

CHAPTER - IV

EFFECT OF INVENTORY MANAGEMENT ON THE PROFITABILITY

— A NORMATIVE AND EMPIRICAL APPROACH

The complexity of modern production and sale and the fact that inventory constitutes a substantial portion of the working capital of a concern necessitates the control of inventories so as to ensure that investment in inventories is maintained at the minimum level consistent with the maintenance of continuous flow of production. The maintenance of inventory at this level is a matter of prime importance as, on this depends the profitability of a concern to a great extent. Surplus of this item when leads to a rise in cost of production, shortage leads to poor operational results. Inventory management, as such, may be spelt out as the avoidance of over investment or under investment in the same, as an essential step to profitability.

Inventory and Profit Determination :

Inventory enters directly in the determination of income in the sense that the amount of earnings will be less if the quantity and the balance among the various components of the same are not at the most economical level. If a large amount of capital is required to operate the business, because of improper inventories, this fact will have an adverse effect on profitability in addition

to consequence of incurring unnecessary expenses<sup>25</sup>. Again sale of a rupee has a material content, labour content, overhead content, interest burden and profit. The respective percentage of each item varies from product to product and organisation to organisation. While the labour and overheads can be considered as constant in the short run, the material content and the interest burden will be variable. Hence price and profits depend on the material content and the interest burden. The material content affects in two ways : first as cost of the materials consumed and secondly by affecting the interest burden ; as, short term bank borrowings are largely affected by inventories. The interest burden consists of two parts ; the interest for fixed capital and that for working capital, the major constituent of which is inventory. Therefore, with better inventory control both the material cost and the interest burden can be reduced and thereby the profits can be increased. Inventories have therefore a direct impact upon the firm's profit. Apart from what have already been stated inventories affect profit in several other ways<sup>26</sup>. For instance, first, too much or too little inventory affects the rate of return on investment because of the increase in cost of inventory resulting from holding and storage, spoilage and obsolescences and capital invested. Piling up of inventories means increased buying costs resulting from haphazard and rush stock accumulation, to pay a higher interest on

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25. Hoffman & Gundreso - Inventories Control, Costing and Effect Upon Income and Taxes (2nd Edition), pp. 4-5.

26. Walker & Baughan - Financial Planning & Policy, Prentice Hall Private Ltd., New Delhi, 2nd Edn., p.172.

borrowed capital tied up therein (short term) higher storage costs etc. Further large inventories cause funds to be diverted from other profitable ventures. This involves an opportunity cost which is also to be considered in this connection. Similarly underinvestment has also some effect on profit, since the firm is unable to produce at the most desirable level of production i.e the cost of production is higher at less than full production than production at the full capacity since the firm experiences additional direct costs for set-ups, extra planning and co-ordination and increased clerical efforts to handle orders. Also it is likely that capital asset and direct labour will not be utilised fully which further lowers the profit margin.

Secondly, the rate at which inventories move through production and distribution process also affects the cost. For any given volume of sales the amount of working capital required for efficient operation is less when inventory turnover is high, than when inventory turnover is low. A high turnover rate means the cost of capital is reduced, release of capital for investment in more profitable areas and decrease in the risk associated with the declining prices and deterioration, obsolescences etc. and increase the amount of profit and the rate of return on capital. Reverse would be the effect if the inventory turnover is low.

As turnover ratio being associated with the Gross Margin Ratio, may be termed as Turn and Earn Index (T & E Index). It considers both the profit earned on sales and the rate at

which inventory turns over. Turn and Earn Index may therefore be ascertained as under :

$$\begin{aligned} \text{T \& E Index} &= \frac{\text{Gross Profit}}{\text{Sales}} \times \frac{\text{Cost of Goods Sold}}{\text{Inventory}} \\ &= \frac{G}{S} \times \frac{C G S}{I} \end{aligned}$$

Inventory turnover (  $\frac{CGS}{I}$  ) shows how rapidly inventory is turning into receivables through sales. This ratio can therefore be said to indicate the use made of available capacity in an operating enterprise. The Gross Profit to Sales (G/S ratio) measures the product profitability in terms of sales turnover. If the inventory turnover is high it indicates that the capacity is fully utilised and the return on investment is convincing. A low turnover means capacity is not fully utilised and as a result the return on investment for inventory is low. Table 33 ( that follows ) of the present study is expressive of the fact that the public enterprises under study started with a low inventory turnover. Gradually though, they improved but at a low rate. None of the companies could push up the ratio even to 2 except Hindusthan Cables Ltd. which tried to maintain this ratio between 2 to 3. In this company also this ratio went down below 2 in two successive years, viz, 1977-78 and 1978-79. In case of other companies the turnover ratio was fluctuating in nature and the same always remained at a very low level. This indicates that the efforts of the public enterprises to reduce overstocking was abortive. Overstocking of inventory made capital scarce and the cost of production high.

