Working Capital Management
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Lecture-54
Management of Accounts Payable

Welcome students, so in the previous class we were talking about the say stretching of the accounts payable and I discuss with you that it will depend upon both the sides. Because we know that if we stretch the payment then certainly the seller would also like to load the credit sales with something which is called as interest factor. So, the buyer will make a cost benefit analysis that where it is beneficial for him to buy on credit.

Because loading factor by the seller and borrowing from the bank and then paying in cash to the seller he would make a comparison of both the options and if borrowing from the bank cheaper as compare to the loading factor the seller is using. In that case it could be advisable for the buyer to buy say on cash or maybe up to that extent he should be expecting to stretch the payments till their means till the point at is beneficial for the buyer to stretch the payment.

Because borrowing from the bank will be expensive rather than borrowing from the seller right. So, these were the certain things we talked about that some important aspects of the management of the accounts payable and we talked about the terms of purchase and then the stretching of the accounts payable. Now I will talk to you say in this class some other things like limitations of the stretching of the payment.

That is not that you can stretch the payment unearningly or anywhere you can go up to that you can make the payment after 2 months, 3 months, 6 months, 1 year or 2 years that or maybe sometime do not make the payment you buy it and then you do not make the payment that is not going to happen. So, if we are seeking the credit which is normal as per the market conditions or the market situations then it looks good.

But when we stretch the thread beyond the level then it is get broken, so we should not allow this kind of situation to come because is stretching of the payment has certain limitations. And these limitations should also be known to us as a student of working capital finance that if buyer stretches the payment then he has to face many things and all these things will not go will not be in the interest of the buyer.

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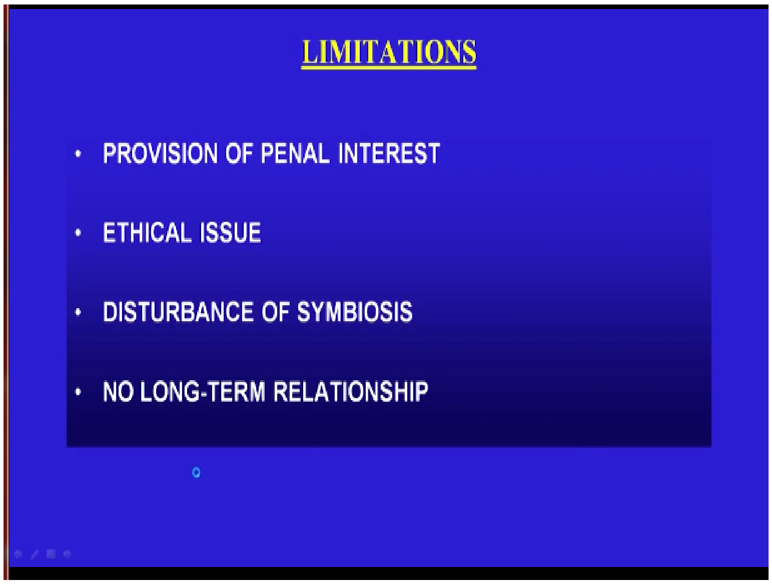

First thing is the provision of the penal interest, it remains the provision in the agreement between the buyer and the seller that if you pay me within the standard credit period I am allowing you, I will charge you this much of the interest maybe 1% per month or 1.5% per month or maybe 2% per month but beyond that if you stretch the payment I will charge a penal rate of interest and that will be very high.

So, for example in case of the credit card it happens, that when you buy things through credit card in the market. So, for certain period of time maybe 28 days or a month the that say payment made through the credit card remains free to the buyer or to the purchaser whose making the payment through the credit card. But if you stretch the payment beyond the permissible credit period allowed by the credit card company or the credit card bank.

Then they say leaving the penal interest rate and that spoils a image of the say borrower also because you say never become a good paymasters. So, that will be the problem, so that will happen same thing here will also happen that penal rate of interest will be charged and if penal rate of interest is label then the fun of enjoying the credit purchases will be far less than loosing the reputation or the goodwill or the credibility in the market.

Second thing is ethical issues, if you say for example if the buyer is in a strong position as compare to the seller. Now I was talking to you sometime back about the say big companies who manufacture the cars or maybe electronics or maybe other automobiles. So, say for example we are talking about the Suzuki India limited. Suzuki India limited is a big company say very strong buyer and say very large size buyer.

