# THE EFFECT OF CREDIT MANAGEMENT ON FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES

**CASE STUDY: MBARARA CENTRAL MARKET**

**A DISSERTATION SUBMITTED TO THE FACULTY OF BUSINESS ADMINISTRATION AND MANAGEMENT IN PARTIAL FULFILLMENT OF THE REQUIREMENT FOR THE AWARD OF THE DEGREE OF BACHELOR OF SCIENCE IN ACCOUNTING AND FINANCE**

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## DEDICATION

I dedicate this research to my family for the support they provided financially, emotionally, and for their prayers.

## ACKNOWLEDGEMENT

During this research, I have met some challenges but there were people that stood by me along the way to guide me through. In a humble way I would like to thank the following persons for their support.

Sr. Andiru, my supervisor for her encouragement and for always responding positively throughout this research process till the end. I thank the traders in Mbarara central market for actively participating in this research. I thank my family for all their efforts and for putting me in this great institution that has groomed me morally, academically, religiously and ethically to be a better citizen. I extend great appreciation to my friends who have been a great inspiration during this education struggle.

Lastly I thank the entire Faculty of business administration and management mostly my lecturers and administrators for the facilitations and parental guidance that has made me achieve my academic dreams.

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## ABBREVIATIONS

| | |
|---|---|
| SMEs: | Small and Medium Enterprises |
| CMA: | Capital Markets Authority |
| SPSS | Statistical Package for Social Scientists |

## ABSTRACT

The purpose of this study was to establish the effect of credit management on financial performance of small and medium enterprises. Mbarara Central market in Mbarara municipality was the case study for the research. The independent variable was credit management and the indicators that were used to measure it are; credit policy, credit period and collection policy. The dependent variable was financial performance and the indicators included sales volume, profitability and liquidity. The specific objectives for the study were; to examine the impact of credit policies on the financial performance of small and medium enterprises, to evaluate the impact of credit period on financial performance of SMEs and to examine the effect of collection policy used by SMEs on financial performance of the enterprise.

The study used a case study design, study population was small and medium enterprises in Mbarara central market, sample size was 50 and sampling techniques used included simple random sampling and purposive sampling. The methods used to collect data from the field were questionnaires that contained closed end questions. SPSS data editor was used to compile the data obtained from the field. The data was analyzed by use of codes and correlation to find out the effect of credit management on financial performance of small and medium enterprises. The data was put into tables and mean, standard deviation and Pearson’s correlation product technique were used to analyze the data.

The findings indicated that there is a positive effect that credit period has on the financial performance of small and medium enterprises, collection policy relatively affects the financial performance of SMEs and credit policy strongly influences the financial performance of SMEs.

# CHAPTER ONE

# GENERAL INTRODUCTION

## 1.0 Introduction

According to Bonna (2004), the sale on credit today has become an essential characteristic in most small medium enterprises business transactions. They grant credit to their customers and also source credit from their suppliers. This new trend in business emphasizes that while some lines of business still settle transactions for cash, others have realized that if they wish to remain in business then they must extend credit to their customers. Bonna (2004) asserted that the term credit means transactions in which goods are sold and services rendered in exchange for a promise. Small medium enterprises offer credit because of its benefits to the business though at times it can have a negative effect on the financial performance of the business. Cohen (2006) stated that the benefits of credit include increase in sales, increase in customer loyalty and increase in profits. Bonna (2006) indicated there is credit risks involved and these include increased administrative costs, and occurrence of bad debts.

According to Onowa (2016), effective credit management determines the business cash flow and there by the liquidity of business operations. Failure to effectively manage credit sees small business experiencing late payment to their creditors and a break down in the supply chain which can affect their ability to service their debtors.

The chapter covers background to the study, statement of the problem, objectives of the study, scope, significance and the conception framework of the study.

## 1.1 Back ground of the study

Myers and Brealey (2003) describe credit management as methods and strategies adopted by a firm to ensure that they maintain an optimal level of credit and its effective management. It is primarily concerned with managing debtors and financing debts. Kagoyire and Dr. Jaya

(2016) stated that policies and procedures must be applied for granting credit to customers, collecting payment and limiting the risk of non payments. A proper credit management will lower the capital that is locked with the debtors and also reduces the possibility of getting into bad debts. Effective management of accounts receivables involves designing and documenting a credit policy. Hitt el al (1996) indicated that many entities face liquidity and inadequate working capital problems due to lax credit standards and inappropriate credit policies. Most small medium enterprises' business transactions are conducted on credit terms. According to Leon, Byrd, and William (2006), credit management involves deciding how customers will pay for purchases, setting credit policies and practices, administering credit operations. The objectives of the above activities include to increase profits, increase customer stability and to protect the firm's investment in accounts.

According to the business dictionary financial performance is the measurement of firm's policies and operations in-terms of money that is the degree to which financial objectives have been fulfilled therefore a process of measuring the policies of a firm in monetary terms. Stoner(2003) as cited in Turyahebya (2013), defines financial performance as the ability to operate efficiently, profitably, survive, grow and react to the environmental opportunities and threats. The financial performance indicators are so many but this study has concentrated mainly on profitability, liquidity and sales performance of a firm. Bouba (2011) added that financial performance measurement generally looks at firms' financial ratios derived from financial statements such as liquidity ratios, profitability ratios and debt ratios. Small and medium enterprises experience poor financial performance and close down in the first 6months of business, a rate considered to be the highest in the world (CMA report, 2010). Liquidity refers to an enterprise's ability to pay its short term debts when they are due. Profitability refers to the various criteria for measuring profit relates the enterprise's earnings to sales, assets, owner's equity and share value.

Kasekende and Opondo (2003) defined SMEs as enterprises employing more than five but not exceeding a maximum of fifty employees with the value of assets including land, building and working capital of less than Uganda shillings fifty million and annual turnover of between Uganda shillings 10milliom - 50million. William, Leslie, Justin (2012) defined SMEs quite differently as a business that has geographically localized operations, is financed by only a few individuals and has a small management team. They may include a tiny one person firm that is the person that starts the business. According to Leon, Byrd, William (2006), a small business is one that is independently owned and operated, is dominant in its field and does not engage in many new or innovative practices. It may never grow large and the owners may not want it to as they prefer a more relaxed and less aggressive approach to running the business. They manage their business in a normal way expecting normal sales, profits and growth. Kyomuhendo (2016) stated that SMEs can be defined in terms of sales volume and number of employees in the business indicated by structural development, profitability and employment levels. They mainly engage in buying produce, market vending, catering, confectionary, shop keeping, second hand clothing, telephone services and transport.

The case study for this research is SMEs in Mbarara central market, this market was started in the early 1960's and it later expanded in the early 1990's. It currently has 1200 traders in total operating both retail stores and whole sale stores. It is located on Mbaguta Street along Buremba road.

## 1.2 Statement of the problem

According to Horne and Wachowicz (1998), Sound credit management is a prerequisite for a firm's stability and continuing profitability while deteriorating credit quality is the most frequent cause of poor financial performance and condition. Credit management is one of the most important activities in any company and cannot be overlooked by any economic enterprise engaged in credit irrespective of its business nature. Turyahabwe (2013) asserted that lack of effective management during SMEs' early stages is a major cause of business failure for small businesses. Kazooba (2006) pointed out that though Uganda is among countries with high start up of SMEs, it also has the highest number of non performing SMEs as well as high number of their closure.

Mbaguta (2002) added that a large number of business failures have been attributed to inability of financial managers to plan and control properly the current assets and current liabilities of their respective business enterprise. Hitt et al (1996) believes that many firms' low performance is the result of poorly performing assets. This means that the basic problem is usually not whether to give credit but how to manage the credit so that there is profitability and credit losses are minimized, thus the reason to undertake the study on the effect of credit management on the financial performance of small medium enterprises.

## 1.3 Broad objective of the study

The purpose of the study is to establish the effect of credit management on the financial performance of small and medium enterprises.

### 1.3.1 Specific objectives of the study

- To examine the impact of credit policies on the financial performance of small medium enterprises
- To evaluate the impact of credit period on the financial performance of small medium enterprises
- To examine the effect of the collection policy used by small medium enterprises on the financial performance of the enterprise

## 1.4 Research questions

- What effect do the credit policies employed by an enterprise have on its financial performance?
- What is the impact of credit period on the financial performance of SMEs
- What impact does the collection policy used by an enterprise have on its financial performance?

## 1.5 Scope of the study

### 1.5.1 Geographical scope

The study was carried out in Mbarara central market in Mbarara district, Mbaguta Street along Buremba road.

### 1.5.2 Content scope

The study covered management of credit and its effect on the financial performance of small and medium enterprises. It was limited to credit policy, credit period and collection policy as measures of credit management while those of financial performance included liquidity, profitability and sales volume.

### 1.5.3 Time scope

The time scope covered a period of three years (2014-2017); this is a period of three years. This is because there was need to collect the data, analyze it, and interpret it for the study.

## 1.6 Significance of the study

To the researcher: She was able to expand her knowledge on the effect of credit management on the financial performance of small medium enterprises. She was able to learn how to collect data, analyze it and eventually report on the data collected.

To the future researchers: the information in the research is later to be used by subsequent researchers who would like to conduct research in the same field of study.

To policy makers: the information collected by the researcher pointed out the effects of credit management on the financial performance of small medium enterprises. The policy makers would be able to use this information to educate the traders on which credit management practices to use to better the financial performance of their businesses.

