Working Capital Management
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Lecture-45
Credit policy Variables

Welcome students, so in the process of say understanding the receivables management now we are in the last leg of this discussion and today will have some more discussion about the receivable management and after that I will close discussion on it and move to the next part that is the management of the third important current asset that is cash. So, after talking about the credit risk analysis where we discuss the different four kind of the analysis to be done that is an analysis of operating structure financial structure then the managerial structure as well as the industry scenario. Now we will talk about the something called as the Credit Policy Variables Credit Policy variables

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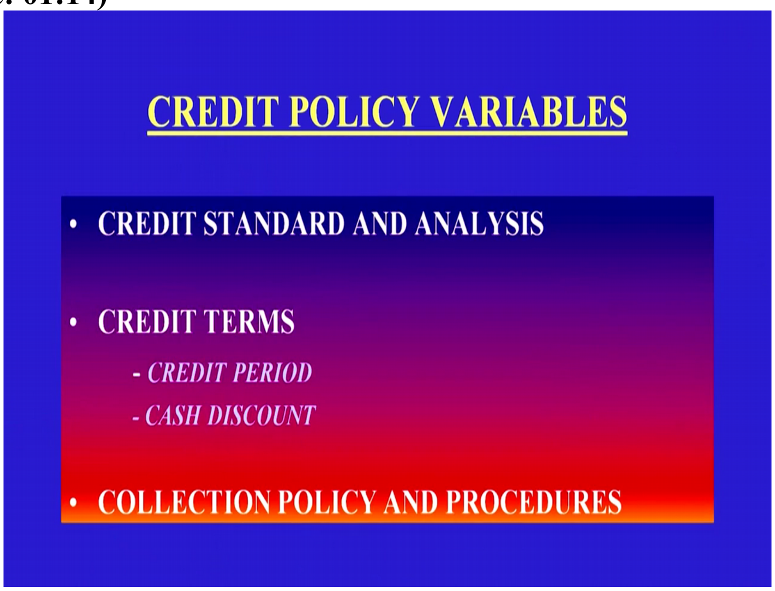

Credit Policy variables are normally 3 credit standards and analysis number 2 is the credit terms which are two important terms credit period and the cash discount and third is third variable is the collection policy and procedures for these are the 3 important variables which are called as the Credit Policy Variables right. Now the credit standards and analysis when we have to grant the credit or any firm has to start getting the credit or has to grant the credit or start selling on the on credit they have to set the standards.

Standards can be very stringent they can be liberal or they can be in between the two. Now if the firms credit standards are very strict in that case only those buyers prospective buyers who enjoy very good reputation on excellent reputation in the market they will be considered for the grant of the credit and whose reputation is not very good I would say it is satisfactory ok but not very good or who are do not do not enjoy good reputation in the market good credit rating in the market they will not be granted any kind of the credit.

So, as per the credit standards what the company's do they normally divide their customers into three broad categories.

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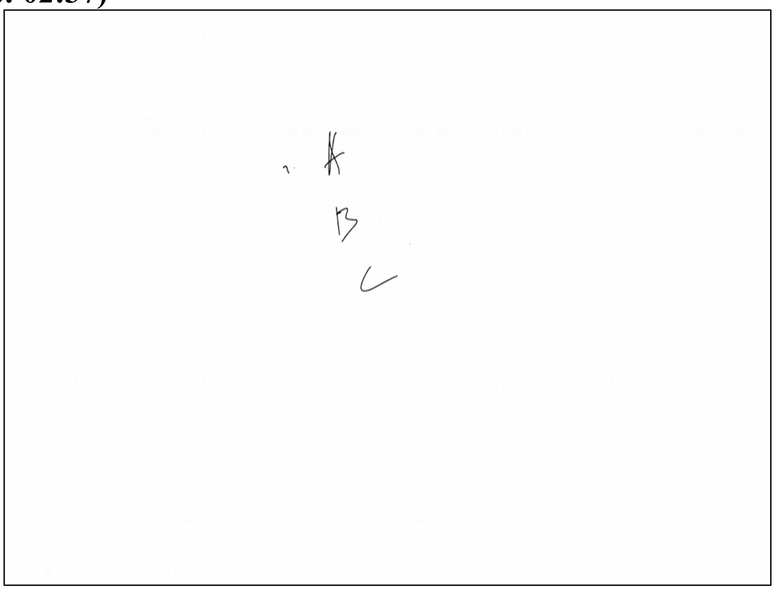