And they buy almost all inputs rather than the gearbox from different suppliers right. So, when they buy the different inputs maybe you have talk about the say glass part or the say rubber parts or maybe the sometime you call it as the even tires and tubes and say any other accessories you talk about seat covers or anything you talk about. So, they not manufacture all these things themselves even steel, they are not manufacture all these things themselves.

But rather they buy from the market from the different suppliers and only gearbox Maruti or Suzuki manufactures itself. So, say for example if there is a small supplier to Suzuki and their he supplying rubber parts, rubber bands which are use to tighten the glasses in the car. So, if he is a small manufacturer and he is supplying it to Maruti and Maruti is (()) (05:06) stretching the payment or delaying the payment then it is unethical should because the buyer is doing all these things because seller is not in position to take action against the buyer.

He does not want to lose a big buyer, so Maruti or the Suzuki India limited is spoiling that relationship for creating this kind of the situation. Let us say big ethical issue that rather than supporting the small suppliers they are say exploiting the supplier, they are harassing the supplier. So, kind of thing should not be allowed those kind of thing should not be allow to happen.

So, ethical issues also another important limitation that it may be done by the buyer or it may be done by the seller both the sides should say act something which is which looks descent which looks within the limits and which looks say maybe say as per the status of the buyer or the seller then there is no harm but if we stretch the payment beyond the level then it is unethical also.

So, this is the second major limitation, third is the disturbance of the symbiosis, I have talk to you many times that when we make the payment to somebody it may be possible that he further has to make the payment to somebody right. It is a chain it is a supply chain right, 1 manufacturer is supplying say may finish product to the other, other is supplying to other and other is supplying to the one who is manufacturing the finish product right.

So, for example if the final manufacturer of the product finish product he has to make the payment to the third level suppliers and he has to make to the second level supplier and he has to make to the first level supplier. So, if the fourth level that is the manufacturer or the user of the finish product, final product for the manufacturing of the finish product. If he is delaying the payment maybe by a day then what will happen, the supplier at the second level will get it means delayed by 1 day.

So, he also will be delaying it to the second level and second level will be delaying it to the third level, so what will happen, total sum buyers among these 4 channels or these 4 buyer and sellers would be disturbed. So, do not think that delaying the payment by 1 day or by some hours or maybe some days does not make a difference, it makes a difference. So, I told you many times that all the times make it a discipline that if the payment is due to the paid on the evening of any day try to make it make the payment in the morning of that day or 1 day before that.

But never allow to it to be paid in the next day morning or maybe evening because that disturbs the total symbiosis because they chain and everybody is depending upon 1 or the other, say if 1 is disturbing the chain all others are getting disturbed and the whole market fields are repercussion of that. So, that kind of thing should be avoided, so this is a disturbance of symbiosis the another limitation and then is the no long term relationship.

If you do once then fine but if you do it regularly stretching the payment or delaying the payment or say using your very strengthful position in the market or you maybe your hegemony kind of the position in the market then what will happen, this will not allow any of the supplier to have long term any of the suppliers should have long term relationship with any buyer maybe how say mighty or maybe strengthful or powerful he is.

But every supplier will look for the alternative they are supplying to this company does not make any sense because they delay the payment, they not make the payment on say on the time say it is spoiling the others reputation also. So, what happens this keep on supplying only till the time they get the alternative, if they get any alternative order or some other buyer who is more discipline who is more responsive to the market, who is more careful to the need to the smaller suppliers, then it is really maybe say they will be certainly looking for the alternative.

So, it means long terms relations are also not possible, so it means notice the cost benefit analysis is not the question of minimizing the NPV by the say peer to the seller they are so many other important issues also which are recognized as limitations of stretching the payment. And these are the 4 important limitations I just talked to you that is the provision of the penal interest and then ethical issue then disturbance of the symbiosis and no long-term relationship.

These are also the limitations of stretching the payment, so NPV is the direct minimizing the NPV's are direct effect but these limitations are indirect effect and because of these limitations the reputation name of buyer also gets spoiled in the market. So, we should avoid this kind of situation that this kind of the situation never emerge and people work in tandem with each other, fulfilling each other requirement and helping each other to attain their business goals right, so this is the say one more part of the accounts payable.

