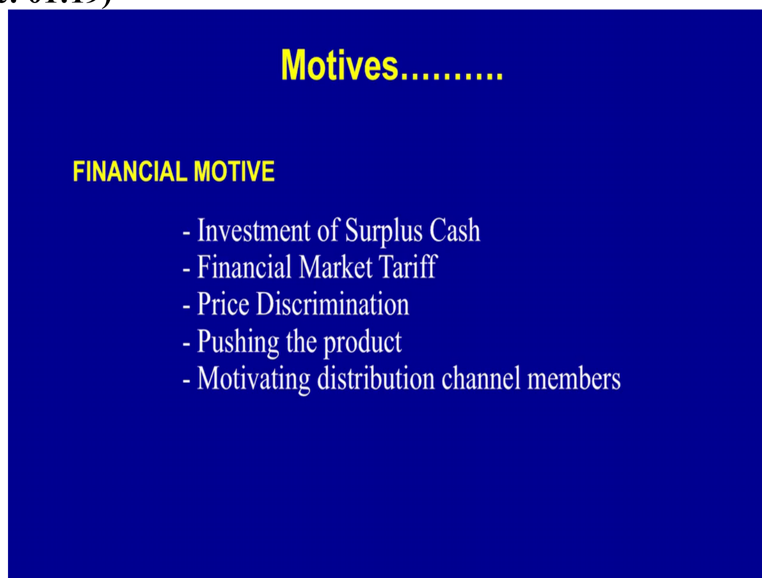
Working Capital Management
Dr. Anil K. Sharma
Department of Management Studies
Indian Institute of Technology-Roorkee

Lecture-32
Motives of Credit Sale-II

Welcome students so we are in the process of learning about why manufacturers extend credit and what are the motives. So, we learnt in the previous class about the operations related motive that is operating motive and the marketing motive. Let us talk about the very interesting motive very useful motive for which they maximize their sales all they sell on the credit that is a financial motive. In this financial motive because ultimate purpose of any business is maximization see value of the firm that maximization of the wealth and that happens to the maximization of the value of the firm.

So, when we are selling in the market may be in cash or on credit ultimate purpose is a maximization of return on investment and that is possible when you self maximum in the market.

(Refer Slide Time: 01:19)



So, financial motive is first important motive is that investment of surplus cash. Sometimes when the companies have surplus cash in some when the companies of surplus cash they have to invest that cash somewhere. Because keeping cash, cash is another current asset and we have already learnt about that have keeping cash as cash is not useful it as a cost. So, it means that cash should be moving within the organisation or out of the organisation within the firm or outside the firm if

it is in the movement it is productive if it is stagnant if it is stopped if it is not doing anything then it only has a cost it has no returns.

So, sometime when you have surplus cash and you weighed different options where to invest that cash then this may be very one very useful option that why not to manufacture more sell on credit, load the credit sales with the interest factor and if they are able to load the credit sales with the interest factor which is little more than the other options available or other avenues of investment available then it is always useful to sell on credit.

