Impact of credit risk on cash management

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Abstract

This study analyzes the impacts of credit management of the profitability and liquidity positions of the three companies in the ABC Group of companies. In particular, this study focuses on the FMCG companies that are considered to have a high number of challenges in the cash management cycles. In particular, this study seeks to develop a platform in which business entities establish effective credit policies that stimulate development in the long-run. In particular, this study undertakes a comparative analysis of three major companies namely: ABC Banking Corporation Limited (Banking division), Chue Wing & Co. (Food division) and Oriental Foods Company Limited (Food division), all of which are located in the First Moving Consumer Goods of the ABC Group. This study is based on two main hypotheses: Credit policy can influence profitability managements in the FMCG sector of ABC Group Companies and there is a remarkable correlation between debtors turnover of the three FMCG Companies and their liquidity position. This study use quantitative approach to understanding the effects of credit risks on cash management that leverage the financial performance of the companies. In particular, some of the ratios that have been applied in this study includes: liquidity, profitability and leverage ratios which has been applied in the understanding of the conceptual framework of the study variables. This study also uses analysis of Variance, commonly called ANOVA, in testing the above hypothesis and making deductions.

Key words: FMCG, Profitability, Liquidity, Credit Risks, ANOVA, Working Capitaland

Impact of credit risk on cash management in (ABC groups) FMCG divisions

1. 0. Problem Formulation

The management of organizations short-term assets offers one of the fundamentals of cash management. Business cash management is also associated with the popular concept of managing treasury that emphasize on certain elements as cash liquidity regarding different processes as well as factors pertaining to increased profitability. Poor utilization of cash assets is often associated with deteriorating performance of a company. In the current world, it is impossible to conduct business activities without the use of cash. It is therefore considered as storage of money which can be used to meet emergencies. Currently most companies use cash for operation of their businesses.

In the modern world, the use of credit cards, bills, debit cards, ECS, draft and fund transfer by the use of internet has been replaced due to the use of paper and coin currency. Cash mainly refers to bank account balances and currency money at different banks. Management of cash is both an art and science of managing a businesss resources so as to sustain its current activities, optimize liquidity and mobilize funds. There are three functions of cash management which include:

i). Proper use of current liabilities and current assets of a company all through the operating of the business

ii). Synchronized and proper planning, management and monitoring of the companys disbursements, collections and account balances.

iii). The management and collection of information to use resources effectively and to identify risks. Improper avoidance of risks through management of cash leads a company to bankruptcy (Saunders and Allen, 2010). In other words, efficient management of cash does not only prevent the bankruptcy of an organization but also makes improvements on profitability.

Duffie and Singleton (2012) posit that credit risk management is the process of decision making thus reducing losses from costs of operation of debts and from bad debts while increasing the volume of credit sales. Managing credit risk entails a procedural mechanism of establishing unique decision regarding investments. The establishment of such decisions must be evaluated carefully since they entail lots of uncertainty. Such financial operations as the management of initiatives may be employed to enhance accuracy and punctuality in generating and managing financial information in order to realize certain standards. Financial operations also acts as the main strengths of companies relative to their expenditures and the overall revenue as reflected on financial statements of firms. Majority of organizational performances are subject to negative influence of credit risks.

Saunders and Allen (2010) found that an important correlation between performances of financial institutions and there credit risk management portfolio exists. Efficiency in credit risk management promotes performance of financial institutions particularly through the avoidance of bad debts that

result to financial losses of a firm. It should also safeguard all the assets of a bank and ensure they are protected from the interests of the investor. Banks should therefore undertake effective credit risk management procedures since credit policies have been perceived to have an impact on the debtors hence gauging the prospects of managers to invest on debtors in order to profitably trade with increased revenue.

The credit policy of a firm determines its performance. It therefore means that a company adopts optimal credit policy; it will maximize investment revenue in debtors (Duffie and Singleton, 2012). Doing so helps promote and improve its performance and financial standing therefore leading informed credit policy decisions that are related to a high financial performance. Credit management policy of any FMCG business is very important. It is something that needs to be updated on a regular basis. Most FMCG firms keep information about credit management as a secret in the competitive market. A credit manager should know a various things while running a company (Szabo 2005). It is important for them to know distributors, clear payment terms, invoice payment, working capital finance, treat all suppliers equally and address bad debts.

For instance, the ABC groups have changes in structure and performance that have implications on the economy. The nature of such businesses is sensitive because they mostly depend on their clients. Financial institutions use the deposits so as to generate credit for all borrowers which is also an activity that earns revenue. Saunders and Allen (2010) posit that the credit management section exposes ABC groups to high risks that may lead to financial challenges including bankruptcy. In the current world, there is rapid

movement of cash and increased borrowing and lending of funds. Few groups are not affected by borrowers nonpayment of obligation from loans. This is as a result the groups inability to collect the expected interest earnings and the loss of principles which result from defaults from credit.