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Now I will discuss with you something interesting that is the say code of ethics say code of the practice I would call it as not ethics. Code of practice which was say evolved by the confederation of the British industries, it is popularly known as confederation of the British industries code of practice which was say adopted evolved voluntarily by the bigger buyers and manufacturers of different products in UK, in Britain right.

And they themselves say evolved this code of practice, you can say it is a code of ethics that we will make one thing sure that when we have to make the payment over suppliers we will never delayed, we will always honor their say our commitment towards them we will never think that we are mighty and very strengthful buyers and suppliers cannot think of not supplying to us or they cannot think of looking for the alternatives.

And they want get the alternatives of the size and strength. So, it is our say you call it as right or provocative as and when we wont to wake the payment we can make the payment we can make the payment means this is not going to say stop the supplies by the suppliers to these bigger and mighty buyers but this is somewhere creating the problem in the long run.

And every supplier could look for the alternatives and they would look for that rather than supplying to the company X, if company Y or company Z or A, B, C, D any company is a better paymaster making the payment on the due date. So, they would certainly keep on looking for, so these bigger manufacturers of the finish product in the different industries they evolved a code of practice that we would support our suppliers.

We would support our say (()) (11:40) manufacturers and as and when their payment become due to made we will make the payment. And on the same basis later on drawing a clue from this code of practice of the confederation of the British industries, code of means this kind of the code was also developed later on by the confederation of Indian industries that is called as CII, CII also understood this fact that sometime it becomes unethical to say through stretch the payment to say lengthen the payment period.

To stretch the payment period by the bigger manufacturers or users of the different inputs towards their suppliers. So, we will also do the same thing how this code by the confederation of the British industries has done. So, what is this code that was popularly called as the say code of practice which was evolved by the confederation of the British industries what that code is, what are the different points of code I would like to share these different points with you.

And main slogan of this code was that prompt peer is good company, prompt peer is good company means if any peer who has to pay to it is suppliers pays on time, pays promptly, pays on or before the end of the credit period. Then that company will be categorized as a good company. And maybe that company can be avoided also rewarded also because say very good paymaster taking care of the needs of their small suppliers.

And they would be say they their effort would be recognized they are say practice would be recognized and that pay even the suppliers would also appreciate that. So, what for the important points the main issue was a responsible company should, a responsible bigger company who is buying different inputs from the different say suppliers small suppliers should number 1 have a clear consistent policy that it pays bills in accordance with the contract whatever is entered into the contract between the buyer and seller, amount, date, discount, credit period all these things remain mentioned in the contract.

And these bigger buyers of small inputs or dif inputs from the small suppliers would honor their commitment and they would clear the payments or make the payments or clear the bills in accordance with a contract or in accordance with the conditions lay down in the contract which has been entered between the supplier and the buyer because every supplier and buyer enters into a long term contract.

In the beginning when they start say doing business with each other, so whatever the terms and conditions are as per this code and who is a member of the confederation of the British industries they will have to say adhere to these different classes of this code of practice. So, first class is of the first condition is have a clear consistent policy that it pays bills in accordance with the contract to the suppliers or the smaller suppliers who are not very strengthful and their payment will not be delayed.

Second point is ensure that the finance and purchasing departments are both aware of this policy and adhere to it both in the bigger company the buying company bigger company who is buying the different inputs from the different suppliers. They will make sure their own finance and their purchase department is knowing about this code of practice and they would know it that as and when any payment becomes due to be made.

They will make the payment on the due date and due time and they will not delayed it will be responsibility of the purchase department, it will be the responsibility of the finance department. Purchase department after purchasing and receiving the material and the invoice they will immediately send it to the finance department. And finance department will release the payment on the due date agree payment terms at the outset of a deal and stick to them, whatever the terms are where in the contract agreed by both the sides supplier and the buyer.

Once they are agreed once the document is signed, in that case nobody will deviate from that, nobody will go against those say points and they would whatever the credit period is mention, whatever the cash discount is there, whatever the payment terms are, what is the say order size is all this things remain return in the say agreement or in the contract and both the sides supplier is naturally because they are small in size.