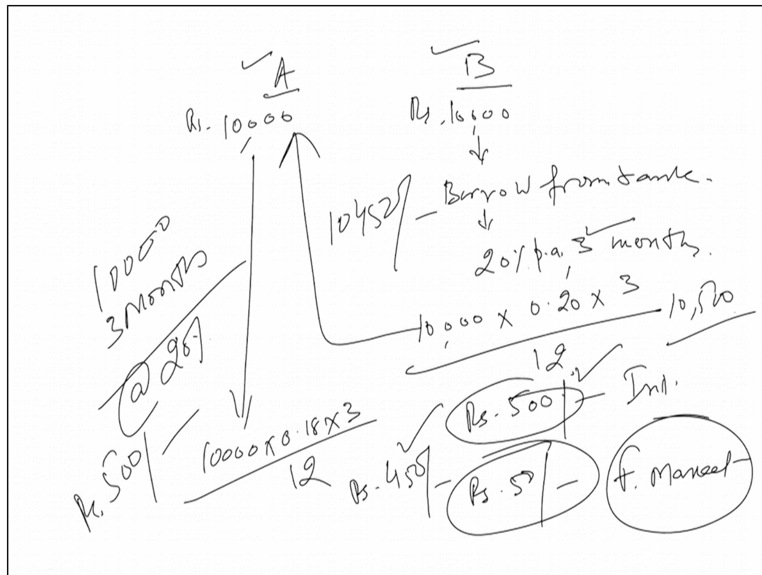
Invest the surplus cash in the credit sales and maximize the sales, maximize the profit and maximum the returns. First motive because we well we have surplus cash within the company we will have to look for that way to invest its cash. If it is not desirable when to sell on credit say for example if the buyer or may be the distribution network they are not ready to pay the interest cost or they are paid that the interest cost which is returning back to the company.

It is much less as compared to the other avenues of investment of the cash then it is no point in investing into the say credit sales and then increases the sales because I return on that investment is not comparable with the other revenues or at least not more than other revenues. That it is always advisable not to sell on credit and not to invest surplus cash. But if it is advisable or if it is useful then this is the first motive surplus cash has to be reasonably or rational invested somewhere and one important option is invested cash in the credit sales that has the multiplier effect.

Your market increases your sales increase your existence in the market goes up and ultimately your cost is recovered your say price is recovered and recovered with the profit, so companies profit loss increase and ultimately this is a purpose of business that we use the cash as the capital and if that is available then there is no problem and we can maximize the sales by selling on the credit because we have surplus cash to invest.

Second reason is again very, very important and interesting reason is the financial market tariff important reason is a financial market. Now what is financial market tariff I will discuss with you with the help of a small example say there is a two parties one is the seller and that is manufacturer we call that is A

(Refer Slide Time: 04:40)



And here is the buyer that is B right, A and B he is a manufacturer and he is the seller. B wants to buy goods worth rupees 10000 from this, this 10000 from this, this is a requirement and A says to B that I am ready to sell you but pay me on cash, I am ready to sell you for 10000 rupees but you have to pay me on cash. He is not agreeing for the credit sales. B want to buy the product at any cost but he does not have that 10000 rupees in cash in hand.

So, what will happen we will borrow this money borrow these funds from bank, bank is one important player in the financial market. And bank charges 20% rate of interest and the credit period is 3 months in this case now how much interest B will pay to A sorry B will pay to the back. Like borrowing 10000 rupees from the bank at the rate of 20% per annum just 20% per annum and the credit period which he wants the credit and he want to buy the goods on credit is 3 months.

In this case if you calculate this will come out as how much 10000 into 20% into 3 by 12 right. So, how much this works out this will work out as say rupees 500 for a period of 3 months by borrowing 10000 rupees from the bank at the rate of 20% per annum he ends up paying 500 rupees to the bank as the interest charge. Now these 10000 rupees he will pay and he will pay to the A. A will get the cash.

When you see A will invest that money in the bank for example he has no other option he invested money in the market and you know it that there is a difference in the interest rates between the lending between lending and borrowing money banks get the deposits the pay lesser the rate of interest on deposits. And when the lend as a loan which are high rate of interest. Here

for example this 10000 rupees again go to the bank and this again goes to the bank and it is 10000 rupees A is investing in the bank and bank for example pays him 18% rate of interest on how much period is that is 3 months and this is the situation.

