

The Relationship between Trade Credit Management Practices and SME Performance: Evidence from Eldoret Central Business District, Kenya

Joseph Otieno Oluoch

Kisii University, P. O. Box 6434-30100, Kenya.

*Corresponding Author

Joseph Otieno Oluoch

Email: oluoch_j@yahoo.com

Abstract: An in-depth understanding and implementation of an efficient credit management system reduces the amount of capital tied up with debtors and minimizes bad debts. For SMEs, good credit management system is vital to business cash flow and success and ensures effective business operation. This paper unpacks the relationship between trade credit management practices and the performance of SMEs. The author demonstrates that trade credit management practices are one of the major predictors in the SME performance. Anchoring itself on data gathered from the Central Business District of Eldoret, Kenya, the author shows that many SMEs in Kenya have employed stringent credit policies. Consequently, such trade credit management policies have had a positive impact on SME performance. This is necessary in ensuring sustained performance of SMEs. This paper adds to the growing corpus of literature on SMEs and recommends that SMEs need to encourage stringent trade credit management policies that would oversee maximization of profits.

Keywords: Trade Credit Management, Working Capital, SMEs, Profit, Business in Kenya

INTRODUCTION

SMEs and Working Capital

Lack of financial management skills within SMEs often creates problems in managing stock in an efficient and effective way. The owners or managers of SMEs are not always aware that there are costs involved in holding too much stock and that there is also costs involved in holding too little. As an effective stock management system is good planning and budgeting systems, there should be a reliable sales forecasts, or budgets, available for stock ordering purposes.

The efficient management of working capital is more vital in small and medium enterprises than it is for large organizations particularly as they are not likely to have access to financial expertise like the large enterprises [1]. There are costs involved both in holding too much or too little cash. Atrill [2] has suggested that there is a need for careful planning and monitoring of cash flows over time.

Working capital management involves administration of current assets and current liabilities which consists of optimizing the level of current assets in partial equilibrium context [3]. Working capital management involves the relationship between firms' short-term assets and its short-term liabilities. Thus, working capital management should make sure that the desirable quantities of each component of working capital are available for management.

Khan and Jain [4] also stress that working capital management is concerned with the problems that arise in attempting to manage the current assets, the current liabilities and the interrelationship that exists between them. Working Capital Management involves the relationship between a firm's short-term assets and short-term liabilities. The goal of working capital management is to ensure that the firm is able to continue its operations and that it has sufficient cash flow to satisfy both maturing short-term debt and upcoming operational expenses. Another goal of working capital management is to manage the firm's current assets and liabilities in such a way that satisfactory level of working capital is maintained in the business.

A firm should maintain an effective working capital policy. Working capital policy is basically about how much working capital the company should maintain should they go for zero risk management. It involves decisions about company's assets and liabilities, what they consist of, how they are used, and their mix affect the risk versus return characteristics of the company. Working capital policies, through their effect on the firm's expected future returns and risk associated with these returns, untimely have an impact on shareholder wealth. Effective working capital policies are crucial to a firm's long-run growth and survival.

There are two policies of working capital. The first policy deals with the determination of the level of

total current assets that should be held by the firm. The option available under these policy boards on aggressive, conservatism or average management of a firm's working capital. The second policy confronting management concerns the relationships among types of assets and the way these assets are financed. Typical working capital policy decisions involve a determination of the appropriate level of cash, accounts receivable, and inventory that the firm should maintain [5, 3]. On the financing side, the entrepreneurs must determine whether to carry these through credit extension from their supplier, short-term bank loans, or longer-term credit arrangement. Another important working capital management is the cash conversion.

Researchers such as Deloof [6], Shin and Soenen [7], Laziridis and Tryfonidis [8], Karaduman *et al.* [9], and Ujar [10] all found a negative relation between WCM, using the Cash Conversion Cycle (CCC), and firm profitability. This means that having a WCM policy which results in as low as possible accounts receivables and inventories and the highest amount of accounts payables leads to the highest profitability. Contradicting evidence is found by Gill *et al.* [11], who carried out a research in the USA and found a positive relation between CCC and a firm's profitability. But they did find a highly significant negative relation between accounts receivables and a firm's profitability. They suggested that a firm can enhance their profitability by keeping their working capital to a minimum. This is because they argue that less profitable firms will pursue a decrease of their accounts receivables in an attempt to reduce their cash gap in the CCC.

