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Research Article

AN ENQUIRY INTO THE CREDIT PERIOD AT MANUFACTURING INDUSTRIES AT CHENNAI – A WORKING CAPITAL PERSPECTIVE

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ABSTRACT

Creditors turnover period is an important component of the working capital management. It is a technique adopted by the industries to pay for its vendors. It also measures the goodwill and the effectiveness of a company's credit management. The present study aims to contribute on the impact of the management of creditors turnover period measured by Average payment period on profitability. Of leading manufacturing companies of CNX 500 listed in NSE from 2010-2016. The study involves both primary and secondary data. The study aims at examining the effectiveness of Average Payment Period of various manufacturing firms from 15 sectors. The Net Operating Profitability used as a measure of organisational performance. The study involves about 162 companies for the secondary data analysis. The primary data confines with 34 companies available in and around Chennai. The study reveals that Construction, Textile, Food, Steel & Aluminium, Pharmaceutical, Electrical & Equipment, Cement, Pump, and Engineering had a significant relationship between Average Payment Period and Profitability. The research study states that effective credit policy should be adopted by the manufacturing companies in order to face the competitive market.

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INTRODUCTION

One aspect of working capital management is the determination of terms of credit specifying the period for which credit is extended and the discount if any is given for an early payment. Trade credit terms offer firms contractual solutions to informational proportions between buyers and sellers. Trade credit is one of the oldest forms of corporate financing and it continues to be very important at present working capital strategies; it refers to the financing provided by a seller to the client (Wei and Zee, 1997).

Trade credit is an essential tool for financing growth. It is a strategy to buy goods or services on account, that is, without making immediate cash payment. For many businesses, trade credit is an essential tool for financing growth. When you're first starting your business, however, suppliers most likely aren't going to offer you trade credit. They're going to make every order c.o.d. (cash or check on delivery) or paid by credit card in advance until you've established that you can pay your bills on time. While this is a fairly normal practice, you can still try and negotiate trade credit with suppliers. One of the things that will help you in these negotiations is a properly prepared financial plan.

LITERATURE REVIEW

Trade credit is the credit extended to the customers by suppliers to let you to buy now and pay later. Any time you take delivery of materials, equipment or other valuables without paying cash on the spot, you're using trade credit. In the last two decades several models and research studies have been appeared to explain the trade credit in detail. Some of the studies have been discussed here in order to have a clear understanding about Accounts payables.

Trade credit terms tend to have a wide variation between the industries but a little variation within the industries. There are differences in the levels of accounts receivable and accounts payable between industries (Banos-Caballero et al., 2010). Also Salawu (2006) found a significant difference between industries on working capital. Deloof (2003: 575) investigated the relationship between corporate profitability and working capital management for a sample of Belgian firms, and reported a significant negative relationship between gross operating income and the number of days' accounts receivable, inventories and accounts payable. He concluded that efficient working capital management could increase profitability. He also argued that the (unexpected) negative relationship observed between the accounts payable turnover ratio and

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profitability could be explained by less profitable firms taking longer to pay their providers of trade credit.

Sagan (1955) pointed out the finance manager's operations were primarily in the area of cash flows generated in the course of business transactions. However, finance managers must be familiar with what is being done with the control of inventories, receivables and payables because all these accounts affect the cash position and to provide the funds when needed to invest temporarily in surplus funds. He suggested that manager should take his decisions on the basis of cash and total current assets. This is important because efficient finance manager can avoid borrowings from outside even when his net working capital position is low. The study pointed out that there was a need to improve the collection of funds. Moreover, this study is descriptive without any empirical evidence. Thus, it is clear that there is a larger scope to improve the funds collection at 1950's itself. Gitman (1974: 82) defined the Total Cash Cycle (TCC) as the number of days between the first cash outflows associated with the production of an item, and the final inflow of cash when the produced item is sold and the cash is received. The TCC is determined by adding the firm's raw material, the production, the finished inventory and accounts receivable turnover times, and subtracting the accounts payable turnover time. By considering the turnover times of the various working capital components, the focus is not only placed on the amount of capital invested, but also on the timing of these investments. Richards and Laughlin (1980: 36) redefined this measure as the Cash cycle, and applied it to evaluate working capital management. Reducing a firm's cash cycle can, therefore, be achieved by decreasing the turnover times of the current assets, and / or increasing the turnover time of the trade payables. A firm with a relatively short cash cycle thus usually manages to receive cash quickly, and pays its providers of trade credit close to the due date.