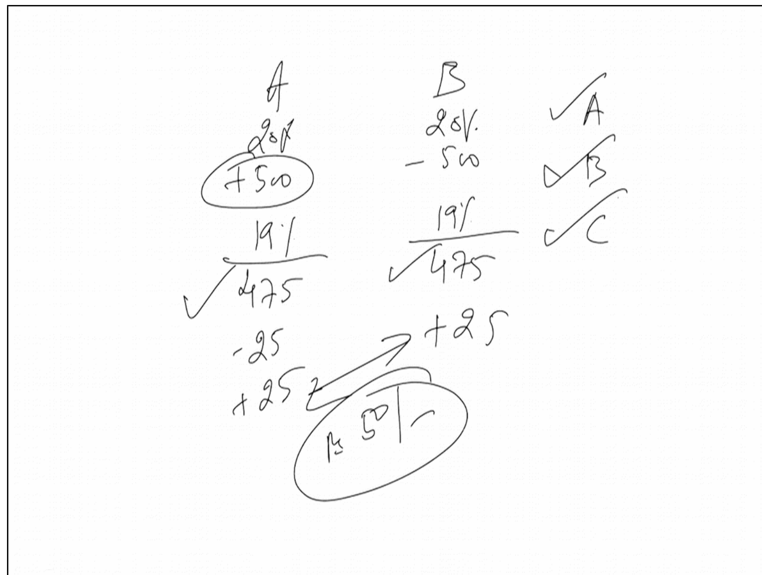
So, in this case if you calculate this how much is amount works out is rupees 450. This 500 rupees which B has paid to the bank and then he paid 10000 rupees to A by boring the money from the bank, A has invested that money in the bank and has got interest on deposits at the rate of 18%, I am telling 18% the difference is 2 but it can be more in the practical situation. So, here means there is a loss of 50 rupees sorry loss of 50 rupees.

This is a loss of 50 rupees to whom to both the sides rupees 50 both the sides. He paid 50 rupees more he got 50 rupees less who got this 50 rupees financial market. This money has gone to the financial market so to avoid the financial market tariff what they could have done is so that nobody is losing this 50 rupees what they could have done is A rather than because A knew it that I have to deposit this money in the bank and I will get 18%.

So, why not I should extend the credit to B and these 10000 rupees sales I will make on the credit period of 3 months at the rate of 20% interest. So, at the end of 3 months he would have ended up getting 500 rupees more. But he did not agree for that then you got 10000 deposited in the bank got the return 450 rupees ultimately both lost 50 rupees in this process and that 50 rupees is going to the financial market.

Option would be better option could be that you could have extended the credit 20% by loading 20% so it means at the end of 3 month important got 10500 rupees. Now how much is getting his getting 10450 rupees, how much is paying? He is paying 10500 rupees back to the bank better option would have been formally remains.

(Refer Slide Time: 10:30)



That again AB, A is loading with that 20% and again B is loading with the 20 % he is getting 5% and he is pay 5; he is getting 500 he is paying 500 or maximum if they want to help each other A could have reduce the rate of interest to 19% he will also be 19%. In this case what would have been the situation A is getting 475 rupees he is paying 475 rupees so to say little loss to him. As compared to this figure there is a loss of 20 rupees but it is a gain of 25 rupees but it is a gain of 25 rupees as compared to the this situation.

He would have ended up getting 475 rupees but he has not agreed for that and got 450 rupees and in this case he also lost 500 rupees so it means 50 rupees in this case both would have easily agreed loading the 19% he also getting something, he is also getting something, he is getting 475 he is paying 475 of 25% of 25 rupees both the sides that could have been the better option. So, to meet these objectives and to avoid the funds to be lost in the financial market tariff as in this case we have seen that rupees 50 are lost in the financial market receivables or credit period they have extended by the companies by the manufacturer's to the customers.

This is the financial market magic of financial market or this is the concept of financial market that how we have to avoid the financial market tariff and to avoid the financial market tariff A extend credit to B and either at the credit period which the B A wants or sometime mutually agreed credit cost, cost of capital and for the period and so in that case is either A gets benefited or B have to pay in anyway the 500 rupees for both of them are getting benefited by 25 rupees.

