3.1 The Preliminary Remarks

The working capital comprises of short-term net assets: inventory, debtors, temporary investment, advances, and deposits required to be made for the supplies and services, prepaid expenses and cash needed to meet contingencies. The working capital management then is to do with the management of all aspects of both current assets and current liabilities, so as to minimize the risk of insolvency while maximizing return on the assets. Each component of the working capital (namely inventory, receivables, payables, etc.) has two dimensions —— TIME ——— and MONEY. When it comes to managing the working capital - TIME IS ALSO MONEY. If any firm can get money to move faster around the cycle (e.g. collect money due from debtors more quickly) or reduce the amount of money tied up (e.g. reduce inventory levels relative to sales), the business will then generate more cash or it will need to borrow less money to fund the working capital. As a consequence, the firm can reduce the cost of bank interest or it will have additional free money available to support additional sales growth or investment. Similarly, if the firm can negotiate improved terms with suppliers e.g. get longer credit or an increased credit limit; it effectively creates free finance to help fund the future sales.

The working capital management is essentially cash management, which also includes credit management. The other important aspect of the concept is that the working capital amount represented by inventories and receivables, in a balance sheet, a static figure on given date, representing the money invested in the working capital. It does not reveal the various business fluctuations taken place during that period. It also fails to explain how the interrelationships varied as between the various components of the working capital and why. The study of such variations with a view to evolve suitable systems to forecast variations for bringing them within a framework of financial discipline are the essence of the working capital management.
The present chapter intends to discuss the need of management of all components of the working capital. The objective of this chapter is to understand the management of cash, receivables, inventory, marketable securities, and current liabilities. Following figure shows the flow of the working capital.

Chart - 3.1 Flow of the working capital

Figure 3.1 shows the cash to cash cycles. The flow of the working capital starts with the purchase of the raw material supplied from creditors. The flow goes through the work-in-process to the finished goods. The finished goods are sold either by cash or on credit. The credit sale of goods generates the debtors or receivables. Subsequently, the debts are realized and get converted into the cash and this cycle ends here.

3.2 Cash Management

Cash is the important current assets for the smooth flow of the business operations. It is the basic input needed to keep the business running without any interruption. It is also the ultimate expected output after the sale of the products or services provided by the firm. Firm should have adequate balance of cash. Shortage of cash disturbs the firm’s
business operations while excessive cash remains idle and hampers the firm’s profitability. To quote Gitman, “liquid assets provide a pool of funds to cover unexpected outlays, thereby reducing the risk of a ‘liquidity crisis’.”^21

Cash in any form like coins, currency, cheques, bank balances, time deposits or marketable security help in immediate disbursement of the firm’s obligations. However, the cash is unproductive, unlike it is invested in inventory or fixed assets. Therefore, the aim of cash management should be to maintain adequate control over cash position to keep the firm sufficiently liquid and to use the excess cash in a profitable way. It is very difficult to predict cash inflows accurately. Sometimes excess outflow also can be possible while paying for taxes, dividends or seasonal inventory built up. Cash sales or prompt realized debtor may leads to excess cash inflows. Therefore, it is very rightly said that liquidity should not be compromised for the shake of profitability and also profitability should not be compromised for the shake of liquidity. Therefore, a balance should be made between these two factors.

Though cash contributes the smallest portion of the current assets, considerable time is devoted to its management. The recent techniques of cash management aims at manage business affairs in such a way as to keep the cash balance at a minimum level. The cash management is concerned with the managing of:

1] Cash flows into and out of the firm,

2] Cash flows within the firm, and

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3] Cash balances held by the firm at a point of time by financing deficit or investing surplus cash.

In order to resolve the uncertainty about the cash flow prediction and lack of synchronization between cash receipts and payments, the firm should develop appropriate strategies for the cash management.\textsuperscript{22} The firm should revolve strategies regarding the following four aspects of cash management:

- **Cash Planning:** Cash inflows and outflows should be planned to project the cash surplus or deficit for each period of the planning period. Cash budget can be prepared for this purpose.
- **Managing the cash flows:** The flow of the cash should be properly managed. The cash inflows needs to be accelerated and outflows needs to be decelerate, if possible.
- **Optimum cash level:** The firm should decide about the appropriate level of cash balances. The cost of excess cash and danger of the cash deficiency should be matched to determine the optimum level of the cash balances.
- **Investing surplus cash:** The surplus cash balances should be properly invested to earn profits. The firm should decide about the division of such cash balance between alternative short-term investment opportunities such as bank deposits, marketable securities, or inter–corporate lending.

