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RESEARCH ARTICLE

MANAGEMENT ANDCONTROL OF TRADE CREDIT IN COMMERCE.

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Abstract

This paper focuses on the management and control of trade credit in a business enterprise. The study adopts literature review methodology. In today's management of business, due to competitiveness, increased in business transactions and ultimate desire to get large chunk of market share for increase profitability, trade credit is inevitable. In order to trade off liquidity risk and profitability, the crafting of credit policy is not only desirable but fundamental to a firm success. The cost and benefits of trade credit must be evaluated and appraised before implementing it. We recommended that for a firm to have efficient and effective trade credit management, the engagement of credit manager and training of all stakeholders in credit administration are vital and not negotiable. The success or otherwise of any business enterprise, most especially small and medium scale enterprises, in this current economic recession in Nigeria depends to a large extent on effective and efficient management of trade credit (account receivables).

Introduction:-

The efficient management of trade credit is fundamental to the survival of any business enterprise (García-Teruel&Martínez-Solano, 2010). It is generally believed that no business can do without credit except such a business organization is a monopolist (Peel, Wilson &Horworth, 2000). The understanding of cash conversion cycle of each business is critical to it management and control of trade credit in business (Raheman& Nasr, 2007). The term trade credit is a phenomenal and part and parcel of any business venture. The complexity of modern business environment, the persistent sophistication in the demand and needs of customers, competitiveness of products, modern technology in marketing and increased in the volumes of transactions have made trade credit a potent tool in the development of modern day commerce (Fatoki, 2010). It needs to be emphasized that if trade credit is not professionally guarded and monitored, it could spell doom for a company (Owolabi&Obida, 2012).

In today's business world, customers who are enjoying trade credit facilities are finding it difficult to honour their obligations thus making it difficult for such business enterprises to continue in business (Barbosa &Moraes, 2004). This has also brought about stringent conditions to be met by credit-worthy customers before credit facilities are extended to them as a result of accumulated bad debts (Fatoki&Smit, 2010). The ultimate effect is always on the business enterprise financial position.

Many small and medium scale enterprises have been sent out of business due to bad debt while some have filed for bankruptcy and are being managed by receivers (Fatoki&Smit, 2010). This development has actually contributed to

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failure of banks in Nigeria. In a typical manufacturing set up, the management of account receivable and payable is very fundamental to its success. If larger percentage of sales is on credit (account receivable) and it takes longer period for credit customers to pay, then the early payment of account payable would suffer (Kitindi, Magembe&Sethibe, 2007). This development could lead to taking short term loans or overdraft from bank with attendant cost or losing the credit being enjoyed from creditors thus leading to shortage of raw materials for continual production of goods or risk the early winding-up of the company on the application of trade creditors for failure to honour obligations as at when falls due (Zainudin&Regupathi, 2011). Sections 408 and 409 of company and allied matter act (CAMA) provide that a creditor may commence winding up proceedings against a company if it is unable to pay its debts which had fallen due after three weeks a demand notice had been served and delivered at the registered office of the company.

Therefore, the incidence of incessant default in payment or settlement of receivables and payables are not healthy for the modern day business (Padachi, 2006). It shows that the company's policy on the management of trade credit is weak. Poor trade credit management and control as enunciated above would lead to accumulated bad debts, instability in or low profits or ultimate losses, distortion in production activities, excessive granting of credit, hindrance to the development of trade and industry and increase in trade credit risk (Barbosa &Moraes, 2004).

It is on this background, therefore, this paper is designed to strike a balance between the risks involved in trade credit and the benefits therefrom through effective planning and control. The risk inherent in trade credit is monumental most especially in this period of economic recession in Nigeria when many small and medium scale enterprises are struggling for survival.

This paper will adopt literature review as its methodology in examining management and control of trade credit in business.

Literature Review:-

Padachi (2006) maintained that management of trade credit is fundamental to the success of a firm. The failure of a firm most of the time is caused by its inability to properly plan and control working capital which comprise of current assets and current liabilities. Firms of different shape and sizes rely more heavily on trade credit to finance their operations.

According to Zainudin&Regupathi (2011), the delay in timely regularization of account receivables can cause financial bottleneck to firm that extended such services to credit customers. They therefor posited that prudent trade credit management is fundamental to the success and survival of any business enterprise most especially small and medium enterprises.

Firms poor trade credit management is considered as a credit risk to banks, suppliers and/or other financial institutions (Tagoe, Nyarko& Smurfit, 2005). It has also been established that poor management of trade credit contributes to failure of small firms (Poutziouris, Michaelas&Soufani, 2005). Small firms, as receivers of trade credit, depend heavily on trade credit as a form of finance due to volatility in their cash flows.

