Chapter II

Review of Literature

This chapter incorporates the review of relevant literature on important aspects of credit management variables of MSMEs in particular and their working in general. The chapter is divided in four sections. The first section presents a review of research literature on credit management variables and the second section does so with regard to the other functions of MSMEs. The research gaps are brought out in third section and the chapter ends with reference section.

2.1 Reviews on credit management variables

Trade credit is the heart of every business entity, specially, in smaller firms. The researchers usually investigated the trade credit as a component of net working capital and a source of short-term finance for business. In this regard, Vaidya (2011) made an exploratory investigation of the relationships among a set of items to measure the management of credit in small and medium-sized enterprises and found that highly profitable firms give and receive less trade credit as compared to the less profitable firms. After an examination of the trade credit of manufacturing firms, Isaksson (2002) revealed that trade credit comprises a significant portion of external financing and described that to access the trade credit, “firm size, demand condition, debt position, promotional activities and educational level of firms” are the important determinants. Whereas, Drever and Armstrong (2005) concluded that there is an important relationship between key measures of credit management practice.

To analyse the accounts receivables the different models are used by different researchers, Carpenter and Miller (1979) described a framework of accounts receivable which is based on weighted Days Sales Outstanding (DSO) and reveals that this method is free from any adverse effects of sales functions and changes in collection experience. In this context, Gentry and Garza (1985) re-examined the before said (Carpenter and Millar) CM model which provides an analysis that why a change in receivable has and what policy or operational changes to make in order to control account receivables. Moreover, Bastos and Pindado (2001) made a comparison between the agency model and traditional model and revealed that agency model
reaches at better results. The study found that days of sales outstanding of firms are positively related to adverse selection and negatively related to moral hazards.

By using a dynamic panel data model, **Garcia-Teruel and Marteinez-Solano (2010)** claimed that the unobservable heterogeneity and potential endogeneity problems can be controlled. The also suggested that when there is an optimal level of account receivables, firms should establish the target level to monitor accounts receivable investment and to avoid the negative effects of value because of uncollectible sales. To minimize the time for collecting the funds submitted by its customers for the payment of their obligations, **Levy (1966)** illustrated a Lock Boxes method. In an attempt to build a game model to analyse the causes of SMEs’ accounts receivable under asymmetric information, **Xuwei and Xiaozhuan (2009)** argued that information management is an important approach to resolve the problem of SMEs accounts receivable.

The firms providing the trade credit have to face with the problems of late payment also. In this regard, **Richard and Sang (2001)** categorized the characteristics of sluggish and speedy payers to reduce the default risk and found that “customer dissatisfaction regarding product/service, customer financial power and depressed supplier/customer relationship are the characteristics of slow paying customers”. The researcher suggested that firms should develop strong relationship with customers so as to reduce late payments. **Howorth and Reber (2003)** examined the influence of variables in small firms between those pay late habitually and those which never or only occasionally pay late and concluded that if habitual late payment is at a high implicit cost, there is a negative relationship between taking discounts and habitual late payment. **Poutziouris et al. (1998)** found that most of the enterprises devoted more time on the post-delivery activities as compared to pre-delivery activities of a firm and also pointed out one fourth of these were facing serious or very serious late payment problems.

To examine the receivable management in which way it is managed in working capital, **Deloof (2003)** found that there is a significant negative relation between operating income and number of day’s accounts receivable and between accounts payable and profitability and also suggested that the managers can create value for shareholders by reducing the number of day’s accounts receivable. In this context, **Garcia-Teruel and Marteinez-Solano (2010)**; and **Teruel and Solan (2005)** found that managers can
create value of firm by reducing the number of days for the accounts which are outstanding. Michalski (2008) found that the use of a liberal policy with the portfolio management approach, increases the value of firm.

Venkiteshwaran (2014) examined the impact of sales assets on the credit quality and reveals that sales assets have a non-trifling impact on issuer-level credit ratings and also supports that rating model do not perform uniformly in speculative grade firms. Roncagli and Bathala (2007) examined the small firms determinants regarding the use of trade credit discounts and found that minority owned firms take substantially less trade credit discount than other firms.

With respect to the financial management practices of trade credit, Asuquo et al. concluded that SMEs can improve their profitability by raising the efficiency of financial management practices. Similarly, Poutziouris et al. (1998) recommended that the owner-managers of small businesses can reduce the costs and enhance the business performance of SME firms, by improving the short-term financial management practices and considering more financing options. Turyahebwa et al. (2013) suggested that the owners of SMEs should develop a positive attitude towards adopting financial management practices so as to achieve the desired business performance.

