Working Capital Management
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Lecture-53
Window Dressing & Management of Current Liabilities

Welcome, so in the previous class we were we discuss the concept of liquidity at length and in this class will be talking about the window dressing and certain other things. And then after that will proceed further to the management of the current liabilities. And the first current liability we will discuss is the accounts payable and the expense credit but let us learn about the window dressing.

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So, when you talk about the window dressing you call it as something like window dressing means artificially managing the liquidity actually the firm is not liquid or firms liquidity as it is shown by calculating certain ratios is not that much it is much less. But if you only look at the ratios then that will be say you can say the deceptive picture it will present a deceptive picture.

And it will not be good for the lender, so lender should be clever enough to understand that no window dressing has being done by the borrower or by the perspective borrower by the potential borrower and he is the genuine buy, he is the genuine company and having a genuine liquidity and as and when our payment will become due to be made, they will make the payment. So, now

how to understand the concept of window dressing let us have a balance sheet here where I have taken only the lower part of the balance sheet which talks about the working capital.

And there we take the current assets in the current liabilities, so we take here as the say this is the balance sheet I would say this is the balance sheet if you prepare in the T form. So, we have a no talking about the upper part we are talking about the lower part and here it is the current assets. And here we have the current liabilities right these are your current assets and current liabilities. So, in this we take here something like say first of all in the order of liquidity.

I am writing that is cash and bank balance the firm has cash and bank balance in the amount is 55 may be you can call it as 1000 crores, lakhs then we have the marketable securities and your marketable securities are say 55. Then your salary creditors, we take here as the salary creditors and the salary creditors amount is say 60 right. And here we take the inventory the last most in liquid current asset and the inventory is 25 right.

So, how much is the total we will see here then we talk about this side we have the current liabilities and then we have first current liabilities as salary creditor right salary creditors. So, this amount is 65 and then we have the bank overdraft right we call it as bank overdraft BOD and BOD is 60 and then we have expense credit and expense credit is how much expense credit is 5 right.

So, this is the expense credit it is 5 total up it up how much it is, it is the 55+15 in is how much 70, 30 and 1 25 is how much is 155. Here how much it is this side if you take it as that it will work out as 65 and 65 is 130. This is your balance sheet right from this balance sheet you now calculate the current ratio right if you let us calculate the current ratio here we have the current ratio.

So, what is the current ratio if you calculate from these figures current ratio will be 155/130 it will be how much 1.19 right. And what is the quick ratio, quick ratio will be the current assets-inventory. So, what is the current assets-inventory that is 130 and current liabilities are to be

taken as 130. So, the quick ratio is this 1.19:1 and this will be say 130/130 this will be how much 1:1 quick ratio right.

Now quick ratio is 5 that is 1:1 but the current ratio is less than the standard rule of thumb and that is the standard rule of thumb and that is the standard rule of thumb is how much 1.33:1. So, if with this balance sheet if the firm goes to the bank or to any supplier, bigger supplier, mighty supplier then they would say that your liquidity position is doubtful we cannot lend you the credit.

Because you are not maintaining the sufficient liquidity ratio and since your ratio is 1.19:1 which should be 1.33:1. So, either you improve the ratio or we will not be able to lend you because our funds may be at risk right. So, this is the balance sheet which is a genuine balance sheet which he is a borrowed is presenting a genuine balance sheet he is saying that I have this state of my current liabilities 130.

And my current assets are 155, so think about me what the bank says no because your current ratio is less than 1.33, so we will not be able to lend you any money. Now what he does, here you prepare another 1, he does 1 thing that he pays here from this say he is the salary creditors he pays how much 50 out of it if he pays 50 out of it how much is left this balance will be left as 5 right.

And from here this side how much **we** paid 50-50 if you are paying, so your balance will be left how much that balance will be again sorry it will be left as not 5 but 15 sorry. This is the balance will not be 5 but it will be, so let us write it again we have here how much was the balance here that balance was 65 here we had 65 right 65. So, what he will do to improve this is a window dressing what he will do he will pay off the say salary creditors he will pay off the say salary creditors this is actual original amount is how much 65 right.

