Working Capital Management
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Lecture-28
Management of Accounts Receivables-I

Welcome students so in the previous class we were discussing the inventory management where we learned the concept of incremental analysis. So, we have to discuss certain more cases about the inventory management but I thought that first of all we should do all the important concepts and if the time permits later on that we can discuss some cases also with regard to the management of different assets. So, for inventory or say managing the inventory or learning how to manage inventory as a current asset I will stop here.

And first I will complete say the management of all the current assets like receivables cash other assets and then we will learn about the management of current liabilities, spontaneous finance and then the sources of working capital finance and after that we are still having the time that we can discuss some cases also one out maybe some cases on inventory or receivables. I will take up at the later stage but here at the moment I am stopping.

As for as inventory management is concerned and in nutshell you can see in the nutshell you can say that the important component which we should learn or the important part in elementary management which we should learn is that ultimate objective of financial manager maybe the financial or the operations are the production department people should be to have optimum investment in the inventory right.

So, in what way we decide the optimum investment in inventory that depends upon the firm but we have to make out we have to analyse that neither we have to pay extra carrying and handling cost nor we have to pay the any stock out cost. So, we should be able to serve all the customer's needs also. We should have the amount of inventory with us also and that we excessive amount is also not invested in the inventory and no order is going un-honoured or unmet. So, that way has to decide the optimum level of investment right.

And in any case if he says problem that we are losing sales because we are falling very tight inventory policies in that case we can think of or we can use incremental analysis the concept of incremental analysis as we have seen and that we discussed about that if there is a restriction on the working capital supply by the bank so, how to deal with that particular situation. So, we learnt something about the management of inventory and I would again say that the important technique which we should use in environment like India.

Or the manufacturing environment like India is EOQ is valid and very useful technique and we should depend upon that for working out the optimum level on economic order quantity or economic quantity of the material which we have to maintain all the times. So I stop here and then now I will move forward with the next asset or the same learning about the management of the next important current assets.

In the say balance sheet of any company the next important current asset is the accounts receivables. We have cash also you have advance payment also we have some other things also. So, now we are going to talk about the accounts receivables. So, when you talk about the accounts receivables I would like to throw a light upon that in the balance sheet you might have seen that there are the different current assets or if you see the balance sheet you will find different current assets.

We have Inventory of the top which we talked about at length that we have the accounts receivables then we are sundry debtors then we have advance payments have advanced deposits so and then we have cash and some short term investments also right. In this case in this situation you talk about accounts receivables separately given and then you talk about the sundry debtors you talk about the advanced payments. All these are in the category of accounts receivables.

Account receivables is a bigger term is a broader term and that includes sundry debtors also that include the advance payments right. So, all these assets we have to learn to manage under the categories of the receivables management because when you talk about that and accounts receivables appear in the balance sheet when we sell on credit right.

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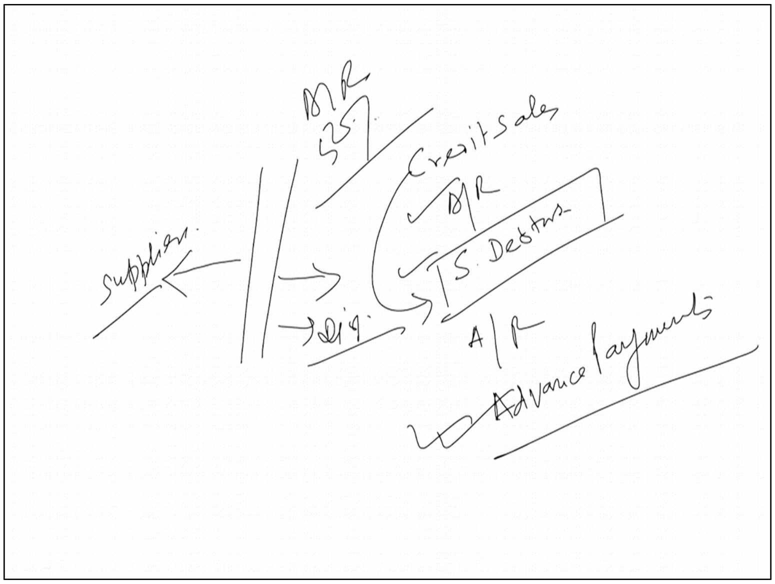