That is a category A customers, B category customers and the C category customers right. A category customers are excellent customers, B are in between and C are the at last stage that if say for example if firm want to pass on it is finished products I means converting the inventory into the receivables then only it can be thought of, that too if the risk is at the acceptable level otherwise the firm would like to keep it does inventory and bear inventory cost.

But sometimes firms prefer that rather than keeping anything in inventory holding inventory on increasing the cost of production because holding the elementary has many cost including obsolesces. They pass on it to the buyer on the credit and is the agreement between the selling company and the buying company that you pass on the product in the market to the people the sell the product finally in the market to the people and after the collection of the sale proceed you can remit our part to back to the company and the that you can have your profits with you.

So, companies whose credit standards are very good and strict they will only like to give the credit to the A Customers of customer and not to be B and C category of customers. But say sometimes what happens that it may not be possible to achieve that targeted sales by simply selling on cash or selling on credit to the A category of the customers. So, sometime after reviewing the Credit Policy maybe for the short term basis or on the short term basis are on the long term basis sometime companies even say liberalise their credit standards.

And sometimes include the B category of the customers also and C category of the customers are only to be taken into account if there is a problem of selling the product in the market. Now if I was talking to you in the previous classes sometime that is a Maruti, Maruti is depending for its most of the inputs from the different suppliers other than the gearbox Maruti is not manufacturing anything. So it means Maruti is A class buyer because Maruti is never going to default they may ask for the longer credit period.

And for that created period also they are allowing the seller or the suppliers to load their credit sales with the interest Factor no problem at all means whatever the sales are made to Maruti Suzuki or Suzuki India Limited those are fully secured because of the reputation of the company Suzuki reputation in India or maybe another multinational deputation in India if they are buying on credit something some reference from the suppliers then they are making the payment of the due date and their say credit is secured.

If you talked about how the C category I was talking to you about the companies like Videocon Onida they in the date of today they are the C category of the buyers that if they want any kind of supplies if they want any kind of supplies in that case there supplies will be or supplying to them on the credit will be highly risky. They would say that will make you the payment back as and when the funds are there with the liquidity is there.

So, means they are the C category of the customers because their own performance has become doubtful in the market. So, even they are selling the final product to the consumers through the retailers or through the distribution channels on the basis that simply keep the product in the store and if you are able to pass it on to the people than your relative path to us otherwise you keep on keeping it.

So, it means simply then the retailer is allowing them the space on the on his shelf to keep their TV or their fridge or there a washing machine and he is ready to help the companies that much is good enough for this type of the companies. So, they are not say in a position to to see that they should be selling to A category of customers are the B category of customers or the C category of customers for them all are well normally they sell to the C category of customers so it means if the customers able to make the sales in the market and collect the sale proceeds and then they will make the payment back to Videocon on Onida otherwise they may not.

So, here credit standard when we talk about credit standards maybe stringent they will be liberal or they may be in between mediocre standards. So, that depends upon that how we have to set the standard when the company's product is very, very good you talk about car segment you talk about Honda car you talk about Suzuki's car any multinational companies cars in India they are doing well.

There are some companies for example when talk about say Fiat or when you talk about General Motors who has the I think closed on its operations in India their products people are not liking much do they are good products for people are sometimes having the preference for Honda or Hyundai products or maybe Suzuki products. So, it means is some of the companies were not able to do the business so for them means their credit standards have to be a liberal their credit standards will be liberal.