The idyllic cash management system is complex to employ. It is dependent upon many factors, like, nature of business, organization structure, competition, culture and option available. Certain decisions while managing the cash can affect other important areas of the firm. For example, to make improvements in the credit policies may hamper the sales. However, in certain cases, without making any fundamental changes, it is possible to significantly reduce cost of cash management system by choosing a right bank and controlling the collections properly.

3.2.1 Motives for holding cash:

The firm normally holds cash for following motives:

I. **Transaction Motive:** Every firm requires to hold the cash to carry on its routine business affairs. It needs cash primarily to make payments for operating expenses like wages, salaries, taxes, etc. The need to hold cash would not arise if there is perfect synchronization between cash receipts and cash payments, but in practical it is not possible. Therefore, the firm should maintain some cash balance. The firm can invest the cash according to the duration of the payments. The firm may purchase the marketable securities whose maturity corresponds with some anticipated payments, such as dividends, or taxes in the future.

II. **Precautionary Motive:** It is essential for firm to hold the cash to meet contingencies or emergency in the future. The precautionary amount of cash depends upon the predictability of the cash flows. Such amount is depends upon the firm’s ability to borrow at short notice when the need arises. The precautionary balance can invest in highly liquid and low-risk marketable securities.

III. **Speculative Motive:** It relates to the holding of cash for investing in profit-making opportunity as and when they arise. A firm may come across an
unexpected opportunity to make profit, some cash balance can be keep aside for such wind falls, for example, purchase a raw material at a heavy discount if it purchased in cash.

IV. **Compensation Motive:** Certain cash balance needs to be maintained to avail certain services like current account in a commercial bank. There should always be a minimum cash balance, which normally varies from bank to bank. This amount remains permanent balance as long as that account is inoperative. It is one sort of investment and provides the compensation motive for holding cash.

### 3.2.2 Cash Forecasting and Budgeting:

Cash forecasting is needed to prepare cash budget. It can be done on short term and long term basis. The forecast is made for a year or less than that is considered as short-term and those which extending beyond one year is considered as long term. The short term forecast are normally develop to determine operating cash requirements, anticipate short term financing, and manage investment of surplus cash. On the other hand, long term cash forecasts are prepared to give an idea of the company’s financial requirements in the distant future. They are not as in detail as the short term forecast. Once it is made, it can be used to evaluate the impact of various developments taking place in the organization. The long term forecast is used to analyze the firm’s future financial requirements, especially the working capital. It also helps to evaluate proposed capital projects and its requirements of funds. It helps to improve corporate planning. The cash budget is a projected summarized statement of a firm’s cash inflows and cash outflows. It provides information about time and enormity of the firm’s receipts and payments for projected period. This information helps the financial manager to determine the future cash needs of the firm, plan for the financing of these needs and exercise control over the cash and liquidity of the firm.\(^{23}\)

\(^{23}\) *Van Horne, J. C. Financial Management and Policy, Prentice - Hall of India, p.422*
One useful method to understand insights about the variability of cash flows is sensitivity analysis. The firm can prepare cash budget based on three forecasts; optimistic, most probable and pessimistic. On the basis of past experience, it may analyze the effects under these conditions. Knowledge of the outcome of extreme expectations will help the firm to prepare contingency plans. A cash budget prepared under the worst conditions will prove to be useful to the management to face those circumstances.

3.2.3 Management of Cash Collection and Disbursement:

Once the cash budget has been made and suitable net cash flow established, it is essential to maintain equivalent projected cash flow to actual cash flow. To achieve this, the cash management efficiency will have to be improved through a proper control of the cash collection and disbursement. A firm can restrict the requirement of cash if its collection is accelerated. Most of the firms take time to generate the invoice accordingly the further process is deferred. In the Indian market buyers enjoy the extra time other than the time grant to them. The cash collections can be accelerated by reducing the lag between the time a customer pays bill and the time the cheque is collected and funds become available for the firm’s use. The firm can request the bank to minimize floating time. If possible, the firm may use decentralized collection system and lock box system to speed up cash collections and reduce deposit float.

The effective control of the disbursement also helps the firm in conserving cash and reducing financial requirements. It normally arises due to spontaneous source of funds arising mainly due to the trade credit, accruals, etc. The firm should try to make maximum use of such opportunities, as it is most of the time interest free up to certain describe period. Early settlements should be done only for fair rate of cash discounts. At the same time, the firm should not make delay in making payments, as it endangers
firm’s credit standing or supplier may build implicit cost or reduce the quality of goods and services he supplies.

