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MODULE 3: **Entrepreneurship**

LESSON 5: **Credit Management**

TIME: **1 hour 30 minutes**

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LESSON 5 CREDIT MANAGEMENT

TIME:

1 hour 30 mins

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OUTCOMES:

By completion of this lesson you will be able to:

- Identify sources of funds;
- Understand the process of sourcing for funds;
- Understand the measures that should be taken to ensure effective utilization of funds;
- Understand repayment procedures.

INTRODUCTION:

Credit is important in a business because it helps to finance business transactions when the business is short of funds. This lesson aims at providing knowledge on how to manage credit given to small scale enterprises to enhance their performance. We will use the case of Hosea Enterprises to understand the sources of funds, process of sourcing for funds, effective utilization of borrowed funds and the repayment process.

Sources of Funds

An entrepreneur can obtain funds to start up his business from various sources, some of which include:

- Family savings/personal savings: This is what an entrepreneur has been able to put aside to start the business. However, it is typically a limited source since most people are not able to save large amounts.
- Banks: This is main source of finance for business organizations but usury banks have stringent conditions that make it difficult for small scale businesses to access funds. Banks, for example, might require collateral which most businesses do not have.
- Savings and credit cooperatives (SACCOS): This is a source of funds that is cheap and also easily accessible. However, one has to be a member of the SACCO.
- Donations: This is money that one can be given by friends or relatives to enable him/her to start the business. This is not a very reliable source.
- Community based groups: Most people come together to save together and then they extend credit to one another. It is a cheap and convenient source but individuals may not have sufficient funds to meet the needs.
- Micro finance Institutions: These have become very popular sources of funds because the funds are easily accessible and they usually target small scale enterprises.

Let us see how one entrepreneur went about accessing sufficient funds to start up his business:

Activity 1

Sourcing of Funds (15 minutes)

Read the case on Hosea Enterprises, organize yourself into a group of 5 and then answer the questions that follow:

Hosea graduated from a technical college in the year 2003. He was not able to get a stable job but worked on small part time jobs. He struggled but he was very determined. Hosea was able to save 20,000 Kenyan shillings from the part time jobs. He decided that it would be worthwhile to start his own business which could give him a stable income. He therefore set out to survey on the type of business that he could start. Hosea was advised by friends that he should start a hardware shop because he had technical skills which could help him in operating the business. He accepted the advice and within two months he had obtained a good location for the business.

The biggest challenge for Hosea was the start-up capital because the 20,000 Kenyan shillings which he had saved was not sufficient to start the business. He therefore approached his father who lent him shs.80, 0000. Now, with 100,000 shillings he was ready to start the business. He rented the business premises for shs.15, 000 per month and was required to pay a down payment of shs. 15,000 so in total he paid shs. 30,000 and he used the balance to purchase the opening stock. The business did very well and he had many customers. He therefore felt that there was a need to expand the business but he was constrained by the lack of funds.

One day a credit officer from one of the local banks came to Hosea's business to buy some tires. He was very impressed by Hosea's business and he had a discussion with Hosea on the growth of the business. Hosea explained to him the problem of the lack of funds. The credit officer invited him to the bank for a further discussion. The following day, Hosea went to the bank and met the credit officer and had a very fruitful discussion and the credit officer agreed to lend Hosea 2,000,000 for business expansion provided he could bring a land title deed to secure the loan. Hosea was in a dilemma because he did not have a title deed. He promised the credit officer that he would be back within a week.

Hosea approached his father to see whether he would allow him to use the family land title deed to secure the loan. His father was very reluctant but Hosea was able to convince him. Hosea promised to work hard and repay the loan without failure. The two agreed to go to the bank to meet the credit officer.

The following day they went to the bank and they were well received. The credit officer accepted Hosea's father's title deed and the family and the family land were mortgaged to secure Hosea's loan. The bank gave Hosea a cheque of 2,000,000. Hosea was over joyed and he promptly started planning how he could expand the business. His father talked to him about the various consequences in case he failed to repay the loan. Hosea promised his father that he would never default on the loan repayment.

When the money was ready and credited to Hosea's Bank account, Hosea was ready to begin the business expansion. However, before the expansion plan was fully conceived, Hosea had a discussion with his friends and was advised that it was important to get married first so that his wife could help him in managing the business.

This idea appeared to be very good to Hosea. He therefore started plans to marry his long term girlfriend. All the wedding plans went well, he used the bank loan to pay dowry and for financing the wedding. They had a very big wedding, people ate and drank. He spent 1,500,000 shillings on the wedding.