So, A is getting 25 rupees more as compared to the returns from the bank B paying 25 rupees less as compared to the interest is paid to the bank they both could have enjoyed but nobody has

enjoyed in this case because that 50 rupees have gone to the financial market as tariff. Then is the price discrimination people say that best way to increase the sales as well as the returns on the sales is, you can sell it both ways cash on credit.

What is the best base you sell both ways cash also and credit also? As we discussed in the previous class also that first objective is selling on cash and if people who are the buyers are the parts of the distribution network, if they are ready to pay the increased price so what is the harm? Yes firm has to calculate the risk possibility of converting those credits is into the bad debt that has to be taken into account. We will have to evaluate the worth of that buyer.

Financial reputation of the buyer should be known to the seller and if the financial reputation is acceptable or the credibility of the buyer is at the acceptable level is no harm because he is ready to pay the increased price so you can easily discriminated the price and you have the justification as a seller. I am selling on the credit I have the right to load my credit sales with interest factor there is no point people were ready to buy on cash sell them at the cash prize.

People were ready to buy on credit price and sell them at credit price and everybody is happy in that case that is another motive for pushing their products. Naturally we have to push the product in the market of course is the product in the market. So, here people say that if you want to maximize the sales or you want to avoid the situation of mounting inventories it is better to sell on the credit always provided your buyers on the credit should be enjoying a good financial reputation.

So, you have to rate your buyers A, B and C, A means excellent buyers and I mean excellent reputation. B means moderate or acceptable level of financial credibility and C means poor. So, we can have a credit policy like there is no restriction of credit to the A then here also we will have to be say some judicious means we have to take care of all the factors. In case of the C we have to be selective careful and we feel that we can expect some bad debts.

But even after adjustment for some bad debts, so if you if you can make the sales it is not bad. To here you can say when you are selling to A you can charge the different price when you are selling to B you can charge different price and since here your taking the maximum risk by selling to C who has a doubtful credibility in the market you can increase the price. So, we are

serving the needs of both all the three customers are you sell maximum to him, you sell moderate to him, you sell minimum.

So, that way you can manage the risk but not selling in the market on the credit. If it is possible that our capacity is production capacity is fully exhausted and we are able to sell maximum cash and part of the credit sales to A and to the B only. Then there is no point to sell to C that is okay accepted. But if there is no problem in the production process and we can produce as much as possible then certainly we should weigh this option that if the risk is wroth taking or the quantum of the risk we are going to take.

If it is calculated risk you must take this is this risk that way as I told you that selling on the credit and maximizing the market as the multiplier impact. Your increase prices will increase markets increase the sales may be when we are selling to the C categories if example 5% of the credits has become the bad debts. Then what makes the difference that be loaded with such a high interest cost that even 5% of the bad debts are not the bad debts in the real sense.

So, you should think of; so for pushing the product in the market we can do this kind of the say calculations. And if we are ready to seller to take the calculated risk we must take this risk that will give us the multiplier effect and we would have many advantages by expanding the market. Then we have the last motive that is a motivating distribution channel is a very critical point. See in the market distribution channel distributors, wholesaler and retailer especially retailers the last channel and directly connected to the customer.

They act as retailers agents of buyers not as agents of sellers because he is more concerned about customer. He is more concerned about the well being of the buyer. So he would like to serve his customer in the best possible way or in the way in which the customer feels happy and always he remains is permanent customer, he does not become is formal customer. So, whatever he is going to sell to him or he is going to advise to buy from him that he would always keep in mind the buyer's interest not the seller interest.