For the company who enjoy a good reputation in the market for example in case of the Samsung. Samsung is the company who accepts dealers and distributors to do the business on the company's terms so they ask the dealers and even retailers to send them advanced post dated cheques and it is not up to the dealer to play is order to Samsung that is I want to have 10, 20 or 30 colour TV's it is up to Samsung that when they have the surplus stock it is passed onto a dealer on particular place he has to accept that order and yes to sell the product in the market and advanced tax used as the payment by the company.

So, in that case they are not giving any credits and if even they are giving the credits that is only for a minimum period of time and that too only the best quality of the retailers in the market. So, we have to analyse the borrowers and accordingly we have to set the centres. If the is at the bar belongs to the A category so for them there is the standard has to be very liberal because payment is security.

And if C category then in that case the company has very, very strict and they have to analyse that firm any angle so that the payments secure. Then we talk about the second thing that is a Credit terms I have talked to you earlier also credit terms means credit period first thing is a Credit period and second is a cash discount it is a option of a given to the buyer to the buyer do you want to buy from any particular supplier on credit or you want the cash discount.

So, if you want to buy on the credit so that credit period standard credit period maybe say the complete the sellers credit period is one month right that credit period is one month. So, this is the one of option that you want to take the credit so yes I can give you the credit for one month 30 days you buy the product for me today and you make me the payment after 30 days that is one term.

Second term is the cash discount that if you are ready to pay me cash in that case I will give you 2% discount I will give you 2% discount that you make me payment less by 2% so choices of the buyer if you had a surplus funds available in that case he would like to buy on cash and enjoy the cash discount. Even he can weigh the option that if we can borrow the funds from the bank and I directly make the payment to the company by enjoy the discount of 2% means 2% if it is per month.

This is the 2% per month so it means per annum will be how much 24% so sometime the buyer weigh the options that if they from the bank if you go to the bank and bank funds are available at 18% so why not to enjoy this because this is going to lose this 2% discount is going to pay 24% cost and if he going to borrow money from the bank he is going to pay 18% to the bank so it means he has to make a choice that whether he has to lose this 2% means if you talk about 24% per annum gain.

And if he is not in a position if he is having no liquidity or he is not able to raise the funds even from the bank then he has to go for the credit period and say one month is ok for him. So, in this case what we have to do is normally as we have seen in the past also but we write here is 2 by we write here like say 2 by 10 net 30 this way the credit terms are written 2 by 10 net 30.

Here 2 by 10 net 30 means we are not saying that he has to make the payment when is buying on cash he has to make the payment immediately he can be allowed to make the payment after 10 days that normal credit period of 10 days I will give it to you if you are ready to pay me within

10 days from the purchase from me I will give you 2% discount so this is 2 by 10 otherwise net discount of the 30 days is permissible to you.

But in that case you will not get any discounts we write that credit terms like 2 by 10 net 30 that if you are making me the payment within 10 days I will give you 2% discount otherwise normal credit period of 30 days is there. So, these are the two credit variables a credit terms that is the credit period and the cash discount. So, these are important and every firm has to decide that what will be there normal credit period.

Because in India as I told you that I did period ranges between 30 to 45 days in some cases it is up to 60 days also and if the firm is not very good but now is not very good was very good in the past in that case the discount credit period maybe more than 2 months also but the normal average if you talk about it ranges around 45 days, 35 to 45 days and in some cases it is 60 days.

So, the firm who is going to grant the credit has to decide that what credit period normally they are going to give and that depends upon the say their brand equity their reputation of the credibility of their product in the market acceptability of the product in the market pricing of the product in the market or maybe say the quality distribution demand of the product in the market. If it is selling like hotcakes then maybe hardly minimum credit period and if it is to me some efforts are to be made of sometimes what happens when the companies have to enter into a new markets.

When many companies have to enter into the new markets in that case they have to sell the things initially on credit. So, that is, that depends upon that in the existing market how much credit period you normally want to give in the new markets how much credit period you want to give. Sometimes the credit period can be extended also if we have the piling up of inventory. So, that can be the short-term changes as we have seen and analysed quantitatively that say they want to normally our credit period is 30 days.