Impact of Trade Credit Management on SMEs Performance – Scholars's Views

Trade credit is twofold, that is, credit sales and credit purchases. Credit sales gives rise to debtors while credit purchases gives rise to creditors who are sources of spontaneous finance. Debtor management means the process of decisions relating to the investment in business debtors. Granting trade credit favors the firm's sales in various ways [12], encourages customers to acquire merchandise at times of low demand [13], allows customers to check that the merchandise they receive is as agreed, ensures that the services contracted are carried out [14], and helps firms to strengthen long-term relationships with their customers [15]. However, it is certain that we have to pay the cost of getting money from debtors and to take some risk of loss due to bad debts. The main aim of debtors' management is to minimize the loss due to bad debtors. For effective debt management, SMEs should analyze credit policy, carry out credit analysis and evaluate collection policy.

Credit policy affects debtor management because it guides management about how to control debtors and how to make balance between liberal and strict credit. If a company does not restrict to sell the products on credit after a given limit of sale, this liberated credit policy will increase the amount of sale and profitability, but risk will also increase with increasing of sale. If we sell the goods to those debtors whose capability to pay is not good, then it is possible that some amount will become bad debts. The company can increase the time limit for paying by such debtors. On the other hand, if company's credit policy is strict, then it will increase liquidity and security, but decrease the profitability. SMEs, therefore, should make credit policy as to the optimum level where profitability and liquidity will be equal.

Akoto, Awunyo-Vitor and Angmor [16] analyzed the relationship between working capital management practices and profitability of listed manufacturing firms in Ghana. The study used data collected from annual reports of all the 13 listed manufacturing firms in Ghana covering the period from 2005-2009. Using panel data methodology and regression analysis, the study found a significant negative relationship between Profitability and Accounts Receivable Days. However, the firms' Cash Conversion Cycle, Current Asset Ratio, Size, and Current Asset Turnover significantly positively influence profitability. The study suggests that managers can create value for their shareholders by creating incentives to reduce their accounts receivable to 30 days. It is further recommended that enactments of local laws that protect indigenous firms and restrict the activities of importers are eminent to promote increase demand for locally manufactured goods both in the short and long runs in Ghana.

Omesa, Maniagi, Musiega and Makori [17] examined the relationships between Working Capital Management and Corporate Performance of manufacturing firms listed on the Nairobi securities exchange. A sample of 20 companies with data for 5 years from 2007-2011 was selected. For analysis, Principal Components Analysis (PCA) was used due to its simplicity and its capacity of extracting relevant information from confusing data sets. From the results using PAC and multiple regression, working capital proxies Cash Conversion Cycle (CCC), Average Collection Period (ACP) and control variables Current Liabilities (CLTA), Net Working Capital Turnover Ratio (NSCA) and Fixed Financial Ratio(FATA) were significant at 95% confidence (p values are < 0.05) to performance as measured by Return on Equity (ROE). Further, ACP was found to be negatively related to ROE while CCC, CLATA, NSCA and FATA affect the performance of SMEs.

The Paper’s Thesis

Working capital management is a paramount aspect of the SME world as it greatly affects a firm’s profitability and risk, and consequently its value [18]. For instance high inventory levels reduces the cost of possible interruptions in the production process or of loss of business due to the scarcity of products, reduces supply costs, and protects against price fluctuations, among other advantages [19]. Consequently, granting trade credit favors the firm’s sales in various ways [20, 12-15]. However, firms that invest heavily in inventory and trade credit can suffer reduced profitability. Thus, the greater the investment in current assets, the lower the risk, but also the lower the profitability obtained. Decisions about how much to invest in the customer and inventory accounts, and how much credit to accept from suppliers, are reflected in the firm’s cash conversion cycle, which represents the average number of days between the date when the firm must start paying its suppliers and the date when it begins to

collect payments from its customers [7, 6]. As such, this paper seeks to unpack the impact of trade credit management practices on performance of SMEs in Eldoret’s Central Business District.

Conceptual Framework

The conceptual framework for this paper shows the independent and the dependent variables and was developed from the analysis of empirical data and findings from literature review. The dependent variable is performance while the independent variable is working capital management. This paper aims at determining how performance is affected by working capital management. Performance markers include profitability, liquidity, growth and sales [21]. Working capital management is represented by one of its components - trade credit management. An SME’s performance is also expected to be influenced by intervening variables such as economic conditions, government policy, leadership style and ownership. Figure 1 shows the conceptual framework.