This is the result of the credit sales so when we sell on the credit we see that accounts receivables come in the balance sheet but that is not accounts receivable they are called as sundry debtors. So, sundry debtors are the parts of the accounts receivable. Accounts receivable is a bigger term account so sorry this is accounts receivable so accounts receivable is a bigger term and it includes many things and in the many things this is accounts receivable not AC it is AR.

So, credit sales give the rise to accounts receivables but accounts receivables include many other things also and that current asset which comes in the balance sheet appears in the balance sheet because of the credit sales is called as the sundry debtors. Sundry debtors also the parts of the accounts receivable and then say for example you talk about advance payments. Advance payments for example we are manufacturing such kind of the product where the raw material is very scares are there is a monopolistic situation in the market as far as the supply of the raw material is concerned.

Only one company or two companies is available in the market for supplying all kind of the raw material and all the uses of that material have to depend upon those companies. So, in that case we want to make sure that supply of the material is always regular on the time and we are not stopping the production; we are not used to stop the production simply for the want of materials for that reason we make the advance payments.

So, when you make that advance payment in that case what happens we are again creating the accounts receivable any kind of advance payment whether we are making supplies material whether we are making it to the employees of the company for example somebody's say has got the advance salary from the company because of certain reason. So, in that case that is also accounts receivable right. So, we had this productive distribution system like this accounts receivables come appear from this side and advance payments generate the accounts receivable from this side right.

So, it means when we are making the payment to supplier here we have to recover that payment from the supplier by receiving the material from the supplier from later date and when you are supplying the materials the finished goods to the distributors here. So, we have to get this is goods are given to the distributors on the credit. So, we again have to recover the price of those goods also so it means in both the case we both the sides accounts receivables RB generated or they are coming up for their appearance and finally they come to the balance sheet.

Because we call is as accounts receivable we call is as sundry debtors we call is as advance payments. So, all kind of these assets or these payments or these transactions or the accounts appearing in the balance sheets cover or are covered under the one category that is called as the accounts receivable. So, it means out of the total accounts receivables in Indian situation say about 50% of the accounts receivables is because of the sundry debtors. So, for example you all the things are given in the balance sheet A

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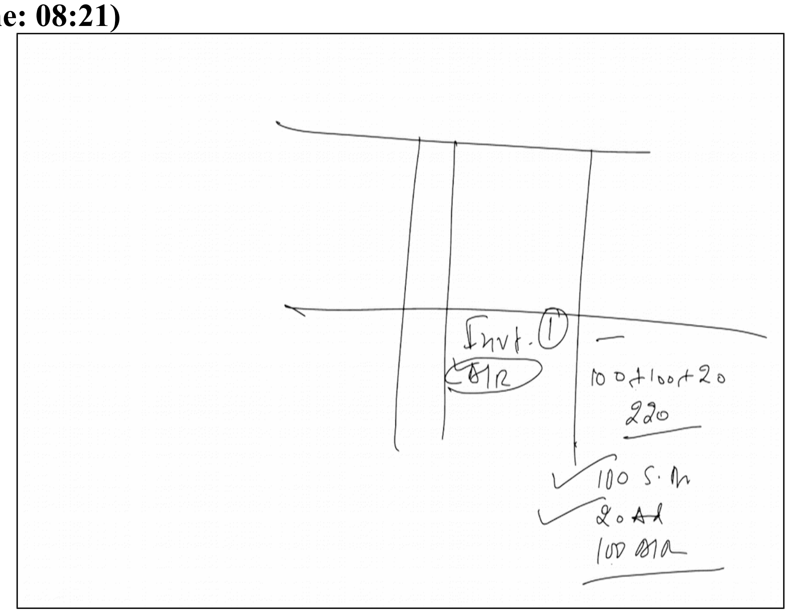

Say for example we have a balance sheet here this is the balance sheet and this is the lower part we have inventory here and then we have accounts receivables then we have sundry debtors then we have advance payments right. All the other current assets we have inventory here right it this is the first assets if we have talked about this asset at length and next thing is the accounts receivable right and for example accounts receivable amount given here say 100. In this balance sheet accounts receivable amount given a 100.