The concept of liquidity management is ubiquitous and is being handled professionally by business owners in view of the current global financial challenges. The managers of business enterprises have been saddled with the responsibility of fashioning out workable strategy that will reduce credit risk, improve cash flows and ensuring timely settlement of financial obligations as at when fall due. The overall aim is to ensure steady or uninterrupted profitability and the maximization of the shareholders' wealth (Owolabi and Obida, 2012).

The significance of liquidity as a life wire to the success of any business enterprise cannot be over emphasized. The efficient management of working capital in ensuring that day to day financial obligations are met is sin-qua-non to the success of an organization (Eljelly, 2004). This reinforces the importance of liquidity in the efficient management of a business enterprise. It is therefore necessary for business enterprise to guide against liquidity dearth in meeting short term obligations. As a result of its overwhelming usefulness, daily appraisal and evaluation of liquidity are crucial to both the internal and external financial analysts in gauging the solvency or otherwise of a firm (Bhunia, 2010). The challenge in the management of liquidity is how to strike a balance between liquidity and profitability (Raheman and Nasr 2007). There is no universal rule to ascertain an optimal liquidity requirement for a firm that would guarantee its desirable profitability without taken into cognizance the peculiarity of its operation.

The efficient management of credit policy, cash flows and cash conversion cycle are fundamental to a firm's liquidity requirement. The processes of extending credit to customers, monitoring, control and efficient management of account receivable are conceptualize into the term called 'credit' (Maysami, 2010). Miller, 2008 opined that credit policy of a typical business entity contains such variables: as collection policy, cash discount, credit term, deposits, customer information and documentation. These variables as contained in credit policy are being used to monitor and control account receivables occasioned by credit sales. It encompasses the evaluation of existing and prospective customer's suitability for credit facilities and the actual regularization of outstanding balances. Credit policy therefore, is the most potent standard for managing account receivables and in order to optimize investment in receivables, a business enterprise is expected to have credit policy.

Credit Policy:-

Credit Policy can be viewed as written guidelines that set the terms and conditions for supplying goods on credit, customer qualification criteria, procedure for making collections and steps to be taken in case of customer default. The term can also be referred to as collection policy. It also the guidelines that spell out how to decide which outstanding balances and how to deal with defaulted accounts.

The aim of managing accounts receivable is to collect receivable without losing sales from high-pressure collection techniques. Accomplishing this aim encompasses credit selection and standard which involve the application of evaluating the customer's credit worthiness and comparing it to the entity's standard, its minimum requirement for extending credit to customers and credit monitoring which involves ongoing review of the firm's account receivable to determine whether customers are paying according to the stated credit terms. Slow payments are costly to an entity's investment in account receivable.

Receivable management means the process of decisions relating to the investment in business account receivables. In credit selling, it is certain that one has to pay the cost of getting debtors and take some risk of loss due to bad debts. To minimize the loss due to not receiving money from debtors is the main objective of account receivables. The trade-off between increase in the market share through its credit sales and the collectability of the account receivable affects entity's liquidity and its eventual profitability. An entity may report large profit and still suffer liquidity problem if bulk of its transactions are in account receivable and collection policy is ineffective. Credit and collection policies encompasses the quality of accounts accepted, the credit period extended, the cash discount given, certain special terms and the level of collection expenditure. In each case, the credit decision involves a trade-off between the additional profitability and the cost resulting from a change in any of these elements.

Receivable management starts with the decision of whether or not to grant credit. Where goods are sold on credit, a monitoring system is important, because without it, receivable will build up to unbearable level, cash flow will fall and bad debts will offset the profit on sales. Corrective action is often required and the only way to ascertain whether situation is getting out of hand is to set up and implement a good receivable control system (Eugene 1992). Eugene (1992) opined that optimal credit policy. Therefore, the optimal level of accounts receivable, depends on the firm's own unique operating conditions. An entity with excess capacity and low variable production cost should extend credit more liberally and carry a higher level of receivable than an entity's operating at full capacity on slim profit margin.

There are various forms of credit in use today classified under public, consumer and commercial credits. Public credit is a type of credit used by various governments units such as federal, state and local governments. Through this credit, goods and services or even funds can be secured from sellers and lenders for execution of government projects under promise of future payments. The payment is normally made from public revenue collection.

Consumer credit is used by the ultimate consumers. Goods and services obtained under this form of credit are not for resale but for household consumption. Almost every person is involved in using this credit at one time or the other.

