Working Capital Management
Dr. Anil K. Sharma
Department of Management Studies
Indian Institute of Technology-Roorkee

Lecture-29
Management of Accounts Receivables-II

Welcome students we are in the process of learning about how to manage the accounts receivables that is a second important current asset in the balance sheets of the firms. And in the previous class I initiated the discussion on management of accounts receivables where we discuss the some basics of the requirement of management of receivables and what in receivables include and than we learn about that what is the importance of sundry debtors? What is importance of advance payments and how the total accounts receivables account for? Now we will be moving forward in the same process and let us see here that how the receivables are behaving over the period of time.

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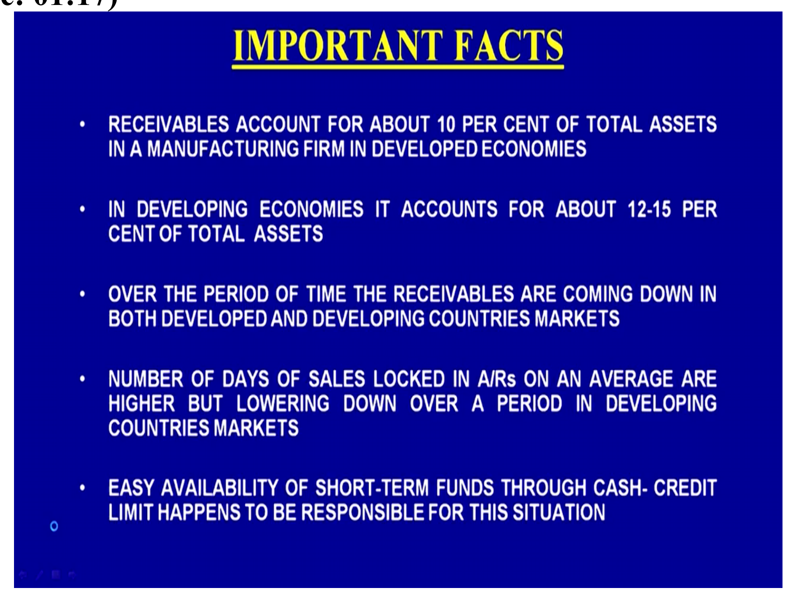

And as I told you that after the liberalisation of Indian economy and the influx of the multinational companies it has brought many things very positive things in the market. First thing is that as I told you that it has increased the competition in the market. So, those Indian companies who were not able to sustain the competition they have gone out of the market. But the companies for sustaining in the market they also have to align with say the rules and practices of the multinational companies operating in India.

So, one thing is that competition has gone up and when the competition has gone up as it is benefit in everybody including customers. So, one reason of discipline in selling on credit is that since this multinational do not give any kind of credit sorry if they give the credits very, very lesser amount of credit they give in the market. So, over a period of time seen that the existence of the accounts receivable and sundry creditors is there in the balance sheet you cannot say that you can do a business without giving the credit.

But the magnitude of these accounts receivables and sundry debtors has seriously come down and we are expecting that over a period of time it will be the minimum amount. So, it means it depends upon the type of the player we are talking about. If the company is very efficient company's product is very good it is acceptable to the people with the company selling a quality product and at a very say competitive price.

In that case selling on the credit is not the requirement of the company sometime the distribution channels are the customers where request the credit which the company can accede to the request. But not the compulsion of the company because they have sufficient demand for their product and they have work hard to create the excellence as well as to maintain the price, so, in that case they can manage accounts receivables in way they wanted. If they want to give the credit they can give credit if they do not want to give the credit they may not give the credit.

Companies who are in the market competing and trying to sustain in the market it may be very difficult for them if their product is not excellent and if the price they are not able to control then it may be possible for them to give the credit in the market to sell the product at a credit in the market. But slowly and steadily everybody will say sail in the same boat and the credit to be given by; the leader in the market or may be by the laggard in the market that difference between the two will not be very high.

