UNIT 13 PAYABLES MANAGEMENT

Objectives

The objectives of this unit are to:

- Explain the significance of payables as a source of finance
- Identify the factors that influence the payables quantum and duration
- Highlight the advantages of payable and provide hints for effective management of payables.

Structure

13.1 INTRODUCTION

A substantial part of purchases of goods and services in business are on credit terms rather than against cash payment. While the supplier of goods and services tend to perceive credit as a lever for enhancing sales or as a form of non-price instrument of competition, the buyer tends to look upon it as a loaning of goods or inventory. The supplier's credit is referred to as Accounts Payable, Trade Credit, Trade Bill, Trade Acceptance, Commercial Draft or Bills Payable depending on the nature of credit provided. The extent to which this 'buy-now, pay-later' facility is provided will depend upon a variety of factors such as the nature, quality and volume of items to be purchased, the prevalent practices in the trade, the degree of competition and the financial status of the parties concerned. Trade credits or Payables constitute a major segment of current liabilities in many business enterprises. And they primarily finance inventories which form a major component of current assets in many cases.

13.2 PAYABLES: THEIR SIGNIFICANCE

Payables constitute a current or short term liability representing the buyer's obligation to pay a certain amount on a date in the near future for value of goods or services received. They are short term deferments of cash payments that the buyer of goods and services is allowed by the seller. Trade credit is extended in connection with goods purchased for resale or for processing and resale, and hence excludes consumer credit provided to individuals for purchasing goods for ultimate use and instalment credit provided for purchase of equipment for production purposes. Trade credits or payables serve as non-interest bearing source of funds in most cases. They provide a spontaneous source of capital that flows in naturally in the course of business in keeping with established commercial practices or formal understandings.

13.3 TYPES OF TRADE CREDIT

Trade Credits or Payables could be of three types: Open Accounts, Promissory Notes and Bills Payable.

Open Account or open credit operates as an informal arrangement wherein the supplier, after satisfying himself about the credit-worthiness of the buyer, despatches the goods as required by the buyer and sends the invoice with particulars of quantity despatched, the rate and total price payable and the payment terms. The buyer records his liability to the supplier in his books of accounts and this is shown as payables on open account. The buyer is then expected to meet his obligation on the due date.

The Promissory note is a formal document signed by the buyer promising to pay the amount to the seller at a fixed or determinable future time. Where the client fails to meet his obligation as per open credit on the due date, the supplier may require a formal acknowledgement of debt and a commitment of payment by a fixed date. The promissory note is thus an instrument of acknowledgement of debt and a promise to pay. The supplier may even stipulate an interest payment for the delay involved in payment.

Bills Payable or Commercial Drafts are instruments drawn by the seller and accepted by the buyer for payment on the expiry of the specified duration. The bill or draft will indicate the banker to whom the amount is to be paid on the due date, and the goods will be delivered to the buyer against acceptance of the bill. The seller may either retain the bill and present it for payment on the due date or may raise funds immediately thereon by discounting it with the banker. The buyer will then pay the amount of the bill to the banker on the due date.

Activity 13.1

You arrange to meet the Finance Executive of an enterprise that procures a wide range of materials from different sources and ascertain.

a) What forms of credit is the firm obtaining?

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b) Which of these forms is most economical from the purchasing firm’s point of view and why?

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c) How does the company organize itself to negotiate effectively with the suppliers for obtaining the best possible credit terms?

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13.4 DETERMINANTS OF TRADE CREDIT

Size of the Firm

Smaller firms have increasing dependence on trade credit as they find it difficult to obtain alternative sources of finance as easily as medium or large sized firms. At the same time, larger firms that are less vulnerable to adverse turns in business can command prompt credit facility from the supplier, while smaller firms may find it difficult to sustain credit worthiness during periods of financial strain and may have reduced access to credit due to weak financial position.

Industrial Categories

Different categories of industries or Commercial enterprises show varying degrees of dependence on trade credit. In certain lines of business the prevailing commercial practices may stipulate purchases against payment in most cases. Monopoly firms may insist upon Cash on delivery. There could be instances where the firm's inventory, turns over every fortnight but the firm enjoys thirty days credit from suppliers, whereby the trade credit not only finances the firm's inventory but also provides part of the operating funds or additional working capital.

Nature of Product

Products that sell faster or which have higher turnover may need shorter term credit. Products with slower turnover take longer to generate cash flows and will need extended credit terms.