Table - 33 : Statement Showing the Inventory Turnover Ratio in the Selected Companies over the Period from 1975-76 to 1984-85

(In Lakhs of Rupees)

Y e a r s	Braithwaite & Company	Hindu- sthan Cables Ltd.	Mining & Allied Machinery Corpora- tion	Hindusthan Copper Ltd.	Jessop & Company Ltd.
1975-76	-	2.4	0.94	0.56	1.18
1976-77	-	2.2	0.82	1.07	1.77
1977-78	1.10	1.7	1.58	1.12	1.68
1978-79	1.24	1.7	1.59	1.13	2.08
1979-80	1.07	2.5	1.49	1.34	1.10
1980-81	1.44	2.6	1.81	1.14	1.26
1981-82	1.45	2.0	1.96	1.57	1.28
1982-83	1.25	2.6	1.77	1.18	1.30
1983-84	1.28	3.1	1.56	1.37	1.56
1984-85	0.77	3.0	1.72	1.79	1.58

Source : Annual Reports of Companies. Results computed

Table 34 exhibits the working capital position of the selected companies for the period from 1975-76 to 1984-85. It would be noticed, on an average, the amount of working capital for all the companies under study showed an increasing trend especially in the last four years i.e from 1981-82 to 1984-85. Individually, Hindusthan Cables Ltd.'s requirements for working capital

Table - 34 : Statement Showing the Working Capital in the Selected Companies over the Period from 1975-76 to 1984-85

(In Lakhs of Rupees)

Y e a r s	Braithwaite & Company	Hindu- sthan Cables Ltd.	Mining & Allied Machinery Corpora- tion	Hindusthan Copper Ltd.	Jessop & Company Ltd.
1975-76	-	1408	2114	5670	3542
1976-77	-	1180	2567	6345	3163
1977-78	1764	1627	711	3491	3620
1978-79	1875	2498	990	3949	2251
1979-80	1592	3693	971	3816	2788
1980-81	1178	3526	417	4416	2763
1981-82	729	3938	568	2503	3313
1982-83	1345	5783	2809	3011	3427
1983-84	1508	6380	2786	3446	3678
1984-85	1582	7580	2970	3744	3866

Source : Annual Reports of Companies. Results computed.

was the highest. For the first three years it was below 2000 lakhs of rupees but thereafter i,e from 1978-79 gradually it was increasing and in 1984-85 the figure came up to Rs.7580 lakhs of rupees. Comparatively Braithwaite Company's figures had been the lowest as the amount did not exceed Rs.2000 lakhs. Mining & Allied Machinery Corporation Ltd., though showed a

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decreasing trend from 1977-78 to 1981-82, but from 1982-83 again it began to rise. In the case of Hindusthan Copper Ltd. this amount had been very high in 1975-76 and 1976-77 and thereafter it remained more or less constant (within 2500 to 3700). The working capital in Jessop & Company Ltd. did not show a wide variation during the period but there had been an upward trend since 1981-82. This indicates that there was an increasing trend for the working capital requirement in the public sector undertakings and a bulk of the sum was unnecessarily blocked up in inventory. This also created another problem - the problem of financing the working capital, which will be taken up for discussion in the next Chapter.

Tables 35 and 36 indicate the index of efficiency with which management of the selected companies were able to produce their products so far as the same could be measured by the application of two indices namely the Gross Margin Ratio and the Turn and Earn Index. It could be noticed from Table 35 that Gross Margin Ratio in all the companies except Hindusthan Cables Ltd. was not only very low but also negative reflecting high cost of goods sold due to firm's inability to purchase raw materials at favourable terms and/or inefficient utilisation of plant and machinery and also due to decreasing sales' revenue.

