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# The Moderating Effect of Financial Literacy on the Relationship between Accounts Receivable Management Practices and Growth of SMEs in Kenya

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*Financial literacy may be defined as the ability of an individual to identify how money may be utilized, managed, so that he/she earn and grow it to improve his financial status and that of others which in the long run improves the economy as a whole. Statistics from FinAccess Kenya indicate that close to 76 per cent Kenyan adults do not adequately understand key financial concepts. The purpose of the study was to establish the moderating effect of financial literacy on the accounts receivable management practices and growth of SMEs. The findings revealed that financial literacy moderates the relationship between ARM practices and growth of SMEs. This can be supported by the regression results which revealed a positive and significant moderating effect. The magnitude of the effect was significant and illustrated that the interactive factor increased the way accounts receivable management practices affected growth of SMEs. The findings would form a basis for government and policy makers to formulate strategies and policies that would help reduce the levels of financial literacy among the adult population.*

***Keywords:*** *SME, financial literacy, Accounts receivable, management practices*

***JEL Classification:*** *G23, G31*

## 1. Introduction

### 1.1. Background to the Study

Remund (2010) stated that financial literacy is the extent to which one understands financial concepts and has the potential and assurance that he/she is able to wade through with tidal waves in a competitive business environment providing suitable decision which gives long term results, more so decisions related to accounts receivable management.

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Accounts Receivable (AR) is one of the largest and most liquid of corporate assets (Kimtai, 2006) which are very important in facilitating business transactions. Pike and Neale (1999) consider accounts receivable as both a source and use of finance in that it can be obtained and extended. However, it can be unproductive unless it generates additional business since it ties up scarce financial resources and exposes organizations to risk of default in situations whereby the credit period is lengthy (Pike and Neale, 1999).Huge amounts of accounts receivable is likely to reduce the firm value and as such the need to have best Accounts Receivable best practices. Mbula, Memba and Njeru (2016) assert that Accounts receivable is a current asset and a component of working capital.

The starting point for accounts receivable management practices is to understand the policies and procedures for sales. Two critical questions to answer are, how and when a firm should evaluate a customer for credit, and whether there exist a credit policy. Myers (2003) describes AR management as methods and strategies adopted by a firm to ensure that they maintain the best optimal level of credit and its effective management. It is a component of financial management which involves Accounts Receivable analysis, Accounts Receivable extension, Accounts Receivable collection and Accounts Receivable financing. Some of the other components of Accounts receivable management practices are policies, measurement and outsourcing options.

Financial Literacy is the ability to have better judgments and to take appropriate actions for the management of cash flow (Njoroge, 2013). Financial literacy includes the ability to recognize sound financial choices. For example, whether to sell goods or credit, how much cash discount to give. It is a cornerstone that affects financial decision making. Financial knowledge and skills matters in any business or non-business activities as each and every decision have financial implications (Njoroge, 2013). Lack of basic financial concepts can be linked to failure of firms. Sabri (2015) established that financial literacy can lead to better financial management practices. Firms employing staff with financial knowledge and skill are more likely to make decisions that may have positive implications on the liquidity position, account receivable management practices will ensure timely, regular and healthy cash inflow by selecting the right customer, ensuring strict recovery, eliminating poor customers and implementing formal credit policy (Sabri, 2015). Financial knowledge is crucial, a person who has sufficient knowledge is less likely to make expensive mistakes, since every decision undertaken would be guided by principles and policies well stipulated. SMEs lack sufficient funds to attract trained financial managers and analysts most often they employee accountants who only look at the conventional accounting function of recording transactions in the books of accounts. The SMEs manager or accountants should be responsible for providing leadership in all aspects of financial decision making like working capital management, capital budgeting decisions, financing decisions, and dividend decisions. It has been noted that the failure to effectively discharge these broad financial management functions have contributed largely to global financial crisis faced by SMEs (Osisioma, 2010).

### 1.2. Statement of Problem

Although scholars are in agreement about the important role played by SMEs in a Country's Economic growth, there is still a fundamental lack of knowledge as to why some of them manage to grow and transition to large firms, while others remain stagnant or fail altogether. The challenges that most SMEs face is striking a balance between liquidity and profitability. This challenge is enormous since SMEs have to wade through stiff competition by attracting and maintaining customers through credit sales and at the same time use aggressive methods of collecting accounts receivables to maintain optimal levels of working capital. Increasing credit sales to improve profitability may end up extending credit to risky customers who will default, such customers will be asked to pay cash as the goods are delivered to them. Inability to manage accounts receivables, made many SMEs in Kenya to suffer financial distress resulting to their eventual collapse. This study was meant to assess whether level of financial literacy of the managers of a business has an impact on the financial status and growth of the business.

