# Working Capital Management

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## Lecture-31
## Motives of Credit Sale-I

Welcome students so we are in the process of learning about the management of accounts receivables and in the previous class we learnt about that how to select the channels of distribution and we have seen it with the help of a small example that both direct and indirect channels can be used by the firms for distribution of their products. But in the modern competitive scenario it is better to use the indirect marketing channels because that has multifarious advantages as against the direct marketing and one important thing is the reduction in the cost which can be passed on to the consumers right.

So, now in the next the current discussion we will be now knowing something about that why receivables are to be extended by the companies or why they should sell on the credit right. What are the motives why company sell on the credit? See we have two side one side is a seller another is a buyer. And both have the different motives I told you sometime in the previous classes that the motive of seller is that he wanted to maximize the sales and when it is not possible to it maximize the sales on cash then he can think of selling it on the credit this is a direct one objective.

But there are different motives of the sellers so I will come to you on those say motives of the sellers. But first we will see that what is a motive of the buyer and what is the motive of the seller. Whether it is buyer or whether it is a channel of distribution maybe the retailer or the wholesaler or the distributor wants the goods from the manufacturer on credit and that was that a sales are made and the amount is collected from the buyer's. Then it can be paid back to the company. So, let us talk first about the buyers motive that or the customer's motive.

May be it can be anything but largely if you are talking about the customers, customers motive is buyers motive is that he wanted to minimise the say present value of the money. When he wanted to make the payment when he wanted to make the payment longer the credit period and when he makes the payment after the end of the credit period at the end of the credit period so time value of money goes down and he is whatever he is a paying to the seller or may be the retailer or may be directly to the company he is paying much less of the price.

So, his motive is the maximization of the say you can call it from his side minimization of the time value of money or maybe paying lesser rather than say maximizing the time value of money he wanted to minimise the time value of money he wanted to pay less he wanted to delay the payment and delaying the payment is directly helping him. This is the one motive that he wants to buy the product in between if she talked about the channels of distribution by they want to buy on credit from the manufacturer.

Because they are not sure that directly if you are buying say 100 colour TV is today from the manufacturer and immediately they will be sold in the market they have to be stored they have to be kept for some period of time. So, he has two options strategy can invest his own money and then you can say keep the stock and then sell in the market and at the later date when it is converted into sales that he can pay the make the payment.

But in many cases if not be possible so for him because of the lack of availability of the funds he would like to buy on credit from the firm and once it is sold in the market you like to make the payment back to the manufacturer to the company because here we have to understand one important point, when we talk about the easy availability of the working capital finance from the banks even in India that is possible in case of the manufacturers.

Manufacturers has a easy access to the working capital finance whether it in the form of CC limits or in the form of the working capital loans or in the forms of say you are discounting of the credit sales bills that is only available to the manufacturer not to the middleman and say the channels of the middleman they have to invest their own funds. So, the formal market the organised sector financial sector or the organised lenders they are not available to the channels or channels of distribution or to the state distribution network.

They are only available to the manufacturer, manufacturer can have CC limit also manufacturer can have the loans or the manufacturer can have the bill discounting facility also. But the middleman the distribution network has two dependent be dependent upon the unorganised sector. And when they are dependent upon the unorganised sector then the financial market tariff is very high for them. What is a financial market tariff?

I will discuss that also but here in this case we will talk about that financial market tariff reproduce very high for him that why would he like to buy on cash. His objective would be that to buy on credit from the manufacturer keep it till the time it is sold in the market and once the material goes to the customer and he pays in cash he can remit in the company's part to the company manufactures part to manufacturer and his own margins can retain.

So, this is objective buyer want to pay minimum so, he wanted to delay the payment so that the net present value of the money is make in the present value of the money he is the payment is making that is minimum he wanted to minimise the present value of the payment which he is making and that is possible after delaying the payment. As per the distribution channel is concerned their objective is that rather than investing their own funds they should buy the materials are the goods on credit from the manufacturer.

And after selling it in the market to the customer and recovering the cash he can pass on the payment to the manufacture. Because for the distribution network organised funding is not available he has either depend upon the unorganised market or even if from the banks the funds are available they are at a very high interest rate. So, his financial cost increases that is financial cost increases because of the increased financial market tariff then he is in trouble.

So he does not want to say be in the trouble and he does not want to say put himself in that kind of the situation. So, his objective is to buy on credit from the manufacturer. And sell it to the customer on cash in between recover the funds and paid back to the company and retain his margins. These are the three important stakeholders and if say a buyers will be the distribution network or maybe the customer.

