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EFFECT OF FINANCIAL MANAGEMENT PRACTICES AND CHARACTERISTICS ON PROFITABILITY: A STUDY ON BUSINESS ENTERPRISES IN JIMMA TOWN, ETHIOPIA

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ABSTRACT

This study investigated the effect of financial management practices and financial characteristics on profitability of business enterprises in Jimma town (Ethiopia). Both primary and secondary data were collected from 37 business enterprises in Jimma town. Analysis of the collected data provided that; profitability was significantly affected by efficiency in financial management practices such as accounting, reporting, & analysis, working capital management, fixed asset management and financial planning and financial characteristics such as current ratio and debt ratio. Therefore, in order to increase profitability, the researchers recommend that business enterprises should continuously improve their financial management practices and financial characteristics.

Keywords: Business Enterprises, Financial Management Practices, Financial Characteristics, Profitability

INTRODUCTION

Financial management is one of the several functional areas of management but it is the center to the success of any business. Inefficient financial management, combined with the uncertainty of the business environment often led Business Enterprises to serious problems. According to Kawame (2010), careless financial management practices are the main cause of failure for business enterprises in Ghana. Regardless of whether an owner-manager or hired-manager, if the financial decisions are wrong, profitability of the company will be adversely affected. Consequently, a business organization's profitability could be damaged because of inefficient financial management. Business Enterprises have often failed due to lack of knowledge of efficient financial management. Moreover, the uncertainty of the business environment causes Business Enterprises to rely excessively on equity and maintain high liquidity and these financial characteristics affect profitability.

Since the Ethiopian People Revolutionary Democratic Front (EPRDF) led government introduced a series of economic reforms in 1992, the private sector in Ethiopia has rapidly grown in terms of the number of businesses, capital and employees. The number of private businesses and limited companies had quickly risen and the majorities are micro, small and medium enterprises. These business Enterprises have contributed considerably to growing GDP and creating jobs for labor-age people (Alemayehu & Tadele, 2004).

Jimma town is one of the oldest and commercial centers found in oromia regional state, Ethiopia. According to the census made in 2007, there are about 3,060 licensed business organizations in Jimma town. Now days this number is increasing at an accelerated rate (Ministry of Trade and Industry, 1997). Although their number is increasing, inefficient financial management practices are assumed to prevail in business organizations found in Jimma town. To my knowledge, there has not been any research on financial management practice conducted on business enterprises in Jimma town. This research paper is aimed at investigating the effect of financial management practice and financial characteristics on the profitability of the business organizations.

RESEARCH PROBLEM AND OBJECTIVES

Most previous researchers have concentrated on examining, investigating and describing the behavior of Business Enterprises in practicing financial management. Their findings are mainly related to exploring and describing the behavior of business enterprises towards financial management practices and characteristics. Although they provided much descriptive and empirical evidence on financial management practices, it appears that there are still some gaps in the literature which need to be addressed. First, most empirical evidences came from the developed economies such as the United States of America. There seems to be a lack of evidence from less developed countries like Ethiopia. Second, most previous researchers focus on investigating and describing financial management practices. There has been little research examining the effect of financial management practices on profitability (McMahon, et al. 1993).

This lack of empirical evidence from less developed economies and the lack of examination of the effect of financial management practices and financial characteristics on profitability are major gaps in the knowledge of financial management. Therefore, it is difficult to convince business practitioners of the need for changes in practices until evidence of the effects of financial management practices and characteristics on profitability are provided and the relationship between the two variables is proved. Based on previous research findings and recognition of these gaps, a study of the effect of financial management on profitability is justified and the effect of financial management practices and financial characteristics should be developed and tested by using empirical data from less developed economies (kieu,2004).

The case of Ethiopia is very serious. Most Business Enterprises have not appointed financial managers to be in charge of financial management of the company. Usually, the owners or general managers with the assistance of the accountant control financial matters of the company. On the other hand, most owners or managers have no formal training in management skills, especially financial management. Moreover, the concepts of financial management have also only been recognized in Ethiopia since the beginning of the 1960s, when the commercial code was introduced by the then imperial government. Hence, financial management is still one of the challenges of Business Enterprises in Ethiopia.

