Presentation on

WORKING CAPITAL MANAGEMENT - II

Part-III

For the students
of
Semester – VI
B.Com.(Hons. & General)

By

Dr. Asim Kumar Manna

Management of components of working capital

Working capital refers to company's investment in short term asset such as cash, inventory, short term marketable securities and account receivable. A sound managerial control requires proper management of such short-term assets. An efficient use of financial resources is necessary to avoid financial distress

Meaning of Accounts Receivables

Receivables => Amounts owed to the firm as a result of sale of goods

A concern is required to allow credit sales in order to expand its sales volume.

Increase in sales => Increase profitability.

After a certain level of sales=> Not proportionately increase production costs.

Increase in sales => More profits.

For investment in receivables => Firm has to incur certain costs, risk of bad debts also.

It is necessary to have a proper control and management of receivables.

Volume of A/Cs Receivable depends => Credit sale and debt collection policy

Liberal credit policy increases the volume of sales but at the same time it also increases the investment in receivables.

Examination of costs and benefits associated with credit policy is one of the important tasks of a finance manager.

Cost of Maintaining Accounts Receivables

Capital Cost: Time gap between the sale of goods and payment by debtors => Arrange funds for meeting their obligations like payment for raw materials, wages, etc. => financed from the funds supplied by shareholders for long term financing and through retained earnings => incurs some cost for colleting funds, known as capital cost.

Collection Cost: Collection costs are the administrative costs (cost of reminder, Collector's fees etc.)

Default Cost: Default cost that arises from bad debt losses.

Delinquency Cost: costs arise for extending credit to defaulting customers. Such costs are legal charges, costs in putting extra effort for collection, costs associated with sending reminders, etc.

Importance of receivables management

Besides the cost of investment, there are two types of risks => risk of opportunity loss and liquidity risk.

The firm has to extend the credit to generate enough sales.

extended too much of credit => high degree of liquidity risk, ability to collect back the amounts due from the customers.

customers whose financial position is doubtful or weak, funds not all realized.

result into the company's ability to meet its own obligations and thus affecting short-term and long-term solvency of the company.

Minimization of liquidity risk => risk of opportunity loss of sales by refusing the credit to its potential customers.

Affect the loss of revenue and the loss of profit.

The objective of accounts receivable management is to arrive at an optimum balance of these two risks. This balancing is not a static but a dynamic one.

To arrive at the balance of these two risks, the company would frequently require to adjust their credit policies.

Dimensions of Receivables Management

Receivables management involves the careful consideration of the following aspects:

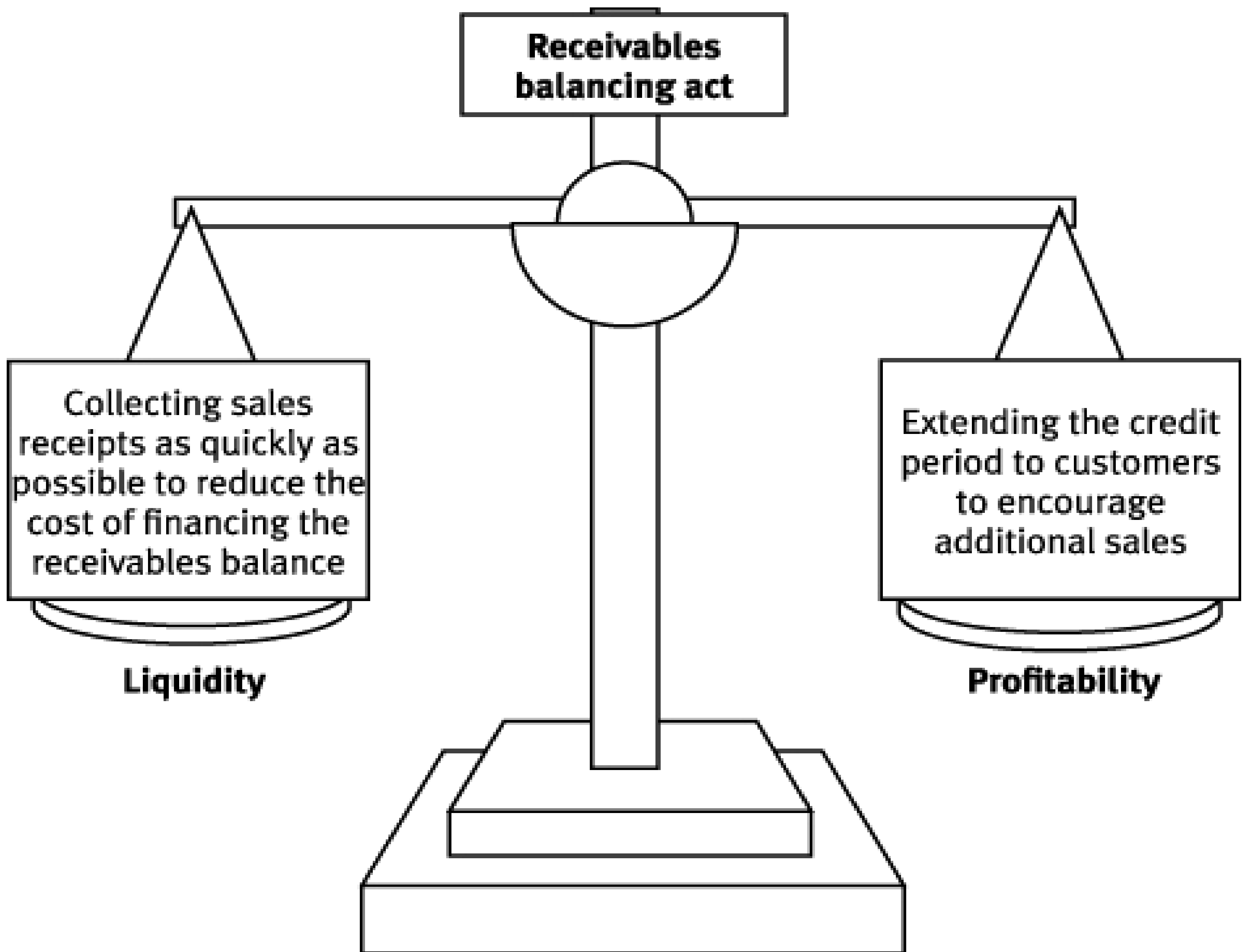
- Forming of credit policy.
- Executing the credit policy.
- Formulating and executing collection policy.

1. Forming of Credit Policy

For efficient management of receivables, a concern must adopt a credit policy. A credit policy is related to decisions such as credit standards, length of credit period, cash discount and discount period, etc. Credit policy has significant impact on the profitability of a concern but it should be ensured that the profit on additional sales arising out of liberal credit policy is sufficiently higher than the cost involved for maintaining additional receivables.

(a) *Quality of Trade Accounts of Credit Standards*:

A finance manager has to match the increased revenue with additional costs. The credit should be liberalized only to the level where incremental revenue matches the additional costs. The optimum level of investment in receivables should be where there is a tradeoff between the costs and profitability. On the other hand, a tight credit policy increases the liquidity of the firm. Thus, *optimum level* of investment in receivables is achieved at a point where there is a tradeoff between cost, profitability and liquidity as depicted below:


Receivables balancing act
Collecting sales receipts as quickly as possible to reduce the cost of financing the receivables balance
Extending the credit period to customers to encourage additional sales
Liquidity
Profitability

(b) *Length of Credit Period*:

Credit terms or length of credit period means the period allowed to the customers for making the payment. The customers paying well in time may also be allowed certain cash discount. A concern fixes its own terms of credit depending upon its customers and the volume of sales. The competitive pressure from other firms compels to follow similar credit terms, otherwise customers may feel inclined to purchase from a firm which allows more days for paying credit purchases. Sometimes more credit time is allowed to increase sales to existing customers and also to attract new customers. The length of credit period and quantum of discount allowed determine the magnitude of investment in receivables.