And in this case if you talk about then sundry debtors amount is again 100 right and advance amount is 20 so these figures are given in the balance sheet. So, if you have to cover only under this one head that is accounts receivables so how much you would show this, you will add 100 + 20 and this will become how much it will be the total amount. We will remove this will not appear in the balance sheet now. Individually they were not appearing in the balance sheet.

So, this total amount will become 220 right out of 220, 100 is the sundry debtors and 20 is the advance payments and remaining 100 is the accounts receivable. So, why we show these all current assets not under one head that is accounts receivable but we show it under the different head's say accounts receivable. Because if you show it in the accounts receivable become 220. But we are showing here we are first what we are doing is that in the accounts receivable sundry debtors amount is quite large.

Similarly an advance payment is also important current asset and that is also significant amount. If it is a significant amount so it means it is better to show it individually in the balance sheet rather than clubbing it under one head of accounts receivable they all are accounts receivable but you have to segregate them. Because their magnitude is quite high so here that we are showing here is the sundry debtors 100 and it is a 20 is the advance deposit. Because if you give only accounts receivable in the balance sheet right.

And then the firm has to go out in search of for generating the working capital finance or maybe having the short term loans or may be the cash credit limit from the banks. Banks have to analyse the balance sheet of the company past three years balance sheets of the company. So, if it is not given clearly that what constitute accounts receivables?

In that case bank would not be able to find out the quantum of credit sales, bank would not be able to find out the quantum of the credit sales and finding out the quantum of credit sales is very, very important. Finding of the quantum of the credit sales is very, very important. Similarly bank would not be able to find out how much payments you are making as advance to the suppliers of raw material because you deal with such kind of the product of such kind of the industry where the making of the payment advance payment is required.

So, that may be vulnerable situation sometimes that if we did not make that was payment company will not get, firm will not get the raw material and the production process may get hampered and if it gets hampered in that case it will be a troublesome situation. So, in this case showing it individually is very good because sundry debtors is coming out or appearing is a balance sheet because of credit sales and any funding agency any source of finance whom we are requesting to provide as finance.

They should be knowing it what is extent of credit sales. Because they would be analysing that out of the total profits a company showing in the profit and loss account how much profit is on cash basis and how much profit is no credit. Because when you prepare the profit and loss account here say we all know that profit and loss account is a nominal account and the profit which is shown by the profit and loss account is that is not the real profit that is the nominal profit right.

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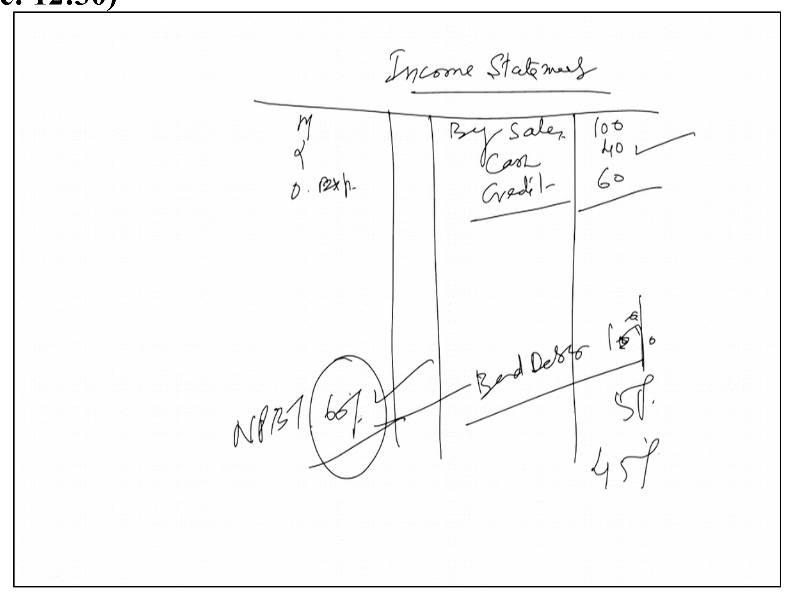