Business credit: This involves businessmen and entities mainly. It is classified into cash and trade credits. Cash credit is concerned with borrowing money from financial institutions and other institutional lenders to finance business activities. It can be on long, medium or short term basis. Trade credit can be described as mercantile or commercial credit. It is regarded as commercial in the sense that the goods and services obtained are for resale or further economic activities that are geared towards profit making. Any resale to ultimate consumers on credit is not regarded as trade credit because they are not for resale. The focus of this paper is on trade credit only.

The Importance of Trade Credit:-

A supplier can use trade credit as a strategy for increasing sales and profitability. When a supplier allows generous credit, more customers may be attracted and this has an increasing effect on sales. Increased sales on the other hand can result in increased profit if trade credit is properly managed otherwise accumulated bad debt may result and low profit posted.

Trade credit can be used by a company to check the activities of competitors. Where competitors are selling on credit the entity may plan for credit extension in order to retain the customers and maintain its market share. It should be noted that customers always shop for where they can obtain the most favourable terms of credit.

Trade credit enables a buyer to finance his business transactions on short-term basis. For instance, if trade credit is allowed to a buyer, arrangements can be made to dispose off the goods and payments made from the proceeds. By this, goods and services for which immediate cash payments are not possible can be enjoyed.

By securing trade credit, the working capital requirement of the buyer is reduced. Where trade is not granted and the purchaser has no cash, he has to look for money either by borrowing or otherwise. But availability of trade credit reduces his requirement problem saving him the time and trouble of looking for more cash to finance the transactions.

Management of trade credit:-

There is no clear-cut acceptable definition of credit management. It can be seen as an assurance statement that trade debtors settle accounts as at when due, credit costs are kept within an acceptable limit, and non-performing credits are managed in such a way that payments are made without damaging established relationship with any esteemed customers.

It therefore suffice to say that trade credit management is all about planning and control of trade credit in order to strike a balance between liquidity risk and profitability (Pandey, 1987). It involves virtually all the fundamental principles of management employed in the management of business enterprise. In credit management there are associated cost s and risk involved. The failure of trade debtors to settle their account as at when due which could ultimately result into bad debts pose serious threat to financial health of an organization with the possibility of plunging such enterprise to untimely liquidation.

Poor credit management could result to extending trade credit to unworthy credit customers. The formulation and implementation of an effective and efficient credit policy will ensure quality information gathering on both the existing and prospective customers to obtain necessary assurance on their credit worthiness. Such information includes and not limited to the character, the business capacity, the financial position and prospect or other circumstances such as business trends likely to affect the future repayment capacity of the customers. This measure will not however completely eliminate the incidences of bad debts but the benefits therefrom should outweigh the cost. The cost associated with the management of credit include personnel cost, cost of recovery, insurance, asset maintenance cost and, ofcourse, the alternative use of capital tied down (opportunity cost). It is then clear that trade credit is an investment which emphasizes the need for a firm to take the cost of trade credit into cognizance before policy on trade credit and pricing are formulated and agreed upon. All the costs associated in the management and control of trade credit must be professionally accumulated and appropriately recovered failing which the financial position of the business enterprise will be negatively affected.

Trade Credit Management Process:-

According to Patrick (1977), trade credit management involves adequate planning which include the following:

- Credit investigation. This is aimed at ascertaining the credit worthiness of a customer. It helps to gauge the customers capacity and willingness to honour his obligation as at when due and at the same time minimizing risk of default. The critical evaluation of the popular 5c's of credit, character, capital, capacity, collateral and condition, will be useful,

- Development of a workable credit policy. Credit policy must be developed, communicated in a clear term to customers and implemented to the letter. It includes such information as credit period, cash discounts for early payment on account, the credit collection processes and interest charges for late payment,
- The establishment of the guideline and procedures for collection of debts. This is aimed at guiding against bad debts. In order to guide against the incidence of bad debts, it is imperative to ensure that:
  i. Business enterprise should not assume that the customers know your credit policy. The management should not be reluctant to ask for payment immediately it falls due,
  ii. A business enterprise must know its customers individually. Credit should not be extended without first investigate the current liability of a credit customer. Immediately a customer begins to ask for extension in the payment of credit due or balance, such a customer should be placed under a close scrutiny.
  iii. The trade credit records must be kept current. The business environment is constantly changing and any change can abruptly alter the financial health of any business. It is therefore necessary to keep abreast of trade reports specifically pertaining to a particular customer or firm in order to guide against avoidable credit risk.
  iv. The collection procedure must be tightened most especially in an uncertain period. The credit policy must be strictly adhere to or implemented. In this situation the request for payment must be more of action compelling,
  v. Extension of payment terms must be vigorously avoided. This will ensure that cash flow position is not endangered and that difficult or undesirable relationship is discouraged.
  vi. Constant review of outstanding balances must be vigorously pursued and request for the speedy payment of the balances within an agreed period of time,
  vii. Others include reduction in collection schedule, effective communication with the debtors and timely resolution of any dispute.