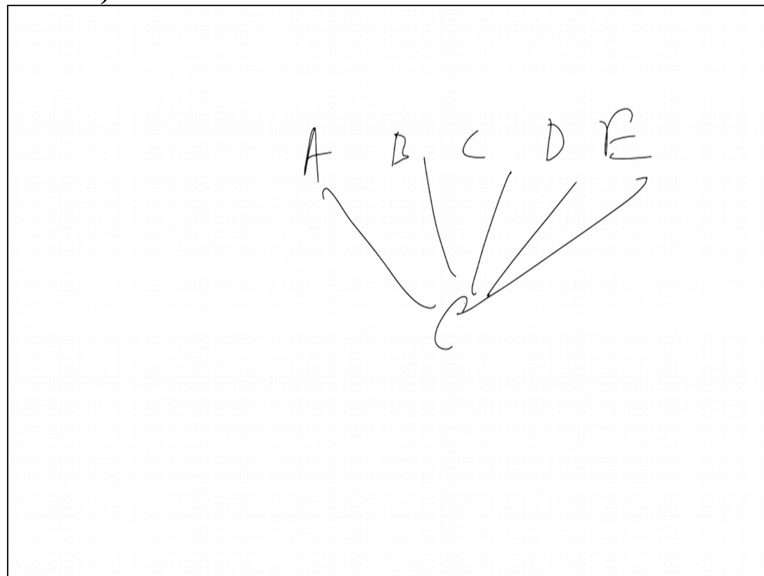
Because sellers are multiple buyers also multiple but he can afford to lose the seller but he cannot or he can afford to lose the manufacturer but he cannot afford to lose customer. Normally the distribution channels especially the retailers who are directly connected to the customers they are the agents of buyers not the agents of sellers organised sectors. In that case now if you want to

change as a manufacturer the retailers loyalty towards manufacturers if you want to shifted from the buyers to the customer to the manufacturer then what we have to do.

We have to give him the credit we have to sell him on the credit we have to give him the option that ok you keep the product and sell it in the market and we will give you this much incentive or you enjoy the credit period for 2 months and after 2 months you can remit the price of this, this, this is much of the stock back to us. From this case what can happen the company which is giving him the maximum credit period and maximum other incentives, maximum credit period and the maximum incentives he would like to sell that company's product in the market.

There are the companies who are not otherwise finding the market so nobody customers are not intended to buy their products. But when we go to the market with the mind fully prepared if you want to buy this product of this company this variant. But there at the shop of the store the seller changes your mind set or the retailer changes your mind set you buy this once more useful as compared to this and many times we change the decision, so, why he is doing all that.

(Refer Slide Time: 20:59)



For example if he is selling 5 companies product, if he is selling the 5 products of 5 different companies such A, B, C, D and E there for him whether the customer wants A, B, C, D or E or is highly affected because A is also giving him some margins B he is also giving some margins C is also giving some margins D is also giving me some margins E also giving some margins. But where he is having the maximum benefit you would like to put that product to the customer and he would like to help the company that you buy this company's product.

Why because of number of incentives and one important incentive is that his gaining maximum by buying on credit keeping the stock, selling in the market remitting the payment after 2 months? So, it means experts say marketing experts say that is not only that you can buy the retailers loyalty by giving the financial incentives you can buy the retailers loyalty by give him the maximum credit, credit period also.

That is also possible you can do that and the companies who are giving him maximum credit period or companies who are selling to the retailers or to the distribution networks on the credit they are successful to sell more in the market rather than the companies who are not giving any credit who are giving minimum credit for the minimum period of time then the retailer has no incentive.

So, you would say it is your choice you go for A B C D or E he is not bother about that. He want to sell the product make sure that customer goes with the product. He buy this this this this product is not bother about that. So, this is one important say conclusion that by giving the extended credit period and at the acceptable rate of interest of with the loading factor the companies are manufacturers sometime they can shift the loyalty of the retailers from the buyers to the manufacture.

Then he will have the reason to act as a agent of the manufacturers rather than acting as agent of the customer. He can convince the customer so he is gaining from both the sides he is selling the product also and he selling the product of the company which is giving maximum credit period apart from many other incentives giving credit can also be reasons that how to maximize the sales or how to help the retailer to change loyalty from the buyers to the sellers.