Vanhorne (1969)¹⁴⁷ in his study recognizing working capital management as an area largely lacking in theoretical perspective attempted to develop a framework in terms of evaluating decisions concerning the level of liquid assets. Once the risk and opportunity cost for different alternatives were estimated then the firm could determine the best alternative by balancing the risk of running out of cash against the cost of providing a solution to the management's risk tolerance limits. Thus, Vanhorne study presented a risk-return trade-off of working capital management in entirely new perspective by considering some of the variables probabilistically. The usefulness of the framework suggested by Vanhorne is limited because of the difficulties in obtaining information about the probability distributions of liquid-asset balances, the opportunity cost and the probability of running out of cash for different alternative of debt maturities.

Richard (2005)¹⁴⁸ study was drawn on the responses of 700 large firms in US, UK and Australia. The study explores trade credit terms through the twin objectives of reducing information asymmetries and discriminatory pricing. The survey initiated that cash discounts for early payment are far more commonly offered by US firms, particularly large seller firms adopting a strong sales-driven approach to trade credit operations. The study also found that many of the credit

management practices employed are associated with the lower Debtor Days.

Ojeka, Stephen (2008) studied the impact of credit policy and its effect on liquidity using the annual reports of selected Nigerian manufacturing companies ranging from 2003-2007 was used for the statistical analysis. The study centered majorly on the effects of each of the individual components of credit policy which include the credit standards, the credit period, the cash discount and the collection period on organization's performance. The findings revealed that companies should ensure the regular review, monitoring of their credit policy, and also should minimize the allowance of cash discounts as much as possible. Finally, the study recommends that organization should consider their mission, nature of their businesses and their business environment before setting up a credit policy. Hence the non-review of the credit policy of organizations will cause liquidity problems associated with the sales. Long et al. (1993) developed a model of trade credit in which asymmetric information leads good firms to extend their trade credit so that buyers can verify the product quality before making payment. Their sample contained all industrial 3999 firms with data available from COMPUSTAT for the three-year period using regression analysis. The findings suggest that producers may extend trade credit by financing their receivables through payables and short-term borrowing.

Bennie (1975) study consisted of 200 firms in Virginia which includes data collected through personal interviews with the Credit managers of fifty sample firms during the second half of 1975. Responses were received from 74 participants out of 200. Upon the basis of the results of this survey several observations can be made. (i) First, of the small businesses examined, few were using more than one or two of the simplest credit control techniques taken for granted by larger firms. The reasons given for their failure to use these techniques included inadequate time, inadequate personnel, lack of knowledge in their use, and lack of confidence in the potential benefits of such techniques. (ii) Second, nearly all of the firms had bad debt rates far exceeding those experienced by larger businesses. Thus the study considers credit policy as a main factor to be analysed.

Increased supplier financing may result in loss of discount for the early payments. Even then the opportunity cost may exceed, depending on the discount percentage and discount period granted. Companies that have shortened their payment terms too much had difficulties in selling their products. Most of the customers will allow a longer payment period, in order to improve the working capital, and also to maintain their product quality. Similarly, by deferred payments the company can acquire heavy financing rate on their credit terms and may even lose the discounts given for prompt payments.

Sustainable working capital management provides a company with flexibility to expand and enhance its operations, improve liquidity, maintain or increase profitability and respond to challenging economic conditions. Investment in receivables formed the second most important current asset next to inventory. Hence, the above discussion of literature helps in identifying the role and importance of credit policy or accounts payable in detail.