### 1.7 Definition of key terms

**Credit**, this refers to the ability of a customer to obtain goods and services before payment with the hope for payment in future.

**Credit management**, this is a function performed within a company to improve and control credit policies that will lead to increased revenues and lower risk including extending more credit to credit worthy customers.

**Financial performance**, this refers to the level of performance of a business over a specified period of time expressed in terms of overall profits and losses during that time.

**Credit risk**, a risk of default on a debt that may arise from a borrower failing to make required payments.

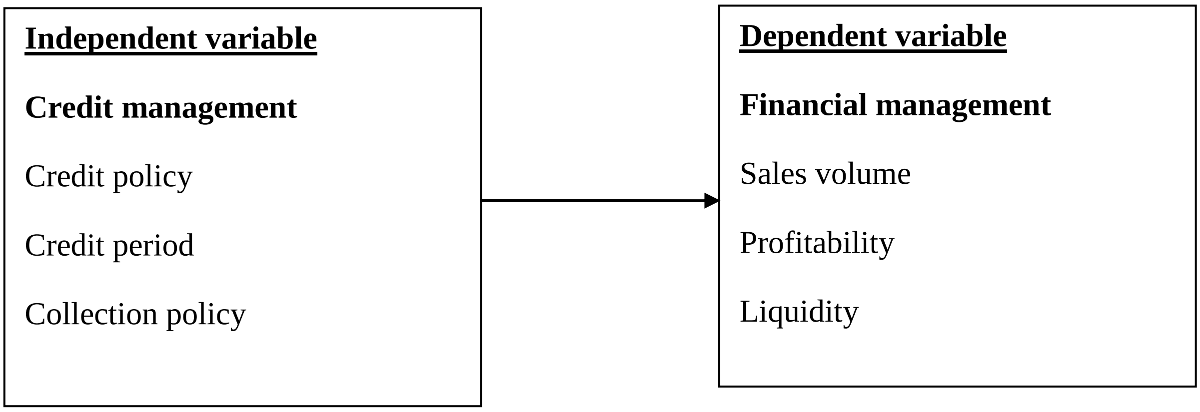
**Collection policy**, this is a policy followed by a firm in an attempt to collect accounts receivables.

**Profitability**, the various criteria for measuring profit related to the enterprise's earnings to sales, assets, owners equity and share value.

### 1.8 Conceptual frame work

This is defined as the logical construction of the relationship between the independent and dependent variable. It enables the researcher to set specific research questions and research objectives that enable the researcher to be able to carry out the necessary research for the study.

**Figure 1.1: Conceptual framework indicating the relationship between credit management and financial performance**




Source; Kagoyire and Shukla (2016) and modified by the researcher.

Figure one above shows the relationship between credit management and financial performance. It is meant to illustrate how each of the variables of credit management affects the financial performance of SMEs. Many entities face liquidity and in adequate working capital problems due to lax credit standards and in appropriate credit policies. According to Kagoyire and Shukla (2016), policies must be applied for granting credit to customers, collecting payment and limiting the risk of non payments. Collection policy was found to have a higher effect on financial performance. If payment is made late, then profitability is eroded and if payment is not made at all then a total loss is incurred. The use of credit checks on regular basis enhances credit management.

**Credit policy**, this is a procedure used by business enterprises when deciding how to get credit customers to pay for their purchases. William (2006) indicated that the credit policy may or may not be written down but it must be communicated to the employees and customers of the business. Neale (1999) asserted that a sound credit policy is the blue print for how the company communicates with and treats its most valuable asset the customer. According to Bonna (2004), a firm’s credit policy is responsible for establishing the strategies under which sales can be properly managed but especially credit sales. The credit policy of an enterprise has a direct relationship with its sales volume.

**Credit period**, according to Ross, Westerfield and Jordan (2001) credit period is the basic length of time for which credit is granted. This varies from industry to industry but it is normally between 30 to 120 days. Profitability of the business enterprise determines the credit period among other factors. A business that is very profitable has a shorter credit period compared to one that is struggling to maintain its profitability.

**Collection policy**, Jaffe, Westerfield, Ross (2002) defined collection as obtaining payment of past due accounts. The credit manager keeps a record of payment experiences with each customer. The average collection period measures the average amount of time required to collect an account receivable. The collection period of a business affects its liquidity either positively or negatively. A longer collection period leads to low liquidity since it has sold most of its stock and has not yet received money for it. This means that it has no cash to finance its other operations and to pay their creditors. Liquidity refers to an enterprise’s ability to pay its short term debts when they are due.

## 1.9 Conclusion

In conclusion, effective credit management determines the financial performance of small and medium enterprises. Therefore this research continues to establish the effect of credit management on financial performance of small and medium enterprises.

# CHAPTER TWO

# LITERATURE REVIEW

## 2.0 Introduction

This chapter covers the views, ideas and opinions of different researchers and authors in relation to the topic of study and organized in relation to objectives of the study.

## 2.1 Theoretical review

Transaction costs theory, it was first developed by Schwartz (1974); the theory conjectures that suppliers may have an advantage over traditional lenders in checking the real financial situation or the credit worthiness of their clients. Suppliers also have a better ability to monitor and force repayment of the credit. All these superiorities may give suppliers a cost advantage when compared with financial institutions.

Three sources of cost advantage were classified by Peterson and Rajan (1997) as follows: information acquisition, controlling the buyer and salvaging value from existing assets. The first source of cost advantage can be explained by the fact that sellers can get information about buyers faster and at a lower cost because it is obtained in the normal course of business. That is the frequency and the amount of the buyer's orders give suppliers an idea of the client's situation. The buyer's rejection of discounts for early payment may serve to alert the supplier of a weakening in the credit worthiness of the buyer and sellers usually visit customers more often than financial institutions do.

## 2.2 conceptual review of credit management

Nelson (2002) views credit management as simply the means by which an entity manages its credit sales. It is a prerequisite for any entity dealing with credit transactions since it is impossible to have a zero credit or default risk. Ross, Westerfield, Jordan (2006) assert that when a firm sells goods and services, it can demand cash on or before the delivery date or it can extend credit to customers and allow some delay in payment. Granting credit is making an investment in a customer, an investment tied to the sale of a product or service. Credit management involves credit policy, credit period and collection policy.

Owizy (2016) states that proper credit management is essential to ensure the solvency and long term survival of small enterprises. Small firms must be pro-active in their credit management practices hence it will positively affect their growth and development. Most business transactions of small firms are conducted on credit terms. Debtors of small scale firms are obtained when goods and services are delivered to customers on credit while creditors may include suppliers that supply raw materials or input to small firms on credit. Failure to effectively manage credit sees small scale firms experiencing late payment to their creditors and a break down in the supply chain then affects their ability to service their debtors.

Weston, Copeland (1992) further explains that credit management covers how a firm can vary its goods and cash flow levels by accepting a certain portion of inventory to be sold on account with a mind of collecting the returns at a later date hence forming an account receivable. Bonna (2004) asserts that not all credits are accounts receivables. Credits include all claims of the entity against other entities or persons for money, goods or service.

### 2.2.1 Credit policy

According to Shim and Siegel (2008) credit policies are written rules that set terms and conditions for the supply of goods on credit. Joss, Westerfield, Jordan (2006) affirm that the components of credit policy include terms of sale, credit analysis and collection policy. Terms of sale are the conditions under which a firm sells its goods and services for cash or credit. Credit analysis is the process of determining the probability that customers will not pay.

Shim and Siegel (2008) assert that a firm can either have a lenient or a stringent credit policy. For a lenient credit policy is where the terms of sale are not very tight in-order to increases firms sales and profits but it incurs high bad debts while a stringent credit policy is where the terms of sale are very tight such that only customers with credit worthiness are given goods on credit, this reduces the number of sales thus low profits and low bad debts therefore the company has to create and optimum credit policy.

Byrd and Megginson (2009) stress that while the credit department can contribute to increased sales and profit, several factors should be considered in formulating a credit policy, some factors are beyond the credit manager's control. A good credit policy should be flexible enough to accommodate these internal and external factors. Some of the credit policies include liberal extension of credit with a liberal collection policy, liberal extension of credit with a strictly enforced collection policy and strict extension of credit with a collection policy adjusted to individual circumstances. Scheufler (2002) proposes that a credit policy creates a common set of goals for the organization and recognizes the credit and collection department as an important contributor to the organization's strategies.

Pandey (2015) emphasizes that the factors that influence credit policy include competition within the industry, customer type and economic conditions like inflation, profit margin and government regulations.

### 2.2.2 Credit period

According to Ross, Westerfield, Jordan (1999) the credit period is the basic length of time for which credit is granted. If a cash discount is offered, then the credit period has two components that is the net credit period and the cash discount period. The net credit period is the length of time the customer has to pay. The cash discount period as the name suggests is the time during which the discount is available. A number of factors affect the credit period that is the buyer's inventory period and the operating cycle. The operating cycle is divided into inventory period and the receivables period. The inventory period is the time it takes the buyer to acquire inventory, process it and sell it. The receivables period is the time it takes the buyer to collect on sale.

Moyer, Mcguigan, Kretlow (1980) explain that a company's credit terms can affect its sales for example if the demand for a particular product depends in part on its credit terms, the company may consider lengthening the credit period to stimulate sales. Analyzing the possible effects of an increase in a company's credit period involves comparing the profitability of the increased sales that are expected to occur with the required rate of return on the additional investment in receivables.