(c) *Cash Discount*:

Cash discount is allowed to expedite the collection of receivables. The concern will be able to use the additional funds received from expedited collections due to cash discount. The discount allowed involves cost. The discount should be allowed only if its cost is less than the earnings from additional funds. If the funds cannot be profitably employed then discount should not be allowed.

(d) *Discount Period*:

The collection of receivables is influenced by the period allowed for availing the discount. The additional period allowed for this facility may prompt some more customers to avail discount and make payments. This will mean additional funds released from receivables which may be alternatively used. At the same time the extending of discount period will result in late collection of funds because those who were getting discount and making payments as per earlier schedule will also delay their payments.

2. Executing Credit Policy

(a) Collecting Credit information: The first step in implementing credit policy will be to gather credit information about the customers.

The information may be available from financial statements, credit rating agencies, reports from banks, firm's records etc.

Financial reports => determining the financial position and profitability position.

Balance sheet=> short term and long term position of the concern.

Income statements=> the profitability position of concern. The liquidity position and current assets movement will help in finding out the current financial position. Proper analysis of financial statements=> credit worthiness of customers.

Credit rating agencies which can supply information about various concerns. These agencies regularly collect information about business units from various sources and keep this information up to date. The information is kept in confidence and may be used when required.

Credit information may be available with banks too. The banks have their credit departments to analyse the financial position of a customer.

In case of old customers, business own records may help to know their credit worthiness. The frequency of payments, cash discounts availed, interest paid on overdue payments etc. may help to form an opinion about the quality of credit.

(b) Credit Analysis:

After gathering the required information, the finance manager should analyse it to find out the credit worthiness of potential customers and also to see whether they satisfy the standards of the concern or not. The credit analysis will determine the degree of risk associated with the account, the capacity of the customer borrow and his ability and willingness to pay.

(c) Credit Decision:

After analyzing the credit worthiness of the customer, the finance manager has to take a decision whether the credit is to be extended and if yes then up to what level.

Match the creditworthiness of the customer with the credit standards of the company. If customer's creditworthiness is above the credit standards then there is no problem in taking a decision.

In case the customers are below the company credit standards then they should not be out rightly refused. Rather they should be offered some alternative facilities. A customer may be offered to pay on delivery of goods, invoices may be sent through bank. Such a course help in retaining the customers at present and their dealings may help in reviewing their requests at a later date.

(d) Financing Investments in Receivables and Factoring:

Efforts should be made that funds are not tied up in receivables for longer periods. The finance manager should make efforts to get receivables financed so that working capital needs are met in time. The quality of receivables will determine the amount of loan. The banks will accept receivable of dependable parties only. The bank will insist on quality receivables only. Besides banks, there may be other agencies which can buy receivables and pay cash for them. This facility is known as *factoring*.

Factoring is the outsourcing of the credit control department to a third party.

The debts of the company are effectively sold to a factor (normally owned by a bank). The factor takes on the responsibility of collecting the debt for a fee.

3. Formulating and Executing Collection Policy

The collection of amounts due to the customers is very important. The collection policy may be strict or lenient.

A strict policy of collection will involve more efforts on collection. Such a policy has both positive and negative effects. This policy will enable early collection of dues and will reduce bad debt losses. The money collected will be used for other purposes and the profits of the concern will go up.

On the other hand a rigorous collection policy will involve increased collection costs. It may also reduce the volume of sales.

A lenient policy may increase the debt collection period and more bad debt losses.

The objective is to collect the dues and not to annoy the customer. The steps should be like (i) sending a reminder for payments (ii) Personal request through telephone etc. (iii) Personal visits to the customers (iv) Taking help of collecting agencies and lastly (v) Taking legal action. The last step should be taken only after exhausting all other means because it will have a bad impact on relations with customers.

Illustration 1:

The following are the details regarding the operation of a firm for the year ended 31 December 2011:

Sales: Rs 6, 00, 000

Selling price: Rs 5 per unit

Variable cost: Rs 3.5 per unit

Total cost: Rs 4.5 per unit

The existing debtor collection period is one month.

From next accounting year, there is a proposal to extend debtors collection period from one month to two months. This relaxation is expected to increase the sales by 25% from its existing level.