With respect to the options for financing accounts receivables, Mian and Smith (1992) examined the different account receivables management policies such as “factoring, secured debt, captive finance subsidiaries and general corporate credit policies” and found that the larger more credit worthy firms create captive finance subsidiaries, while, the small firms issue secured debt accounts receivable. The study also concluded that size, concentration, firm’s traded debt and commercial paper are important aspects in explaining the firms’ choices between the policies. Levy (2010) analyzed the effect of irregular information between managers and outsiders on the use of accounts receivable in financing in firm’s functions and found that firm’s irregular information increases the amount of financing in the account receivables. However, Turyahebwa et al. (2013) proved that the SMEs firms used internal funds as compared to borrowed funds. In this regard, Freixas (1993) mentioned in their research work that account receivables may be used as collateral for the loans a firm obtains. But if the market measured the credit risk correctly in terms of price, this is equivalent to a loan to the firm that has bought on credit.
In the same context, Bose (2013) investigated the need of the financing requirement in MSME sector and revealed that there is a need to create a facilitate environment to make sure about credit flow and regarding the management of credit and Abdulsaleh and Worthington (2013) presents the empirical study with respect to the comparison of SME firms with large firms in terms of their financial decisions.

To use the factoring as a financing option of account receivables has also received the attention of researchers. For instance, Soufani (2002) reveals from their research that the factoring companies have different criteria to select their client or to offer their financial services to their client than other financial institutions and include the 13 features which influence the decisions in factoring market. Regarding factoring as a debt collection technique, Klapper (2005) observed that this technique is used by the high-risk suppliers to transfer their credit risk to their high-quality buyers. The study also found a positive relationship between use of factoring and level of economic development and growth of countries.

The researchers have generally viewed that a carefully documented credit policy is a fundamental requirement of sound credit management practice to counter the risks involved and to maintain a balance between risk and returns involved. The researcher proposed different models for maximizing the sales and minimizing the losses from bed-debts. After carrying out marginal analysis of credit sales, Davis (1966) found that there is greater probability of older accounts not being collected and recommended that in formulating a strategy to minimize the bad debts, all reasonable methods of collection should be included. Mehta (1968) ascertained a control system model through sequential decision theory for routine credit investigation problems and found that the relationship between operating rules concerned with routine decisions and the control indices is extremely helpful for framing an optimal credit policy.

In this regard, Hill and Riener (1979) found that the firms with higher bad debt loss rates can reduce the loss by offering the highest cash discounts, and also suggested that before offering the cash discount firms should consider changing credit policy as well as the firm’s changing opportunity costs. Contrarily, Lieber and Orgler (1975) presents four special cases of the simplified model of accounts receivable which comprise the components of credit and collection policies as well as the investment in account receivables and the impact of credit terms on sales.
To examine the different levels of the account receivables as well as operating risk related to purchasers for maximizing the value of firm through portfolio management theory, Michalski (2008) found that liberal credit policy burdens the business with higher costs of accounts receivable, while, on the other hand help to enlarge their income from sales. Whereas, Benishay (1965) presented a model for analyzing the decisions in the area of credit sales and accounts receivables and found that mean collection period of a firm is directly related to both external and internal considerations of the payment patterns of a firm's customers.

To study the effects of credit policy on the liquidity, Ojeka (2011) concluded that companies should ensure the monitoring and regular review of their credit policy and should minimize the allowance of cash discounts as much as possible. The researcher recommended that the organizations should consider their aim, nature of their business and business environment before setting up a credit policy. While for examining the effects of credit policy on profitability, Kungu et al. (2014) noted that the way in which credit policy is designed impacts on the profitability of firms and also found a weak significant positive relationship between credit policy and profitability.

To analyse the effects of changes in credit policy, Weston and Tuan (1980) found that when there are some changes made in credit policy, then the sales will also change and for the computations of sales change, other investment related to sales should also included. Rajan (1994) investigated the correlation between changes in credit policy with changes in the condition of demanding credit in banks and suggested that banks should maintain a credit policy of lending if and only if borrowers have a positive net present value (NPV) projects.