While accelerating collections a decentralized collection procedure it is advisable if payees are far from a single central account; the transit time possibly will increase. The firm may use the technique of ‘playing the float’ to maximize the available funds. One of the primary responsibilities of the financial manager is to maintain a sound liquidity position of the firm so that the dues are settled in time. Normally, a firm maintains the operating cash balance along with certain amount of safety stock. The amount of cash balance depends on risk and return trade-off. The firm may maintain small cash balance and invest the excess cash in highly liquid marketable securities.

3.3 Inventory Management

The term inventory is originated from the French word *inventaire* and the Latin *inventariom* which implies a list of things found. The term inventory has been defined by the American Institute of Accountant as the aggregate of those items tangible personal property which are held for the sale in ordinary course of business, are in the process of production for such sales, or are to be currently consumed in the production of goods or services to be available for sale. The American Production and Inventory Control Society (APICS) defines inventory management as a branch of business management concerned with planning and controlling inventories. The role of the inventory management is to maintain a desired stock level of specific products or items.

The system that plans and controls inventories must be based on the product, the customer, and the process that makes the product available.\textsuperscript{25} The money invested in the excess inventory could be better utilized in other endeavors such as debts reduction, product development, process improvement, etc. The same rule applies to other investments such as lot size stock or work-in-process buffers. If the inventory is needed it is an asset. If it is not really needed, it is liability.

The inventory refers to the stockpile of the products a firm is offering, company is manufacturing for sale, and components that make up the product.\textsuperscript{26} The various forms in which the inventories exist in a manufacturing company are the raw materials, work-in-process, and finished goods. The raw materials are basic inputs which have been purchased and stored for the future production. Work-in-process inventories are semi-manufactured products. Finished goods inventories are completely manufactured products which are required for smooth marketing operations. Firms also maintain a fourth kind of inventory, i.e. supplies stores and spares, which include materials like soap, broom, oil, fuel, light, bulbs, etc. Though these materials do not directly enter production, they are necessary in the production process.


\textsuperscript{26} Bolten, S.E., Managerial Finance, Houghton Mifflin Co., Boston, 1976, p.426.
Inventories serve as a link between production and consumption of goods. It is essential to know how much inventory to have on hand to ensure continuity of supply in the event of an uncharacteristic increase in either the demand and/or the lead time. This quantity of inventory is called the safety stock. There is no universally used formula for determining safety stock quantity. 27

The inventories constitute the most significant part of the current assets of a firm. A considerable amount of funds is required to empower in inventories. Therefore, it is extremely necessary to manage inventories efficiently and effectively in order to avoid unnecessary investments. The negligence in management of inventories will be endangering its long-term profitability. A firm should make every possible effort to reduce excessive inventories without any adverse effect on the production and sales. The levels of inventories for a firm depend on nature of its business. The management of inventories becomes very crucial for those organizations where they hold substantial amount of inventory. Maintaining inventories involve tying up of the company’s funds and incurrence of storage and handling costs. It is quite expensive to maintain inventories, but due to transaction motive, precautionary motive, and speculative motive reasons it needs to be held. A firm needs to maintain adequate stock of materials for a continuous supply to the factory for uninterrupted materials whenever it is needed. It is not possible for a company to procure raw materials whenever it is needed. A time lag exists between the demand for materials and its supply. Sometimes due to the uncertainty raw material supply may be delayed. To avoid such situations the firm should maintain sufficient stock of the raw materials.

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Another reason for holding material is to gain quantity discounts and anticipated price rise. Work-in-process inventory builds up because of the production cycle. Efficient firm tries to reduce span of production cycle by using various techniques. Stock of finished goods has to be held because production and sales are not instantaneous. A firm can not produce goods immediately as per the customer’s demands. For seasonal sales substantial inventories of finished goods should be kept to take the advantage of the peak demand. If the firm fails to fulfill the customer’s demands it is possibly he would depart to competitors.

3.3.1 **The major objectives for inventory management are:**

- To provide economies of bulk purchase, safeguard against various kinds of fluctuations like seasonal, fiscal, political, technological, etc.
- To ensure regularity in quantum and pattern of production.
- To cater to the needs of the customers through off-shelf deliveries, particularly in peaks of seasonality.
- To ensure high inventory turnover.
- To maintain proper input-output scheduling so as to minimize the lead time.
- To maintain continuity in the flow of the right quality material from right sources at the right moments.