That is the nominal profit because when you prepare that this is the income statement we call it as income statement. So, this income statement here we start income statement we take care the material, labour and other expenses right. We take these expenses here and this time this side we take by sales and sales when we take we never show the sales as how many sales around cash and how many sales are on credit. For example we have sold for 100 rupees in the whole of the year for which they prepare the balance sheet and income statement.

And out of that 60 rupees is the credit sales and the 40 rupees is the cash. It means finally is the profit net profit before tax which we are showing here that out of that profit the total profit coming here 60% of the profit is also nominal that is also on credit and when you are showing this much of the net profit before tax on the credit we have not realised it, in that case it may not be possible that the firm will be able to realise this 100% credit profit.

Not the profit which is still on credit which still is yet to be received only sales have been made for the amount has not been received. So, out of this only 40 percent is the cash profit 60% is the credit profit this 60% of the credit profit weather will be realised or not that will be the question to answer in future and we all understand that there is the sum something which is known as bad debts right.

So it means out of the 60 % even 10% are the bad debts and or some time you have to give the discount or something like that 10% is the bad debt or because of other reasons you are not able to recover 5 more % took for giving the more discount on making provision for the debtor or anything. It means ultimate what will happen your profit will come down to 45% so it means the total profit will be 45% + 40%, 85 %.

So the profit which we are showing here as 100% that will come down to 85%. So, just to know this situation or this a particular situation to deal with this particular situation what we do is that be shown in the balance sheet all the accounts receivables there are shown category wise and in the accounts receivables in the Indian situation in the Indian scenario out of the total accounts receivables 50% around 50% is because of sundry debtors. Half of the accounts receivable that because of sundry debtors so we should be knowing that how much sundry debtors are there in a firm.

And if you know the extent of sundry debtors you will be knowing the extent of credit profits which we have not received yet. They are not actual profit there the on credit because sales are still on say credit basis that is why that sundry debtors are there. So, it means any funding agency or any external stakeholders maybe the internals also but large with external stakeholders they can get to know that what is the overall financial health of the company.

Company is highly profitable for but 80% of the company sales are on credit means 80% of the profit is also credit. So, we have to answer this question that is why in the balance sheet under the accounts receivable we do not show all the things together. We segregated it, so that we can find out that if you summed it up in this balance sheet, the total accounts receivable amount will become 220. But if you are out of this 220 rupees how much is a sundry debtors 100.

How much is the advanced deposits that is 20, so it means these three things make the accounts receivable and remaining 100 is other account receivable for example some say bills accommodation bills raised by the firm or maybe sometime we have had other kind of may be the funds we have given to somebody and we have to receive these funds back so their called as accounts receivables. So, out of this thought 220, 100 is only sales or sundry debtors 100 is out of sundry debtors and 20 are advance deposit.

So, other accounts receivables are 100 only so it is always better and we show it in the balance sheet you might have seen all the balance sheet. So, you will see in the balance sheet that we have account receivables also we have sundry debtors also and we have advance deposit also or advance payments also. But in nutshell they all are say categorised under the same category and their called as accounts receivable right. May be we have to understand that this very important current assets.

Inventory is the one and after that in the; in terms of liquidity or in terms of lack of liquidity you can count this accounts receivable earlier as I told you some previous class that accounts receivables being included while calculating the quick ratio when you are calculating while calculating the quick ratio when you are calculating the following the liquidity of the firm when we were calculating the liquidity understanding the liquidity position of the firm.