Their objective is that they want to minimise the present value of the money which they are making the payment may be the buyer making a payment to the distributor or distributors making the payment to the manufacturer. Now come to the next side that is the objectives of the manufacturer's. Why are motives of the manufacturer's, why they want to say give the credits are they want to sell on the credit why they are extending the credit or by their creating the accounts receivables in the balance sheet?

They have already seen that this asset is also we call it as asset but to create the receivables in the balance sheet and generate the funds to fund the account receivable it is a cumbersome task. And ultimate is the sales are the credit sales not cash sales. So, in that case maybe it is possible that they are going to recover the sales fully which are made on the credit or part of the sales maybe the bad debts also.

So, but still they sell on the credit because we have already concluded agreed upon the discussion and finally we have concluded that selling everything on the cash is not possible in any business world. So, we have to extend the credits a part of the sales go on cash and part of the sales go on credit. So, why they sell it on the credit maximize the sales or maybe entering into the new market or maybe any other objective.

So, here for our discussion I have divided the manufacturers motive into three broad components.

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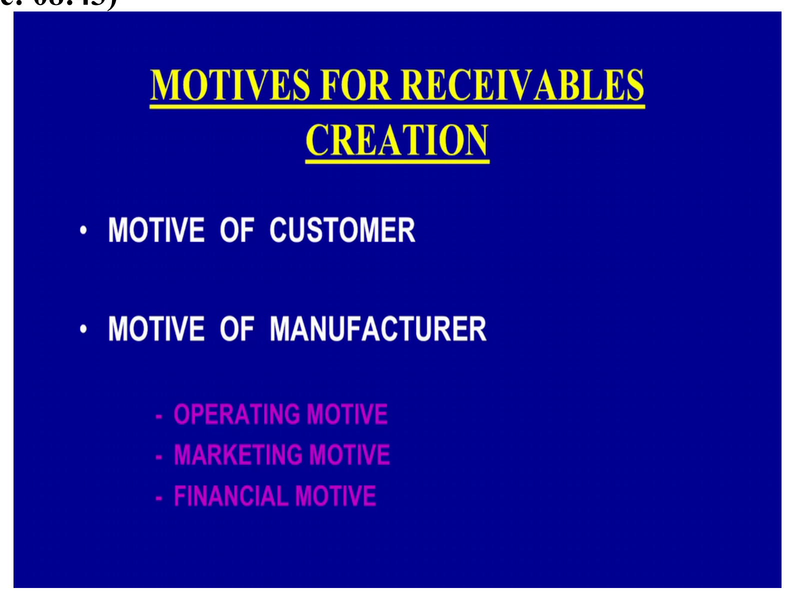


First component is the operating motive second component is a marketing motive and third component is the financial motive. One is from the operations point of view he want to extend the credit and other is for the marketing point of you he want to extend the credit and third one is the from the financial angle he wants to extend the credit because by say selling on credit sometime he can maximize his return on investment that is why maximizing the sales when he is selling on cash + credit that total sales go up.

So, his revenue increases his profits increases doing this process it takes a lot of risk. So, let us talk about these motives in detail. First we will learn about the first motive that is operations of the operating motive and here the reason for extending credit in the market for the manufacturer's that there can be different situations in the market.

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One is adjust manufacturing process second is because of the varying prices of the products third is formation of the customer queues or product queues and fourth one is allow receivables. Now he has a four options right he has four options available and which one is more suitable to him, which one is more useful to him, as a manufacturing he would go for that right. He will prioritise all these options and which one is more useful and suitable to him to go for that.

So, first one is a adjust manufacturing process see when we if it is a seasonal industry then certainly there is going to a problem and if it is a normal a product still that is subject to the cyclical trends of the market sometime sales pick up and sometimes it go down sometime there is a week period sometime lien period. So, in all the period he has to maintain the sales and say when we talk about the festival season in India the sale of electronics go up.

The sale of your automobiles also go up, people like to buy during festivals. But when festival season is not there still they have to maintain the sales. So, maybe people are postponing their sales or they are not interested to buy but in that case means manufacturing has to go on. Because otherwise but will happen his option is that if you want to sell on cash only he will produce he will manufacture maximum and when the sales go down then he has to minimise.

