particularly power, insurance, opportunity cost of capital invested or interest on capital tied-up as well as the cost of deterioration, obsolescence, shrinkage, depreciation and pilferage are small. While the costs of property tax, handling, security, and clerical record keeping are not incurred at all. Therefore, as per the opinion of the financial manager, costs of
holding inventory of finished goods is less significant for the management to give special attention. Keih Bahri Tannery uses both materials and finished goods inventory as a guarantee to get overdraft facility from the bank. In order for the bank to allow overdraft, the bank requests financial statements including a cash flow statement of the current year, budgeted financial statements for the next year and insurance coverage of the firm’s current and fixed assets. The insurance coverage is based on the estimated market value of the working capital assets mainly inventory and receivables. However, the financial manager said that: “NASPPE has to approve first in order for us to have the right to use the overdraft facilities”.

**Concluding remarks** The financial manager believes that because of its close linkages with its suppliers and customers, the inventory levels of Keih Bahri Tannery are kept to a minimum. He also believes that raw materials inventory is minimised because suppliers store them at their own premises until they accumulate certain minimum level. In which case the cost of inventory holding is shifted from the factory to the suppliers. The factory collects its materials from the places of its suppliers and production starts upon arrival of the shipment. The inventory level of its finished goods is also reduced because these goods are shipped to the customer upon completion of the production process. Therefore, the firm applies a type of the “just-in-time” approach to manage its inventory. According to the financial manager, the firm has established long-term supplier and customer relations, which it manages by trust. However, compared to the total assets, we can observe that there is large amount of current assets in the firm’s balance sheet (see section 7.3.4.1). The major part of this current asset is inventory. This is indication that the firm’s management has not proper understanding of the level and impact of its inventory costs.

### 7.3.1.3. Receivables management

In this section we want to know if Keih Bahri Tannery creates value by managing receivables. Therefore, we asked the firm’s financial manager questions regarding if and how it formulates its policies of accounts receivable management, controls its credit collection, the costs of accounts receivable balances and bad debts. For more detailed information see also Appendix 7.2.1.3.

**Credit policy and receivables management** According to the financial manager, Keih Bahri Tannery gives little attention to receivables management because it sells only on cash basis (except for government and transition firms) and it has an insignificant level of receivables. According to the financial manager, there are three main reasons for not selling on credit (see also Appendix 7.2.1.3-A), first, the firm does not want to extend credit, second, there is no tradition of selling on credit and the third, because there is high uncertainty of customers credit worthiness. However, the commercial manager believes it is not because the customers do not ask for credit or because there is lack of information on credit applicants. Since it does not have credit policy and therefore it does not sell on credit, the firm does not incur costs such as costs of customer screening, receivable collection or bad debt losses. However, a reference to the firm’s financial statements reveals a very significant amount of receivables from debtors and related enterprises. This amount according to the financial managers is due from the Dahlack Shoe Factory (the main customer and transition firm itself) and Asmara Shoe Factory. During the interview the financial manager stated that: “We do not sell on
account so the question of receivable management is not relevant here. However, there is one outstanding receivable, which was due from Asmara Shoe Factory now privatised under a name of Bini Shoe Factory. Since privatised firms are sold to their private owners free of debt it is the NASPPE which is responsible to pay the debt”. As a result the firm is incurring carrying cost of this uncollected debt. However, the financial manager’s opinion is that, the cost of holding the levels of receivables is still not significant therefore the firm does not use any receivables management approaches.

7.3.1.4. Managing working capital investment - Comparison of transition firms

Do the transition firms reveal similarity or do they have material differences in managing their working capital levels of investment, particularly cash, inventories and receivables? This section will try to answer this question.

**Cash management** All transition firms apply the receipts and disbursements approach to plan for their cash requirements. The purpose of cash planning for all firms is only for transaction purposes. None of them reported that they budget cash requirements for speculative, precautionary or bank compensating balance purposes. This is mainly because they are not allowed to make investments with a long-term motive. The transition firms other than Keih Bahri Tannery and Sembel House Hold Factory forecast their cash budget mostly on the basis of past experience. Asmara Textile Factory and Dahlack Shoe Factory also use expected sales as base to forecast their annual cash requirements. Since they all belong to the government, the government owned Commercial Bank of Eritrea provides overdraft if they need it. They control cash payments using the voucher system, checks, bank reconciliation and with a petty cash system. The transition firms collect cash at sales, which they use as a mechanism to speedup cash collection. Only Asmara Textiles Factory makes credit sales. They all control cash collections by depositing at the bank on a daily basis as well as by separating sequential operations where cash is involved.

**Materials inventory management** The materials inventory policy of Keih Bahri Tanney and the other transition firms strongly aim at minimising inventory holding costs and ordering costs, safeguarding against inventory shortages and keeping production running. The major cost of inventory holding that the transition firms reported include opportunity cost of capital tied-up in materials inventory, cost of deterioration (including obsolescence, shrinkage, depreciation and pilferage). Other costs like power, insurance, property tax, handling, security and clerical record keeping are small in all the firms except the costs of materials handling and security which is significant for Dahlack Shoe Factory. So, all firms reported that these costs on the average are less significant for the management attention and they all try hold the minimum level required. Only Keih Bahri Tannery uses economic order quantity and just in time inventory management approaches for selected materials. Most firms have a differing opinion on the use of selective control of materials inventory. Lalmba Sack Factory, Sembel House Hold Factory and Dahlack Shoe Factory control on the basis of criticality in case of shortage, while Lalmba Sack Factory and Dahlack Shoe Factory also use usage rate. Moreover, Sembel House Hold Factory and Dahlack Shoe Factory apply scarcity in case of shortage in the market. All use only the average cost technique to determine the cost and value of materials used in production and in inventory.
**Finished goods inventory management** The transition firms (except Lalmba Sack Factory and Keih Bahri Tannery) hold finished goods inventory to satisfy customer demands and to take advantage of economies of scale. While Lalmba Sack Factory and Sembel House Hold Factory keep inventory for safety stock, Asmara Textile Factory and Lalmba Sack Factory use stocks to meet high seasonal demands but none of them uses stocks to decrease holding costs. Inventory holding costs for all the firms is very small or not incurred at all and therefore not relevant for the management and all (except Keih Bahri Tannery which does not use any) try to hold only the minimum level required. The firms except Keih Bahri Tannery and Lalmba Sack Factory selectively control the physical safety of the finished goods on the basis of usage rate rather than cost or criticality in case of shortage. All the firms in transition to privatisation use the average cost technique to determine the costs and value of finished goods sold and in inventory.

**Receivables management** None of the transition firms use any technique of managing accounts receivable because they sell to private customers only on cash basis. So they rarely have a policy of credit terms, screening credit applicants, measures to collect overdue receivables. Therefore, they have no risk of bad debts or doubtful accounts. The reason why they do not sell on credit according to their commercial managers is because they do not have the policy due to government regulations. They also believe that there is high uncertainty that private debtors may not pay back and that there is no tradition of buying and selling on credit. However, they have the opinion that it is not because customers do not ask for credit or that there is lack of information on credit applicants.

**Concluding remarks** The management of the firms in transition to privatisation give emphasis to controlling the physical safety of working capital investments. They have no short or long-term vision on how to maximise the value of their investments. They are not empowered to manage their working capital levels and operations. The firms are not allowed to accumulate inventory, which they will not sell within three months. They are also not allowed to buy or sell on credit whose cash transaction extends for more than three months. In general, the firms are not allowed to design and implement short and long-term investment policies. As one manager put it, they have become a hostage of the privatisation process.