He will pay how much 50 he will pay, so how much is left now he is left with a salary creditors of 15. So, and this side he has paid he has paid the from the 55 lakhs or rupees or crores of the balance 50 are gone. Because this 50 is paid, so 50 is reduced from the cash, so how much is left

with he is left with only 5 right. Now you look at the new balance sheets totally is much if you look at this side new balance sheet totally will be here.

If you put it, it will be how much 15 and 5, 20, so it will become how much this will become 80 this balance sheet will this side will become 80. And this side will become how much because he has paid use some of the cash available, so it is 20, 80 and it is 125. So, it will become 25 it will become 105 right.

So, this is the new balance sheet he will change the balance sheet once his first balance sheet is rejected by the bank. He will change the balance sheet, so now his liabilities have come down by 500000 and his cash is as also come down by 500000. Now you calculate the ratio again if you calculate the ratio again what is the current ratio. If you calculate the current ratio that is 105/80 this is how much if you calculate this ratio that is 1.31:1.

And what is the quick ratio, quick ratio is –inventory, so it is how much it is 80. So, 80/80 will be how much 80/80 will be 1:1. So, your quick ratio is same it was 1:1 earlier, now it is also 1:1, current ratio has improved it was 1.19 earlier and now it is 1.31. So, he would say that now I have better balance sheet, improved balance sheet my ratio is nearer to 1.33 which is 1.31, so it means you give me the credit and accept my balance sheet.

Because my liquidity position is has improved, I have improved my liquidity position and I should be given the credit. Now as a student of working capital management or student of finance you analyze this new balance sheet earlier the liabilities current liabilities were 50 65 means salary creditors were 65, bank overdrafts was 60 and expense credit was 5. So, total was 130 but in this side the cash position was quite strong.

They had the cash and bank balance of 55 marketable securities that is a back-up liquidity of 15 salary creditor as 60 and inventory as 25. But now when the cash worth 50 lakh has gone out they are left with only the 5 lakh rupees of the cash which is the pure liquidity. Earlier we had 55 lakhs of the cash. Now we are left with the 5 lakhs of the cash only and the 15 lakhs of the say back-up liquidity is there in the form of marketable securities.

And the other are the less liquid assets salary creditors and inventory is the most less liquid or the least liquid current asset. So, in this picture now as a student of finance you can easily understand though the ratio has improve though the current ratio has improved from the 1.19 to 1.31. But the liquidity of the firm has gone down if you look at the absolute values given in the balance sheet.

It is better to have 55 rupees as a cash rather than only to have the 5 lakh rupees of the cash because these salary creditors which he has paid just now they might have not become do it. So, he has earn the cash discount also and he has paid of this liability also without investing anything from his pocket. He has improved his liquidity position without investing even a single money from his pocket.

He has improved his liquidity position is only the change in the balance sheet figures. There is no change practically, no cash is infused. no cash is invested, no additional investment is made, no inventories created, no salary creditors are created, no marketable securities are created rather whatever the cash was there he paid off part of the obligations out of that cash or with the help of that cash.

So, in that way your current liabilities have come down by 50 lakhs but the cash has also come down by the same amount and overall if you look at this balance sheet then you would say that liquidity position of the firm has detoriated rather than it has improved. Though the ratio has improved, so we can say that if the banks look at only the ratio. Then they will accept it but if they are looking at the absolute values also.

Then they will be really wondering that what this company has done and this is a clear cut case of the window dressing. So, it is a point of caution for all of us that as a student of finance tomorrow if we are working in the market as a lender and even as a borrower if we are working as a lender be careful do not only believe in ratios. You believe in the absolute values also and if you are a borrower you should do you can do this kind of things.

But be careful that these things can be say observed or can be seen or can be found by the lender also. And if the lender finds that without even investing even a single penny from your pocket, you have improve the liquidity of the firm which is a clear cut case of the window dressing that may not be a appreciated by the lender. And lender may for the reject the case, so this is the window dressing how we go for it.

So, it means you can say the conclusion here is that these ratios are also amenable to the any kind of changes or adjustments or fluctuations anytime you can change these current ratios artificially managing the liquidity and that is to be clearly seen that if any lender is clever if any supplier is clever enough smart enough he will be able to find it out that what is happening in the firm but towards in the original balance sheet what is now it is in the change balance sheet how much funds the firm has invested from it is pocket.

