



## A Conceptual Study of Trade Credit Management on SME's

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### Abstract

Business finance includes both types of funds long term as well as short term which required for daily expenses in the business and also known as working capital. Working capital management includes management of inventory system of firm, cash management, accounts payable management, and receivables management, which means trade credit management. Receivables are one of the largest assets of the business enterprise. The level of receivables will be based on certain factors like, credit policy of the firm, credit period, discount and collection policy. Trade credit confined to receivables arising from transaction between companies. For small businesses the efficient receivables is a critical component and one of the most important elements of working capital management. Proper management of receivables will lead to increase in sales and profit enhancement. The Objective of the study is to get the conceptual clarity of working capital and trade credit, and how this affects SME's

**Keywords-** Working capital, Receivables, Trade credit, Management, SME's

### Introduction

#### Financial Management

Money is required at every activity of business. Business finance includes both types of funds long term as well as short term. For managing these funds a system is required, which is known as financial management. Key financial management decisions involve where to invest? From where to raise funds, How much distributed among shareholders in the form of dividend and how to manage working capital of the firm. The financial managers must ensure the availability of adequate funds as and when needed to purchase raw material, to pay wages and salaries for meeting day to day demands of the organization. (PC Tulsian, 2012)

#### Working Capital

Working Capital refers to funds required to be invested in the business for a short period generally one year. It is measure of company's efficiency and short-term financial health. It shows whether a company has short term assets to cover its short term debt. It is required to meet day to day operating expenses and for holding stocks of raw-materials, spare parts, consumables, work in progress and finished goods and book debts. It is essential due to existence of operating cycle.

The primary purpose of working capital management is to make sure the company always maintains sufficient cash flow to meet its short-term operating costs and short-term debt obligations. Working capital management involves the relationship between a firm's short-term assets and its short-term liabilities. The goal of working capital management is to ensure that a firm is able to continue its operations and that it has sufficient ability to satisfy both maturing short-term debt and upcoming operational expenses. The management of working capital involves managing inventories, accounts receivable and payable, and cash.

Calculation of working capital ratio is current assets/ current liabilities. Current assets include cash and cash equivalents, short-term investments, account receivables, inventory, prepaid expenses etc. Current liabilities include accounts payable, short-term debt, current interest payments for long-term debt salaries taxes. This calculation gives understanding what percentage a firm's current assets are of its current liabilities.

Wanjiku , 2013 mentioned the importance of working capital management in the overall performance of the firm. Various components of working capital management like accounts payable period, accounts receivable period and inventory conversion period have the significance relationship with profitability of the firm. The study used regression and correlation analysis to show the results.

Working capital management not only focuses on handling current assets but also supervision of current liabilities of the company. The three core areas of working capital management are receivables management, cash management and inventory management. Reliance infrastructure manages its receivables by using aging study method. RIL expected to realize its receivables within a stipulated time, but most of the times, this is not the situation due to several reasons like bill break up not being accepted by the customer, dispatch letter not enclosed.

RIL has a credit policy of 30 days from invoicing date. If the bill goes beyond 60 days of non-payment, it requires managerial consideration and beyond 90 days a worrying situation for the company. In this situation aging analysis comes into effect to gear up the recoverable amount. RIL is using a lenient credit policy in projects where there is any involvement of Government. (Srivastava, 2011)

Srinivas K.T observed that it is very essential to have proper working capital management for a company to achieve its objectives and maintain financial soundness. The study found that company was financially sound because of increasing production which led to an increase in Net Profit. The study analyses the working capital management of KPCL (Karnataka Power Corporation) and its financial performance through various ratios like current ratio, liquid ratio, working capital turnover ratio, debtors turnover ratio, cash turnover ratio etc. The paper concludes that though the company is earning profits each year, but their funds were not utilized efficiently.

Huynh Ngoc Trinch examines the influence of working capital for non-financial companies which include manufacturing and service sectors of Dutch. The data of 62 companies was studied covering the period from 2006-10. Pearson Co-relation analysis, Fixed Effects model and ordinary least square methodology are used. The paper concludes that efficient management of working capital leads to a decrease in borrowings and it has a great impact on profitability and liquidity of the firm.

Working capital has two concepts. The first one is gross working capital and the other one is net working capital. Gross working capital means the total of current assets and the net working capital means current assets minus current liabilities. These two concepts of working capital are significant components of financial management. Its importance can be withdrawn from the following two reasons:

First, the investment in current assets represents a substantial portion of total investment.

Investment in current assets and the level of current liabilities have to gear quickly to changes in sales. (Chandra, 2015)

Large companies pay attention to WC as Working Capital is a measure of liquidity, and thus it measures future credit-worthiness. For small businesses and start-ups, working capital is required to finance operations for the business to run smoothly.

Working Capital is significant for companies because it is a measure of a company's ability to pay off short-term expenses or debts. Alternatively, high working capital means that few assets are not being invested for the long-term, so they are not being utilized efficiently. WC is only one measure of a company's operating liquidity. It is not the only measure, and it is certainly not a guarantee of a company's ability to pay. A company may have positive WC, but not enough cash to pay an expense tomorrow. Similarly, a company may have negative WC, but may be able to adjust some of their debt into long-term debt in order to reduce their current liabilities.

(Bereznicka, 2013) provides insights into the relative importance of the selected working capital determinants from the European Union. The determinants considered in the study include both external and internal factors, managers' perspective because they invest a significant amount of time and effort in searching for an optimal balance between liquidity and profitability and, consequently, between risk and return. WC management, considering the combined effect of the main components: inventory, accounts receivable and accounts payable. The discussion regarding the factors that affect WC policy is complex. The objective of this study is to establish the hierarchy of the three factors that are commonly believed to impact WC, i.e., the country- and industry-specific factors and the firm size, and thus contribute to the corporate finance knowledge of short-term decisions. The research is based on a sample of firms of all sizes from 13 industries and 9 EU countries, and it covers the period 2000-2009. Corporate decisions concerning WC can be affected by a number of factors of both external and internal characters. One such factor is the impact of corporate financing decisions. The main objective of the study is to evaluate the impact of the country effect, the industry effect and the size effect in the corporate WC ratios in selected EU countries. The intended result of the analysis is, therefore, to determine which of these factors has the greatest influence on WC policy. As a result, the study should provide a hierarchy of the factors according to the strength of their impact on the WC. To solve this research problem, which can be defined as the assessment of the relative importance of the three effects, the analysis is conducted in three sections: across countries, across industries and across size groups. The pairs are as follows:

- Country-specific and industry-specific factors,
- Industry-specific and size-specific factors, and
- Country-specific and size-specific factors. The findings provide evidence that corporate working capital is most affected by country-specific factors, followed by industrial factors and firm size.