So we have seen here if you look at the trends here, important database that database is called as a PROWESS of the centre for monitoring Indian economy which is reporting say the financial data or the financial statements of many companies thousands of companies. So, from there we have seen a trend we have tried to see trend about the accounts receivables and say sundry debtors.

So, and then we tried to compare with the international trends, so we have found from the data which is available or maybe you can also verify it by just resorting into the database PROWESS database where the thousands of companies data is there. So, you can make analysis that in different companies in any industry what is the percentage of the accounts receivable as a percentage of the total assets.

And what is the percentage of the sundry debtors as a percentage of the accounts receivable so we have seen in the trend is declining if you see over a period of time that is trend is declining that receivables account for about 10% of the total assets in a manufacturing firm. In the developed economies means it is around 10% of the total assets. So, total receivables we are talking about and if this is the percentage which shows in the same time some years back.

But this is declining over a period of time and if you talk about the developing economies including India it accounts for about 12 to 15% of the total assets. So, still the magnitude is very high but still 12 to15% of the total assets is very high but yes it is coming down over a period of time. And over the period of time the receivables are coming down in both developed and developing economy markets.

Because we have discussed the reason that as companies are moving towards excellence and in the say era of the cut throat competition seller has to reduce the price to the say maximum possible extent to bring down the price which is the minimum price they can charge from the customers in the market from the markets. So, in that case if still they have to sell on the credit is very difficult.

So, they are achieving excellence in the in the quality of the products and they are reducing the prices to the extent that in this situation seeking the credit or requesting for the credit also this kind of demands are not coming from the customer the distribution channels also. And in a way these MNC have created a say situation in the market where they do not encourage the credit sales.

But still they will give credits because they cannot sell 100% production on cash for their credit period will be controlled by the seller not by the buyer because if you think about who say needs a credit. We have the two sides one is the seller and other is a buyer right. Now the objective of the seller is that the company want give either no credit or the minimum credit.

And objective of the buyer is that he wants have maximum credit and now the objective of the seller is that not to give the credit at all so that the time value of money is maximum for him. And the objective of the buyer is that he wants to delay the payment to the maximum possible time was maximum possible extent. So, that the time value of the money for him which is paying to the computer by the product is minimum to both are moving in the different directions and to achieve the different objects.

In this case we have to create a situation that if the if the product is excellent and the prices it is very, very competitive then the company things about their some time with the situation demands that there is a negative effect up on the market companies sales or sometime it is very difficult for the company to adjust manufacturing process or anything else then it may be possible to give some credit in the market. But largely these MNCs I have personally seen these MNCs as largely we talk about the electronics sector.

In the electronics sector in India we have three companies who are the say leaders in the market you can say the different markets in a different proportions we have Samsung, LG and Sony. Samsung is a leader in the market followed by LG and then Sony. So, it means they have created a situation in the market that anybody who wants to work with Samsung say for example they have to work in a way that any distributor or wholesaler or retailer has to sell the product or has to perform in the market as per the philosophy of the company.

And company wants that you are not expect much credit from us and in many cases companies asks the distribution channels also to send the advance text to the company and production process is continuous and when any material is ready or any say for example 100 colour TV ready they have to be now say sold in the market. So, they will be sent to the distributors even sometime is a distributors not placed any order. Sometime even without order also they will have to work as per the companies instructions and they will have to perform in the market,

So, and since the company has advanced tax from the distributors or maybe any other channel of distribution from the one side truck load of TV to the distributor and they present the cheque and the distributor to the bank, so companies payment is collected. And company's condition is that we cannot perform on such conditions then you need not to be out of the distributor of the Samsung. So, it means you can see the situation that they are not giving any kind of the credit.

So, in a competitive scenario when the prices are too low quality is excellent then it is a prerogative of the seller in the market whether to give any kind of the credit or not to give the credit and over a period of time because of the increased competition increased excellence increase performance and existence of MNCs in the market the receivable or credit sales are coming down. Another thing we are seeing from another point of view in another model is another indicator.

