2.10.Management of Working Capital :

Working capital management, therefore refers to all aspects of the administration of both current assets and current liabilities. In other words, working capital Management is concerned with the problems that arise in attempting to manage the current assets, current liabilities and the interrelationships that exist between them.

The basis objective of working capital management is to manage firms current assets and current liabilities in such a way that the satisfactory level of working capital is maintained i.e., it is neither inadequate nor excessive. The current assets should be sufficient enough to cover current liabilities in order to maintain a reasonable safety margin. Moreover, different components of working capital are to be properly balanced. In the absence of such a situation, the financial position in respect of the firms liquidity may not be satisfactory ins spite of satisfactory liquidity ration.

Working capital management policies have a great effect on firms profitability, liquidity and its structural health. A finance manager should, therefore, chills out appropriate working capital management policies in respect of each of the components of working capital so as to ensure higher profitability, proper liquidity and sound structural health of the organization.

The management of working capital has been studied under the following three heads in this chapter.

Ref. : Dr.S.N.Maheshwari, Financial Mangt., Sultan Chand & Sons, 2004.

1. Management of cash.
2. Management of accounts receivables and
3. Management of inventory.

2.11.a. Management of Cash

INTRODUCTION

Cash is one of the current assets of a business it is needed at all times to keep the business going. A business concern should always keep sufficient cash for meeting its obligations. Any shortage of cash for meeting its obligations. Any shortage of cash will hamper the operations of a concern and any excess of it will be unproductive. Cash is the most unproductive of all the assets. While fixed assets like Machinery plant, etc. and current assets such as inventory will help the business in increasing its earning capacity, cash in hand will not add anything to the concern.

Cash Management :

Cash Management has assumed importance because it is the most significant of all the current assets it is required to meet business obligations and it is unproductive when not used.

Cash Management deals with the following.

i) Cash inflows and outflows.
ii) Cash flows within the firm.
iii) Cash balances held by the firm at a point of time.

Cash Management needs strategies to deal with various facets of cash following are some of its facets :

Ref. : Gupta & Sharma, Fin.Mangt., Kalyani Publishers, 2004.

a) Cash Planning :

Cash planning is a technique to plan and control the use of cash. A projected cash flow statement may be prepared, based on the present business operations and anticipated future activities. The cash inflows from various sources may be anticipated and cash outflows will determine the possible used of cash.

b) Cash forecasts and budgeting :

A cash budget is the most important device for the control of receipts and payments of cash. A cash budget is an estimate of cash receipts and disbursements during a future period of time. It is an analysis of flow of cash in a business over a future, short or loan period of time. It is a forecast of expected cash intake and outlay.

The short term forecasts can be made with the help of cash flow projections. The finance manager will make estimates of likely receipts in the near future and the expected disbursements in that period. Though it is not possible to make exact forecasts even then estimates of cash flows will enable the planners to make arrangement for cash needs. It may so happen that expected cash receipts may fall short or payments may exceed estimates. A financial manager should keep in mind the sources from where he will meet short term needs. He should also plan for productive use of surplus cash for short periods.

The long term cash forecasts are also essential for proper cash planning. These estimates may be for three, four, five or more years. Long term, forecasts indicate company's future financial needs for working capital, capital projects etc.

Ref. : Gupta & Sharma, Fin.Mangt., Kalyani Publishers, 2004.

Both short term and long term cash forecasts may be made with the help of following methods :

i) Receipts and disbursements method.

ii) Adjusted net income methods.

i) Receipts and disbursements method :

In this method the receipts and payments of cash are estimated. The cash receipts may be from cash sales, collections from debtors, sale of fixed assets, receipts of divided or other incomes of all the items : it is difficult to forecast sales. The sales may be on cash as well as credit basis. Cash sales will bring receipts at the time of sale while credit sales will bring cash later on. The collections from debtors (credit sales) will depend upon the credit policy of the firm. Any fluctuation in sales will disturb the receipts of cash. Payments may be made for cash purchases to creditors for goods, purchase of fixed assets for meeting operating expenses such as wage bill, rent, rates, taxes or other usual expenses, dividend to shareholders etc.

The receipts and disbursements are to be equaled over a short as well as long periods. Any shortfall in receipts will have to be met from banks or other sources. Similarly, surplus cash may be invested in risk free marketable securities. It may be easy to make estimates for payments but cash receipts may not be accurately made. The payments are to be made by outsiders, so there may be some problem in finding out the exact receipts at a particular period. Because of uncertainty, the reliability of this method may be reduced.

Ref. : Gupta & Sharma, Fin. Mangt., Kalyani Publishers, 2004.