So, he has to stop the production or he as to lower down his production. He has to minimise the production in this entire process what he is doing he has to adjust is manufacturing process very,

very frequently. And adjusting the manufacturing process very, very frequently is not possible. If it is not possible in that case if some production is going on at the same phase. But sales decline in the market because of any reason then what will happen the inventory bill mount and when inventory bill mount in that case is cost of maintaining and managing that inventory will also go high. It may be possible tomorrow that whether he is able to recover that cost from the customer of sometime it is not.

So, his option is either to adjust the manufacturing process if it is not possible to adjust the manufacturing process then what is option either to raise the inventory or sell on credit in the market. If he is raising the inventory to avoid the say the non recovery of the credit sales in that case he is increasing cost. And cost is normally cost increases because of the carrying cost handling cost all these cost. But sometime the cost is because of obsolesces also.

Some of the material is sold in the market today and sold at a later date then there is a say we can call it as a reduction in the quality of the product, so that is the problem, so he has option either to adjust the manufacturing process at the time of peak sales produce maximum at the time of lean sales for the lean sales produce less produce accordingly. So, what is the option if it is easy for him to adjust the manufacturing process he would be the first person to do that and to sell on credit?

But if it is not possible then what is there, either to mount the inventory or to sell on credit in the market because people are not ready to buy on cash that network distribution network is not ready to buy on cash and in that case either to give the credit. If he is giving the credit, if he is selling on credit so what he is doing converting his one current asset that is inventory into another current asset in to accounts receivables.

Because of the credit sales though cash is not there, he is not receiving cash. He is converting that into another asset. But when his converting that rather than from inventory to accounts receivables if you prefer secretion of accounts receivables then in that case he is passing on almost all kinds of the risk to the distribution network or to the customer. That if he is not mounting inventory it is going to the distribution network, distributor, wholesaler or retailer then it is his job now to maintain and to keep the stock with him.

And for example he is passing on the product even to the customer on credit to his customer not got the cash. But he has passed on his delivered the product to the customer and customer is bound to make the payment to him at the end of the credit period. So, the choice is always with the manufacturer, so this is the first option that either to adjust the manufacturing process or to sell on the credit. There is nothing useful to by building the elementary because that way he is creating the problem for himself.

And sometimes it happens that even selling on the credit is also not possible selling on the cash is also not possible selling on the credit is also not possible for some companies for some product for some period of time. For the time being the problem comes in that case the option is that if adjustment of the operating or manufacturing process is not possible then manufacture and store then inventory will start mounting.

I am sure that you are sometime in the past also have discussed with you the story of SAIL Steel Authority of India Limited in the late 90s when the company had to say company face the stiff competition from the private sector companies from the Jindals, Lloyds then Essar Steel. So, because before 1991 steel sector was used only open for the public sector players not for the private sector manufacturers.

But after 1991 after liberalisation of Indian economy when this was opened up for the private competition of the private players the steel sector was opened up for the private manufacturers or private companies. Then SAIL had to face a big competition from them and as a result of that the immediately lost market. Further market was nest by the Jindals even they were in the north also in central India also best market went to the ESSAR and Lloyd. So, it means almost you can say that 40 to 45 % market they immediately lost.

Now you see SAIL is a big company India manufacturing steel and having 6 plants and lakhs of employees and a big network and big setup. So, for SAIL it is not possible to not to produce and adjust the manufacturing process that with the sale can do but what will happen that there are thousands of employees who were working on the regular basis. Their salaries have to be paid they will come to office; they will come to the plant, if there is no production for this reduction in the production.

So, what that additional work force will do, there on the permanent or the regular rules so what the company had to do you have to continuously go for the production. But when the production was continued but sales got declined because of her they lost the sales in the market for what is a way out. Even if for sale people were not ready to buy the company's product even on credit. It was not possible even for the company sell the product on credit either to the distribution network or to the customers.

So, only option that left at that company at time to the company was that to store the product finished goods. Finished products and ultimately that caused the mounting level of inventory and when you see that when the production is continuous for sales have got stuck or they have half from the 100% market earlier if it is reducing by 40-45%. Then what is happening It means is a big problem for the company which is a very large public sector company and immediate suddenly they lost their sales.

So, only problem to the company which the company even faced and facing even today is that the company's financial health will get this deteriorated. And slowly and steadily the company will become sick organisation and if that problem is not resolved as early as possible then ultimately it may be required that company has to be closed down. So, sale is since then SAIL is trying hard to become a profit making organisation or to see come out of the situation of the; you called as state of sickness.