Further, for examining the policies and criteria followed by banks for determining the extent of credit, Rangarajan (1979) found that that there is interruption between the objectives and considerations that influence policy-makers in determining the over-all credit levels and also suggested that banks should change the criteria used by them for providing credit to individual borrowers to achieve the credit policy objectives. Whereas, Kalunda et al. (2012) found that the financial stability of the customer and the existing credit policy are the two most important factors for establishing a credit control policy and eliminating the bad customers is the major objective of a credit policy. While, Molina and Preve (2009) examined the credit policy and its effect on the costs in distressed firms and found that that if the firms facing the probability
problems they increase their receivables and when they have cash flow difficulty they reduce their receivables.

While evaluating the impact of receivable on financial liquidity, Elangovan (2005) suggested that the companies should take the advantage of factoring services for all the credit line customers and the company should remind their customers periodically before the due date by sending reminder letters or paying a personal visit. Ifurueze (2013) examined the impact of credit sales on the profitability and liquidity and found that the high debtors turnover has a positive effect on the firm’s ability to satisfy the obligations of its creditors, whereas, tight debtors collection policy minimize the problem of cash flow and liquidity. Whereas, to solve the collectable problems of receivables in Bosnia and Herzegovina, Ljubic and Mance (2009) produced a new model of collection risk management. The model is based on cash flow indicators, working capital ratios, current ratios, and debt-equity ratios.

By using the variance analysis for monitoring the accounts receivables, Gallinger and Ifflandes (1986) found that the tightening of credit has the downward effect on sales and receivables. In this regard, Shim (1981) estimated the cash collection rates from credit sales and suggested that a probabilistic budget should be developed to exhibit the expected values and a probability interval regarding cash collections. Using the Lagged Regression Approach, Leitch and Lamminmaki (2009) described a measurement of collection efficiency of New Zealand supply-chain organizations for comparing the corrected average collection period (ACP) and ageing schedule to their traditional counterparts and found that both the traditional ACP and traditional Aging Schedule were affected by changes in credit sales.

In a study of the relationship between plant & machinery (manufacturing sector) or equipments (services sector) and the receivables management variables, Ponniah and Mohan (2011) found that the profile of receivables management depends upon the investment made by manufacturing sector and services sector in plant & machinery and equipments. In a study of different collection period of different industry in Malaysia, Zainudin (2008) concluded that the companies who collect their debts soonest, provide better returns. The study also revealed that debt collection period is negatively associated with company size, implying that SME firms were facing the maximum delay.
With regard to the credit risk, Gyamfi (2012) analyzed the effectiveness of the techniques used by the micro finance firms to manage their credit risks and suggested that the firms should invest in computerized systems to assess their credit risks track records and for constructing the credits granted reports. The study also concluded that firms should undertake insurance policies to cover the risk of credit granted to customers. Regarding different methods and concepts of risk diversification for accounts receivable in SMEs, Lixin and Jiao (2012) recommended that five steps should be taken for the controlling of risk associated with accounts receivables. These include development of effective sales processes, a credit approved system according to management requirements, standardization of accounting for reflecting the overall size of accounts receivable, checking of the accounts at regular intervals and establishment of responsibility system of accounts receivable collection.

In a study of Kenya, Mwangi and Muriuki (2013) brought out that any of the industry like oil industry, which deals in credit was affected by adverse effects of credit risks and also recommended to understand the all prevailing factors and conditions of credit risk management processes to minimize the credit risk. In the same country, the study of Kalunda et al. (2012) on credit risk management practices of pharmaceutical companies revealed that “letters of credit, credit insurance and factoring of debt” are the most used credit risk management practices.

Having analysed the effectiveness of SMEs as compared to the large firms, Altman and Sabato (2005) found that by applying the different models and procedures which are specifically focused on the SME segment, SME firms manage their credit risk effectively.

In the study of Nigeria, Onaolapo (2012) examined the efficiency of credit risk management in the commercial banking sector and observed that a pragmatic credit management and screening procedures were the necessary efforts to improve the earnings from credit. Carey (1998) analysed the credit risk in private debt portfolios and found that in the riskier grades, private debt performs better than public debt. Chusaini and Ismal (2013) analyzed the credit risk in Indonesia, Islamic banking industry and found the good index value of credit risk management regarding credit risk management policies and procedures in the Indonesian Islamic banking industry.