### 7.3.2. Managing working capital finances

In this section we study if Keih Bahri Tannery creates value by managing working capital finances. Therefore, we asked questions regarding the sources of financing, costs of financing and their relevance to management. For detailed information on managing working capital finances, refer to Appendix 7.2.2.

**Sources, costs and influences of working capital financing** In order to finance its short-term financing needs Keih Bahri Tannery uses the surplus cash that it generates from its operations. According to the firms’ financial manager, trade credits, secured borrowing, accruals, bank overdrafts and short or long-term debt are not considered as the firm’s sources of finance. However, the firms balance sheets show a sizable trade credit balance indicating it also purchases on credit. Moreover, the financial manager of Keih Bahri Tannery has explained the financing of working capital investment as follows: “Basically we finance our working capital investment with internally generated
Since the firm uses its own financing resources for its working capital needs, the only measure it takes when its financing needs exceed its resources is to increase its cash sales or use overdraft if the worst comes. In order to allow overdraft, the bank requests audited financial statements of the current year including a balance sheet, income statement and cash flow statement, budgeted financial statements for the next year and insurance coverage of the firm’s current and fixed assets. Since inventory and receivables are part of the current assets they are used as a guarantee in applying for overdraft facilities. Before the bank approves the overdraft facilities the firm has to get permission from NASPPE to request for overdraft facilities from the bank. According to the financial manager, it is not the firm managers but NASPPE which is empowered with the decisions regarding the firm’s short-term financing. However, the firm’s financial manager believes that there is no problem of short-term financing that the firm encounters so far.

7.3.2.1. Managing working capital finances - Comparison of transition firms

Sources, costs and influences of working capital financing The main source of short-term financing for all the transition firms (except Keih Bahri Tannery) is the bank overdraft. Moreover, Asmara Textile Factory, Lalmba Sack Factory and Sembel House Hold Factory also use short-term debt from the commercial Bank of Eritrea as a source of working capital financing. Lalmba Sack Factory also uses retained earnings a source of short-term financing. Unlike the other transition firms Keih Bahri Tannery does not use bank loans to finance its working capital needs mainly because it has enough cash inflow from its operations. None of the firms claimed to use long-term debt, retained earnings, equity capital, bank loans, trade creditors, secured borrowing or accruals to finance working capital investments. All reported that they have no problem financing their short-term working capital needs mainly because there is the bank overdraft facility readily available for them regardless of their profitability.

All transition firms except Keih Bahri Tannery experience cash deficits, which they finance with bank overdraft. Again with the exception of Keih Bahri Tannery and Dahlak Shoe Factory (the only two firms showing good profit for most of the seven years), all reported that the costs of financing are mainly bank interest expense and bank service charges.

7.3.3. Managing working capital operations

7.3.3.1. Purchase management

In this section we study if Keih Bahri Tannery creates value by managing working capital operations of purchases. We asked questions on the firm’s purchase policy, purchasing techniques, purchasing activities and costs, approaches of contacting, contracting and control of suppliers. For detailed information on managing working capital operations with regard to purchases, refer to Appendix 7.2.3.1.
**Purchases policies** According to the commercial manager of Keih Bahri Tannery the objective of purchasing materials is to take advantage of cash discounts and quantity discounts. The firm rarely purchases to decrease ordering costs and never to meet seasonal high production requirements. It forecasts its materials requirements in order to determine the quantity on hand and on order and the inventory usage during lead time but rarely to determine the safety stock requirement. The base that the firm uses to estimate materials requirement is mainly its past experience and the opinion of the management but rarely the forecasted sales volume. The firm purchases chemicals from foreign markets and animal skin from the local market. With regard to the local purchase the commercial manager said that: “Any trader with an appropriate trading license registers its address and gets preservative chemicals (6 kilos of salt per a unit of material free of charge) and advises on how to buy and handle the materials. When suppliers inform us that they have collected the necessary volume of material, we use our own transportation to get the raw materials to the factory site.”

According to the commercial manager, the firm purchases on a cash basis. It does not purchase on credit mainly because there is no tradition of buying and selling on credit and so its suppliers do not provide it with credit facilities, but not because the firm does not want to buy on credit. According to the commercial manager the purchasing procedure is also dictated by government regulations, which aims at controlling the purchase operation.

**Contacting, contracting and controlling suppliers** Keih Bahri Tannery makes efforts to find suppliers by getting in contact and describing the materials to potential suppliers. According to the commercial manager, the firm’s supplier contact policy is tailored towards choosing the cheapest channel of communication and managing by trust. When entering into contract with a potential supplier the firm’s policy emphases on routine contract agreements with terms known to both partners in advance of the contract agreement. Its supplier control is also based on routine control agreement with terms known to both partners in advance. Keih Bahri Tannery controls its purchase agreements by relying on the commitment of its suppliers and by trusting them and it rarely requires a pledge or guarantee. But still, according to the commercial manager, the overall costs of contacting, contracting and controlling suppliers are relevant to the management.

### 7.3.3.2 Sales management

In this section we study if Keih Bahri Tannery creates value by managing working capital operations of sales. With this objective in mind we asked questions on sales policy, selling and distribution techniques, sales activities and costs, approaches of contacting, contracting and control of customers. For detailed information on managing working capital operations of selling see Appendix 7.2.3.2.

**Sales policy** The sales technique applied is that buyers come to the factory site with a production order, on the basis of which the factory produces. When the production process is completed the factory informs the customers to collect the goods.

According to the financial manager, Keih Bahri Tannery sells to the private buyers only on cash basis because there is high uncertainty that debtors may not pay back and there
is also no tradition of buying and selling on credit. However, he believes that it is not because customers do not ask for credit or there is lack of information on credit applicants. Since Keih Bahri Tannery sells only on a cash basis it does not have any policy of credit granting and control of credit standards. The financial manager believes this policy may be affecting the volume of sales and its customer relation. The firm sells its products mainly to the local markets and rarely to foreign markets. The objective of Keih Bahri Tannery’s sales policy is to take care of regular customer demands and expand its market share but rarely to decrease inventory holding costs or to meet seasonal sales requirement. The main base that it uses to forecasts its sales requirements are mainly the production capacity and customer demands, the objective of which is to establish the quantity on hand and on order, to determine the safety stock requirement and inventory usage.

Contacting, contracting and controlling customers Keih Bahri Tannery’s approach of finding markets for its products is by getting directly in contact with potential customers and attending trade fairs and exhibitions. The commercial manager believes that the overall cost incurred in the process of contacting customers is relevant to the management. It also negotiates the sales agreement with potential customers, including the terms of sale and evaluates the proposed purchase terms of its customer. Keih Bahri Tannery also relies on the commitment and trust of its customers. He believes that the overall costs of contacting customers, getting into contract and controlling sales agreements is relevant to the management. Therefore, it uses approaches such as making terms of agreement known in advance, developing long-lasting relationships and routine contract agreements but rarely employs lawyers or sales agents.

7.3.3.3. Managing working capital operations - Comparison of transition firms

Here, we present a comparative analysis of the transition firms’ management of working capital operations of purchasing materials and selling finished goods.

The purchase operation According to the commercial managers, the firms in transition to privatisation have no clear policy on the purchase of their materials. It is only Keih Bahri Tannery that manages its purchase of materials mainly to take advantage of quantity and cash discounts, while Dahlack Shoe Factory also reported that it has a policy of decreasing holding costs and meeting seasonal production requirements. All reported that they forecast purchase requirements based on the expected sales volume. While Lamba Sack Factory and Dahlak Shoe Factory use the opinion of their purchasing staff, Dahlak Shoe Factory and Keih Bahri Tannery use their past experiences to estimate purchase requirements. They all purchase on cash basis from the cheapest source. The reason why they do not buy on credit at least from the local market with all the firms is because suppliers do not provide credit. Lamba Sack Factory, Dahlack Shoe Factory and Keih Bahri Tannery also reported that there is no tradition of buying and selling on credit.