#### **The Major Determinants of Working Capital Are:** (Pandey, 2015)

- *Nature of business* - Trading and non-manufacturing firms having a lesser investment in fixed assets, but they require a large sum of money for the working capital. So, it depends on the nature of business that how much working capital is required.
- *Market and demand conditions*- Growing firms may need funds continuously, and hence require large working capital amount. Large number of firms may face cyclical or seasonal demands and accordingly requirement of working capital exists.

- *Technology and Manufacturing policy*- Longer the manufacturing cycle of the firm, higher the working capital required. So if technological manufacturing the product is there in the company that will shorten the cycle and hence requirement of working capital too.
- *Credit policy*- A liberal credit policy without rating the credit worthiness of the customer, will create a problem of collection on time, which will lead to large funds of investment in debtors and working capital.
- *Availability of Credit from suppliers*- Like in the case of debtors, if the firm has liberal credit terms from its suppliers, then it can enjoy the credit period for longer term, which means less working capital.
- *Operating efficiency* – Optimum utilization of the resources will lead to no wastage and this will lead to less working capital requirement.
- *Price level changes*- Rise in prices of the raw material and in other things means for the same quantity now more funds required, which will affect the working capital limits.

The operating cycle in working capital consists of four major events starting from purchase of raw material, payment for raw material, sale of finished goods and finally collection of cash from credit sales.

**Operating cycle**= Inventory conversion period- Receivables conversion period

**Cash cycle**= Operating cycle- Accounts payable period (Bhalla, 2011)

The cash cycle has three distinct parts. The first part of the cycle represents the current inventory level and how long it will take the company to sell this inventory. This stage is calculated by using the day's inventory outstanding calculation.

The second stage of the cash cycle represents the current sales and the amount of time it takes to collect the cash from these sales. This is calculated by using the day's sales outstanding calculation.

The third stage represents the current outstanding payables. In other words, this represents how much a company owes its current vendors for inventory and goods purchases and when the company will have to pay off its vendors. This is calculated by using the day's payables outstanding calculation.

Firms sell on credit due to cut throat competition in the market and to facilitate sales. Other factors like product pricing, product quality, economic conditions and firm's credit policies may have an influence on the level of receivables of the firms. The credit policy variables include credit standards, credit terms and collection policies and procedures. Credit standards may have tight and loose. If the firms have tight credit standards this will result to less credit sales and vice-versa. To check the credit standards of the firms three C's can be used- character of the firm to which credit is given, capacity to repay on time, condition means analysis of financial statements. (James C. Van Horne and John M. Wachowicz, 2000)

Philip K. (2010) cited four basic things businesses must strive for effective credit management:

- Know who your customers are before you start trading with them.
- Agree payment terms before supplying,
- Invoice promptly after you have sent the goods; and
- Do not be afraid to ask for payment when it is due.

## Trade Credit

Trade credit (TC) is an important financing and investment channel that companies commonly demand and supply to one another. For example, TC is embodied in a contractual arrangement in which, as part of a transaction, a buyer and a supplier agree that payment may be deferred until a predetermined date following the physical delivery of goods or services.

The supply of trade credit, measured by the volume of credit sales, has a direct, positive and significant effect on the demand for financing from suppliers and an indirect effect through the days sales outstanding of customers. The theory indicates that it is likely that market power has a direct influence on the supply of trade credit. Although it was not possible to test this hypothesis due to lack of data on market power of the firms, it is expected that a possible bias caused by the omission of this variable is small, particularly from the supply side, considering that small and medium-sized companies presumably face intense competition.

Trade credit constitutes a main element of company's liabilities and also assets in the form of accounts receivables. Trade debtors are the third important corporate assets according to a survey in UK in small and medium sized firms of UK. Trade credit management has 5 major elements-: credit risk assessment, credit collection, credit granting decision, financing accounts receivable and assumption of credit risk. For credit risk assessment "3C" has been involved-: character, capacity and capital. (Lamminmaki, 2004) Under the study authors studied trade credit management outsourcing practices in large Australian companies, out of 6 major elements of credit management functions the credit risk assessment is the most frequent outsources activity in large Australian firms and smaller firms have a greater propensity to outsource trade credit management.

### There are four major types of costs involved in Trade credit management:

*Collection Cost*- Those costs that are incurred in collecting the debts from the customers to whom credit sales have given. Collection cost can include stationary, staff salary, postage etc. Collection of receivables is one of the tasks of receivable management.

*Capital Cost*- Trade Credit involves blockage of funds in goods and services provided on credit for a period, which increase the investment in current assets and involve some cost. This cost can be taken from a part of either shareholders fund or from borrowed funds. If it is a part of shareholders' funds it involves some opportunity cost or if used borrowed funds then involve payments of interest.

*Delinquency Cost*- The costs arises due to the failure of the customer to meet their obligations on due date. This involve two types of cost, first the blockage of funds for an extended period and second the cost initiated for trying to collect from the customer and legal charges etc.

*Default Cost*- This can also be represented by bad debts. Sometime customer may not be able to repay the dues to the firm because of many reasons. Bad debts are a kind of loss for the firm.

According to (Shehzad L.Main and Clifford W. Smith, 1992) businesses sells most of the merchandize on credit and not in cash payments. There are some incentives joined to credit sales, which are not there in cash payments like Cost advantage, market power and present value of seller's tax, however total tax obligation would not affected. Credit sells generates accounts receivables and thus there is a need to manage accounts receivables for the development of a healthy organization. For a healthy trade credit process, various aspects of credit administration must be assigned like credit risk of the customer, maturity of receivables, credit terms and default risk. Factoring contracts offers external administration of credit sales by outside intermediary. Credit administration depends upon the scale of the organization; larger firms may have different credit policy than smaller firm. In the paper the author's mentioned five functions of credit-administration process: credit-risk assessment, credit granting, accounts receivable financing, credit collection, and credit-risk bearing.