Arora et al. (2005) investigated the three different models of the structural and the reduced-form approach [Vasicek-Kealhofer (VK) model, Merton model and Hull-
White (HW) model] and revealed that before applying the any type of credit risk model, their strengths and weaknesses must be assessed. Fatemi and Fooladi (2006) investigated the current practices of credit risk management in large US financial institutions and found that only a minority of banks utilize either a proprietary or a vendor-marketed model for the management of their credit risk. Contrarily, Scherr (1996) described the different methods for determining the credit limits with two sets of purposes, firstly information credit limits and the second is risk credit limits.

With regard to the receivable costs, Walia (1977) brought out the implications of different credit policies regarding the explicit and implicit cost of accounts receivables. The study found that for making the rational credit policy decision, a firm should be aware of the opportunity cost as well as the explicit cost. In this regard, Hill and Rainier (1979) examined the cost of offering discounts as well as whether a firm offer cash discount for the early payments of debts or not. They suggested that a firm should offer the discount by considering the various factors such as variable costs, firm's cost of funds, bad debt loss rate, the proportion of sales expected to be paid with a discount, change in sales and timing of payments, etc. The study also concluded that firms with higher bad debt loss rates can afford to offer higher cash discounts which help the firms to reduce the loss. Zambaldi et al. (2011) revealed that banks of brazil faced the difficulties in expanding the supply of credit to small firms due to cost, collateral-dependency and constraints.

By using the sensitivity analysis to determine the optimal number of credit applicants accepted by a creditor regarding credit granting policy, Greer (1967) revealed that decreasing the expected present value of future profits from credit selling and increasing the variable cost of producing and selling for credit is the necessity of a new optimal policy. In the same vein, Bierman et al. (1970) presented a multi-stage model for the problem of "give credit or do not give credit" regarding credit granting decision. However, Srinivasan and Kim (1987) provided a comparable analysis of the statistical classification models to imitate the decisions of a credit granting expert and showed that sequential partitioning procedures present better results rather than others.

In an examination of the credit creation and credit administration of commercial banks Abdulrasheed and Etudaiye-Muhtar (2010) noted that risk profile assessment of customer is the main feature of credit origination. Banks should develop the adequate procedures regarding borrower’s industry, purpose of credit, source of repayment and
repayment history. Babalola and Mohammed (2014) discerned that the applicant’s character, capacity, ability to pay, qualification for credit, collateral and prevailing economic conditions reduced the inefficiency of credit control and debt recovery of banks.

By reviewing the 5C's method in the banking sector, Abbadi and Abu Karsh (2013) found that the banks concentrate more on collateral, capital, and capacity of the debtors than their characters and conditions. Samreen et al. (2013) revealed that the firms should analyze the credit history of the customer for avoiding the credit risk, before providing the credit. In the same vein, Purohit et al (2012) brought out that the capacity of the borrower to pay a credit should be determined during the credit evaluation and approval and this can be done by checking the bank statements of an individual borrower and financial statements of businesses.

2.2 Reviews on MSMEs

The researchers have generally viewed MSMEs as a means to develop the developing economies, support the large scale industries and provide direct or indirect employment to the masses. Yan (2010) found a negative relationship between competitive pressure and performance of small and medium enterprises. The researcher also reported a positive relationship between magnitude of export assistance and their length export experience. In this regard, Liedholm, (2001) observed that export assistance varied according to location of MSMEs.

In a study of the relationship between MSMEs and large industries, Bhatheja et al. (2007) observed that MSMEs form an integral part of the supply chain of large-scale industries and provide vital forward and backward linkages to the overall industrial sector. The study attributed importance to Small Scale Industries (SSIs) in Indian economy due to their considerable contribution in terms of ‘production, sales and employment’. Sharma (2011) revealed that the SSI sector in India has been exhibiting a striking export performance and has potential to provide employment opportunities for the poor. This is because the studies reveal that Indian industry has made remarkable progress in various fields, like, manufacturing, food processing, textile & garments, IT and service sectors etc.

Some studies have noted that the wave of liberalization and globalization was counter-productive for the MSMEs. The reason for this is that every reform in an economy is
countercyclical which decides success and failure for every individual unit. Liberalization and globalization are critical examples of this view, as pointed out by Bhateja et al. (2007). This phenomenon has been advocated by them as a basis for government support for the sustenance of small units. They suggested that the government should see the implementation phase of the developing industries in the backward areas so that ancillary units could get their share. The researchers also emphasized on the increased role of ‘Panchayats’, the local self government, in the development of smaller industrial units and forceful promotion of women entrepreneurs.