So, these are the different motives we call it as investment of surplus cash, we go sell in the credit, financial market tariff understood, price discrimination is the one important reason pushing the product and maximizing the sales in another reason and motivating distribution channels for channel members is the another important reasons. These are the three important motives buyer, sellers or manufacturers extend the credit and why they are selling on the credit in the market.

So, first go for cash and after that credit and credit and cash both makes a total sales when is the profit and loss account of the companies they only show the total sales did not bifurcated in cash

or credit so in that case it total sales maximization of the sales maximum presence in the largest market and gaining or retaining the largest market share right.

(Refer Slide Time: 24:40)

LIMITATIONS OF CREDIT TIME

- MARGINAL COST CONSIDERATION
- TAX CONSIDERATION

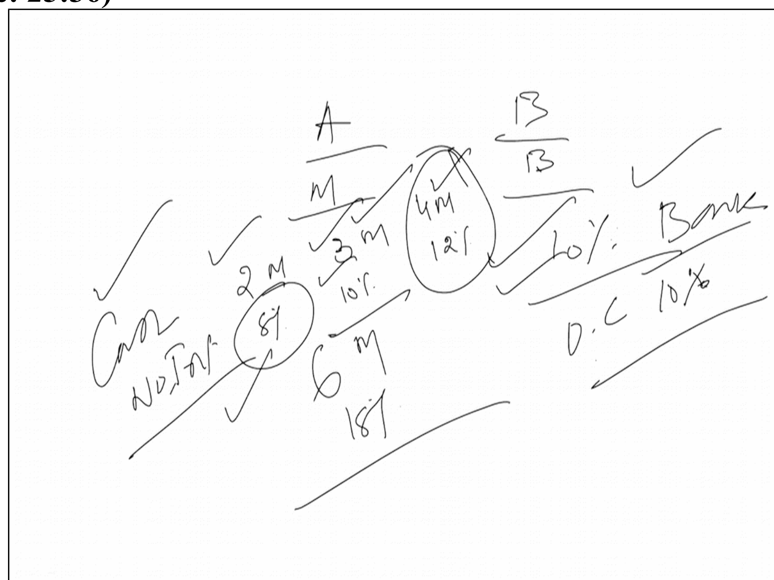
DETERMINING MAXIMUM LENGTH OF CREDIT PERIOD

ELEMENTS OF TRADE-CREDIT POLICY

- Written credit policy
- Credit limit
  - Information credit limit
  - Risk credit limit

Let us move to the next part and here we talk something about limitations of credit period time. First limitation is the marginal loss consideration this limitation is such limitation which restricts the buyer now to buy on the credit beyond the credit period because marginal cost of marginal consideration there are now two customers two parties A and B, A is the manufacturer and B is the buyer when you are amazing A is selling to B on the credit.

(Refer Slide Time: 25:36)



A says if you want the credit period of 2 months say introspective will be 8% and talk about the annual. Then if you want to have the credit period of 3 months I will be charging 10% interest if you want to have a credit period of say 4 months that I will charge the interest 12% and if you

want to have a credit period of 6 months then I will charge the interest at the rate of 18% because he as to charge interest, so we are talking on the marginal cost consideration right.

Now here if you talk about the buyers B as a buyer and his cost of capital. So, in this case for example we have to see that how much interest he is asking for and how much it is cost of capital he will make a comparison. And in that case he will see that for B he is charging 8% interest. So, how much interest I am paying to the bank for example he buys on cash then no interest, and then there is no interest.

And if he buys on credit there is 8% interest and the credit period is 8% of the credit period is 2 months now he will compare that he is paying 8% interest to the manufacturer to the company or to the buyer buying on the credit. Then at what rate he is getting the funds from the bank that is 6%. In this case what he will do, he would buy or borrow funds. He will borrow the funds from the bank and then he will make the payment to the A to the manufacturer.