All the firms make efforts to contact and screen suppliers as well as to describe the materials to a potential supplier. In order to contact, enter into contract and control suppliers the firms choose the cheapest channel of communication, with routine
agreements where terms are known in advance to the partners (see Appendix 7.2.3.1-F). However, only Keih Bahri Tannery reported that the costs of these efforts to be relevant.

**The sales operation** The sales policy of the firms in transition to privatisation is to take care of customer demands and meet seasonal sales requirements but not to decrease cost of inventory holding or expand market share except for Keih Bahri Tannery. All transition firms forecast sales according to their past experience and statistical forecasting approaches with the objective of estimating future demands.

Except for Asmara Textile Factory and Lalmba Sack Factory, other transition firms sell on cash basis so for these firms there is no question of customers defaulting. All firms except Keih Bahri Tannery said that there is no probability of customers backing down from their agreement and the difficulty of getting another partner is small for the transition firms. While all transition firms reported that they use the cheapest channel of communication, Asmara Textile Factory, Dahlack Shoe Factory and Keih Bahri Tannery also make their terms known in advance, develop long lasting relationships and customer trust to manage the costs of contact, contract and control of sales transactions. However, it is only Keih Bahri Tannery, which considers that the costs of contact, contract and control of sales transactions to be relevant.

### 7.3.4. Performance evaluation of working capital decisions

Here, we study if and how the transition firms make performance evaluation of their working capital decisions regarding levels of investment and financing as well as operations of purchasing and selling. First, we asked the managers if and how they evaluate their working capital decisions. Then, we used the firms’ financial statements to analyse the performance of working capital levels and operations. For detailed information refer to Appendix 7.2.3.3 on performance evaluation of working capital decisions, Appendix 7.2.3.4 for financial analysis of Keih Bahri Tannery and Appendix 7.2.3.5 for a comparative financial analysis of the transition firms.

**Working capital performance evaluation criteria** According to the financial manager, Keih Bahri Tannery has a policy of comparing its working capital investment performance with other firms using specific criteria of inter-firm benchmarks. As Appendix 7.2.3.3 reveals the firm also evaluates its internal performance of working capital investment decisions by comparing the performance of the past with the present and the actual with the expected. However, it does not use any customer satisfaction or accounting based approaches to evaluate its performance. We nevertheless computed accounting ratios to study the firm’s financial performance. We divided the evaluation of Keih Bahri Tannery’s financial performance into three sections. First, we studied its investment composition using asset structure ratios, second, the liquidity ratios and short-term financing composition are used to evaluate the firms’ working capital financing and lastly, we used activity and profitability ratios to study the firms overall efficiency in turning over the assets and generating profit.
7.3.4.1. Performance evaluation of working capital investment

*Working capital investment composition* In order to find Keih Bahri Tannery’s investment composition, we evaluated its financial statement data using asset structure ratios. The main asset structure ratio relevant to our study is working capital to total assets and its breakdowns, particularly cash, receivables and inventory to working capital ratios. We used the terms “inventories and stock” as well as “accounts receivable and debtors” interchangeably. We have used the terms inventories and receivables in our literature review while empirically we found that the firms in Eritrea use the terms “stock” for inventories and “debtors” for accounts receivable.

*Working capital to total assets ratio* is expressed in percentages and may indicate the extent that the firm uses working capital assets. It can also be used to study if such a composition is sound given the nature of the activities the firm is in. Asset structure ratios of Keih Bahri Tannery for the seven years studied indicate that, on the average 91% of total investment is in current assets. Taking the global norm of 50% into consideration, this working capital to total assets investment ratio is very high. This is a reflection of the absence of investments in fixed assets. This working capital to total assets investment ratio has increased from a percentage 59% in 1996 to as high as 98% in 1999 and 2000 (See figure 7-1). Normally, this is at the expense of expanding production capacity by investing in more productive fixed assets in the long-term. Therefore, the low production capacity and profit margins experienced by Keih Bahri Tannery may also be due to this high current asset investment.

![Figure 7-1: Asset structure and current debt leverage (% – Keih Bahri Tannery (1994-2000)](image)

Source: Appendix 7.2.3.4.

As it is revealed by Figure 7-1, the short-term debt compared to the total assets accounted to relatively smaller percentage. This implies that the leverage of short-term financing is relatively small in the total assets. We also computed inventory to working capital, receivables to working capital and cash to working capital, which on average accounted to 56%, 25% and 19% respectively. A reference to Figure 7-2 reveals that the firm’s major working capital investment is on inventory, which has moderately increased during the seven years. Generally, the composition of inventory in the total working capital assets is large (see Appendix 7.2.63.4 and Figure 7-2), which normally implies a warning on the policy of working capital management particularly with respect to inventory management.
The analysis of Keih Bahri Tannery’s asset structure ratios has revealed that the firm has excessively invested on working capital whose turnover is very slow (see figure 7-5 on working capital activity). This implies that it misses both targets of minimising investments in current assets and increasing the activity of working capital investments. This indicates that the firm is not doing well as far as working capital investment is concerned. The financial analysis also shows an excessively large proportion of investment in inventories, which contradicts with the manager’s opinion that inventory management is no problem to the firm. Investment in receivables, which is mostly owed by related enterprises (other government or transition firms), is not as large. Moreover, the fact that debtors are related government firms gives less risk of bad debts.

**Concluding remark** The analysis of Keih Bahri Tannery’s asset structure ratios has revealed that the firm has excessively invested on working capital whose turnover is very slow (see figure 7-5 on working capital activity). This implies that it misses both targets of minimising investments in current assets and increasing the activity of working capital investments. This indicates that the firm is not doing well as far as working capital investment is concerned. The financial analysis also shows an excessively large proportion of investment in inventories, which contradicts with the manager’s opinion that inventory management is no problem to the firm. Investment in receivables, which is mostly owed by related enterprises (other government or transition firms), is not as large. Moreover, the fact that debtors are related government firms gives less risk of bad debts.

### 7.3.4.2. Performance evaluation of working capital financing

Here, we use ratios on liquidity and short-term financing composition to study Keih Bahri Tannery’s liquidity management and the use of short-term financing sources. We analysed Keih Bahri Tannery’s short-term financing in order to study how the firm’s investments are financed and its liquidity position. Detailed information regarding liquidity ratios and short-term financing compositions are indicated in Appendix 7.2.3.4.

**Liquidity position** The ability to pay debts as they fall due and the degree of certainty and ease with which an asset is converted into cash is measured using liquidity ratios. The liquidity position is analysed using the current ratio and the quick ratio, which for the seven years averaged 2.2 and 1.0 respectively. As figure 7-3 shows, during the seven years, the firm has maintained a more or less constant above the global norm current ratio and quick ratio and we can therefore conclude that it has satisfactory liquidity position.
As it is indicated in Appendix 7.2.3.4 and Figure 7-4, short-term financing of Keih Bahri Tannery is composed mainly of trade creditors which accounted on the average 64% of the total short-term financing also include the debt to related enterprises. However, we have observed from the firm’s balance sheet that the credits to “related enterprises” (that is to other government and transition firms) has been paid back in total in 1997 after the firm was slated for privatisation. The remaining short-term financing includes other sources, particularly provision for taxation amounting to 36% on the average. The factory does not use short-term bank loans or bank overdraft to finance its working capital investments (see also figure 7.4).