### 2.2.3 Collection policy

Horne and Wachowicz (1998) state that the collection policy is determined by the combination of collection procedures it undertakes. These procedures include things such as letters, phone calls, personal visits and legal action. Optimal credit and collection policies would be those that resulted in the marginal gains equalizing the marginal costs. When payments cannot be collected, compromise settlements may provide a higher percentage of collection.

Byrd and Megginson (2009) add that the collection of unpaid accounts is an important part of credit management. The collection effort should include systematic and regular follow up, which is vital to establish credibility with the customer concerning credit terms. It should be timely which is now feasible since most businesses have computer capacity to show the age of a bill. When account is past due, prompt contact with the customer, made tactfully and courteously generally produces results.

Kagoyire and Dr. Shukla (2016) affirm that collection was found to have a higher effect on financial performance. A key requirement for effective credit management is the ability to intelligently and efficiently manage credit lines.

Bonna (2004) states that collection of accounts is one of the important bases for a firm's cash inflows. Sellers must always take a hard line on accounts that they deem to be past due because a company's collection policy seems to be its largest source of cash receipts which if neglected could lead to financial and business losses to the creditor.

**2.3 Conceptual review of financial performance**

The English dictionary states that the word performance is derived from the word 'Parfourmen' meaning to carry out or executing an activity. In a wider context performance is the ability to accomplish a given task measured against standards of accuracy and completeness. The business dictionary defines financial performance as the measurement of firm's policies and operations in-terms of money that is the degree to which financial objectives have been fulfilled. Bouba (2011) states that financial performance measurement generally looks at firm's financial ratios derived from their financial statements such as liquidity ratios, profitability ratios and debt ratios.

Bonna (2004) affirms that it is necessary to be able to assess whether or not a company has performed well over a certain period of time. From its profit and loss account, analysts can observe the profit it has generated. It is also necessary to know if a company is in a good short-term financial position, and if it is in a good financial position for long-term growth. One of the most common means of analyzing accounts is the use of financial ratios. Jacobs (2001) defines a ratio as the simplest mathematical expression of two magnitudes which are meaningfully related, and which are expressed in relation to each other (as a quotient). McLeary (as quoted by Mosalakae: 2007) defines a financial ratio as an expression of a relationship between any two figures or group of figures in the financial statements of an undertaking. Ratio analysis and interpretation can be used by many different stakeholders; especially those outside of the organization who want to invest Ratios can also be used to compare an enterprise's current position with its past positions. Jacobs (2001), highlights commonly used ratios, which are classified into the following four main categories:

Liquidity: this is an enterprise's ability to pay its short term debts when they are due. It refers to the solvency of the enterprise's total financial position.

- Activity ratios: these measure how quickly various accounts are converted into money or sales.
- Debt ratios: these measure the extent of debt in relation to total assets
- Profitability: the various criteria for measuring profit relate the enterprise's earnings to sales, assets, owner's equity and share value.

**2.3.1 Liquidity**

According to Ross et.al (2002) liquidity is the rate at which an asset can be turned into immediate cash. It measures the ease with which a firm can meet its financial obligations with the liquid asset which is available to them. Kakuru, (2007) states that liquidity is the ability of a firm to fulfill its current cash-flow obligation when they fall due and he further says liquidity is achieved by keeping a huge amount of current asset on hand.

Henrekson (2000) states that liquidity is analyzed in two ways either structurally or operationally. In the case of structure, liquidity is assets and liabilities on the balance sheet while operational liquidity is cash flow measures.

Pandey (2010) asserts that the most common ratios which indicate the extent of liquidity or lack of it are current ratio and quick ratio. The current ratio is the measure of the firm's short term solvency. It indicates the availability of current assets in shillings for every one shilling of current liability. The quick ratio establishes a relationship between quick or liquid assets and current liabilities. It is a better measure of liquidity.

Bhunia (2010) further explains that liquidity has a significant role in the success of a company thus a firm must ensure it doesn't lack or maintain excess cash to meet its short term obligations. Raheman and Nasr (2007) add that there is no specific way of determining the optimal level of liquidity and the liquidity requirements depend on the specific nature of the business.

### 2.3.2 Profitability

According to Pandey (2005) profitability is the ability of a firm to generate more revenue than costs incurred when generating the revenue. Profitability measures the level at which a business generates profits from factors of production such as labor, management and capital. Wanguru (2015) further explains that profitability is the level at which an organization successfully and efficiently uses its asset and funds and converts them into profits. Profitability is making profits from business operations that show how management uses organization assets to make more profits.

Pandey (2010) affirms that profits are essential but it would be wrong to assume that every action initiated by the management of the company should be aimed at maximizing profits, irrespective of concerns for customers. The profitability ratios which include profitability in relation to sales and profitability in relation to investment are calculated to measure the operating efficiency of the company.

### 2.3.3 Sales Volume

Codjia and Media (2000), define sales volume as quantity of items sold by a business during a given period of time and this can be measured as sale revenue that is a shilling amount made by a firm during the period of time under review. Business dictionary defines sales volume as the number of units sold per particular product. Collins dictionary defined sales volume as amount of overall sales of a product in a given financial period under review.

## 2.4 effect of credit policies on the financial performance of the enterprise

Horne and Wachowicz (1998) state that credit policy can have a significant influence on sales. If our competitors extend credit liberally and we do not, our policy may have a dampening effect on our firm's marketing effort. Credit is one of the factors that influence the demand for a firm's product. Consequently, the degree to which credit can promote demand depends on what factors are being employed. In theory, the firm should lower its quality standard for accounts accepted as long as the profitability of sales generated exceeds the added costs of the receivables.

Siegel (2008) assert that credit terms have a direct impact on revenues of the firm like incase of a lenient credit policy, the firm sets terms and standards that aren't very tight that is the firm can even grant credit to customers whose financial position is doubtful. The firm usually uses this credit to increase its sales and profits but it can incur high bad debts. Credit is granted at high discount rates. For the case of a stringent credit policy, the firm sets terms and conditions that are tight by only granting credit to those customers that are credit worthy. If a firm uses this credit policy, the sales will be very low but the costs of bad debts and collection will be very minimal.

Kontus (2013) affirms that a loose credit policy means that the firm offers credit sale to any customers who asks for it in-order to increase its sales and profitability but the costs of such a credit policy is high debts, liquidity problem and the high costs of credit management and if the credit policy is stringent, few customers will be granted credit sales thus low sales but the bad debts will be few and this leads to low profitability.

Ojeka ( 2012) asserts that a firm should have an optimum credit policy so that it maximizes the advantages of credit sale while minimizing the costs of credit sales like bad debts and collection costs. If the company's policy is favorable, the liquidity level and the profitability levels are at desirable levels therefore firms should monitor and review their credit policy regularly so that they manage their account receivables very well.

Parkinson (1997) adds that if a firm considers using a restrictive credit policy, it will lose sales as customers perceive such a policy as lack of inducement but the firm won't have any bad debt losses and its liquidity position won't be affected while if the firm uses a lenient credit policy, the volume of sales is low and this leads to low profitability but the liquidity position of the firm won't be affected because of a lessen occurrence of bad debts. Pandey (2010) in agreement with Parkinson states that a firm may follow a lenient credit policy in order to sell on credit to customers on very liberal terms and standards. Credits are granted to customers for longer periods even to those customers whose credit worthiness is not fully known or whose financial position is doubtful. A firm following a stringent credit policy sells on credit on a highly selective basis only to those customers who have proven credit worthiness and who are financially strong.

Despite the fact that credit policy helps to retain old customers, increase sales which affects the profitability of the enterprise positively, there are some shortfalls that could befall the business. A lenient credit policy may increase the bad debts of the enterprise as some customers neglect their duty to clear their bill. Slow paying debtors could also take advantage of the lenient credit policy hence tying down a lot of cash which would be used to pay the business' creditors hence affecting the liquidity of the business. A stringent credit policy is good though this could chase away loyal customers hence reducing on the sales of the business which eventually affects the profitability of the business. The customers would rather buy from the competitors that offer a better credit policy to them.

Pandey (2010) explains the costs involved with the firm loosening its credit policy. These include production and selling costs, administration costs and bad debt losses. Production and selling costs increase with expansion in sales. As a firm starts loosening its credit policy, it accepts all or some of those accounts which the firm had earlier rejected. Thus the firm will recapture lost sales and thus lost contribution. Administration costs involved when the firm loosens its credit policy include credit investigation and supervision costs and collection costs. The firm is required to analyze and supervise a large number of accounts when it loosens its credit policy. Similarly, the firm will have to intensify its collection efforts to collect outstanding bills from financially less sound customers. Bad debt losses arise because the firm tends to sell to customers with relatively less credit standing when it loosens its credit policy.

Loosening the credit policy is good because it increases the firm's profitability hence having a positive effect on its financial performance but it can also have a negative impact on it. Financial managers should be careful when picking which credit policy to use to grant credit.

### 2.5 impact of collection policy on the financial performance of the enterprise

Brigham and Houston (1996) define collection policy as the procedures the firm follows to collect past due accounts. For example, a letter might be sent to customers when a bill is 10days past due, a more severe letter followed by a telephone call, would be sent if payment is not received within 30days and the account would be turned over to a collection agency after 90 days. The collection process can be expensive in terms of both out of pocket expenditures and lost goodwill. Customers dislike being turned over to a collection agency.