But sometime when the stock is piling up and demand is sluggish in the market so we will have to relax our standards and would have to increase credit period from the 30 days to 45 days right or other way around we can have the other option available to be given to the buyers that how much discount we are ready to give. So, normally discount remains 1to 2% depending upon the order. If the order size is very big than 1% discount and if it is small then it can be 2% depending upon the order.

So, that it was interpreted to the buyer also and this not very, very expensive to the seller also. So every company has to have this particular variable that is credit terms which are to credit period and cash discount then we talk about the collection policy and procedures. Collection policy and procedures collection policy and procedures should be very, very stringent very, very clear very, very particular. Sometimes what happens that when we are selling on credit then every company has to create one department which is known as the debt collection department.

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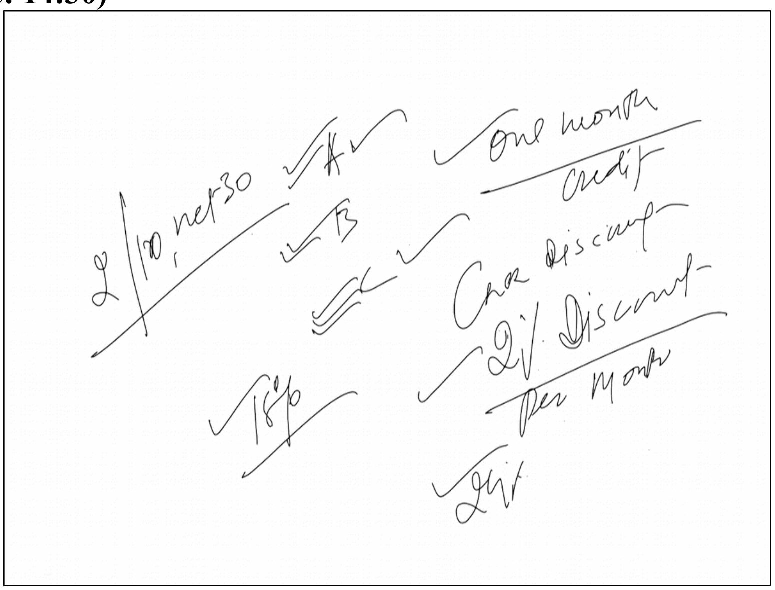

This is called as debt collection department and when a sale is made from the sales department that invoice duly accepted after the receipt of the consignment dual accepted by the buyer is received by the sales department Marketing department sales department and marketing department and then the marketing department send this that invoice to the this debt collection department. This goes to the DCD debt collection department full-fledged department company has to establish.

And their job is to keep track of that how much credit sales behind made and over different periods like weeks months fortnights how many or which order is becoming due to be received this which payment is becoming due to be received against order the supplied in the past they have make say for example there are the different dates 1,2,3,4,5,6,7 like this we are the dates and they are making a proper record.

That on first three payments are expected here 5 payments are expected here 4 payments are expected to this way for multiplying payment on enabled for example 1 lakhs each. So, this means on 1st 3lakhs rupees should be collected by this department. So, this is only possible if there are maintaining a proper that debt collection department and the department maintaining the proper records of a credit sale.

These days the trend has come up in India it is new trend but in the other countries like USA of this kind is already exists that normally firm who sell on credit may take the services or help of one agency which is called as Factors. Who are the Factors? Factors is a agency or specialized agents who apart from providing many services to the manufacturing companies they provide one service that they maintain this department also that is debt collection department of the companies.

If a company who is the seller who is the manufacturer and seller on credit if they want to dismantle their debt collection department because we can make a comparative analysis in the comparative analysis that, collection department has a cost we have to have the people we have to have the space we have to have the some equipments also and it has a monthly cost and it has the annual cost for a maintaining the debt collection department which makes our sales very expensive particularly when we are selling on credit.