Financial Position of Seller

The financial position of the seller will influence the quantities and period of credit he wishes to extend. Financially weak suppliers will have to be strict and operate on higher credit terms to buyers. Financially stronger suppliers, on the other hand, can dictate stringent credit terms but may prefer to extend liberal credit so long as the transactions provide benefits in excess of the costs of extending credit. They can afford to extend credits to smaller firms and assume higher risks. Suppliers with working capital crunch will be willing to offer higher cash discounts to encourage early payments.

Financial Position of the Buyer

Buyer's creditworthiness is an important factor in determining the credit quantum and period. It may be logical to expect large buyers not to insist on extended credit terms from small suppliers with weak bargaining power. Where goods are supplied on a consignment basis, the supplier provides extra finance for the merchandise and pays commission to the consignee for the goods sold. Small retailers are thus enabled to carry much larger levels of stocks than they will be able to finance by themselves. Slow paying or delinquent accounts may be compelled to accept stricter credit terms or higher prices for products, to cover risk.

Terms of Sale

The magnitude of trade credit is influenced by the terms of sale. When a product is sold, the seller sends the buyer an invoice that specifies the goods or services, the price, the total amount due and the terms of the sale. These terms fall into several broad categories according to the net period within which payment is expected. When the terms of sale are only on cash basis, there can be two situations, viz., Cash On Delivery (COD) and Cash Before Delivery (CBD). Under these two situations, the seller does not extend any credit.

Cash Discount

Cash discount influences the effective length of credit. Failure to take advantage of the cash discount could result in the buyer using the funds at an effective rate of interest higher than that of alternative sources of finance available. By providing cash discounts and inducing good credit risks to pay within the discount period, the supplier will also save on the costs of administration connected with keeping records of dues and collecting overdue accounts.

Degree of Risk

Estimate of credit risk associated with the buyer will indicate what credit policy is to be adopted. The risk may be with reference to buyer's financial standing or with reference to the nature of the business the buyer is in.

Nature and Extent of Competition

Monopoly status facilitates imposition of tight credit term whereas intense competition will promote the tendency to liberalise credit. Newly established companies in competitive fields may more readily resort to liberal trade credit for promoting sales than established firms which are more formal in deciding on credit policies.

Datings

In seasonable industries, sellers frequently use datings to encourage customers to place their orders before a heavy selling period. For many consumer durables, the demand will be of this type. The need for an air-conditioner is felt in the summer, leading to heavy ordering at a particular point of time. This has double advantages. For manufacturer, he can schedule production more conveniently and reduce the inventory levels. Whereas, the buyer has the advantage of not having to pay for the goods until the peak, of the selling period. Under this arrangement, credit is extended for a longer period than normal.

13.5 COST OF CREDIT

Billing methods can vary. The payment of invoices may be stipulated as a number of days after the date of the invoice or after the receipt of the goods. In instances of seasonal business, when the supplier wishes to induce customers to acquire and hold inventories in advance of the peak sales period, he may resort to dating. The supplier, under this arrangement, extends longer duration credit to the buyer and allows him to pay for the goods when the peak period sales pick up. In some cases, a series of despatches effected during a period, say, a month, are bunched together for invoicing and the credit term is reckoned from the invoice date.

When the credit does not cover cash discount for early payment, the trade credit is considered to be a cost free source of financing for the buyer. It is not uncommon for some of the buyers to delay payments beyond the due date, thus extending the period of use of costless trade credit.

Trade credit is a built-in source of financing that is normally linked to the production cycle of the purchasing firm. If payments are made strictly in accordance with credit terms, trade credit can be regarded as a cost free, non-discretionary source of financing. But where the buyer takes the privilege of delaying payment beyond the due date, it assumes the form of discretionary financing and if this becomes a regular feature resulting in delinquency, trade credit will cease to be cost free. The supplier may stop credit or may charge a higher price for the product, to cover the risk.

The supplier may offer cash discount for payment within a specified number of days after the invoice or after the receipt of goods. Generally such concessions for expedited settlement are given to select customers on informal basis. Where the aim is to induce earlier payment wherever possible, cash discounts are provided for in the credit terms. The quantum of discount offered will vary for different categories of business and clients.

Cash discount is to be distinguished from the other categories of discount that may be offered by the seller, namely, the trade discount and the quantity discount. The trade discount is a reduction from the invoice or list price offered to the dealer or trader in the channel of distribution. Quantity discounts are given when purchases are made in sizeable lots.

When the cash discount is allowed for payment within a specified period, we can compute the cost of credit. For instance, if 30 days' credit is offered with the stipulation of a 2 per cent cash discount for payment within 10 days, it means that the cost of deferring payment by 20 days is 2 per cent. If payment is made 20 days earlier than the due date, 2 per cent of the amount due can be saved, which amounts to an attractive annual saving rate of 36 per cent.