3.3.2 **Cost of Inventory**

Every firm maintains some stock of raw materials, work-in-progress and finished goods depending upon the requirement and other features of the firm. It is benefited by inventory, no doubt, yet it must also consider various costs involved in holding inventories. These costs are as follows:
1. **Carrying Cost:** This is the cost incurred while maintaining an inventory of raw material, work-in-progress or finished goods. Two basic costs are associated with holding a unit in inventory. These are:

   a. **Cost of storage:** This means and includes the cost of storing raw material by the firm. This cost may be in relation to rent of the space occupied by the stock, the cost of people employed for the security of the stock, cost of infrastructure required like air conditioning, etc., cost of insurance, cost of pilferage, warehousing costs, handling cost, etc.

   b. **Cost of financing:** This cost includes the cost of funds invested in the inventories. The funds used in the purchase or production of inventories have an opportunity cost; i.e., the income which could have been earned by investing these funds elsewhere. If by any chance the firm needs to pay interest on the borrowings made for the purchase of materials, then there is an explicit cost of financing in the form of interest.

The carrying costs of inventory include the required rate of return on the investments in the inventory, in addition to storage cost, etc. The carrying cost includes, therefore, both the real cash outflows and the opportunity cost associated with the funds invested in the inventories. It may be noted that, the total carrying costs is entirely variable and rise in direct proportion to the level of inventories carried. The total carrying cost moves in the same direction as the annual average inventory.

2. **Cost of Ordering:** The cost of ordering includes the cost of acquisition of inventories. It is the cost of preparation and execution of an order, including the cost of paper work and communicating with the supplier. There is always minimum cost involved whenever an order for replenishment of goods is placed. The total annual cost of ordering is equal to the cost per order multiplied by the number of orders placed in a year. The number of orders determines the average inventory being held by the firm. Therefore, the total order cost is inversely
related to the average inventory of the firm. The ordering cost may have a fixed component which is not affected by the order size; and a variable component which changes with the order size. For example, transportation charges maybe payable per unit subject to a minimum charge per trip.

The carrying cost and the cost of ordering are the opposite forces and collectively determine the level of inventories in any firm. The carrying cost considerations require that the firm should maintain the inventory at the lowest level and should be replenished as frequently as possible. This will result in lowering of the total carrying cost; but this also requires frequent orders to be placed and therefore, results in increasing the total cost of ordering. A financial manager has to achieve a trade-off between the carrying costs and the cost of ordering.

3. **Cost of Stock-outs:** It is a situation where firm is unable to fulfil requirement of customers or production department. The stock out refers to the level of inventory is zero or insufficient to meet demand. The firm needs to sacrifice the sales and it also affect to other related items. Most of the time it is expensive as a loyal customers of firm wait till the goods arrive but some goodwill definitely lost. The stock-out of raw materials or work-in-progress can cause the production process to stop, at the same time when the firm needs to pay wages to its employees. Therefore, the trade-off on inventory is essential. On the one hand, having too high an investment in inventory results in large carrying costs, which will drag down the value of the firm. Thus having too small an inventory may result in either lost sales or higher ordering costs for the firm.
3.3.3 Techniques of Inventory Management

The decision making in inventory involves a basic trade-off between risks and returns. The return results because lower level of inventory saves money. Since the investment in inventories is the least liquid of all the current assets, any error in its management cannot be readily rectified and hence is a costlier affair for the firm. The goal of inventory management should therefore be to establish a level of each item of the inventory. A systematic approach for the inventory management should be adopted to secure expected returns at minimum cost. The finance managers need to consider the following questions:

a. Are all items in the inventories equally important, so some separate attention is required for particular inventory?

b. What should be the size of each order or replenishment?

c. At what level should the order for replenishment be placed?

Various techniques have been suggested to deal with these problems, like:

A] **ABC Analysis:** It is known as Always Better Control Analysis. This analysis is based on the proposition that managerial time and efforts are scarce and limited and some items of the inventory are more important than others. Therefore, ABC analysis classifies various inventory items into three sets or groups of priority and allocates managerial efforts in proportion to the priority. The most important items are classified as ‘class A’, those of moderate importance are classified as ‘class B’, and the remaining items are classified as ‘class C’. The finance manager should monitor different items belonging to different groups in that order of priority. Maximum attention is required for ‘class A’ items, followed by items in ‘class B’, and then items in ‘class C’.

ABC classification is done on the basis of the total consumption value. It has been generally observed that 10 percent of the items normally consume approximately 70
percent values; this category is called ‘A’ class of items. Similarly, the next 20 percent by number consume 20 percent by values; this is the ‘B’ class of items. The rest 70 percent consuming 10 percent of values are identified as ‘C’ item. Following figure shows ABC analysis of inventory items.