And how much see how they have try to improve the liquidity position of the firm. So, be careful about the window dressing, in both the cases as a lender also as a borrower also right. So, with this we complete the discussion on say the cash management, to the liquidity management and we have learnt sufficiently that how to manage the cash, how to maintain the liquidity how to manage the liquidity in the firm and how say the firm's financial cost can also be kept under control.

And the technical insolvency you can also be avoided right it technical state of the technical insolvency can be avoided. So, it means firm should keep optimum amount of the cash all the times neither too high nor too low and they should be able to capable of making the payment to all it is obligations or towards it is all liabilities as and when it becomes due. So, with this I will stop here and after this because we have discussed sufficiently and all the 3 major current assets we have discussed at length on inventory management.

We have discussed at length on the receivable management we have discussed at length on the cash management including liquidity management. So, after these 3 current assets these are the major current assets need to be managed in the balance sheet of a firm or buy a firm right other

current asset like advanced deposits prepaid expensive there is hardly anything to manage. So, if you are able to manage these current assets efficiently and effectively.

And now the current liabilities some of the current liabilities then I think we will be in a position to have a better short-term funds position in the firm and manage it effectively. So, after discussing at length the 3 current assets inventory receivable and cash. Now we will move forward to the other side of the balance sheet and learn about that the management of the current liabilities right or the same.

You can call it as payables management or the current liabilities management, so when you talk about the payables management or the management of the accounts payable. We talk here about many things and when you talk about the payables, what are the payables what are the current liabilities. It can be many things right many prepare the balance sheet it can be salary creditors, it can be expense creditors.

It can be bank overdraft, it can be your tax liabilities, it can be your debutant liabilities many liabilities will be there. So, we are going to talk about all these liabilities but more discussion and attention is required here in case of 2 important current liabilities. And these 2 account important current liabilities or accounts payable how to manage your accounts payable, I am not talking at **at** the movement about all the current liabilities.

We will be moving according to the importance and the first set of the current liabilities is trade credits may the salary creditors and the accrued expenses.

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ACCOUNTS PAYABLE

ACCOUNTS PAYABLE =

TRADE CREDIT + ACCRUED EXPENSES

"PROVIDE FINANCE TO BUSINESS ON ON-GOING BASIS"

Hence;

'SPONTANEOUS' OR 'SELF ADJUSTING' SOURCE OF FINANCE.

These are the 2 important outstanding expenses as we say trade credits means suppliers credit if any supplier is supplying raw material or anything. Then how to manage it and accrued expenses are say expense is of your power bills, water bills then say wages of workers, salaries of employees because everybody is extending a short-term credit of the firms. So, it has to be properly managed because it will become due to be paid.

Salaries and wages become due to be paid after 30 days or 1 month similarly in case of these utilities power and the water expenses we have to pay or bills we have to pay normally once in month. And then even the salary creditors as I told the standard credit period in India is 30 to 45 days. So, that will also become to be paid, so we are ready to borrow money in the form of these expenses and in the form of say salary creditors.

But we have to pay that also and that will become due to be paid within very short span of time, so we should be careful about that right. So, when you talk about the accounts payable it includes 2 things that is trade credits+accrued expenses right. And we call them spontaneous overseas of finance. I told you in the beginning if you remember when we started discussion on this subject especially I told you that there are 3 sources of finance not 2 sources of finance.

We do not have only long-term and the short-term sources of finance rather we have 3 sources of finance long-term sources of finance, short-term sources of finance and the spontaneous finance

right. Now we are going to talk about the third source and that is called as the spontaneous source of finance why we call accounts payable are the spontaneous source of finance because it is self-adjusting kind of a source of finance.

Once the agreement is or terms are agreed by the supplier and the buyer. When both the sides have agreed upon the common terms, then automatically have material keep on coming in, payments keep on going on, on the due dates. And everybody adheres to those terms and conditions nobody thinks of disturbing this symbiosis. If anybody disturbs supplier defaults in sending the supplies or buyer defaults in making the payments.

Then this symbiosis can be disturbed otherwise this symbiosis cannot be disturbed or should not be disturbed. So, it means once we have the agreement with the difference suppliers that is normally long-term agreement. So, that you will supply as the material you will give us the credit for 45 days, on the 45th day it will be ever responsibility as a buyer to make your payment to have to make sure that the your payment reaches in your office.