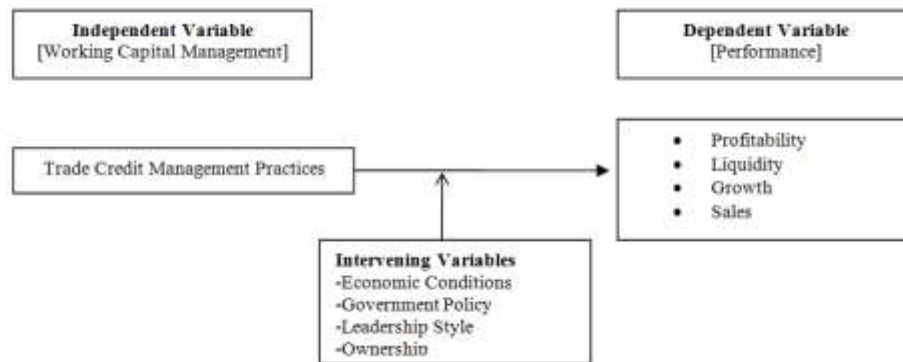


Fig-1: Conceptual Framework

Research Approach

A survey design was employed in the study. This was because the study required an explanation on the relationship between study variables on different SMEs. Therefore, data was obtained from different SMEs to find out if the relationship between the variables is common to them or not. The study aimed at collecting data without manipulating the research variables or the respondents to get the perception of the respondents toward their own assessment in identifying the effects of working capital on SME’s performance. Inferences about relations among variables were made, without direct intervention from concomitant variation of independent and dependent variables [22].

The study was conducted within the Central Business District of Eldoret town. Eldoret town is a town found in Kenya, Rift Valley Province, Uasin Gishu County. It is bordered by six counties namely Trans Nzoia, Elgeyo Marakwet, Baringo, Nandi, Kericho and Kakamega. It covers an area of approximately 3350 Km² with approximate population

of 900,000 residents. The central business district of Eldoret runs from Bandaptai building to the East, Uganda road to the North, U.G Primary School to the west and Sosiani River to the South. It has 2268 licensed micro, small and medium enterprises.

The criteria used to arrive at the target population were the number of employees (between 5 and 50), industry and space occupied by these businesses. Based on the above criteria, total population for this study was found to be 300. The study targeted accountants in 300 SMEs traders in Eldoret Central Business District. For researcher’s convenience, these SMEs were stratified into 7 categories as follows: General Trade, Wholesale, Retail, Stores& Shops; Agriculture and forestry; Transport, Storage and Communications; Accommodation and Catering; Professional Services, Technical Service & Personal Services; Private Education, Health and Entertainment services and Factories, Workshops, and Contractors. This number was obtained from the county government of Uasin Gishu trade licensing department.

The researcher targeted the population of all SMEs in the study area which stands at 2268 according to municipal licensing department. Stratified sampling technique was used to divide the data into strata after which random sampling was used to select a sample from each stratum through balloting. Yamane's [23] sampling method was used to determine the sample size. A proportion of the sample size was then computed. The final sample was 171 respondents.

Questionnaires and document analysis were used for data collection. When developing the questionnaire items, the fixed choice and closed-ended formats were used. These were used to guide the respondents to answer questions per the requirements of the research. Regarding document analysis, the researcher used trading accounts, profit and loss accounts, balance sheets and cash flow statements. The data obtained from these statements was used to compute various ratios relating to profitability, liquidity and growth as performance measures. The researcher used both descriptive statistics and inferential statistics to analyze the data. Descriptive statistical tools that were used are frequency, percentages, mean and standard deviations while inferential statistical tools that

were used are multiple regression and correlation techniques.

RESULTS AND DISCUSSION

Descriptive Statistics of Trade Credit Management Practices

The study conceptualized that credit management practices have a direct effect on SMEs' performance. Five items were used to measure the trade credit management practices and respondents asked to indicate their agreement or disagreement on the five items. Responses were elicited on a 5 point scale ranging from 1 - strongly disagree to 5- strongly agree. Generally, the analysis of the responses reveals that respondents mainly agreed with the suggested credit practices. Table 1 shows the results of this analysis. In particular, respondents tended to agree that the firm applies stringent credit policy ($M = 3.89$, $SD = 0.907$), that the firm maintains optimum debtors level ($M = 3.67$, $SD = 0.923$), and that the firm keeps creditors ledgers and control accounts ($M = 3.63$, $SD = 0.956$). However, respondents were not sure whether the firm asked for longer credit period from the supplier ($M = 3.49$, $SD = 0.906$).

