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CREDIT MANAGEMENT SPONTANEOUS SOURCE OF WORKING CAPITAL

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ABSTRACT

Working capital management is very significant in the field of financial management. It plays a leading role in promoting industrial growth. It is highly concerned with short term financial decisions. Generally any organization involves two types of capital. Fixed capital and variable capital: Fixed capital is just like physical body of industrial organization and variable capital or working capital is like circulating blood in physical body of any organization. Spontaneous source of finance is one of the most important features in business cycle. It reduces the amount of negotiable financing. The word spontaneous indicates that the credit is easily available source of working capital to the business for normal course of business activities. When we sell our products, generally we demand cash, or cash before delivery, but it is not possible for us to sell on cash only. In most cases, we allow some delay in payment, as per accounting concept, these delays create receivables, and these receivables called credit.

KEYWORDS: *Spontaneous, Circulating Blood, Negotiable, Anathema, Variable Capital.*

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Introduction

Working capital management is very significant in the field of financial management. It plays a leading role in promoting industrial growth. It is highly concerned with short term financial decisions. The shortage of working capital caused many institutions to fail and in many cases, they possess stagnation. Mainly a firm invests in the form of two ways (1) Fixed assets in the form of permanent capital. (2) Current assets in the form of moving capital or working capital. Fixed capital is essential for the generation of fixed assets like land, building, machinery, furniture etc. Fixed assets facilitate working efficiency and fulfill basic needs required for production. While working capital is needful to meet the day to day requirements of organization. Working capital in any firm is as much needful as blood in human body. So, we can say that fixed capital is just like physical body of industrial organization and variable capital or working capital is like circulating blood in physical body of any organization.

Working capital may be defined as the excess of current assets over current liabilities. All Assets which are convertible in to cash with in current financial year or accounting period these are as liquid as cash or near cash sources. We may categorize the working capital finance in to three parts (1) Spontaneous source of finance, the finance which arise in natural way in the operation of business is called spontaneous financing such as, credit sales trade creditors credit from business concerns. (2) Short term source of financing. It can be defined as the extra money that a business needs to operate its short term activities and run the business on short term basis. There are some common sources through which we can generate our short term financing. Short term sources may be categorized as internal sources such as tax provision, dividend provision and external sources such as bank overdraft, trade deposits, public deposits and bills discounting. (3) Long term sources of working capital may also be categorized as, internal sources such as retained profits, depreciation provisions and external sources such as share capital, long term loans and debentures. Long term external sources are highly concerned with lenders such as financing institutions, commercial banks. These types of financing may be either short term or long term or both.

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Spontaneous source of finance is one of the most important features in business cycle. It reduces the amount of negotiable financing. The word spontaneous indicates that the credit is easily available source of working capital to the business for normal course of business activities. The term credit depends on the business norms set by entrepreneur and the relationship between buyer and seller. These sources include trade credit allowed by the sundry creditors, credit from employees and other trade related credits. The largest benefit of credit sources of working capital is its effortless raising and insignificant cost compared to traditional ways of financing. Mainly spontaneous source of working capital are trade credits, sundry creditors, bills payable, note payable, accrued expenses. Actually the cost factor depends a lot on the term of such credit as well as maximum credit limit, the period of credit and the discount on the cash payment. Each supplier must have a maximum credit limit for buyer depending on business capacity and credit worthiness of the buyer. The credit period may be defined as thirty days, forty five days etc. Discount on cash payment should also be allowed to the buyer if the payment is made immediately on buying of materials. This percentage of discount would be an opportunity cost for buyer.

What is Credit?

When we sell our products, generally we demand cash, or cash before delivery, but it is not possible for us to sell on cash only. In most cases, we allow some delay in payment, as per accounting concept, these delays create receivables, and these receivables called credit. In other way if we do not pay for our purchases immediately just after or before buying the goods. It is called credit purchase. It creates bills payable as per accounting language. These payable are the most important source of short term finance or working capital. All type of sales do not involve credit such as goods produced to the consumer's specification or including substantial delivery cost. If we are supplying goods to a wide variety of irregular customers. We prefer cash before delivery (C.B.D.) on first situation and cash on delivery (C.O.D.) on second situation. Expensive and customer designed products require progressive payments as the work is being done. For example, a high level consulting contract may require 25% payment on field research 35% on submission of a report and rest 40% on final completion of project. Credit policy is not always harmful for institution it is beneficial for organization up to a certain extent and certain conditions. It encourages additional sales, promotes new customers add additional demand of product. Slowness in collection of credit and probability of bad debts involves negative situation for business. So we must make some provisions for bad debts, but provisions for bad and doubtful debts reduce our net profit.

