CREDIT MANAGEMENT PRACTICES IN THE SERVICE INDUSTRY:

THE CASE STUDY
OF
TELKOM KENYA LIMITED

BY

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A RESEARCH PROJECT   SUBMITTED IN PARTIAL FULFILLMENT FOR
THE DEGREE OF MASTERS IN BUSINESS ADMINISTRATION
IN THE
FACULTY OF COMMERCE

UNIVERSITY OF NAIROBI

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STUDENT'S DECLARATION

This Research Project is my original work and has not been presented elsewhere for any other assessment or reward.

Signature................................ Date .....25/9/06..........

Supervisor's Approval

This Research Project has been presented for examination with my approval as the University of Nairobi Supervisor.

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ACRONYMS/ABBREVIATIONS

IOMA	Institute of Management Accountants Report
BPPG	Best Practice Performance Group
EFT	Electronic Funds Transfer
CPA	Certified Public Accountant
CPS	Certified Public Secretary
TELKOM	Telkom Kenya Limited

PART A-QUESTIONNAIRE

WS	Work station
LHU	Length as head of Unit
LE	Level of Education
PQ	Professional Education

PART B-QUESTIONNAIRE

BD	Bad Debts
DT	Debtors' Turnover
DW	Debts Written-Off
NoC	Number of Customers
DC (%)	Percentage of Debt Collected
RCA	Rank of Corporate Accounts
RPEA	Rank of Personal Accounts
RPARA	Rank of Parastatal Accounts
RGA	Rank of Government Accounts

PART C--QUESTIONNAIRE

CWCP	Written Credit Policy

CMCC	Modify Corporate Credit Policy
CHA	Has Achieved
CSCM	Staff involved in Credit Management
CHAC	Head office allow credit
CCLC	Credit Limits to clients
CPT	Payment terms
CMD	Monitoring of debtors
CFCC	Funding of credit to clients
CCD	Collection of debts
CFAC	Firm's age or potential customer
CFT	Frequency of transactions (level of usage)
CPQ	Product quality or Reputation of the firm
CF	Factoring
CCI	Credit Insurance
CDC	Debt Collection
CIS	Credit Information Services
CBR	Bank reference
CTR	Trade reference
CFS	Financial Statements
CPC	Personal contact
CCA	Credit Agencies
CPPR	Past Payment records
CTJ	Trade Journals and Business Magazines
CCR	Controlling Risk in Accounts receivable
CDDC	Due diligence on your customers upfront
CCAR	Collecting accounts receivable
CUTMC	Using technology to manage credit

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ACKNOWLEDGMENT

My sincere gratitude goes to the following people, who in their own special way contributed to the successful completion of this project:

Mr. Lisiolo Lishenga, whose expertise, understanding and patience added immense value to my project work.

My friend Mohammed "Badi" Loo, for his motivation and moral support.

Mr. Patrick Ojera, whose support and persistence gave me the necessary resolve and resilience to forge ahead.

Dr. Karanja, for his intellectual criticism and guidance at the initial stages of this research.

My dear wife Lilly, for her love, encouragement and judicious amount of moral and physical support that motivated me to get this research done.

Many thanks also goes to my cherished mother, Hellen Onono without whose support, guidance and love I dread to wonder where I would be today.

Mr. Kamasara, the Chairman of the department of Business Administration, the various lecturers in the School of Business and the administration of the University of Nairobi in general.

DEDICATION

The embodiment of this piece of academic is dedicated to two people who shaped my life in a very special and lasting way:

Solomon Onono Ade,

My late father who taught me many things and always reminded me that hard work is the most assured secret to success.

and

in an endearing manner to

Mama Damar Ouko

My loving late grandmother and counselor par excellence!

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ABSTRACT

The aim of this research was to find out the reasons which have led to the large outstanding debt and also establish the relationship between the debtors' problem and the credit policies of Telkom Kenya Limited hereinafter referred to as "TELKOM", by reviewing its credit management practices and bench marking these against the ideal or best practices.

The study focused on the population involving the heads of Credit Units in the seventeen (17) Credit Units regions of TELKOM spread across the country.

A qualitative and quantitative research method was complementarily used in order to have a more objective interpretation of data. Data was collected by use of the questionnaire method. Questionnaires were administered personally at the head office or sent through the Regional Accountants to the various Credit regions of TELKOM as the circumstances dictated. Secondary data like the financial statements were also used to understand the financial performance of the company in detail.

The data analysis technique has been aligned to meet the three objective of study, namely: to identify and evaluate the credit management practices (debt collection and follow up) within the different regions of TELKOM and draw a comparison with the corporate credit policy and best practices in credit management; to evaluate the level of bad debts within the different regions of TELKOM; and to establish the relationship between credit management practices and level of bad debts in TELKOM, regionally.

All the seventeen regions responded and the findings on the three set objectives indicates the inability to effectively practice credit management policies , lack of proper vetting procedures and Government's slow pace in meeting its obligations as some of the factors which have led to the debt growth at TELKOM.

In order to manage credit sales effectively therefore, TELKOM must re-assess its sales contracts with the Government and Personal accounts holders. These are the worst

defaulters and consequently contribute to the highest proportion on the provisions for bad debts of the company.

It has also been observed that in reality the disconnections policy is not strictly adhered to and in some instances, it takes up to almost six months before the telephone lines of defaulting customers are discontinued. TELKOM management attributes this approach to the rapidly growing competition which has prompted such measures as ways in assisting in customer retention.

Slow and inefficient collection of debts has also been a major contributing factor to TELKOM'S present cash flow problems. Debtor days stretched to more than one year as at 30th June, 2003 and 380 days in the subsequent financial year .This reflects badly when compared to the one month stipulated credit period of the company.

To improve on credit management practices and therefore tackle the debtors problem, TELKOM'S management must empower the regions and accord them a free hand in managing accounts receivables since the regional officers are more familiar with the socio-economic factors of the local environment in addition to being best placed to deal better with the local clients than the head office. Currently, the empowerment of the regions appears arbitrary, selective and in certain instances, discriminative.

CHAPTER ONE

1.0 INTRODUCTION

1.1 BACKGROUND

Credit Management has established itself worldwide as a vital management function with a major contribution to make to the economic well being of organizations of all kinds. Efficient credit management, with its crucial impact on cash flow, can make the difference between survival and insolvency in the private sector, or between cost effective and wasteful administration in the public sector. Effective management of accounts receivable therefore presents important opportunities for organizations to achieve strategic advantage through improvements in customer service, cash management and reductions in costs.

Modern firms must sell on credit in this competing environment to enhance sales turnover. However selling on credit has it hazards. Customers will routinely seek the best terms possible, often attempting to postpone payment for as long as possible. Unfortunately, delinquent payments hurt company's cash flow and eventually result into write-offs which, according to Wells (2001) erode company's profitability by the cost and other direct expenses incurred to make sale.

The term credit policy refers to the combination of decision variables considered in the extension of credit and effective collection of credit. Credit policy is a statement outlining an organization's credit management objectives together with the actions to be taken in relation to credit risk management, invoicing, collections, query management, accounts receivables maintenance and management reporting.

Van Horne (1989) notes that besides economic conditions, the firm's credit policies are chief influences on the level of a firm's accounts receivables. He further asserts that there is a cost to carrying the additional receivables as well as a greater risk of bad-debt losses. The point is that credit and collection policies are interrelated with the

pricing of a product or service and must be viewed as part of the overall competitive process.

Economic conditions and increased competition compel organizations to offer services on credit; accompanying the benefits of increased sales, there are high default risks that may adversely affect the organization's future. Organizations therefore come up with appropriate credit management policies that will reduce the incidence of defaults.

In manufacturing and commercial firms, accounts receivable is among the largest and liquid assets, (Anderson, 2004). A properly managed accounts receivable portfolio can expedite cash flow and support corporate cash requirements. Companies have traditionally viewed accounts receivable as a basic function. They are beginning to realize, however, that improving the process can lead to significant financial gain for the company. Fewer outstanding account balances mean fewer bad-debt write-offs and enhanced profitability.

In communication companies, the observed emphasis on turnover by concentrating on recruitment of customers has resulted on less emphasis on credit and debt management. Ironically, this has put the profit of these organizations at risk. With revenue leakage occurring throughout the industry and cost spiraling as demand for more sophisticated services soars, some companies may be facing a crisis if they fail to address the credit management problem, (Brown,2003).

In establishing an optimum credit policy, an organization must consider the important decision variables which influence the level of receivables and the impact of such decision variables on turnover. In this regard, the major controllable decision variables include: Credit Standards and Analysis, which set the criteria a firm follows in determining which customers qualify for credit extension; Credit terms which stipulates the conditions under which the organization sells on credit to customers, for example the decision on whether or not to offer discount, credit period and credit

limit; and Collection Policy ,which lays down clear-cut collection procedures geared towards ensuring timeliness and efficiency in debt collections.

Credit policies vary from one organization to another or even in different departments within an individual firms; a firm's unique operating conditions dictate the kind of credit policy to adopt. Brealey and Myers (1988) suggest that if services are offered on credit, the sale is not complete until the accounts receivable is collected.

In Kenya, for instance, many financial institutions have collapsed due to among other factors, poor credit policies. Institutions such as Ari Credit Finance, Trade Bank, Post Bank Credit and Euro Bank are a few examples. Additionally, Kenya Commercial Bank and National Bank of Kenya Ltd. also underwent restructuring to save them from imminent collapse due to non-performing loans. The increase in bad debts provisions continued to erode the banks profitability in Kenya and the growth in bad debt provisions has also lead to corresponding decrease in after tax profit (attributable earnings), (Financial Standard, 2001)

The bad debts problem transcends across industries in all the sectors of the economy from service, agriculture, financial, hospitality to educational institutions. In this regard, TELKOM is not an exception having been weighed down by the problem of uncollectible debt over the years.

A perusal of some of the company's documentations confirms that there are clear standards in significant part of its credit management operations. TELKOM has in place a credit control policy which outlines the customers vetting process, requirements of a customer prior to obtaining a telephone account, payment details, temporary service provision and legal action in instances of default. Other business development priorities and terms and conditions that should be adhered to in order to for credit to be approved are also incorporated.

However, TELKOM still has a large provision for uncollectible debts which amounted to KShs 14.2 billion as at 30th June, 2004 implying that the machinery for follow up of non-paying customers is not effective.

This study will therefore address the credit management procedures at TELKOM and assess the adequacy and effectiveness in mitigating against the growth in accounts receivables. It will further seek to establish the reasons which have lead to the increasing debtors' level.

1.2 PROFILE OF TELKOM KENYA LTD

TELKOM is a wholly owned Government Parastatal operating under the Companies Act. The Company provides both local and international telecommunication services in addition to data and other auxiliary services. It falls under the Ministry of Information and Communication and currently has a presence in seventeen administrative regions covering the entire country.

The Company was formed in April 1999 through an Act of Parliament which separated the then Kenya Post and Telecommunication Corporation into three entities, namely: the Communications Commission of Kenya, Postal Corporation of Kenya and Telkom Kenya Limited.

Initially renowned only for provision of fixed line telecommunication services, TELKOM has over the years moved to diversify its services and products to encompass the divergent and dynamic nature of customer needs. Today, TELKOM offers a wide array of voice and data services highly tailored to meet the growing expectations of customers and other users whilst also bringing into the market a host of benefits and value added services accruing from the application of modern technologies in global telecommunication arena.

With the commitment to satisfy the ever changing and divergent customers' needs by offering efficient, reliable and affordable telecommunication services, TELKOM

continues to embrace modern technologies in each and every sector of its service provision and operations towards the accomplishment of market objectives.

While the Company still controls the largest market share in provision of fixed telephone services with a customer base of about 280,000 connections, increased competition from mobile telephone operators and other telecommunication providers has over the years resulted into a decline of its revenue base and seriously eroded its profitability.

The financial performance has further been aggravated by the huge uncollected debts. TELKOM has a poor record on recovering its billings with approximately 15% of telephone billings not collected. The potential for improvement in this area is significant as world-wide averages for bad debts in the telephone industry is around 3-5%.