During any recessionary period, businesses will try to use the available means of funds for daily practices rather than taking outside loans or debts from the market, especially when market is in crises and banks becomes less patient for allowing fresh and new funds arrangement to businesses. In such a situation companies will reevaluate the quality of their accounts receivables to lessen cash flow problems caused by sluggish collections. During such a time, the credit policy has three determinants, the term of credits, technique for collections and overall credit standards. In small and medium enterprises, the credit policy is dictated by the norms of the industry prevalent in the country. The credit policy of the company will see the analysis between incremental cost and incremental benefits. (Zinger, 2009)

Receivables are a major asset of corporation. A survey of the receivables practices of 200 large American corporations to obtain the information on whether firms are maximizing the value of their shareholder's wealth in the area of receivables. The focus of this study is to see the receivables practices in American corporations. To maximize the short term financial management, managers will speed cash inflows, reduce administrative costs, connected cash flows and recognize the tradeoffs. The survey asked the respondents whether they use the five C's like credit scoring and financial statement analysis before granting credit. In the presale area, firms may want to examine their credit granting processing and firms appear to maximizing the value of shareholder's wealth. (Ricci, 1999)

Accounts receivables are the receivable amount from the customers of the company from where they will get money at a future date. Here, customers refer to those to whom company has made credit sales. Accounts receivables are also known as trade receivables. (<http://www.accountingcoach.com/blog/what-is-accounts-receivable>)

The term receivables management is defined as debt owed to the firm by customers arising from sale of goods or services in the ordinary course of business. When a firm makes routine or ordinary sales to customers but not received immediate payment, the firm grants trade credit and recorded as accounts receivables in the book of accounts of corporates. These accounts receivables are received in the near future within a period of one year. Receivables management is also known as trade credit management. Thus accounts receivables represents extension of trade credit to customers, allowing them to a reasonable period of time in which they can provide the payments. (MY Khan, 5th Edition)

### **Control of Accounts receivables:**

For monitoring accounts receivables two important concepts are day's sales outstanding and ageing schedule.

*Day's sales outstanding:*

DSO may be defined as the ratio of accounts receivable outstanding at that time to average daily sales figure during the preceding 30 days, 60 days or 90 days

$DSO = \frac{\text{Accounts receivable at time "t"}}{\text{Average daily sales}}$

A rise in Days Sales Outstanding (DSO) can mean the vicious cycle of nonpayment (e.g. delay, past-due, nonpayment and sometimes insolvency) is set in motion. DSO is a valuable indicator, as it measures how long companies must wait before they collect payments. (Subran, 2016)

*Ageing schedule:*

AG classifies outstanding accounts receivables at a given point of time into different age brackets. It is an important tool used in working capital management to project pattern of collections and estimate doubtful debts.

*Collection matrix:*

For studying correctly the changes in payment behavior of customers, it is helpful to look at the pattern of collections associated with credit sales. (Chandra, Financial Management Theory and Practice, 9th Edition)

*Accounts Receivable Turnover ratio* = Net Credit Sales / Average Accounts Receivable

This formula measures the efficiency of extending credit to customers and collecting. This formula shows the average number of times a company collects its open accounts in a year. A higher ratio means efficient credit and collection process.

*Inventory Turnover ratio* = Cost of Sales / Average Inventory

This formula represents the total number of times inventory is sold and replaced from the company. A higher ratio implies that the company is efficient in managing its inventories.

*Days Inventory Outstanding ratio* = 360 Days or 365 days / Inventory Turnover

This is also known as "inventory turnover in days". It shows the number of days inventory maintains in the warehouse. In other words, it measures the number of days from purchase of inventory to the sale of the same. The shorter the DIO the better.

*Accounts Payable Turnover* = Net Credit Purchases / Ave. Accounts Payable

Represents the number of times a company pays its accounts payable during a period. A low ratio is favored because it is better to delay payments as much as possible so that the money can be used for more productive purposes.

*Days Payable Outstanding ratio* = 360 Days or 365 days / Accounts Payable Turnover

This is also known as "accounts payable turnover in days" or payment period". It measures the average number of days spent before paying obligations to suppliers. Unlike DSO and DIO, the longer the DPO the better

*Operating Cycle* = Days Inventory Outstanding + Days Sales Outstanding

This formula measures the number of days a company makes 1 complete operating cycle, i.e. purchase merchandise, sell them, and collect the amount due. A shorter operating cycle means that the company generates sales and collects cash faster.

*Cash Conversion Cycle* = Operating Cycle - Days Payable Outstanding

CCC measures how fast a company converts cash into more cash. It represents the number of days a company pays for purchases, sells them, and collects the amount due. Generally, like operating cycle, the shorter the CCC the better.

*Total Asset Turnover ratio* = Net Sales / Average Total Assets

It measures the overall efficiency of a company in generating sales using its assets efficiently. The formula is similar to ROA, except that net sales are used instead of net income.

(<http://www.accountingverse.com/managerial-accounting/fs-analysis/financial-ratios.html>)

## Factoring

Factoring is a service that covers the financing and collection of account receivables in domestic and international trade. It is an ongoing arrangement between the client and Factor, where invoices raised on open account sales of goods and services are regularly assigned to "the Factor" for financing, collection and sales ledger administration. The buyer and the seller usually have long term relationships. The client sells invoiced receivables at a discount to the factor to raise finance for working capital requirement. The factor may or may not accept the incumbent credit risk. Factoring enables companies to sell their outstanding book debts for cash.