But that is not possible because Steel sector is open now for the private participation private competition they have better product lesser price is better distribution Network and sale being a public sector company lacks all these kinds of capabilities. So, there was a problem that despite the fact that company wanted to extend the credits it was not possible that nobody was ready to buy company's product on even credits only option was that production means no adjustment in the manufacturing process possible so produce and store.

So, it means inventory started mounting that caused the sickness of the company which event today still it is going on and even today the Steel Authority of India SAIL is a loss making company. So, that is the problem we face so it means first option is even you are just for manufacturing process or do something else. Second varying prices of the products see when the company sell on credit. When some companies their first objective is to maximize the market and retain their market position or expand the market position.

After sufficiently selling for cash when they decide to sell on the credit this is the precondition and it has to be mutually agreed by both the side's buyer and seller also that the product being sold on credit will not be sold on the price as it is being sold on cash. It means the credit period which is being given or being allowed by the manufacturer to the customer or to the distribution network that will be loaded with their price will be loaded with the interest component which the manufacturer is supposed to pay to the lender from where they got the funds through from the credit sales.

And if it is their own resources it is coming from their own resources that it also has the opportunity cost. Two prices cannot be same cash price has to be different and the credit price has to be different. Now sometimes company gives the offer that ok if you want to buy from us on cash will pay you delivery at this price. But you want to buy on credit will give you on this much. So, varying prices are offered at that in that case the seller is also not at loss.

The manufacturer is also not at loss one thing is that his maximizing he sales, he is maximizing is market or the market where he is in companies in that is retaining its market share. So, cash sales or cash is immediately coming as the delivery of the goods takes place. But in case of the credit sales they are loading the price basic price with the interest component which is either a opportunity costs or the cost of the capital they have to pay which is used to fund the credit sales.

So, varying prices are there, so they vary the prices and whichever the price is acceptable to the customer on maybe the distribution Network at that they sell the product. But in both the cases first the company's option in sell maximum of the cash after that now when the cash buying on the cash capacity is over of the buyer and the distribution network then after that the story of the credit sale begins and then that is sold at the varying prices.

So it means and here also varying price means depends upon the credit period. Somebody wants a Credit period of 10 days price will be different; somebody wants the credit period of say 1 months price will be different and the company has a standard policy of giving the credit sales for a period and maximum period which the company has decided his 2 months then the price will be different for 2 months.

But in every case company is able to maximize it sales retains its market share and company is able to recover its price also that the basic price inclusive all the cost plus interest cost also so there is no problem to the company. So, if you want no credit you pay different price you want some credit view pay different price you want a moderate credit you pay a different price and if you want the longest credit of 2 months you pay different price.

So, depending upon the market requirements companies opts to give the credit and that is causing the selling the product of the varying prices. But in any case company does not want to keep the product in the warehouse they do not want to mount the inventories. This is always advisable to sell on the credit so that is one option available with the company this is the second option. Third option is formation of the customer’s queues or the products queues.

Now for example if the company is adjusting the manufacturing process somehow. So, and the production goes down because there is insufficient closing stock of the closing inventory and immediately for example the demand picks up what will happen company has adjusted the manufacturing process they have minimise the production and whatever the material is there in the warehouse in the in the inventory.

If for example immediately that also goes to the market so then there will be the problem of the customer queues. People want to buy the product as and when they wanted but the product is not there with the company so customer’s queues will be there which is also not good for the seller. Because it will create the out of stock on the stock out cost so that is also a not good for the for the for the manufacturer's which means they want to go for the regular manufacturing process sell on cash as well as on credit or some time there is a product queue.

If they do not adjust a manufacturing process what will be there, there your product queue and product queue what will do it will mount the inventories. In both the cases company has to see that there is no loss of reputation there is no loss of revenue there is no loss of profitability and their ROI is maximized. Out of these first three options last option is Allow receivables. So, it means adjusting manufacturing process is also not good. If they do it then either they will customer queues or product queues and varying prices if it is possible.

Again then the outcome is selling on the credit that if when buying on cash capacity is over may be for the distribution network for the customer then they would like to buy on credit and companies have no other option but to sell on credit. So, because of this just these ultimate that the bottom line is companies want to run their operations smoothly. Low fluctuation in the operating process is desirable, no ups and down in the manufacturing process is desirable.