That is the number of days of sales locked in the accounts receivables say normally when we see that that the credit is average credit period is say 2 months or on an average that for 2 months company sells on the credits. So, it means 60 days sales are blocked in the credit sales so they sell it today and the money comes after 60 days of funds come after 60 days. So, it means for 60 days the company has to arrange for the funds because the production process is continuous and it has to be supported with the funds.

So it means number of days sales blocked in the credit sales or in the receivables we have seen that this study is also coming down. Earlier when we talk about the credit period in this country was sometime 3 months also. It has come down it came down to 2 months and now the current credit period is somewhere between 30 days to 45 days and in worst case scenario it can be 45 to 60 days. But no company they can be exceptions but largely the companies are added to this credit Period.

There are the companies were very worst case of companies in the market and want to sustain in the market so there the credit period can be even given 2 months. But that they are not miss large in number very few companies are even giving the credit period up to 60 days and lastly the credit period given by the companies in the different manufacturing sectors is somewhere 30 to 45 days which means over a period of time it has come down for 3 months to 2 months to 45 days and 45 days to 30 days 1 month.

So, we can expect that in the time to come it may further go down. The number of days sales locked to the accounts receivables we have seen the tentatively it is also coming down. This a good development in the market because people who are in the habit of buying on credit and then paying it at a delayed periods after delayed period on a delayed then that kind of the say indiscipline is going away from the market.

And even the distribution channels are becoming discipline and customers are also have got the message that when the price has got the same remarkable cut and the companies are selling their product in the market is the minimum possible price then I think as a customer also they cannot expect any credit. Another important here is easy availability of the short term funds through the cash credit limit. Even if see where the companies are giving even the credit and they are selling their production in the market on the credit.

Sometime the credit period is much longer even beyond 45 days that is happening only because of the one thing that is because of easy availability of the credits from the banks. As we have seen the different ways that how bank finance can be say used by the companies to finance its current assets are the working capital requirements. One thing is that one important word which is only prevalent in India that is CC Limited cash credit limit.

So since easy funds are available through cash credit limit so companies also do not think much for selling on the credit. Because they know it that if they are we are selling on the credit maybe for a period of 2 months then for continue with the operating process for the manufacturing process they can easily have the funds from the bank and for a given period of time they can fund their credit sales or maybe the accounts receivables with the help of the funds provided by the banks and that to on the CC limit basis.

So, that is the one important reason but over a period of time as we have discussed in the past also that this facility is also bound to come to an end. I told you that RBI has instructed the banks or issued the guidelines to the banks that any working capital requirement of the company which is of up to 10 crore and above then the way or the mode of funding that requirement should be in the ratio of 18-20 with 80% should be in the form of working capital loan + bill discounting facility and only 20% has to give manager CC limit.

For the time being it is not being implemented by the bank but it is expected that soon banks will have to do it because of certain reasons because banks overall financial health is also not good. So, they cannot extend the credit in the form of the CC limit which is highly unproductive
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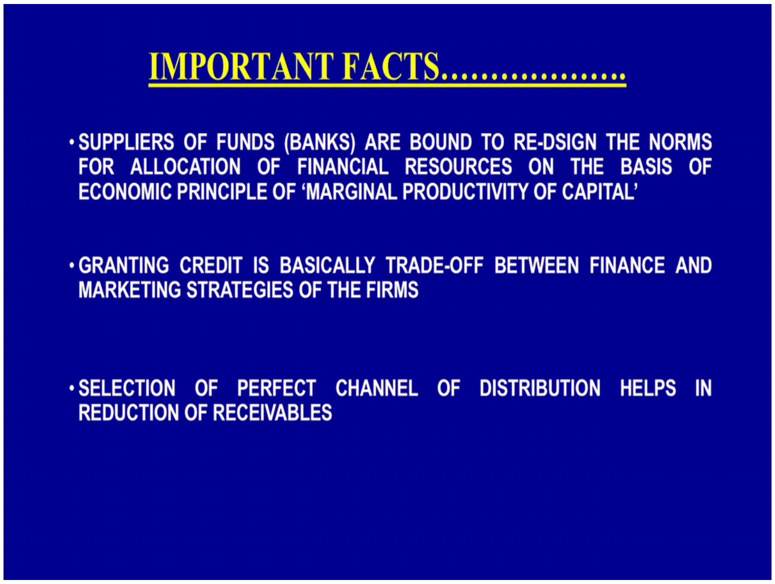