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Table - 35 : Statement Showing Gross Margin Ratio of the Selected Companies over the Period from 1975-76 to 1984-85

(In Lakhs of Rupees)

Y e a r s	Braithwaite & Company	Hindu- sthan Cables Ltd.	Mining & Allied Machinery Corpora- tion	Hindusthan Copper Ltd.	Jessop & Company Ltd.
1975-76	-	14.91	-10.22	16.62	15.61
1976-77	-	16.47	-11.73	14.36	10.86
1977-78	- 4.03	18.42	-106.38	-25.26	-0.50
1978-79	- 8.60	12.30	-18.29	8.78	-10.90
1979-80	-41.51	1.22	- 7.66	15.30	-12.06
1980-81	-30.38	16.31	-24.68	1.21	0.85
1981-82	-53.64	12.44	-21.45	-29.52	0.37
1982-83	-21.78	12.87	-22.60	- 9.32	2.97
1983-84	+19.91	13.56	- 6.80	3.55	0.60
1984-85	-12.26	13.63	- 4.88	1.11	1.72

Source : Annual Reports of Companies. Results computed



Table - 36 : Statement Showing the Turn & Earn Index (TE Index) of the Selected Companies over the Period from 1975-76 to 1984-85

(In Lakhs of Rupees)

Y e a r s	Braithwaite & Company	Hindu- sthan Cables Ltd.	Mining & Allied Machinery Corpora- tion	Hindusthan Copper Ltd.	Jessop & Company Ltd.
1975-76	-	0.36	0.10	0.09	0.18
1976-77	-	0.37	0.10	0.15	0.19
1977-78	0.04	0.31	1.69	0.31	0.01
1978-79	0.11	0.21	0.29	0.12	0.23
1979-80	0.44	0.03	0.11	0.21	0.13
1980-81	0.44	0.42	0.45	0.02	0.01
1981-82	0.78	0.25	0.42	0.46	0.01
1982-83	0.27	0.33	0.40	0.11	0.04
1983-84	0.26	0.42	0.11	0.05	0.01
1984-85	0.09	0.41	0.08	0.02	0.03

Source : Annual Reports of Companies. Results computed.

Hindusthan Cables Ltd., though, was able to maintain a favourable Gross Margin Ratio throughout the period of study except in 1979-80 when it came down to 1.22, it was more or less constant. In the case of Hindusthan Copper Ltd. and Jessop & Company Ltd., this ratio was to some extent satisfactory ; mostly in 1975-76, 1976-77 and 1979-80 for Hindusthan Copper Ltd., and the

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first two years of Jessop & Company Ltd., but in other years this was very poor and disappointing.

As already stated Table 36 is the picture obtaining in the sample companies in respect of Turn and Earn Index over the period between 1975-76 and 1984-85. It would be observed that the turn and earn index in these companies could not be very high, as both the components of this ratio i.e the Gross Margin Ratio and the Inventory Turnover had been low.

It is, therefore, important for financial manager to formulate and initiate inventory policies which will ensure correct level of inventory holding at any time. In other words he is to strive for securing balance between the economics of holding large inventories and that of small inventories in order to earn a high rate of return on the total investments.

According to Mr.P.D. Anna<sup>27</sup> a possible line of approach for the purpose will be :

- (1) Keep stock at low but not too low. Make stocks keep pace with sales whether up and down
  - (2) Make volume purchase to obtain better prices but don't overbuy
  - (3) Increase turnover - but only at a satisfactory net profit
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27. P.D! Anna - Inventory and Profit, Chapter II - American Management Association, New York, 1966.

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- (4) Give particular attention to the high margin inventory items but don't lose sight of those low margin products with high turnover rates.
- (5) Dispose of all obsolete items but before the new product has taken hold in the market.

