Working Capital Management

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Lecture-36
Goals and Functions of Accounts Receivables Management

Welcome students so we are in the process of learning about the receivables management and in the previous class I was talking to you about deciding the credit limit. So, one thing is that we learned about is that working out the credit score and after that if the if the borrower or maybe the customer or maybe any member of the channel of distribution if the cross the desired score 4.5 be discussed in the previous class.

In that case now the question arises what should be the credit limit to him, how the credit limit should be decided. For deciding the credit limit there is a problem that credit limit has to be in terms of the number of days the credit period and second thing is the order size what should be the order size up to what order size we should full fill his demand then let him sell the product in the market return the sale proceeds of the order back to the firm.

And then we can think of sending in the second order so these are the two important things. So, while sorting out this issue. Two important issues were raised by the people by the experts and finally we have zeroed in on that the credit limit should be decided in two ways. There should be to credit limits one is the information credit limit and the second one is the risk credit limit and they are not mutually exclusive.

They are interdependent they are interrelated they are interdependent information credit limit means when we decide about the repaying capacity of the borrower or maybe the by number of factors are taken into consideration one we saw that we can calculate the score and one somebody crosses the score that we have to see his financial position maybe under the score we have already seen the financial position, financial position is good.

But another important factor to be taken into account is the liquidity position of the buyer or the other borrow his a very good in financial terms is very good his asset liability position is very good his overall financial performance is very good his selling too much in the market he is making a lot of sales in the market is having huge profits is overall performance is excellent in

the market but sometime even the best performing buyers are the players in the market are caught into a situation of the technical insolvency and simply because of the lack of liquidity.

Because he has to make the payment on the due date and it is a rule in the business world that say if X has to make the payment to Y after period of 30 days access the manufacturer Y and Y is the manufacturer's by extending in the credit for period of 30 days and he has to access to make the payment to buyer after 30 days because the credit period is 30 days. So, always quotes he demands discipline demands that he should make the payment is better for him for the X make the payment to by that he can make the payment on the evening of 29th or may be 29 day.

It is better to make the payment one day before that is on the 29th day evening or rather than postponing it to the 31st day. For the buyer or maybe for X In this case it may be a question of one day that he is only delaying the payment by one day how does it matter. I can make the payment today I can make the payment tomorrow it does not matter it does not make a difference. But it makes a difference in the business world because Y is depending upon that I received this payment for X and I will make the payment to my supplier.

So, that supply of the raw material and other inputs remains continuous and there is no interruption in the manufacturing process. So, because of the problem created by the tax buyer in this case funds could not reach up to buy that is a manufacturer and finally the funds could not reach to the supplier by his supplier right. So, this disturb the total symbiosis disturb the total synchronisation. One is depending upon the other and other is depending upon the other is depending upon the channel.

If there is one channel in the chain does not work well then the other all other channel get disturbed. So, there is a disciplined financial discipline which is demanded in the manufacturing world or in the business world that always stick to the date and make the payment on the due date. So, when we have worked out score that only financial position was taken into account we have not thought about that whether he is having a sufficient liquidity or not. For that purpose even that is ok with the banks also.

When the banks decide the CC limit they also demand certain liquidity ratios and liquidity ratios we have already seen that three important ratios there is many liquidity ratios but at least three liquidity ratios are also worked out by the bank and in that case current ratio is the most

important ratio for the banks and banks also want some cushion because they are lending the funds without any kind of security without any kind of collateral.

The banks want to make sure that as and when the payment will be due to be made by the borrower to the bank the borrower has a sufficiently liquidity and for that they demand the current ratio should be more than one It was too is 2:1 but now it is 1.33:1. So, when the firm's manufacturers look at the deciding of all the work out the credit limit they depend upon certain information and that information is about the liquidity performance of the liquidity position of the buyer.

He is very good financially but what is his liquidity on that particular day he may not have the funds to pay to the manufacturer so he disturbs the total symbiosis. So, in that case the credit limit is decided in terms of information credit limit. And information credit limit says that look at the liquid to work out the liquidity ratios of the borrower and think about what is current ratio what is his quick ratio what is his cash ratio.

So, it is within the given rules of thumb say for example the manufacturer also demands the current ratio has to be more than one thing that case he was sure about that the total current assets are not being finance from the current liabilities. He is financing from the long term sources also so it means at any point of time if any current assets is not convertible into cash. He will have the funds from the long term sources, so he can make our payment.