We used activity and profitability ratios to study how efficient and profitable Keih Bahri Tannery’s investments and operations are managed.

**Figure 7-3: Liquidity position – Keih Bahri Tannery (1994-2000)**

**Source: Appendix 7.2.3.4**

**Figure 7-4: Short-term financing composition – Keih Bahri Tannery (1994-2000)**

**Source: Appendix 7.2.3.4**

7.3.4.3. Performance evaluation of working capital operations

We used activity and profitability ratios to study how efficient and profitable Keih Bahri Tannery’s investments and operations are managed.
**Operational efficiency of working capital activities** We wanted to know how efficient the management of Keih Bahri Tannery turns over each type of working capital element. We measured the operational efficiency of working capital activities using activity ratios including inventory turnover, receivables turnover and overall working capital turnover. The turnovers are also converted to average days they are held before they are sold (inventory) and collected (receivables). Inventory turnover indicates the rapidity with which inventory is turned over to cash through sales. Inventory turnover of Keih Bahri Tannery for the seven years indicates that annual cost of goods sold is on the average 0.8 times average inventory. This implies inventories were held an average of 456 days. Receivables turnover measures the number of times credit sales or receivables is turned over to cash. The firm’s average receivables indicate that annual sales was 1.3 times average receivables or 281 days accounts receivable held uncollected. Overall working capital turnover, measures the capacity of working capital to generate sales volume and was 1.0 times average current assets. As Figure 7-4 clearly shows the firm’s working capital turnovers are decreasing during the seven years of study.

**Figure 7-5: Working capital activity – Keih Bahri Tannery (1994-2000)**

Source: Appendix 7.2.3.4

**Concluding remarks** Our activity analysis shows a very slow inventory and receivables turnover and long periods of inventory and receivables held. The above analysis of working capital turnovers indicates that all types of current assets turned over very slowly. These low turnovers also reveal the firm’s inefficient inventory management, non-existent receivable collection policy, low sales as a result of non-encouraging sales policy (we have observed that one of its major customers - Asmara Sweater Factory - has shifted to another competitor recently) and low levels of production capacity. These aspects indicate that the firm is not doing very well as far as the decision related to the management of working capital activities is concerned.

**Overall profitability** We have analysed profitability ratios, in order to assess the profitability of Keih Bahri Tannery’s seven year operations. These ratios relate the firm’s gross and net profits to sales as well as net profits to total assets and respectively include, gross profit margin, operating profit margin and return on total assets. As Appendix 7.2.3.4 shows, the firm’s average gross profit margin amounted to 34%, net profit margin was 15% and the return on assets 14%. It can also be observed from Figure 7-6 that the firm has a quite good profit position. As it is revealed earlier in
this chapter the firm has more or less monopolistic market position. In addition private firms have not yet entered the market except for the comparatively very small import firms owned by individuals or families. This profitability rate is also a result of the firm’s ability to purchase raw materials at favourable terms, efficient utilisation of plant and machinery and lowering cost of production. The firm’s relatively more efficient management of its backward linkages may have also contributed to this high profitability. Moreover, a reference to Figure 7-6 indicates that the profitability ratios have been more or less constant since 1996.

Figure 7-6: Overall profitability – Keih Bahri Tannery (1994-2000)

![Graph showing profitability ratios from 1994 to 2000]

Source: Appendix 7.2.3.4

**Cash flow Analysis** It can be observed from table 7-1 that the net cash inflows of Keih Bahri Tannery except for 1996 and 1999 ended at positive balance. It can moreover also be observed that both the changes in working capital assets (stocks and debtors) had an average negative impact on the net cash flow while the changes in creditors had positive effect. The fact that the overall net cash flow ended up at a positive average implies also that the major sources of cash for the firm were items other than stocks, debtors and creditors, implying that these items did not make much contribution to the net cash inflows of the firm.

| Table 7-1: Cash flow Analysis – Keih Bahri Tannery (figures in '000) |
|----------------|-------|-------|-------|-------|-------|-------|
| A. Annual net cash flow | 1903  | -954  | 1042  | 1252  | -904  | 630   |
| B. Net cash flow to total assets | 2%    | -8%   | 9%    | 8%    | -8%   | 5%    |
| D. Annual change |
| Increase (-), decrease: stocks* | -1911 | -2605 | 1407  | -1241 | 1252  | -175  | -545  |
| Increase (-), decrease: debtors* | -185  | -788  | -1317 | -450  | 1582  | 28    | -189  |
| Increase, decrease (-): creditors** | 138   | -222  | 1093  | 1282  | -1218 | 568   | 273   |
| E. Annual % effect on NCF |
| Increase (-), decrease: stocks | -100% | 273%  | 135%  | -99%  | -139% | -28%  | -144% |
| Increase (-), decrease: debtors | -10%  | 83%   | -126% | -36%  | -175% | 4%    | -58%  |
| Increase, decrease (-): creditors | 7%    | 23%   | 105%  | 102%  | 135%  | 90%   | 88%   |
| Others | 103%  | -279% | -114% | 33%   | 179%  | -66%  | 114%  |

*(Year1-year2), **(Year2-year1)

Source: computed from the firm’s financial statements
7.3.4.4. Working capital performance - comparison of transition firms

In order to study the impact of management’s decisions on the transition firms’ investments, financing and operations, relevant ratios have been computed from the firms’ financial statements. For more information refer to Appendix 7.2.3.3 for comparative performance measurement and evaluation criteria applied by the transition firms and Appendix 7.2.3.5 for comparative accounting based performance evaluation.

**Performance measurement and evaluation criteria** According to their financial managers, the transition firms (except Asmara Textile Factory) evaluate their performance of working capital investment decision by using a comparative analysis of past versus present and actual versus expected. However, none of them uses inter-industry benchmarks. Moreover, except Lalmba Sack Factory, which reported that it uses almost all the accounting and customer satisfaction measures of performance, the other firms reported that they use none of them. The computation of the firms’ accounting based performance evaluation reveals the following results.

**Investment** Here we compare asset structure ratios of the five transition firms. The seven-year average composition of current assets to total assets revealed 97% for Asmara Textile Factory, 64% for Lalmba Sack Factory, 92% for Sembel House Hold Factory, 86% for Dahlak Shoe Factory and 91% for Keih Bahri Tannery.

The seven year average working capital investment composition on inventories, receivables and cash respectively shows 88%, 10% and 1% for Asmara Textiles Factory, 80%, 18% and 2% for Lalmba Sack Factory, 95%, 5% and 0% for Sembel House Hold Factory, 84%, 11% and 5% for Dahlak Shoe Factory. As it has been indicated earlier the inventory, receivables and cash investment composition for Keih Bahri Tannery was 56%, 25% and 19% respectively.

It could be observed from the above information on current assets to total assets and working capital investment composition that Asmara Textile Factory has the highest (97%) current asset composition, 88% of which is invested in inventories. The second to Asmara Textile Factory current asset composition is Sembel House Hold Factory with 92% of total assets invested in current assets out of which 95% is on inventories.

**Financing** We analysed the overall financing management of the transition firms using liquidity ratios, particularly current and quick ratios. The current and quick ratio positions respectively for the transition firms show an average of 0.7 and 0.1 for Asmara Textiles Factory, 1.8 and 0.4 for Lalmba Sack Factory 1.4 and 0.1 for Sembel House Hold Factory, 1.5 and 0.3 for Dahlak Shoe Factory. As it was mentioned earlier in this chapter the current and quick ratios for Keih Bahri Tannery were respectively 2.2 and 1. Asmara Textile Factory has recorded the lowest liquidity position while Keih Bahri Tannery is the most liquid transition firm.