The overall trade credit management is to ensure prompt and cheap settlement of debts and effective management of relationship. Business enterprises that sell goods or provide services must as a matter of necessity carefully coin workable credit policy most especially in an inflationary or recessionary economic period.

Functions of the credit unit;-

In order to ensure the effectiveness and efficient management of trade credit, depending on the size of the firm, the type of goods and services sold and the size of the customers base, there must be a dedicated unit or table for that purpose which must be manned by a qualified and competent personnel such as a professional accountant or sales manager. Though some management gurus are of the opinion that credit related issues should not be handled by Sales manager or production manager in order to guide against pressure that could distort the credit objective (Hutson& Butterworth, 1974). They argued that sales manager could jettison the credit policy of the firm to satisfy their selfish gain in form of increase in sales commission to the detriment of the firm.

It has also been argued that for efficient administration of credit, an independent credit manager should shoulder the responsibility credit management which reports directly to the Chief Executive Officer. The credit manager will however constantly liaise with both the sale manager and accountant for effective management of the firm's credit.

The functions of credit managers include the following:

- Critical analysis of credit request, granting of approvals and efficient management of trade credit,
- Information gathering on both current and prospective customers creditworthiness, financial capacity, business relationship with other competitors and constant evaluation of risk faced by their individual business,
- The crafting, custodian and execution of credit policy and objectives of the firm.
- Ensuring speedy payments of all outstanding and liaising with various law enforcement agencies in the course of regularizing accumulated bad debts.

Qualities and Skills of a Good Credit Manager:-

A good credit manager must:-

i. Possess good analytical ability. Must be able to derive tangible information from information made available in taking timely and informed decision,

ii. Develop good telephone conversation skill or etiquette in communicating or interacting with customers and other stakeholders,
iii. Possess good communicating skill. Must be good at writing business letters using appropriate and professional language or tenses.
iv. Have a good personality. He must have pleasing but business-like personality that will insinuate unflinching support of trade debtors and at the same time facilitate easy access to vital information that could assist in collection process,
v. Be a man of highly emotional intelligence. This will assist the credit manager to conduct himself in a professional manner, command self confidence, self awareness, self control as well as the ability to communicate, influence, initiate and accept change.
vi. Be able to develop good human relationship with both the internal and external customers with a view to achieving the firm's credit policy and objectives. His cordial relationship with sales manager, accounts department, customers and other stakeholders will, in no small measure, determine his success. He must therefore be diplomatic and at the same time have good human relations,
vii. Be a man of high integrity and ethical standard in dealing with the firm's customers,
viii. Have a sound and adequate knowledge of the status of every trade debtors account, firsthand knowledge of the products of his firm and customers, the credit policy, procedures, terms and conditions as well as the impact of legislation on credit management,
ix. Have a good and sound credit control system. This would facilitate early and timely dispatch of invoices and statement of accounts to customers, effective follow-up with debtors for timely recovery, regular contact and communication with debtors and follow-up, regular update of customer's account, and strict adherence to rules and regulations of the firm's trade credit policy.

Recommendations:-

Any business enterprise that is determined to survive in this dispensation of stiff competition, inflationary and recessionary period, trade credit must be efficiently and effectively managed in order to experience an appreciable growth and development.

The credit manager and other personnel involved in the management of receivables must be adequately exposed to training. This is necessary in view of the complexities of the modern day businesses and sophistication of customers and other stakeholders. Also, the tertiary institutions in Nigeria should review their curriculum to accommodate this new trend with a view to producing astute professionals that will shape a new direction for business management and survival.

The business enterprises should as part of their social responsibility constantly engage their customers on maintenance of good accounting system that will assist in the management of their accounts with a view to detecting errors, mistakes and fraud that could be an impediment to the successes of the businesses.

The various trade associations and agencies such as Manufacturers Association of Nigeria, Association of small scale and medium enterprises, National Association of Chamber of Commerce, Industries, Mines and Agriculture of Nigeria (NACCIMA), Trade groups and associations and other self-employed association should have a comprehensive information and data of their members that could be of assistance in obtaining necessary credit reports through credit risk management system (CRMS). This will assist the credit manager and other credit management institutions like banks to take timely decision for the overall benefits of their members.

Conclusion:-

We have established that no business is an island. Every business needs the assistance of another in form of trade credit to grow and develop since resources are scarce. The risk and associated costs in trade credit management are enormous that need professional skills to manage effectively and efficiently in order to avoid untimely death of any business enterprise. Therefore, the efficient and effective management of trade credit will ensure the overall achievement of goals and objectives of a business enterprise.

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