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Subject: FINANCIAL MANAGEMENT

CHAPTER: WORKING CAPITAL - II

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LECTURE NO. 04

SUB: FINANCIAL MANAGEMENT

CHAPTER: WORKING CAPITAL - II

TOPIC; Policies relating Current Assets – Conservative, Aggressive and Balanced ; Various sources of finance to meet working capital requirements; Financing current assets: Strategies of financing (Matching, Conservative, and Aggressive policies) ; Management of components of working capital (debtors management only–credit period -simple type)

Sub Topic – 4: Management of components of working capital (debtors management only–credit period -simple type)

Managing debtors

Debtors are people or businesses who owe you money. Proper management of your debtors will help you get paid faster and prevent bad debts. Prompt collection of debtors' accounts will also help you maintain a healthy cash flow. Giving your customer an invoice or bill after they have supplied a product or service is a way of offering credit, since you have to wait for the payment. By giving your customers time to pay for goods or services already delivered, you are making it easier for them to make purchases. This will increase sales, but will reduce the cash flow critical to your business.

Managing debtors is often referred to as credit management, and includes:

• collecting debts on time

• setting credit limits and payment terms

• making credit applications and credit checks

• enforcing a clear credit policy

• considering debtor finance.

Debt management also involves keeping debtor records - this is a legal tax requirement. There are also laws governing how you are allowed to follow up debts with your customers.

Let us make an in-depth study of the meaning, characteristics, objectives and cost of maintaining debtors.

Meaning of Debtors :

 In the examination of one of the most important components of current assets, namely, cash, it was observed that, in order to reduce the operating cash requirement, collection of debtors/receivables, should be accelerated in such a manner that the average collection period reduces.

 The term ‘debtor’ is used to define as ‘debt owed to the firm by customers arising from sale of goods or services in the ordinary course of business’.

Debtors/Receivables, as asset, represent amounts owed to the firm by customer from sale of goods or services.

 A firm grants trade credit to maintain its sales from the hands of the competitors and, at the same time, to attract the potential customers to purchase its products at favourable terms. Trade credit arises only when the firm sells its product to the customers but does not receive immediate cash, i.e., at the time of credit sales. Receivables/Debtors are created out of trade credit and which are collected in the near future.

Characteristics of Debtors:

Debtors have got three distinct characteristics:

 (i) It involves risk which should carefully be studied since cash sales are riskless whereas, at the time of credit sales, cash is yet to be received.

 (ii) It is based on present economic value. At the time of sale the economic value of goods passes immediately, whereas, the seller expects an equivalent benefit at a later date.

 (iii) It implies futurity. The value of goods or services received by the buyer will be payable by him at a future date.

 No doubt debtors/receivables play a significant role in the total current asset composition since their position is next to inventories. In India, they form about one-third of total current asset.

Objectives of Debtors:

 It has already been stated above that accounts receivables/debtors are generated which is collected at a future date only when the firm grants credit against an ordinary sale of goods or services without receiving cash. Credit sale is an essential part of the present competitive economic system. It is granted in order to increase the volume of sales.

As such, debtors/receivables, which are created out of credit sales, are considered as a marketing tool for increasing sales. It may be mentioned in this respect that credit which is granted to the customer is done in the ordinary course of the business, i.e., on an open account. In other words, there will be no formal acknowledgement of debt obligation. But extension of credit involves cost and risk.

 Therefore, management should weigh the benefits against cost. As such, the objective of debtors/receivables management is ‘to promote sales and profits until that point is reached (i.e., optimum point) where the return on investment in further funding of receivables is less than the cost of funds raised to finance that additional credit (i.e., cost of capital)’.

Cost of Maintaining Debtors:

 The specific cost arising out of examination of credit which are related to the determination of the objectives of receivable management are:

1. Collection Costs; 2. Capital Costs/Cost of Financing; 3. Delinquency Costs; and 4. Default Costs.

1. Collection Costs:

 These costs are those which are to be incurred by a firm in order to collect the amount on account of credit sales, i.e., these expenses would not be incurred if the firm does not sell goods on credit, e.g., additional expenses incurred for the maintenance of credit and collection department, expenses incurred for obtaining information about credit-worthiness of potential customers.

2. Capital Costs/Cost of Financing:

 The amounts which are locked up in debtors on account of credit sales may be financed from one of the following three sources:

(i) Share capital; (ii) Debt capital (long and short-term); and (iii) Retained earnings.

Illustration:

A firm sells its article at a profit of 25% on cost and the average balance of debtors amounts to Rs. 8,00,000. Investment in debtors is being financed by bank borrowings at 15%.

Ascertain the cost of financing average debtor

 

3. Delinquency Costs:

 When the period of payment becomes due (i.e., after the expiry of the credit period) but is not received from the customers, the same is known as delinquency cost.

It includes:

(i) Blocking up of funds/cost of financing for an extended period; and

(ii) Cost of extra steps to be taken to collect the over-dues, e.g., reminders, legal charges etc.

4. Default Costs:

 Sometimes the firms may not collect the over-dues from the customers since they are unable to pay. These debts are treated as bad debts and are to be written-off accordingly since the amounts will not be realised in future. Such costs are termed as ‘Default Costs’. Although the firms make proper provision against bad debts, the cost will increase if the amount of credit sales is increased in proportion to cash sales.

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