So, if we are thinking of that rather than maintaining our own debt collection department DCD we can take the help of the one agency specialised agency which is called as Factor and Factors job is that when any firm is when was any company has taken the services of Factor who has appointed from Factoring firm called as FF Factoring firm. Any company has appointed their as a service provider is Factoring company has their service provider.

So what they do first thing they do is debt collection department is dismantle that is removed from the company is the cost they saved. And this job is transferred to this external agency which is called as Factor. The day when the sales are made by the sales department and marketing department, marketing department then after getting the invoice duly accepted by the buyer passes it on to the Factor that invoice is sent to Factor and that invoice is maintained by Factor till the time that credit period becomes over.

On the due date or maybe one day before the due date a phone call has to be made by the Factor to the payer that tomorrow your payment is due for this much to this company and we hope that your cheque will be ready and you will be sending the check to us or maybe making the online transfers right. And of the due date next schedule make sure that the transfer payment is transferred by the Factor to the company.

So, there can be to arrangements that the paying company can make the payment to the Factor or directly the paying company can make the payment to the selling company and Factor can be informed that yes we have already made the payment of this particular order yesterday it was you may have already made the payment on that date. So, the Factor can make the say enquired entries. But in some cases when for example the payment is delayed by the by the buyer to be made to the seller if it is delayed then say some notices some legal work or some technical notice or legal notice as to be done.

First they so the normal and ssimpler things reminding them making a phone call and if they are not listening then they will give them and simple notice, proper informing them in writing and still they are not listening then sending them the legal notice and all that. If all these things are not working then they Factor will inform the company that we are your payment was due from this particular company in this particular customer on this date and be he has not made the payment to you till date or in your account.

We tried it at our level best and he is not responding or has refused to make the payment so please let us know what is to be done. So, means total rights are transferred by this company to the say Factors and Factors provide apart from so many things as discussed with you the Factors that appropriate place what are the services the Factors provide but here the important service the Factor providers that they perform the job of the debt collection department.

And it is not only the debt collection function but they help the selling company by reminding the payer by writing him the letters by issuing him the simple notices by themselves or even by giving the legal notices to the extent possible that try to help the selling company to realise the payment from the buying company and if it is not possible then find the matter reported to the selling companies that your payment was due and he has not made the payment we have done this much so you know you see what is to be done.

This service can be taken so it means collection policy and procedure has to be clearly laid down by every company that is how the payment will be collected whether the payer will be asked to deposit the payment directly in the bank account or he will be ask to send the cheque and cheque will be deposited in the bank by the selling company after receiving it or any other way it has to be collection policy has to be very, very clear very, very even say stringent also.

So, that nobody takes a feeling that if we delayed the payment nothing is going to happen and if you not make the payment even then nothing is going to happen there should be the provision for the penal rate of interest also if the payment to be made by a person that the existing buyer, buyer in the past is delayed he must be penalized for delay in the payment normally that some 2, 3, 4 days the delay may not be very, very significant.

But if it is like a week or 15 days or a month then he should be penalized by charging the penal rate of interest. So, this is something about the collection policy and procedures these 3 points make the Credit Policy Variables that credit standard and analysis credit terms and the collection policy and procedures. With this be complete the discussion on management of the accounts receivables very important second current assets.

First we discussed at length the inventory management then we discuss at length the receivables management we had lengthy discussion discussed many things about it and about receivable management and very important second current assets. And now we will be moving to third current assets which are called management of cash. Management of the cash is another very important asset because it is third important assets.

We have to manage the cash very efficiently and sincerely or otherwise it will create problem and may increase cost. So let us move to the management of the learning about the management of the third current asset cash management. If you talk about the cash management here then we will be talking about this cash management and this will be the next part of discussion for us now cash when you talk about the cash management you think that what to manage in cash is very simple.

If we have cash then we have the cash and we can keep it with us or what is there special to manage what we are talking about the cash to be held by the company. As like inventory and receivables cash is all important third current asset. As I told you that if properly we are not able to manage the inventory it is going to cause the cost. If we are not able to manage the receivables accounts receivables it is going to cause the cost.