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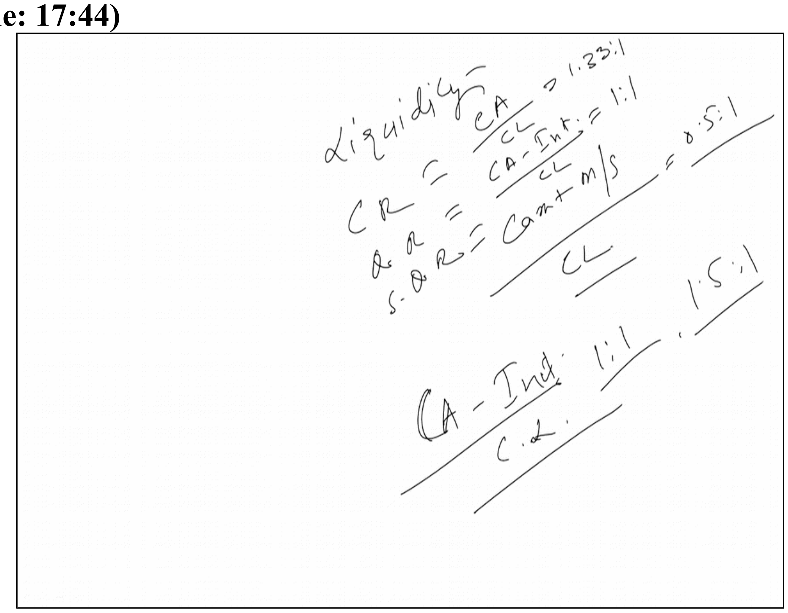

So, what we were doing we are calculating current ratio, quick ratio and the super quick ratio right. Current ratio when we calculate with a call current assets divided by current liabilities then we calculate the quick ratio we take current assets minus inventory and divided by current liabilities and then you take the quick ratio with take the cash plus marketable securities divided by current liabilities right.

This ratio is considered as 1.33 : 1 this ratio is considered 1:1 and this ratio is considered as 0.5:1 right. Earlier there was no liquidity and when the sundry debtors are also accounts receivables were also in liquid like or less liquid like inventory so for calculating the current ratio we were taking all the current assets into account. For calculating the quick what we were doing current assets minus inventory minus accounts receivables we subtracted them also and then we are calling divided by the current liabilities so it means that way it was the current ratio and quick ratio of the assets ratio.

We call it as asset ratios also but now we are doing that from the current; now from the, this is the current assets and what we are doing now currently when we are calculating the current quick ratio we are only doing this that is current assets minus inventory divided by the current liabilities and that is why the rule of thumb has also come down. And this rule of thumb is here this rule of thumb is now that is 1:1 earlier it was 1.5:1.

Because accounts receivables were part of the quick ratio why we have excluded the sundry debtors or maybe the accounts receivables for calculating the quick ratio and how we consider that accounts receivables are now quickly convertible into cash as compared to inventory or they are far more better or quickly convertible into cash as compared to inventory the reason is that as we have discussed in the past also that we have the bill discounting facility from the banks.

If we are not we have sold on the credit and you period is for example 2 months we are going to release the payment after 60 days. But after making the sales of 10 days after making the sales if the firm required the funds, funds from knows that the funds from the credit buyers will come over or say debtors will come after 50 days because we have given them a credit of 60 days. So, what is a way out they would not make the payment before 60 days because it is agreed by both the sides the credit period 60 days.

In that case firm can go to the bank and firm can get the bills discounted. Those credit sales bills can be got discounted by the firm and for the time being firm can raise the funds. So, whatever the bills are there; so, what happens that normally there are the total sundry credited for accounts receivables I would call it as, they are divided into three categories that is A category, B category and C category of the accounts receivables right.

A category of the bills firms do not want to get discounted from the bank because getting the bill discounted for the banks is a costly affair. But it helps the firms to raise the funds as and when they are required and firm is able to make the payment to its different stakeholders when it has to be and firm is able to avoid the situation of technical insolvency. So, that is good fine but there is a very expensive transaction because first bank will give you 80 % of the bills. So, you have to wait for the 20 % till the credit period ends.