To ensure TELKOM's continued sustainability in the ever increasing competitive environment and enable it cope with the demands of a rapidly changing and dynamic sector, the company must therefore intensify its efforts in debts recoverability to provide it with the much needed cash-flow to finance its recurrent and capital budget obligations. In this regard, effective credit management practices are therefore necessary for its continued survival now and in future.

1.3   STATEMENT OF THE PROBLEM

In the commercial world the way in which organizations manage their accounts receivable has significant implications for the financial health of those organizations. Profitable firms must ensure that the management of receivables is both efficient and effective, (www.anao.gov.au, 1997).

According to the financial statements of TELKOM, trade debtors stood at Kshs.25.1 Billion as at 30th June, 2004 compared to Kshs 13.4 Billion as at 30th June, 2000. The bad debt provision amounted to Kshs 14.2 Billion for the period ended 30th June,

2004. On the average, out of the total monthly billing, approximately 15% of the outstanding debt is rolled over to the subsequent month thus worsening the already bad situation further.

The average debt collection period or the debtors' days for this period also increased from 256 days for the financial year ended 30th June, 2000 to 381 days in the year ended 30th June, 2004.

The due date for the accounts rendered is clearly stated in the invoice and consequently, any customers in breach of this requirement is disconnected from receiving further services and recovery measures immediately undertaken. Despite this, we still see growth in bad debts. This kind of problem requires a review or evaluation of credit management policies and practices at TELKOM. The dismal performance on collection of receivables clearly demonstrates that the company's credit management system has not been effective in mitigating credit risks and timely follow up of debtors.

The aim of this research is therefore to find out the reasons which have led to the large outstanding debt position and to further establish if there is any relationship between the debtors' problem of TELKOM and the existing credit policies by reviewing its credit management practices and bench marking this against the ideal practices.

Credit management crisis is a worldwide problem. In Kenya empirical and case studies have been carried out on credit risk management in the agricultural, financial and publishing sectors respectively, Njiru (2003) studied *Credit Risk Management by Coffee Cooperatives in Embu District*; Kabiru (2002) studied *The relationship between credit risk assessment practice and the level of non performing loans of Kenyan Banks* while; Mutwiri (2003) studied *The use of 6 C's credit risk appraisal model and its relationship with the level of non- performing loans of commercial Banks in Kenya;* Osman (2003) studied *The credit management policy of Nation Media Group* focusing largely on its distributors.

The decision to undertake a similar study in TELKOM is borne out of its vulnerability to credit risk exposure coupled with the fact that no study has been done in the area of credit management in the Kenyan communication sector and specifically Telkom Kenya Ltd despite its regional diversity added to its position as a major player within this service sector.

1.4   OBJECTIVES OF THE STUDY

This is an in depth case study of TELKOM, which intends to achieve the following objectives:

- To evaluate the credit management practices within the different regions of TELKOM and assess adherence to the Corporate Credit Policy and Credit management best practices

- To evaluate the level of bad debts within the different regions of TELKOM.

- To establish the relationship between credit management practices and level of bad debts in TELKOM, regionally.

1.5   IMPORTANCE OF THE STUDY

Receivables form an important part of an organization's assets. It is for this primary reason that an utmost care must be taken to ensure efficient and effective management of receivables. This study will therefore be useful in the following ways:

1.5.1   To Management of Telkom Kenya Ltd. and other managers in general:

The result of this study is important in that it will enlighten this group on the best credit management practices in management of receivables in the service industry sector.

1.5.2   Financial analysts:

The study will provide added material to help advice their clients appropriately.

1.5.3 Researchers and Scholars:

This study will also add to the body of knowledge in the finance discipline, form a basis for further research in the service sector in particular, and credit management in general.

CHAPTER TWO

2.0   LITERATURE REVIEW

2.1   CREDIT MANAGEMENT PRACTICES

Credit is the ability of a business or individual to obtain economic value on faith, in return for an expected future payment (Christie and Bachuti, 1981). Trade credit, involves a joint commodity – financial transaction whereby the exchange of good is separated in the time from the exchange of money (Lee and Stowe, 1993). In effect, goods or services are exchanged for a loan, which is subsequently exchanged for cash. Unsecured open account trade credit represents a substantial figure on most corporate balance sheets. Studies suggest that accounts receivable, as a percentage of total assets, are approximately 21% for US manufacturing corporations (Mian and Smith, 1992), 19% for large UK companies (Pike et., 1998) and over 30% in small/medium-size UK firms (Wilson et al., 1995). Moreover, the unsecured nature of most trade credit arrangements generates significant corporate exposure to the delinquency risks of slow payment and debt default.

One of the largest surveys carried out in the U.K., by Credit Management (2004), revealed there was a dramatic increase in the level of outstanding business debt. The specific research findings were: the average time to get paid in the UK is 45 days and one third of firms receive payment from customers after a 60-day period; only 54 percent of companies have a written credit policy; 52.5 percent of companies operate with either no dedicated credit management staff or just one person involved in credit management; nearly one in ten of businesses do not set credit limits on their accounts; only 11.8 per cent of the firms are willing to charge interest on overdue accounts although 71 per cent of respondents indicate that their credit terms allow them to do so; smaller firms tend to have the highest percentage of accounts paid on time. This figure decrease as the firm size increases

The message emerging from prior studies is that trade credit is extended for a variety of reasons. A firm's credit management policy and application should reflect this diversity and provide a framework for consistent credit decisions, compatible with credit goals and overall business objectives. Typically, credit policy includes the specification of credit goals and a range of policies covering such activities as credit risk screening credit limits, payment terms, monitoring, collection and funding. Credit policy formulation also considers the organization structure of the credit function (e.g. whether to centralize, decentralize, or create a separate credit subsidiary), and corporate contextual variables such as age of the buyer firm, frequency of transactions, product quality, selling channel and industry sector (Ng et al., 1999).

With the development of financial markets has come a wide range of specialist intermediate credit activities, such as factoring, credit insurance, debt collection and credit information services. The strategic thrust towards focusing on business strengths and contracting-out non-core activities has forced many firms to re-evaluate the role of the credit management function, and the extent to which credit activities should be conducted internally or sub-contracted to financial intermediaries. However, the literature offers little guidance as to the areas and circumstances where value could be enhanced through external credit management arrangements.

The safe extension of credit depends on complete and accurate information regarding every detail of the borrower's credit standing. A lending policy should define the financial statement requirements for businesses and individuals at various borrowing levels and should include appropriate guidelines for audited, non-audited, interim, cash- flow and other statements (Kabiru , 2002).

The basis of a sound credit risk management is the identification of the existing and potential risks inherent in lending activities. Measures to counteract these risks normally comprise clearly defined policies of the institutions credit risk philosophy and the parameters within which credit risk is to be controlled. The three major policies pertaining to credit risk management include: policies aimed at limiting or

reducing credit risk; policies of asset classification and policies of loss provisioning (Basel committee on Banking Supervision, 1999).

Business firms can extend credit to 3 groups of customers: other business firms, individual customers and government units. All the three are bound to default. Credit risk assessment is a quantitative analysis of the likelihood that a customer won't pay for goods or services purchased on credit. This analysis helps management to determine who to qualify for credit. The result of such risk assessment is the classification of credit customers into credit classes. The general credit policy of the firm will specify which classes of customers will be extended credit (Schall and Haley, 1988).

Credit management involves five main steps (Brealey and Myers, 1988): first, you must establish the terms of which you propose to sell your goods or offer services. You should decide on whether to give discount for prompt payments or not; second, you must decide what evidence you need for indebtedness; third, you must consider which customers are likely to pay their bills; fourth, you must decide how much credit you are prepared to extend to each customer; finally, after you have granted credit, you must have a system of collecting the money when it becomes due.

In considering the extension of credit, there are three primary policy variables to consider in conjunction with the firms profit objective; credit standards (the firm must determine the nature of the credit risk on the basis of prior record of payment, financial stability, current net worth and other factors), terms of credit (the firm decides on whether to offer discount or not – this will have a strong impact on the eventual size of the accounts receivable balance) and collection policy (an increase in the average collection period may be due to a predetermined plan to extend credit terms or the consequences of poor credit administration) (Block and Hirst, 1987).

Credit risk can either be classified as firm specific credit risk (the risk of default of the borrowing firm associated with the specific types of project risks it takes) or

systematic credit risk (the risk of default associated with general economy wide or macro-conditions affecting all borrowers). Credit scoring can be done by assessing customers' character, capacity, capital, collateral and the conditions of his business (Brealey, Myers and Marcus, 1995).

Transaction cost theory can be applied to credit management, specifically regarding the economic rationale for integrating, or 'internalizing'(Coase, 1937), the credit management function within firms, or entering into market transactions whereby a third party specialist manages the credit operation. According to Williamson (1979), it is the superior ability of the firms to reduce human opportunism through hierarchical controls, rather than market mechanisms, that justify the very existence of organizations. Hill (1990) identifies two further conditions under which organizations are superior to sophisticated markets, (i) when transaction outcome are highly complex or uncertain, and (ii) when reputations of transacting parties are hard to establish. Given the routine nature of credit management activity and the availability of credit ratings through credit information companies, it might appear that large elements of credit management activity could be conducted more efficiently through the market than through internal mechanisms. Those elements of the credit function that remain in-house are assumed to be more cost effective than entering into separate contracts with external agents to carry out such duties.

Smith and Schnucker (1994) focus on the transaction costs in the factoring decision, while M&S broaden the activities to include credit insurance, credit reporting, credit collection and captive finance subsidiaries. This is particularly the case where the credit sale involves specific investment (whether in time or money) in meeting customer requirements (Williamson, 1979; and Smith, 1987). Given the large amount of capital employed in accounts receivable risky assets, the choice of credit management policies, and whether they are conducted internally or through the market, has important implications for the value of the firm.

2.2 HISTORY AND FUTURE OF CREDIT

At least 300 years ago, credit was used in the civilization of Babylon, Syria and Egypt but it was in medieval Europe that trade developed rapidly on the back of credit facilities. (Edwards, 1997).

In the 12th Century, great trading fairs were held in Europe and merchants traveled from fair to fair buying and selling continuously, so that a supplier at one place would be paid by the proceeds of his buyer's buyer in another place. Credit was widely used in medieval England to sell basic commodities and rich merchants were able to get advantageous discounts by generating ample cash in advance. Trade credit as a significant source of financing business increased in the 18th and 19th Centuries when trade expansion was helped by loans from local banks to local firms. (Edwards, 1997)

The earliest of business transactions did not include an accounts receivable component. In those days of direct barter, the sales process required no credit checks; vendor and buyer simply exchanged goods or services on the spot. Much has changed since then. The evolution of credit represents one of the most seminal changes. Not only has credit left an indelible imprint on modern business, it has also spawned the accounts receivable function.

Today, accounts receivable plays a vital role in the overall health of a company; documented evidence has confirmed that a well-managed portfolio of accounts receivable can boost cash flow and expand working capital. Consequently, successful companies continually seek new ways to improve their accounts receivable function. **(inc.com/articles/2000)**

2.3 FOUNDATION OF CREDIT MANAGEMENT

Effective management of credit risk is a critical component of a comprehensive approach to risk management and essential to the long-term success of any organization (Sinkey, 1992).

Poor credit policies have led to financial fiascos resulting into the collapse of a number of organizations due to bad debts. Organizations need to identify measure, monitor and control credit risk and determine how to hold capital against these risks. Measures have to be taken to ensure that they will be adequately compensated if borrowers default (Edwards, 1997).

Since exposure to credit risk continues to be a major issue in contemporary financial management, credit managers need to adopt appropriate mitigation measures to curb the risk. Most of the credit problems reveal a basic weakness in credit granting and the monitoring process. These problems can be avoided by formulation of an effective internal credit process (Brealey and Myers, 1988).

Credit risk arises because counterparties may be unwilling or unable to fulfill contractual obligations. Losses due to credit risk however can occur before the actual default when reflected in market prices (Pickford, 2001).