You are required to advice, whether to accept or reject the new credit policy assuming the firm's return on investment is 25%.

Solution: Statement showing profitability under existing and proposed credit policy

	Existing Policy	Proposed Policy
Sales (in units)	1,20,000	$1{,}20{,}000 \times \frac{125}{100} = 1{,}50{,}000$
Sales	6,00,000	7,50,000
Less: Variable cost	4,20,000	5,25,000
Contribution	1,80,000	2,25,000
Less: Fixed cost*	1,20,000	1,20,000
Profit	**60,000**	**1,05,000**
Debtors	$\frac{6{,}00{,}000}{12} = 50{,}000$	$7{,}50{,}000 \times \frac{2}{12} = 1{,}25{,}000$

Change in profit: (1,05,000 – 60,000) = 45,000

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$$\text{Existing Variable cost} = \text{Rs } 4{,}20{,}000$$

$$\text{Existing Total cost} = 4.5 \times 1{,}20{,}000 = 5{,}40{,}000$$

$$\therefore \quad \text{Fixed cost} = 5{,}40{,}000 - 4{,}20{,}000 = \text{Rs } 1{,}20{,}000$$

$$\text{Existing investment in debtors} = [\text{F.C} + \text{V.C}] \times \frac{1}{12}$$

$$= (4{,}20{,}000 + 1{,}20{,}000) \times \frac{1}{12}$$

$$= 61{,}667$$

$$\text{Investment in debtors under proposed policy} = [5{,}25{,}000 + 1{,}20{,}000] \times \frac{2}{12} = 1{,}07{,}500$$

$$\therefore \quad \text{Increase in investments in debtors} = 1{,}07{,}500 - 61{,}667 = 45{,}833$$

$$\therefore \quad \text{Rate of return on increased investment in debtors} = \frac{45{,}000}{45{,}833} \times 100 = 98.18\%$$

Since the firm's required rate of return is 25% but the changes in credit policy resulted in a return of 98.18%, the new policy should be adopted.

Illustration 2:

Swastika Ltd. has a present annual sales level of 5,000 units at Rs 150 per unit. The Variable cost per unit is Rs 100 and the annual fixed cost is Rs 1,50,000. The company presently grants a credit for one month to the debtors. The company is now considering two proposals to increase the credit period to 2 months or 3 months and made the following estimates.

Credit Policy	Existing	Proposed	
	1 Month	2 Months	3 Months
Increase in Sales	–	10%	15%
% of bad debts	1%	2%	4%

The company plans a return of 20% on investment in receivables. You are required to calculate the most profitable credit policy.

Solution: Evaluation of different credit policies

Credit Period	Existing Policy	Proposed Policy	
	1 Month	2 Months	3 Months
Sales (units)	5,000	5,500	5,750
Sales (@ Rs 150)	7,50,000	8,25,000	8,62,500
Less: Variable cost (@ Rs 100)	5,00,000	5,50,000	5,75,000
Contribution	2,50,000	2,75,000	2,87,500
Less: Fixed cost	1,50,000	1,50,000	1,50,000
Operating Profit (A)	1,00,000	1,25,000	1,37,500
Cost of sales (Fixed cost + Variable cost)	6,50,000	7,00,000	7,25,000
Investment in debtors	$6{,}50{,}000 \times \frac{1}{12}$ = 54,167	$7{,}00{,}000 \times \frac{2}{12}$ = 1,16,667	$7{,}25{,}000 \times \frac{3}{12}$ = 1,81,250
Cost of funds: (B)	$54{,}167 \times \frac{20}{100}$ = 10,833	$1{,}16{,}667 \times \frac{20}{100}$ = 23,333	$1{,}81{,}250 \times \frac{20}{100}$ = 36,250
Bad debts [% on sales]: (C)	7,500	16,500	34,500
∴ Net Profit [$A - (B + C)$]	81,667	85,167	66,750

Since profit is higher if 2 month's credit is allowed, it is advisable to adopt 2 months credit policy.

Thank you