So, they cannot think of say violating the code of means the terms of the contract but the bigger strengthful mighty buyer who is buying the inputs from these suppliers, they would also adhere to the terms agreed upon in the contract and they would follow it, they would honor it, they would honor all the terms and conditions.

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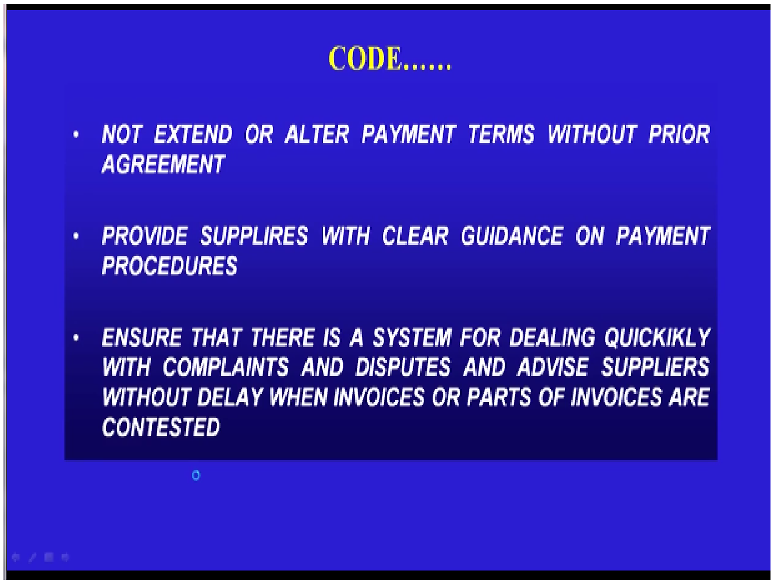

Not extend or alter payment terms without prior agreement, no side maybe the supplier or maybe the buyer nobody will have the right to alter the payment terms without the prior permission even supplier if they want to minimize the credit period whatever the credit period they are offering or they are currently giving if they wont to reduce it they will inform it to the buyer. On the other side how many means days or the how much time is being taken by the buyer to make the payment.

If they want to delay the payment for any particular order they would inform the supplier there this time because of any reason maybe the liquidity or maybe other reasons. We will make you the payment after 5, 10 or 15 days and they may allow the supplier to load that additional credit period also with the interest factor.

So, it means both of them will be informing each other nobody will violate any of the terms and conditions, provide suppliers with clear guidance on the payment procedures, how the payment will be made, from which branch the cheque will be issued, which branch of the cheque will be drawn on and after how much time the payment will be debited from the paying companies account and credited to the receiving companies account all these this payment procedure must be clearly communicated to the suppliers.

So, that he knows that what will be his float that if he receives the cheque on any particular date and immediately he transfer or sends that cheque to the bank then after how many days that cheque will be credit to his account. And which branch will be honoring that cheque against which branch of the buying company the cheque will be drawn on and once that cheque reaches there they will honor the cheque, they will allow the payment to be made.

And bank will collect the payment on behalf of the supplier and by debiting the buying companies account they will be crediting or sending the payment to the supplier. So, procedure is clearly lay down, this is another important condition in the code of practice. Ensure that there is a system for dealing quickly with complaints and disputes and advise suppliers without delay when invoices or parts of the invoices are contested.

If there is any dispute that you means agree to give us 6 month credit period, now you are giving us 45 days credit period, you agreed to give us 2% if we make the payment within 10 days. So, now we have made the payment within 10 days why do not you give us discount all any kind of the dispute is there on the terms and conditions return and agreed upon in the contract that will be if there is any dispute that will be speedily addressed.

There might be dispute because they are the 2 parties and when there are the 2 parties, there is (()) (19:12) disputation were dispute there can be a dispute and if there is a dispute immediately that will be sorted out by the supplier also, it should not be the case their supplier buyer keep on thinking that I am very strengthful buyer. If he misbehaves with me then there is nothing to worry about with change the supplier.

That does not give a good reflection, good feeling means to the supplier also and to the general market players also. So, both the sides could be responsible both the sides could take interest in resolving their problem and resolving that complaint dispute quickly as quickly as possible. And both the sides will remains the disputes will remain settled and they will quietly calmly helping and supplying to each other.