## 2. Literature Review

Majority of studies have proved that financial literacy has a positive effect on entrepreneurship success. However, there are also cases of illiterate persons running successful enterprises. In Kenya where vast majority of SMEs are in informal sector, many Jua Kali and farming entrepreneurs are financially illiterate and yet they run very successful SMEs. Njoroge, (2013) in his study concludes that there is positive relationship between entrepreneur's success and financial literacy. He noted SMEs that are more successful are run by entrepreneurs who are financial literate and understand key financial concepts that include, risk management, interest rates, time value for money and financial market. However, other scholars contend that lack of financial knowledge of effective receivable management combined with the uncertainty of the business environment leads to poor performance by SMEs (Abor and Biekpe, 2005).

It is important that a firm understands its business position as far as its cash flow is concerned, however this can be done quite effectively when a manager has a certain level of financial literacy. Nunoo et al. (2012) in a study to examine how financial literacy influences SMEs in Ghana found that financial literacy is crucial in stimulating the SME sectors. The stiff competition in the global market that most SMEs face means that the SMEs have to have formal control over their financial decisions than ever. This has placed greater demands on financial directors and managers to be more financial literate in order to improve decision making. To this end, there has been a rising interest in the financial literacy from academic community, international organizations and governments recently (Olga, 2011). Nyabwanga (2011) studied the effects of working capital management practices on financial performance of small scale enterprises in Kisii, South district. In his study, he established that majority of business operators did not have business management knowledge and further suggested a study to unravel the impact of training on performance of business. Njoroge (2013), on the other hand, concludes that there is positive relationship between entrepreneur's success and financial literacy.

Njoroge (2013) observed that SMEs that are more successful are run by entrepreneurs who are financial literate and understand key financial concepts that include, risk management, interest rates, time value for money and financial market. Financial literacy would make an entrepreneur more knowledgeable and better at making informed decisions as to the kind of accounts receivable management practices to adopt. Hartog et al. (2010) used the U.S. National Longitudinal Study of Youth to examine the effects of various personal characteristics among entrepreneurs and employees. They found that verbal abilities appear to be more important for employees, while mathematical, technical and social abilities are more important for entrepreneurs. Financial literacy can facilitate the decision making processes such as payment of bills on time, proper debt management which can improve the credit worthiness of potential borrowers to support firm performance (Adomako, 2014). Being financial literate is a plus to an entrepreneur. Financial literacy enable investors to evaluate and compare financial products, such as bank accounts, saving products, credit and loan options, payment instruments, investments, insurance coverage, so as to make optimal decisions (Miller et al., 2009).

## 3. Research Methodology

This study adopted a mixed survey research design. The target population was 5401 registered SMEs under Single Business Permit Registration. Proportionate stratified random sampling technique was used to select 359 SMEs. Primary data was collected using semi-structured questionnaire. The data was analyzed using the Statistical Packages for Social Sciences (SPSS). Analysis of the data collected focused on both the descriptive statistics (trends) and inferential statistics (Pearson Correlation Coefficients) and multiple regression coefficients. The analyzed data was presented in frequency tables and graphs. Regression analysis was used to establish the relationship between the independent and dependent variables.

## 4. Research Findings and Discussion

### 4.1. Entrepreneurs Background Information

This section analyzes the background information of the respondents. This section presents the descriptions of the respondents in terms of their gender, level of education, number of years in current firm. Results are as presented in Table 1, 2, and 3, respectively.

***Table 1.*** *Showing Respondents' Gender*

| Gender | Frequency | Percentage |
|---|---|---|
| Female | 117 | 57.6 |
| Male | 159 | 42.4 |
| **Total** | **276** | **100** |

Source: Field data, 2016

Results in table 2 reveal that 57.6% of the respondents were male while 42.4% of the respondents were female. It is observed that most entrepreneurs who operate SMEs are male. This can be attributed to the culture dynamics of the residents of Kakamega who have for a long time viewed means providers while women stay at home to take care of the children. However, the small margin can be seen as a good indicator of changes in the culture and thus a representation of the study population.

***Table 2.*** *Showing Respondents' Level of Education*

| Qualification | Frequency | Percentage |
|---|---|---|
| Primary | 29 | 10.5 |
| Secondary | 118 | 42.8 |
| Graduate | 122 | 44.2 |
| Postgraduate | **7** | **2.5** |
| **Total** | **176** | **100** |

Source: Field data, 2016

Further, results in Table 3 show that 44.2% of the respondents were graduates, 42.8% of the respondents had acquired education up to the secondary level while 10.5% of the respondents had acquired education up to primary level. Only 2.5% of the respondents had acquired education up to post graduate level. This is an indicator that most of the respondents were educated implying that they were better positioned to learn and apply ARM practices in their firms with an aim of experiencing growth this could also imply that most of the educated were trying their hands on entrepreneurship either as a result of not getting jobs or as an incentive from the government from the youth funds and women funds. Indeed this can also be attributed to Government's initiative of providing free and affordable education to all.