So, now it is the time is coming a situation is arising in the market in the banking industry also that they are the banks also have to start lending on the basis of the marginal productivity of the capital marginal productivity of the capital. It means where the productivity of the capital is high where the banks are expecting that they will generate maximum returns from the loans or from the lender going to make in the market. So, that is going to the final way out so it means providing the funds through CC limits even is going to be difficult for the banks.

And is the time or soon the time is going to be there that RBI guidelines are going to added by the banks because marginal productivity of the capital would force the banks to move say change the mode of funding for providing the working capital requirements for fulfilling the working capital requirements by way of the working capital loans rather than the CC limit or the cash credit limit. So, it means this principle which is already there in the other countries which is being followed in the other countries.

We also have to fall in line and we also have to follow the; this principle of the marginal productivity of the capital. As I told you that in US bank finance is the least preferred source of working capital financing. They resort to other source of financing like factoring, forfeiting, inter corporate deposits, deposit from the other financial Institutions, commercial paper for these sources are not becoming important in India because of the easy availability of the bank finance.

So, if it is not popular in USA if it is not popular bank finance is not popular in Europe then how it can be popular in India earlier you had a situation reverse of the term structure of interest rate and the rest of the world be had the term structure of interest rate but when we say this economy was liberalised opened up when we globalise, this economy was globalised then have to follow the term structure of interest rate which says that the longer the period of the say borrowing higher will be the interest rate to be charged from the borrower by the banks.

So, now we had to align with the rest of the world, in case of the term structure of interest rates. In this case also we will have align with the rest of the world where the bank finance is the least popular source. Where the other countries are in the debt world so why it is so popular in India and banks are going to pay big price or under a pressure from the industry or maybe the financial pressure is too much which is now going beyond the capacity of the bank.

So, we can expect that soon the bank may resort to the way of funding for fulfilling the working requirement working capital requirements of the companies on the principle of marginal productivity of capital. So if that happens then CC limit kind of the things may completely go out of market. Banks, companies will get the working support from the banks but by way of working capital loans and by way of the bill discounting facility and that should be done also because banks cannot be expected to full fill the companies are the industries requirements unendingly.

So, that is going to happen but currently the reason for the large amount of accounts receivables in case of Indian companies especially is that easy availability of the bank finance through CC limit is the one imported reason. Granting credit is basically trading off between the financing and strategy of the firm. This is important part here see we have the two important divisions or subunits in the company's one is the finance department and other is a marketing department right.

Target of the marketing department is that they shall maximize the sales. Objective of marketing departments that they should maximize the sale and if they have to maximize the sales every time they cannot achieve the target by selling on cash, so sometime they have to sell on the credit. So, company has given it to the market that we have this much of the production. Sales have to be this much by setting aside some minimum stock which we are keeping.

So, maximum production should go to the market and marketing departments only concerned with achieving the objective irrespective of the fact whether it is on cash or it is on the credit. Company selling the product in the market whether the product goes to the market on cash or on the credit marketing department is not going to answer this question. May be at the end of the day they would say that our target was this much to sell the 100 units of the product in the market we have sold 100 units in the market 100, 500, 10 units in the market our target is over achieved in the market.

But important question is what part of the seles has gone to the market on cash and the credit component is to be taken seriously. The objective of the marketing department is to sell maximum in the market whether on cash or on credit that is not important for them. And objective of finance department is to maximize the return on investment. So in that case sometimes what happens that say the firm has got surplus funds.