So, these are some of the conditions which are there which are some of the you can call it as this is the terms of the reference, 6 terms of the reference are there in this. So, 1 is regarding the say clear and consistent policy second is the say information to the say finance in the purchase department third one is that say payment, terms that say how that payment will be made.

And then will be the next thing is that not to alter and extend the credit period and then is say clear guidance over the payment procedure to the suppliers and then if there is any dispute that we will resolve it as quickly as possible and we will not allow this any kind of the dispute to be there right. So, same code of practice or you can say is a code of ethics was decided to be evolved by the confederation of Indian industries, it is already evolved almost same terms and conditions are there in that code also.

And they also agree that being the bigger buyer, strengthful buyer, mighty buyer, we should not harass our suppliers as and when any payment becomes due to be made after the credit period is over. We will make the payment to the suppliers and we will keep them in the good humor, so same code and the practice is also very good, very healthy practice and this way both the sides remain happy they feel encourage they feel to say feel good to do business with each other and fulfill each other requirements.

Now we come to the next part, next part is the cost of stretches, I was talking to the cost stretching sometime in the previous slides. Now we will clearly discuss upon that what is the cost of stretching, if you stretch the payment because certainly the buyer would like to stretch the payment and the supplier would like to not to stretch the payment by the buyer. But certainly because as we have agreed in the beginning of discussion on this subject that no business is possible only on cash.

So, it means we have to give the credit, we have to sell our production or services on credit but when we are selling on the credit then how much credit period should be allowed and what is the responsibility of the buyer to make the payment. And for example if the misbehave known it that buyers objective is to minimize the NPV of the payment whereas the sellers objective is to maximize the NPV of the recede is going to make on account of his credit sales.

So, buyer wants to have maximum credit period and the seller want to give the minimum credit period but when the credit is given and taken. There is certainly the cost to the buyer who buys on the credit because even you go to the market if you like to buy any product on cash certainly you are going to pay the different price. But when you seek credit or request for the credit to the supplier or any shopkeeper then certainly he would say resist and they he would say that okay.

If you want to buy it on the credit and want make him as the payment up to 15 days, 20 days or 1 month, I will charge you this much price. So, it means he is charging with the cost of extending the credit, so certainly there is has to be the cost. Because both the prices cannot be same, the credit price cannot be same as the cash price otherwise everybody would love to buy on credit. So, when you talk about the cost that yes cost of credit is there, cost of stretching is there, cost of delaying the payment is there, cost of buying on the credit is there, so what is the cost, how to calculate their cost.

So, there are the 2 cost involved in it, one cost is the direct cost, direct cost is the penal rate of interest that when there is a clear cut contract between the 2 sides buyer and seller that I will sell you at this price and the buyer says I will buy you buy at this price and this much of the credit period will be given and taken by both the sides. And if anybody any buyer if stretches the payment beyond that permissible credit period, then he has to pay the penal rate of interest.

So, first thing is the direct cost which is in the monitory terms which is in the financial terms that is the direct cost because you have to compensate the seller for delayed payment by paying him the interest cost of that fund which is invested or those funds which are invested in the amount which are the production which is being supplied by the supplier to the buyer. So, that is a direct first is the penal rate of interest or the direct cost, I will discuss with you the direct cost and there is a model how to calculate the direct cost.

There is a clear cut model for knowing it and apart from that there are the indirect cost, so I will discuss with you now the model that is about the direct cost. So, how to calculate the direct cost we can calculate the direct cost with the help of 1 model and that model is called as you can say that this model you can understand under the title of economics of stretching the payments.

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Economics of Stretching the Payments

Cost of St. the Payment

$$C = V\left[\frac{1+D}{1+t_s k} + I\right]$$

C = cost of delaying the payment

V = Value of order

D = Direct cost of delayed payment calculated on Rs. 1

t_s = No. of days the payment is stretched

I = Indirect cost of St. the payment

k = daily O.C. of the firm on Rs. 1

So, this is a model developed by some people and how to calculate the say the cost, cost of stretching the payments. So, you can say that is the cost of stretching the payment, so this model is here C=V capital V then 1+D/1+Tsk and then is +i right. With the help of this model we can calculate the direct cost that penal rate of interest that would be charged and is a direct cost for delaying the payment.