Table-1: Descriptive Statistics of Credit Management Practices

	Mean	Std. Deviation
The firm applies stringent credit policy	3.89	.907
The firm maintains optimum debtors level	3.67	.923
The firm keeps creditors ledgers and control accounts	3.63	.956
The firm ask for longer credit periods from supplier	3.49	.906

The mean scores indicate that the credit practices were well managed in most of the SMEs with an average deviation of 0.9 on either side of the normal curve. This therefore had a potential to impact positively on overall performance and hence the need to investigate the nature of the impact.

Descriptive Statistics of SME Performance

SME performance was conceptualized in the study as the dependent variable. Analysis of SME performance was conducted from two perspectives. First, a comparison was made of the financial

statements of the SMEs over three years (2011-2013) on selected business practices. One way Analysis of Variance (ANOVA) was used to examine if there were significant differences in financial statements over this period. Results presented in Table 2 reveal that none of the mean differences were significant (all p-values were above the alpha level of 0.01). This implies that the mean differences in financial statements over this period were not significantly different. Hence, it may be assumed that there were no significant improvements in financial performance of the SMEs during this period.

Table-2: Comparison of Financial Statements between 2011 and 2013

Business practice	F	Sig.
Sales	.831	.480
Purchases	.483	.639
Operating costs	.522	.618
Stock	.135	.876
Debtors	.069	.934
Cash	.040	.961
Bank	.143	.870
Fixed assets	1.227	.357
Creditors	.604	.577
Capital	.013	.987
Retained Profits	.257	.782

Second, SME performance was assessed using means and standard deviations of responses given by respondents on topical issues regarding non-financial performance. Four items reflecting on aspects of non-financial performance were proposed to measure SME performance. Respondents were asked to indicate whether they agreed or disagreed with the suggested items. Responses were elicited on a 5-point scale ranging from 1- strongly disagree to 5-strongly agree.

Results presented in Table 3 reveal that respondents were not sure whether or not SME

performance in terms of sales, profits, and liquidity and transaction costs was high. The mean response score was approximately 3.00 in most of the items with an average deviation of approximately 0.8. In particular although respondents tended to agree that SME sales are high (M = 3.72, SD = 0.754), they were not sure whether the SME profits were high (M = 3.46, SD = 0.743), whether the firm was highly liquid (M = 3.41, SD = 0.860), or whether transaction costs were high (M = 3.10, SD = 0.869).

Table-3: Descriptive Statistics of SME Performance

	Mean	Std. Deviation
Sales are high	3.72	.754
Profit are high	3.46	.743
The firm is highly liquid	3.41	.860
Transaction costs are high	3.10	.869

Predictive Analysis - The Impact of Trade credit Management on SME Performance

Results from Table 4 indicate that the trade credit management practice is a significant predictor of SME performance ($\beta=0.281$, $p<0.01$). The standardized coefficient ($\beta=0.281$) implies that an increase of 1 standard deviation in the trade credit management is likely to result in 0.281 standard deviations increase in

SME performance. The t-value of 7.122 shows that trade credit management practice is an important predictor of SMEs performance. The study supports the findings by Gakure, Cheluget, Onyango and Keraro (2012) whose study revealed that there is a strong negative relationship between accounts payables and performance.

Table-4: Regression Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	.255	.205		1.248	.214		
	Trade Credit Management	.187	.026	.281	7.122	.000	.658	1.520

a. Dependent Variable: SME Performance

CONCLUSION AND RECOMMENDATION

The discussions in this paper have demonstrated that SME firms employ stringent credit policies to its customers while maintaining optimum debtors' level. Using relevant data, the paper has shown that trade credit management practices are one of the major predictors in the SME performance. This paper thus concludes that stringent trade credit management policies have a positive impact on SME performance and help in guiding the management in terms of balancing and controlling SME debtors and creditors. This is necessary in ensuring sustained performance of SMEs. It is therefore the recommendation of this paper that SMEs need to encourage stringent trade credit management policies that would oversee maximization of profits.

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