The average working capital financing composition of trade creditors, short-term bank loans, bank overdrafts and others accruals respectively shows 52%, 5%, 38%, 4% for Asmara Textiles Factory, 76%, 5%, 18%, 4%, for Lalmba Sack Factory. Moreover, trade creditors, short-term bank loans, bank overdrafts and others accruals respectively were 47%, 0%, 25%, 29%, for Sembel House Hold Factory and 58%, 0%, 19%, 23%,
for Dahlak Shoe Factory. As it has been indicated earlier that of Keih Bahri Tannery was 64%, 0%, 0%, 36%, respectively. Trade creditors (which includes credits to related firms) is observed to be the main source of finance while the short-term bank loans is the least used in all the transition firms.

**Operations** Profitability and activity ratios are used to study a firms’ efficiency of its overall operations. The seven year average activity ratios – inventory, receivables and working capital turnovers respectively revealed 0.7, 1.2 and 1.2 for Asmara Textiles Factory, 0.4, 0.7 and 0.7 for Lalmba Sack Factory, 0.1, 10.4 and 0.6 for Sembel House Hold Factory, 0.5, 2.0 and 0.9 for Dahlak Shoe Factory. As it has been indicated earlier the inventory, receivables and working capital turnovers for Keih Bahri Tannery were 0.8, 1.3 and 1.0 respectively. The receivables turnovers for Sembel House Hold Fascotry and Dahlack Shoe Factory indicates excessively high and abnormal ratio. Otherwise, Asmara Textile Factory and Keh Bahri tannery scored the highest while the other three transition firms have relatively low working capital turnovers.

Profitability (gross profit, net profit and return on assets) ratios for the seven years averaged respectively -8%, -11% and -13% for Asmara Textiles Factory, 11%, -20% and -5% for Lalmba Sack Factory, 20%, -22% and -2% for Sembel House Hold Factory, 13%, 4% and 4% for Dahlak Shoe Factory. The inventory, receivables and working capital turnovers for Keih Bahri Tannery were 34%, 15% and 14% respectively. Keih Bahri Tannery with 15% and 14% and Dahlack Shoe Factory with only 4% each for net profits and return on assets are the only transition firms which have made profits during the seven years that we have studied. The other three transition firms reported negative returns through out the seven years of our study.

**Cash flow Analysis** Comparison of net cash flows of the five transition firms revealed that all except Asmara Textile Factory and Keih Bahri Tannery had experienced negative net cash flows on the average during the years because both the working capital assets have showed an increasing trend. The largest impact on net cash flows for Asmara Textile Factory and Keih Bahri Tannery was by the stocks while debtors made the largest impact for the other three firms.

**Concluding remarks** Comparing the transition firms’ average composition of current assets in the total assets with the global norm of 50% gives a clear indication that their major investment is in current assets. As we have understood from the interviews with the firms’ managers this is because the government has followed a policy of not investing in the transition firms because they are in the process of privatisation. Therefore, investment in capital assets is completely disregarded. This has resulted in the firms’ serious problem of production capacity and sales. More than 80% of the investment in working capital for all the firms, (except for Keih Bahri Tannery) is on inventories. Asmara Textiles Factory has the highest current asset to total asset ratio (97%).

The liquidity ratios indicate that all transition firms except Lalmba Sack Factory and Keih Bahri Tannery face liquidity problems because both current and quick ratios are well below the acceptable global norm of 2 for current ratio and 1 for quick ratio. It is also observed that Asmara Textiles Factory, which has the highest current to total asset ratio, has also the lowest current and quick ratios. This implies that the excessive current asset investment is financed with current liabilities and that the firm may possibly face
liquidity problems. The analyses of the working capital activities indicate that all the firms have extremely low inventory, receivables and overall working capital turnovers. The implication of this is that the firms are holding their inventories and receivables for a very long period, which is a sign of inefficiency in working capital management. As for the profitability ratios, three out of the seven firms reveal that they experienced losses and ended up at a negative return on assets during the seven years.

7.4. External working capital management - supplier and customer linkages

This section explores if the transition firms have proper inter-firm co-operation with their suppliers and customers. We evaluate if the transition firms have proper inter-firm co-operation with their suppliers and customers on the primary activities as well as on sale/purchase operations and inventory management. We also asked what benefits they get as a result of their co-operation or why they do not co-operate. Therefore, we review the response of one of the transition firms – Keih Bahri Tannery and compare the responses of the transition firms. We also examine the responses of their suppliers and customers. For detailed information on external working capital management particularly, for the responses of firms on firm-supplier co-operation and firm-customer co-operation, see Appendix 7.3.1. See also Appendix 7.3.2 for response of suppliers and Appendix 7.3.3 for responses of customers.

7.4.1. Firm-supplier co-operation

The objective of this section is to study how transition firms manage supplier linkages. We asked the firms’ management if and how they co-operate with suppliers on primary activities, as well as purchase operations and inventory management. We also inquired about the benefits of firm-supplier co-operation or reasons for the lack of firm-supplier co-operation.

7.4.1.1. Responses of the central firms - Keih Bahri Tannery

**Firm-supplier co-operation on primary activities** According to its general manager, the specific activities that Keih Bahri Tannery strongly co-ordinates with its suppliers include in most inbound activities, production operations and outbound activities. On the primary activities of marketing and sales it co-operates only on the purchase channel selection. It also co-operates on the after sales services like installation, parts supply and products adjustment. However, the general manager also believes the firm does not co-operate with its suppliers on primary activities such as advertising, promotion and sales force as well as on the primary activity of after sales service, particularly on repair and customer training.

**Firm-supplier co-operation on purchase and inventory management** Keih Bahri Tannery co-ordinates its materials purchase and inventory management with suppliers by specifically agreeing on the timing, quality and quantity of materials to be purchased as well as the terms of transportation. However, the firm’s co-operation policy is only with selective suppliers because the commercial manager believes it is not beneficial to co-operate with all suppliers. In addition to this some suppliers also
lack the willingness to co-operate. Moreover, the financial manager agrees that this co-operation reduces the cost of inventory ordering and carrying, the time and cost of purchasing materials and that it helps in creating firm-supplier trust.

**Concluding remarks** The commercial manager of Keih Bari Tannery believes that his firm co-operates with its suppliers on most primary activities as well as activities of purchase operations. This co-operation creates inter-firm trust and reduces the cost of inventory carrying and ordering as well as the cost of purchasing and time it takes to purchase the materials. Keih Bahri Tannery is one of the very few firms that have close firm-supplier co-operation. It has a very strong supplier network throughout the country. It gives its suppliers incentives such as preservative chemicals and transportation facilities for their goods from their location to its factory site. As a result of this it is able to generate more income and decrease costs. This assertion is supported by the findings in its financial statements, which indicate that compared to the other transition firms it has the highest gross and net profit percentage and the highest liquidity positions.

### 7.4.1.2. Firm-supplier co-operation - Comparison of transition firms

**Firm-supplier co-operation on primary activities** Asmara Textiles, Dahlack Shoe Factory and Keih Bahri Tannery responded that they co-ordinate inbound activities with their suppliers. Asmara Textiles Factory and Keih Bahri Tannery also co-operate on production operations. Except for Keih Bahri Tannery and Asmara Textile Factory the other three firms have no co-operation linkages with their suppliers on production operations, marketing/sales or after sales service.

**Firm-supplier co-operation on purchase and inventory management** The commercial managers of the transition firms (except for Eritrea Steel Sheets Factory) responded that they co-operate with their suppliers specifically on the timing, on the quality and quantity of materials to be purchased as well as the terms of transportation. They believe this co-operation reduces the time needed to purchase their materials as well as the cost of purchasing materials and carrying inventory of materials. This co-operation, they believe, helps them in creating firm-supplier trust.