II) Adjusted Net Income Method :

This method may also be known as sources and uses approach it generally has three sections : Sources of cash uses of cash and adjusted cash balance. The adjusted net income method helps in projecting the company's need for cash at some future date and to see whether the company will be able to generate sufficient cash. If not then it will have to decide about borrowing or issuing shares, etc. In preparing its statement the items like net income deprecation, dividends, taxes, etc. can easily be determined from company's annual operating budget. The estimation of working capital movement becomes difficult because items like receivables and inventories are influenced by factors such as fluctuations in raw material costs, changing demand for company's products and likely delays in collections. This method helps in keeping a control on working capital and anticipating financial requirements.

Ref. : Gupta & Sharma, Fin.Mangt., Kalyani Publishers, 2004.

Investment Of Surplus Funds :

There are, sometimes, surplus funds with the companies which are required after sometime. These funds can be employed in liquid and risk free securities to earn some income. There are a number of avenues where these funds can be invested. The selection of securities or method of investment is very important. Some of these methods are discussed herewith:

1. **Treasury Bills :**

The treasury bills are issued by RBI on behalf of the Central Government. Earlier they were issued on the basis of tenders floated regularly but now are available on tap system, i.e., on rates announced by RBI every week. These bills are issued only in bearer form. Name of the purchaser is not mentioned on the bills, rather they are easily transferable from one investor to another. No interest is paid on the bills but the return is the difference between the purchase price and face (par) value of the bill. Since there is a backing of the Central Government, these are risk free securities. A very active secondary market exists for these bills so it has made them highly liquid. Treasury bills are one of the popular marketable securities even though the yield on them may be low.

2. **Negotiable Certificates of Deposit (CD's) :**

The money is deposited in a bank for a fixed period of time and marketable receipt is issued. The receipt may be registered or bearer, the latter facilitates transactions in the secondary market. The denominations and maturity periods are decided as per the needs of the investor. On maturity the amount deposited and interest are paid. The CD's are different from the treasury bills which are issued on discount. The short-term surplus funds can be used to earn interest in this method. The investment is secure unless the bank fails, the chances of which are remote.

3. Unit 1963 Scheme :

The Unit Trust of India's unit 1964 scheme is very popular for making short term investments. It is an open ended scheme which allows investors to withdraw their funds on a continuing basis. The units have a face value of Rs.10. The purchase and sale value of units is not based on net assets value but it is determined administratively in such a manner that they rise gradually over time.

4. Ready Forwards :

A commercial bank or some other organization may enter into a ready forward deal with a company willing to invest funds for a short period of time. Under this system the bank sells and repurchases the same security (that means that company purchases and sells securities in turn) at predetermined prices. The difference between the purchase and sale price is the income of the company. Ready for wards are generally done in units, public sector bonds or government securities. Ready forward deals are linked with the position of the money market. The investor can hope to earn more if money market is tight during busy season and at closing of the year.

5. Badla Financing :

Badla financing is used in stock exchange transactions when a broker wants to carry forward his transactions from one settlement period to another. Badla financing is done through operators in stock exchange. It is the financing of transactions of a broker who wants to carry forward this deal to the other settlement period. The badla rates are decided on the day of settlement. Badla transaction is financed on the security of shares purchased whose settlement is to be carried forward. Sometime this financing facility may be extended for a particular share only. For example, a company may provided badla finance to a broker Rs.10 crores for purchasing ACC shares in forward market. Badla rates vary with demand and supply position of funds.

6. Inter- Corporate Deposits :

These are short term deposits with other companies which attract a good rate of return. Inter-corporate deposits are of three types :

i) Call Deposits :

It is a deposit which a lender can withdraw on one day's notice. In practice it takes three days to get this money. The rate of interest at present is 14 per cent on these deposits.

ii) Three Months Deposits :

These deposits are popular and are used by borrowers to tide over short -term inadequacy of funds. The interest rate on such deposits is influenced by bank overdraft interest rate and at present the borrowing rate is 22 per cent per annum.

iii) Six-month Deposits:

The lenders may not have surplus funds for a very long period. Six-month period is normally the maximum which lenders may prefer. The current interest rate on these deposits is 24 per cent per annum.

7. Bill Discounting :

A bill arises out of credit sales. The buyer will accept a bill drawn on him by the seller. In order to raise funds the seller may get the bill discounted with his bank. The bank will charge discount and release the balance amount to the drawer. These bills normally do not exceed 90 days.

A company may also discount the bills as a bank does thus using its surplus funds. The bill discounting is considered superior to inter- corporate deposits. The company should ensure that the discounted bills are (a) trade bills (resulting from a trade transaction) and not accommodation bills (helping each other). b) the bills backed by the letter of credit of a bank will be most secure as these are guaranteed by the drawee's bank.