Reverse factoring has emerged as a financing solution that is initiated by the ordering parties to help their suppliers secure financing of receivables at favorable terms. The purpose of this paper is to study the impact of RF schemes on small and medium enterprises' operational decisions and performance. In this environment of relatively low liquidity, the cost of financing has increased and suppliers, especially small and medium enterprises are finding it more difficult to obtain the credit they need. The scarcity of cheap external financing has driven many firms to look across their financial supply chain for opportunities to improve the management of working capital, optimize their cash flows, and unlock trapped cash. Supply chain finance involves the use of financial instruments, processes, and technologies that facilitate interventions in the financial supply chain by tracking events in the physical supply chain. Reverse factoring is the most popular instrument among the different supply chain finance schemes, has been initiated by large firms with high-quality credit rating as a mechanism for soothing their suppliers' financing problems. It involves a three party arrangement between a buyer a factor (usually a bank), and a supplier. In this arrangement, the buyer promises she will promptly pay the invoices from her trade transactions with the supplier to the factor, in order for the factor to provide an approved-invoice-based financing solution to the supplier (Serrano, 2016)

Reverse factoring aims to reduce working capital in supply chains and promote stability of cash flows. Reverse factoring is thus an efficient way to reduce the cost of trade credit. For a buyer and its suppliers, the direct benefits of a reverse factoring arrangement are reductions in working capital costs. For a bank, reverse factoring provides income through the interest and/or fees charged when suppliers borrow against the value of their accounts receivable. Variables selected in the study that shows the benefits of reverse factoring are: receivables volume, Initial buyer payment terms, initial supplier payment terms, buyer's extended payment terms, suppliers extended payment terms, Buyers cost of capital, suppliers cost of capital, suppliers payment term reduction, buyers realized

payment terms, suppliers realized payment terms and reverse factoring rate. Market factors are relevant for understanding the adoption of reverse factoring arrangements. Traditional methods used to assess the value that firms can obtain from reverse factoring – and by extrapolation, potential market value – consider direct benefits based on a snapshot of market conditions. (Umberto Dello Iacono, 2015)

(Gama, 2015) Small and medium sized firms played an important role in the national development and in creating employment, productivity and strong pillars for corporate finance. The corporate finance literature presents traditionally results on long term financial decisions including capital structure, investments, dividends and company valuations. Many factors are responsible for decisions regarding current assets and current liabilities. In the paper two approaches for working capital management discussed, aggressive approach where firm is maintaining low level of current assets and high investment in non- current assets and this kind of approach can have a risk with insufficient supply of short term funds. The second approach is conservative approach, where a firm maintains high level of investment in current assets as compared to its non- current assets. Most of the SME's have more percentage of current assets over its long term assets. This means most of the investment in inventories, accounts receivable and cash balances. SME's often have a lack of market power and resources to manage their trade debtors effectively, which can lead to increase in the risk of late payments and defaulting payments. The purpose of the paper is to see the effects of working capital management on the profitability of SME's in Portuguese firms from the period 2002-2009. Return on assets is the dependent variable and independent variables divided into two groups, first the variables related to working capital management and second related to control variables. Working capital management variables are number of day's accounts receivable, number of day's accounts payable, number of day's inventory and cash conversion cycle. The control variables in the used are size of the firm, growth in sales, and leverage in term of debt, current assets ratio ( Current assets/ Total assets) and also current liabilities ratio ( Current liabilities/ Total liabilities). In this study a negative relationship with profitability was found for inventory, accounts payable and accounts receivable and cash conversion cycle.

### Importance of Trade Credit for SME's

The research on MSME finance shows that, small businesses are mostly relying upon self-finance or on debt finance through banks. Shortage of working capital finance is one other major reasons for the sickness of more than 94% of MSMEs in India (Task force of prime Minister on MSME, 2010) Trade credit is necessary for SMEs, whose access to capital markets is very limited and who have more difficulties in funding themselves using bank finance, Granting trade credit improves sales, higher profitability and smooth short term cash flow, but mismanagement of the same can lead to the negative effects on the value of the firm. SIDBI (Small) is focussing on SMEs in receivables management to assist in issues such as delayed payments and weak receivables to improve the growth of SMEs in India.

According to the study, SME's are more dependent on trade credit for cash management purposes rather than on bank finance services.

According to the MSME report, 2012 payment cycles in the manufacturing sector are quite long resulting in hindrance to working capital and short term funds due to late payments from customers. It can be seen that the management of trade credit is essential in the current time period. Ineffective handling of trade credit can cause liquidity problems and in extreme cases can bring to bankruptcy for an unwary credit grantor. Proper management will leads to increase in sales and profit enhancement.

MSME role in economic and societal progress is well recognized in India. MSME contributes 8% to GDP and 40% of its exports. MSME provides employment to more than 60 million persons. This sector is highly varied in terms of scope and enterprises and more than 94% of the MSME's are unregistered. Major issues concerning the MSME sector are:- Lack of availability of adequate and timely credit, High cost of capital, collateral requirements, limited access to equity capital etc. (Prime Minister's Task Force on Micro, Small and Medium Enterprises, 2010)

#### Summary Results of Fourth All-India Census of MSMEs with reference year 2006-07

Parameters	Registered in no's	Unregistered in no's	Total	Registered in percentage	Unregistered in percentage	Total
Manufacturing	1035102	6418294	7453396	66.67	26.15	28.56
Service	517390	18130011	18647401	33.33	73.85	71.44

SME's in India account one- sixth of the total GDP income. The SME units are more concentrated in manufacturing sector as compare to service sector. Manufacturing SME's contributes 90 percent of total industrial units in the country. Cluster based operations have become a high growth channel among SME's. Some of the nation's clusters have become leading producers in their respective fields. According to the United Nations Industrial Development Organization clusters are agglomerations of interconnected companies and associated institutions. Some of the prominent clusters are: Panipat clusters famous for country blankets, Tripur clusters

famous for cotton hosiery, Agra clusters for footwear, Ludhiana clusters for multiple product clusters like cotton knitwear, bicycle and sewing machines.