2.4 CREDIT POLICY

The term credit policy is used to include all the company's systems and include credit selection, credit standards, credit terms and collection policy.

According to Brown (2003), the first step for any company in any industry is to define its credit policy. This must include customer acceptance criteria, credit vetting, credit limits and payment terms. The board must define the balance for the business between the potential profitability of the customer, the desire to retain the customer whilst maximizing their use of products and services and the exposure to potential bad debt. From this stems the customer acceptance policy with the boundaries of what the company does, and does not want to do business with. The balance between the need for market share and growth on the one hand, and profitability on the other, will determine the appropriate element of risk in taking on new customers.

Once this has been established, the customer acceptance policy needs to be updated as circumstances change. An excellent example of what happens when this does not take place is the UK mobile industry of eight years ago when the rush for market share between the competing networks was crucial and profitability was definitely not a consideration. Credit checking was temporarily dropped in haste, and service providers repented at their leisure, some of them going out of business under the resulting debt burden.

2.4.1 ELEMENTS OF AN EFFECTIVE CREDIT MANAGEMENT POLICY

According to Rowe (2004) some of the key elements of an effective credit management policy are as follows:

Check a new customer's creditworthiness before drawing up a contract; set strict limits and stick to them; prepare unambiguous written contracts and/or terms and conditions of trading; involve the sales force in negotiating the payment terms and ensuring that these are understood and agreed at the start; make sure that you know and comply with the procedures used by your customers' buying and accounts department; initiate and maintain close contact with your customers, particularly with the person responsible for paying your account try to create a rapport so that you are on top of the list to be paid even when money is tight; make regular credit checks on customers; ensure that all dispatch notes and invoices are accurate and delivered to the right person at the right time; put a stop on supplies to customers who are not paying.

In addition, use their desire for service to urge them to pay; send regular reminders and chase payment persistently by phone, fax, e-mail, and visits to customers; if all else fails, place the matter in the hands of a debt collection agency or lawyers.

2.4.2 THE IMPORTANCE OF A WRITTEN CREDIT AND COLLECTION POLICY AND PROCEDURE MANUAL

The main role of credit policy is to provide a framework for consistent credit decision compatible with the goals of the credit function. The credit policy requires regular

review and clear documentation. According to Pike and Cheng (2001) a survey conducted, to establish the causes of late payments in the U.K., found that virtually all (94%) firms have a credit policy manual, although only 54% regard it as 'fully documented'. As might be expected, this is considerably higher than the 35% of small/medium-sized firms with a written credit policy found by Wilson et al's (1995) survey. Credit practices are highly visible within the industry and form an important element in perceived corporate image. It is not therefore surprising that over three-quarters of responding firms (77%) included an ethics code on credit management practice within their policy statement.

Among the benefits of a written policy are that the policy will reduce bias and subjectivity in credit decisions being made, the process becomes more predictable (something sales and senior management will appreciate); and since everyone understands the ground rules, exceptions will be made based on business considerations (Dennis, 2004)

Advantages.

There are a number of advantages /valid reasons for investing the time and effort to develop a written credit policy. Among the more important reasons are that a written policy is one way to ensure continuity in the department in the event that key personnel leave the credit department; it helps ensure consistent credit decisions-meaning that all customers will be treated fairly; it can be used as a training tool; it can be used to help evaluate or benchmark job performance against established standards documented in policies and procedure manuals; the manual can be presented to senior management to ensure consistency between credit department operations and management operations.

Relevance

A policy must be relevant to the way the credit department actually operates. To be relevant, the credit policy must be current, and must be kept current.

2.4.3 CHOOSING THE RIGHT TYPE OF CREDIT POLICY

Among the alternative types of credit policy that a firm can choose from are strict analysis of risk and strict collections, strict analysis of risk with liberal collections, liberal analysis of risk and vigorous collection effort, or liberal analysis of risk and liberal collections states Wallis(2002) :

2.4.3.1 Strict Analysis of Risk and Strict Collections

Under this policy, only high-credit –rated accounts are accepted, and very little variation from terms is allowed. The analysis of risk is thorough; collection efforts require a greater effort, and selling may be restricted. But the increased effort may pay sizeable dividends in the form of improved accounts receivable turnover and minimal bad-debt losses, leading to increased cash-flow and profitability.

2.4.3.2 Strict Analysis of Risk with Liberal Collections

This policy is somewhat more liberal in its collection procedures. It concentrates on the selection of good credit risks but does not aggressively press payment. The assumption is that the good risks will, on average, pay their bills within terms; any additional time is less expensive to carry than the cost of following up accounts that are only a few days past due. If your cost of capital is high, this type of policy may not be wise, especially when customer orders involve sizeable amounts. A more prudent course would be to follow collections closely.

2.4.3.3 Liberal Analysis of Risk and Vigorous Collection Effort

The credit analysis is liberal, so nearly all customers that apply will be accepted. But once the sale is made, close control is kept over collections. This type of policy would normally be followed in organizations selling high mark-up, low unit-price goods or services. The cost of credit analysis is relatively low in this type of credit policy, but collection costs are usually quite high.

2.4.3.4 Liberal Analysis of Risk and Liberal Collections

Very few lines of business would find this policy profitable to operate. One advantage might be that it tends to lower credit costs. Yet the costs related to carrying receivables for long periods coupled with a resulting increase in bad-debt expense more than offsets the savings. The principal motivation for a company adopting this policy is to obtain maximum sales volume .For this policy to be effective, profit margins must be set high enough to counter the slow turn in receivables resulting bad-debt losses.

2.5 MANAGING RISKS

According to Greengard (2003) for most companies, winning the battle for market share and new customers is essential to success. Advertising and marketing executives conjure up elaborate campaigns to entice corporate decision makers to part with their cash. Sales people mine, leads and court potential buyers with relentless zeal. Yet many of these efforts ignore a basic business truth: Not all customers are created equal.

Managing credit risks remains an essential and challenging corporate function. Unfortunately, it's one that is often no more than an afterthought. Many organizations give a great deal more attention to retaining customers and snaring new accounts than they do tracking who is paying, who is lagging behind and who might default. But as the current economic malaise drags on and bankruptcy rates climb, effective credit management becomes an increasingly critical factor in achieving success.

2.5.1 CREDIT RISK CATEGORIES

According to Pickford (2001), Credit risk is the potential for financial loss resulting from the failure of a borrower or counter party to honor its financial or contractual obligation.

Credit risk may be classified as firm specific credit risk (the risk of default of the borrowing firm associated with the specific types of projected risk taken by that firm)

or systematic credit risk (the risk of default associated with general economy wide or macro-economic conditions affecting all borrowers). Most of the bank failures in the 20th Century were attributed to credit risks. Because of the potentially dire effects of credit risk, it is important to perform a comprehensive evaluation of a firm's capacity to assess, administer, supervise, control, enforce, and recover receivables, loans, advances, guarantees and other credit instruments (Edwards, 1997). An overall credit management review will therefore include an evaluation of the credit risk management policies and practices of a company.

2.5.2   CUSTOMER RISK ASSESSMENT

This process involves monitoring and collecting information about customers who intend to get credit. Ross et al (2002) identify aspects of credit risk management function as: credit portfolio management, credit risk management policies, and policies to limit or reduce credit risk and asset classification. A company's lending function should ensure that credit is extended on a sound and collectible basis and funds are invested profitably for the benefits of shareholders and protection of the depositors. To mitigate these exposures, organizations are expected to have clearly defined policies of the institutions credit risk philosophy and parameters within which credit risk is to be controlled (Ross et al, 2000).However, effective customer risk assessment may be hampered by information asymmetry; borrowers may not provide all the pertinent information about their financial abilities and history.

For most firms with credit policies, cash deposits to safeguard against non-payment and making prepayments are some of the common measures adopted to minimize default. Besides analyzing the customers past payment history to know whether he is likely to pay, lenders can also get assistance from credit rating agencies. Such agencies report the experience that other firms have had with your customer. Financial institutions can also be contacted to find out how they think about your customer's credit standing. Many lenders that use credit-scoring systems employ ad hoc formulae to establish which customer is a potential credit risk (Brealey and Myers, 1988).

2.5.3 CONTROLLING RISK IN ACCOUNTS RECEIVABLE MANAGEMENT

One of the best ways to avoid long accounts receivable time-lines is by doing due diligence on your customers up front. By combining early due diligence with close attention to aging receivables and using strategies like keeping backup like credit card numbers on file ,small-business owners can get a handle on their account receivables and keep their bottom lines healthy, even when customers are dealing with their own economic challenges. (McCrea, 2004)

A critical aspect in the granting of trade credit is the control of risk of bad debt losses. Financial writers have generally measured this risk by the expected value of the probability distribution of these losses. Cohen and Hammer (1966), for example, define the return on credit sales as the difference between gross profit and expected bad debt losses.

Similarly, Dun and Bradstreet Inc. suggest that a firm should make a credit sale to a customer only if the operating profit on sales exceeds the expected bad debt losses. According to this study carried out by Mao and Sarndal (1974), the results indicate that the prediction of bad debts is best if a firm's customers are small and there is a wide distribution of sales among them. The prediction will however not be accurate if the default risks are closely correlated, for example, when sales are concentrated in a few large customers.

Arguably, the safest way of reducing risk is to restrict the credit terms. For example, almost half the firms surveyed regularly require high-risk customers to pay prior to delivery, in full or part. In their findings out of the studies conducted in UK companies, Pike and Cheng(2001) state that the role of the sales team often extends to cash collection, 68% of firms involving sales staff in the collection procedure, employed by 29% of firms, was viewed as particularly attractive by those firms.

2.5.4 MODELS OF CREDIT RISK

Lenders and borrowers use models of credit risk to help address various issues. Various investors are interested in knowing the spreads that may demand for investing in credit risky securities such as loans and bonds (Holtham, Clive and Evans, 1993).

The structural approach with strategic default focuses on the bankruptcy code, liquidation costs and the bargaining power of lenders and borrowers. It is based on the idea that lenders and borrowers prefer to renegotiate debt contracts rather than liquidate the company, which is costly to both since the lenders know beforehand that reconstructing will occur later, they typically charge a premium in the pricing of loans. The presence or absence of a bankruptcy code, its perceived "friendliness" to lenders or borrowers, and the existence of a credible threat serve to set the bargaining boundaries and hence the spreads (Holtham et al, 1993).

Reduced form models do not specify who the lenders or borrowers are, but concentrate specifically on the probability of default and the recovery rates. The lynchpin in this class of models is the absence of arbitrage. In other words, these models operate under the assumption that investors behave rationally and do not "leave any money on the table". The focus of these models is the time to default. By their very nature, default is a surprise event in the reduced form models. These models are particularly valuable in the pricing of credit derivatives (Pickford, 2001).

2.6 SIGNIFICANCE OF TRADE CREDIT LIMITS

Companies should establish and develop scorecards from which credit limits are set for all new customers. Even on an unsophisticated billing and credit management system it should be possible to assign basic categories of follow up activity such as good average or poor. Technology that is more sophisticated will allow setting of individual credit limits and setting of individual credit limits and contacting customers when they reach it. What is more, experience has shown that this is not necessarily the sales and marketing disaster they fear because many genuine residential customers are

grateful for advice of what they are spending and even for suggesting that they be placed on a more advantageous/appropriate tariff.

A credit limit is the maximum credit a lender will provide a borrower at one time. A survey focusing on credit limits by Besley and Osteryoung's (1985) found that: (i) a majority of firms use credit limits (ii) The primary rationale is to control exposure risks, and (iii) Subjective judgment is the predominant limit –setting method.

Credit limits represents firms' responses to problems in developing and monitoring selling relationships. Studying credit limits shows how firms perceive their credit policy problems and how they attempt to resolve them.

The main question is why are credit limits used?

According to Beranek and Scherr (1991), there are three generic explanations for use of credit limits:

2.6.1   Credit limits and default probability
Most survey participants (92.7 percent) said that credit limits are used to control risks. This hypothesis posits that the greater the amount of credit extended, the higher the probability of default/delinquency, this proposition is consistent with but not equivalent to adverse selection as an explanation for credit rationing in banking. Credit limits may be a response to that perceived relationship.