So, if this was a situation of this kind of the situation is there then they have to resort to selling on the credit so that production is continuous sale is continuous inventory is minimum and there is no either the customer queues or the product queues. So, operations allow credits. Second motive can be quite interesting motive can be marketing motive. Now marketing motive is also there because ultimate purpose of every company is to manufacture and sell maximum in the market, expand the market.

So, if we are in one market if we want to go to the other market because they are different market geographically also and other wise also different segment of the market demographically also different segment of the market. So if you are in one market we will move to the other market say we are an Indian company we are operating in currently mapping for three states.
Now we have thought that we have reached that is saturation point in 3 states. Now let us move to the fourth state, 5th, 6th, you want to enter three more states initially the product may not be possible to be sold on the cash and to beat the target of the company what they do they give the credits. They develop the habit to the distributors also and among us the buyers also.

And when the people start buying this company's product that people start buying this any companies product in the new market maybe for the first time then and if they like the product then there is a demand for the product and after that company may reduce the component of credit sales and company may increase the component of cash received so for example we will discuss.

A small story of you might have heard about a product which is detergent which is washing powder and the brand name of Nirma. Nirma then it was for the first time developed the product was manufactured in developed by Mr. Kersanbhai in Gujarat. Initially he thought of developing this product and he developed it also he was not sure about whether should be acceptable to the people in the market or not. So, because he had to face a big competition from the multinational company named HLL at that time it was HLL today it is called as HUL Hindustan Unilever it at that time it was Hindustan Lever Limited.

So, he was expecting that at that time the largest market share of the washing powders and cakes hospital was with the HLL or HUL. And if this kind of the product comes in the market because at that time to the premium segment HLL was providing Surf and for the lower segment they were providing one product which is named which was named as sunlight, sunlight. Even the sunlight was beyond the reach of the common man.

So, that Kersanbhai thought of develop a washing powder which is a comparable to sunlight not at least Surf and if I price it means at the lowest possible will that would be acceptable to the people. So, he developed a product and he started distributing is free of cost. First he distributed to his neighbour then in his own street where he was living. Then when the response was very good he started giving it to his say relatives and some other near and dears.

And everybody responded very well response was very good who got wonderful then he started formally selling the product in the market. So it means initially it is free sale and then when the product was accepted and it was successful in the market now you see today then NIRMA is where the NIRMA is a popular brand name of India. But they have started with a story by selling the product free of cost in the market.

So, here we are talking free of cost sometime very big companies also do they start selling the product for passing on the product to the customers free of cost or sometime then move to the next level that selling on credit and once the product is established in the market there is a sufficient and significant market for the product after that then they change the proportions of cash and the credit sales. One thing is as a marketing motive to break into the new market or the competitive market we have to sell some time more on credit less on cash and the position can be replaced later on.

Second is monitoring and carrying cost will go up that when we are going under the marketing motive and selling more on the credit? There has to be a specialised department of special department to be created in the company which is known as the credit sales department. Because when you are selling on credit you have to recover that credit sales also. So, to receive the orders pass on the orders means meeting their requirement of the people that maintaining the total records and then preserving the invoices.

And then say sending the notices when the payment is due if it is not paid by the buyer and then making sure that yes on the payment is received on the due date. And all these things have to be done the companies have to create a specialised department which is known as the credit sales department of the debt collection department right so the cost goes up that has to be; there that cost will go up certainly that cost will go up.

But anyway when you are prepared to sell on the credit the companies are prepared to have that department also because selling is one part for the collecting the credit sales is another part and people who are doing this job only for that we have to pay with the specialised department. So, what will happen the cost of the credit sales will go up? That is why I am telling you prices are different for the cash sales the price is different and the credit sales the price is different.

But to deal with this cost component part companies normally treat it as the promotional cost because otherwise also the company has to spend on advertising of their product. So, partly they can advertise it in the market and partly the cost of maintaining a sales collection department or debt collection department plus some other costs associated with means the financial cost is used as the loading factor to recover the cost of capital.

This total cost can be treated by the company as the promotional cost of the promotional expense or advertising expense or maybe that every company has the advertising budget. So, that the part which is being say required by the company to beat it say maintaining the sales collection department or for say recovering the cost of capital that can we met and if any amount is left that that can be used for further advertising the product in the market.

So these are the two motives operative motive and the marketing motive for selling on the credit in the market for extending credit in the market and creating accounts receivable. We will continue the discussion for the most important motive is the financial motive that I will discuss with you in the next class thank you very much.