Manufacturing enterprises are classified with their investment size as follows:

Description	Manufacturing Enterprises	Service Enterprises
Micro Enterprise	Upto USD 62,500	Up to USD25,000
Small Enterprise	Above USD62,500 and up to USD1.25 million	Above USD25,000 and up to USD0.5 million
Medium Enterprise	Above USD1.25 million and up to USD2.5 million	Above USD0.5 million and up to USD1.5 million

Source: Small & Medium Business Development Chamber of India, Aranca Research

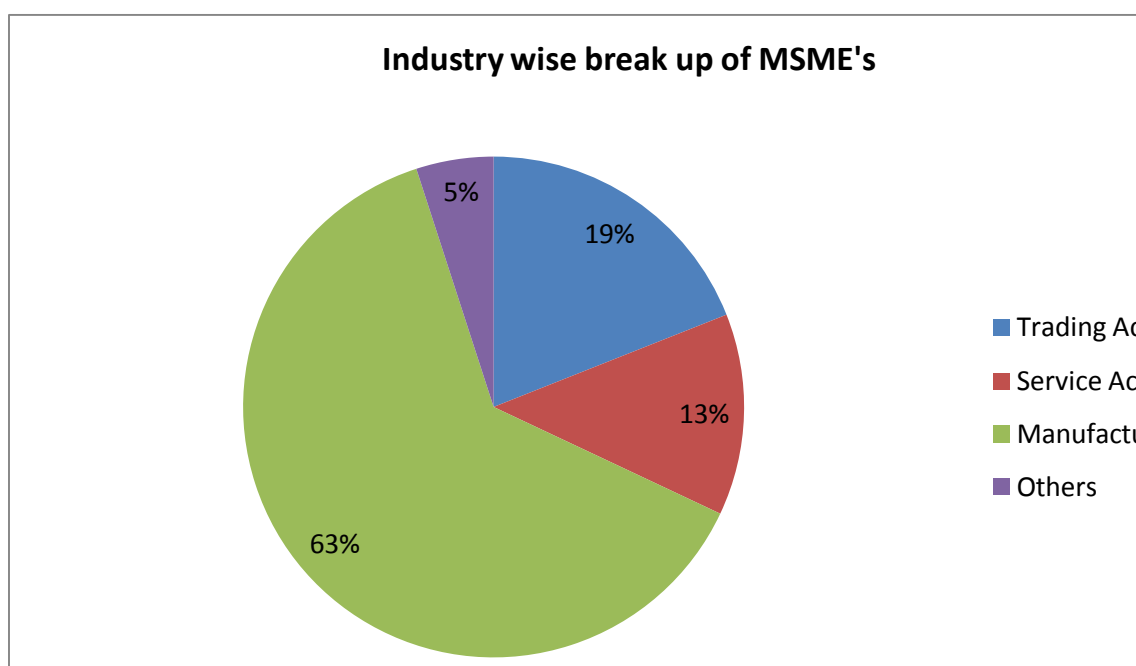
SME's currently contribute 45 % of the nation's industrial output as well as 40% of the total exports. (India Brand equity Foundation, 2012)

Micro, Small and Medium Enterprises (MSMEs) contribute nationally

- 8% of the country's GDP
- 45% of the manufacturing output
- 40% of the exports
- 21% of employment 2<sup>nd</sup> highest after agriculture

Enterprises	Manufacturing Enterprises: Investment in Plant & Machinery
Micro	Up to INR 25 Lakh
Small	INR 25 Lakh–INR 5 Crore
Medium	INR 5 Crore –INR10 Crore

(Sources: Annual Report 2014-15, Ministry of Micro, Small and Medium Enterprises, Government of India)



(Sources: Industries Commissionerate, Government of Gujarat)  
(Vibrant Gujarat, 2017)

The development of small and medium enterprises has taken place in the form of different industrial clusters. There are, in all 83 industrial clusters for different industry groups have been identified in the state, developed at a number of different locations. The approach of cluster based development has helped in improving cost

competitiveness of the industries by way of creating common facilities, developing market centers and brand names, promotion of skill.

(Cluster Development, 2017)

### **Credit Policy Impact on Profitability of SME's**

Hakim Lyngstadaas and Terje Berg: Provides effect of working capital management (WCM) on the profitability of SMEs Norwegian firms. The data contains 21,075 Norwegian SMEs and 84,300 observations were made for the period between 2010 and 2013. Panel data regressions with fixed effects and two-stage least squares analysis was used. The result shows that decrease in cash conversion cycle leads to increase in profitability.

Maria Amélia Pais, Paulo Miguel Gama (2015): studies how working capital management affects the profitability of small and medium-sized Portuguese firms. The paper covered 6,063 small and medium-sized Portuguese firms covering the period 2002-2009. Panel regressions and instrumental variable approach was used to study the paper. Paper concludes that profitability of firm depends upon various components like decrease in period of outstanding liabilities, collection amount pending from customers, less inventory holding etc. Also, the use of working capital management policies efficiently increases firms' profitability.

Salla Marttonen, Sari Monto, and Timo Kärri, (2013): study the impact of working capital on company's profitability. To carry out the study, analysis of financial statements was done and Analytical modeling methodology was used. The paper shows the importance of working capital and it presents model named Flexible Asset Management which shows there is negative correlation between return on investments and working capital.

Godfred Adjapong Afrifa, Kesseven Padachi, (2016): The purpose is to analyze relationship between working capital level and profitability of SMEs. The paper utilizes panel data regression analysis. The data of 160 listed SMEs was collected covering period from 2005 to 2010. The results show that the firms' profitability is maximized when working capital is optimal.

N. Suresh Babu & Prof. G. V. Chalam (2014): This study shows that working capital management has remarkable impact on firm's profitability. To analyses the same, secondary data was collected from database named PROWSS and certain magazines, newspapers, working papers which covered period of 14 years i.e. 1997-98 to 2010.11. They used certain statistical techniques for the study like correlation analysis, multiple regression analysis, "t" test, "F" test, ANOVA and SSPS-20 software for analysis They have examined various empirical relationships of variables like between Inventory Conversion Period (ICP) and Profitability of the firm, Average Collection Period (ACP) and Profitability of the firm, Average Payment Period (APP) and Profitability of the firm and Cash Conversion Cycle (CCC) and Profitability of the firm. The paper concluded there is positive relationship between all research variables and profitability of firm and some had negative relationship too like APP and CCC with profitability. Also, for overall leather industry, efficient working capital management is essential for Profitability. So, they should efficiently manage components like cash, inventory management, receivables etc. with profit.

Bana Abuzayed (2011): examines the effect of working capital management on firm's performance and profitability. The paper studies data of listed firms which covers period from 2000-2008 and have used one estimation technique, panel data analysis, fixed and random effects and generalized methods of moments. Cash conversion cycles and its components are used as measure of working capital management. Paper concluded that there is positive relation between profitability and cash conversion cycle.