The responses on the job titles included; owner, data entry clerk, manager, accountant, business lady, salesman, underwriter, cyber attendant, salonist, trader, shopkeeper, supervisor, sales woman, farmer barber, sales agent, relationship manager, finance manager, engineer, driver, financial analyst, M-pesa attendant, mechanic, assistant manager, hotelier, co-owner, massager, trader, retailer, clerk, hawker, waiter, bodaboda operator, wholesaler, revenue officer, clinical officer and pharmacist. This is an implication that the data collection process was diversified. This is of importance as the results will represent people from different professions.

***Table 3.*** *Showing Respondents' Number of Years in the Business*

| Number of years worked | Frequency | Percentage |
|---|---|---|
| 1-5 Years | 193 | 69.9 |
| 6-10 Years | 68 | 24.6 |
| 11-15 Years | 10 | 3.6 |
| More than 15Years | 5 | 1.8 |
| **Total** | **276** | **100** |

Results in table 4 also revealed that 69.9% of the respondents had worked in the firm for a period of 1 – 5 years while 24.6% of the respondents had worked in the firm for 6 – 10 years. Another 3.6% of the respondents had worked in the firm for 11 – 15 years while a paltry 1.8% of the respondents had worked in the firm for more than 15 years. Since all the characteristic classifications were represented with the majority of the respondents having worked or dealt with SMEs for a period more than3 years the information obtained was believed to be reliable. This is an indicator that most of the respondents had not worked in the firm for a long period of time and thus did not have much experience on how to run the firm's operations. Hence, it could be of great significance that they acquire information on Account Receivable Management (ARM) practices. This would go a long way in ensuring that they experience growth. However, an experience if 1 – 5 years is good enough to give reasonable information on which this study based its results.

### 4.1.1. Business Demographics

This section outlines the sector of the businesses, the type of business ownership and the period the business has been in operation. Results are presented in Table 4.

***Table 4.*** *Sector of Business*

| Sector | Frequency | Percentage |
|---|---|---|
| Retail | 90 | 32.6 |
| Health and Beauty | 12 | 4.3 |
| Construction | 6 | 2.2 |
| Agriculture | 19 | 6.9 |
| Manufacturing | 33 | 12 |
| Hospitality | 39 | 14.1 |
| Transport | 31 | 11.2 |
| Service | 46 | 16.7 |
| **Total** | **276** | **100** |

Results revealed that 32.6% of the respondents operated firms in the retail sector, 16.7% of the respondents indicated that they operated firms in the service sector, 14.1% operated firms in the hospitality sector, 12% operated firms in the manufacturing sector, and 11.2% operated firms in the transport sector while 6.9% were in the agricultural sector. Results also revealed that 4.3% operated firms in the health and beauty sector while a paltry 2.2% operated firms in the construction sector. This indicates that the study looked at diverse sectors. Results in Table 5 revealed that 55.1% of the respondents were sole traders, 25.4% of the respondents had partnerships while 14.1% of the respondents indicated that they operated family trust firms. Another 5.4% of the respondents had public enterprises. Majority of SMEs are either sole traders or partnership. The low percentage of public enterprises could be attributed to the high capital outlay required to start and the long procedures involved.

***Table 5.*** *Showing Respondents in Business*

| Type of Business | Frequency | Percentage |
|---|---|---|
| Sole trader | 152 | 55.1 |
| Partnership | 70 | 25.4 |
| Family trust | 39 | 14.1 |
| Public Enterprises | 15 | 5.4 |
| **Total** | **276** | **100** |

Source: Field data, 2016

### 4.2. Descriptive Results

#### 4.2.1. Moderating effect of Financial Literacy on Accounts Receivable Management Practices

The study sought to assess the financial literacy of the respondents. The study specifically investigated the following elements of financial literacy; financing of receivable options available, credit monitoring methods, computation of discounts, computation of financial ratios, credit analysis methods and credit collection methods.