And then in this case she would see that what rate he is borrowing. Here it is not 6% but here the rate of interest is like 10% rate of interest here is 10% from the bank. If you want to buy on cash he will have to borrow money from the bank or his cost of capital for this is opportunity cost is again 10%. So, if he is earning 10% or he is paying 10% to the bank and he is making the payment to him on cash. So, it means how much interest is going to the back 10%.

But if it is possible to have a credit for 2 months he is sufficient if he is happy with the credit of 2 months for the credit period of 2 months and manufacturers is ready to sell him at 8%. So, what will happen he would like to buy for a credit period of 2 months or for example here it is safe up to 10%, bank is charging 10% and for 3 months credit period the manufacturing also charging 10%. So, where maximum we can go is sick and maximum go up to 3 months.

But in this case when you talk about the next month it is a 4th month if you borrow the money from the bank will charge 10% per annum where as the manufacturer is charging 12% per annum. So, what will happen he would restrict the buyer even the buyer despite being the buyer when we say the buyers intention is always to minimise the present value of the money he is paying back to the seller.

He himself would say that my credit period should not be 4 months I would like to buy it for 3 months because here his cost of borrowing funds from the bank on his opportunity cost is equal

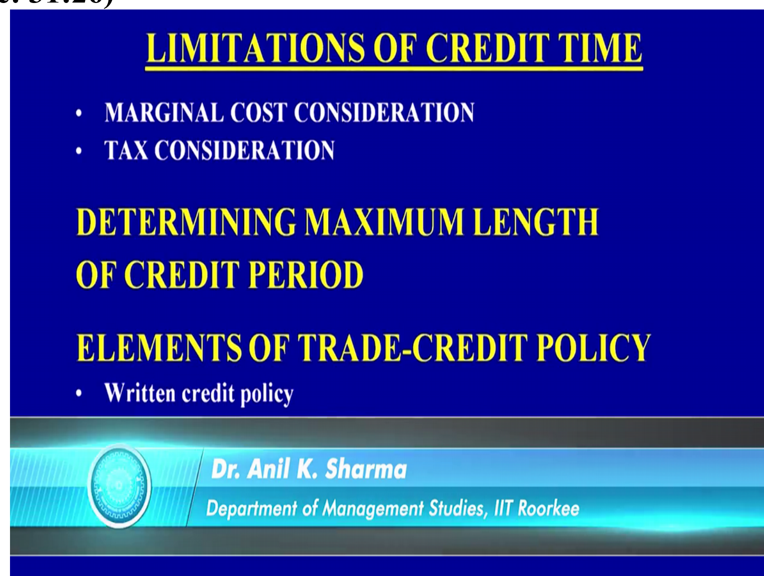
to the cost is paying to the manufacturer maximum beyond that there is a imbalance. He is paying less to the bank and his paying more to the manufacturer, so, he himself would say any how and if in any case for example in any situation if he has to buy the product 4 months credit period.

In that would he do borrow the money from the bank and pay to the manufacturer. So, he would not be asking for the say credit period of the credit for the 4th month and he would say that yes I will be paying cash because so if he is only paying 10% to the bank rather than 12% to the manufacturer. So, he would buy or rather like to buy on cash if it is a 4 months requirement. Normally what he will do that his limit is credit to his buyer up to 3 months.

And that there is a limitation on the credit period marginal cost consideration because in that case marginal cost for the buyer will increase because the loading factor in the fourth month is very high from the manufacturer as compared to the opportunity cost or borrowing from the bank so he would to go for the credit period of 3 months rather than credit period of 4 month. So, this is the one important reason which is limiting the credit period to be expected or to be enjoyed by the buyer.

And companies also have to have the reasons to load the credit sales because they have to recover the cost of capital.

(Refer Slide Time: 31:26)



The Other important limitation is the tax conservation which is again very, very interesting and serious consideration that consideration for that limitation of not allowing the credit period to be

extended to any limit or any extent of any number of months that the reasons for that I discuss with you in the next class thank you very much.