Pedro Juan García-Teruel Pedro Martínez-Solano, (2007): The paper studies effects of working capital management on Spanish SME's firm. The research studied panel of 8872 SMEs effect of working capital management on its profitability through panel data methodology which covered period from 1996 to 2002. The results indicate value can be created by reducing inventories and the number of days for their outstanding accounts. Additionally, shortening the cash conversion cycle exceed the firm's profitability.

Abenet Yohannes Hailu and Professor P. Venkateswarlu (2015): explains that working capital influences performance of the firm. Secondary data is collected covering period from 2010-2014 of around 30 manufacturing companies. Panel data regression method is followed. Additionally, EViews version 7.0. was used to research dependent variable i.e. Return on Assets and independent variable i.e. Account Receivable, Cash Conversion Cycle and Account Payables. Also, Ratios like Current Ratio, Debt Ratio etc. were calculated. Research concludes that managers should efficiently manage each component of working capital to the optimum level.

(Oppedahl, 1990) Authors considered the importance of working capital decisions for the financial health of the firms. To show the importance, two examples have been given in the article. First the investment in accounts receivable increasing or decreasing by many different parameters including:- The financial stability required, length of credit allowed, cash discount given and the intensity of the collection effort. The second example related to working capital area is regarding marketable securities; if the firm has ideal funds for shorter period then it will invest in marketable securities such as commercial paper, certificates of deposits, T- bills and banker's acceptance etc.

(Razali Haron, 2016) Observed the importance of effective and sound working capital management that managers should prepared on the factors affecting working capital management to improve firm's performance. The cash conversion cycle is a measurement of working capital management. The independent variables and their measurements are, profitability (net profit/total asset), debt (total debt/total asset), sales growth (sales t-salest-



1)/salest-1), free Cash flow (free cash flow/total asset), firm size (natural logarithm of sales) and liquidity (current asset/current liabilities). A negative relationship is spotted between profitability and firm size with working capital management for all the three periods. The negative relationship between profitability and firm size with working capital management provide robust evidence on pecking order theory. Sales growth is negatively related to working capital management before and after the crisis periods.

(Abuzayed, 2012) The financial crises of 2008 and recession brought focus of industries towards the investments in short term assets and resources which have a maturity of less than one year. This flamed the importance of working capital management at companies all over the world. Liquidity and profitability and the balance between both are a challenging decision of corporate managers. This requires that business must be run both efficiently and profitability. An asset liability mismatch can lead to insolvency for a firm and on the other hand too much focus on liquidity will be at the expense of profitability. Thus a tradeoff between both is required and hence creates a dilemma for the corporate manager. Working capital management is of importance to all firm size operating in both developed and emerging countries. But particularly for small and medium firms the requirement's in management for working capital are much high due to limited access of funds in small firms from external sources. However the failure rate in smaller firms is much higher than the larger firms, primarily the reasons of the failure are weak financial management particularly poor working capital management and inadequate long term financing. Hence, working capital management decisions in smaller firms is a very sensitive area for managers. Measuring firm's liquidity position is a big question. Some traditional studies used current ratio and quick ratio for measuring corporate liquidity and by collection the information regarding the cash conversion cycle and operating cycle of the firm rather just calculating the liquidation value of the its assets. The total cash conversion cycle is defined as inventory days, receivables days less number of payables days. In general, some studies research the factors affecting working capital management of a firm. These factors can be classified into two categories. External factors like politics, business, economic environment and industries effect. Internal factors like management system, management policies, investment policies, organizational behavior and financial capability. The study examines the effect of working capital management on firm's performance on small emerging markets from 2000 to 2008 in Jordan. The traditional view of the relationship between the cash conversion cycle and firm's profitability is that a longer cash conversion cycle hurts profitability of a firm. The reason why the paper chose listed firms is due to more reliability and availability of financial data. Dependent variables used in the study are Gross operating profits and Tobin Q's. Independent variables used are Cash conversion cycle, Accounts receivables days, inventory days, accounts payable days. Control variables are size of the firm, Sales growth, Leverage, Financial assets to total assets and gross domestic products. Study concluded that cash conversion cycle has a positive relation with firm's profitability, which indicated that more profitable firms are less motivated to manage their working capital.

(Anna- Maria Talonpoika, 2016) The purpose of the paper is to develop the strategies for financial working capital. Financial working capital is different from operational working capital. In operational working capital there are components of cash conversion cycle which involved like- number of days of inventory, number of days of receivables, number of days of payable. But in case of financial working capital only items related to financial flow cycle includes in working capital calculations. Other current assets and other current liabilities are taken in calculation of financial flow cycle. Other current assets are those assets which not include trade receivables and inventories. Other current liabilities are those current liabilities which do not include accounts payables. In the study qualitative comparative analysis is used to formulate the strategies. The data for the period 2008 to 2012 has used and selected from Helsinki Stock Exchange. Paper has concluded 11 strategies for financial working capital. The strategies aim to increase the financial working capital in the firm.

(Hakim Lyngstadaas, 2016) One important factor regarding a firm's financial management is working capital management. SME's pay more attention to working capital management due to several factors, like current liabilities are most important aspect of the external funding for SME's. Current assets constitute most of the total assets in SME's. Risk profile is more than compared to larger firms. The paper studies the effect of working capital management on the profitability of selected SME's of Norway between the periods of 2010 to 2013. The study excludes the firms related to banks and insurance. ROA is used for the measure of profitability and ROIC that is return on invested capital used as proxy variable for profitability. Independent variable to measure working capital management are inventories, accounts receivables, accounts payables and cash conversion cycle. CCC is a dynamic measure for working capital. It is the time gap between goods manufactured and payment from customers. During this time span the firm needs finance for operating activities, so linger CCC means higher level of working capital requirement.  $CCC = INV + ACR - ACP$

(Venancio Tauringana, 2013) Working capital management importance can be measured by the cash conversion cycle and its components that is inventory, accounts receivables and accounts payable. The objective of the paper is to investigate the importance of working capital management and SME's profitability. Literature on SME's suggests that small firms have limited access to resources as compared to their large firms. Research has found that SME's poorly managed due to lack of management competence and this one the key reason for the growth constraints of smaller firms. Due to limited resources it is important that small firms emphasize on their working capital management part, which can lead to profitability by managing the components of working capital.