The main objective of this study is to investigate the effect of financial management practices and financial management characteristics on profitability. Specifically, this study will

- Investigate the effect of Efficiency in financial management practices such as accounting, reporting, & analysis, working capital management, fixed asset management and financial planning on the profitability of firms
- Examine the effect of financial characteristics such as liquidity, leverage and asset turn over on the profitability of firms

LITERATURE REVIEW

Specific Areas of Financial Management Practices

Most authors and researchers approach the specific areas of financial management in different ways depending upon their emphasis. Walker and Petty as cited by kieu (2004) defined the main areas of financial management including financial planning (cash planning, fixed asset planning, profit planning), investment decision-making, working capital management (cash, receivable and inventory management) and sources of financing (short-term and long-term financing, intermediate financing and going public). A study made in Malaysia by Mohd, et al (2010) identified the components of financial management as financial planning and control, financial accounting, financial analysis, management accounting, capital budgeting and working capital management. Chung & Chuang (2010) classified financial management practice in to the following five specific areas: Capital structure management, working capital management, financial reporting and analysis, capital budgeting and accounting information system. Generally, from the above and other literatures, it is possible to identify four major areas of financial management practices.

1. Financial Accounting, Reporting and Analysis: these include the nature and purpose of financial records, bookkeeping, cost accounting, and use of computers in financial record keeping, the nature, frequency and purpose of financial reporting, auditing, analysis and interpretation of financial performance.
2. Working Capital Management: Working capital management involves managing the level and financing of the firm's investment in current assets, which includes cash, marketable securities, accounts receivable and inventory. It is a strategy focusing on maintaining efficient levels of both components of working capital, current assets and current liabilities, in respect to each other.
3. Capital budgeting (Fixed asset) Management: Unlike working capital decision, capital budgeting decision commits funds for a long term capital projects or fixed assets which have an impact on the company's strategic position.
4. Financial Planning and Control (Management Accounting)**:** this includes financial objectives and targets, cost-volume-profit analysis, pricing, short term financial budgeting and control, and management of responsibility centers.

Financial management practice in this study has focused on these four major areas.

Effect of Financial Management Practices on Profitability

The effect of financial management practice on profitability was found to be positive. Paramasivan, et al (2009) argued that financial management helps to improve the profitability position of business organizations with the help of strong financial control devices such as budgetary control, ratio analysis and CVP analysis. Mcmohon & Holmes (1991) pointed out that financial managers are crucial to the profitability, survival and well being of small business enterprises. In his study on small business in Vietnam, Kieu (2004) found out that efficiency in financial management practices such as accounting information system, financial reporting and analysis, working capital management, fixed asset management and financial planning and good performance in financial characteristics such as liquidity and business activity has a positive impact on profitability. In addition, the study conducted by Chung & Chuang (2010) also reveals efficiency in capital structure management, working capital management, financial reporting and analysis; capital budgeting and accounting information system has a positive impact on profitability of business organizations.

Effect of Efficiency in Accounting, Reporting and Analysis Practice

Tourna and Germanos (2000) studied about the role of accounting information on business strategy formulation in Greece. The study found out that, the use of accounting information system helped owners or managers to design and implement a strategic plan that will enable their business profitable in the long run. Kieu (2004) also found out that efficiency in accounting information system and financial reporting and analysis enhanced profitability. The efficiency of business organizations in this case was approximated by the on time and accurate recording and summarizing of business transactions, the frequency of preparing financial report and financial analysis, the degree of computerization of the accounting information system (kieu, 2004). In addition, different accounting and financial management books also confirm that good accounting, reporting and financial analysis practice enhance performance by helping decision makers design and implement wise and strategic decisions. From this, it is possible to formulate the following hypothesis

Hypothesis 1: Efficiency in financial accounting, Reporting and analysis practices have a positive effect on profitability

Effect of Working Capital Management on Profitability

In the study conducted in Belgium, Deloof (2003) found out that the way working capital is managed will have a significant impact on the profitability of a firm. Padachi (2006) investigated the relationship between profitability measured by return on assets and working capital management by taking 58 firms in Mauritius using panel data analysis for the period 1998 -2003. The regression result showed that high investment in inventories and receivables is associated with low profitability. Gill, et al (2010) also studied 88 American firms and found out statistical significant relationship between cash conversion cycle and profitability. From this, the following hypothesis can be formulated.