So, those surplus funds can be parked anywhere so finance people sometimes think that rather than parking it outside may be manufactured and sell beyond our level on the credit. So, currently when we are selling on the credit by giving a certain credit period and largely on the cash also our sales are say for example the level given is X but you want to increase the sales beyond that level. We have surplus funds we can produce more we can manufacturer more and we can serve the other markets also.

In the existing markets also if we give the credit and start selling on the credit on increase the credit period the sales can increase. So, how they are going to do that because your surplus fund then they want to park their funds somewhere. So they can park this first into the credit sales so in that case of a sometimes to meet the objective of the finance people they have to go for extra manufacturing or manufacturing and selling in the market and with their objective of maximizing sales and the profits.

On the say instruction of the finance department to park the surplus funds the credit sales can be done and surplus funds can be parked was invested in the accounts receivables. But finally we cannot go pick and how can have to extremes whether the objective was the finance department subject to a marketing department is there has to be a trade off that how much funds be surplus funds we have how much credit we can give in the market because we have to keep into consideration the recovery of the credit sales.

May be unendingly keep on selling in the market on the credit basis that is not going to serve the purpose. So, we may have to think that there has to be trade of the marketing departments objective is also met and finance department objective is also met and firms overall value is maximized. So, that is important objective that this trade off has to be taken seriously and we should think about that your sales are also going up sales collections are also maximum and the amount or the percentage of the component of the bad debts is also minimum.

So, that has to be borne in mind and one important reason that to increase or decrease accounts receivables whether the accounts receivable this should be there or not that also depends upon the another important point is that is the perfect channel of distribution is important question here. To decide the extent of the magnitude of the accounts receivables we will have to talk about think about the channel of distribution. If you think or when the companies want to sell the product in the market, largely there are two channels.

One channel is the direct sales in the market and another channel indirect sales in the market. When there is direct sales in the market as I already know it. Some companies have their own exclusive stores and they manufacture and sell the product in the market not through any indirect channels by the company owned channels. We had sometime in the past that Bata shoes available only in the exclusive store of the Bata and they continued with the strategy for the distribution channel for the longer time.

But now they are resort into the strategy which is both that is their selling through the exclusive store also and they are selling through the say indirect channels also to maximize the sales in the market because in today scenario it is not possible to depend upon the one channel on the direct marketing only. So sometime that is the situation but we have seen many companies are selling directly in the market and in that case say there are many positive is also there many negative is also.

The main positive part here is that companies control up on the customers is direct what customers want what changes in the product customers what changes in the design of the product customers want and how they are feeling about the price of the product and other attributes of the product all customer related information is directly coming to the company because companies directly selling through their own company owned at outlet in the market.

So, they have not to look for the customer information towards the other channels right. The negative part of it is that having the exclusive stores these days especially in the big cities or towns is becoming a very, very costly affair because finding the place maintaining the store paying for the overhead store overhead is very, very expensive affair. So, what happens in that case the price of the goods go up and in many cases people may not like it.

So, because it is a price sensitive economy we have a limited income we cannot everybody cannot go to buy the Reebok shoes or may be the Nike shoes or maybe the Puma shoes or maybe some branded products in the market that is not possible for all. Even if you talk about the Bata Shoes branded shoe sold through the direct channel and indirect channel also if you compare the quality of the shoe and price of the shoe there is a big difference because same quality of the shoes is available in the market.

That may not be Bata that is good quality shoe and is available sometime at the one third of the price. So, the because of the exclusive stores or maintaining the exclusive stores cost goes off very high. So, everybody cannot afford to that cost. So, that means sales of the companies are affected. So, increased cost is the negative part and direct control upon the information and the requirements of the customers as a director information from the customer comes to the company just a positive part of the channels of distribution.

But here these days what is happening in India also know the trend has started that people have very lesser amount of time. Time is the problem, these days when we go out for the shopping when you go out for the shopping we tried to go to a store where almost all the things of household are the one for the daily needs are easily available. We do not have the time that for shoes we can go to exclusive store and for refreshments we can go to another exclusive store for the grocery we can go to another exclusive store or for the say other requirements pick and go to the exclusive store.