8. Investment in Marketable Securities :

A firm has to maintain a reasonable balance of cash. This is necessary because there is no perfect balancing of inflows and outflows of cash. Sometimes more cash is it in marketable securities. It will bring some income to the business. The cash surpluses will be available during slack seasons and will be required when demand picks up again. The investment of this cash in securities needs a prudent and cautious approach. The selection of securities for investment should be carefully made so that the amount is raised quickly on demand.

9. Money Market Mutual Funds (MMMF) :

'Money market mutual fund' means a scheme of a mutual fund which has been set up with the objective of investing exclusively in money market instruments. These instruments include treasury bills, dated Government securities with an expired maturity of up-to one year, call and notice money, commercial paper, commercial bills accepted by banks and certificates of deposits. Till recently, only commercial banks and public financial institutions were allowed to set up MMMFs. But in November 1995, the Government has permitted private sector mutual funds also to set up money market mutual fund. MMMFs are wholesale markets for low risk, high liquidity and short-term securities. The main feature of this fund is the access to persons of small savings.

Ref. : Gupta & Sharma, Fin.Mangt., Kalyani Publisher, 2004.

2.12.b. Receivables Management

Introduction :

A sound managerial control requires proper management of liquid assets and inventory. The assets are a part of working capital of the business. An efficient use of financial resources is necessary to avoid financial distress. Receivables results from credit sales. A concern is required to allow credit sales in order to expand its sales volume. It is not always possible to sell goods on cash basis only sometimes, other concerns in that line might have established a practice of selling goods on credit basis. Under these circumstances, it is not possible to avoid credit sales without adversely affecting sales. The increase in sales is also essential to increase profitability. After a certain level of sales the increase in sales will not proportionately increase production costs. The increase in sales will bring in more profit.

Thus, receivables constitute a significant portion of current assets of a firm But, for investment in receivables, a firm has to incur certain costs. Further, there is a risk of bad debts also. It is, therefore, very necessary to have a proper control and management of receivables.

Meaning of Receivables :

Receivables represents amounts owed to the firm as a result of sale of goods or services in the ordinary course of business. These are claims of the firm against its customers and form part of current assets.

Ref. : Gupta & Sharma, Financial Management, Kalyani Publishers, 2004.

Receivables are also known as accounts receivables, trade receivables, customers receivables or book debts. The receivables are carried for the customers. The period of credit and extent of receivables depends upon the credit policy followed by the firm. The purpose of maintaining or investing in receivables is to meet competition, and to increase the sales and profits.

Meaning and Objectives of Receivables Management :

Receivables management is the process of making decisions relating to investment in trade debtors. The investment in receivables is necessary to increase the sales and profits of a firm. But at the same time investment in this asset involves cost consideration also. Further, there is always a risk of bad debts too. Thus, objective of receivables management is to take a sound decision as regards investment in debtors.

In the words of Bolton, S.E., the objective of receivables management is "to promote sales and profits until that point is reached where the return on investment in further funding of receivables is less than the cost of fund raised to finance that additional credit."

Ref. : Gupta & Sharma, Fin.Mangt., Kalyani Publishers, 2004.

Dimensions Of Receivables Management :

Receivable management involves the careful consideration of the following aspects :

1. Forming of credit policy.
2. Executing the credit policy.
3. Formulating and executing collection policy.

4) Forming of Credit Policy :

For efficient management of receivables, a concern must adopt a credit policy. A credit policy is related to decisions such as credit standards, length of credit period, cash discount and discount period, etc.

5) Quality of Trade Accounts or Credit Standards :

The volume of sales will be influenced by the credit policy of a concern. By liberalizing credit policy the volume of sales can be increased resulting into increased profits. The increased volume of sales is associated with certain risks too. It will result in enhanced costs and risks of bad debts and delayed receipts. The increase in number of customers will increase the clerical work of maintaining the additional accounts and collecting of information about the credit-worthiness of customers. There may be more bad debt losses due to extension of credit to less worthy customers. These customers may also take more time than normally allowed in making the payments resulting into tying up of additional capital in receivables. On the other hand, extending credit to only credit worthy customers will save costs like bad debt losses, collection costs, investigation costs, etc. The restriction of credit to such customers only will certainly reduce sales volume, thus resulting in reduced profits.