Duffie and Singleton (2012) assert that ABC groups conduct credit management as one of the measures of giving credit to borrowers. It is also done by the possession of a credit procedure and mechanism. The activity also involves training staff, credit appraisal and setting credit terms and standards to offset chances of a loss and improve the financial performance. ABC groups develop strategies so as to either reduce or eliminate the credit risk. In the management of such risks, such groups must be concerned with financial performance. In spite of the efforts that are made to address poor credit management, ABC groups have difficulties that result from credit management processes that are undertaken.

Non-performing credit on the performance of ABC groups can be affects the economy. In the ABCs FCMG sector, there is a perceived relationship between credit and their financial performance which this study seeks to understand. There is a relationship between credit and financial performance of ABC groups. Such organizations need to adopt credit management practices to ensure that they do not undergo losses during adverse economic periods (Saunders & Allen 2010). It is worth noting that there is a positive relationship between financial performance and credit management. It therefore implies that ABC groups should adopt credit management practices that lead to improved financial operations (Duffie and Singleton,

2012). There is also a significant relationship between profitability and credit management in ABC groups.

Most studies are mostly conducted on techniques and tools of credit management, strategies and practices used by various businesses. Most of the studies conducted do not establish a distinct relationship between profitability and credit management. A gap exists in the study of the impacts of credit risks on financial performances of business entities. It is therefore essential for researchers to focus on credit management. This study focuses on the operation of ABC groups. According to Duffie and Singleton (2012), over the last few years, most ABC groups have well-developed systems that help in modeling credit risks from various aspects of their business. Such models can be used to aid ABC groups in aggregating, quantifying and managing possible risks across product and geographical lines. The output of such models play an important role in the groups performance and risk management processes which include compensation based on performance, analysis of customer profitability, pricing based on risks and active credit management.

Modeling credit management may prove to form good management skills. It also has the potential to be applied in supervisory oversight of companies. Addae-Boateng et al. (2013) posit that credit management involves making informed decisions that relate to the investment of money. Such decisions need to be analyzed carefully because they are usually characterized by uncertainty. Financial performance comprises one of the initiatives by the management that is used to upgrade timeliness and accuracy of the financial information in order to meet the required standards while sustaining daily

business activities. It can also be defined as the operational potency of a business relative to expenditure and revenue just like the trait shown in other financial statements of different companies (Saunders and Allen, 2010).

The role of ABC groups remains central in economic activities involving finance. Their effectiveness could lead to a positive impact on the economy because a profitable and sound ABC group is able to withstand constraints and contribute to a stable financial system. The determinants of a groups performance have attracted interest of research, management, supervisors and financial markets because the knowledge of external and internal determinants of margins and bank profits is vital for different parties. Financial institutions are usually engaged in activities such as trading and investment which leads to risks (Saunders and Allen, 2010). It therefore means that instability of financial performance in ABC groups emanates from poor credit management.

The credit policies of ABC groups have a great influence on debtors. They are therefore able to trade in profitable way thereby increasing revenue. The credit policy of such groups defines the performance of a firm which means that once a company adopts optimal credit policies. They are therefore able to maximize revenue earned. As a result, it promotes and improves its performance and financial standing. The credit policies a company are the main influences on debtors. The measuring of the credit managers position to invest in clients as well as the ability to trade with robust revenue is important for ABC groups. Since credit management defines performance, it therefore means that a business should adopt credit policies.

Capital requirement may reduce hazard incentives by enabling members to absorb some parts of the losses. It therefore reduces the value of insurance that is put in option. It can be argued that it is a way to evade the consequences since supervision may not prevent ABC groups from manipulation and gaining of risks that are based on ratings from within (Addae-Boateng et al. 2013). Such businesses may therefore operate with an inadequate credit management thereby affecting position and financial performance.

Financial institutions usually use a credit committee to approve loans. A credit committee makes decisions on the regarding loans. It is essential in controlling the reduction of credit risks and improving the recovery of loans. Decisions for granting a loan can be arrived after making an analysis that is carried out by the committee thus reducing the chances of an individual to abuse the authority by granting credit to relatives and friends. It would result in poor credit recovery and financial performance. Non-performing credit affect the operations of ABC groups (Mishra and Deepti Mishra, 2010). There is need for such groups to adopt a good credit management department to ensure that there is smooth flow of funds thus ensuring efficiency in the running of the business.

Such practices includes ensuring appropriate collaterals, limiting credit to other people, credit securitization, sufficient assessment framework of credit and processes used in solving problematic loans. A combination of good credit management by ABC groups with close supervision by the managers results in enhanced performance. Credit scoring by businesses helps access money for development activities. ABC groups are recommended to use

credit assessment before lending to clients (Mishra and Deepti Mishra, 2010). In addition to that, credit policies need to be reviewed regularly.

ABC groups use credit management practices so as to mitigate risks as an objective of credit appraisal. Credit management practices impact such organizations positively thereby ensuring the efficiency in conducting the obligations of the business and meeting the set objectives. ABC groups use qualitative credit assessment methods so as to make decisions that allow them to make decisions while at the same time liquidity runs on credit concentration of borrowers and adverse trading by creditors. Credit diversification and guarantee can also be used to find ways that can be applied to mitigate credit risk.