And it may create a situation where the cost is more than the returns it is contributing to the company and ultimately we are ending at the loss making proposition right. So, like inventory like receivables now we have the third important asset which is cash management. Cash management is again current asset and it has a cost. So, in the firm because when you are talking about a large sized a company there we are not talking about that 10, 20, 30, 40 lakh cash.

When we are talking about the millions of the cash sometime the collection of the cash is in millions for example talk about the cold drink companies Coca Cola and Pepsi what is your daily collection of the cash they are collecting cash daily on the daily basis and cash depositing it in the banks and banks are managing their cash. So, the collection sometime goes into the million and crore. So, in that case what part of the total collection has to be kept as cash? How much it has to be invested into the market into the marketable securities or into the other kind of assets.

And keeping the cash what is the cost involved and if there is a shortage of the cash what are the consequences what are the outcomes of that part that is very important thing to be taken care of.
So, many things will talk about the cash management but we will start here with that is Cash Management is concerned with three things.

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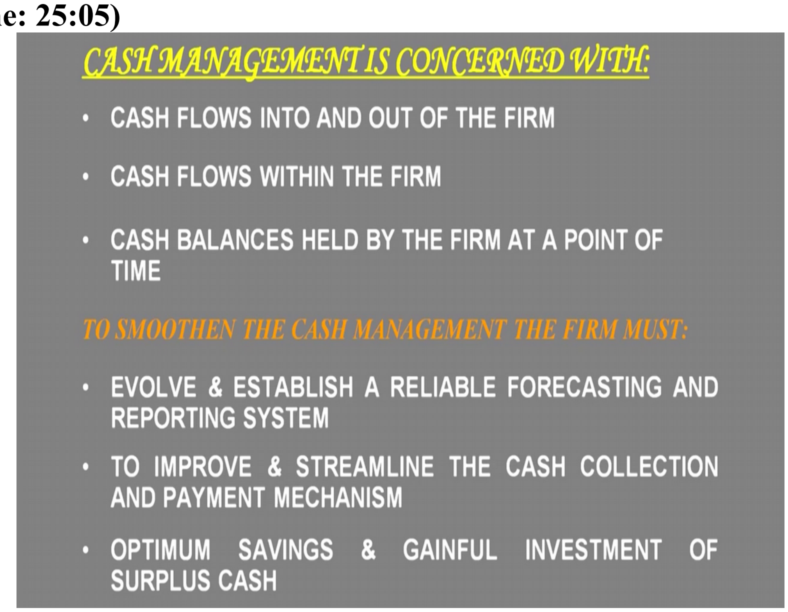

Cash flows into and out of the firm cash flows into and out of the firm, cash flows within the firm and cash flows held by the firm at a point of time so cash flow into and out of the firm think about it this is the cash flow into and out of the firm it is into and out of the firm we will have to think about when you are talking about the cash flows into and out of the firm we are to be careful here that what does it mean firm is holding the cash.

It means as I am telling you Coca Cola and Pepsi they collect the cash everyday from their distributors from their retailers. So, the cash is flowing into the firm and it is going out also when the payment is made by the company to the suppliers when the company is made payment is made by the company to the supplier of power to of the water of the salary to the employees other office expenses or maybe the other kind of the inputs we are buying will be the raw material these companies are buying.

So, for that also the payment has to be made it say for example for suppliers of bottles do the product is manufactured by then that powder which they convert it into the cold drink that is manufactured by them just a patented product but say bottles as you talk about that covers you talked about and will be the grates you talked about all this is a material which is purchase and it is on the credit basis and the payment has to be made after some period of time. So, cash flow into the firm and out of the firm.

How much cash is flowing in on the daily basis weekly basis monthly basis and how the cash is flowing out and at one particular point of time what is the net balance of the cash available. So, for this reason every firm makes the cash budget. If they are very efficient and having the sufficient resources in that case what they do they prepare the weekly budgets they prepare the weekly budgets they know that in next 6 or 5 days how much cash is flowing into us how much cash is flowing out on account of the different payments what is a net balance is going to be with us.