Return on Inventory  
and Inventory Level :

Determining the proper level of inventory should be based on return on investment frame work. Return on Investment is the Key Ratio of Profit to Investment. It is a prime indicator of the profitability of business. Since well managed inventories help reducing both the direct expenses of a business and its investment base keeping customers happier too, the ratio can be dramatically improved. Sales levels, costs and investments are the three basic components in the measurement of Return on Investment (ROI). Amount of profit will increase if, keeping sales volume constant, cost of sales is reduced, or, keeping cost of sales constant, volume is increased. Since cost of sales depends much upon inventory control, proper inventory control can beneficially affect ROI. Again, if we keep sales volume and cost of sales constant, ROI will improve. ROI can also be increased by decreasing investment in inventory. This relationship between sales, cost and investment is shown below :

$$\begin{aligned} \text{ROI} &= \frac{\text{Sales} - \text{Cost}}{\text{Investment}} = \frac{\text{Profit}}{\text{Investment}} = \frac{\text{Profit}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Investment}} \\ &= \text{Profit Margin} \times \text{Investment Turnover} \end{aligned}$$

To explain this proposition, it may be said that the profit margin ratio indicates the management's efficiency in manufacturing, administering and selling the products. The latter part of the ratio is employed to evaluate the efficiency with which the firm manages and utilises the assets in which the investments are made. Return on Investment again depends, a great deal, on the manner of utilisation of inventory which forms an important part of current asset in any organisation

$$\text{ROI} = \frac{\text{Profit}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Fixed Assets} + \text{Current Assets}}$$

Capital invested in fixed assets is fixed. It is already sunk and very little can be done to reduce it. That leaves one with working capital investment, the most of which is invested in inventories. The scope for improving the return on investment lies therefore in the efficient management of inventory. If ways and means are diverted in saving these inventory costs (through firm's contract with the suppliers, reduction of leadtime in purchases, economic purchases, economic substitution, standarization of production, shortening the manufacturing cycle of the various products, import substitution of spares and components, effective sales efforts and the like activities of the company), it will improve the profit position of the company<sup>28</sup>. It is therefore rightly claimed that efforts for saving a rupee in materials cost is almost equal to the efforts made for additional sale of Rs'.10<sup>29</sup>. This is

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28. Materials Management : An Integrated Approach, P. Gopal Krishnan & Mr. Sundarsan, Prentice Hall of India Private Ltd., New Delhi.

29. Dean S Ammer, Materials Management. Richard Irwin Inc. First Indian Report, 1977, D.B. Taraparevals Sons & Company, Bombay.

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especially true in an economy like India.

The Central Statistical Organisation study shows that not less than 90 % of the working capital is invested in different kinds of inventories like finished goods, work-in-progress, components of raw materials, stores and spare etc. Such a high level of investment results in (1) unnecessary tie-up of firm's funds and loss of profits (2) risk of liquidity and (3) excessive carrying costs. Over-investment in inventories consumes the funds of the firm, which can not be used for any other purpose - and thus it involves an opportunity cost. Large quantity of inventory is also associated with the excessive carrying costs which will impair the profitability of the firm. Excessive inventories carried for a long period increase the chances of loss of liquidity. It may not be possible to sell the inventories in time and at full value. Raw materials are generally difficult to sell as the holding period increases (except under the conditions of inflation and scarcity, when it may pay to the company to hold stocks of raw materials) Work-in-progress is far more difficult to sell. Difficulties may also be faced to dispose of the finished goods inventories as time lengthens. Another danger of carrying excessive inventory is the physical deterioration of some inventories (specially raw materials) or they may become obsolete when in storage with the passage of time. All these have a reverse effect on the profitability of the firm. Fortunately inventory investment is more responsive to control. Studies

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have revealed that scientific inventory control technique namely the economic size in place of purchase judgement base has been responsible for reduction in total inventory investment by 20 % to 30 % without sacrificing the customer service<sup>30</sup>. This would in turn improve the profit position of the firm.

#### Position in the Public Sector

##### Undertakings Under Study :

Inventories constitute the most significant part of current assets of a large majority of companies in India. For example, on an average inventories are approximately 60 % of current assets, more than 90 % of capital employed and 100 % of net working capital in the public sector undertakings. Such huge inventories involve unnecessary blocking up of working capital with all its effect on profitability. A few years ago a study of 22 public undertakings revealed that on an average the inventories held were equivalent to 11 months' production cost. According to this study, if the undertakings were able to reduce their inventories to 6 months' production cost, capital to the extent of Rs.104 crores could be released and it could be gainfully employed in other essential projects. But the most depressing aspect of it is that instead of going down, the inventories have been steadily going up. This phenomenon of the public sector undertakings has been found to have affected their profit earning capacity as profit margin, on the aggregate, has been estimated to have been

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30. American Management Report 35, Page 56.