And payment is made by the sundry debtors or the debtor and ones that payment comes the bank will charge interest for a period of say in the example we are discussing for a period of 50 days if the funds are given by the bank, the bank will charge interest at a higher rate for that period of 50 days and for the amount which is it amount which is used that is 80% which is given to the firm immediately and apart from that bank charges on commission and administrative charges also.

So it means it is very, very expensive affair what happens if there is a good category of the bills firms do not want to get discounted from the banks because by to lose money on those accounts receivables which are fully secured and on those bills the payment on the due dates is certainly or it is it is bound to come at a certain that the payment will be received.

C category of the bills are those where which are doubtful accounts receivables or sundry debtors which are quite doubtful that we have sold to somebody on the credit in the event of maximizing sales are other than keeping inventory with us we passed on that inventory to the some distribution channel on credit. But there is doubt that their overall performance is not good in the past there may be possible that out of the 100% credit sales we may recover only 80% or 90% are there is a possibility that we may lose 10%.

So, they are the C category of accounts and B category of accounts are which are having the say moderate credit rating. They do not default normal the normal case they do not default they make the payment on the due date. Somehow if there is a very serious issues or very serious problem and there is there is some unforeseen problem faced by the company because of the lack of liquidity then it will be possible but normally they are good accounts.

But normally they are good accounts not best accounts but good accounts and they are doubtful accounts you can say little bit doubt is attached to this. What happens as I told you that A category accounts are very good company does not want to lose any funds on that so that they do not get these bills discounted from the bank. C category of the bills banks do not want to discount because banks are really doubtful about the realisation of the funds on the due date.

So it is only the B category of the bills which are discounted by the bank and firms are also interested to get these bills discounted because they are only in the good category or in the fair category. So, that amount is at least available means some time with easily could you have liquidity crunch with the firm and if they are not having any other source to make the payment to their dues. So, and they do not want to have situation which is called as technical insolvency of the firms.

In that case what they can do they can get the bills discounted and go to the bank at the B categories of the bills discounted from the bank and run the show for the time being and on the due date when the payment is realised that the entire adjustment is done. So, this is there way out so why we have done is that while calculating the current ratio now accounts receivables are removed from the numerator. So, only we subtract from the total current assets only inventory for calculating quick ratio not current.

And inventory is the least liquid you cannot sell the inventory in the market as and when you wanted. So, in that case is the least liquid current assets but accounts receivables when they least liquid by bill discounting facility was not there from the banks. It was a part of the quick ratio it was a part of say subtracting from the current assets for calculating the part of ill liquid assets to be subtracted from the current assets while calculating the quick ratio.

But now when facility is available from the banks we can get a discount from the banks sometimes now in India because after 1991 we have got many other sources of working capital finance also. In some cases when banks are not able to discount some bills that these bills can be got discount from the other sources an important source which provides a bill discounting facility is the factor. Factoring service and factory services and factoring services already started in India that is not picking up.

But the services already started in India and from this factors the bills can be got discounted about the factors affecting services are that I discuss with you in the sometime later on what factors is and again alternative if the banks are not providing the liberal working capital that is a one part. Now in this case we are subtracting it from the current while calculating quick ratio only inventory is subtracted not the receivables.

Because other receivables have become a little more liquid as compared to the inventory so for calculating the current ratio we take all current assets for quick ratio current assets minus inventory but not minus receivables. And for super quick ratio only be take into account the cash plus very short term securities, marketable securities and then we calculate liquidity ratio. So, there is one part of the story.

In this case when we are talking about the income statement about the concept of the sundry debtors have to be shown separately in the balance sheet. So, that anybody outside or any financial institution who wants to analyse balance sheet of the company they can easily make out of the total accounts receivables but part on account of credit and how much advance deposits have made remaining how are the accounts receivables which are not because of the credit because of the advance deposit.

So, in this case we are finding that in Indian scenario 50% of your account receivables are because of sundry debtors remaining some amount is because of advanced deposits but now we are in a competitive situation. So even advance deposits are going down over that is and even you see this credit sales are also going down. When you analyse the balance sheets of the company pick up the balance sheet of any company and analyse it for the past 2, 3, 4 years.