That net balance is going to be surplus may be the receipts are more than the payments or the net balance is going to be deficit that the payments are more than the receipts. So, if there is going to be surplus you have to be prepared well in advance how and where that amount has to be invested. Again that has to go how much we want to keep cash as cash and remaining part he was very large surplus is there. How it has to be managed and where it has to be invested this question has to be answered immediately.

So, that you do not lose that I am immediately when you get the surplus cash it goes to the avenue where it should be invested. Similarly if the situation is reverse that there is a shortage of cash when we are budgeting when we are preparing the budget for the next 5 or 6 days we know that there is shortage of the cash in advance because budgeting done only to the say to fix up road map.

And we know that there will be shortage our payments will be exceeding the receipts, so if we know that in advance it means we have to make the arrangements well within the time maybe one week before will make the arrangements that on Thursday next we need this much of the 10 lakhs of the cash flow from where it will come we are not keeping it in beyond level in the firms we have to arrange for bank or from selling the marketable securities or any other that will be known to us if we are planning our cash properly.

So, surplus are going to be invested in the market and deficits are going to be made by arranging the cash for the different sources and finally we are going to maintaining balance so for that you understand that cash management is important. Then is a cash flow within the firm, cash flow within the firm will be is like to maintain the liquidity at all levels. Purchase department want to purchase material on cash. So, they should be provided sufficient cash as and when demanded by them. Salaries I have to be paid to the employees at the end of the month.

So, they should be sufficient cash, utility bills have to be paid by the company at the end of the month should be sufficient cash then marketing department needs a cash, sales department needs cash advertising people need cash whom so ever at what point of time how much cash they are asking for that is the responsibility of the Finance Department to make arrangement cash and to provide to fulfil all everybody say requirement within the firm.

So, it means cash must be following on within the firm and sufficiently it must be flowing there should not be any shortage of the cash and there should not be any abundance of the cash. So, what we have to do is we have to learn here how to maintain the optimum balance of cash. So, that is another thing they are going to learn by learning the cash management and third important point in the cash management is that cash balances held by the firm at a point of time.

How much cash you want to know I am emphasising up on I am discussing since we started the discussion on the cash management that at any point of time how much cash should be there as I told you more than the required level of inventory is also and more than the required level of credit sales is also bad and similarly more than the required level of the cash is also bad. So, we cannot afford to keep the high level of current assets reason being there highly expensive assets.

And if any extra investment is made into these assets that will directly and off with paying extra cost and the return on these investments between very, very low. So, we have to maintain or learn how to maintain the optimum level of the cash. So, that needed it is more now it is less cash is available when we need the cash and cash is not surplus all in abundance so that it is lying unused and we are not able to make the proper use of the cash.

For example if you look at the balance sheet of two companies like a public sector company and private sector in the public sector companies large PSU find the huge amount of the cash huge balance is of the cash and they will show in the balance sheet in the current assets that this much lakhs or crore or billions of rupees of the cash is there in the balance sheet. Now what that cash is doing in that company if that cash is not properly managed by the company it means they do not know how to manage cash.

It should have been not cash should have been shown as the marketable securities it should have been shown as some other in any kind of the short term investment invested into the treasury bills or anywhere. So, that that cash is earning something but this it does not belong to anybody say public money is it government money does not belong to anybody and their management is also not very, very professional.

So, it means nobody bothers about the management of the cash in the PSU's. But in the private sector companies you will be very, very say y curious to know the balance is cash and you will find at any point of time there is no surplus amount of the cash will find. Their maintenance optimum amount just to fulfil their regular operations for surplus of the cash or unused amount of the cash that high amount of the cash will not be available in the private sector companies as computer PSU's.

So, it means cash management is very, very important is a third important assets and you must learn about it how to manage the better and efficient management of cash remaining more and quite interesting things about the cash management we will discuss in the next class thank you very much.