**Concluding remarks** Three out of the five transition firms co-operate with their suppliers on primary activities related to the inbound activities and two of them in production operations but all do not co-operate on marketing and sales. Only Dahlack Shoe Factory and Keih Bahri Tannery reported of firm-supplier co-operation on after sales service particularly parts supply and product adjustment. All except Sembel House Hold Factory co-operate with their suppliers on purchase related activities and inventory management (see Appendix 7.3.1.1-B). Moreover, the transition firms believe that their co-operation with their suppliers helps them to reduce the time needed to purchase their materials as well as the cost of purchasing materials and carrying inventory of materials and that it creates firm-supplier trust. However we observed that, since the transition firms are still government owned they reveal typical characteristics of the government firms. Particularly, we observed (except for Keih Bahri Tannery) that they care very little about establishing strong long-term firm-supplier relationship with the private suppliers. The fact that they are in transition to privatisation has also put their managers into a very uncertain future position, crippling their managerial confidence and
job security. As a result of which very few of them have officially pursued objectives and/or mission statements on how to achieve their objectives.

7.4.1.3. Responses of supplier: Asmelash Hides and Skins

We also had to find the responses of the suppliers of the transition firms, in order to answer part 2(b) of the research question: “How do the transition firms in Eritrea manage their supplier linkages”. We evaluated the firm-supplier co-operation on primary activities and on sales and inventory management as well as related benefits or the reasons for non-co-operation. Finally we study the supplier evaluation of the central firm efficiency. So, we approached Asmelash Hides and Skins, one of the main suppliers of Keih Bahri Tannery whose general manager responses follow. For more detailed information on the responses of the suppliers of the transition firms on firm-supplier co-operation, see Appendix 7.3.2.

**Firm-supplier co-operation on primary activities** According to the general manager of Asmelash Hides and Skins the two firms co-operate only on some outbound activities, particularly delivery vehicle operation and order processing but not on finished goods warehousing or inventory control. Overall, the manager believes that his firm does not co-operate with Keih Bahri Tannery on most primary activities. Specifically, the two firms do not co-operate on, production operations (machining, packaging, assembly, equipment maintenance, product testing or facility operations), marketing and sales (advertising, promotion, sales force, sales channel selection) and after sale service (installation, repair, customer training, parts supply or product adjustment). According to its general manager, Asmelash Hides and Skins is not co-operating with Keih Bahri Tannery on the primary activities because the Keih Bahri Tannery has not developed a culture of co-ordinating with its suppliers.

**Firm-supplier co-operation on sales and inventory management** The manager of Asmelash Hides and Skins believes that his firm co-ordinates its sales ordering procedure with Keih Bahri Tannery’s purchase procedure. It is co-ordinated in such a way that Keih Bahri Tannery does not need to order now and then. Asmelash Hides and Skins buys and collects the raw materials, which it stores until enough materials are collected, then informs Keih Bahri Tannery to pick up the materials. Keih Bahri Tannery uses its own means of transportation and also supplies Asmelash Hides and Skins with salt free of charge to preserve the materials. The two firms make their sales-purchase transactions on a cash basis, so Keih Bahri Tannery pays cash once the quality and quantity is checked and approved by its management. However, the manager of Asmelash Hides and Skins has reservations with regard to exchanging skilled staff and credit facilities. He believes that Keih Bahri Tannery does not co-operate in providing credit facilities and he said that, “Keih Bahri Tannery is very slow in responding to the request of sending transportation to pick-up the materials and it sometimes even refuses to buy”. Despite of these shortcomings the manger of Asmelash Hides and Skins believes that the inter-firm co-operation with Keih Bahri Tannery enables his firm to decrease the time needed to sell the goods, the cost of selling as well as the cost of ordering and transportation (see Appendix 7.3.2C).

**Supplier evaluation of firm efficiency** The manager of Asmelash Hides and Skins believes that his firm’s relation with Keih Bahri Tannery is not good enough. The
manager’s opinion is that, even though Keih Bahri Tannery is efficient in its payment habits, it is less efficient in processing its purchase orders, marketing approach, bilateral communication, explanation to inquiries, in taking advantage of the services that Asmelash Hides and Skins offers and in its courtesy.

Concluding remarks: We particularly inquired on Keih Bahri Tannery’s firm-supplier co-operation from the point of view of its main supplier – Asmelash Hides and Skins. As a result of the interviews that we conducted with the manager of Asmelash Hides and Skins we find that the strongest link is on the purchase/sales operation. Keih Bahri Tannery helps its suppliers in transporting the materials to its factory thereby decreasing the costs of transportation of its supplier and it also provides them with preservatives so that their storage costs, particularly loss due to spoilage is reduced. The weakest link is on the primary activities such as production, marketing and after sale operations as well as providing credit facilities. This according to the supplier of Keih Bahri Tannery is limiting its operational capacity and liquidity.

7.4.1.4. Firm-supplier co-operation - comparison of suppliers of transition firms

In order to get a comparative knowledge of inter-firm co-operation on the supplier side; we approached the suppliers of three firms in transition to privatisation. These suppliers include, Alighider Agricultural Project - supplier of Asmara Textile Factory, Keih Bahri Tannery - supplier of Dahlak Shoe Factory as well as Asmelash Hides and Skins - supplier of Keih Bahri Tannery. The questions asked to the suppliers refer to their co-operation on the primary activities, with particular emphasis on purchase operation, inventory management and evaluation of the firms’ efficiency. For detailed information of suppliers’ response on firm-supplier co-operation, refer to Appendix 7.3.2.

Firm-supplier co-operation on primary activities Overall the suppliers believe that they are not co-operating on the primary activities with the firms in transition. Particularly, they all agree that they do not co-operate on production operations (machining, packaging, assembly, equipment maintenance, product testing or facility operations), marketing and sales (advertising, promotion, sales force, sales channel selection) as well as after sale service (installation, repair, customer training, parts supply and product adjustment). The supplier who responded positively on the inter-firm co-operation on outbound activities such as delivery vehicle operation is the supplier of Keih Bahri Tannery. Suppliers of Dahlak Shoe Factory and Keih Bahri Tannery also reported that they co-operate on order processing. Most of the suppliers of transition firms (except for the supplier of Keih Bahri Tannery) responded that they do not co-operate on finished goods warehousing and inventory control.

Firm-supplier co-operation on sales and inventory management: The suppliers do not believe that they efficiently co-operate their sales and inventory management with the transition firms. The only co-operation reported is between Asmara Textile Factory and its supplier on credit transactions without discount and between Dahlack Shoe Factory and its supplier on providing goods when just needed. They all do not have co-operation agreements on exchanging skilled staff or credit transactions with discounts.
The main reason for the lack of co-operation they believe is because the transition firms have not developed the business culture of co-ordinating their primary activities as well as sales and inventory management policies. Moreover, all the suppliers believe that the lack of co-operation is not because they do not have the specific policy or that they do not see the benefit of closely working with specific customers. Though they reported of the above shortcomings, the suppliers of Asmara Textile Factory and Keih Bahri Tannery believe that the limited inter-firm co-operation helps them to decrease the time needed to sell the goods, the cost of selling as well as the cost of ordering and transportation. The supplier of Asmara Textile Factory also reported that its co-operation helps it to decrease the carrying costs of finished goods inventory as well as in creating inter-firm trust.