2.6.2   Credit limits and Risks Control
Review of finance literature identified four other potential explanations for credit in terms of   risk or uncertainty. These are not necessarily mutually exclusive.(i) Credit limits hedge uncertainty with respect to the likelihood of default or delinquency.(ii) Since default of a major customer can increase the probability of the seller's default in a domino effect, credit limits reduce that risk by limiting receivables from such customers.(iii) Granting credit to a buyer with a higher beta than that of the seller increases the seller's asset beta, thus increasing the required rate of return on the entire

seller's asset.(iv) Credit limits are really a manifestation of agency problems in monitoring the performance of credit managers, and not actually "risk control" at all.

The first three of these rationales lead to optimal values for credit limits based on shareholder wealth maximization; procedures to determine these optimal limits are given in the respective references. In the fourth rationale, credit limits results from managers' conflicting objective to grant credit and to limit bad debt. The resulting credit limits will depend on the relative strengths of the two incentives within a firm.

2.6.3   Credit limits and credit investigation expenses

A major task of credit management is to control credit investigation expenses. Since such costs are likely to increase with the amount of information gathered, the optimal quantity of information collected will depend upon amount owed, profit margin, information costs, and default and /or delinquency probabilities. Credit limits can be set at the maximum credit grantable upon prior investigation without triggering additional investigation costs.

According Beranek and Scherr (1991), there is strong support for the idea that a major function of credit limits is to control credit investigation expenses. Most credit managers report that violation of an existing credit limit triggers additional investigation expenditure. Several aspects of credit limit policy vary significantly with sales per customer, and these variations agree with what would be expected if limits were used as investigations controls. This is "risk control" in the sense that a credit investigation produces information regarding a buyer's ability to pay.

2.7   CUSTOMER CREDIT SELECTION AND ANALYSIS

A common approach to customer credit selection and analysis is the use of the 'five Cs' of credit as an initial screening and risk assessment device. Applying the 'five Cs' involves a review of potential customer's capacity, capital, character, collateral, conditions and competition.

According to Avila (1997), credit analysis requires a formal instrument for measuring the risk originating from the most important "Cs" whereas the decision to lend the money or not has to be made. Credit analysis is, largely, a way to evaluate the inherent risks in providing a loan and credit services. Credit analysis is risk analysis. Therefore, in evaluating credit risk it is important to understand the relationship among financial risk, business risk and corporate risk.

Financial risk is related to enterprise's financial situation and perspectives. It concerns the "C" that represents capital. Business risk is linked to the industry where the firm works. It derives from the "C" which synthesizes conditions and "C" which denotes how the company behaves before its competitors. Corporate risk is pertinent to the company's structure and activities. It regards the "C" which depicts capacity.

Business risk analysis requires an overview of a company's operating environment, focusing on the nature of the industry, industrial prospects, and patterns of industrial cycles, regulatory restrictions and competitive factors that affect the industry. Otherwise, corporate risk analysis involves corporate strategies, management structures and policies, strength of support from shareholders, subsidiaries and affiliates, market position and operating efficiency.

Quantitative analysis applies to financial risk. Qualitative analysis applies to business and corporate risks. They require respectively the so-called hard and soft models.

The old adage 'prevention is better than cure' is appropriate here. (Mc Menamin, 1999).

Following are explanation about the relevance of each "C" and a different approach for the elements' conditions and capacity:-

Character

Character is relatively easy to investigate, it relates to an assessment of the personal character, honesty and integrity of the customer and his willingness to comply with

credit terms and conditions. Character references may be sought from bankers' business contacts and associates to establish whether there are any outstanding legal judgments against the customer.

A survey of transactions carried out by the company provides information about past credit experiences. The managers' and major shareholders' reputations in the market especially against competitors, and the firm's relationships with clients and suppliers are useful information sources.

The search to investigate the managers' and major shareholders' characters should embrace not only their judicial situation but also their honor. In other words, one must research not only the portion of a person's character, which gives him a sense of respecting the law, but also the portion which causes him to perform his tasks with honesty and ethics. In this sense, it is very important not to limit the investigation to the traditional information sources, such as public notary's office and banks.

If there is any reason to question the borrower's character, no further analysis is needed, and the credit should be denied.

Collateral

Collateral only means commitment and this relates to an evaluation of the assets which the customer has available as security for the required debt.

It extends the failure effects, encompassing firms and shareholders' properties. According to McNaughton (1992), "good credit management does not consider collateral to be a substitute for creditworthiness, which is the existence of cash flow adequate to repay the loan." In this view, collateral merely provides an additional margin of protection for a loan that is already acceptable; it is often referred to as "a second way out."

One can suppose that collateral makes the borrower more afraid not to repay the debt, prompting his punctuality. However, the borrower knows that the bank will probably

not seize the collateral without trying to negotiate an agreement. The forced liquidation of an asset usually erodes its value significantly. On the other hand, if the firm does not succeed, the value of collateral will probably fall.

Capital

Capital is related to a company's financial strength. How substantial are the customer's capital resource? What is the customer's capital structure? In other words, it reveals if the firm's financial structure and the business results are adequate to support loan service and investments that the enterprise is responsible for. The loans must be repaid without harming the business or consuming its capital base. The bank usually is a limited-scope partner.

Conditions

The decision to grant credit to customer can be influenced by current economy and business conditions generally or by specific business conditions, relating to the applicant or the firm itself. For instance, if the applicant for the credit is a small business and there is an economic recession in the country, the risk of small business failure in such circumstances is considerably increased.

Capacity

This is an assessment of the potential customer's ability to repay the debt. The assessment would include a financial analysis of the customer's account with a particular emphasis on liquidity and borrowings. Information is also likely to be sought from sources such as bankers and other suppliers relating to the customer's payment record elsewhere.

Alternatively, if the firm itself is finding sales for some of its products slow it may take a more relaxed view to granting credit to a potential customer.

Competition

Nowadays one can add another "C" by considering **Competition**. According to Compton (1985), competition "includes the vulnerability of a company to others whose new, enhanced or cheaper products may reduce its share of the market." The framework introduced by Porter (1985) is extremely useful for studying conditions and understanding the nature of competition. However, credit analysis should also expand upon the firm level.

2.8 INFORMATION SOURCES FOR CUSTOMERS VETTING

The ability to measure the probability of borrowers' default depends on the amount of information a firm has about the customer. This information may be obtained from internal or external agencies.

According to Anderson (2000), the major sources of information available to companies in assessing customers' credit worthiness are:

Bank reference

Customers' bank may provide this to indicate their final standing. However, the law and practice of banking secrecy determines the way in which banks respond to credit enquiries, which can render such references uninformative, particularly when the customer is encountering financial difficulties.

Trade reference

Companies already trading with the customers may be willing to provide references for the customer. This can be extremely useful, if the companies approached are a representative sample of all the clients' suppliers. Such references can be misleading, as they are usually based on direct credit experience and contain no knowledge of the underlying financial strength of the customer.

Financial accounts.

The most recent accounts of the customer can be obtained either from the business, or for limited companies. While subject to some limitations, past accounts can be useful in vetting customers. When the credit risks appear high or where substantial levels of credit are required, the supplier may ask to see evidence of the ability to pay on time.

Personal Contact.

Through visiting the premises and interviewing senior management, one should gain an impression of the efficiency and financial resources of customers and the integrity of its management.

Credit Agencies.

Obtaining information from a range of sources such as financial accounts bank and newspaper reports, court judgments, payment records with other suppliers, credit agencies can prove a mane of information. They will a credit rating for different companies. The use of agencies has grown dramatically in recent years.

Stephen Lewis of the Credit Services Association and member of the Better Practicing Group commented: *"Chasing overdue invoices from tardy customers can be a frustrating and time consuming task. Appointing an agent to do the legwork for you means that you are freed from the burden of chasing bad debts, leaving you to concentrate on running your business. Debt collection agencies work either on a "flat fee" basis or "no collection, no fee" basis (when charges can be between five and fifteen per cent of the amount collected), an attractive alternative to writing off the debt."*

Experience.

For existing customers, the supplier will have access to their past payment record. However, credit managers should be aware that many failing companies present solid payment records with key suppliers in order to maintain supplies. Indeed, many companies go into liquidation with flawless payment records with key suppliers.

General Sources of information.

Credit managers should scout trade journals, business magazines and the columns of the business press to keep abreast of the key factors influencing customers' businesses and their sector generally.

The availability of more information along with lower average cost of collecting such information allows firms to use more sophisticated and usually quantitative methods in assessing default probabilities (Edwards, 1997).

2.9   MONITORING ACCOUNTS RECEIVABLES

The most commonly employed performance measure is debtor days, employed by 84% of responding firms according to the study carried out by Mao and Sarndal (1974). Other popular monitoring methods include aged debt reports and cash collection performance against targets or variance analysis.

2.9.1   Variance   Analysis

Gallinger and Ifflnderhe (1986) have stated that traditional monitoring techniques of day's sales outstanding (DSO) and aging schedules still appear to be the primary vehicles used by analysts to evaluate a firm's accounts receivable balance.

Some scholars have however highlighted deficiencies in these conventional calculations. As discussed by Stone (1976), many analysts recognize that receivables can be influenced by sales effects, and they attribute this to seasonal or cyclical factors. One way to overcome these problems is to abandon DSO measures and aging schedules and rely on balance fractions or payment. Another approach is to use an accounting based variance analysis model. The variance analysis model compares actual against budgeted receivable performance.

A real advantage of using a budget is that it can overcome the many problems inherent in historical data. Assuming that management has conscientiously calculated the budget amounts, then conditions expected to exist during the budget period are

incorporated into the accounts receivable budget. This is obviously better than comparing actual performance to some prior period that may not be representative of conditions prevailing during the budget period.

Additional advantages of a variance methodology are as follows:

First, errors in sales projections and collections forecasts are readily evident. This provides management with the opportunity to assess budget assumptions and improve the quality of forecasts.

Second, DSO calculation is independent of both sales and averaging period and any sales trend, thus overcoming criticisms of traditional measurement techniques. The independence of the DSO calculation allows identification of a collection experience variance and a sales effect variance.

Third, the sales effect variance can be decomposed into components that allow the influence of sales on receivable balances to be understood.

2.9.2 Average Collection Period

Average Collection Period (ACP) analysis is a widely used technique for examining the effectiveness of a company's credit policies. However, it is not without its problems. The analysis can send false signals to management that the credit policy may be a problem when it reality it is not. Unless supplemental analysis is done, the ACP technique may not give an accurate picture of what is happening in this area. (Institute of Management Accountants Report (IOMA) June 2001)

Disadvantages of ACP Analysis

First, ACP analysis is sensitive to the level of accounts receivable on the date when it is measured and the basis used for calculating sales per day. Thus, any seasonality in sales and the corresponding level of receivables will affect the computed ACP.

Second, where the ACP is used to monitor receivables over time, sales per day must be calculated to reflect the true experience of the company through time. However, what the period of time should be to determine this figure is not clear. The general problem is one of "aggregation" of data.

2.9.3   Days Sales Outstanding (DSO)

Culpepper (2005) states that directors and executives should keep a close eye on changes in their company's DSO (Days Sales Outstanding). DSO, a useful measure of the quality of receivables, indicates the amount of time it takes to turn receivables into cash.

DSO is calculated by dividing Accounts Receivable by Average Revenue per Day. Lower DSOs are generally more desirable. A rising DSO is usually a sign of trouble and points to the likelihood of future earnings problems.

Rising DSOs ... A Warning Sign
A lengthening in a company's DSO is only rarely connected to a financial weakness of its customers. Sometimes, DSOs will increase due to an unusually high volume of sales booked just before the close of the quarter.

Some troubling reasons for rising DSOs include: large-scale products or service disputes and customers refuse to pay until the problems are resolved; products or services have been oversold, and customers refuse to pay until the unfulfilled promises have been met; extended payment terms may be offered that allow the buyer to delay full payment long after everything necessary has been done for the vendor to earn the revenue; other overly aggressive revenue recognition practices.