On the basis of that possibly or similarly you talk about the quick ratio and the cash ratio. So, similarly we take the decision on the basis of this information limit that if say If some firm is some borrower, some channel member distribution channel member is having a good liquidity and having a good overall financial position is also good liquidity position is also good and he is not solely depending upon the supplies from the manufacturers but he is investing his own funds also in the process then there is no problem.

Then you can decide the credit limit on the basis of that information financial information liquidity information little on the higher side. But if that is financial position is good but the liquidity position is not good then we will have to think about while deciding the limit this is the information limited.

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LIMITATIONS OF CREDIT TIME

- MARGINAL COST CONSIDERATION
- TAX CONSIDERATION

DETERMINING MAXIMUM LENGTH OF CREDIT PERIOD

ELEMENTS OF TRADE-CREDIT POLICY

- Written credit policy
- Credit limit
  - Information credit limit
  - Risk credit limit

Second limit is the risk credit limit credit limit is in terms of the order size. Normally when we work out the information limit information credit limit we saw that he has a good liquidity he has sufficient funds with him and he can make the payment on due date to the firm so there is no problem. But that information limit was decided for a particular level of a or the given level of the order. Say for example every month will be supplying 10 colour TV's to a retailer or may be 50 colour TV's to a retailer that his normal order size.

If he 50 colour TV's from the firm Samsung on credit for a period of 30 days or 45 days so it means he has the capacity of selling those 50 colour TV's in the market during that period of 45 days in the market and immediately on the 45th day or 46 day morning he can remit the payment to Samsung. So, that information is fine that is decided that limit is decided on the basis of the liquidity and the financial performance and the information which the company has gathered.

But if the order size increased is a company says he is doing very well his excellent distributor is excellent in the market increase credit limit from 50 colour TV's to 100 colour TV's, so what will happen now that is called as a risk credit limit. Now the company the manufacturer itself is taking a huge risk. They have increased the order size is means the borrower also place the order and company has agreed to that of size.

This batch size they have increased the company of started supplying him not 50 colours TV's a month but 100 colours TV's a month and there comes a problem. He has a capacity to sell 50 colour TV's efficiently in the market. For selling hundred colour TV's in the period of again 45

days maybe a problem. So, in that case he does not want the distributor of the retailer all the customer does not want to default he wants to make the payment on due date.

But if he could not sell all the 100 TV sets in the market and if he does not have the own recourses also like to make the payment back to Samsung in that case what will happen there is the situation of default. Despite the fact that the channel number does not want to default, despite the fact that companies also clear about his financial and liquidity position but because of the increased order size that much of the liquidity was not maintained by the retailer and he defaulted in making the payment back to the company.

So, company got the payment for 50 TV's on the due date for the remaining 50 the payment is blocked. So, we have to decide the limit taking into account first thing is you work out all kind of financial and liquidity information about the customer or the potential buyer. Decide the limit and that limit will be for a given order size so the risk level is calculated. But as the order size from the buyer increases and company accepts to the request at that level company is taking the extra risk for that level we have to work out the again a new limit.

Therefore 50 C TV's yes we are ok but for the 100 colour TV's you have to improve your liquidity position. Then your current ratio will not work as 1.3 you will have to keep the current ratio as 1.5 or we have to have multiple resources or your cash position must be very good. You keep more amount as cash to improve your cash and marketable securities short term marketable securities position and you keep more assets into the cash or the near cash forms.

We have to ask him to improve before rising is risk credit limit on raising the order size or accepting that increase request for the order size we will have to ask him to improve is liquidity position. So, that that risks the companies going to take is not the risk and he is able to make the payment on the due date. So, this way we decide the limits that is a information credit limit and the risk credit limit and before that score we have to work out which is going to facilitate had a written Credit Policy.

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GOALS & FUNCTIONS OF A/Rs MANAGEMENT

- Credit terms
- Opportunity Cost
- Receivables at cost or sales price

Now we proceed for the next part and that part is some goals and functions of accounts receivables management. Functions of accounts receivables management when you managed accounts receivable we have to take into account certain other important things number one is the credit terms, number 2 is opportunity cost and third one is receivables at the cost of that the sales price right. Credit terms now it is important question when you talk about the credit terms what are the credit terms normally we have two credit terms.