However, at least some firmness is needed to prevent an undue lengthening of the collection period and to minimize outright losses. A balance must be struck between the costs and benefits of different collection policies.

Pandey (2010) asserts that a collection policy is needed because all customers do not pay the firm's bills in time. Some customers are slow payers while some are non payers. The collection efforts should therefore aim at accelerating the collections from slow payers and reducing the bad debt losses. A collection policy should ensure prompt and regular collection. Prompt collection is needed for fast turnover of working capital, keeping collection costs and bad debts within limits and maintaining collection efficiency. Regularity in collection keeps debtors alert and they tend to pay their dues promptly. Dickerson (1995) asserts that collection policy is a guide that ensures prompt payment and regular collections. The rationale is that not all clients meet their obligations, some just take it for granted, others simply forget while others just don't have a culture for paying until they are persuaded to do so.

Nyawera (2013) affirms that collection efforts aim at accelerating collections from slow payers to avoid bad debts. Pandey (1995) adds that prompt payments are aimed at increasing turnover while keeping low and bad debts within limits. Ssemukono (1996) states that collection efforts are aimed at accelerating recovery from slow payers and decrease bad debts. This therefore calls for vigorous collection efforts.

Nevertheless caution should be taken against stringent steps especially on permanent clients because harsh measures may cause them to shift to competitors, Van Horne (1995). Brighan (1997) asserts that the collection process can be rather expensive in terms of both product expenditure and lost good will. It is quite expensive to employ an agency to collect the firm's debts for those customers that fail to pay. Once a lot of cash is tied up in debts because of weak collection policy, the firm will have no money to finance its creditors. This paints a bad picture for the firm in the books of their suppliers who are the creditors in this case. Most SMEs offer credit to their customers and yet they do not have a set up collection policy as they rely on instincts when giving out goods on credit. This affects the performance of the business because they will have no cash to buy more inventories from their suppliers and cash to finance other business operations.

### 2.6 impact of credit period on the financial performance of SMEs

Ross, Westerfield, Jaffe (2002) state that credit periods vary among different industries. For example a jewelry store may sell diamond engagement rings for 5/30, net 4months. A food whole seller, selling fresh fruit and produce might use net 7. Generally a firm must consider three factors in setting a credit period that is the probability that the customer will not pay, the size of the account and the extent to which goods are perishable. Lengthening the credit period effectively reduces the price paid by the customer which generally increases sales.

Horne (1999) affirms that credit terms involve both the length of the credit period and the discount given. Credit period is another means by which a firm may be able to affect product demand. As before, the trade off is between the profitability of additional sales and the required return on the additional investment in receivables. Ross, Westerfield, Jordan (2001) adds that there are no magical formulas for assessing the probability that a customer will not pay. In very general terms the classic five Cs of credit are the basic factors to be evaluated. These include character, capacity, collateral and conditions. A firm may rate customers based on very poor or very good. It may grant credit to customers that have a score above 30.

Gitman (1997) explains that an enterprise analyses credit information to be able to evaluate the credit worthiness of the customer. The enterprise is able to estimate the maximum amount of credit each customer is capable of supporting. Bonna (2004) adds that a seller will generally allow more extended payment if it’s customers are in low risk businesses, if their accounts are large, if they need time to ascertain the product quality and if the goods are not quickly resold than otherwise.

According to research carried out by Bonna (2004), credit sales boost businesses, increase profits and attract many customers who in normal circumstances don’t have ready money to pay for the goods and services. Most businesses offer credit to increase sales which later leads to increased profitability if the customers pay their due amount and there are no defaults. Pandey (2010) stresses that if the extended credit period motivates sales, a comparison between the cost of extended credit period and the additional profit resulting from increased sale should be made. If profits exceed cost, the collection period may be extended, otherwise not.

## 2.7 Conclusion

This chapter shows different author’s works on credit policy, collection policy, credit period, liquidity, profitability, sales volume, and the effect of credit policy on financial performance of SMEs, the impact of collection policy on financial performance of small and medium enterprises and the impact of credit period on the financial performance of SMEs.

# CHAPTER THREE

# RESEARCH METHODOLOGY

## 3.1 Introduction

This consists of the research design, area of study, study population, samples size, sampling techniques, data sources, data collection methods, quality control, measurement of variables, ethical consideration and the study limitations. It basically points out how the research was conducted.

## 3.2 Research design

Donald and Pamela (2006) defined research design as the blue print for fulfilling objectives and answering questions. The study used a case study design because it collects data about a specific event. Yin (2009) defined a case study as a strategy that involves an empirical investigation of a particular contemporary phenomenon within its real life context. The researcher used both quantitative and qualitative approaches.

## 3.3 Area of study

The study was conducted in Mbarara Central Market located on Mbaguta Street along Buremba road in Mbarara district because it has the most number of SMEs that usually make sales on credit which makes it appropriate for my study.

## 3.4 Study population

Lee and Lings (2008) referred to population as that who you wish to generalize your result. According to Bryman and Bell (2009), population is universe from which the sample is to be selected thus study population are set of individuals, groups to be studied or tested.

The study population was 50 SMEs in the central market; the population consisted of the owners of the SMEs that were present at the time when the questionnaires were given out.

Not all the shops in the market qualified to be SMEs, the researcher concluded this by observing and looking at their appearance. Inquiries were also done from the leader for all the traders on the municipality council.

## 3.5 Sample size

According to Martin (2005) a sample refers to the number of elements in a portion of the population whose results can be generalized to the entire population. This is the population that will be used in this study. It will consist of respondents picked out of the traders in Mbarara Central Market. Using the population and sample size table as illustrated by Amin (2005) the sample size was denoted by (S) and the population sizes were denoted (N).

Using solvins formula

$$n = \frac{N}{1 + Ne^2}$$

Where: n=sample size

1=constant number

N=population size

e = desired margin of error set at 0.5 level of Confidence

Therefore for my research: N=50

=50/ (1+1(0.5)²

=40 respondents

During the field work study, 40 questionnaires were issued to 40 respondents but 4 were not returned. This means that only 36 were fully filled and returned to the researcher.

## 3.6 Sampling techniques

These are those methods that the researcher hopes to use in identifying the respondents that will participate in the research. The researcher used simple random sampling method; this is where every element in the population has a known and equal chance of being selected as a subject. The researcher used this method in order to give chance to any one that wants to be a respondent for the study. The researcher also used purposive sampling; this is when information is obtained from a specific target group to accommodate specific purpose of the study. This method is used so that the reason for carrying out the research is meaningful.

### 3.7 Data sources

The researcher used primary sources of data collection. Sekaran and Bougie (2013) defined primary sources as those that provide firsthand information relating to a specific purpose of study. The primary sources used were questionnaires. Additional explanations by some of the respondents on the effect of credit management on the financial performance of their businesses were jotted down by the researcher during the course of the study.

### 3.8 Methods of data collection

These are the means the researcher used to collect information

#### 3.8.1 Questionnaire

According to Sekaran and Bougie (2013) a questionnaire consists of formulated written set of questions to which the respondents record their answers. The questionnaires contained closed questions which required the respondent to tick any of the alternatives before them. The questionnaires were used because they cover a wide range of areas and save time compared to other methods of data collection. These questionnaires were used to help respondents who were a bit shy to answer the questions.  The researcher personally distributed the questionnaire by going to each respondent’s stall whereby incase a respondent had any inquiries about any question; the research could help the respondent understand the question better. The information gathered was compiled into final information for analysis.

### 3.9 Data analysis and presentation

Sauders (2003) stated that displaying data involved reducing the data into organized and condensed manner that everyone could understand and data analysis involves using of statistical methods to form meaningful information. The data from respondents was entered into an SPSS Data editor that resembles a spread sheet. The data was analyzed by use of codes and correlation to find the effect of credit management on the financial performance of SMEs. The data was displayed in tables.

### 3.10 Quality control

The researcher checked the validity and reliability of the research tools used.

#### 3.10.1 Reliability

Sekaran and Bougie (2013) defined reliability as the degree of consistency between coders processing the same data indicating the extent with which the measure is free from errors. According to Carmines and Zeller (1979), reliability concerns to what extent the instruments yield the same results on repeated trials. Respondents' additional explanations and observations made by the researcher concurrently supplemented each other and provided better information obtained from the study. The questionnaires were edited with the supervision of an expert to avoid double entry of data during analysis and to reduce errors.

#### 3.10.2 Validity

According to Abel and Olive (2003) validity is the accuracy and meaningfulness of inferences, which are based on the research results. The researcher consulted a supervisor and other experts that have experience in the field of study to ensure validity of the instruments used.

### 3.11 Measurement of variables

The researcher used standard deviation, arithmetic mean, frequency and coefficient of variations to measure credit management and financial performance. The researcher used a 5point scale by Likerts where the respondents responded to the levels of agreement in the sense of strongly disagree, disagree, not sure, agree and strongly agree.

### 3.12 Ethical consideration

According to Sauders et.al (2003) ethics is concerned with the appropriate behavior of the researcher in relation to the rights of the subject of the study and those affected by the study.