We use some specific terms, which are generally used in credit policy for procurement of credit . Such as credit period discount ratio, discount period and seasonal dating. The term credit involves the length of credit period and the discount given. For instance the term "2/15 net 30" means that the payment must be paid within thirty days, the customers who will pay within 15 days, would be given 2% discount. If a customer who buys on above condition decides not to tape cash discount and pay on the 30th day. It means that customer obtains an extra 15 days credit but pays 2% more for the goods. Obviously, he got a cheaper loan but damages its reputation for credit worthiness. For the solution of such problem we use credit instruments such as Open account, promissory notes commercial drafts (known as bills of exchange) etc. The management of credit is not simple task. Mismanagement of Credit policy may cause heavy loss for any organization. Credit manager has limited options to manage credit policy of the firm. He has not clear cut choices for a liberal or a more stringent credit policy. It may not be assumed that all Customers are bad or all are good. Many of them may be good; some of them may be defaulters or pay consistently late. In other condition we recover our credit money, but it costs more to collect and we lose the interest of defaulter months. Like other financial decisions credit policy determination and credit allocation also involves strong and typical decision making.

So, we must remember some specific things, which are essential for credit management:

- Maximization of profit should be final goal of the firm. We should not focus on minimizing the number of bad accounts. We must try to maximize the expected profit. All credit involves only two facts the best that may be happen is that customer will pay or may be defaulter. In first condition the firm achieves full additional revenues. In the second condition the firm receives nothing and looses the costs. If the margin of profit is high, we are justified in a liberal credit policy and if it is low we cannot afford many bad debts.
- We should not made credit decisions of an order by order basis. It should be differing according to as the case may be. We should not set a credit limit for each customer.

- The credit decision it not static problem. It is dynamic problem. We must look only at present not in the past. Actually credit management is a technique which involves some steps. The steps are given as follows.
  - It must be established like normal terms sales. We should decide the length of payment period and size of cash discounts.
  - It is an essential to decide the form of contract with a customer.
  - We must try to assess credit worthiness of each customer.
  - We should try to establish sensible credit limits. The main object of credit management is to maximum of profit not to minimize the number of bad debts.

These steps are correlated. We can afford more liberal terms of sale. If we are very careful about whom we grant credit. A suitable credit policy adds up to a sensible whole. It is very true that our credit policy always affect the working capital. If we are able to recover our receivables with in due time period, It would be beneficial for our organizational growth, but if we are unable to recover our receivables with in due time or not recover our receivables. It would create bad debts. Which will be harmful for our organization .So it is challenging task for credit manager to make balanced credit policy for the organization? It would be beneficial for organization to improve sales. The need of working capital becomes essential, when our business or industry is in developing stage.

Efficient working capital management helps to maintain the smooth functioning of operating cycle. The measurement of working capital may be done through dividing current assets by current liabilities .Working capital ratio below 1.0 indicates that organization is facing trouble to meet its short term obligations and working capital ratio of 1.2to 2.0are mentioned to desirable but a ratio higher than 2.0 may indicate that organization is not in the position to efficient use of its assets for increasing revenues. The role working capital is very significant for any type of business or industry. The measurement of working capital may be done through working capital cycle. It is period of time which takes to turn the net current assets and net current liabilities into liquidity (cash). If the cycle is longer, the capital will be locked in the operational cycle of business getting any returns on investments. The short term of working capital cycle, indicate company's ability to free up its cash stock in working capital, It means the working manager must be try to shorten the working capital cycles for the improvement of short term liquidity for increasing business efficiency .

Working capital cycle may be either positive or negative. A positive working capital cycle makes balance between incoming and outgoing payments to minimise net working capital and maximise free cash flows. Such as if any company pays its supplies in 30 days but takes 60 days to collect it's receivables has a working capital cycle of 30 days. This 30 days cycle needs to be funded through a bank operating line and the interest on this financing is a carrying cost that reduces the company's profitability. The requirement of growing business is cash and being able to free up cash by reducing the working capital cycle is the most economic way for the growth of business. Negative working capital means a company, s current liabilities exceed to it's current assets. It means that the liabilities needs to be paid within one year exceed the current assets that are manageable over the same period. A buyer usually counters negative working capital in a target as detrimental because it signifies additional capital that will be required to run the business after closing. A buyer prefers to see a working capital ratio of 1 to 1.5 times, which means there is at least one rupee of current asset for every rupee of current liability. This assures the buyer that the company can generate sufficient cash over without turn to cover supplies out pay roll obligation.

Conclusion

Actually credit management covers the diversified field of credit related areas by permitting consumers credit requests to managing the credit options. It is the duty of credit manager to see the credit lending process for banks, credit card companies, and other financial institutions directly involved with credit. Spontaneous source of working capital is the basic source of working capital finance. As its name indicates that this is the source which is always easily available to business in order to operate the normal business activities. The term and conditions are dependent on the relation of the both parties buyer and seller. Credit management is one of the challenging tasks for any organization. The survival and removal depends upon sound credit policy. At present any organization cannot ignore credit selling, but better management of credit policy would be beneficial for any organisation. So the main focus of credit sales must be recovery of receivables, which creates bad debts. Bad debts are just like anathema for any business organisation.

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