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reduced to one fourth of normal rate.

In Table 37 inventory holdings in terms of production and the corresponding profit position in different years for the companies under studies have been shown. It shows inventory holdings in the case of Braithwaite, Hindusthan Copper Ltd., Mining and Allied Machinery Corporation Ltd. and Jessop & Company Ltd. were more than six months' value of cost of production. It was only in the case of Hindusthan Cables Ltd. that it had been less than six months' value of cost of production. This high level of inventory holdings resulted in more and more tieing up of working capital as shown earlier in Table 34 with adverse effect on profit. It was no wonder therefore that profit before tax for all the companies, except Hindusthan Cables Ltd., as shown in Tables 37 to 37 G on an average, had been negative.

**Table- 37 : Statement Showing the Inventory(F.G.,W.I.P & Spares) in Relation of Cost of Production(Including depreciation) Braithwaite & Company Ltd. (Accounting Year Ending (31.3. )**

(Figures in Lakhs of Rupees)

Y e a r s	1975-76	'76-77	'77-78	'78-79	'79-80	'80-81	'81-82	'82-83	'83-84	'84-85
Inventory	-	-	1688	1297	1530	1506	1480	1563	1768	2795
(Finished Goods Work-in-Progress and Stores)										
Cost of Production	-	-	1506	1662	2170	2583	2534	2337	2840	3511
Inventory holding in relation to cost of production ( In terms of months)	-	-	13.45	9.36	8.96	7.00	7.00	8.02	7.47	9.54
Profit before Tax	-	-	-31	-277	-863	-856	-991	-507	-143	-655

Source : Annual Report of the Company, Figures computed



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Table - 37 A : Statement Showing the Inventory (F.G.,W.I.P. & Spares) in Relation of Cost of Production-(Including Depreciation) Mining & Allied Machinery Corporation Ltd.(Accounting Year Ending 31.3 )

(Figures in Lakhs of Rupees)

Years	1975-76	'76-77	'77-78	'78-79	'79-80	'80-81	'81-82	'82-83	'83-84	'84-85
Inventory (Finished Goods Work-in-Progress and Stores)	2089	2576	1507	1272	1512	1565	1550	1852	2385	2324
Cost of Production	3026	3487	3211	3517	4100	4708	6349	6367	6402	NA
Inventory holding in relation to cost of Production (in terms of months)	8.28	8.86	5.63	4.34	4.43	4.00	2.95	3.50	4.17	NA
Profit before Tax	40	35	-2265	-994	-954	-1570	-1288	-1007	-791	-1197

Source : Annual Report of the Company, Figures computed

Table - 37 B : Statement Showing the Inventory (F.G., W.I.P. & Spares) in Relation of Cost of Production (Including Depreciation) Hindusthan Cables Ltd. (Accounting Year Ending 31.3.)

(Figures in Lakhs of Rupees)

Y e a r s	1975-76	'76-77	'77-78	'78-79	'79-80	'80-81	'81-82	'82-83	'83-84	'84-85
Inventory	483	609	1237	1792	1704	1367	1609	2261	2308	2495
(Finished Goods Work-in-Progress and Stores)										
Cost of Production	2461	2691	4129	4687	6543	5809	8151	10066	11772	13849
Inventory holding in relation to cost of Production (in terms of months)	2.36	2.72	3.37	3.60	3.13	2.82	2.37	2.70	2.35	2.16
Profit before Tax	249	438	680	436	-294	738	630	707	847	901

Source : Annual Report of the Company, Figures computed

Table - 37 C : Statement Showing the Inventory(F.G.,W.I.P & Spares)  
In Relation of Cost of Production(Including depreciation)  
tion) Hindusthan Copper Ltd.(Accounting Year Ending  
(31.3. )

(Figures in Lakhs of Rupees)