If cash discount is not availed, the effective rate of interest of the funds held will work out to 36.7 per cent. The interest is Rs. 2 on Rs. 98 for a period of 20 days, and the rate of interest will be:

$2/98 \times 360/20 = 36.7$ per cent.

If 60 days' credit is extended, with a cash discount of 2 per cent for payment within 10 days, there is a saving of Rs. 2 for paying 50 days ahead. The effective rate of interest is $2/98 \times 360/50 = 14.7$ per cent. For 90 days' credit, with 2 per cent cash discount for payment within 10 days, the effective interest works out to 9.2 per cent. Thus the more liberal the credit terms, the saving from cash discount declines and so does the effective rate of interest for using the funds till the due date. If, however, the discounts are not taken and the settlement is made earlier than the due date, the effective rate of interest will vary. For a firm that resists from taking the cash discount, its cost of trade credit declines the longer it is able to delay payment.

The rationale for availing trade credit should be its savings in cost over the forms of short term financing, its flexibility and convenience. Stretching trade credit or accounts payable results in two types of costs to the buyer. One is the cost of cash discount foregone and the other is the consequence of a poor credit rating.

The contention that there is no explicit cost to trade credit if the payment is made during the discount period or if the payment is made on the due date when no cash discount is offered, is not totally tenable. The supplier who is denied the use of funds during the credit period may bear the cost fully or pass on part of it to the buyer through higher prices. This will depend on the nature of demand for the product. If the demand is elastic, the supplier may opt to bear the cost himself and refrain from charging higher prices to recover part of it. The buyer should satisfy himself that the burden of trade credit is not unduly loaded on him through disguised price revisions.

Repeated delinquency and deterioration in credit reputation do involve an opportunity cost though it is difficult to measure. Some suppliers may be more tolerant to delayed payments at some times than on other occasions. A policy of delayed payments is bad business practice and in the long run can prove very expensive or may even lead to freezing of credit source. Credit reputation is a precious asset that needs to be preserved with utmost care. The long run policy should be to avail discounts, if offered, utilize credit periods to the full and discharge obligations on schedule.

The following formula can be used for determining the effective rate of return:

R = C (360)/D (100-C), where

R = Annual interest rate for the use of funds

C = Cash discount

D = Number of extra days the customer has the use of supplier's funds.

Let us take an illustration.

A firm wants to hold additional inventory but does not have the cash to finance it. If the credit term is 2 per cent discount for payment within 10 days with 60 days credit period, and the bank rate is 9 per cent, should the firm take the discount?

If the discount is not taken by the 10th day, the effective rate of interest on the funds held and utilized for the remaining 50 days will be:

$2/98 \times 360/50 = 14.7$ per cent.

The bank rate is 9 per cent only. Therefore it is advisable to take the discount offered, even if it involves utilizing bank borrowing for effecting early payment for availing the cash discount.

Stretching Accounts Payable

It is normally assumed that the payment to the supplier is made at the end of due date. However, a firm may postpone payment beyond this period. This type of postponement is called stretching or Leaning on the trade. The cost of stretching accounts payable is two fold : the cost of cash discount foregone and the possible deterioration in the credit rating. If a firm stretches its payables excessively, so that its payables are significantly delinquent, its credit rating will suffer. Suppliers will view the firm with apprehension and may insist on rather strict terms of sale. Although it is difficult to measure, there is certainly an opportunity cost to a deterioration in the firms quality of payment.

Activity 13.2

Meet the Finance Executive of a large enterprise that has been growing at a fast pace and enjoying substantial credit facilities from different suppliers and also meet the Finance Executive of another large firm which has been under financial strain for some time but is yet getting trade credit from suppliers, and get responses from them on following aspects.

a) Do the suppliers change their trade credit policy from time to time or are they consistent irrespective of customer's shifting fortunes?

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b) How do the two companies that you contacted evaluate the credit terms offered by suppliers? Do they reckon the cost of credit and. if so, what initiatives do they take to keep the cost of credit to the minimum?

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13.6 ADVANTAGES OF PAYABLES

Easy to obtain

Payable or Trade Credit is readily obtainable, in most cases, without extended procedural formalities. During periods of credit crunch or paucity of working capital, trade credit from large suppliers can be a boon to small buyers.

Suppliers assume the risk

Where the suppliers have the advantage of high gross margins on their products, they would be able to assume greater risks and extend more liberal credit.

Informality

In trade credit, there is no rigidity in the matter of repayment on scheduled dates, occasional delays are not frowned upon. It serves as an extendable, convenient source of unsecured credit.