In the in the recent past if you see that the accounts receivables are going down because companies are now say minimising the investment in the credit sales. And since in most of the manufacturing subsectors I would say subsectors of the manufacturing sector in most of the sectors we have multinational performing. So, because of their discipline because of their excellence because of their good quality product and because of their say considering the customer is king their able to sell of their product largely their products on cash.

So, they are creating a situation in the market where all the distribution channels have to by maximum from the these companies on cash and then for sell it in the market and their they are again fixing it up of the target also that you buy this much number of units from us, If you are our distributor and dealer you by if you want to do business with us we have to do it at the excellent level at the best possible level.

So, if you buy from us will give you the no credit or if you will give you the credit for you for a minimum period of time and the minimum amount. So, you and we have to sell this much of units monthly or maybe quarterly or maybe bimonthly in the market and every month for every 2 months after you will be getting this much of the stock and you up to sell the stock in the market and you have pay us in cash or sometime not in cash at least advance tax.

So, that when we send you the truck load of material immediately will represent your check in the bank and we collect our payment. Because of this increased competition in the market and because of the increased financial discipline in the market and because of the presence of the multinational companies who are very, very efficient and who do not create a situation of the say buying on credit of selling on the credits. So, in that case the overall accounts receivable situation is improving.

Or even sundry debtors are coming down advance deposits are also coming down but still they are there and it will take a time that when it is becoming lowest of the negligible amount but still in the balance sheets of the firms today accounts receivables exist sundry debtors exist advance deposit exist and we will have to deal with this current assets. But again I would emphases here again that we will have to make again say optimum investment in the accounts receivables.

Rather I would say that the minimum investment in accounts receivables. If it is possible try to sell maximum on cash never to do not encourage distributors, dealer or maybe the company directly selling in the market, do not encourage the credit sale only in the situation for example if you are say having a product of selling a product in the market which is less saleable in the market which does not have the same sufficient market existing of for the product of which company there is no sufficient market then we are going to sell on credit.

But largely if you want to sell on your product in the market it has to be on cash or it is on the cash. For example we talk about the electronic sector electronics we have largely 3 companies operating in India good companies operating in Indian companies Samsung, Sony and LG. On the other side we have Indian companies like Videocon; we have Onida or some other companies also. For Samsung there is a market why should we sell on credit and normally they are not selling on the credit.

For LG there is a market so they are not giving any credit they are not selling on credit. Sony there is a market the quality is excellence so they are not selling on credit. In case of Videocon you will find in case of Videocon we find the credit period is very, very high because their product is not easily acceptable to the people in the market, if somebody has to buy product on cash why not to buy the excellent product.

If you are going to buy on cash why not buy excellent product. So, in some cases if you see analyse balance sheet of Videocon and or Onida and finalize balance sheet of Samsung and LG you find there is a day night difference in the accounts receivables, sundry debtors maybe sometime advance deposit also advance payments also. Because Videocon has to sell most of their products in the market on credit otherwise people are not ready to buy that on cash.

If you look at the Samsung is a name in the market and people are after the product. So, they have made up the Goodwill their brand name in the market. So, why they should sell on credit as they have the give the credit also very minimum amount of the creditors incentive to the distributed, dealers just for some period of time but not for the longer duration. So, as the; new competition is coming in the market new discipline is coming in the market we are aligning Indian market Indian manufacturers are aligning distributor aligning with the rest of the word.

In that case this market is also moving slowly and steadily towards perfection, excellence and completion. So, in that case the extent of receivables is going down in the balance sheets of Indian companies also but still it is sufficient for sufficiently high and we will have to create a situation where most of the production is going to the market or to the consumers on cash.

So, if you have to make investment in the accounts receivables invest minimum not maximum and try to sell maximum cash. So, I will stop here and remaining many other interesting concepts about the management of accounts receivables we will discuss in the next class. Thank you very much.