Hosea now had only 500,000 to expand the business. This was too little, given the costs of the things he needed to stock the business. The business income was too low to finance the loan repayment and meet the household expenses. Hosea started lagging behind in loan repayments. Within the first year, their first baby came and the family demands increased. The loan repayment was proving hard to meet.

One morning the credit officer came to see Hosea's business and was shocked to see the low stock. He therefore gave Hosea two months to improve on the loan repayment otherwise the bank would sell his father's land to recover the money. At the end of the two months the loan repayment was even worse, and the bank had no option other than to sell the family land.

Today Hosea's family has no land and they are squatters.

Discussion Questions

1. How did Hosea get the capital to start the business?
2. Do you think Hosea needed extra funds to expand the business or should he have continued with the small business?
3. Should Hosea's father have refused to give the title to the family land to secure the loan?
4. What do you think went wrong in Hosea's plan?
5. Was it wrong for Hosea to get married?
6. Was the bank wrong to sell the land?
7. If you were Hosea, what would you have done?

Funds Application Process

The process of application depends on the source of funds. The banks have the most complex process. This entails completion of application forms and submission of all the documents required by the bank. The SACCOS and micro finance institutions have a simpler process although applicants have to complete forms and provide any other information required. The other sources are informal and hence do not have too many complications.

Activity 2

Application (10 minutes)

Refer to Hosea's case and describe the process that Hosea used to get the funds to start his business. Comment on the problems that he encountered and show whether he was able to solve the problems effectively.

Effective Utilization of Funds

Loan utilization is critical because it affects the loan repayment. It is important that a loan is utilized for the intended purpose, if the loanee diverts the funds to other purposes it means that he/she will not generate sufficient revenue to repay the loan.

Activity 3

Utilization (15 minutes)

Work in your group again, refer to Hosea's case and discuss his problems in loan repayment. Did he utilize his funds as he had stipulated?

Repayment Procedures

The loan repayment procedure defers from one financier to another and the repayment agreement contract between the borrower and the lender. Some of the key aspects agreed upon are:

- Loan repayment period
- Number of instalments
- Interest rate in percentage
- Penalty on default

Activity 4

Repayment (20 minutes)

In your group refer to Hosea’s case once more and discuss the process that he was supposed to follow to repay the Ksh.2, 000,000 loan.

Conclusion

This course unit has discussed the credit management by entrepreneurs and has specifically explained the sources of funds, application procedure for funds, loan repayment process and effective utilization of funds. The Hosea case was used to show how an entrepreneur can manage credit.

Summary

The main points covered in this lesson include:

- Sources of funds for entrepreneurs
- Application process
- Loan repayment process
- Utilization of funds

Enrichment

Kenya SACCO Net: http://www.kenyasacconet.org/

Glossary

Technical words used in this lesson include:

Credit
Credit is the trust which allows one party to provide resources to another party where that second party does not reimburse the first party immediately (thereby generating a debt), but instead arranges either to repay or return those resources (or other materials of equal value) at a later date. The resources provided may be financial (e.g. granting a loan), or they may consist of goods or services (e.g. consumer credit). Credit encompasses any form of deferred payment. Credit is extended by a creditor, also known as a lender, to a debtor, also known as a borrower.
Wikipedia: http://en.wikipedia.org/wiki/Credit_(finance) CC: BY SA

Loan
A loan is a type of debt. Like all debt instruments, a loan entails the redistribution of financial assets over time, between the lender and the borrower. In a loan, the borrower initially receives or borrows an amount of money, called the principal, from the lender, and is obligated to pay back or repay an equal amount of money to the lender at a later time. Typically, the money is paid back in regular instalments, or partial repayments; in an annuity, each instalment is the same amount. The loan is generally provided at a cost, referred to as interest on the debt, which provides an incentive for the lender to engage in the loan. In a legal loan, each of these obligations and restrictions is enforced by contract, which can also place the borrower under additional restrictions known as loan covenants.
Wikipedia: http://en.wikipedia.org/wiki/Loan

Collateral
In lending agreements, collateral is a borrower's pledge of specific property to a lender, to secure repayment of a loan. The collateral serves as protection for a lender against a borrower's default - that is, any borrower failing to pay the principal and interest under the terms of a loan obligation. If a borrower does default on a loan (due to insolvency or other event), that borrower forfeits (gives up) the property pledged as collateral - and the lender then becomes the owner of the collateral. In a typical mortgage loan transaction, for instance, the real estate being acquired with the help of the loan serves as collateral. Should the buyer fail to pay the loan under the mortgage loan agreement, the ownership of the real estate is transferred to the bank. The bank uses a legal process called foreclosure to obtain real estate from a borrower who defaults on a mortgage loan obligation.
Wikipedia: http://en.wikipedia.org/wiki/Collateral_(finance)