That is not the time now earlier it was there then the people had a stable life and there is no shortage of the time there is no paucity of the time now the time is the problem. So, in the evening when you come from the office we want to buy something for households other approaches that we want to go to a shop or restore where almost all the things are available at under one roof or even if you want to buy any particular product or to buy single product people want to try or want to know about the quality in the prices of different companies and their products and then they zero in on one product.

Say for example if they want to buy even shoes so they would like to go to store which is having the product of the multiple companies different companies rather than going to Bata rather going to Nike rather than going to Puma because if you go there means if you are not decided in your mind. Until unless if you are not decided in your mind that you are going to buy Nike shoes in any case you are not going to say compromise lesser than Nike that is good.

But largely people want to buy shoes they can buy Nike also they can buy Puma also they can buy any other shoes also but if the varieties available people prefer that and if variety is not available sometime people may drop the sales or maybe we postpone the sales. So, people want it that yes they should be the different companies product available at the same place so alternatives are available in terms of the quality in terms of the cost in terms of the price.

And they want to have choices so because of the say requirement of the choices the indirect channels have much more value rather than the direct channels. So, in the past period seen that directs channel is also working very well but these days now the trend is changing and their also we have seen that what happens you might have seen that when we buy the product from the exclusive stores they are very, very expensive because cost of maintaining the store is very high overheads are very high.

And all those overheads have to be passed on to the consumers where as it may not be possible in case of the indirect marketing. If you go to a shop where at a retailer is having the products of different companies and you have number there you can have a choice that this product you want to have you can have you do not have a premium product that is also available you want to have the regular product that is also available.

In that case the retailer's overheads are distributed to the many companies so cost of maintaining the store comes down and those over heads or the cost of those overheads can be passed onto the many manufacturers or different companies. So, that benefit directly goes to the customer because prices go down. So, this is a very important as a positive point of the indirect selling in the market. But that the to give the credit or not to give the credit to a large extent it depends upon the channel we are say finally selecting.

Because building a channel takes a time lot of time it takes and if your building a channel of distribution network where we have distributors, wholesaler and retailer in the process and we have built this channel by working hard for many years you cannot stay away convert to direct marketing or if we have the direct marketing network we have created and we have the number of exclusive stores in the different cities and different towns.

So, you cannot straight away say that we will dismantle it and move to the indirect marketing that is also not possible. So, these days at least if that thing is not possible we are falling the middle path that has Nike shoes will be available at the Nike store also and they will be available at the other place is also so that both that changes can be used by the companies and maximize that can maximize the sales and minimise the credits.

For you see when you go for the direct marketing another positive benefit of the direct marketing is that credit sales are minimum almost negligible when you buy any branded products on the market on credit we go and pay in cash and come back. So, it means that when then the customer is paying in the cash the outlet is also as must be buying from the company in cash so it means there is no credit period at all.

Company can afford to not to sell after their production in the market on the credit or to give the minimum credit is the store is being managed by some outside agency. But if it is being organised by the company employees there is no question of credit. But in case of the indirect distribution yes we have to give the credit and when we give the credit accounts receivables appear in the balance sheet and this another outcome of the indirect marketing.

But in that case we can increase the sales also we can minimise the price also and if the price is lower down then certainly we can maximize the sales and in that way seller is also gaining and the buyer is also gaining. So, that is important part in this important question about you want to choose. So, in this case we are finding that the trend is like that companies are moving slowly from the direct marketing to the indirect marketing because of certain things.

And in that case is cost is controllable but the credits are coming up in the market we have to sell on the credit and what are the important points and other important components and how we should select a channel of distribution this is the important discussion I think we should have further more discussion about the channel of distribution because it is a direct or serious impact upon the accounts receivables so further more discussion on the channel of distribution I will have in the next class thank you very much.