The study has used the panel data regression model and data collected through the questionnaire from 19 selected SME's from London stock exchange for the financial period 2005 to 2009.

In the questionnaire five point Likert scale has established for importance of working capital management and its components. A firm can also adopt a conservative strategy to WCM which advocated an increase in investment in working capital. This strategy is adopted with a view to stimulating sales and to increase profitability. An increase in accounts receivables will lead to increase in sales because of credit period given to customers. Trade credit can help customers to build strong relations with the seller. But at the same time trade credit create an opportunity cost for the firm by blocking the money in receivables.

The study investigates the working capital management (WCM) practices adopted by Indian firms listed on the National Stock Exchange (NSE). The paper has used the questionnaire method for collecting data from financial managers. For developing the questionnaire five- point scale has used. The evidence shows that the majority (54.5%) of sample firms follow a moderate approach in financing their activities, which involves a trade-off between liquidity and profitability. Respondents tend to use an informal approach for WCM and consider receivables management as the most important component of WCM. Many managers now consider WCM as strategically important, which can be a source of competitive advantage. Although WCM is gaining importance among CFOs, shareholders, loan providers, and legal advisers, academics often overlook the topic. Development in the WCM-related literature is limited in scope (Singh and Kumar, 2014). The primary focus of researchers has been on either studying the relation between a firm's WCM efficiency and profitability

A dominant portion a firms resources is dedicated to working capital. A major portion of working capital is dedicated to trade credit. Trade credit appears in both liabilities side and assets side of balance sheet. Liabilities side as accounts payable, which is a source of finance for seller and accounts receivables, which is an investment for seller. Four methods of financing trade credit are: Captive finance companies, factoring, accounts receivable secured debt and general corporate debt. The purpose of the paper is to extend the existing theories relating to trade credit to provide empirical evidence. Financial based theory developed by Schwartz suggested that firms that can obtain funds at a relatively lower cost will offer trade credit to firms that must pay higher cost to financial intermediaries. Second theory suggested that firms in relatively high tax brackets gain by offering trade credit to firms in lower tax brackets. Third trade credit theory suggested that capital market imperfections require selling firms to maintain adequate liquid funds for either investing it in marketable securities or lending through trade credit facility. Next theory on trade credit focused on uncertainty in products demand in a firm's operating decisions. As demand fluctuates, sellers either increase in the price or have to provide longer trade credit or they can vary production to match demand and it leads to increase in production cost. According to the paper in colonial times, trade credit was extended for one year due to non-availability of easy transport and payment methods. Bad debts were also quite non- existent, even after uncertain payment terms. Merchant usually purchased goods once in a year (Michael S. Long, 1993)

Accounts receivable constitute a significant portion of companies' balance sheets, highlighting the importance of the management and financing of this type of asset. The extension of trade credit requires the assignment of five functional responsibilities: (1) customers' credit risks must be assessed, (2) the decision to grant trade credit must be made (including the establishment of credit terms and limits), (3) the trade credit must be collected, (4) the default risk must be borne and (5) the receivable must be financed until it has been paid by the purchaser. The determinants of Accounts Receivable Management- Transaction Costs, Economies of Scale, Financial Needs, Risk / Financial Health, Financial Flexibility, Industry Sector. (Thomas Hartmann-Wendels)

(Dana Kubičková, 2013) Research focused on the different practices follow by managers in a SME to manage receivables. Main weaknesses have been detected in the monitoring of solvency and financial position of business partners.

Working capital management focuses on three factors that affect a company's free cash flow: the pace at which the company pays what it owes its suppliers, how quickly it collects what it's owed by its customers, and the amount it has invested in inventories. Companies exercise considerable control over their payables, since they're the ones writing the checks. As the recession hit, many big companies took longer to pay their suppliers, pushing out their days payables outstanding (DPO). Companies face steady pressure from customers to extend their sales terms (Special Report treasury & risk 3, 2015)

(James N. Kungu, 2014) Paper studied the effect of credit policy on the profitability of Kenyan Manufacturing firms. In the study some elements of credit policy that are credit terms, collection efforts, credit period and credit standards are researched on 81 manufacturing firms with the help of ANOVA. The study recommended that the finance managers of firms should regularly review the credit policy to ensure increased profitability.

(Chludek, 2011) Trade credit is an extremely expensive source of financing with annual interest rates exceeding 40 percent. The paper argues that the average interest rate of trade credit does not exceed the cost of alternative funds. Trade credit can serve as implicit quality insurance because the customer can inspect the quality of delivered goods and services during the net period, verifying quality before payment. Trade credit is a major source of financing of the business. Trade credit has two forms basically. The one is net terms and second is two part terms. Net terms means the customer gets only a payment deferral, for example 30 net terms means, debtors have a credit period for 30 days for full payment after the invoice date. Two part terms means where a discount

offers to debtor for quick payments. For example 2/10 net 30 means total credit period is 30 days, but if the debtor wants to avail the discount in payment than for 2 % discount on full payment, it has to pay within 10 days. So, discount is offered is payment is made in shorter period than the full credit period by the debtor. The trade credit price results implicitly from the opportunity cost of forgoing an offered discount.

Trade credit is a legally binding agreement between two business partners in which the buyer can purchase goods or services. On account and pay the supplier at a later date. It is a kind of short term loan provided by the supplier to the buyer. According to a study of UK firms during the period 193-1995, 55% of short term credit is from trade credit. The paper focuses on the buyer side of trade credit. For the buyer's trade credit are termed as accounts payable in their books of accounts. Research for the trade credit and its relationship with the determinants in the form of other financing sources is limited. The paper focuses on SME's of Sweden for the period of 2009 to 2012. Target population comprised all non- financial firm having employee 1-49 as small firms and 50- 199 as medium firms. Although many companies get finance largely from bank loan as a collateral loan, but SMEs have to depend on trade credit as a short term financial source due to unavailability of collateral assets. The main interest is whether the trade credit is an alternative or a complement to other financial sources for SMEs. Previous literature shows the two determinants of trade credit internal financing and external financing. Other firm level determinants are- firm size, firm age and industry affiliation. Dependent variables for trade credit are accounts payable as accounts payables to total assets. The short term debt ratio as short term debt payable within one year to total assets. The long term debt ratio as long term debt payable after one year to total assets. Return on assets proxy for profitability as firm's book value of net profit after taxes divided by total assets. Turnover, total assets and number of employees used as proxies for determine the firm size. The study reveals that short term debt positively influences trade credit.