A sound inventory management would provide cushion to the company to address to measure the two major issues namely, material holding and material pricing. Following table 3.1 summarize the ABC analysis in the following term:

Table 3.1 ABC Analysis:

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>A Item</th>
<th>B Item</th>
<th>C Item</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>High consumption Value</td>
<td>Moderate consumption Value</td>
<td>Low consumption Value</td>
</tr>
<tr>
<td>2.</td>
<td>No stock holding</td>
<td>Low stock holding</td>
<td>Moderate stock holding</td>
</tr>
<tr>
<td>3.</td>
<td>Frequent ordering:</td>
<td>Moderate ordering</td>
<td>Bulk ordering</td>
</tr>
<tr>
<td></td>
<td>Quick delivery</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td>Online MIS for better management</td>
<td>Online MIS for divisional heads</td>
<td>MIS for managers</td>
</tr>
<tr>
<td>5.</td>
<td>Maximum and frequent follow up</td>
<td>Periodic follow up</td>
<td>Exceptional follow up</td>
</tr>
<tr>
<td>6.</td>
<td>Very rigorous forecasting</td>
<td>Rigorous forecasting</td>
<td>Running forecasting</td>
</tr>
<tr>
<td>7.</td>
<td>Centralized focus in streamlines</td>
<td>Centralized focus in streamlines</td>
<td>Decentralized focus in streamlines</td>
</tr>
</tbody>
</table>

Management of different category will invite thrusts of various kinds of degree. Like, category A, being the most valuable items would call for a more rigorous management focus than the other two categories. Selective control could be considered from the point of view of unit price or cost of acquiring raw materials also. This analysis would be
termed as XYZ analysis. While ABC analysis based on the collective behaviour of the material items, the XYZ is based on the unit level analysis. ABC and XYZ can be applied at each and every stage on inventory. This analysis gives the guideline for an objective functioning of profitability maximization and liquidity optimization. Balancing between two or among many objective has been the core function of inventory management. This can be fulfilled through a system of selective control.²⁸ The principle of selective control aims at assigning higher weightage to more important items of the inventory. The most general pattern of selective control is done through ABC analysis, whereby most important element is identified as item of A category, the next important item falls under B category, and then the least important is placed under as C category.

B] Economic Order Quantity Model: The importance of effective inventory management is directly related to the size of the inventory. Effective management of inventory is essential to control the investment in inventory. The finance manager needs to tackle the order quantity problem and the order point problem. The inventory management basically focuses on maintaining an optimum level of inventory in order to minimize cost attached with different levels. Average level of inventory, to a great extent, depends upon the number of units procured.

C] Re-Order Level: The re-order level is the level of inventory at which the fresh order for that item must be placed to procure fresh supply. The re-order level depends upon length of time between the placement of an order and receiving the supply, and the usage rate of the item.

This inventory is constantly being used up. This is true regardless of the type of inventory. Raw materials and work-in-progress inventories are being used in the production while the finished goods are being sold regularly. The rate at which the inventory is being used up is called the usage rate. The re-order level can be determined as $R = M + tU$ where $R$ = Re-order level, $M$ = Minimum level of inventory, $t$ = Time gap/delivery time, and $U$ = Usage rate.

**D] Safety Stock or Minimum Inventory Level:** Safety stock is the minimum level of inventory desired for an item given the expected usage rate and the expected time to receive an order. It protects the firm from stock out costs over the long run.

The application of EOQ model presupposes the determination of minimum level or safety level for each item that the firm must maintain. The safety level is ascertained and introduced as a part of inventory management because there is always an uncertainty involve with respect to the time lag, usage rate or any other factor. Therefore, the firm may face a situation of stock-out even if utmost care has been taken. If it is expected to be costly, to run out of inventory result in strong customer dis-satisfaction and in the possibility of lost future sales, then higher safety stock is necessary. Another determinant of the safety stock is the cost of carrying additional inventory, in terms of the carrying cost as well as the opportunity cost associated with the investment in the safety stock. The greater the cost, the smaller the safety stock and vice versa.

The EOQ Model assumes that the purchase price per unit is fixed and constant irrespective of the number of units purchased by the firm. However, in practice it does not happen always, probably the firm may get discount on number of units purchased by the firm or reduction of the cost price. While making such purchase, the firm should take care that total carrying cost of inventory will increase if EOQ is high.
E] Just in Time Inventory (JIT)

The fundamental principle of JIT is that the firm should keep a minimum level of inventory on hand and rely on suppliers to deliver stock ‘just in time’ as and when its need arises. This is in direct contrast to conventional inventory management of philosophy, where emphasis is given to maintain sufficient level of stocks, to avoid stoppage of production. The firm may go ahead with large stock, when it’s carrying cost and interest rates are low, but when carrying costs are large, it is costlier to maintain the inventories. In JIT, the firm keeps minimum stock of inventory to satisfy immediate needs of the production. This system significantly reduces the inventory carrying costs. This also helps to reduce the working process inventory by eliminating inventory buffers between different production departments. To implement this system effectively, it is required to have a high degree of coordination and cooperation among suppliers, manufacturers, and different production centres. The management must be ready to trade off cost to develop close relationship with suppliers and promote speedy replenishment of inventory in return for the ability to hold lesser safety stock.