RESEARCH METHODS

The present research intends to contribute towards the important component of working capital management known as the Creditors turnover period on the organisational performance with reference to India (Chennai). The study aims to find the relationship between the Payment period and its effects on the organisational performance which is a measure of profitability of the selected manufacturing firms from CMIE proress Database for a period of 2010-2016. The study includes both secondary and primary data.

Objective of the study

To study the sector-wise relationship between the Cash conversion cycle and Net Operating Profitability of 15 leading listed manufacturing sectors at Chennai for a period of 2010-2016.

Methods of Analysis

The present study adopts Random Sampling method. The tools such as Descriptive statistics, Ratio analysis, Correlation has been used to analyse the secondary data. Questionnaire survey was used to measure the primary data. Out of the 162 companies only 34 companies were available at Chennai. Hence the primary survey was conducted only with these 34 companies. The statistical analysis was performed using the SPSS tool 19.0 version.

Analysis and Interpretation

This chapter deals with the analysis and interpretation of data obtained from 162 S&P CNX 500 manufacturing companies from CMIE PROWESS DATABASE in India which is listed in National Stock Exchange. The 162 companies selected includes fifteen sectors such as Automobile, Electrical and Equipment, Steel and Aluminium, Pharmaceutical, Cements, Consumer Durables, Engineering, Textiles, Chemicals, Tyres, Pumps, Food, Sugar, Trading and Construction. The secondary data includes Income Statements, balance sheets, Profit and Loss Accounts and Cash Flow Statements etc.

Descriptive Statistics and Correlation for Working capital components for the selected 15 manufacturing sectors

Sectors	APP	
Automobile sector	MEAN	169.31
	S.D	53.66
Electrical equipments	MEAN	41.99
	S.D	23.55
Steel & aluminium	MEAN	66.4
	S.D	42.73
Pharmaceutical	MEAN	58.84
	S.D	25.13
Cement	MEAN	44.89
	S.D	28.29
Consumer durables	MEAN	39.507
	S.D	13.226
Engineering firms	MEAN	48.95
	S.D	21.31
Textiles	MEAN	73.46
	S.D	37.37
Chemical	MEAN	48.22
	S.D	15.42
Tyre	MEAN	42.15
	S.D	10.47
Pump	MEAN	46.47
	S.D	15.72
Food firms	MEAN	71.67
	S.D	41.02
Sugar	MEAN	94.05
	S.D	30.04

Trading	MEAN	29.72
	S.D	10.02
Construciton	MEAN	259.02
	S.D	38.61

Source: Calculation based on Annual Reports of firms from 2010-2016

The above table has arrived at the descriptive statistics (i.e) Mean and standard deviation for Average Payment Period. The mean and standard deviation of each sector has been presented. All the industries should try to strike a balance with the payment period. The longer the companies takes to pay for their creditors the more the cash the company has on hand, which is utilised for free cash flow. But on the other hand, a high payment period is too long to pay for its suppliers, where the suppliers will be dissatisfied and may refuse to extend credit in future. There are companies which even give discounts for timely payments. Now we will discuss the payment period realised by the selected industrial sectors of the study.

1. In Automobile sector, Payment period is 169 days. The cycle days were high and it should be reduced to minimum.
2. In Electrical Equipment's sector the Payment period is 41 days. These days can also be reduced.
3. In Steel & Aluminium sector, Payment period is 66 days, which means they start paying within 66 days from the date of the bills received from the suppliers.
4. In Pharmaceutical sector, the Payment period has got the highest mean of 58 days.
5. In Cement sector, Payment period is about 44 days.
6. In Consumer Durables sector, Payment period is about 39 days.
7. In Engineering sector, Payment period is 48 days. This period should be reduced to minimum.
8. In Textile sector the Payment period is 73 days.
9. In Chemical sector the Payment period is 48 days. This period is also moderate.
10. In Tyre sector Payment period is about 42 days.
11. In Pump Sector Payment period is about 46 days. This period can also be reduced.
12. In Food sector the Payment period is about 71 days. This implies that food sector took too long period to pay for its suppliers.
13. In sugar sector the Payment period is about 94 days. This implies that sugar sector took too long to pay for its suppliers.
14. In trading sector, the Payment period is 29 days. This period can be reduced to minimum.
15. In Construction sector the Payment period is about 259 days. It has been observed that the credit period in construction sector is very poor.