**Suppliers evaluation of firm efficiency** The suppliers’ opinion is that the transition firms are efficient only in their payment habits. It is only the supplier of Asmara Textile Factory who is satisfied with inter-firm co-operation and rated the firms as efficient in processing purchase orders, bilateral communication and explanation to inquiries, marketing approach and courtesy but not in using the services that the supplier provides. The suppliers of Keih Bahri Tannery and Dahlack Shoe Factory agree that, the transition firms are not efficient in processing purchase orders, bilateral communication and explanation to inquiries as well as marketing approach and courtesy.

**Concluding remarks** Overall, the suppliers’ responses reveal that the transition firms do not co-operate with their suppliers. With the exception of the few primary activities that Keih Bahri Tannery co-ordinates with its supplier, the transition firms’ supplier linkages are very weak on all primary activities, purchase operations and inventory management. The suppliers’ responses also indicate that the overall efficiency of transition firms is poor. The interviews conducted with the managers of the suppliers indicate that they all would like to have a closer link with the central firms if it were not for the lack of co-operation from side of the transition firms.

**7.4.2. Firm-customer linkages**

In order to study how efficient transition firms manage their customer linkages we studied their general and commercial managers’ response about what and how they co-operate on primary activities, particularly, sales operations and inventory management.

**7.4.2.1. Responses of the central firms - Keih Bahri Tannery**

This section deals with the firm-customer co-operation from the point of view of Keih Bahri Tannery and its customer Selamawit Shoe Factory. For detailed information on the response of the managers of Keih Bahri Tannery and the other transition firms, refer to Appendix 7.3.1.2.

**Firm-customer co-operation on primary activities** According to the general manager of Keih Bahri Tannery, the firm co-ordinates its primary activities with its customers. These customer co-ordinated primary activities include, inbound activities (receiving, storing, distributing to production, and inventory control), production
operations (machining, assembling, equipment maintenance and product testing), outbound activities (finished goods warehousing and handling as well as order processing). However, according to the firm’s commercial manager, the firm does not co-operate with its customers on all primary activities related to marketing and sales and after sales service. Where there is no firm-customer co-ordination, the manager’s opinion is that it is because some customers have not developed the business culture and at times Keih Bahri Tannery does not see the benefit of closely working with specific customers. But the commercial manager believes that it is not because due to Keih Bahri Tannery’s lack of policy on inter-firm co-operation.

**Firm-customer co-operation on sales and inventory management** According to the firm’s commercial manager Keih Bahri Tannery co-ordinates its sales and inventory management with customers. It specifically agrees on the terms of transportation, the quality and quantity of goods to be produced and presented to the customers on the basis of just in time. According to the financial manager the benefit that Keih Bahri Tannery gets as a result of its inter-firm co-operation include, minimising the cost of transportation, decrease the cost of carrying inventories and increasing sales. As for the reason of non-co-operation with customers, the main reasons according to the firm’s commercial manager are that the firm’s customers do not co-operate and the firm does not see the benefit of co-operation as well.

**Assessing customer satisfaction** According to the commercial manager, Keih Bahri Tannery gets customers feedback on the quality of its products and services by making periodic assessments of customer opinion. It also allows customers to return any product with inferior quality in addition to making strict quality control at the production floor. However, it does not give its customer the option of paying only if the products are as per their expectation. As per the general manager’s opinion, the factory’s customers sometimes show their dissatisfaction with regard to the speed of production and quality of products. The manager agrees on the firm’s weakness here and he traces the problem to the old machines and the lack of skilled labour. He says: “The old machines which do not get proper maintenance and repair are causing unacceptable delays and reduce product quality. The lack of quality labour is another problem because almost all the best of the well-trained and productive workers have gone to the war front”. He also adds, “Since Keih Bahri Tannery is in transition to privatisation, the government does not approve any capital investment or major repairs during this transition period”.

**Concluding remarks** According to interviews conducted and the questionnaire data collected from the commercial and general mangers of Keih Bahri Tannery, it can be concluded that its firm-customer linkages is strong on co-ordinating primary activities, particularly, outbound activities and production operation. However, the firm has very weak firm-customer co-operation on marketing and sales (particularly it lacks a sales credit policy) and after sales service. Therefore, its firm-customer co-operation policy is concerned with cost reduction while it does very little to increase sales. Nevertheless, the firm’s managers believe that Keih Bahri Tannery benefits as result of its co-operation with its customers.
7.4.2.2. Firm-customer co-operation - Comparison of transition firms

**Co-operation on primary activities** With the exception of the activities that Keih Bahri Tannery co-ordinates with its customers, the other firms response indicates very low firm-customer co-operation on any primary activities. Dahlack Shoe Factory co-operates only on outbound activities particularly finished goods warehousing, delivery vehicle operation and order processing while Lalmba Sack Factory also co-operates on outbound activities of finished goods warehousing and handling.

**Firm-customer co-operation on sales and inventory management** The commercial managers of the transition firms reported in the questionnaire that they all co-operate with their customers by having an advance agreement on the product quality and quantity. Asmara Textile Factory, Dahlak Shoe Factory and and Keih Bahri Tannery also co-operate on the means and terms of transportation. However, only Keih Bahri Tannery has an agreement with its customers to get the goods just when they are needed for production. This co-operation, according to the managers decreases the inventory carrying costs, cost of transportation and it helps to increase sales. The main reasons for the non-co-operation with customers according to the firms’ commercial managers is because their customers do not co-operate.

**Customer assessment** The transition firms assess customers opinion by allowing customers to return any product with inferior quality and making strict quality control at the production floor. Keih Bahri Tannery and Sembel House Hold Factory also make periodic assessment of customers’ opinion. However, none of the transition firms give their customers the option of paying only if the products are as per their expectation.

**Concluding remark** All the firms except Keih Bahri Tannery have very weak firm-customer co-operation. Their very limited co-operation is on outbound activities - order processing, which according to the opinion of their managers, helps to decrease the carrying costs of the inventory. Moreover, we observed that the firms’ managers believe the (limited) co-operation helps them to decrease the inventory carrying costs, the costs of transportation as well as to increase sales.

7.4.2.3. Responses of customer - Selamawit Shoe Factory

We now turn to the study of the transition firms firm-customer co-operation from the point of view of their customers’ and try to answer part 2(b) of the research question “How do the transition firms in Eritrea manage their customer linkages”. So, we approached Selamawit Shoe Factory, one of the main customers of Keih Bahri Tannery. We inquired for the specific co-operation on the primary activities and sales operation as well as inventory management. We also asked the customers of the transition firms about the benefits that they gets as a result of the co-operation or the reasons for the non-co-operation. Finally we analyse the customer rating of firm efficiency. For detailed information on the response of the customers on inter-firm co-operation, refer to Appendix 7.3.3.

**Firm-customer co-operation on primary activities** According to its general manager, Selamawit Shoe Factory co-operates with Keih Bahri Tannery only on inbound activities, particularly order processing. Overall, the general manager
believes that the two firms do not co-operate on other inbound activities, production operations, outbound activities, marketing/sales and after sale services.

**Firm-customer co-operation on sales and inventory management** The general manager of Selamawit Shoe Factory reported that the two firms do not have explicit agreement sales and inventory management. Particularly, they do not co-operate in exchanging skilled staff, using credit transactions with or without discount or in providing with goods when just needed. The manager of Selamawit Shoe Factory believes that this lack of co-operation does not help to decrease the inventory carrying costs, the cost of transportation as well as it does not help to increase sales. The reason for this lack of co-operation he believes is because Keih Bahri Tannery has not developed the business culture and not because Selamawit Shoe Factory does not have the specific policy or that it does not see the benefit. Overall, the manager’s opinion is that this business relation is not creating long-term trust and co-operation.