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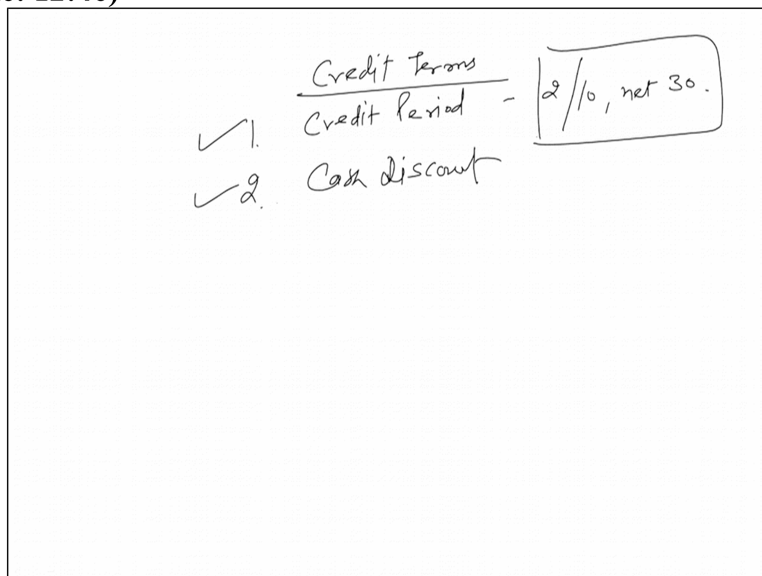

Credit terms include here we have two credit terms one is credit period and second is the; one is the credit period and second is the cash discount these are the two credit terms, credit period. We have to decide very carefully the credit period to be given to the different buyers. Normally in

the business language we write the credit terms like this 2 by 10 net 30 this is a credit term what does mean 2 by 10 net 30 what does it mean.

That I will discuss with you but two important terms are one is a credit period and second is the cash discount. Normal credit period for example in India the normal credit period in the electronics are in the manufacturing sector and that too in electronics sector is say 45 to 60 days. But that is normal credit period for the buyer who has the normal standing or the manufacturer normal standing in the market. For the firms who are excellent performance in the market for example these multinational companies Samsung, Sony and LG you talk about.

They are excellent performers in the market they will not agree to the credit period. They will say they will give you the minimum credit period and the; our credit period is say 30 days. You have to; if you want to do the business with us you will have to sell the material in the market within a period of 30 days only that maximum is 30 days nothing else. After 30 days they are as a security these companies as a security from the retailers or from the any bulk buyers they ask them to say provide advanced tax to the company and the credit period is 30.

Company has supplied for example 100 colour TV’s one retailer and for a period of 30 days on the 30th day whether he has sold those colour TV’s in the market or he has not sold in the market company will present his cheque in the bank and they will collect the payment from his account standard. Second option that normal credit period we are giving you 30 days but if you want to say earn more while doing business with us we can give you some cash discount.

But in that case you will have to remit us the payment on the 10th day so it means in that case we will reduce your credit period but we will give you discount of 2% and see in the business language discount earned is the cash earned. So, many retailers and many a times they take it very seriously that if I am able to sell the product push product in the market at the reduced credit period.

I will be able to increase my return on sales or my return on investment and I am getting the credit for example for a period of 10 days not 30 days but I am getting the cash discount of 2% so it means if I have to pay 10 rupees to the company I am ending up paying only 8 rupees and 2 Rupees are directly come into my pocket. So, nobody would like to forgo allow that discount to be foregone and to be not to be enjoyed.

So, this is a very important term, so credit terms credit period normal credit period and cash discount if both are to be given if only one has to be given then you can say normal credit period is 30 days. But if you want to enjoy the cash discount then the credit period will be 10 days. So, for example I have written here 2 by 10 net 30. 2 by 10 means normal net 30, 30 means normal credit period is 30 days. But if you make the payment within 10 days you will be given 2% discount, 2 by 10 payment within 10 days 2% discount.

But if you are not able to enjoy that discount, if you do not have the discount then you have to make the payment was on 30th day. So, these are the two important credit terms which everybody has to be careful about. Then we talk about some other things opportunity cost, opportunity cost is an important part while deciding the credit sales or the limit of the credit sales or the credit to be given.