- The researcher cited and acknowledged works of other researchers that she consulted.
- The researcher quoted names of the researchers and also indicated the years they published their works. She also referenced her work.
- The researcher got a letter of introduction from Uganda Martyrs University authorizing her to carryout research in Mbarara Central Market. The letter was presented to the traders before interviewing them.
- The researcher didn't force any subject to participate in the research and the subject had a right to withdrawal completely or partially from the process. The respondents agreed voluntarily and the information was got with their consent.
- The researcher ensured that the privacy of the respondents was kept; she included a confidentiality phase in the questionnaire assuring respondents that their names won't be mentioned. The information got was exclusively used for the study.

### 3.13 Study limitation

- The researcher faced a limitation of short period of time to carry out the research and the researcher overcame this by using both quantitative and qualitative approaches to collect data
- It was difficult to meet some traders because they were busy attending to customers and others did not want to participate in the study.
- Negative response of some respondents hindered the success of the study. The researcher overcame this by convincing the respondents that the study was purely for learning purposes and that their names won't be exposed

- Scarcity of books about credit management and financial performance in the library. It was very hard to obtain information from the departments. The researcher overcame this by using online journals and dissertations of other academicians.

3.14 Conclusion

The chapter has discussed the different procedures and designs the researcher applied in obtaining, analyzing and presenting the data from respondents in Mbarara central market.

# CHAPTER FOUR

# PRESENTATION, INTERPREATION AND DISCUSSION OF THE FINDINGS

## 4.0 Introduction

This chapter presents findings of the research from the field. Data was collected and analyzed with the guidance of the study objectives that is; to examine the impact of credit policies on the financial performance of small medium enterprises, to evaluate the impact of credit period on the financial performance of small medium enterprises and to examine the effect of collection policy used by SMEs on the financial performance of the enterprise.

## 4.1 Response Rate

A total of 40 questionnaires were distributed but only 36 of them were returned correctly filled by the respondents hence the response rate was 90%.

## 4.2 Background of the respondent

The background of the respondents was classified according to age group, gender, number of years spent trading in the market, collection procedure used by the traders to collect money from their debtors and the duration they take to pay their creditors.

### 4.2.1 Age group of respondents

**Table 4.1 classification according to age group**

| | Age Group | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | Below 40 years | 24 | 66.7 | 66.7 | 66.7 |
| | Between 40-45 years | 7 | 19.4 | 19.4 | 86.1 |
| | Between 46-50 years | 2 | 5.6 | 5.6 | 91.7 |
| | Above 50 years | 3 | 8.3 | 8.3 | 100.0 |
| | Total | 36 | 100.0 | 100.0 | |

**Source: primary data (2017)**

From the table above 66.7% of the respondents were below the age of 40, 19.4% of them were between the ages of 40-45 while 8.3% were above 50 years. This indicated that most of the respondents in Mbarara Central market fall in the age bracket of 40years and below. This age bracket is an active age for productivity and effective performance in operations without any major body limitatio

### 4.2.2 Gender of respondents

**Table 4.2 classification based on gender of respondent**

| | Gender | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | Male | 16 | 44.4 | 44.4 | 44.4 |
| | Female | 20 | 55.6 | 55.6 | 100.0 |
| | Total | 36 | 100.0 | 100.0 | |

**Source: primary data (2017)**

From the table above 55.6% of the respondents were female while 44.4% were male. This indicated that there was gender balance and the researcher was able to obtain distinct data from different sex that was unbiased.

### 4.2.3 Number of years spent trading in the market

**Table 4.3 classification according to number of years spent trading**

| | Duration of trading | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | Below 5 years | 16 | 44.4 | 44.4 | 44.4 |
| | Between 5-10 years | 10 | 27.8 | 27.8 | 72.2 |
| | Between10-15 years | 6 | 16.7 | 16.7 | 88.9 |
| | Above 15 years | 4 | 11.1 | 11.1 | 100.0 |
| | Total | 36 | 100.0 | 100.0 | |

**Source: primary data (2017)**

The table above indicates that 44.4% of the respondents have traded in the market for 5years and below, 27.8% have traded between 5-10 years in the market, and 16.7% between 10-15 years and 11.1% have traded in market above 15 years. This indicated that most of the respondents have been working the market for a period of 5years and below.

## 4.3 Descriptive analysis of credit management

### 4.3.1 Descriptive analysis of the credit period.

The first objective for the study was to evaluate the impact of credit period on the financial performance small and medium enterprises. The findings were presented, analyzed, interpreted and categorized on how respondents strongly agreed, disagreed not sure, agreed and strongly agreed. A mean of 1.0-1.9 represented strongly disagree, 2.0-2.9 represented disagree, 3.0-3.9 represented not sure, 4.0-4.4 represented agree and 4.5- 5.0 represented strongly agree.

**Table 4.4 Descriptive Statistics of credit period.**

| Credit period | N | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|---|
| Lengthening the credit period reduces price paid by customers | 35 | 1.00 | 5.00 | 2.4000 | 1.43895 |
| Credit period can be used to increase demand | 35 | 1.00 | 5.00 | 3.3143 | 1.10537 |
| Credit period helps determine credit amount and goods to get on credit | 35 | 1.00 | 5.00 | 3.5429 | 1.24482 |
| Credit information analysis determines credit amount | 35 | 1.00 | 5.00 | 3.9429 | 1.02736 |
| Credit period guides in knowing credit worthiness of the customer | 35 | 1.00 | 5.00 | 4.1429 | 1.14128 |
| Valid N (listwise) | 35 | | | | |

Source: primary data (2017)

### 4.4.1 Lengthening the credit period reduces price paid by customers

As observed from the table above, majority of the respondents disagreed that lengthening of the credit period does not reduce the price eventually paid by the customer. The mean of 2.4000 demonstrated that majority of the traders do not reduce the prices of commodities already even if the customers take a long time to pay their debt. The customer is expected to pay the same money despite the time taken to clear their debt. The standard deviation of 1.43895 indicated that there were variations in the answers provided by the respondents. This is in contrast with Ross, Westerfield, Jaffe (2002) who stated that lengthening the credit period effectively reduces the price paid by the customer which generally increases sales.

### 4.4.2 Credit period can be used to increase demand

From the table above, most of the traders were not sure that credit period is a means by which a firm can increase demand of a product. The mean of 3.3143 indicated that the traders were not certain that credit period increases the demand of a product. The standard deviation was 1.10537 which meant that there were variations in the answers provided by the respondents. The results from the research are relevant because they correlate with Horne (1999) who stated that credit period is a means by which a firm may be able to affect product demand.

### 4.4.3 Credit period helps determine credit amount and goods to get on credit

Respondents were asked whether credit period helped to determine credit amount and goods to get on credit and majority of them were not sure a few of them agreed. The mean score of 3.5429 explained the closeness between the respondents that agreed and those that were not sure. The standard deviation of 1.24482 indicated that there were variations in the answers provided by the respondents. The traders explained that customers that take longer period to pay up their debts are given less goods on credit than those that take a shorter period to clear their bill. A shorter credit period allows the traders to get more goods from the suppliers on credit since they are assured of prompt payment from fast paying customers.

### 4.4.4 Credit information analysis determines credit amount

The results in the table above show that respondents agreed to the statement that credit information analysis determines credit amount as evidenced by the mean of 3.9429. the standard deviation was 1.02736 which meant that there were variations in answers provided by respondents. This relates to Gitman (1997) who stated that an enterprise that analyses credit information is able to evaluate the credit worthiness of the customer.

One of the respondents observed

“When I give customers goods on credit, some pay earlier than others and other always making prompt payments while others default or take long to pay. This helps me too determine who to give credit to next time. In the market there are some customers well known to most of as defaulter, so we don’t give such people goods on credit because of what we know about them already from past purchases.”

### 4.4.5 Credit period guides in knowing credit worthiness of the customer

From the table above, respondents agreed that credit period guides in knowing credit worthiness of the customer. The mean of 4.1429 indicated that majority of the traders rely on credit period to establish which of their customers are worthy to receive goods on credit. The standard deviation of 1.14128 indicated that there were variations in the answers provided by the respondents. The traders explained that once a customer always clears their debts promptly in the shortest time possible such a customer is more worthy to receive credit. This is because the traders are assured of her payment.

### 4.3.2 Descriptive analysis of collection policy

### 4.3.3 Collection procedure for collecting money from debtors

**Table 4.5 Debtor money collection procedure**

| | Collection procedures | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | Letters | 2 | 5.6 | 5.7 | 5.7 |
| | Phone calls | 21 | 58.3 | 60.0 | 65.7 |
| | Personal visits | 8 | 22.2 | 22.9 | 88.6 |
| | Legal action | 4 | 11.1 | 11.4 | 100.0 |
| | Total | 35 | 97.2 | 100.0 | |
| Not sure | | 3 | 8.3 | | |
| Total | | 36 | 100.0 | | |

Source: primary data (2017)

The table above indicates that 60.0% of the respondents use phone calls to collect their money from debtors, 22.9% carry out personal visits to the debtors, 11.4% take legal action while 5.7% write the debtors letters to remind them about their debt. This indicated that technology has advanced as most of the respondents prefer phone calls to the old method of writing letters. Phone calls are cheaper to make and most SMEs have no time to track down debtors so making a phone call to remind them is much cheaper as more prompt payments are made using this.