3.3.4 Threats in inventory managements:

- The possibility of declining market value of inventory below than the firm pays for it, which resulted into inventory losses.
- The purchased inventory is subjected to losses due to changes in the technology. Such changes may sharply reduce final prices of the goods when they are sold or may even make the goods unsalable. This is the most acute risk, where the product required a high degree of technological sophistication.
- There are substantial risks involve in inventories of goods which are dependent on the current styles. For example, a readymade industry prone to the risk of
changing consumer tastes or agriculture commodities are subjected to risk due to unpredictable changes in production and demand.

- Nevertheless, all inventories bear substantial losses due to the spoilage, shrinkage, theft, poor inventory control, or other risks of this sort. It is essential to have knowledge about the degree of risk involved in the firm’s investment in inventories and after appropriate evaluation such losses may be included in the cost.

3.4 Receivables Management

Accounts Receivables occupy an important position in the structure of current assets of the firm. They are the outcomes of rapid growth of credit sales granted by the firm to their customers. Credit sales are reflected in the value of Sundry Debtors [SDs in India]. It is also known as Trade Debtors [TDs], Account Receivables [ARs], Bills Receivables [BRs] on the asset side of the balance sheet. The term receivable is also defined as debt owed to the firm by customers arising from sale of goods or services in the ordinary course of business. According to Joseph, the purpose of any commercial enterprise is the earning of profit. Credit in itself is utilized to increase sales, but sales must return profit.


Account Receivable management means making decisions related to the investment in current assets as an integral part of operating process, the objective being maximization of returns on the investment in receivables. In other words, accounts receivables management involves maintenance of receivables at optimum level. It is a critical area in financial management. Accounts receivables can reduce both profitability and liquidity of the organization. No firm would like to sell its products and render services on credit unless it is compelled to do so. Under normal circumstances, any kind of credit sales has its own cost on the exchequer of the company. Receivables management helps organization to maintain control over account receivables. It helps in keeping the track of customers. Therefore, an organization can manage sales made on accounts more effectively and at lower overhead costs.

It is an extension of credit to customers, allowing them a reasonable period of time in which to pay for the goods received. The credit sale is an essential part of the modern competitive business world. It is treated as a marketing tool to induce the buyer to consume goods or services. It certainly promotes sales and thereby profits. However, extension of credit involves risk of cost. Management should weigh the benefit as well as cost to determine the goal of receivables management. When returns are observed to be lesser than the cost of finance credit then firm should stop that facility to the customer.

To form and practice effective credit policies is the joint and coordinated responsibility of Marketing or Recovery Manager, the Production Manager, and Finance Manager. The customer here has to be managed tactfully, as competitive market firm cannot afford to lose its customer. While formulating the credit policy of the firm the incremental returns from costs of investment in receivables are analyzed in detail.

3.4.1 The various costs associated with receivables:

1. **Additional Fund Requirement for the Company:** When a firm maintains receivables, some of the firm’s resources remain blocked in them because there is a time lag between the credit sale and receipt of cash from the customers. To the
extent that the firm’s resources are blocked in its receivable, it has to arrange additional finance to meet its own obligations towards its creditors and employees like payments for purchases, salaries, and other production and administrative expenses. Whether this additional funding is financed through its own resources or from outside, it involves a cost to the firm in terms of interest or opportunity costs.

2. **Administrative Costs:** When a company maintains receivables, it has to incur additional administrative expenses in the form of salaries of the staff who maintain records of debtors, expenses on investigating the credit worthiness of debtors, etc.

3. **Collection Cost:** These are costs, which the firm has to incur for the collection of the amount at the appropriate time from the customers.

4. **Defaulting Cost:** When the customer make default in payment not only the collection effort has to be increased but the firm may also have to incur losses from bad debts.

5. **Opportunity Cost:** It is vital in credit policy. The cost is the loss of the opportunity to earn if investment is not made in accounts receivables. So, while calculating the profit on sales, a due deduction of opportunity cost should be made.