Hypothesis 2: Efficiency in working capital management practice has a positive effect on profitability

Effect of Capital Budgeting (Fixed Asset management) on Profitability

Capital budgeting decisions are critical to the success of any firm. Brigham & Ehrhardt (2008) argued that capital budgeting decision is vital to a firm's financial well being and are among the most important decisions that owners or managers of a firm must make. Their rationale for that belief is that capital budgeting decision often involves significant capital outlay to acquire fixed assets. Additionally, the acquisition of these assets often comes with long lasting and recurring financial obligation. Furthermore, efficient utilization and control and management of acquired fixed assets are also equally important. Appropriate acquisition process, proper record keeping , periodically evaluating the efficiency of the fixed asset, regular repair and maintenance and proper disposal of fixed assets will enhance the performance of firms. In a study conducted in South Africa, Olawale, et al (2010) found out that the use of sophisticated investment appraisal techniques such as NPV and IRR methods have a positive impact on the profitability of firms. From this the third hypothesis will be formulated as follows

Hypothesis 3: Efficiency in fixed asset management (Capital budgeting) practice has a positive effect on profitability

Effect of Financial Planning on Profitability

Companies typically prepare a wide array of plans and budgets. Some of which include sales plan, production plan, cost plan and expense budget and budgeted income statement and balance sheet. These budgets are very important to anticipate the future in advance. This will in turn help to minimize risks and because of the tradeoff between risk and return, profitability increases. Therefore, preparing detailed financial plan or budgets will have a positive effect on profitability of the firm (Horngreen , Datar & Foster , 2006). From the above discussion, the following hypothesis can be formulated

Hypothesis 4: Efficiency in financial planning (short term budgeting) practices has a positive effect on profitability

Effect of Financial Characteristics on Profitability

Liquidity measured by current ratio, leverage measured by debt ratio and business activity measured by total asset turnover ratio are the three independent financial characteristics used in this study.

Liquidity measured using current ratio refers to the relative proportion of current assets such as cash, receivables and inventories as compared to current liabilities. The greater the relative proportion of liquid assets, the less risk of running out of cash and profitability decrease, since these liquid assets become idle and do not earn any revenue. On the other hand, when liquidity of a firm is low, the risk is very high and profitability will increase because of the tradeoff between risk and profitability (Higgins, 1995).

In physics, a lever is advice to increase force. In business financial leverage measured by Debt ratio is a device used to increase owners return (Brigham & Ehrhardt, 2008). Higgins (1995) argued that the impact of financial leverage on return on equity depends on the size of return on investment and the after tax interest rate. Financial leverage measured by debt to total asset increases return on equity, when return on investment is greater than the after tax interest rate. When the return on investment is less than the after tax interest, increase in leverage reduces the return on equity. Therefore, leverage improves financial performance when things are going well but worsens performance when things are going poorly (Uwalomwa and Uadiale ,2012)

Many people believe that assets are good things: the more the better. The reality is just the opposite. Unless a company is about to go out of business, its value is in the income stream it generates and its assets are simply a necessary means to this end. In dead, the best possible company would be the one that produces income without any asset. Other things constant, financial performance improves as asset turnover rise (Higgins, 1995). From the above discussion, the following three hypotheses can be formulated.

Hypothesis 5: Profitability of business organizations is negatively related to the current ratio

Hypothesis 6: Profitability of business organizations is positively/negatively related to the debt ratio.