### 4.3.4 Duration taken before collecting money from debtors

**Table 4.6Duration taken before money is collected from debtors**

| Duration | for collecting payments | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | 5-10 days | 18 | 50.0 | 51.4 | 51.4 |
| | 10-30 days | 17 | 47.2 | 48.6 | 100.0 |
| | Total | 35 | 97.2 | 100.0 | |
| Not sure | | 1 | 2.8 | | |
| Total | | 36 | 100.0 | | |

Source: primary data (2017)

51.4% of the traders take 5-10 days to collect money from their debtors while 48.6% take 10-30 days. This indicated that most of the traders prefer to get their money early to use it to make other purchases.

### 4.3.5 Duration taken before paying suppliers after purchase.

**Table 4.7 Duration taken before paying creditors**

| | Duration before paying creditors | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | 3 days after purchase | 4 | 11.1 | 12.1 | 12.1 |
| | 5 days after purchase | 6 | 16.7 | 18.2 | 30.3 |
| | 7 days after purchase | 16 | 44.4 | 48.5 | 78.8 |
| | 30 days after purchase | 7 | 19.4 | 21.2 | 100.0 |
| | Total | 33 | 91.7 | 100.0 | |
| Not sure | | 3 | 8.3 | | |
| Total | | 36 | 100.0 | | |

Source: primary data (2017)

48.5% of the traders pay their suppliers 7days after purchase, 21.2% make their payments 30days after purchase, 18.2% pay 5days after purchase while 12.1% pay 3days after purchase. The 8.3% that is missing pay immediately the purchase is made. Making payments 7 days after purchase is quite fair as it earns the traders the trust of the suppliers.

One of the traders is quoted to have said

“Suppliers trust us more when we can pay them promptly for their supplies”.

**Table 4.8 Descriptive Statistics of collection policy**

| Collection policy | N | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|---|
| collection of unpaid monies is important in credit management | 35 | 1.00 | 5.00 | 4.0000 | 1.32842 |
| compromise settlement provides higher percentage of collections | 35 | 1.00 | 5.00 | 3.0857 | 1.19734 |
| a short collection policy implies prompt payments | 35 | 1.00 | 5.00 | 3.3429 | 1.32716 |
| excessive collection policy affects liquidity of the enterprise | 35 | 2.00 | 5.00 | 4.2857 | .82503 |
| Valid N (listwise) | 35 | | | | |

Source: primary data (2017)

### 4.8.1 Collection of unpaid monies is important in credit management

From the table above majority of the traders agreed that collection of unpaid monies is important in credit management. The mean of 4.0000 indicated that the traders understand the importance of collecting their debts from their customers by all means possible to be able to recover the money invested in the stock they buy through sales made. The standard deviation was 1.32842 and this indicated that there were variations provided by the respondents. This is in agreement with Pandey (2010) who asserted that a collection policy is needed because all customers do not pay the firm's bills in time. Some customers are slow payer and others are non payers. The non payers need to be reminded a lot or else they default their accounts. This is in concurrence with Byrd and Megginson (2009) who added that collection of unpaid monies is an important part of credit management. They add that the collection effort should include systematic and regular follow up, which is vital to establish credibility with the customer concerning credit terms.

Managing accounts receivables and accounts payable is very indispensable in business. Majority of the traders in the market understand this that is why they make it priority to collect all their money from debtors.

### 4.8.2 Compromise settlement provides higher percentage of collections

As illustrated in the table above, majority of the traders were not sure that compromise settlements given to credit customers provide a higher percentage of collections. The mean of 3.0857 indicated that the traders understood that at times their customers are not in a good place financially and being a bit lenient with them provided a better chance of getting their money for goods sold. The standard deviation of 1.19734 meant that there were variations in the answers given by the respondents. Some of the traders said that they allowed their customers to pay in installments only when they were sure that such customers will not default. One of the traders explained

"At times offering compromise settlements to customers give them leverage to default their payments completely, they take advantage of their compromise."

### 4.8.3 A short collection policy implies prompt payments

As observed from the table above, majority of the respondents were not that a short collection policy implies prompt payments from credit customers. The mean of 3.3429 indicated that the traders at times realized more payments when they used a short collection policy to recover their money from credit sales and at times they had to lengthen it to get more payments. The standard deviation was 1.32716 which meant that there variations in the answers provided by the respondents. This is in contrast to Dickerson (1995) who attested that collection policy is a guide that ensures prompt payment and regular collections.

### 4.8.4 Excessive collection policy affects liquidity of the enterprise

From the table above, majority of the traders strongly agreed that an excessively long collection policy affects the liquidity of the enterprise as the enterprise will have no money to pay its creditors. The mean of 4.2857 indicated that the traders tried using a long collection policy with hopes of collecting more money from debtors but instead they found that their businesses had become illiquid and they had no money to pay their creditors and to finance their other business expenses. The standard deviation of 0.82503 indicated that there were variations in the answers provided by the respondents. This is in agreements with Brigham (1997) who asserted that most SMEs offer credit yet they have a long or no collection policy, this eventually affects their performance as they will have no cash to buy more inventories from their suppliers. One of the traders explained that prolonging the collection policy makes it more costly to run the business operations as they will have no immediate cash. Most of the traders complained of having no cash to make new purchases to restock their stalls.

### 4.3.3 Descriptive analysis of credit policies

**Table 4.9 Descriptive Statistics of credit policies**

| Credit policies | N | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|---|
| a lenient credit policy has a direct impact on the revenues of a firm | 35 | 1.00 | 5.00 | 3.9429 | 1.08310 |
| a loose credit policy leads to increase in sales | 33 | 1.00 | 5.00 | 2.6061 | 1.22320 |
| a loose credit policy leads to a number of costs | 35 | 2.00 | 5.00 | 4.0286 | .78537 |
| a strict credit policy reduces sales but protects enterprise from bad debts | 35 | 1.00 | 5.00 | 3.8857 | 1.15737 |
| a credit policy determines the amount of sales made by the business | 35 | 1.00 | 5.00 | 3.2571 | 1.37932 |
| Valid N (listwise) | 33 | | | | |

Source: primary data (2017)

### 4.9.1 A lenient credit policy has a direct impact on the revenues of a firm

The traders were asked whether a lenient credit policy had a direct impact on the revenues of a firm and majority agreed. The mean of 3.9429 indicated that traders had seen their revenues change because of the credit policy used. The standard deviation of 1.08310 indicated that there were variations in the questions answered by the respondents. Some of the traders' revenues were affected negatively due to a lenient credit policy while others had seen their revenues change positively. A lenient credit policy increased the sales of some businesses while others incurred bad debts. This is in agreement with Shim and Siegel (2008) who stated that a lenient credit policy is where the terms of sale are not very tight in order to increase firm's sales and profits but it incurs high bad debts.

### 4.9.2 A loose credit policy leads to increase in sales

As observed in the table above, majority of the traders disagreed that a loose credit policy leads to increase in sales. The mean of 2.6061 indicated that a loose credit policy did not increase sales for the traders but instead they incurred more losses due to bad debts. The standard deviation was 1.22320 and this meant that there were variations in the answers provided by the traders. During the process of the research the researcher found out that most of the traders do not have the knowledge on how to set a credit policy so it becomes hard to decide which policy to use to manage their debt.

### 4.9.3 A loose credit policy leads to a number of costs

The respondents were asked whether a loose credit policy leads to a number of costs and majority of them strongly agreed. The mean of 4.0286 indicated that the traders had a lot of costs due to the credit policy they used. The standard deviation of 0.78537 indicated that there were variations in the answers provided by the traders. Some traders explained that they had to close down business for some months due to bad debt losses incurred by employing a loose credit policy; this is because some customers defaulted on their payments completely yet the traders had to pay the suppliers for the goods they got from them. The suppliers ignored the fact that some of the goods had been sold on credit and that their money had not been recovered yet.

#### 4.9.4 A strict credit policy reduces sales but protects enterprise from bad debts

The results indicated in the table above, show that majority of the respondents were not sure that a strict credit policy reduces sales but protects the enterprise from bad debts. The mean of 3.8857 indicated that the traders had adopted for a strict credit policy to keep in business and protect their businesses from bad debts and some customers that take advantage of their lenience. The standard deviation of 1.15737 indicated that there were variations in the answers provided by the respondents. This is in contrast with Shim and Siegel (2008), who asserted that a stringent credit policy reduces the number of sales thus low profits and low bad debts.

#### 4.9.5 A credit policy determines the amount of sales made by the business

As illustrated in the table above, majority of the respondents were not sure that the credit policy determines the amount of sales made by the business. The mean of 3.2571 indicated that the rules that set terms and conditions for the supply of goods on credit determine the amount of sales made by the business. The standard deviation was 1.37932 which meant that there variations in the answers provided by the respondents. This meant that traders that set strict terms and conditions made fewer sales than their counter parts that had lenient terms and conditions.