To control these expenses the credit policy should encompass the various components like:

   a) Credit standard  
   b) Credit period  
   c) Cash discount  
   d) Collection policy

Credit and collection policies have significant roles to play in the working capital management. It is said that financial manager should effectively handle five Cs that is: Credit, Capital, Capacity, Character, and Conditions. ‘Capital’ refers to the financial
resources of the company. ‘Capacity’ refers to the ability of the firm to perform its operations successfully. ‘Character’ refers to the reputation of the owners and the management for the homes and fair dealing. Cash flow can be significantly enhanced if the amounts owing to a business are collected faster. Every business needs to know.... who owes them money.... how much is owed.... how long it is owing.... for what it is owed.

Slow payment has a crippling effect on the business; in particular on small businesses who can least afford it. If the firms don't manage debtors, they will begin to manage its business as it will gradually lose control due to reduced cash flow. Possibly firm may experience an increased incidence of bad debt. The following measures will help manage the firm’s debtors:

1. Have the right mental attitude to control of the credit and make sure that it gets the priority it deserves.
2. Establish clear credit practices as a matter of company policy.
3. Make sure that these practices are clearly understood by staff, suppliers, and customers.
4. Be professional when accepting new accounts, and especially larger ones.
5. Check out each customer thoroughly before you offer credit. Use credit agencies, bank references, industry sources etc.
6. Establish credit limits for each customer... and stick to them.
7. Continuously review these limits when the firm suspects that tough times are coming or if operating in a volatile sector.
8. Keep very close to the firm’s larger customers.
9. Invoice promptly and clearly.
10. Consider charging penalties on overdue accounts.
11. Consider accepting credit/debit cards as a payment option.
12. Monitor the firm’s debtor balances and ageing schedules, and don't let any debts get too large or too old.

The following chart provides the details of evaluating an individual accounts.

Chart no. 3.2

Evaluation of Individuals Accounts

Obtaining Credit Information

1. Internal Sources
2. External Sources
3. Financial Statements
4. Bank Reference
5. Trade References
6. Credit Rating Agencies

Credit Analysis

1. Quantitative
2. Qualitative
   • Character
   • Capacity
   • Capital
   • Collateral
   • Conditions
   • Case History

Making Credit Decision

Comparing
1. Creditworthiness with predetermined Standard
2. Benefits of credit extension with likely bad debt losses

Receivables management requires a lot of decision making exercises, setting credit standards, identifying credit terms like about credit period and cash discount, collection policy, evaluation of the individual accounts. Evaluation of the individual accounts is the prime activity, which affects firm’s profitability. In this, the firm should develop a procedure for evaluating credit applicants and consider the possibilities of bad debt or slow payment. Mere determination of appropriate credit policy will not serve the purpose of minimizing investment in receivables and reducing bad debt losses, without credit
evaluation of individual accounts and identification of their credit worthiness. In other words, the firm has to evaluate the customer before extension of credit.

The credit evaluation procedure involves three related steps: viz, 1) obtaining credit information, 2) analyzing the information, and 3) making the credit decision.\textsuperscript{32} The success of collection depends on monitoring and controlling receivables. The traditional techniques are Receivables turnover, Average Collection period, Aging Schedule, and Collection matrix.

### 3.4.2 Credit Policy:

A firm’s credit policy deals with its credit standards, credit period, cash discounts and collection procedures. The credit policy may be lenient or stringent (tight).

1. **Lenient Credit Policy:** It is the policy where the seller sells goods on very liberal credit terms and standards. In other words, goods are sold to the customers whose creditworthiness is not up to the standards or whose financial position is doubtful. Advantages of this policy are it helps to increase the sales due to the liberal credit terms and favorable incentives granted to the customers. It also helps to enhance profitability of the firm as higher level of production and sale reduces the fixed cost.

Apart from the advantages it has some disadvantages. Lenient credit may result into bad debts losses that arise due to the non-payment credit sales. It also leads to liquidity problem, as when the firm is not able to receive the payment at a due date, it may become difficult to pay current maturing obligations.

2. **Stringent Credit Policy:** This is the policy of credit where seller sells goods on credit on a highly selective basis, i.e. the customers who have proven creditworthiness and financially sound will granted credit facility. Advantages of this policy can be minimum bad debt losses due to selected creditworthy customers. A firm here also benefits with sound liquidity position. However this policy is not free from its limitations. It restricts sale and thereby profit. It may also fails to utilize its resources efficiently, that leads to increase in cost per unit.

It is always advisable to the firms that their credit policy should lay between lenient and stringent credit policy. In other words, they follow optimum credit policy. Optimum credit policy involves a balance between costs and benefits. The major considerations in costs are liquidity and opportunity costs. The optimum credit policy occurs at the point where there is a trade off between liquidity and profitability. Therefore, the management has to strike a balance between easy credit to promote sales and profit and tight credit to improve liquidity. The important variables of credit policy should be identified before establishing an optimum credit policy.