So, here C means, what means the C that is the cost of delaying the payment that is to the buyer. If he delays the payment he has to pay the cost in terms of the interest then we have the V, V is the value of order, how much size of the order, how much payment is delayed because buyer places the orders, different kind of the orders and that every order has to be received and supplied by the supplier and received by the buyer.

And there is a credit period associated to that on the end of the credit period the payment has to be released, so what is the value of that order, this is the V, D is the direct cost, direct cost of delayed payment calculated on rupees 1 on each rupee of the order. That is a direct cost that is D, Ts is the number of days the payment is stretched and i is the indirect cost of stretching the payment right. So, almost we have addressed all the factors here and if we use this model with the help of this model.

You can easily find out the direct cost of stretching the payments that is C=V*1+D/1+Tsk+i. So, C is the cost delaying the payment, V is the value of the order, D is the direct cost of delayed payment calculated on rupees 1 each rupee, Ts is the number of days the payment is stretched and yeah one more thing I think we have left here, payment is stretched, i is the indirect payment and k is the yes what is k, k is the daily opportunity cost of the firm who is delaying the payment on rupees 1. Because if they are delaying the payment it means they have to pay the penal rate of interest they should be paying the penal rate of interest.

If they are investing that money by not paying it to the supplier they are investing it elsewhere and they are earning more than the penal rate of interest then it is justified that okay. If you are being paid, charge the 2 rupees 2% per month interest, it means you are paying 24% annually. But that funds which were not paying it to the supplier you are investing elsewhere in the market and you are getting 36% then it is justified okay you earn 36% from there and you pay 24% here, so you still have the 12% gain.

So, that opportunity cost we will have to calculate and that to the daily opportunity cost on each rupee of the order we will have to calculate. So, almost everything we have factored into this model that is the cost of delaying a payment, value of order, direct cost of delayed payment calculated on rupees 1, Ts is the number of days the payment is stretched, I is the indirect cost of stretching the payment and k is the daily opportunity cost of stretching to the firm.

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You can say like this that cost of stretching to the firm who is stretching, the firm who is stretching the payment to them there is a cost opportunity cost. So, they can stretch the payment and there is no harm to them of stretching the payment. So, this is how we can calculate the direct cost, here it is the indirect cost, I is the indirect cost. Indirect cost is also there, what is the indirect cost now.

We can think here that what is the indirect cost, indirect costs are the points of indirect cost are listed here. Number 1 is gradual erosion of the goodwill, if you time and again there is a payment, how big you are, how strengthful, how mighty you are, financially strengthful you are in the market, your goodwill will be going down day by day because your reputation will be reputed as very bad paymaster or delaying the payment, defaulting the payment.

So, no good people would like to do the business with you, this is the 1, poor credit dating. So, your credit dating will also go down as a buyer and not making the payment on time, it is a high cost and maybe next time anybody want to give or extend any kind of the credit to this company who is dealing the payment they would think means 10 times whether to say extend credit to them.

Then sours the relationship between the buyer and the suppliers, in a relationship will not be that good as if it is that if you are making the payment on time and you are not delaying the payment at all in any case. Loss of supplier's flexibility that is a major issue, loss of the supplier's flexibility because I told you that there might be chain like that if there 1 supplier.

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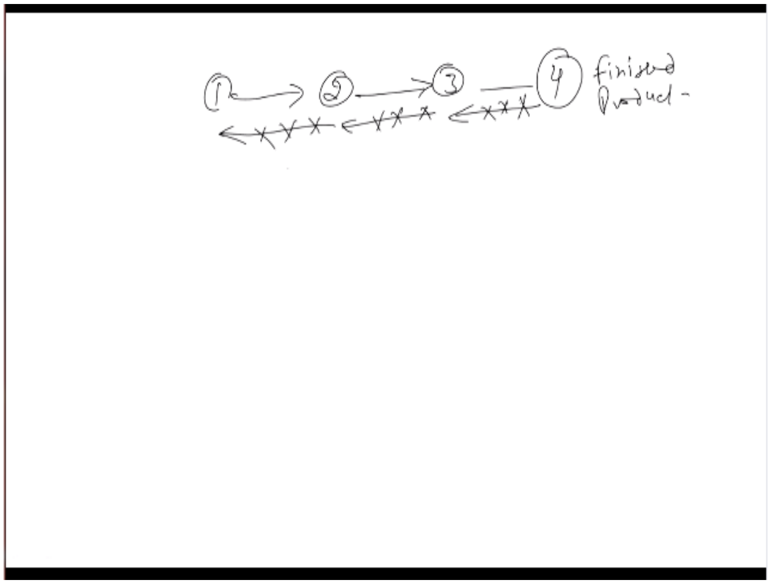