So, it means whenever there is a need of material you place the order and as and when the payment becomes due you send the check. So, no need to arrange special finance we know it that for inventory for your these expenses we need not to worry about. For example you have to talk about the salaries of employees do employees go for every month the special agreement to be entered between the company and the employees or the workers.

Once it is settled that your salaries this much you will be paid after 30 days or 31 days or maybe at the end of the month or maybe in the first week of every month no problem. Employee keep on coming he renders the services and then automatically in the first week or at the end of the month he gets the salary that is transporters account same is the case with the powers supply companies, same is the case with the water supplying companies that when the supplier has the power.

This supplier has the water we do not ask them time and again after how much time I have to pay your bill. Bill automatic comes after 1 month or 2 months according to the payment terms. And

we send the payment and that way that system is going on, same is the case with the suppliers. So, suppliers once that term is accepted by both the sides or terms are accepted by both the sides.

It means that is naturally it is going on that is processes naturally going on, so it means there is nothing to worry about or think about anything right. So, this is called as the management of accounts payable we call this as the ongoing source of finance or provides these accounts payable provide finance to the business on the ongoing basis. And that is why it is called as the self adjusting or the spontaneous source of finance.

Now how much say how to manage the accounts payables how to manage your most important current liabilities that is called as account payables, how to manage the accounts payables. I have written here actually originating from the production budget payables appear on the books of accounts.

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HOW TO MANAGE ACCOUNTS PAYABLES?

"ACTUALLY ORIGINATING FROM PRODUCTION BUDGET, PAYABLES APPEAR ON THE BOOKS OF ACCONTS WHEN MATERIALS ARE RECEIVED AND TAKEN TO STORE"

SOME IMPORTANT ASPECTS OF MANAGEMENT

- TERMS OF PURCHASE
  - CREDIT PERIOD
  - CASH DISCOUNT
- STRETCHING ACCOUNTS PAYABLE

"COST-BENEFIT ANALYSIS OF AN ACCOUNTS PAYABLE POLICY WILL REST ON MINIMISING THE NET PRESENT VALUE (NPV) OF DISBURSEMENTS"

When materials are received and taken to the store right, then materials are purchased and taken to the store, so then the payables appear in the balance sheet. So, if you talk about this originally emanating from where production budget then you prepare the production budget you know it that what is your material requirement from where it will come, it will come from the supplier and once the supplier makes the delivery gives invoice.

Invoice is accepted return back to the supplier and material reaches in the warehouse or in the godown then automatically once the material is receipt and invoice is accepted 1 copy is retained another copy is given back to the supplier. It means in your balance sheet this current liability will appear, that is the accounts receivable.

So if you compare it in the accounts receivable and payable accounts receivables appear in the balance sheet as an asset once that supply of the material has been sent to the buyer. And payables appear in the balance sheet as a liability when that material has been received from this supplier right. So, difference is in the 1 case we are receiving the material, in the other case we are sending the material.

And in 1 case we have to receive the payment which we have talked earlier and in the other case we have to make the payment right. And payment terms are pre-decided they are standard means standardize or there are the standard payment terms. Now we have to talk about some important aspects of management of see this accounts payable. We have normally 2 things that is the terms of purchase and stretching accounts payable.

Terms of purchase is, it include terms of purchase include what credit period and cash discount terms of purchase credit period and cash discount, how much credit period of firm can ask from the supplier and cash discount. If we are ready to make the payment on cash or maybe within a minimum credit period. For example within 10 days he is saying that okay if you make me the payment within 10 days, I will give you discount of 2% otherwise the normal credit period of 35 or 40 days I am giving you.

So, that is the choice of the firm he has given both the terms supplier has given both the terms that if the payment is made to him within 10 days automatically he will give us the cash discount. So, we need to pay him say total invoice value-the discount amount but if we payer is not able to make the payment within 10 days. Then what will be done normal credit period of 35 or 40 or 45 days will be there.