### 4.4 Descriptive analysis of financial performance

**Table 4.10 Descriptive Statistics**

| Financial performance | N | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|---|
| sales volume is the total sales revenue made by the enterprise | 35 | 1.00 | 5.00 | 3.8857 | .99325 |
| sales volume is increased by increased demand of the enterprise's products | 36 | 1.00 | 5.00 | 4.1111 | .88730 |
| increased sales volume indicates profitability of the enterprise | 35 | 1.00 | 5.00 | 3.6571 | 1.37076 |
| liquidity has significant role in the success of an enterprise | 35 | 1.00 | 5.00 | 3.9429 | 1.21129 |
| liquidity is achieved by having many debtors | 35 | 1.00 | 5.00 | 2.7429 | 1.17180 |
| paying suppliers is good but affects the liquidity of the enterprise | 34 | 1.00 | 5.00 | 3.5882 | 1.23381 |
| the aim of the business is to make profits despite of the amount of credit given and received | 36 | 1.00 | 5.00 | 4.0556 | 1.16972 |
| not every action taken by the trader is meant to bring in profits to the business | 36 | 1.00 | 5.00 | 3.5000 | 1.36277 |
| granting customers goods on credit affects the profitability of the business | 35 | 1.00 | 5.00 | 3.2286 | 1.26225 |
| bad debt losses cause the business to fall into losses | 36 | 1.00 | 5.00 | 3.8333 | 1.20712 |
| Valid N (listwise) | 33 | | | | |

Source: Primary data (2017)

### 4.10.1 Sales volume is the total sales revenue made by the enterprise

The results in the table above show that majority of the respondents were not sure that sales volume is the total sales revenues made by the enterprise. The mean of 3.8857 indicated that not all enterprises measure their revenue based on the sales made. The standard deviation of 0.99325 indicated that there were variations in the answers provided by the respondents.

One of the traders that deals in selling flour explained that,

"Not all the sales that are made actually bring in revenue. At times the sales made are made on credit and some of those customers do not pay their owed money. This means that such a sale is written off with no money as the trader incurs the cost of having to clear the debt by either increasing prices for the products or using some of the retained profits from past sales to pay the suppliers and clear off the debt."

### 4.10.2 Sales volume is increased by increased demand of the enterprise's products

As illustrated in the table above, majority of the respondents agreed that sales volume is increased by the increased demand of the business's products. The mean of 4.1111 indicated that increased demand for products in the market led to increase in the sales made by the traders. The standard deviation of 0.88730 indicated that there were variations in the answers provided by the respondents. The more customers demanded for a certain product the more sales were made and the fewer traders would be willing to give out that product on credit. The only products that were given out on credit were those that were not on high demand.

### 4.10.3 Increased sales volume indicates profitability of the enterprise

From the table above, majority of the respondents were not sure that increase in sales indicated profitability of the business. The mean of 3.6571 indicated that most traders did not measure the profitability of their business based on the sales made. The standard deviation was 1.37076 and this meant that there were variations in the answers provided by the respondents. Increased sales for a business meant more profits for the business though at times increased sales did not actually mean more profits because those sales could be credit sales. This is in contrast to Bonna (2004) who attested that credit sales boost businesses, increase profits and attract many customers who in normal circumstances do not have ready money to pay for the goods and services. Most businesses offer credit to increase sales which later leads to increased profitability if the customers pay their due amount and there are no defaults.

### 4.10.4 Liquidity has significant role in the success of an enterprise

As observed in the table above, majority of the respondents agreed that liquidity has a significant role in the success of an enterprise. The mean of 3.9429 indicated that the traders understood that there is need to have assets that can be turned into immediate cash. The standard deviation of 1.21129 indicated that there were variations in the answers provided by the respondents. This is in agreement with Bhunia (2010) who stated that that liquidity has a significant role in the success of a company thus; a firm must ensure it doesn't lack or maintain excess cash to meet its short term obligations.

### 4.10.5 Liquidity is achieved by having many debtors

From the table above, majority of the respondents disagreed with the statement that liquidity is achieved by having very many debtors that are yet to pay cash. The mean of 2.7429 indicated that the traders did not agree that having many debtors is good for business because there would be no cash to pay their creditors for goods purchased. The standard deviation of 1.17180 indicated that there were variations in the answers provided by the respondents. Debtors defaulted some of their payments and this affected the financial performance of the business. This is in contrast to Kakuru (2007) who stated that liquidity is achieved by keeping a huge amount of current asset on hand.

#### 4.10.6 Paying suppliers is good but affects the liquidity of the enterprise

The respondents were asked whether paying suppliers is a good practice but affects the liquidity of the enterprise and majority of them were not sure but a few agreed with the statement. The mean of 3.5882 indicated that majority of the traders in the market did not fully understand that it is good to have some cash on them as they carried out business. The standard deviation was 1.23381 which meant that there were variations in the answers provided by the traders.

Some traders explained that they pay their suppliers early to keep their trust in them so that they can always get goods on credit any time they want. This is because the suppliers trust them already as they make prompt payments on their purchases. A small percentage of the traders mentioned that they are forced to pay cash for their purchases because their suppliers do not accept giving them goods on credit.

#### 4.10.7 The aim of the business is to make profits despite of the amount of credit given and received

As observed in the table above, majority of the respondents agreed that the aim of a business is to make profit despite the amount of credit given and received. The mean of 4.0556 indicated that majority of the traders started their businesses with the aim of making profits; they did not anticipate that there might be losses involved as some had to close down for some months and reopen after getting some money to restock from loans, family and friends. The standard deviation of 1.16972 meant that there were variations in the answers provided by the traders. This is in agreement with Pandey (2005) who stated that profitability is the ability of a firm to generate more revenue than costs incurred when generating the revenue.

#### 4.10.8 Not every action taken by the trader is meant to bring in profits to the business

The results from the table above show that majority of the respondents were not sure that not every action taken by the trader is meant to bring in profits to the business but a few agreed. The mean of 3.5000 indicated that at times traders take actions that increase sales but in the long run no profits are eventually made or a few profits are made and losses are incurred. The standard deviation of 1.36277 indicated that there were variations in the answers provided by the respondents. This is in agreement with Pandey (2010) who affirmed that profits are essential but it would be wrong to assume that every action initiated by the management of the company should be aimed at making profits, irrespective of concerns for customers.

#### 4.10.9 Granting customers goods on credit affects the profitability of the business

The respondents were asked whether granting customers goods on credit affects the profitability of the business and majority of them were not sure. The mean of 3.2286 indicated that granting customers goods on credit had not automatically increased sales which increased the profits made by the traders. The standard deviation of 1.26225 meant that there were variations in the answers provided by the respondents. At times granting customers goods on credit could lead to bad debt losses. This is in contrast to Wanguru (2015) who explained that profitability is the level at which an organization successfully and efficiently uses its asset and funds and converts them into profits. Profitability is making profits from business operations that show how management uses organization assets to make more profits. Most traders grant credit to customers to increase sales with the hope that these sales will turn into profits once cash has been paid for them by the customer.

#### 4.10.10 Bad debt losses cause the business to fall into losses

As illustrated in the table above, majority of the respondents were not sure that bad debt losses cause the business to fall into losses. The mean of 3.8333 indicated that the traders had incurred a number of costs because of bad debts that they were forced to write off because the customers had failed to complete their payment. The standard deviation of 1.20712 indicated that there were variations in the answers provided by the respondents. Three of the traders complained that they were forced to close down business for some months because of bad debts incurred. This is because they had no money to pay suppliers and to restock their stalls. Another trader told of a scenario she had with one prominent customer.

“This customer was quite loyal and always made her payments in time, on one occasion when she asked for good worth shs 300,000 on credit, the trader did not hesitate to give her. She later asked for more promising to pay next month, being a loyal customer she was given the goods on credit. She later failed to clear both debts claiming to be broke. Attempts were made to make her pay but she disappeared and her whereabouts are not known up to now. The trader had to reduce on her stock for a year hence cutting down her sales and profits for that year. She spent a lot of money in trying to call her, transport costs going to her place to demand for her money and having to pay some people to help her recover her money”.

## 4.4 Correlation Analysis

### 4.4.0 Correlation between credit period, collection policy, credit policy and financial performance of small medium enterprises.

### 4.4.1 Correlation results for the effect of credit period on the financial performance of SMEs

**Table 4: 11 showing the results of the effect of credit period on the financial performance of SMEs**

| | | credit period | financial performance |
|---|---|---|---|
| credit period | Pearson Correlation | 1 | .583** |
| | Sig. (2-tailed) | | .000 |
| | N | 35 | 35 |
| financial performance | Pearson Correlation | .583** | 1 |
| | Sig. (2-tailed) | .000 | |
| | N | 35 | 36 |

**. Correlation is significant at the 0.01 level (2-tailed).

Source: primary data (2017)

The researcher sought to establish whether credit period had an effect on the financial performance of SMEs; this was approached using Pearson correlation product moment. The table above consists of the variables: credit period on the financial performance of small medium enterprises (Pearson correlation (r =0.583). The r value of 0.583 indicates that credit period moderately affects the financial performance of small medium enterprises. This is supported by Pandey (2010) who stressed that if the extended credit period motivates sales, a comparison between the cost of extended credit period and the additional profit resulting from increased sale should be made.

### 4.4.2 Correlation results for effect of collection policy on the financial performance of SMEs

**Table 4.12 showing results of effect of collection policy on the financial performance of SMEs**

| | | collection policy | financial performance |
|---|---|---|---|
| collection policy | Pearson Correlation | 1 | .475** |
| | Sig. (2-tailed) | | .004 |
| | N | 35 | 35 |
| financial performance | Pearson Correlation | .475** | 1 |
| | Sig. (2-tailed) | .004 | |
| | N | 35 | 36 |

**. Correlation is significant at the 0.01 level (2-tailed).

Source: primary data (2017)

The researcher sought to establish whether collection policy had an effect on the financial performance of small medium enterprises. This was approached using the Pearson correlation product moment technique. The table above comprises of variables: collection policy on the financial performance of small medium enterprises, Pearson correlation (r= 0.475) significant level (0.01). The r value of 0.475 is positive indicating that collection policy moderately affects the financial performance of small medium enterprises. This is supported by Brighan (1997) who asserted that the collection process can be rather expensive in terms of both product expenditure and lost good will. It is quite expensive to employ an agency to collect the firm's debts for those customers that fail to pay. Once a lot of cash is tied up in debts because of weak collection policy, the firm will have no money to finance its creditors. This paints a bad picture for the firm in the books of their creditors. Most small medium enterprises offer credit to their customers and yet they do not have a set up collection policy as they rely on instincts when giving out goods on credit. This affects the performance of the business because they will have no cash to finance other business operations.