2.9.4   Aging Schedules

Receivables Aging Schedule - This schedule is a listing of debtors by aging category. Analyzing this schedule allows Accounts Receivable management to spot problems in

accounts receivable early enough to protect the agency from major revenue problems. It may also assist in highlighting individual delinquent accounts.

2.9.5 Performance indicators

As a result of a research conducted by BPPG and reported on Auditor-General's Audit Report No. 29, Management of Accounts Receivable in the Commonwealth, in Australia, the following statistics compare the common benchmark against the best practice:

SUGGESTED PERFORMANCE INDICATORS

Indicator	Common Benchmark	Best Practice Bench mark
Effectiveness Measures		
Debtors turnover i.e. average time to collect	30 days	23 days
Debt written off as a percentage of total debt	10%	1%
Percentage of debts collected within terms of trade	50%	90%
Debtors by age group as a percentage of total debt -aged 30 to 60 days -aged 60 to 90 days -aged > 90 days	30% 20% 15%	15% 10% 5 %
Proportion of debts settled by electronic means, i.e. EFT	10%	100%

In addition to measuring the effectiveness of the accounts receivable process as a whole specific debt collection techniques and their effectiveness should be monitored. This information can be used when assessing alternative debt collection strategies. It is of assistance when conducting assessments of this type to be cognizant of the costs of the relative collection strategies.

2.10 DEBT MANAGEMENT FOLLOW UP/DUNNING TECHNIQUES.

These have to be proactive, not reactive, and must be constantly reviewed and improved. Yet, amazingly, only two thirds of communications companies follow the basic credit management rule of trying out new follow up/dunning techniques. Everybody uses letters and phone calls to chase overdue payments but there is a surprising lack of use of new techniques, or of mixing and matching follow-up methods to keep debtors on their toes.

2.11 CRITICAL SUCCESS FACTORS IN CREDIT AND COLLECTIONS

According to Schmidt (1997) some of the critical success factors in reducing payment risks in receivables are: elimination of barriers to payments by offering customers multiple payment options, flexible billing cycles and incentives to pay early; creation of a single point of contact for all incoming customers calls regarding payments, and use of technology to route the calls to the appropriate service representative or automated activities; electronically receive and post customer payments to the billing system in real time to reduce processing costs and expedite cash-flow; ensure that all employees with customer contact work together to deliver a consistent message to the customer regarding company policy and goals; use credit scoring to assign the customer a credit rating that will trigger appropriate sales and collection treatment; prioritize delinquent accounts for collections follow up, allocate appropriate collections resources, and provide real-time access to customers' information; use performance measures to select and monitor outside collection agents, if it is cost justifiable to employ them; develop, monitor and motivate collection specialists using individual and team performance measures; use credit and collection process to enhance customer satisfaction.

2.12 BENCHMARKING ACCOUNTS RECEIVABLES BEST PRACTICES

Executives at many organizations tend to look at the receivables process as a very basic and standardized function. However, there is a growing realization in corporate

finance circles that considerable cost savings can be generated by benchmarking accounts receivable. And, perhaps even more important, your company's relations could improve dramatically. Using best practices can streamline the collections process, accelerates cash flow, reduces costs and improves customer relations.

Benchmarking accounts receivables presents an opportunity to improve the perception of your company's overall commitment to customer service. For example, you can ensure that all employees with customer contact work together to deliver a consistent message to the customer regarding company credit policies and goals by providing training in a "team" environment. You also can develop, monitor and motivate collections specialists by using team performance measures that link customer satisfaction with team results.

According to Mc Lemore (1996), many companies that have benchmarked the accounts receivable process have adopted the following best practices: Use the credit and collections process to enhance customer satisfaction. Some world-class organizations actually send their credit personnel with their sales representative to explain credit terms to clients; continuously update customers' credit ratings using a behavioral scoring system. Monitor customer payment behavior, usage activity and total customer exposure vs. assigned credit lines by integrating technology; electronically receive and post customer payments to the billing system in real time. This reduces processing costs and expedites cash flow; move to automatic invoicing and adjustments posting; create a single point of contact for all incoming customers regarding payment and use technology to route the calls to appropriate service representative or automated activities.

In an article appearing in IOMA Report (2005) ,it is stated that unhappy customers tie up their suppliers' cash by creating high levels of accounts receivables and not only do these disgruntled clients tie up cash, but they also waste time ,cost money, and aggravate your staff. These problems can be avoided with little planning and monitoring.

Nisberg (2004) has also cited some of the accounts receivable best practices as follows: Know your clients individually, particularly the decision maker; keep communication open so you know the intentions of the debtor; differentiate between potential bad debts from sound clients, among the red flags are: payments by post-dated cheques, or constantly late payments, or both; frequent change in management; low level of liquidity; a frequent change of banks; when more time is requested on a payment, let the client know that time is money and that they may be able to buy time by providing a down payment and scheduling the balance of the debt; tighten your collection policy. Adhere to strict credit limitation, and avoid providing extended payment terms; resolve disputes quickly and amicably; pursue partial payments, with request for balance; keep your records current to support claims; make customers aware of your credit policy.

2.13 QUALITIES OF AN EFFECTIVE CREDIT MANAGEMENT SYSTEM

A company's credit process can be grounded in a series of fundamental policies. These may include ultimate business accountability for managing credit risks, consistent standards for credit originating, measurement and documentation, uniform risk measurement standards, a minimum of two authorized credit – officer signature requirements, portfolio limits to ensure diversification and maintain risk/capital alignment and single centre of control for each credit relationship that coordinates credit activities with that client, directly approves or consents to all extensions of credit to that client, reviews exposures, and ensures compliance with exposure limits (Brucaite and Yan, 2001).

Financial risks emanate from adverse movements in economic variables that affect a firm's activities. These adverse movements can reduce income, expected profits, reported value of foreign assets, increase in foreign liabilities etc. turbulence in the business environment has created need for increased focus on risk hence managements need to develop the capacity to accept and manage risks effectively. A number of high

profile risk management disasters necessitated the need for sound financial risk management in the 1990 (Li, 2003). Companies have to come up with process through which they can control the negative outcomes of their financial exposures. Companies are encouraged to have a credit policy in a place so that they can monitor their exposure to credit on a continuous basis.

Pickford (2000) indicates that macro-economic factors such as recession or collapse in exchange rates may cause borrowers to default on loans. If lenders do not have adequate information about the borrowers, strategic default can occur. Failure to repay can also be as a result of industry –specific factors or company-specific factors. If equity markets are not well developed, companies may end up with a high debt to equity ratio, which can easily lead to default.

2.14   THE BANKRUPTCY CODE

The bankruptcy code defines the right and responsibilities of creditors and borrowers in the event of default, anchor the process of coordination, renegotiation, and restructuring for a financially troubled borrower, and formalize the lenders access to the borrowers' collateral (Buttimer, 2001).

This code balances the conflicting forces. On one hand, the integrity of a debt contract must be upheld so that lenders have an incentive to lend money in exchange for debt contracts. This implies a strict enforcement of the absolute priority rule, which respects the seniority of debt holders over equity holders in their rights to residual cash flows. On the other hand, the code must prevent the enforced liquidation of companies that suffer nothing more than a lack of liquidity. To prevent their liquidation, it may become necessary to inject additional capital into the distressed company, which may also be forthcoming at a higher priority than existing debt claims.

The bankruptcy code differs from country to country. The perceived efficiency, enforceability, and fairness of a particular country's code have a major influence on

the development of credit markets. Investors' perception of the code as 'borrower friendly' or 'lender friendly' has important implications for the spreads. The bankruptcy code in the USA is regarded borrower friendly since the debtor remains in control. The code in UK is considered lender friendly since it operates on the principles of receivership (Pickford, 2001).

In most countries, the code has three important provisions:

First, when a company seeks protection under the bankruptcy code, all payments to creditors are suspended. This ensures that there is no "rush to the exit" by creditors who may have an incentive to cut a deal with the borrowers at the expense of other creditors.

Second, the judiciary authorities play an active role in supervising the process of reorganizing a bankrupt company's affairs. Major decisions cannot be taken without the court's approval. If the court is not satisfied with the reorganization plan proposed by the existing management, it may appoint a new management team.

Finally, under the US bankruptcy code the borrower remains in control on bankruptcy filling, though at the request of the creditors the bankruptcy court can change the company's management. The rationale for this provision is that the borrower is in a better position than creditors to turn around the company and should therefore get the first shot. The receivership doctrine works in reverse, giving creditors the first opportunity at reorganization.

2.15 CREDIT MANAGEMENT AT TELKOM KENYA LTD.

The Credit Management Unit of TELKOM Ltd is a fully-fledged Unit headed by a Credit Manager who reports to the Chief Finance Officer. The Unit is controlled from the Headquarters' offices in Nairobi and it coordinates the credit management functions of the seventeen regional offices spread countrywide. The main role of the headquarter unit is to set operational and policy guidelines, monitor performance

through periodic reports and oversee the administrative functions of the regional offices. The Unit has a workforce of eighty-five officers (85).

The key functions of the Unit involve Credit vetting, Credit rating, Credit control, debt follow-up and management. Though the vetting, rating and control functions are partially- automated, they are still largely manual. The debt follow-up aspect involves correspondence through the E-Mail, telephone, letters and physical visits.

2.15.1 ORGANISATIONAL STRUCTURES

The Credit Manager is responsible for four assistant managers in charge of Corporate Accounts, Personal Accounts, Government and Parastatal Accounts respectively. Reporting to each of these managers are a Senior Accountant, two Assistant Senior Accountants and two Accountants. There are also several Clerical officers reporting to these officers.

The regional offices are headed by senior or assistant senior accountants depending on the capacity of the telephone exchanges in terms of customer connections. These regional heads in turn report to the Regional Managers on credit functions involving their respective regions and to the Credit Manager on policy and guidance on any exceptional issue.

2.15.2 RESPONSIBILITIES

(1) Headquarters Office

The role of Headquarter unit is to monitor regional debt collection performance; initiate and execute debt collection strategies for the regions; monitor the effective implementation of credit control policies; and coordination of usage of debt collection instruments such as disconnections in the regions. The headquarter office also handles the role of operational interface between customers and the company through involvement in all credit extension arrangements for both corporate and non-corporate customers.

Equally important is the need to create excellent relationships with all customers and provide advisory services to management on credit control and debt collection strategies.

(2) Regional Office

The regional offices on the other hand are responsible for the implementation of the company's credit policies within the regions in conjunction with headquarter credit control and debt collection branch and ensuring an operational interface between customers and the company through involvement in all credit extension arrangements for corporate and non- corporate customers.

(3) Credit Control Management Reports

There are several reports, which are generated periodically to monitor the performance of the Unit. These reports are:

Corporate Debt Collection Reports -This is a weekly report and it constitutes revenue collections for regional offices and the headquarters.

Disconnection impact analysis reports. This report is done on regional basis and it shows decline/growth measurement history of debt e.g. when initial bill was produced; individual restoration reports categorized as restored after full, part or no payment at all; statistics as to likely delinquencies and effort to collect before delinquencies.

Post Disconnection Performance reports-This report is also on regional basis and is compiled one billing month after the disconnection impact analysis report. The report shows the analysis of aging and collections; summaries of agreements; credit arrangements and terms of agreement; exceptional report on non- conformance cases and action being taken.

Final Accounts reports -It indicates the collection performance; agreement and terms of agreement and exceptional report on non -conformance cases and action being taken.

(4)   The staff deployed.

The calibre of staff deployed in the unit on the average has good computer literacy and have attained varied levels of education ranging from O-levels to CPA and University degrees. The staff are self-motivated and target driven and possess good public relation and analytical skills. Majority have undergone training in techniques of handling customers.

(5)   State of equipment and tools deployed.

Though computers are widely used these are inadequate to fully meet the challenges offered by the job. Lack of adequate transport to reach customers is also a major handicap.

CHAPTER THREE

3.0 RESEARCH METHODOLOGY

3.1 RESEARCH DESIGN

The study is a survey study of credit management practices in TELKOM.