It has been observed that automobile and construction sector have realised a high payment period. And the sectors such as sugar, Textile, Food, Steel & Aluminium and Pharmaceutical the payment period is little low payment period compared with the previous sectors. This implies that the automobile and Construction sector are trying to hold the cash for their business activities, by delaying the payments to their suppliers. These sectors should focus on the payment periods because, they may lose their good suppliers and their discounts as well.

Table showing the Correlations between the Net Operating Profitability and the Average Payment Period of Automobile, Electrical equipment, Steel and Aluminium, Pharmaceutical, and Cement sectors for the period of 2010 – 2016

Automobile	NOP	Pearson Correlation	1
	APP	Pearson Correlation Sig (2 tailed)	0.175 0.18
Electrical & equipment	NOP	Pearson Correlation	1
	APP	Pearson Correlation Sig (2 tailed)	-0.302* 0.019
Steel & aluminium	NOP	Pearson Correlation	1
	APP	Pearson Correlation Sig (2 tailed)	-0.319** 0.001
Pharmaceutical	NOP	Pearson Correlation	1
	APP	Pearson Correlation Sig (2 tailed)	-0.483** .000
Cement	NOP	Pearson Correlation	1
	APP	Pearson Correlation Sig (2 tailed)	-0.273* .015

** Correlation is significant at the 0.01 level (2- tailed).

* Correlation is significant at the 0.05 level (2-tailed).

From the above correlation table, it has been observed that the co-efficient of Average Payment Period, has (-.175) and a P value of (.180) which is insignificant. Since the (P value > .05) there is no relationship exist between Average Payment Period and the Net operating profitability of the Automobile sector. From the above correlation table, it has been observed that the co-efficient of Average Payment Period, has (-.302*) and a P value of (0.019) which is significant at 5%. It has been found that there is a negative correlation between Average Payment Period and the Net operating profitability of the Electrical Equipment sector.

From the above correlation table, it has been observed that the co-efficient of Average Payment Period, has (-.319**) and a P value of (.001) which is significant at 1% and it is negatively correlated with the Net operating profitability. The negative correlation between Average Payment Period with Net operating profitability indicates that an increase in the Average Payment Period will decrease the Net operating profitability of the Steel and Aluminium sector.

From the above correlation table, it has been observed that the co-efficient of Average Payment Period has (-.483**) and a P value of (.000) which is significant at 1% and it is negatively correlated with the Net operating profitability. The negative correlation between Average Payment Period with Net operating profitability indicates that an increase in the Average Payment Period will decrease the Net operating profitability of the Pharmaceutical sector.

From the above correlation table, it has been observed that the co-efficient of Average Payment Period has (-.273*) and a P

value of (.015) which is significant at 5% and it is negatively correlated with the Net operating profitability of the Cement sector.

Table showing the Correlations between the Net Operating Profitability and the Average Payment Period of Consumer durables, Engineering, Textiles, Chemical and Tyre sectors for the period of 2010-2016

Consumer Durables	NOP	Pearson Correlation	1
	APP	Pearson Correlation Sig (2 tailed)	-.567** .000
Engineering	NOP	Pearson Correlation	1
	APP	Pearson Correlation Sig (2 tailed)	-.358* .020
Textiles	NOP	Pearson Correlation	1
	APP	Pearson Correlation Sig (2 tailed)	-.365** .001
Chemicals	NOP	Pearson Correlation	1
	APP	Pearson Correlation Sig (2 tailed)	-.244 .039
Tyres	NOP	Pearson Correlation	1
	APP	Pearson Correlation Sig (2 tailed)	-.064 .738

** Correlation is significant at the 0.01 level (2-tailed).

* Correlation is significant at the 0.05 level (2-tailed).