Hypothesis 7: Profitability of business organizations' is positively related to the total asset turnover ratio

The effect of these seven independent variables on profitability can be summarized as shown in the table below.

Table 1. Effect of Financial Management Practices and Characteristics on Profitability

Financial Practice & Characteristics	Expected Impact on Profitability
Efficiency in Financial Accounting, Reporting & Analysis	Positive
Efficiency in work in capital Management	Positive
Efficiency in Fixed Asset Management	Positive
Efficiency in Financial Panning	Positive
Increase in Current Ratio	Negative
Increase in Debt Ratio	Positive/Negative
Increase in Total Asset Turn Over	Positive

Source: Own summery

RESEARCH DESIGN AND METHODOLOGY

Due to limitation of time and fund, the target population in this study could not cover all business organizations in Ethiopia. The target population for the study is therefore, business organizations in Jimma town. According to the data obtained from Jimma town trade and industry office, there are about 3,060 licensed business organizations of all sizes as of June 2011. But all these are not taken for the study. As the study requires secondary data, only business organizations that keep books of account were selected. According to the data obtained from Jimma town revenue office, of the business organizations available in the town, only 135 business organizations have been keeping accounting records till June 2011.Therefore, the target populations for the study are the whole 135 business organizations. Since their number is small and manageable, the total 135 business organizations were considered for the study. But only 37 usable questionnaires were collected back, which is approximately a response rate of 27%.

In this research, both survey and secondary data methods are used in combination. Survey is chosen as a research technique in this study because it is very useful to investigate financial management practices of many Business Enterprises. Questionnaires were designed and directly delivered to Business Enterprises to collect primary data related to their financial management practices.

Secondary data were mainly used to derive the financial ratios measuring liquidity, financial leverage, activity and profitability of business organizations. The financial statements of the business organizations were the source of such information. The audited financial statements of the selected business organizations for the year 2010/11 were collected from Jimma town revenue office for uniformity purpose.

In developing a causal relationship and testing hypothesis of association, there are two kinds of variables involved: dependent and independent variables. The independent variable involved includes variables used to define the efficiency of financial management practices and variables used to define financial characteristics. Independent Variables Related to Financial Management Practices include efficiency in Financial Accounting, Reporting and Analysis practice, efficiency in Working capital management practice, efficiency in Fixed Asset Management practice and efficiency in Financial planning practice

The efficiency of each of this financial management practices was measured by using ten items on five-point scales in which the respondents were asked to rate where the positions of their businesses are for each item described. On the scale, 1 represents extremely low efficiency, 2 represents low efficiency, 3 represents medium efficiency, 4 represents high efficiency and 5 represents extremely high efficiency. After respondents have ranked the efficiency of financial management practices for each items under each variable, the average of the ten items is computed using Excel for each respondent. The only difference is the efficiency measure for working capital management which is measured in terms of cash, receivable and inventory management practice by raising 10 items for each, which means a total of 30 items for working capital management as a whole.

In addition to the above four independent variables, current ratio, debt ratio and total asset turnover ratio were used as additional independent variables. Their values were calculated from the 2010/11 annual financial statement. In this study, profitability measured by profit margin (PM) and Return on Asset (ROA) are viewed as the dependent variable. Using the variables defined above, the model of the effect of financial management practices and financial characteristics on profitability can be formulated as follows:

PM =f(EARA, EWCM, EFAM, EFP, CR, DR, TAT)

ROA= f(EARA, EWCM, EFAM, EFP, CR, DR, TAT)

Where: PM = Profit Margin

ROA= Return on Asset

EARA= Efficiency of Accounting, Reporting and Analysis Practice

EWCM= Efficiency of Working Capital Management

EFAM = Efficiency of Fixed Asset Management

EFP = Efficiency of Financial Planning

CR = Current Ratio (Measure of liquidity)

DR = Debt Ratio (Measure of Financial Leverage)

TAT= Total Asset Turn Over (Measure of Activity)

In these models, by making some standard assumptions, the above equation can be restructured into linear multiple regression equations as follows:

$$PM = b_0 + b_1 EARA + b_2 EWICM + b_3 EFAM + b_4 EFP + b_5 CR + b_6 DR + b_5 TAT + e_1$$

$$ROA = b_{00} + b_{11} EARA + b_{22} EWICM + b_{33} EFAM + b_{44} EFP + b_{55} CR + b_{66} DR + b_{55} TAT + e_2$$

Where: b_i & b_{ii} (I= 0,1,2,3 …) are the coefficients, ε is the error variable, EARA, EWCM ,EFAM & EFP are independent variables related to financial management practices and CR, DR and TAT are the independent variables related to financial characteristics.