Both the sides will agree that yes now this credit period is there, so terms of purchase include 2 things credit period and the cash discount. Then stretching accounts payable here point of discussion is or point of interest is they have 2 parties. One is the supplier another is the buyer objective of the supplier is that he should get his payment back as early as possible and objective of the buyer is that he should delay the payment as much as possible.

Because objective in the payer's mind is that he wanted to minimize the net % value of the cash is paying to the supplier as much as possible means if he is paying 10,000 rupees actually he is paying 8000 rupees. Because if he delays the payment if you calculate the 10,000 if paying paid first on today that will be 10,000 but 10,000 paid after 30 days that will not be 10,000. So, the objective of the buyer is that he should minimize the net present value of the payment he is making to the supplier.

But on the other side objective of the supplier is that he should maximize the net % value, so, to give the minimum credit period. So, supplier want to give the minimum credit period, buyer want to give have the maximum credit period and somewhere they have to agree on the common terms that is the common credit period as well as the cash discount.

But if you recall I have told you sometime back in case of the receivables management that there is a limitation of time and because of the say loading factor even the buyer wants to extend the credit or credit period he cannot he want like to extend it he would like to make the payment and get free from his obligation. He wants like to extend the credit why because when you are asking for the credit from the supplier.

He would load the credit sale bills with the certain interest factor or certain interest amount and that is called as the loading factor. For example 2:% per month it means 24% if you delay the payment for 30 days you will have to pay the interest at the rate of 2% per month. If you delay the payment it will become 4% if the delay the payment for 2 months then it will become 4%, so it means it is 24% per annum.

So, what happens borrower or the buyer makes a cost benefit analysis he says that if I borrow money from the bank and pay him in cash to the supplier in cash. How much interest I am paying to the bank and if he is I am allowing him to load his credit sales with the interest component or the interest factor, how much interest he is charging on the supplies on credit right, so both the things are clear.

He has to make a cost benefit analysis that cost benefit analysis of an accounts payable policy will rest in the minimizing the net percent value of disburse is clearly return here. So, if for example if the borrowing from the bank is expensive and borrowing from the supplier is say much cheaper. Then certainly he would like to go for borrowing and extending the credit period for example that is certain up to one particular point of time that is say for example up to 30 days you compare the 2 interest rates.

Then the suppliers in interest rate is lesser than the banks interest rates if you make it 45 days then both are coming closer but if you make it 60 days than it may be possible that supplier is loading it is becoming 2% per month. It means it is becoming 4% he is loading with the 4% it becomes 24% per annum where as bank is ready to give you the credit at the rate of 18% per month it means it is much better for the buyer to borrow from the bank.

If he can borrow from the bank that is also precondition bank should be ready to land him. If he can borrow money from the bank then is better for him to borrow at 18% rather than allowing him to load the credit sale with 24% and then to make him the payment on in cash. But that does not happen in all the times because there should be a reason for the buyer to seek the credit from the supplier.

And if there is a the interest rate of the bank is lesser than the suppliers, interest rate then the buyer would convince him that your charging more than the bank why should I buy from you on credit. So, I have to look for the another supplier, so to some extent of time the supplier would say that if you are seeking a credit of 30 to 45 days. I will charge you the interest or load my credit sales with the 1% per month interest it means 12% I will charge.

And if you go to the bank you have to pay 18%, so naturally the buyer would like to seek the credit from the supplier and allow him to load the credit sales with the 1%. But if he extends the credit period that maybe the second part of the condition. If he extend the credit period from 1 month or maybe 45 days to 2 months or 3 months. Then he says that my interest will also go up and that will become 2% per month, 24% per annum whereas banks interest rate is again 18%.

So, naturally automatically buyer would not like to extend it beyond 30 or 45 days up to which the interest is only 1% per month after that for him seeking credit from the supplier will become useless. So, it means the objective of the buyer is to minimize the NPV of the payment he is making and objective of the supplier is to maximize the NPV of the recedes is going to have from his buyers or from the prospective or from the potential buyers.

So, this is the say corrects of the discussion here just we have initiated the discussion on the payables management. So, we have discussed so far that what the payables are why the payables appear in the balance sheet and what are the terms of purchase and what is the meaning of stretching of the accounts payable more interesting concepts relating to the management of accounts payable or accounts management of the accounts payables, I will discuss with you in the next class, thank you very much.