Continuous Financing

Even as the current dues are paid, fresh credit flows in, as further purchases are made. It is a continuous source of finance. With a steady credit term and the expectation of continuous circulation of trade credit-backing up repeat purchases, trade credit does in effect, operate as long term source.

13.7 EFFECTIVE MANAGEMENT OF PAYABLES

The salient points to be noted on effective management of payables are:

- Negotiate and obtain the most favourable credit terms consistent with the prevailing commercial practice pertaining to the concerned product line.
- Where cash discount is offered for prompt payment, take advantage of the offer and derive the savings there from.
- Where cash discount is not provided, settle the payable on its date of maturity and not earlier. It pays to avail the full credit term.
- Do not stretch payables beyond due date, except in inescapable situations, as such delays in meeting obligations have adverse effects on buyer’s credibility and may result in more stringent credit terms, denial of credit or higher prices on goods and services procured.
- Sustain healthy financial status and a good track record of past dealings with the supplier so that it would maintain his confidence. The quantum and the terms of credit are mainly influenced by suppliers’ assessment of buyer’s financial health and ability to meet maturing obligations promptly.

- In highly competitive situations, suppliers may be willing to stretch credit limits and period. Assess your bargaining strength and get the best possible deal.
- Avoid the tendency to divert payables. Maintain the self liquidating character of payables and do not use the funds obtained there from for acquiring fixed assets. Payables are meant to flow through current assets and speedily get converted into cash through sales for meeting maturing short term obligations.
- Provide full information to suppliers and concerned credit agencies to facilitate a frank and fair assessment of financial status and associated problems. With fuller appreciation of client's initiatives to honor his obligations and the occasional financial strains which he might be subjected to for a variety of reasons, the supplier will be more considerate and flexible in the matter of credit extension.
- Keep a constant check on incidence of delinquency. Delays in settlement of payables with references to due dates can be classified into age groups to identify delays exceeding one month, two months, three months, etc. Once overdue payables are given priority of attention for payment, the delinquency rate can be minimized or eliminated altogether.

13.8 SUMMARY

Payables or trade credit is a self liquidating, easy-to-obtain, flexible source of short term finance. Buyer's credit reputation, as reflected in evidences of his willingness and ability to meet maturing obligations will determine the quantum and period of credit he can command. Factors like competition, nature of the product and size of the supplier's firm also influence terms of credit, besides relevant commercial practices or conventions. It will be prudent to take advantage of cash discount facilities when available and avoid over-stretching payables by frequent delays in payments. If good credit relations are maintained with suppliers, payables can be a ready and expanding source of short term finance that will correspond to the needs of a growing firm.

Payables are not altogether cost-free but if managed well, the costs can be substantially lower than the alternative sources of short term finance.

13.9 KEY WORDS

Accounts Payable: is a liability arising from the purchase of goods or services on credit.

Trade Acceptance: is a bill or instrument drawn by the seller on the buyer, the amount which the buyer accepts to pay at an agreed future date.

Promissory Note: is a formal document signed by the buyer promising to pay the amount thereof to the seller on demand or at a certain future date.

Delinquency: is the failure to meet the obligation on the due date.

Datings : A practice of encouraging buyers to place orders before a heavy selling period.

Stretching : Postponement of payment beyond due date.

13.10 SELF ASSESSMENT QUESTIONS

1) Why is trade credit used extensively by firms?
2) What are the different forms of trade credit? Explain.
3) Trade credit is regarded as a spontaneous source of short term finance. Comment.

4) Distinguish between trade discount, quantity discount and cash discount.

5) What are the factors that influence the availability of trade credit?

6) What are the principal advantages of trade credit or payables?

7) Over extension of trade credit is a major factor in the financial difficulties of most companies that fail. Explain.

8) A company has regularly been obtaining 90 days' credit, with a cash discount of 2 per cent for payment within 10 days and has found that it can let the account slide for an extra 30 days without injuring its credit rating or losing its source of supply. Will it pay the firm to borrow from a finance agency at a rate of 7 per cent to take advantage of cash discount?

9) Compute the cost of not availing the following discounts on a purchase of Rs. 10 lakhs a year.

   a) 2/10, net 30

   b) 3/10, net 40

   c) 2/5, net 25

   d) 1/10, net 46

10) You receive a bill from a supplier with the term 2/15, net 45.

   a) If you can borrow funds from your bank at 12% per annum, should you avail discount ?

   b) Suppose the terms are 1/5, net 15, and you can borrow at 12%, should you avail discount ?

13.11 FURTHER READINGS

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