Making MSMEs competitive has also received the attention of researchers. For instance, Morris and Basant (2010) observed that, in the age of liberalization and globalization, any attempt at creation of a competitive small scale sector in the country would need to explicitly take note of the emerging global production and knowledge networks.

The importance of marketing strategies for the MSMEs has been brought out by Hakimpoor et al. (2011). They hypothesized that the size, formality, diversity, density, stability and flexibility of marketing network will positively moderate the relationship between strategic marketing planning and performance of small and medium enterprises to test the validity of their model. The study observed that structural dimensions of marketing network are important moderators on relationship between strategic marketing planning and SMEs’ performance.

In a study of small and medium enterprises in construction sector of China, Yan and Chew (2011) revealed that their performance was critically dependent on competitive marketing strategy, relationship marketing strategy and business environment. Their study also revealed that there was a negative relationship between competitive pressure and performance of construction SMEs.

Referring to small businesses, Barbu et al. (2010) reported that small businesses use a variety of branding tactics, some of them very creative and one-step-ahead of the branding manuals. Entrepreneurs understand branding in their own way and this adds new developments in the theory and practice of branding. Egbetokun et al. (2008) revealed that SMEs focus on incremental product and process innovation.
As reported by Gilmore et al. (2001) SME owner/managers rely heavily on using their networks and their networking skills for all aspects of marketing in the context of competitor activity. They also noted that creation and existence of effective networking will be concerned with maximizing marketing opportunities and ensuring the enterprise’s survival and development through successful interactions with customers, banks and competitors. In a study with reference to banks and MSMEs, Lindstrand and Lindberg (2011) observed that normally banks do not participate in SME business networks when the latter are internationalized. But when the SME’s international business expands, there will be a greater demand for financial services that the bank may be able to offer.

By using a desk research, Hill (2001) carried out a multidimensional study of key determinants which affects marketing activities of SME and longitudinal investigation of the nature of SME marketing that was undertaken. There is research evidence to show that government help has been considered imperative in promotional efforts of MSMEs. Hallberg (2000) concluded that if the promotional help on the behalf of government was ensured then market access could be improved as well as economic benefits could be provided to these small firms. Mitchell (2012) highlighted several implications of branding in sales promotion of MSMEs. The researcher affirmed that their model might provide a useful tool kit for retail SME owner managers to aid the coordination of their brand communication more effectively. Barbu et al. (2010) evaluated the role of branding in small business and identified the practices that small businesses use to enhance their brand and the brand dynamics in small business.

Reijonen (2009) found that SME marketers perceived marketing through concrete practices that often relate to promotion, selling and customer relationships and they professed a combination of several philosophies to succeed. A case study carried by Ghatak (2009) brought out that MSMEs were faced with constraint of credit, technology and red-tapism. He felt that more support is needed for MSMEs from the government in the form of priority sector lending, government procurement programme and marketing support. The researcher found that the less awareness and the less knowledge about the new methods and techniques available in the business world were the main reasons of the failure of the SMEs. The findings revealed that there was no significant impact of marketing strategies on their business growth.
2.3 Research gaps

The literature review describes the different aspects of credit management in various ways. Some researchers studied the policies of credit management in MSMEs, while others carry out the same research for the further variables of credit management like credit risk, credit granting, credit evaluation, collection procedures etc. But there are very few studies which have carried out one step evaluation of credit management practices among MSMEs. Also, most of the researchers selected only one or two sectors of industry like manufacturing or service. However, the checking of cross industry variation is also important for MSMEs regarding credit management variables.

Keeping all these differences in mind, the present study is planned with the intention of finding the interrelation between all the variables of credit management. The review of various studies shows that these mostly covered the aspects like the role and relevance of micro, small and medium enterprises in the exports, economic growth and development and employment of the country. Some of the studies have examined the importance of credit management and its one or the other strategic aspects in business endeavours of small and medium enterprises, to the neglect of micro enterprises. Hardly any study has covered micro, small and medium enterprises together. Similarly, there is hardly any study which has studied all the aspect of credit management in MSMEs from the standpoint of owner/entrepreneurs. It will be interesting to study how the entrepreneurs perceive the strategies regarding credit management of MSMEs and what differences are there in this regard among the micro, small and medium enterprises. Bringing out important considerations or factors that could form an input for the credit management of MSMEs will also be an important aspect of this study. The present study has been undertaken to fill these research gaps.

2.4 References


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