6) Length of Credit Period :

Credit terms or length of credit period means the period allowed to the customers for making the payment. The customers paying well in time may also be allowed certain cash discount. There is no binding on fixing the terms of credit. A concern fixes its own terms of credit depending upon its customers and the volume of sales. The customers of industry act as constraints on credit terms of individual concerns. The competitive pressure from other firms compels to follow similar credit terms, otherwise customers may feel inclined to purchase from a firm which allows more days for paying credit purchases. Sometimes more credit time is allowed to increase sales to existing customers and also to attract new customers. The length of credit period and quantum of discount allowed determine the magnitude of investment in receivables.

A firm may allow liberal credit terms to increase the volume of sales. The lengthening of this period will mean blocking of more money in receivables which could have been invested somewhere else to earn income. There may be an increase in debt collection costs and bad debt losses too. If the earnings from additional sales by lengthening credit period are more than the additional costs then the credit terms should be liberalized.

7) Cash Discount :

Cash discount is allowed to expedite the collection of receivables. The funds tied up in receivables are released. The concern will be able to use the additional funds received from expedited collections due to cash discount. The discount allowed involves cost. The financial manager should compare the earnings resulting from released funds and the cost of discount. The discount should be allowed only if its cost is less than the earnings from additional funds. If the funds cannot be profitably employed then discount should not be allowed.

8) Discount Period :

The collection of receivables is influenced by the period allowed for availing the discount. The additional period allowed for this facility may prompt some more customers to avail discount and make payments. This will mean additional funds released from receivables which may be alternatively used. At the same time the extending of discount period will result in late collection of funds because those who were getting discount and making payments as per earlier schedule will also delay their payments. For example, if the firm allowing cash discount for payments within seven days now extends it to payments within fifteen days. There may be more customers availing discount and paying early but there will be those also who were paying earlier within seven days will now pay in fifteen days. It will increase the collection period of the concern.

9) Executing Credit Policy :

After formulating the credit policy, its proper execution is very important. The evaluation of credit applications and finding out the credit worthiness of customers should be undertaken.

10) Collecting Credit Information :

The first step in implementing credit policy will be to gather credit information about the customers. This information should be adequate enough so that proper analysis about the financial position of the customers is possible. This type of investigation can be undertaken only up to I certain limit because it will involve cost. The cost incurred in collecting this information and the benefit from reduced bad debt losses will be compared. The credit information will certainly help in improving the quality of receivables but the cost of collecting information should not increase the reduction of bad debts losses.

The sources from which credit information will be available should be ascertained. The information may be available from financial statements, credit rating agencies, reports from banks, firm's records etc. Financial reports of the customer for a number of years will be helpful in determining the financial position and profitability position.

Credit information may be available with banks too. The banks have their credit departments to analyze the financial position of a customer.

In case of old customers, business's own records may help to know their credit worthiness.

11) Credit Analysis :

After gathering the required information, the finance manager should analyse it to find out the credit worthiness of potential customers and also to see whether they satisfy the standards of the concern or not. The credit analysis will determine the degree of risk associated with the account, the capacity of the customer to borrow and his ability and willingness to pay.

12) Credit Decision :

After analyzing the creditworthiness of the customer, the finance manager has to take a decision whether the credit is to be extended and if yes then up to what level. He will match the creditworthiness of the customer with the credit standards of the company. If customer's creditworthiness is above the credit standards then there is no problem in taking a decision. It is only in the marginal cases that such decisions are difficult to be made. In such cases the benefit of extending the credit should be compared to the likely bad debt losses and then a decision should be taken. In case the customer's are below the company's credit standards then they should not be out rightly refused. Rather they should be offered some alternative facilities.

13) Financing Investments in Receivables and Factoring :

Accounts receivables block a part of working capital. Efforts should be made that funds are not tied up in receivables for longer periods. The finance manager should make efforts to get receivables financed so that working capital needs are met in time.

The banks allow raising of loans against security of receivables. Generally, banks supply between 60 to 80 per cent of the amount of receivables as loans against their security. The quality of receivables will determine the amount of loan. The banks will accept receivables of dependable parties only. Another method of getting funds against receivables is their outright sale to the bank. The bank will credit the amount to the party after deducting discount and will collect the money from the customers later. Here too, the bank will insist on quality receivables only. Besides banks, there may be other agencies which can buy receivables and pay cash for them. This facility is known as factoring. The factor will purchase only the accounts acceptable to him and may refuse purchase in certain cases. The factoring may be with or without recourse. If it is without recourse then any bad debt loss is taken up by the factor but if it is with recourse then bad debts losses will be recovered from the seller. The factor may suggest the customers for whom he will extend this facility.