3.2 TARGET POPULATION

The populations of interest are the heads of Credit Units in the regions of TELKOM. There are seventeen (17) Credit Units spread across the country. The study also targeted two key senior management members at the head office. This resulted into 17 responses.

All heads of Credit Units in TELKOM were recruited as respondents. This method eliminated the bias inherent in both probability sampling and in the non-probability sampling procedures. This is because if only some heads of credit units were sampled and others left out, this would have created some suspicion, fear and restlessness about the intention of the study. In any case, the number 17 is not large enough to merit a sampling procedure.

In addition, a purposive sample of two key personnel was drawn for in-depth interviews. From definition, a purposive sample is a non-probability sampling technique in which an experienced individual selects a sample based upon his or her judgment about some appropriate characteristic required of the sample member (Zikmund, 2000). The appropriate characteristics in this case were TELKOM employees representing Finance and Accounts Department and Credit Management Division, respectively.

3.3 DATA COLLECTION PROCEDURES/INSTRUMENT

Qualitative and quantitative research methods were complementarily used in order to have a more objective interpretation of data. The combination of methods used

provided a rich portrait of the phenomena under study (Gilmore and Carson, 1996). Nancarrow et al (1996) also support this view and believe that the assignment of techniques between both approaches cannot only be beneficial but can also add significant value to the research being undertaken.

Data was collected by use of the questionnaire method. Closed and open-ended questions were used to solicit ideas related to the research problem from the respondents. Questionnaires were administered personally at the head office or sent through the Regional Accountants to the various Credit regions of TELKOM, as the circumstances dictated.

Secondary data .e.g. the financial statements have also been used to understand the financial performance of the company in depth.

3.4   DATA ANALYSIS

The data analysis technique has been aligned to the three objective of study, namely: to identify and evaluate the credit management practices (debt collection and follow up) within the different regions of TELKOM and draw a comparison with the corporate credit policy and best practices in credit management; to evaluate the level of bad debts within the different regions of TELKOM; and to establish the relationship between credit management practices and level of bad debts in TELKOM, regionally.

3.4.1   Section A- Demographic

This section of the questionnaire related to the demographic and has been analyzed using descriptive statistics so as to enable the comparison between the demographics and diversity across regions. The descriptive statistics are mean, variance, and standard deviation. The mean is a commonly used measure of the center of a batch of numbers or the average response on an item by respondents. Variance is a measure of how far the data (or scores for responses) are spread about the mean. Sample variance equals the standard deviation squared. The standard deviation provides a measure of

how spread out the data is. To calculate the variance, simply square the standard deviation value.

3.4.2 Question on Section B - Credit Sales And Bad Debt Across The Regions

This section relates to the second objective and requires that we establish the characteristics of credit sales and bad debt across the regions. The ultimate objective is to classify a region, through ranking, as experiencing low bad debts (1) or high bad debts (0). Thus we end up with a categorical response variable with two outcomes, high or low bad debts.

3.4.3 Section C – Credit Management Practices

This section C relate to the first objective. These questions have also been summarized using descriptive statistics and analyzed using factor analysis.

3.4.4 Linking Credit Management Practices to Level of Bad Debts

The final analysis has been to link section B and C as a step to addressing the third objective i.e. to establish the relationship between credit management practices and level of bad debts in TELKOM, regionally. This has been achieved by comparing the mean score for the two classes, namely the regions with low bad debts and those with high level of debts.

CHAPTER FOUR

4.0   DATA ANALYSIS AND FINDINGS

4.1   BACKGROUND   INFORMATION

There were seventeen (17) regions involved in study and all responded. The summary statistics are in **Table 1** below. The period in service as head of workstation (WS) ranged from 4 months to 8 years. However 29.4 percent of the respondents have been in station for 5 years, 32.5 percent have 4 years and 17.6 percent of them have been in service for 3 years. The majority of the respondents (i.e. 52.9 percent) hold 'O' level education while 23.5 percent are of 'A' level education. The rest is shared equally between postgraduate and undergraduate.

In terms of professional qualifications only a total of 58.8% have either CPS or CPA, 29.44% have credit management qualification, while the rest have no straight professional qualification at all. This suggests that unless there exists an in-house training, most of the respondents seem to lack prerequisites for managing credit sales.

Table 1: Summary of Background Information

Code	Valid Cases	Missing	Mode	Std. Dev	Variance	Minimum	Maximum
WS	17	0	1(a)	5.05	25.5	1	17
HCU	17	0	2	2.152	4.633	4months	8
LE	17	0	4	1.007	1.015	2	5
PQ	16	1	1(a)	1.414	2	1	5
(a) = Double mode exists							

4.2   SALES LEVEL AND BAD DEBTS LEVEL

Over the period 2001 to 2005 the region with the highest sales was Nairobi Central with sales of Kshs. 4,843.52 million thus was followed by Nairobi South

Kshs. 4,410.85 million. The areas with least sales were Eastern Kshs. 97.8 million, Voi with Kshs. 119.80 million and Northern Kshs. 127.59 million. The average highest sales were Kshs. 1475 million in 2002.

During the same period the area experiencing most difficult collection problem were Nyanza South where 51.6 percent of the debts were not collected within the terms of trade Western 48.6 percent; Central Rift 48.4 percent, Eastern 13.2 percent, Nairobi Central 16.2%, Coast 20%, Nairobi South enjoyed the best collection performance.

4.3   HIGH SALES HIGH AND BAD DEBTS

Using cross tabs tested whether high sales is followed by bad debts. The Chi- Square of 0.554 with a P-Value of 0.457 was observed. This shows that high sales are not followed by bad debts. In summary, there are other factors that explain the incidence of bad debts.

However for purposes of robustness, a correlation test shows some relationship, suggesting that as sales increase the percentage of bad debt reduces. This could be attributed to the introduction of prepaid services which has managed to avert the debt growth where all personal accounts are now transferred to. The Pearson Correlation between sales (average of five years) and percentage of sales not collected in time is – 0.66 with a p-value of 0.004.

4.4   RANKING ACCOUNTS IN TERMS OF BAD DEBTS

The best payers fall under Corporate Accounts (RCA), with a mean score of 3.36 and a mode score of 4, (see **Table 2**) i.e. 47.1 percent of respondents, while Government Accounts (RGA) and Personal Account (RPEA) are the worst i.e. these two accounts are ranked, across regions as top defaulters
(with a mode of 1). The low standard deviation suggests agreement by respondents on mean ranks.

Table 2: Summary of Payment Patterns of Different Accounts

	N		Mean	Mode	Std. Deviation	Min.	Max	Percentiles	
	Valid	Missing						25	50
RCA	14	3	3.36	4	0.842	2	4	2.75	4
RPEA	14	3	1.64	1	0.929	1	4	1	1
RPARA	14	3	3	3	0.679	2	4	2.75	3
RGA	16	1	1.88	1	1.088	1	4	1	1.5

This suggests that it is highly risky selling telephone services to individuals and government units and that better approaches be identified in managing personal and government accounts. In a policy perspective, if government is using it privileged position to defer its obligation to the corporation then privatization and not debt collection problem will solve the credit management problem in this firm.

Table 2 a: Frequency Table on Pattern of Payments

Variable	1	2	3	4	Total
RCA	0.00	21.43	21.43	57.14	100
RPEA	57.14	28.57	7.14	7.14	100
RPARA	0.00	21.43	57.14	21.43	100
RGA	50.00	25.00	12.50	12.50	100

The frequency table above confirms that 57.14 percent of respondent rank Personal Accounts holders as topping the least of defaulters' i.e. number one defaulter followed by Government Accounts, 50 percent. The least defaulter is Corporate Accounts.

When classified into level of bad debts i.e. 0 for regions with high bad debt and 1 for regions with low bad debts, the mean score for 0 is 3.50 and 3.25 for Corporate Accounts, i.e. the ranking varies according to regional level of bad debts.

4.5   ORGANIZATION OF CREDIT MANAGEMENT

Nearly all units have written credit policy. All of the respondents, i.e. 100 percent have and adhere to written credit policy. The guidelines or specific approaches to management of credit are largely provided for by head office. Over 82.4 percent of respondents see the need to modify credit policy as specified by the head office.

The number of staff involved in credit management as a proportion of total employees varies from region to region, but it is as high as 50 percent in a region to a low 5 percent in another region. However 23.5 percent of the respondents have 10 percent of total employees involved in credit management, while 11.8 percent of the units have 20 percent of staff in credit management.

When asked whether the head office allow units to manage credit freely, 58.8 percent said ''NO'' while 41.2 percent said ''YES''. It appears that there is a lack of consistency in empowering the regions in the management of credit. Telkom is selective on who is or not allowed to manage credit.

4.6   CREDIT GOALS AND OBJECTIVES

The most important credit goal is collection of debt (CCD) and is ranked by respondents as Extremely Important with a mean of 4.71 and a standard deviation of 0.47. This variable (CCD) has the lowest standard deviation, suggesting agreement across respondents on its importance as credit management goal.

Table 3: Credit Goals and Objectives

Variable	N	N*	Mean	Rank	St Dev	Minimum	Maximum	Q1	Q3
CCLC	17	0	4.00	VI	0.94	2	5	4	5
CPT	17	0	4.29	VI	0.59	3	5	4	5
CMD	17	0	4.24	VI	0.66	3	5	4	5
CFCC	16	1	2.25	SI	1.34	1	5	1	3
CCD	17	0	4.71	EI	0.47	4	5	4	5

Payment terms (CPT) is the second but considered very important item (VI), followed by monitoring of debtors with a mean score of 4.24. Funding of credit to clients is considered least in terms of importance (SI). This is because TELKOM might not be having direct funds for such an activity. However, its standard deviation of a high 1.34 shows lack of agreement among respondents.

4.7 CONTEXTUAL VARIABLES IN MANAGING CREDIT

The contextual variables include firm's age or potential customer (3.0), frequency of transaction (3.05) and product quality or reputation of the firm (3.00). However the high standard deviation ranging from 1.52 to 1.73 suggests lack of agreement.

Table 4: Contextual Variables in Managing Credit

Variables	N	Mean	Rank	St Dev	Minimum	Maximum	Q1	Q3
CFAC	17	3	(MI)	1.73	1	5	1	5
CFT	17	3.06	(MI)	1.52	1	5	1	4
CPQ	17	3	(MI)	1.7	1	5	1	4.5

All the contextual variables are listed as moderately important though some respondents ranked such variables as extremely important while some considered them important (see maximum and minimum in **Table 4** above). The perceptions on these variables vary from region to region.

4.8 SPECIALIST CREDIT MANAGEMENT FACILITIES

The surprising result is that this corporation have not found it necessary employing factoring, (88% of respondents do not employ factoring) and credit insurance (94.1% do not employ credit insurance) in managing credit sales. Factoring and credit insurance is not used at all. However a handful of units (43.8 percent) use credit information services. (Table 5)

Table 5: Specialist Credit Management Facilities

Variable	N	N*	Mean	Rank	St Dev	Minimum	Maximum	Q1	Q3
CF	16	1	1.06	NA	0.25	1	2	1	1
CCI	17	0	1.12	NA	0.49	1	3	1	1
CDC	17	0	2.53	MoT	0.51	2	3	2	3
CCIS	16	1	1.63	S	1.03	1	5	1	2
NA= not at all; MoT = Most of The Times; S = Sometimes									

Nearly all units (52.9% most of the times and 47.1% sometimes) employ the services of debt collectors in credit management. The debt collection has a mean score of 2.54 meaning most of the units used most of the times and its standard deviation is a low 0.514 which confirms that it is widely usage across units.

4.9 SOURCES OF INFORMATION

The safe extension of credit depends on complete and accurate information regarding every detail of the borrower's credit standing. Such information is from different sources. A lending policy defines the information requirements for businesses and individuals at various borrowing levels.