**4.4 3 Correlation results for effect of credit policy on the financial performance of SMEs**

**Table 4.13 showing results of credit policy on the financial performance of SMEs**

| | | credit policy | financial performance |
|---|---|---|---|
| credit policy | Pearson Correlation | 1 | 1.000** |
| | Sig. (2-tailed) | | .000 |
| | N | 36 | 36 |
| financial performance | Pearson Correlation | 1.000** | 1 |
| | Sig. (2-tailed) | .000 | |
| | N | 36 | 36 |

**. Correlation is significant at the 0.01 level (2-tailed).

Source: primary data (2017)

The researcher sought to establish whether credit policy had an effect on the financial performance of small medium enterprises. This was approached using the Pearson Correlation product moment technique. The table above comprises of variables: credit policy on the financial performance of small medium enterprises, Pearson correlation (r =1.000).

The r value of 1.000 indicates that credit policy has a strong influence on the financial performance of small and medium enterprises. This is supported by Pandey (2010) who explained that a firm may follow credit policy in order to sell on credit to customers on very liberal terms and standards though a lenient credit policy may increase the bad debts of the small and medium enterprises as customers neglect their duty to clear their bill. On the other hand a stringent credit policy is good though this could chase away loyal customers hence reducing the sales of the business which eventually affects the profitability of the business. Despite the fact that credit policy helps to retain old customers, increase sales which affects the profitability of the SMEs positively, there are short falls that could befall the business.

### 4.5 Conclusion

In this chapter, the variables of credit management and financial performance were analyzed quantitatively and qualitatively in relation to the objectives thus the findings were relevant to the study.

# CHAPTER FIVE

# SUMMARY, CONCLUSION AND RECOMMENADTIONS

## 5.0 Introduction

This chapter presents the summary of the findings of the study, conclusion of the findings, recommendations and the suggestions for further studies.

## 5.1 Summary of the findings

The findings indicated that there is a positive effect that credit period has on the financial performance of small and medium enterprises. The correlation, r- value was 0.583 and this indicated that the credit period used by SMEs affects the sales made which directly affects the profitability of the business. A long credit period reduces the price paid by the customers but this could impact the businesses' profits as some customers take advantage and default their payments.

The findings indicated that collection policy moderately affects the financial performance of SMEs. The correlation, r- value was 0.475 and this indicated that collection policy used by small and medium enterprises affects the liquidity of the business. This is because, if the SMEs use a long collection policy, they will have no immediate cash to restock their stalls and to finance their other business operations. Therefore SMEs should maintain a medium collection policy so that there are prompt payments from debtors hence having enough cash to finance the other business operations.

The findings indicated that credit policy strongly influences the financial performance of small medium enterprises. The correlation, r- value was 1.000 and this indicated that credit policy is very essential because it affects the sales made which affects the profitability and liquidity of SMEs. A loose credit policy increases sales and profitability but there are bad debt losses involved and some liquidity problems for the business.

## 5.2 Conclusions

According to the findings from the previous chapter, there is a relatively moderate effect that credit period has on the financial performance of small medium enterprises in Mbarara Central Market, collection policy has a positive effect on the financial performance of small medium enterprises and credit policy strongly influences the financial performance of small medium enterprises.

## 5.3 Recommendations

Since most of the traders use a lenient credit policy to collect their debts which leaves them in debt, they should adopt a strict credit policy to be able to protect their businesses from bad debts. This might reduce the sales made but it will cut down costs incurred in trying to get the money from debtors and any bad debt expenses. This good practice will improve on the profitability of the SMEs in the market.

The traders in the market should stop the practice of paying suppliers immediately after purchase before ascertaining that the goods bought will bring in profit for the business. Paying suppliers early is a good practice as it earns the traders the trust of the supplier but could kill the business slowly.

The traders should keep up the good practices of credit management so that they can boost their sales and make more profits. They should maintain the practice of calling debtors to remind them to make payments on their balances because some of them tend to forget and others just want to be apprehended to be able to pay.

## 5.4 Suggestions for further study

More studies should be carried out on the effect of credit management on the financial performance of SMEs. The time for this study was rather short and not all the variables were exhausted so more variables should be used by researchers to get more results and better conclusions.

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## APPENDIX I

## RESEARCH QUESTINNAIRE

Dear respondents, I am **Batamba Josephine** a student of Uganda Martyrs University pursuing a Bachelor of Science Degree in Accounting and Finance. I am undertaking a research on the effect of credit management on the financial performance of SMEs in Mbarara Central market. You have been selected to participate in this activity by answering the questions in the questionnaire appropriately; your answers will be kept confidential.

I will be grateful for your participation.

SECTION A: **BACKGROUND OF THE RESPONDENT**

For the following questions tick the most appropriate box

1. Age group

(a) Below 40 years ☐

(b) Between 40-45 years ☐

(c) Between 46-50 years ☐

(d) Above 50 years ☐

2. Gender for respondent

Male ☐

Female ☐

3. How long have you been trading in this market?

(a) Below 5 years ☐

(b) Between 5-10 years ☐

(c) Between 10-15 years ☐

(d) Above 15years ☐

**SECTION B:**

**Tick the appropriate box based on your line of business.**

4. Which collection procedure do you use to collect money from debtors?

i. letters ☐

ii. phone calls ☐

iii. personal visits ☐

iv. legal action ☐

5. How long do you take to collect money from your credit customers?

5- 10days ☐

10-30days ☐

6. How long do you take to pay your suppliers that give you goods on credit?

(a) 3 days after purchase ☐

(b) 5days after purchase ☐

(c) 7 days after purchase ☐

(d) 30days after purchase ☐

In sections C and D the following scale will be used to answer the questions.

Tick in the appropriate box basing on your level of area of use.

| Scale | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| particulars | Strongly disagree | Disagree | Not sure | Agree | Strongly agree |
| | SD | D | NS | A | SA |

**SECTION C: credit period**

| Details | SD | D | NS | A | SA |
|---|---|---|---|---|---|
| Lengthening the credit period reduces the price paid by the customer | | | | | |
| Credit period is a means by which a firm can increase demand of a product. | | | | | |
| Credit period helps the enterprise to know the amount of credit to give out to a customer and determine how much goods they should get on credit from their suppliers. | | | | | |
| Credit information analysis enables the trader to determine the amount of credit to give the customer. | | | | | |
| Credit period guides the trader in knowing the credit worthiness of the customer; they are able to know who to give their goods on credit. | | | | | |

**Collection policy**

| Details | SD | D | NS | A | SA |
|---|---|---|---|---|---|
| Collection of unpaid monies is an important part of credit management. | | | | | |
| Compromise settlement given to customers that cannot make payments provides a higher percentage of collections. | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| A short collection policy implies prompt payments by the credit customers. They pay regularly as compared to a long collection policy. | | | | | |
| An excessively long collection policy affects the liquidity of the enterprise as it will have no money to pay its creditors. | | | | | |

**Credit policies**

| Details | SD | D | NS | A | SA |
|---|---|---|---|---|---|
| A lenient credit policy has a direct impact on the revenues of the firm. | | | | | |
| A loose credit policy leads to an increase in sales | | | | | |
| A loose credit policy leads to a number of costs such as bad debt losses. | | | | | |
| A strict credit policy reduces the sales but protects the enterprise from bad debt losses. | | | | | |
| The credit policy determines the amount of sales eventually made by the business. | | | | | |

## SECTION D:

**The effect of sales volume on the financial performance of SMEs**

| Details | SD | D | NS | A | SA |
|---|---|---|---|---|---|
| Sales volume is the total sales revenue made by the enterprise. | | | | | |
| Sales volume is increased by the increased demand of the enterprise’s products. | | | | | |
| Increase in the sales volume indicates that the enterprise is profitable because of the supernormal profits made from the sales. | | | | | |

**The liquidity and financial performance of the enterprise**

| Details | SD | D | NS | A | SA |
|---|---|---|---|---|---|
| Liquidity has a significant role in the success of an enterprise. | | | | | |
| Liquidity is achieved by having very many debtors that are yet to pay to recover the cash. | | | | | |
| Paying suppliers too early is a good practice but it affects the liquidity of the enterprise. The business will have no immediate cash to run its operations. | | | | | |

**The profitability and the financial performance of the enterprise**

| Details | SD | D | NS | A | SA |
|---|---|---|---|---|---|
| The aim of a business is to make profit despite the amount of credit given and received. | | | | | |
| Not every action taken by the trader is meant to bring in profits for the business. | | | | | |
| Granting customers goods on credit greatly affects the profitability of the business. | | | | | |
| Bad debt losses from customers that fail to pay affects the profitability of the business since there are no profits made in the long run. Bad debts cause the business to fall into losses. | | | | | |

***Thank you for participating in this research.***