Then he is supplying it to number 2 and he is supplying it to number 3 and this is the 4 who is the manufacturer of the finish product, this is the chain. So, it means this person is making the payment to him, he is making the payment to him, he is making the payment to him. So, when the payment is delayed here when there is a problem here or somewhere , so it means when this payment is delayed certainly this problem will reflect in case of the 3.

And it will reflect in case of the 2, so it means this total chain is getting disturbed, it does not mean that if 1 person is delaying the payment. So, the only say is a fact upon the 1 means 1 supplier only because they are in the chain, 1 is manufacturing at the 1 level then he is supplying into the other, then he supplying to the other, then he supplying to other and then the third one is supplying to the fourth who is manufacturing the finish product.

So, it means total relationship is spoiled and this symbiosis is disturbed, so supplier's flexibility also because supplier also have the limited credit to give. If you do not make the payment to them on time from where will they bring the funds, they will not be able to bring the funds and to say keep on supplying to somebody unendingly or investing the funds from their pocket because your financial strength is also limited.

So, that will be another indirect cost and then is the delayed supply of materials, there will be the delayed supply of materials. Somehow means if this kind of the situation emerges, first the supplier would look for the alternative if we getting the alternative then fine if he does not get the alternative then he would start supplying to more than 1 buyer right. So, he would see that I will first supply to the 1 who is making with the prompt payment.

Then if some material is left it will go to the second and some material is left it go to the third and if some material left it will go to the fourth. So, it means what will happen the buyer who is delaying the payment or who is disturbing the symbiosis or who is not a good paymaster he will get the supplies in the last. So, what will happen suppliers will start delaying the supplies and that will also be another issue that will also be a another problem.

So, it means we have both the cost one cost is the direct cost and another cost is the indirect cost. So, direct cost we can calculate with the help of the model we have just discussed here this is the model and the indirect cost number of points are there of the indirect cost here erosion of the goodwill, poor credit dating, souring of the relationship with the supplier, loss a supplier's flexibility and the delayed supply by the supplier to the buyer.

So, this is the indirect cost which also should be factored into this model somehow quantitatively but for example if we are not able to factor this indirect cost in this model. Then still we are able to have other components which are the components of direct cost or causing or making the direct cost and they are something like that is the value of order, direct cost of stretching D. Then is the number of days the payment is stretched and then is the daily opportunity cost of the amount each rupee of the delayed payments.

So, all these factors are there and there is a direct cost in terms of the penal rate of interest he has to pay and that cost is the one which he has pay to the or he has to make the payment to the means to the supplier and that will be called as the direct cost and so, it means there is a cost of stretching the payments not all ways the benefit to stretch the payment. If you stretch the payment to acceptable level every would you would accept it.

But if it is beyond the level then it will not be possible and if should not be done so, it means what we have to do is we have to stretch the payment to the label which is acceptable to both the sides right which is known to both the sides which is acceptable to both the sides. Then only it is possible otherwise it is not possible. So, after this so, say today I will not discussing any problem of this model whatever the model I have discussed with you.

I will only means discuss conception be the model with you next class I will be discussing once small case small problem that how we can use this model and how to calculate the cost of stretching that is c so, if we have some say imaginative figures we can use those figures and we can say know how to use this models. So, in the next class I will certainly do that so, today we discuss the cost.

And we learnt it that this is the cost of stretching which is both direct and indirect cost apart from that there are some other issues also involved that is say you can call it as float management is the one concept. We have discussed to some extent the float management but I will again throw light on this in the next class.

And there are some other points to be talked about the say accounts payable about the other accrues that is salaries variable and fix expenses taxes and debutants and some points about the over trading as evolved of caution. So, all these things I will discuss with you in the next class thank you very much.