14) Formulating And Executing Collection Policy :

The collection of amounts due to the customers is very important. The concern should devise procedures to be followed when accounts become due after the expiry of credit period. The collection policy be termed as strict and lenient. A strict policy of collection will involve more efforts on collection. Such a policy has both plus and negative effects. This policy will enable early collection of dues and will reduce bad debt losses. The money collected will be used for other purposes and the profits of the concern will go up. On the other hand a rigorous collection policy will involve increased collection costs. It may also reduce the volume of sales. A lenient policy may increase the debs collection period and more bad debt losses. A customer not clearing the dues for long may not repeat his order because he will have to pay earlier dues first, thus causing loss of customers. The collection policy should weight various aspects associated with it, the gains and losses of such policy and its effect on the finances of the concern.

Ref. : Gupta & Sharma, Fin.Mangt., Kalyani Publisher, 2004.

2.13.c. Management of Inventory

Inventory means the stock of the product and the components of the product i.e. raw materials, work in progress and finished goods. Thus, a large part of working capital is invested in inventories. The management of inventories is, therefore necessary to avoid heavy losses due to leakage, the ft and wastage because neglecting the management of inventories may jeopardize the long run profitability of the concern and the concern may fall ultimately. Holding inventories involves storage costs. Inventory management will minimize these costs.

Meaning of Inventory :

Inventories are the stock of product of the company and component thereof that makeup the product. There are three types of inventories : raw materials, works in process, and finished goods. Raw materials are materials and components that are inputs in making the final product. Work in process, also called stock in process, refers to goods in the intermediate stages of production. Finished goods consist the final product that are ready for sales. While manufacturing firms generally hold all three types of inventories, distribution firms hold mostly finished goods.

Management of Inventory :

Inventories often constitute a major element of the total working capital and hence it has been correctly observed, "good inventory management is good financial management."

Ref.: Prashnna Chandra, Fin.Magt., Tata MC GRAW Hill, 1997.

Inventory management coverage a large number of issues including fixation of minimum and maximum levels, determining the size of the inventory to be carried, deciding about the issue price policy : setting up receipts and inspection procedure, determining the economic order quantity; providing proper storage facilities, keeping check on obsolescence and setting up effective information system with regard the inventories. However management of inventories involves two basis problems :

1. Maintaining sufficiently large size of inventory for efficient and smooth production and sales operation.
2. Maintaining minimum investment in inventories to minimize the direct indirect costs associated with holding to maximize the profitability.

Inventory should neither be excessive nor inadequate. If inventory are kept at a high level, higher interest and storages cost would be incurred. On the other hand, a low level of inventory may result in frequent interruption in the production schedule resulting in under utilization of capacity and lower sales.

Objects of Inventory Management :

The main objectives of inventory management are operational and financial. The operational objectives mean that the material and spares should be available in sufficient quantity so that work is not disrupted for want of inventory. The financial objective means that investment in inventories should not remain idle and minimum working capital should be locked in it. The following are the objectives of inventory management :

Ref.: Dr.S.N.Maheshwari, Fin.Mangt., Sultan Chand & Sons, 2004.

1. To ensure continuous supply of materials, spares and finished goods so that production should not suffer at any time and the customers demand should also be meet.
2. To avoid both over-stocking and under – stocking of inventory.
3. To maintain investments in inventories at the optimum level as required by the operational and sales activities.
4. To keep material cost under control so that they contribute in reducing cost of production and overall costs.
5. To eliminate duplication in ordering or replenishing stocks. This is possible with the help of centralizing purchases.
6. To minimize losses through deterioration, pilferage, wastages and damages.
7. To design proper or organization of inventory management.
8. To ensure perpetual inventory control so that material shown in stock ledgers should be actually lying in the stores.
9. To ensure right quality goods at reasonable prices. Suitable quality standards will ensure proper quality of stocks. The price analysis, the cost analysis and value analysis will ensure payment of proper prices.
10. To facilitate furnishing of dates for short term and long term planning and control of inventory.

Ref. : Gupta & Sharma, Fin.Mangt., Kalyani Publishers, 2004.

Tools and Techniques of Inventory Management :

Following are the important tools and techniques of inventory management and control :

1. Determination of stock levels.
2. Determination of safety stocks.
3. Selecting a proper system of ordering for inventory.
4. Determination of Economic Order quantity.
5. A.B.C. Analysis.
6. VED. Analysis.
7. Inventory Turnover Ratios.
8. Aging schedule of Inventories.
9. Classification and codification of Inventory.
10. Preparation of Inventory Reports.

Ref.: Gupta & Sharma, Financial Management, Kalyani Publishers 2004.

Chapter No. 3. Profile of Rayat Sahakari Sakhar Karkhana Ltd., Shewalewadi (Masoli), Tal-Karad, Dist-Satara