**Customer evaluation of firm efficiency:** The manager of Selamawit Shoe Factory evaluated Keih Bahri Tannery as efficient in its cash collection habits, bilateral communication, impartiality with other buyers, explanation to inquiries, knowledge of its customers, product quality and delivery. However, the manager believes that Keih Bahri Tannery is less efficient in processing purchase orders and in its marketing approach. The general manager of Selamawit Shoe Factory believes that Keih Bahri Tannery’s inter-firm co-operation is not efficient for three reasons. “*First, it is a monopoly in the Tannery industry; no market will be lost for it if it does not co-operate with its customers. Second, it is a government firm, therefore its managers have job security regardless of the firm’s profitability. Third, its machines are too old to satisfy customer demands in quantity and quality terms.*”

**Concluding remarks** According to the results of the interview conducted and information collected using a questionnaire, the customer of Keih Bahri Tannery is not positive about the firm’s firm-customer co-operation. Keih Bahri Tannery does not co-operate on primary activities, sales operations and inventory management with its customer. This according to the manager of Selamawit Shoe Factory does not help to decrease the carrying costs of inventory or the ordering and purchasing costs, so it does not contribute to the creation of value.

7.4.2.4. **Firm-customer co-operation: comparison of customers of transition firms**

In order to compare the views of customers of the transition firms, interviews were made and structured questionnaires distributed and collected from the customers of the five transition firms. For detailed information of the response of the customers of transition firms on firm-customer co-operation, refer to Appendix 7.3.3.

**Firm-customer co-operation on primary activities** Most of the customers of the transition firms agree that the transition firms do not co-operate with them. The only aspects of primary activity that most of them co-operate are on the inbound activity of order processing. The customers responded that the transition firms do not co-operate on other inbound activities, production operations, outbound activities, marketing/sales and after sale services.
**Firm-customer co-operation on purchases and inventory management** The customers of the transition firms also reported that do not have co-operation agreements on exchanging skilled staff, credit transactions with or without discount or in providing with goods when just needed. The customers believe that the cause for the lack of co-operation is that the transition firms have not developed the culture of co-ordinating their purchase activities and inventory management. However, it is not because the customers do not have the policy of not co-operating or that they do not see the benefit of closely working with specific supplier. Since the transition firms and their customers are not co-operating, customers believe that there is no benefit of co-operation.

**Customer evaluation of firm efficiency** Most of the customers evaluated that the central firms are efficient in their cash collection, product costs and quality (except for Keih Bahri Tannery), delivery (except for Asmara Textile Factory and Keih Bahri Tannery) as well as impartiality with other buyers. Most of the customers responded that, the transition firms are not efficient on marketing approaches, explanation to inquiries, purchase order processing, bilateral communication and knowledge of their customers.

**Concluding remark** According to the general managers of the five transition firms, there is very little inter-firm co-operation on all primary activities as well as purchase operations and inventory management. The managers of the customers believe that the main reason for the lack of closer inter-firm co-operation is that the transition firms do not have the policy of inter-firm co-operation.

**7.5. Conclusions**

In this chapter, we explored Keih Bahri Tannery’s and other transition firms’ internal and external management of working capital levels and operations. Here we try to have an overview of our findings.

**The role of working capital management** All managers of the transition firms believe that the management of working capital levels of investment and financing as well as operations of purchases and sales has a pivotal role in creating firm value. However, the firms’ value creation potential in this area is hampered by the lack of managerial empowerment and uncertainty due to the privatisation process. Other managerial constraints include a lack managerial empowerment for making decisions working capital investment and financing as well as lack of production capacity and skilled labour. The transition firms lack a clear objective in managing both working capital levels and operations. The managers believe also that they are doing very little in managing their working capital because they are not empowered. They are restricted to the control function, which is evidenced by the strict control mechanisms imposed over the levels of cash, receivables and inventory as well as operations of cash collections, cash payments, purchases and sales. The reason for the lack of a clear working capital management policy is the imposition of government regulations, which are implemented under the supervision of NASPPE (National Agency for Supervising and Privatising Public Enterprises). Policy measures and decisions, which can have both a short and long-term effect are taken by the higher authorities in the privatisation agency which practically overtakes the firms’ overall management.
**Working capital investment and financing** We find that the transition firms have no clear policy of managing the levels of working capital investment and financing. As a result all firms except Keih Bahri Tannery are in a serious problem of liquidity. They all have negative net cash flows that they finance with a bank overdraft, the annual interest cost of which is a sizable proportion of their total costs. Over the first five years of study, overdraft interest cost as percentage of total expenses was: 48% for Asmara Textile Factory, 32% for Lalmba Sack Factory, 31% for Sembel House Hold Factory, 36% for Dahlack Shoe Factory and 3% for Keih Bahri Tannery. This is an indication that the firms have financed their working capital needs with bank overdraft. Given that Asmara Textile Factory, and Lalmba Sack Factory made losses and the other firms made marginal profits, it would have been a good signal for them to change the management of their working capital levels and operations, which they did not. Their level of receivables is increasing mainly because of the slow paying related (government) enterprises. While inventory balance is increasing due to mainly low sales. The cumulative effect of this lack of policy is the increase of both bank overdraft and creditors. Management has no opportunity or motive for reducing the investments in working capital levels or minimising the cost of short-term financing. This has greatly affected the efficiency of the firms in managing internal working capital levels of investment in cash, receivables and inventories.

**Working capital operations** Analysis of purchase and sales operations shows that the transition firms have no policy on how to purchase their materials and sell their products. The management of the firms working capital operations is restricted only to the application of clerical procedures of purchases and sales. The study showed that there is no mechanism of enhancing the contact, contract and control aspects of purchase and sales transactions. Their purchase and sales policies are dictated by government regulations to a large extent. So long as they remain in transition, their management of working capital operations will probably remain crippled and they will have no vision of the long-term. This makes the managers quite powerless. They reported that they are totally restricted to think in terms of short-term control of working capital levels and operations and/or the custody aspect of working capital management. So the benefits that they can get in the long run by efficiently managing working capital operations are foregone.

**Evaluation of internal working capital management** Analysis of performance evaluation has also indicated that the firms use no accounting, customer satisfaction or quality based performance measurement and evaluation criteria. Liquidity analysis showed that the firms are in immediate risk because all liquidity ratios except for Keih Bahri Tannery are below the generally accepted global norm. Investment in current assets, whose turnover ratios are very low, make more than 80% (except for Lalmba Sack Factory) of the total investment in assets. Except that of Keih Bahri Tannery all profitability ratios (gross profit, net profit and return on assets) indicate low or negative levels.

**Inter-firm co-operation** All transition firms (except Keih Bahri Tannery) reported that they make little co-operation on all the primary activities with both their suppliers and customers. However, Keih Bahri Tannery and its supplier Asmelash Hides and Skins and customer Dahlack Shoe Factory reported that they co-operate in their in and out bound activities, particularly delivery vehicle operation and order processing. This
may have contributed to the fact that Keih Bahri Tannery is observed to be the most successful transition firm. Though the remaining transition firms co-operate closely with related firms (government and transition), they have less inter-firm co-operation with the private firms. As a result both private suppliers and private customers have expressed their dissatisfaction on the transition firms’ co-operation regarding primary activities. The weak inter-firm co-operation between the transition and private firms has negatively affected the transition firms’ value creation potential as revealed by the working capital activity and profitability measurements. The main reasons for the lack of co-operation according to the managers of both transition firms and their suppliers is the interference of government regulations, lack of management policy and the uncertainty during the transition process. All the customers of the transition firms believe that the reason for the lack of inter-firm co-operation is because the transition firms do not co-operate.