Debtors due over 90 days (unless within agreed credit terms) should generally demand immediate attention. Look for the warning signs of a future bad debt. For example:

- longer credit terms taken with approval, particularly for smaller orders.
- use of post-dated checks by debtors who normally settle within agreed terms.
- evidence of customers switching to additional suppliers for the same goods.
- new customers who are reluctant to give credit references.
- receiving part payments from debtors.
In short it is very important to know that profit only come from the paid sales.

**Strategies in working Capital Management:** So far the banks were the sole source of funds for working capital needs of the business organization. However, many more finance options are available to smooth business operations presently. Depending upon firm’s risk taking ability, following strategies can be adopted for the management of working capital.

1. **Conservative Approach:** This approach suggests how to maintain high level of current assets in relation with the sales. According to the followers of this approach, surplus current assets help to meet unforeseen variation in production plan, sales, lead time in procurement of material without disturbing production plan. There would not be stoppage of the business operations due to shortage of funds, raw materials, or consumables. Sufficient stock of finished goods will also be maintained to meet the market fluctuations. The higher the liquidity levels reduce the risk of insolvency. However, lower risk may be translated into lower returns. Excess investment in current assets may lead to higher interest (cost of capital) and carrying cost. This strategy also suggests the need of working capital should be financed by long term funds like share capital or long term debts. The excess cash is invested in short-term marketable securities and in need; these securities are sold-off in the market to meet the urgent requirements of working capital. However, the cardinal principle of corporate finance states that, long term assets should financed by long term source and short term assets by a mix of long term and short term sources.

2. **Aggressive Approach:** Unlike conservative approach in this approach current assets are just maintain to meet the current liabilities without keeping any cushion for variation in working capital needs. The core working capital is financed by long term sources of capital, and seasonal various are satisfied through short term borrowings. Adoption of this strategy avoids excess investment in net working capital and thereby cost of financing working capital. However due to this strategy firm may need to
make frequent arrangements of working capital finance and may not meet sudden business fluctuations.

3. **Matching Approach:** Under matching approach to financing working capital requirements of a firm, each asset in the balance sheet assets side would be offset with a financing instrument of the same approximate maturity. The basic objective of this method of financing is that the permanent component of current assets and fixed assets is to be met with long term funds and the short term and seasonal variations in the current assets would be financed with short term debt. If the long term funds are used for short terms needs of the firm, it can identify and take steps to correct the mismatch in financing. Efficient working capital cycle reduces the operating cycle. The length of the operating cycle is equal to the sum of the lengths of the inventory period and the receivables period. Just in time inventory management technique reduce carry costs by that goods are parked as inventories. To shorten the receivables period without necessarily reducing the credit period, corporate can offer trade discounts for prompt payment. This strategy also called as ‘hedging approach’.

4. **Zero Working Capital Approach:** Using this strategy for working capital management is the latest trend in corporate. In this approach current assets are always equal to current liabilities. The excess investment in current assets is. Current ratio is 1 and quick ratio is below 1. There may be threat of liquidity crisis, however, if all current assets handle effectively and accounted at their realizable values, this fear can be omitted. The opportunity cost can be saved by avoiding excess investment in current assets and as bank cash credit limits are linked to the inventory levels, interest cost is also saved. Further there would be a self imposed financial discipline on the firm to manage their activities within their current liabilities and current assets.

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This approach also helps to control over borrowing or diversion of funds. Zero working capital also ensure a smooth and uninterrupted working capital cycle at the same time it pressurized the finance managers to improve quality of current assets always. There should also be a continuous displacement in current liabilities and the possibilities of having over dues should be avoided. Zero working capital approach ensures good balancing act in financial management.

**Working Capital Policies:** It is determine by the degree of investment in current assets for achieving a expected level of sales. These policies can be restricted or aggressive, relaxed or conservative and moderate. Under restrictive policy the company maintains the lower investment in current assets. This policy also does not suggest any provision for contingencies or unexpected events. It represents the aggressive approach and expects high return with the acceptance of higher risk. Unlike, this approach a relaxed policy represents conservative approach. It recommends cushion of sufficient funds to meet uncertainties, contingencies, seasonal fluctuations, changes in activity levels, changes in sales etc. The level of current assets ensures the liquidity here. However, marginal returns are also lesser. Moderate working capital ensures expected profitability and risk levels which fall between restricted and relaxed working capital policies.