Opportunity cost is the one which the seller has to take into account and the buyer also has to take into account. Buyer has take into account the opportunity cost we have discussed in the previous class that 2 classes back in the past that as we have seen the marginal cost consideration. Because marginal coast consideration means is that what is his opportunity cost is opportunity cost is say that he is borrowing from the bank his paying a particular rate of interest to the bank.

But when he is borrowing from the supplier or maybe manufacturing he is paying the higher rate of interest to the suppliers. So it is better for him to borrow from the bank and make the payment and to enjoy the only credit period where the interest charged by the manufacturer by the supplier is lesser than the bank rate. This is from the buyer's point of view but for the manufacturer also is a million dollar question they have to be very carefully looked at the opportunity cost.

What is opportunity cost for the seller see we talked about the investing the surplus funds in the credit sales when firms seek or the manufacturer's seek cash credit limit from the banks, banks also decide the cash credit limit at in total first and then they divided into the different current assets this much of the CC limit you can invest in the inventory. This much of the CC limit you can invest in the credit sales, this much you can use as cash, this much you can use this for making the advance payments all these.

So, here opportunity cost that whatever the surplus funds maybe from the bank or form is owned resources the manufacturer has first he would sell on cash after that he would think that remaining to expand my market the remaining production can go to the market on credit. And I know that if I am going to sell on credit I am going to load my credit sales with the interest factor. Now how much that interest factor he can load the sales with normal there is a standard percentage in the market various standard rate in the market.

For example the normal loading factor is we have been discussing in the previous class is there 2% per month or 24% per year now here if he is investing his surplus funds in the credit sales by extending the credit to the different channels of distribution or to the customer he is earning 2% per month or maybe if it is the credit period of say 2 months that he will be earning 4% that is opportunity cost for a period of 2 months.

Annually that is 24% what say his otherwise opportunity cost is high because if we invest that surplus funds in any other investment avenue for example in the stock market for example he may be on say any other assets or any other investment he earns 30%. So, I think he would be very serious that only limit the credit that I will give you this much of the credit, this much of the sales on the credit and loading factor since it is 24%. So, I will be loading with 24 % but if you want to have more sales on the credit for me you have to pay to the interest at the rate of 30% per annum and in that case that will increase to 2.5% per month.

So, if now the buyer is ready to pay 30% per annum rate of interest or 2.5% per month then he would extend the credit beyond that level also otherwise he will restrict the credit he should restrict the credit because he is earning by investing the surplus funds in the other revenues is 30% investing in the credit sales is 24% but he has to invest in the credit sales also because market has to be served both in cash as well as in credit.

So, that is fine but opportunity cost is important component and we have to see here that if we are having the better opportunities to invest the funds elsewhere that we should go for that after selling for a minimum amount of the credit sales or selling on credit. But if it is not there then yes then we will have to think about that our credit terms can be little lenient or say we can have the loose Credit Policy or we can say some relaxed Credit Policy that can be possible.

But if the opportunity cost of selling on the creditors high then the Credit Policy has to be tightened. Third important function of the receivables management is important question that is million dollar question that is valuing the receivables at the cost of the selling price at what should be valuing account receivables while talking about the investment in receivables which we are talking about the opportunity cost.

What cost of what opportunity cost of production or the sales value now there are two schools of thought one school of thought says that in the receivable we are investing only the cost of production and not the profit there are two components. One components is that when you are talking with the receivables total sales value when you are talking anything in the sales value it has the two components cost of production COP Plus the margin or the profit which the firms is keeping.

Now I meant it not investing as a manufacturer the margin I am investing only the cost of production. Cost of production comes in terms of material, in terms of labour in terms of other overheads. So, these are this maybe they are the direct and indirect overheads this is the investment I have made. For example one product colour TV which Samsung is selling in the market for a 20000 the cost of production of their TV is a 15000.

So it means while selling that colour TV in the market he is investing or selling that in the market on credit he is investing only 15000 he has not invested 20000. Should he value his receivables credit sales is making in his own records for the analysis purpose 20000 or else 15000. Because the cost is 15000 and selling price is 20000, 20000 selling prices includes the profit of 5000.

Now this profit is not been invested by him, should he think about it also while calculating the cost of the funds invested in the credit sales. Now let us discuss it in some detail the logic here is that when we manufacture a product and product goes on the market we sell it on cash. It is converted product is converted into cash and operating cycle is complete your operating cycle is complete here. But when we manufacture the product it is not possible to be taken to the market on cash.