RESULT AND DISCUSSION

Before proceeding to regression analysis, correlation analysis is made to investigate the relationship between variables. Correlation matrixes were used for association analysis to determine whether muticollinearity exists among variables. This was also used by previous researchers such as kieu (2004) and Chung & Chaung (2010). The correlation analysis includes dependent variables such as Profit margin (PM), Return on Asset (ROA) & Return on Equity (ROE) and independent variables such as the Efficiency of Accounting, Reporting & Analysis (EARA), Efficiency of Working Capital Management (EWCM), Efficiency of Fixed Asset Management (EFAM), Efficiency of Financial Planning (EFP), Current Ratio (CR), Debt Ratio (DR) and Total asset turnover (TAT).

Table 2. Correlation Matrix among the Ten Variables

	PM	ROA	ROE	EARA	EWCM	EFAM	EFP	CR	DR	TAT
PM	1									
ROA	.376*	1								
ROE	.341*	.839**	1							
EARA	.486**	.459**	.412**	1						
EWCM	.596**	.476**	.412**	.650**	1					
EFAM	.455**	.445**	.454**	.700**	.506**	1				
EFP	.540**	.418**	.410**	.526**	.624**	.628**	1			
CR	-.367*	-.086	-.012	-.182	-.236	-.054	-.076	1		
DR	-.099	.190	.154	.285	.146	.212	.175	-.221	1	
TAT	.349*	.396**	.167	.527**	.558**	.409**	.369*	-.311*	.367*	1

Note: *. Correlation is significant at the 0.05 level (2-tailed), **. Correlation is significant at the 0.01 level (2-tailed).

Table 2 above shows the correlation coefficient among the ten variables under study. As expected, Profit Margin, Return on Asset, and Return on Equity are significantly and positively related with efficiency in Accounting, Reporting & Analysis, Efficiency in Working capital management, Efficiency in fixed asset management and efficiency in financial planning at a significant level of 0.01. In addition, the profit margin is significantly positively related with Total asset turnover, return on assets and return on equity at a significant level of 0.05. On the other hand, profit margin is significantly negatively related with current ratio at significant level of 0.05. But debt ratio was not found to be significantly related to any of the variables. Multicollinearity indicates a problem in multiple regression analysis. When the independent variables have a high probability of correlation, the regression coefficient becomes less reliable and confidence in the accuracy of the equation is questioned. A general rule is that if a correlation between any two variables is greater than or equal to 0.70, then a high degree of interrelation can be inferred and the possibility of multicollinearity exists (Kieu, 2004). As it is shown in the correlation matrix, the correlation coefficient among profitability and the seven independent variables (EARA, EWCM, EFAM & EFP, CR, TAT, DR,) are less than 0.7 which implies multicollonearity does not exist. In addition, the relationship between profit margin and ROA is not greater than 0.7. But the relationship between ROA and ROE is greater than 0.7 which implies either ROA or ROE should be used in the analysis. Therefore, profitability measured by profit margin and return on assets were used as a dependent variable. Return on equity was omitted because it is strongly positively correlated with Return on assets (r = 0.8390).