Y e a r s	1975-76	'76-77	'77-78	'78-79	'79-80	'80-81	'81-82	'82-83	'83-84	'84-85
Inventory	7001	7486	5349	6563	7042	8614	8720	11028	12144	12203
(Finished Goods Work-in-Progress and Stores)										
Cost of Production	6461	8586	9054	8356	10490	10659	13693	16092	17384	21315
Inventory holding in relation to cost of Production (in terms of months)	13	10.46	7.09	9.43	8.06	9.70	7.64	8.22	8.38	6.90
Profit before Tax	-263	+201	-3111	-181	-434	-1085	-4255	-2578	-864	+171

Source : Annual Report of the Company, Figures computed

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Table - 37 D : Statement Showing the Inventory(F.G.,W.I.P. & Spares) in Relation of Cost of Production(Including depreciation) Jessop & Company Ltd. (Accounting Year Ending 31.3 )

(Figures in Lakhs of Rupees)

Y e a r s	1975-76	'76-77	'77-78	'78-79	'79-80	'80-81	'81-82	'82-83	'83-84	'84-85
Inventory	2213	1433	1908	1119	1581	1613	1659	1972	1844	1596
(Finished Goods Working-in-Progress and Stores)										
Cost of Production	4310	3997	4843	4845	3745	4709	5049	6135	6149	6383
Inventory holding in relation to cost of Production (in terms of months)	6.16	4.32	4.73	2.85	5.07	4.11	3.94	3.85	3.60	3.00
Profit before Tax	12	65	-503	-913	-930	-1163	-744	-1117	-393	-268

Source : Annual Report of the Company, Figures computed

How inventory had been largely responsible for the difference in performance between two groups of companies under the same industry - one group belonging to the private sector and the other under public sector could be gauged from Table 38 below. The industry chosen is chemical and pharmaceutical industry.

Table - 38 : Showing Inventory, Sales, Profit before Tax in the Comparable Units Under Public and Private Sector in One Year

(Figures in Lakhs of Rupees)

	Private Sector 67 Companies Accounting Year ending on 31-3-80	Public Sector 16 Companies Accounting Year ending on 31-3-80
Inventories		
(Raw materials Finished Goods Work-in-Progress and Stores)	Rs.33368	Rs.39217
Sales	Rs.172904	Rs.98421
Inventory holdings in relation to Sales (in terms of months)	2.3 months	4.8 months
Profit before Tax	Rs.21659	Rs. 7535
Ratio of Profit to Sales (in Percentage)	12.5	-

Source : (i) For Private Sector Companies R.B.I. Bulletin October 1981,  
(ii) For Public Sector Companies - Public Enterprise Survey. B P New Delhi, 1979-80  
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It would be observed from the same Table that investment in inventory in 16 companies under public sector exceeded the investment for the same in the 67 companies under the private sector. Further when the inventory holding in the private sector companies had been only 2.3 months' value of sales, the comparable figure for the public sector companies had been 4.8 months' value of sales. In consequence, when the profit before tax in relation to sales had been 12.5%, the same had been nil in the case of the companies under the public sector.

Table - 39 : Showing the Impact of Inventory Reduction to a Common Size of Rs.10,000 on the performance of the Public Sector Companies in a Single Year

(Figure in Lakhs of Rupees)		
	Private Sector	Public Sector
Inventories	Rs.10,000	Rs.10,000
Sales	Rs.52,173	Rs.25,000
Profit at 12.5 % (with inventories equal to 2.3 months' sales)	Rs. 6,521	Rs. 3,125
Excess Inventory	N i l	Rs. 5,208
Excess Inventory Less Marginal Carrying Cost on Excess Inventory at 15 %	-	Rs. 781
Resultant	Rs. 6,521	Rs. 2,344
Profit	on 12.5 %	on 9.4 %

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Table 39 is the projection of the impact of reduced inventory holding to a common size figure of Rs.10,000 lakhs with equal holding period viz, 2.3 months' value of sales on the performance of the public sector companies. It shows that with inventories reduced to Rs.10,000 lakhs, excess inventory at the end of the period in the public sector units had been Rs.5208 lakhs and the carrying cost being 15 % (generally assumed for public sector) the profit had been Rs.2344 i.e 9.4 %. This improvement was due to reduction in inventory investment.

The foregoing analysis serves to indicate that to achieve higher operational efficiency and profitability of an organisation it is very essential to reduce the amount of capital locked up in inventories. This will, not only, help in achieving increased return on investment by minimising tied-up working capital but also improve the liquidity position of an enterprise.