It has to go to the market if it has to go to the market it has to go on credit. Otherwise it will have to be kept in the warehouse. So, you are having options like either you will have it as an inventory or you will have it as another current asset that is the credit sales. So, either it will not

be converted into cash right. So, if it is not possible to be converted into cash what will be either it is inventory in the warehouse or accounts receivable.

And in both the cases you are not getting the cash here also here also you are not getting the cash only is a conversion of one current asset into another current assets which is certainly not cash. So, here first we talk about the inventory when if you keep it is inventory we are keeping it is inventory with us and inventory is inventory. But we are converting passing on that inventory to the channel of distribution in the market to the distributor, wholesaler, or the retailer.

Again he is not paying us back in cash so he will also keep the product until unless it is sold in the market. So we shift that inventory to the channels place and again that is inventory but it is gone out of the books and place of the manufacturer to the books and place of the channel of distribution. But it is still not converted into cash now question people who say that the receivable should be valued at cost they say that since inventory is being valued at the cost of the selling price which aboriginal over.

We have standard rule because of the convention of conservatism in the accounting we value always this is standard rule that inventory should be valued at the cost of the selling price whichever is lower. So, why not account receivables? Again the accounts receivables is also the converted form of the inventory had you not passed it on to the channel warehouse then you could have retained it in your own warehouse as a manufacturer.

So, that it would have been called as inventory so if it is converted from the accounts inventory to the accounts receivable still it is inventory it should be valued like inventory should be valued at only cost and the logic for that is there is a manufacturer is investing only the cost part not the profit part. But this is another school of thought who says that profit also has the opportunity cost. If for example he had been sold the product on cash you would have realize the entire amount and that 20000 would have come to the manufacture to Samsung.

And then they could have reinvested that reinvested that for manufacturing the say other number of the colour TV's. So, it should be valued at the selling price and sometime back RBI also had the stipulation and it was the guideline to the banks that while you are providing the working capital finance for supporting credit sales or say for creation of the accounts receivables by

manufacturers. The inventory sorry accounts receivable should be valued at the selling price not at the cost price to help the manufacturer to see more credits on the banks.

He should be asked to calculate or bank should accept his calculations on the selling price of the accounts receivable and the accounts receivables it should be valued at the selling price not at the cost price. So, that was the one direction or the guidelines from RBI but recently the RBI has be drawn this direction to the bank now to the left to the banks that what is to be done whether they want to consider it on the cost price of the selling price that is between the borrower and the lender that is between the firm the manufacturer and the bank.

But both the schools of thought are valid and they can be accepted so some firms can valued some firms can evaluate the selling price both way it has to be accepted by the banks and the firm also has to apply a logic here. See when you are talking about the logic to be applied here we will have to think about that say what is opportunity cost of that profit which we are investing elsewhere. For example if he sell the product on cash we get the cash back immediately that is a cost plus profit and that that total sales proceeds are investable.

We will be there in to the next lot of the production and again the new accounts receivables or somewhere outside the firm and that is going to give us the sufficient or the handsome amount of the return. So, they have to think about that, that but is my total cost of say making these credit sales including the financial cost and the handling cost and if I value it at the cost price then how much you return on that extended credit of those increase credit sales is there means how much is a return on the credit sales.

What is my cost while considering the investment at the only cost price and what is my cost while considering the investment and total cost plus the profit both then he has to compare those cost, cost at the cost of production cost of funds as a cost of production as cost of investment as at the cost of production level at the cost of investment at the total selling price level and then he has to compare with the return on sales of those credit sales available.

If in both the cases the return on sales is higher than the total investment cost then there is no problem to decide whether you valued at the costs are valued the selling price always it is a profitable proposition because selling price is very high. But if the decision is different that if you are valuing at the investment cost at the cost price then it is a profitable proposition but if

value at the selling price investment will increase cost will increase return on the sales remains the same.

So, it will become a negative proposition that depends upon that practically in the market what happens what is the cost what is investment different firms have to take the different decisions and arrive at whether to extend the credit sales weather to loosen the Credit Policy relax the Credit Policy or not that will depend upon the situation in the market. Now how to take that kind of decision and how to compare the investment cost with the return on sales and some other important related issues I will discuss with you with a small example or small situation we will have the information about in the next class thank you very much.