Table 6: Sources of Information

Variable	N	N*	Mean	Rank	St Dev	Minimum	Maximum	Q1	Q3
CBR	17	0	2.71	MI	1.45	1	5	1	4
CTR	17	0	3.24	MI	1.56	1	5	1.5	5
CFS	16	1	3.06	MI	1.57	1	5	1	4
CPC	17	0	3.94	VI	0.83	2	5	3.5	4.5
CCA	17	0	2.00	SI	1.23	1	5	1	2
CPPR	17	0	4.35	VI	0.70	3	5	4	5
CTJ	17	0	2.47	SI	1.23	1	4	1	4

As shown in Table 6, the most important source of information in making credit decisions is past payment record with a mean of 4.35 and a standard deviation of 0.70. Given a low standard deviation of 0.70, the respondents are in agreement on level of importance attached to this variable. For this mean score, past payment records is considered a very important source (VI) of information. The next source ranked as very important is personal contact with a mean score of 3.94. Bank reference is considered by 92.70 percent of respondents as moderately importance while a credit agency as a source of information is considered of slight importance.

The lack of reliance on banks as a source of information is expected given that banks in this country are reluctant to release information about their client, while the credit

agencies as sources of information is yet to be developed. At the same time, the units might not be relying on these sources because the Head Office makes most credit management related decisions.

4.10   CRITICAL SUCCESS FACTORS WITHIN UNITS

The key risk facing credit management units is failure to collect accounts receivable. With respect to controlling risk in accounts receivable, 82.4 percent of respondents accept that their level of success is average (1.94). This is fairly representative given a low standard deviation of 0.104. Similar results are obtained when it comes to due diligence on customers up from, with 70.6 percent rating their success as average and collecting accounts receivables where all respondents, again, rate their success as average.

Table 7: Critical Success Factors within Units

Variable	N	Mean	Rank	St Dev.	Minimum	Maximum	Q1	Q3
CCR	17	1.94	AV	0.43	1	3	2	2
CDDC	17	1.71	AV	0.47	1	2	1	2
CCAR	17	2.00	AV	0	2	2	2	2
CUTMC	17	1.65	AV	0.86	1	4	1	2
AV = Average								

However, the success in use of technology is mixed and blurred. Though the mean score of 1.65 suggest that the units are on average successful, 52.9 percent of the units are not successful in using technology to manage credit. This is a pointer that there is room for use of technology in managing credit.

4.11   CRITICAL SUCCESS FACTORS IN REDUCING PAYMENT RISK.

The results are summarized in **Table 8** below. Use of technology (CUTRP) with the highest mean score of 4.12 and a standard deviation of 0.93 is rated as a very important factor in reducing payment or non-payment risk. It is not surprising that provision of real time access to customers (CPRTA) information with a mean score of 3.88, ensuring that employees work together 3.76 and use of technology to route

customer enquiries on payments to appropriate service representatives or automated activities (3.71) are all ranked as very important given that technology help in timely processing of information.

Overall no item in this section is on average ranked as not important. The least ranked item is incentives to pay early (CIPE), with a mean of 2.71 with a high standard deviation of 1.40. The high standard deviation suggests lack of or concurrence on this item as an approach to reducing non-payment risk.

The results are blurred when we consider offering customers multiple payment options, flexible billing cycles and incentive to paying early. Most units tend to consider these approaches as less effective.

Table 8: Critical Success Factors in Reducing Payment Risk

Variable	N	N*	Mean	Rank	St Dev	Minimum	Maximum	Q1	Q3
COCM	17	0	3.41	MI	1.064	1	5	3	4
CFBC	17	0	3.18	MI	1.286	1	5	2	4
CIPE	17	0	2.71	MI	1.404	1	5	1.5	4
CCSPC	16	1	3.00	MI	1.211	1	5	2	4
CUTRP	17	0	4.12	VI	0.928	3	5	3	5
CUTRC	17	0	3.71	VI	1.448	1	5	2.5	5
CEWT	17	0	3.77	VI	1.3	2	5	2	5
CCSM	17	0	2.77	MI	1.348	1	5	1.5	4
CPDAC	17	0	3.77	VI	1.147	1	5	3	5
CPRTA	17	0	3.88	VI	1.364	1	5	2.5	5
CUOCA	17	0	2.94	MI	1.197	1	5	2	4

There seems to be less use of credit scoring model. This could be due to lack of capacity on the part of employees, or data useful in building such models or both or even the supporting technology as suggested earlier.

4.12   TECHNIQUES FOR MONITORING ACCOUNTS RECEIVABLES

The most valuable technique in monitoring accounts receivables is days sales are on standing, which is on averaged, is ranked by respondents as useful (2.41) while

average collection period and variance analysis have identical ranking of 2.06 each i.e. the units consider them as useful.

Table 9: Techniques for Monitoring Accounts Receivables

Variable	N	Mean	Rank	St Dev	Maximum	Minimum	Q1	Q3
CDD	17	1.88	Useful	1.05	1	4	1	3
CVA	17	2.06	Useful	0.97	1	4	1	3
CACP	17	2.06	Useful	0.83	1	3	1	3
CDSO	17	2.41	Useful	1	1	4	1.5	3
CAS	17	1.94	Useful	0.97	1	4	1	3

However the use of variance analysis and average collection period is not uniform across the units suggesting differences in professional qualification or guidance from head office.

Ageing schedules are not popular with the units, 41.2 percent of the units consider it useless.

4.13 CREDIT MANAGEMENT PRACTICES AND THE LEVEL OF BAD DEBTS?

We start the analysis by seeking an answer to the question: Does level of Bad Debts depend on credit goals? This is achieved by testing whether regions with high level of bad debts (0) do have credit goals that differ from those areas with low level of debts (1). The results summarized in **Table 10** below show that the level of bad debts does not depend on credit goals. For example funding of credit to clients (CFCC) if ranked as slightly important by both groups, and payment terms is listed as very important by each group (0's = 4.33; and 1's = 4.25 against the overall of 4.29). Even the standard deviations across the groups do not differ much for the critical variable such as payment terms (CPT) and monitoring of debtors (CMD).

Table 10: Comparing Means of High (1) and Low (0) Level of Debt on Credit Goals and Objectives

CLDNTC		CCLC	CPT	CMD	CFCC	CCD
0	Mean	4.11	4.33	4.33	2.11	4.67
	N	9	9	9	9	9
	Std. Deviation	1.05	0.71	0.71	1.17	0.50
1	Mean	3.88	4.25	4.13	2.43	4.75
	N	8	8	8	7	8
	Std. Deviation	0.83	0.46	0.64	1.62	0.46
Total	Mean	4.00	4.29	4.24	2.25	4.71
	N	17	17	17	16	17
	Std. Deviation	0.94	0.59	0.66	1.34	0.47

The contextual variables (see **Table 11**) too do not influence level of bad debts. The respondents consider these variables as largely irrelevant.

Table 11: Comparing Means of High (1) and Low (0) Level of Debt on Contextual Variables

CLDNTC		CFAC	CFT	CPQ
0	Mean	3.11	3.11	2.78
	N	9	9	9
	Std. Deviation	1.90	1.45	1.56
1	Mean	2.88	3	3.25
	N	8	8	8
	Std. Deviation	1.64	1.69	1.91
Total	Mean	3	3.06	3
	N	17	17	17
	Std. Deviation	1.73	1.52	1.70

In terms of specialist credit management facilities, while regions with low bad debts sometimes rely on credit information services (CCIS), the high bad debt regions tend to ignore this facility (See **Table 12** below).

Table 12: Comparing Means of High (1) and Low (0) Level of Debt on Specialist Credit Management Facilities

CLDNTC		CF	CCI	CDC	CCIS
0	Mean	1.13	1.22	2.56	1.38
	N	8	9	9	8
	Std. Deviation	0.35	0.67	0.53	0.74
1	Mean	1	1	2.5	1.625
	N	8	8	8	8
	Std. Deviation	0.00	0.00	0.53	0.52
Total	Mean	1.06	1.12	2.53	1.50
	N	16	17	17	16
	Std. Deviation	0.25	0.49	0.51	0.63

Table 12B below is a summary of means of information for the two groups, low (0) and high (1) bad debts. The successful region i.e. with low bad debts rely on trade reference more than the less successful ones. However both groups equally rely on personal contact as a source of information – (low 4.00 and high 3.88) and both rank this source as very important source of information.

However when it comes to past payment as a source of information, regions with high bad debts consider it an important source with a score of 4.44. Trade journals and business magazines are ranked as important by areas with low bad debts (3.23) and not important by those with high debts.

Table 12B: Comparing Means of High (1) and Low (0) Level of Debt on Sources of Information

CLDNTC		CBR	CTR	CFS	CPC	CCA	CPPR	CTJ
0	Mean	2.56	3.11	2.88	4.00	2.00	4.44	1.78
	N	9	9	8	9	9	9	9
	Std. Deviation	1.67	1.76	2.03	0.71	1.50	0.73	1.09
1	Mean	2.88	3.38	3.25	3.88	2.00	4.25	3.25
	N	8	8	8	8	8	8	8
	Std. Deviation	1.25	1.41	1.04	0.99	0.93	0.71	0.89
Total	Mean	2.71	3.24	3.06	3.94	2.00	4.35	2.47
	N	17	17	16	17	17	17	17
	Std. Deviation	1.45	1.56	1.57	0.83	1.22	0.70	1.23

In terms of critical success factors (see **Table 13**), there is a difference in ranking, the low bad debt regions consider offering customers multiple payment options (COCM) very important (3.75) whereas the high debt region on average consider it moderately important (3.11). The same ranking applies to flexible billing (CFB) ranked by 0's as 2.67 and 1's as 3.75.

However the two groups give almost identical ranking to use of technology to route customer enquiries on payments to appropriate service representatives (CUTRC), ensuring employees work together (CEWT).

Table 13: Comparing Means of High (1) and Low (0) Level of Debt on Critical Success Factors

CLDNTC		COCM	CFBC	CIPE	CCSPC	CUTRP	CUTRC	CEWT	CCSM	CPDAC	CPRTA	CUOCA
0	Mean	3.11	2.67	2.44	2.78	4.11	3.78	3.78	2.78	3.56	3.89	2.78
	N	9	9	9	9	9	9	9	9	9	9	9
	Std. Dev	1.36	1.32	1.59	1.39	1.05	1.48	1.20	1.56	1.33	1.27	1.48
1	Mean	3.75	3.75	3.00	3.29	4.13	3.63	3.75	2.75	4.00	3.88	3.13
	N	8	8	8	7	8	8	8	8	8	8	8
	Std. Dev	0.46	1.04	1.20	0.95	0.83	1.51	1.49	1.16	0.93	1.55	0.83
Total	Mean	3.41	3.18	2.71	3.00	4.12	3.71	3.76	2.76	3.76	3.88	2.94
	N	17	17	17	16	17	17	17	17	17	17	17
	Std. Dev	1.06	1.29	1.40	1.21	0.93	1.45	1.30	1.35	1.15	1.36	1.20

In terms of technique, there are no marked difference except when it comes to ranking of days sale outstanding which is on average ranked as sometimes useful by 0's and very useful by regions with low bad debt (1's). Otherwise most of the techniques are ranked as useful. (see **Table 14 below)**

Table 14 - Comparing Means of High (1) and Low (0) Level of Debt on Techniques in Monitoring Accounts Receivables

CLDNTC		CDD	CVA	CACP	CDSO	CAS
0	Mean	2.00	2.11	2.00	2.56	2.11
	N	9	9	9	9	9
	Std. Deviation	1.12	1.05	0.87	1.13	1.05
1	Mean	1.75	2.00	2.13	2.25	1.75
	N	8	8	8	8	8
	Std. Deviation	1.04	0.93	0.83	0.89	0.89
Total	Mean	1.88	2.06	2.06	2.41	1.94
	N	17	17	17	17	17
	Std. Deviation	1.05	0.97	0.83	1.00	0.97

CHAPTER FIVE

5.0   CONCLUSION, LIMITATIONS AND RECOMMENDATIONS

5.1   CONCLUSIONS

To manage credit sales effectively, TELKOM must re-assess its sales contract with the Government and Personal accounts holders. These are the worst defaulters and consequently contribute to high provisions for high debts.