From the above correlation table, it has been observed that the co-efficient of Average Payment Period, has (-.567*) and a P value of (.000) which is significant at 1% and it is negatively correlated with the Net operating profitability. The negative correlation between Average Payment Period with Net operating profitability indicates that an increase in the Average Payment Period will decrease the Net operating profitability of the Consumer Durables sector.

From the above correlation table, it has been observed that the co-efficient of Average Payment Period, has (.358*) and a P value of (.020) which is significant and it is negatively correlated with the Net operating profitability. The negative correlation between Average Payment Period with Net operating profitability indicates that an increase in the Average Payment Period will decrease the Net operating profitability of the engineering sector.

From the above correlation table, it has been observed that the co-efficient of Average Payment Period, has (-.365**) and a P value of (.001) which is highly significant at 1% and it is negatively correlated with the Net operating profitability. The negative correlation between Average Payment Period with Net operating profitability indicates that an increase in the Average Payment Period will decrease the Net operating profitability of the Textile sector.

From the above correlation table, it has been observed that the co-efficient of Average Payment Period has (-.244*) and a P value of (.039) which is slightly significant and negatively correlated with the profitability. This indicates a relationship exist between Average Payment Period and the Net operating profitability of the Chemical sector.

From the above correlation table, it has been observed that the co-efficient of Average Payment Period has (-.064) and a P value of (.738) which is insignificant. Since the (P value > .05) there is no relationship exist between Average Payment Period and the Net operating profitability of the profitability of the Tyre sector.

Table showing the Correlations between the Net Operating Profitability and Average Payment Period of Pump, Food, Sugar, Trading and Construction sectors for the period of 2010-2016

Pump	NOP	Pearson Correlation	1
	APP	Pearson Correlation Sig (2 tailed)	-.499** .005
Food	NOP	Pearson Correlation	1
	APP	Pearson Correlation Sig (2 tailed)	-.614** .000
Sugar	NOP	Pearson Correlation	1
	APP	Pearson Correlation Sig (2 tailed)	.348 .059
Trading	NOP	Pearson Correlation	1
	APP	Pearson Correlation Sig (2 tailed)	.206 .411
Construction	NOP	Pearson Correlation	1
	APP	Pearson Correlation Sig (2 tailed)	.337** .000

** . Correlation is significant at the 0.01 level (2-tailed).
* . Correlation is significant at the 0.05 level (2-tailed).

From the above correlation table, it has been observed that Average Payment Period, has a co-efficient of (-.499**) and a P value of (.005) which is significant at 5% and it is negatively correlated with the Net operating profitability. Since the (P value < .10) the results indicate that there is a negative correlation between the Average Payment Periods with the Net operating profitability. This implies that an increase in the Inventory period will decrease the profitability of the Pumps sector.

From the above correlation table, it has been observed that Average Payment Period, has a co-efficient of (-.614**) and a P value of (.000) which is significant at 1% and it is negatively correlated with the Net operating profitability. The negative correlation between Average Payment Period with Net operating profitability indicates that an increase in the Average Payment Period will decrease the Net operating profitability of the food sector.

From the above correlation table, it has been observed that Average Payment Period has a co-efficient of (-.348) and a P value of (.059) which is insignificant. Since the (P value > 0.05) the results indicate that there is no relationship exists between the dependent variable Net operating profitability with the independent variable Average Payment Period of the Sugar sector.