This article explains the two strands literature available for trade credit. The first literature arguments that firms increase the level of trade credit , when other alternatives sources of finance are limited and the second approach studies the supply of trade credit. In the article relationship between a firm and its clients taken into consideration as agency relation from which two phenomena arise: adverse selection since clients do not know the characteristics and quality of the product which they are buying and moral hazard in that buyer might not pay for the goods bought when the payment is due. Sample selected in the article is based on active manufacturing firms of UK with a 4 year data ending in 2002 year comprising of 336 companies. The test applied was panel data methodology. Trade credit is one of the oldest forms of corporate financing. Depending on the type of credit policy, payment can be made at different times. Payment can be made on time, before time or after time. When payment does not occur on or before time, trade credit is extended and the seller assumes the credit risk. The firms with lower liquidity or better access of capital market will be credit rationed firms as compared to firms with limited options available for credit from the capital market. (Rafael Bastos, 2007)

Trade credit is used as a source of finance in developed countries. Accounts receivable is a major part of corporate balance sheet in liabilities side also in the form of accounts payable and assets side also. In this paper the study shows the interdependence between the two major sources of short to medium term corporate funds that is institutional loans and trade credit. Trade credit is considered as the expensive financing alternative because suppliers have a higher direct cost of funds. Mainly there are two motives for using trade credit in corporates. The first motive is the transaction motive. Many firms use trade credit a transaction cycle for normal course of business. The primary benefit of trade credit is cash management tools by delaying payments to their suppliers for matching cash receipts from sales. This part can be shown as accounts payable in corporate balance under liabilities side. The second motive to use trade credit is financing motive to provide goods to customers on credit. Credit extension can be served a tool of short term financing to their customers through trade credit. The test used in the study is panel data based on UK firms of all sized from the period 1981 to 2000. (Atanasova, 2007)

In the paper panel data methodology used on 16000 manufacturing firm records for the year 1990 to 1999 to show the uptake of trade credit varies with the monetary cycle. High trade credit used by the firms when bank rates are high and low trade credit when bank lending rates are low. Suppliers evaluate the credit worthiness of firms on same basis which banks are evaluating before providing loans to customers, such as solvency, credit risk and age. There are four main motives for providing trade credit to the customers by the firms. First is the price discriminate as trade credit reduces the effective price offered to low quality buyers. Second is the transaction motive for cash management by including accounts payables and get extension from payables. Third is a financing motive, as trade credit considers as a short term loan to customers. Lastly sales motive, to remain in the competition, to increase the market share. (Simona Mateut, 2002)

Trade credit is a vital component of corporate finance in many countries. Japan is no exception with its corporate sector having about 15% of its total assets in trade payables. This paper examines the determinants of the relationship between trade credit and bank loans. By using data on trading companies that supply both loans and trade credit we are able to determine the relative importance of both institutional differences and instrumental differences for the trade credit-loan relationship. The paper determines the relative importance of both institutional differences and instrumental differences for the observed behavior of trade credit in the Japanese economy. One of the interesting features of trading company credit is that not only do these firms provide trade credit, but they also supply other forms of credit, such as loans, stock investments and loan guarantees. Findings showed varying

degrees of responsiveness of these credit instruments to business conditions. When we aggregate these instruments we observe a significantly stronger negative correlation between trading company credit and business conditions in recent years. A possibility is a higher degree of commitment, by the general trading companies, to prospective client firms through stock purchases or investment. (Iichiro Uesugi, 2004)

Many theories have been put forward to explain the existence of trade credit. Trade credit may be used as a source of funds if raising capital through other sources is more expensive. Price discrimination being illegal in many countries, firms may choose to discriminate between buyers using trade credit. Some firms may choose to make early payments to take advantage of discounts while others may have an incentive to pay towards the end of the credit period. Suppliers may have some funding advantage over banks in evaluating and controlling credit risk. Firms attempt to increase sales and lower finished goods inventories by offering trade credit both on a gross and net basis. When inventories of finished goods and semi-finished goods and raw materials raise firms tend to post-pone payments to their supplier and this shows up on their books of accounts as higher accounts payable. This is likely to help firms tide over negative shocks to sales. Thus trade credit in general can be seen to arise as a financial response to variable demand for their finished goods. Highly profitable firms are found to both give (on both net and gross basis) and receive less trade credit. There could be many underlying results for this finding. Firstly more profitable firms may not face a major problem with respect to variability of demand for their product. The need to offer trade credit for inventory management is thus smaller. Moreover the need to accept trade credit for such firms would also be lower, as inventories would rarely be high. (Vaidya, 2011)

This paper investigated the determinants of trade credit in India. The paper suggests that strong evidence exists in support of an inventory management motive for the existence of trade credit. Highly profitable firms will give and receive less trade credit and the firms with greater access to bank credit offer less trade credit to their customers. Similarly, firms with higher bank loans receive more trade credit. Holdings of liquid assets have a positive influence on both accounts receivable and accounts payable.

According to the Authors (George W. Gallinger, 1986) old-style and often confusing techniques of days sales outstanding (DSO) and aging schedules still appear to be the principal vehicles used by analysts to evaluate a firm's accounts receivable balance. They showed the conventional procedures to be misleading and capable of frequent faults. Receivables can be influenced by sales effect, and they attribute this to seasonal or recurring factors. They attempt to eliminate or at least minimize these effects by comparing calculated DSO ratios and aging schedules against those of ancient periods. So to overcome the problem they used a different approach that is accounting based dollar variance analysis model which compares actual and budgeted receivable performance and identifies collection experience, sales pattern and sales quantity influences on receivable balances. Thus the model overcomes the shortages of the traditional models.

## Conclusion

Failure to effectively manage credit system, SME's experiencing late payments to their creditors in the supply chain which then affects their ability to service their debtors. Organization may benefit by managing effectively their credit and collection procedures. Proper management of trade credit will help SME's to improve their productivity and performance. Efficient management of receivables will lead to increase in sales and profit enhancement.

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