Table 3: Profitability Regression Model using Profit Margin as Dependent Variable

R = 0.751 R^2 = 0.564 Adj. R^2= 0.475 S.E.E = 0.1266539

ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.707	7	.101	6.293	.000
	Residual	.545	29	.016		
	Total	1.252	36			

PM = -0.320+0.126EARA +0.248EWCM +0.114EFAM + 0.273EFA – 0.326 CL - 0.320 DR + 0.013TAT

Model	Un standardized coefficient (B)	Std. Error	Standardized Coefficient (Beta)	t	Sig
Constant)	-.320	.156		-2.046	.0490
EARA	.036	.053	.126	.6760	.0500
EWCM	.058	.042	.248	1.378	.0177
EFAM	.026	.040	.114	.6430	.0500
EFP	.038	.023	.273	1.659	.0106
CR	-.020	.008	-.326	-2.671	.0120
DR	-.344	.135	-.320	-2.549	.0150
TAT	.005	.059	.013	.0870	.0931

Source: SPSS Result

Table 3 above reveals that profitability measured by profit margin and the seven independent variables are significantly correlated with the correlation coefficient R= 0.751. The table also reports the model of profitability as measured by profit margin with the coefficient of determination R^2 = 0.564. The coefficient of determination indicated that 56.4% of the variation in profitability for the sample of 37 firms can be explained by the changes in practices of accounting, reporting and analysis, working capital management, fixed asset management & financial planning and change in performance of current ratio, debt ratio & total asset turnover ratio while 43.6% remains unexplained. In addition, the table reports the summary of Analysis of Variance and F-statistics, which reveals the value of F = 6.293 are significant at the 0.0001level. The value of F is large enough to conclude that the set of independent variables as a whole were contributing to the variance of profitability measured by profit margin and therefore, the model represents the actual performance of the firms under study.

As indicated earlier, because total asset turnover was not found to be significantly related to profit margin at a significant level of 0.05, it was removed from the regression equation to improve the accuracy of the model. After removing, total asset turnover and rerunning the regression revealed that all statistical parameters including F-value, t-statistics and standard error of estimates have been improved.

In the second model, return on asset is used as dependent variable while the independent variables include efficiency in accounting, reporting & analysis, efficiency in working capital, efficiency in fixed asset management, efficiency in financial planning, current ratio, debt ratio and total asset turnover. The result of the regression showed the four financial practices and the three financial characteristics influence return on asset with a coefficient of determination R^2 = 0.306. This indicated that 30.6% of the variation in return on asset is explained by the seven independent variables while 69.4% remains unexplained. In addition, the value of F=2.142 is significant at the 0.05 level. The value of F is not high as that of F in the first model but it is large enough to conclude that the set of independent variables as a whole were contributing to the variance of return on assets.

The result of the regression analysis for a test of hypothesis confirm that the four financial management practices and two financial management characteristics are significantly related to profitability of business organizations, but no sufficient evidence was obtained for total asset turnover. The result of hypothesis testing for individual independent factors was summarized as follows

Table 4. Summery of the Finding for Test of Hypothesis

Hypothesis	Result of the Finding
Efficiency in financial accounting, reporting and analysis has a positive effect on profitability	Supported
Efficiency in working capital management has a positive effect on profitability	Supported
Efficiency in fixed asset management has a positive effect on profitability	Supported
Efficiency in financial planning practice has a positive effect on profitability	Supported

Table 4. Summery of the Finding for Test of Hypothesis (Contd….)

Hypothesis	Result of the Finding
An increase in current ratio has a negative effect on profitability	Supported
Increase in debt ratio has a negative effect on profitability	Supported
Increase in the total asset turnover ratio has a positive effect on profitability	Not Supported

CONCLUSION AND FUTURE RESEARCH

In conclusion, the empirical finding implies that factors of financial management are good tools for improving enterprise's profitability. This finding leads to the conclusion that the efficiency of financial management practices and characteristics can bring about higher profitability. Therefore, business organizations can improve profitability by raising the efficiency of financial management practices and characteristics. Sound financial management is essential to the success of businesses organizations. Successfully managing financial resources is important in new as well as expanding business. So time should be taken to develop and implement financial management practices that ensure success of business enterprises. In addition, a more comprehensive survey throughout the country was suggested as a future study area to come up with country level conclusion.

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