From the above correlation table, it has been observed that the co-efficient of Average Payment Period, has a co-efficient of (-

.206) and a P value of (.411) which is insignificant. Since the (P value > 0.05) there is no relationship exist between the dependent variable Net operating profitability with the independent variable Average Payment Period of the trading sector.

From the above correlation table, it has been observed that the co-efficient of Average Payment Period has (-.337**) and a P value of (.000) which is highly significant at 1% and it is negatively correlated with the Net operating profitability. The negative correlation between Average Payment Period with Net operating profitability indicates that an increase in the Average Payment Period will decrease the Net operating profitability of the Construction sector.

Analysis of Primary Data

The analysis of the questionnaire survey for which the data has been drawn through a field investigation has been presented in this chapter. The analysis and interpretation for the study according to the nature of data collected in 34 manufacturing concern in Chennai.

The estimated debtor's collection period and creditor's turnover period of selected industrial units at Chennai

This is an accounting measure used to quantify firm's effectiveness in extending credit. It shows how efficiently a firm uses its cash. The extended period implies that a company operates on cash bases which have an extended credit terms. A considerable low period implies the company should re-assess its credit policies in order to ensure the timely collection of credit, which will not earn any interest for the firm. Creditor's turnover period helps a company to assess its cash situation. This will demonstrate how a business handles its outgoing payments. The payment requirements will usually vary from supplier to supplier, depending on its size and financial capabilities.

Table showing the creditor's turnover period for selected industrial units at Chennai

Estimated Creditors Turnover Period	No. of Respondents	Percentage of Respondents
0-14 days	1	3
15 - 45 days	20	59
45 - 90 days	13	38
Total	34	100

Source: Primary Data

It has been found that 33 companies are delaying the payments to their suppliers. A high period means there is relatively short time between purchase of goods and payment for them. Conversely a lower accounts payable turnover period signifies that a company is slow in paying its suppliers. So the surveyed companies should focus on maintaining their relationship with their vendors by decreasing their payment period, which in turn will increase the market value of the industries and also enhance the organizational performance (i.e) profitability.

FINDINGS AND DISCUSSION

The study identifies the issues related to the Average Payment Period and organisation profitability of the 15 manufacturing industries through the questionnaire survey and the secondary data analysis.

It has been understood that lower the payment period the higher will be the profitability. It has been observed that the higher payment period in the construction sector and the automobile sector. The same case is applicable to the sugar, Textile, Food, Steel & Aluminium and Pharmaceutical sectors. In the correlation analysis it has been projected that steel, Pharmaceutical, consumer Durables, Textiles, Pump, Food, Construction sectors had a highly significant impact on profitability. It has been identified that even though automobile and sugar sector had a high payment period, they don't have a significant relationship with the profitability.

From the secondary data analysis, it has been found that the payment period is more than 30, which means that it takes them about a month and more to pay their vendors. It has been found that only 11 industries are related to the credit associated with profitability.

SUGGESTIONS AND CONCLUSION

Most of the companies sell goods on credit, and it is mandatory for the company to establish an effective credit policy. Many of the firms tends to extend their credit and find it difficult in recovering their bills. The customer offering credit should investigate the credit rating of the supplier before allowing them to purchase on credit. Credit policy differs based on their cash flow circumstances. Government also influences the credit policy of the industries through the changes in the interest rates. So, it is important to build a conservative policy, which will minimise the defaults.

It is understood from the analysis that the payment period varies by Industry to Industry. Hence a sector can compare its payment towards its industry Average, to check whether they pay their vendors too quickly or leisurely. And from the primary data it has been revealed that companies are holding the cash longer for which is used for short-term investments, and also to increase the working capital financing. It has been concluded that if an industry is stretching out its payments period then it is planning to improve its cash flow. And if the industry tends to pay its suppliers frequently then they will have a benefit of getting payment discounts, without getting a hit out of a price increase and also to maintain a good relationship with the supplier. It is clear from the study that the credit policy differs based on the nature of the product, economic environment, risk, bad debts and financial position of the Industry as a whole.

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