Telkom does not make specific provisions against each account receivable. The billing system extracts the balance of accounts outstanding for over 90 days known as 'Final Accounts' and a 95% provision is made against these accounts. Management believes that at least 5% of all accounts over 3 months are recoverable. From the outstanding balances between 0-90 days, TELKOM separates the current debtors of 0-60 days and a 50% provision is made on all accounts between 60-90 days known as 'Temporarily out of service'(TOS) whereby the subscribers telephone line is disconnected. The TOS period represents the 30- day notice to the defaulting customers to settle the outstanding amount after which the line is completely discontinued.

In reality however, the disconnections policy is not strictly adhered to and in some instances, it takes upto almost 6 months before the telephone lines of defaulting customers are discontinued. Telkom management attributes this approach to rapidly growing competition and these measures assist in customer retention.

Slow and inefficient collection of debts has been a major factor for TELKOM'S present cash flow problems, with debtor days stretching to more than one year in June 2003, with the June 2004 figure standing at 380 days.

However to improve on credit management, TELKOM management must give the regions a free hand in managing accounts receivables because they are better placed

to deal with the local clients better than the head office. The current policy is selective and appears discriminative in deciding on those allowed to manage credit.

The less successful regions can learn from the successful ones. The specific areas to learn from are: sources of information for vetting, setting credit goals and objectives and techniques for monitoring accounts receivables. This is because significant differences were observed on these variables between low and high levels of bad debts.

5.2   LIMITATIONS OF THE STUDY.

There were several difficulties. The biggest limitation was the time available. Some answers were unusable because they did not make sense. The major limitation was data particularly on sales and bad debts. This meant that the results had to be interpreted in light of these factors.

5.3   RECOMMENDATIONS

5.3.1   Telkom is making efforts to improve collections, however a more concerted effort is required with clearly laid down policies and procedures. Telkom needs to collect existing debt and also put in place efficient debtors management systems to avoid future collection problems.

5.3.2   An efficient system of debt collection is essential. A good system should involve customers paying promptly, following up disputed invoices speedily, issue statements and reminders at appropriate intervals, and generate management reports such as an aged analysis of debtors.

5.3.3   A clear policy must be devised for overdue accounts, and followed up consistently, with appropriate procedures (such as disconnecting lines). Materiality is important. Whilst it may appear nonsensical to spend time chasing a small debt, by doing so, TELKOM may send a powerful signal to its customers that it is serious about the application of its credit and collection policies.

5.3.4   Ultimately, a balance must be struck between the cost of implementing a strict collection policy (i.e., the risk of alienating otherwise good customers) and the tangible benefits resulting from good credit management.

5.3.5   However, it should be noted that these recommendations cannot be successful if implemented in isolation. TELKOM requires a change in corporate culture, improvement in customer service, implementation of systems software and network upgrade and modernization in order to have an effective and efficient debtor management system.

Listed below are measures which should be undertaken to address this problem:

i.   Existing debtors

ii.   Consider converting all default lines to pre-paid accounts

iii.   Consider offering discounts (say 40%) on old balances to give defaulters incentive to pay up and resume connection of their lines

iv.   Strict adherence to credit policy by putting default accounts on 'temporally out of service' (TOS) and disconnecting all long-term defaulters (and consider conversion to pre-paid as suggested above).

v.   Consider possible legal recourse on huge defaulting accounts.

vi.   Allocate portfolios of default accounts to credit staff and offer incentives (bonuses) based on collections.

Going forward:

Credit risk management at Telkom is not computer aided and the only automated function relates to billings to customers. Tracking down defaulting customers becomes

difficult because there are no early warning systems to monitor and report exceptions and overrides to credit policies resulting in large uncollectible balances from customers. TELKOM needs to put in place an ICT activity to support credit decision making which will enable it to monitor all accounts and facilitates proper credit risk management.

Other than extending the implementation of an automated system, there are further opportunities for TELKOM to use technology to enhance the effectiveness and efficiency of credit and collection processes. TELKOM should consider the following:

i.   Automated data uploads of customer information from credit reference agencies

ii.   Adopting scorecard system for credit risk management;

iii. Electronic invoicing and payment systems; and

iv.   Usage of e-mail dunning

v.   Establishment of clear credit practices as a matter of company policy. These practices must be clearly understood by both staff and customers. Credits limits for each customer should be established and company should adhere to them. Adequate collection procedures should be in place, by following up debtors with formal letters, telephone calls and if necessary, disconnection of the line.

vi.   Aggressive marketing of pre-paid plans in an effort to increase proportion of pre-paid to post-paid lines which, while reducing the total revenue from the lines, will ensure collection due to the nature of the prepaid service.

vii. Consider partnering with commercial banks to introduce easier modes of payment for customers (e.g. water bills can now be paid at Co- operative Bank branches)

viii. Adequate credit checks on all new applications for connections

ix. Timely and accurate billing should be implemented in order to reduce disputes. Once the capabilities of network are enhanced, itemized billing should be done to reduce disputes.

Standardizing processes based on best practice, will help to drive performance improvement across the company. The TELKOM credit management application is inconsistent from one region to another. This inconsistency does not augur to the need to have standardized processes based on the best practices. The management of TELKOM must therefore endeavor to address this anomaly.

In accordance with best practice, TELKOM needs to contact major corporate customers before invoices fall due to ensure that there are no disputes and that payments will be processed in time.

5.4 SUGGESTIONS FOR FURTHER RESEARCH.

There should be a study that emphasizes on other characteristics such as geographical, social and governance across regions.

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APPENDICES

Appendix 1

Cover Letter

Dear Respondent,

I am conducting a research on the Credit Management Practices in the service industry: The case study of Telkom Kenya Limited. This study is in partial fulfillment of the requirement for a Masters degree in Business Administration at the University of Nairobi for which I am enrolled as a student.

In this regard, I have enclosed a questionnaire for your kind attention and action. It is my expectations that the outcome of this research will be useful to your esteemed institution and it will therefore be my pleasure to share the findings of this study with the management of Telkom Kenya Ltd.

Kindly complete the questionnaire and return it to my attention at the address cited below. Alternatively, you could also send it electronically via e-mail to ronono@hotmail.com. Incase of any enquiries, do not hesitate to contact me on cell phone *0722-705468*.

Thanking you in advance,

Yours sincerely,

RESEACHER
Ronald Onono
P. O. Box 34721, 00100,
G.P.O., Nairobi

Appendix 2

QUESTIONNAIRE

(Credit management practices at Telkom Kenya Ltd.)

A: Background Information

(i)   Indicate your work station?

Western ☐	Coast ☐	Nairobi/C ☐	North Rift ☐
Northern ☐	Voi ☐	Nairobi/N ☐	Central Rift ☐
Southern ☐	Malindi ☐	Nairobi/S ☐	Eastern ☐
Nyanza/W ☐	Central ☐	South Rift ☐	
Nyanza/S ☐	Mt. Kenya East ☐		

(ii)   How long have you been head of your unit? ....

(iii)   What is your highest level of education?

Primary school ☐	'O' Level ☐
'A' Level ☐	Undergraduate ☐
Post Graduate ☐	

(iv)   Which professional qualification do you hold?

Accounting (CPA) ☐	CPS ☐
Credit Management ☐	Any Other ☐

B: LEVEL OF BAD DEBTS (This relate to your unit only)

	As at 30th June	2001	2002	2003	2004	2005
1.	Sales (Turnover) in Kshs. (Total billing)					
2.	Bad Debts in Kshs.					
3.	Debtors turnover (i.e. average time to collect)					
4.	Debt written off as a percentage of total debt					
5.	Percentage of Debt collected within terms of trade					
6.	Debtors aged 30 to 60 days					
7.	Debtors aged 60 to 90 days					
8.	Debtors aged > 90 days					
9.	What is the number of your customers					

10.   Rank the following in terms of highest bad debts:

Entity	Rank
Corporate accounts	☐
Personal Accounts	☐
Parastatal Accounts	☐
Government Accounts	☐

C: Credit Management Practices

General:

1. Does your unit adhere to any written credit policy? Yes ☐   No ☐
2. Does your unit see a need to modify corporate credit policy (as specified by the head office) to achieve a fit with prevailing regional circumstances? Yes ☐ No ☐

If yes, how has this been achieved?

....

....

....

....

If no, give your reasons

....

....

....

3. What is the number of staff involved in credit management as a proportion of total employees in your unit?

....

4. Does the head office allow your unit to manage credit freely? Yes ☐   No   ☐

Credit Goals and Objectives

State the level of importance attached to the following credit goals and objectives in your unit?

Use the scale Extremely Important (EI); Very Important (VI); Moderately Important (MI); Slightly Important (SI) and Not Important (NI). (Please tick your choice)

	EI	VI	MI	SI	NI
	5	4	3	2	1
5. Credit Limits to clients	☐	☐	☐	☐	☐
6. Payment terms	☐	☐	☐	☐	☐
7. Monitoring of debtors	☐	☐	☐	☐	☐
8. Funding of credit to clients	☐	☐	☐	☐	☐
9. Collection of debts	☐	☐	☐	☐	☐

How important are the following contextual variables in managing credit or in deciding on whom to extend credit to?

	EI	VI	MI	SI	NI
	5	**4**	**3**	**2**	**1**
10. Firm's age or potential customer	☐	☐	☐	☐	☐
11. Frequency of transactions (level of usage)	☐	☐	☐	☐	☐
12. Product quality or Reputation of the firm	☐	☐	☐	☐	☐

To what extent does your unit rely on the following specialist credit management facilities?

	Most of the Times	Sometimes	Not at all
	3	**2**	**1**
13. Factoring	☐	☐	☐
14. Credit Insurance	☐	☐	☐
15. Debt Collection	☐	☐	☐
16. Credit Information Services	☐	☐	☐

Any other

State the level of importance attached to the following sources of information in making credit decision in your unit.

	EI	VI	MI	SI	NI
	5	**4**	**3**	**2**	**1**
17. Bank reference	☐	☐	☐	☐	☐
18. Trade reference	☐	☐	☐	☐	☐
19. Financial Statements	☐	☐	☐	☐	☐
20. Personal contact	☐	☐	☐	☐	☐
21. Credit Agencies	☐	☐	☐	☐	☐
22. Past Payment records	☐	☐	☐	☐	☐
23. Trade Journals and Business Magazines	☐	☐	☐	☐	☐

How successful is your unit in:

	Very successful	Average	Not successful
	3	2	1
24. Controlling Risk in Accounts receivable	☐	☐	☐
25. Due diligence on your customers upfront	☐	☐	☐
26. Collecting accounts receivable	☐	☐	☐
27. Using technology to manage credit	☐	☐	☐

How important are the following critical success factors in reducing payment (or non payment risks?)

	EI	VI	MI	SI	NI
	5	4	3	2	1
28. Offering customers multiple payment options	☐	☐	☐	☐	☐
29. Flexible billing cycles	☐	☐	☐	☐	☐
30. Incentives to pay early	☐	☐	☐	☐	☐
31. Creation of single point of contract for all incoming customers	☐	☐	☐	☐	☐
32. Use technology to receive and post customer payments	☐	☐	☐	☐	☐
33. Use technology to route customer enquiries on payments to appropriate service representatives or automated activities	☐	☐	☐	☐	☐
34. Ensuring that employees work together	☐	☐	☐	☐	☐
35. Use of credit scoring model to assign the customer credit rating	☐	☐	☐	☐	☐
36. Prioritize delinquent accounts for collection follow-up	☐	☐	☐	☐	☐
37. Provision of real time access to customers information	☐	☐	☐	☐	☐
38. Use outside collection agent	☐	☐	☐	☐	☐

How useful are the following techniques in monitoring accounts receivables?

	Very Useful	Useful	Sometimes Useful	Useless
	1	2	3	4
39. Debtors days	☐	☐	☐	☐
40. Variance analysis	☐	☐	☐	☐
41. Average collection period (debtors)	☐	☐	☐	☐
42. Days sales outstanding	☐	☐	☐	☐
43. Ageing schedule	☐	☐	☐	☐
44. Any other	☐	☐	☐	☐