19BAE711-WORKING CAPITAL MANAGEMENT

Trade Credit

Trade credit is a type of commercial financing in which a supplier allows a business to purchase goods or services on account, delaying payment until a later date. It is a common practice in business-to-business transactions and serves as a crucial tool for managing cash flow and fostering business relationships.

Objectives

1. **Improve Cash Flow**: Allow businesses to manage cash flow by deferring payments.
2. **Increase Sales**: Encourage purchases by offering more flexible payment terms.
3. **Build Relationships**: Strengthen business relationships between suppliers and customers.
4. **Competitive Advantage**: Offer attractive credit terms to gain a competitive edge.

Types of Trade Credit

1. **Open Account**: The supplier ships goods to the buyer with an invoice stating the payment terms. Payment is expected within the agreed credit period.
2. **Promissory Note**: The buyer signs a promissory note committing to pay the supplier at a specified future date.
3. **Bill of Exchange**: The supplier draws a bill of exchange instructing the buyer to pay a specified amount at a future date. The buyer accepts the bill by signing it.
4. **Letter of Credit**: A financial institution guarantees the supplier's payment, ensuring the supplier receives payment even if the buyer defaults.

Key Components

1. **Credit Terms**:
   - **Credit Period**: The duration within which the buyer must pay the invoice (e.g., 30 days, 60 days).
   - **Discount for Early Payment**: Incentives for early payment, such as 2% discount if paid within 10 days.
   - **Late Payment Penalties**: Interest or fees for payments made after the due date.
2. **Credit Limit**: The maximum amount of credit extended to a customer based on their creditworthiness and payment history.
3. **Invoicing**: Accurate and timely invoicing to ensure customers receive and process invoices promptly.
4. **Collection Procedures**: Systematic follow-up on overdue accounts through reminders, phone calls, or emails.
5. **Credit Evaluation**: Assessment of a customer's ability to pay based on financial health, payment history, and credit reports.

Advantages

1. **Cash Flow Management**: Helps businesses manage their cash flow by deferring payments.
2. **Sales Growth**: Increases sales by offering more flexible payment options.
3. **Customer Loyalty**: Builds customer loyalty by providing favorable credit terms.
4. **Financial Flexibility**: Provides financial flexibility to businesses, allowing them to allocate funds to other critical areas.

Disadvantages

1. **Risk of Non-Payment**: The risk that customers may default or delay payments.
2. **Increased Costs**: Costs associated with managing and collecting receivables.
3. **Cash Flow Impact**: Potential negative impact on cash flow if large amounts of credit are extended without timely collections.
4. **Administrative Burden**: Increased administrative work to monitor and manage credit accounts.

Best Practices

1. **Establish Clear Credit Policies**: Define clear and consistent credit policies, including credit terms, limits, and collection procedures.
2. **Credit Evaluation and Monitoring**: Regularly evaluate and monitor customers' creditworthiness.
3. **Automated Invoicing and Reminders**: Use automated systems to send invoices and payment reminders promptly.
4. **Aging Analysis**: Perform regular aging analysis to categorize receivables based on the length of time they have been outstanding.
5. **Early Payment Incentives**: Offer discounts or other incentives to encourage early payments.
6. **Collection Procedures**: Implement systematic follow-up and collection procedures for overdue accounts.
7. **Customer Communication**: Maintain open and transparent communication with customers regarding their accounts and any outstanding balances.
8. **Periodic Reviews**: Regularly review credit policies and procedures to reflect changing market conditions and business needs.

Control Aspects

1. **Credit Approval Process**:
    - **Approval Hierarchy**: Establish levels of authority for credit approval based on the amount of credit requested.
    - **Documentation**: Ensure all credit applications and approvals are well-documented and stored securely.
2. **Credit Monitoring**:
    - **Regular Reviews**: Conduct periodic reviews of credit limits and terms for existing customers.
    - **Aging Reports**: Generate and review aging reports to monitor outstanding receivables.
3. **Collection Procedures**:
    - **Timely Invoicing**: Ensure invoices are issued promptly and accurately.
    - **Follow-Up Mechanisms**: Implement systematic follow-up procedures for overdue accounts.
4. **Segregation of Duties**:

- **Role Separation**: Separate responsibilities for credit approval, invoicing, and collections to prevent fraud and errors.

Risks and Challenges

1. **Credit Risk**: The risk of non-payment or delayed payment from customers.
2. **Economic Downturns**: Economic downturns can impact customers' ability to pay, increasing the risk of bad debts.
3. **Market Competition**: Competitive pressures may lead to more lenient credit terms, increasing credit risk.
4. **Fraud**: The risk of fraudulent activities, such as falsified credit applications or collusion between employees and customers.

Conclusion

Trade credit is a vital tool for managing cash flow, fostering business relationships, and driving sales growth. By establishing clear credit policies, regularly evaluating and monitoring credit risk, and implementing effective collection procedures, businesses can leverage trade credit to achieve their financial and operational objectives. Maintaining open communication with customers and using technology to streamline processes are key to successful trade credit management.