***Table 6.*** *Showing moderating effect of Financial Literacy*

| Statement | Very low | Low | Averag | high | Very High | Mean |
|---|---|---|---|---|---|---|
| 1. Financing of receivable options available. | 6.50% | 20.30% | 50.00% | 18.50% | 4.70% | 2.95 |
| 2. Credit monitoring methods. | 6.50% | 12.30% | 36.60% | 33.70% | 10.90% | 3.30 |
| 3. Computations of discounts. | 12.70% | 16.70% | 34.80% | 25.70% | 10.10% | 3.04 |
| 4. Computation of financial ratios. | 15.30% | 22.90% | 36.70% | 20.40% | 4.70% | 2.76 |
| 5. AR analysis methods. | 9.50% | 27.50% | 35.90% | 17.60% | 9.50% | 2.90 |
| 6. AR collection methods. | 1.80% | 12.30% | 41.70% | 29.70% | 14.50% | 3.43 |

Source: Field data 2016

### 4.3. Inferential Statistics

#### 4.3.1. Multi-Linear Regression

The stud sought to establish the moderating effect of financial literacy on the relationship between Accounts receivable management practices and growth. The moderation effect was tested using Ongore and Khisa (2013) approach. Each variable was interacted with the moderator and the model took the following estimation equation:

$$Y = \beta_0 + \beta_1 X_{1*}.M + \beta_2 X_{2*}.M + \beta_3 X_{3*}.M + \beta_4 X_{4*}.M + \beta_5 X_{5*}.M + \varepsilon$$

***Table 7.*** *Multi-Linear Regression after Moderating.*

| Variable | B | Std. Error | t | Sig. |
|---|---|---|---|---|
| (Constant) | 35.758 | 1.195 | 29.93 | 0.001 |
| Account Receivable analysis and Financial literacy($X_{1*}$.M) | 0.001 | 0.006 | 2.123 | 0.009 |
| Account Receivable Extension and Financial literacy($X_{2*}$.M) | 0.008 | 0.007 | 2.166 | 0.024 |
| Account Receivable Collection and Financial literacy($X_{3*}$.M) | 0.003 | 0.005 | 3.586 | 0.005 |
| Account Receivable risk assessment and Financial literacy($X_{4*}$.M) | 0.01 | 0.005 | 2.159 | 0.032 |
| Account Receivable Financing Practices and Financial literacy($X_{5*}$.M) | 0.003 | 0.008 | 3.323 | 0.007 |
| R square =69.23 | | | | |
| F statistic(p value) =11.298(0.000) | | | | |

$$Y = 35.758 + 0.001X_{1*}.M + 0.008X_{2*}.M + 0.003X_{3*}.M + 0.01X_{4*}.M + 0.003X_{5*}.M$$

$R^2$ improved to 69.23% after moderation. Further the interaction terms of all the variables were significance since the calculated P values were less than the critical p value (0.05). Therefore the study concluded that financial literacy has a moderating effect on the relationship between Accounts receivable management practices and growth.

#### 4.3.2. Test of Significance of Regression Coefficients

In determining the cause effect relationship between the dependent variable and the explanatory variables the regression coefficients were tested at the5% level of significance using t-test. The regression is presented in Table 7. The study sought to find out the moderating effect of financial literacy levels on the relationship between Accounts receivable management practices and growth of SMEs.

In Table 7, the significant level for all is less than 0.05 indicating that there is a significant impact of financial literacy on the relationship between Accounts Receivable and Management Practices and growth of SMEs. This may be attributed to the fact that knowledge of Accounts receivable management practices leads to their use by the owners. This study differs with the one of Nyabwanga (2011), who studied the effects of working capital management practices on financial performance of small scale enterprises in Kisii South district. In his study, he established that majority of business operators did not have business management knowledge. However, the findings concurs with Njoroge (2013), in his study concludes that there is positive relationship between entrepreneur’s success and financial literacy. Njoroge (2013) noted that SMEs that are more successful are run by entrepreneurs who are financial literate and understand key financial concepts that include, risk management, interest rates, time value for money and financial market. This study agrees with the study of Sabri (2015) who posits that there is positive relationship between ARM practices and Growth.

## 5. Summary of Findings, Conclusions, and Recommendations

### 5.1. Summary of Findings

The study found that the SME owners were informed about various aspects of finances such as using credit monitoring methods, computing discounts and using credit collection methods. However, results revealed that the SME owners who were more financially literate were able to manage their accounts receivables.

### 5.2. Conclusion

The study concluded that financial literacy moderates the relationship between ARM practices and growth of SMEs in Kakamega County, Kenya. This can be supported by the regression results which revealed a positive and significant moderating effect. The magnitude of the effect was significant and illustrated that the interactive factor increased the way Accounts Receivable management Practices affected growth of SMEs. It can be concluded that when SMEs empower their employees with more knowledge in ARMP the SMEs would be successful.

### 5.3. Recommendations

The study recommends that financial literacy moderates the relationship between ARM practices and growth of SMEs in Kakamega County, Kenya. The study recommends that financial institutions within Kakamega County should endeavor to educate SME owners about the ARM practices. This would result to economic growth within the county which would also impact them positively. The study also recommends that SMEs owners should take the initiative to be financial literate. This would help to speed the growth of their businesses. Government should encourage entrepreneurs to learn about Accounts Receivable Management Practices, SMEs growth translates to economic growth for the entire Nation which will mean reduction in poverty levels. SMEs would be able to sustain themselves.

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