Working capital and liquidity management in factoring : A comparative study of SBI and Canbank factors

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Working capital is a capital required to manage day to day operation of a business. Management of adequate working capital is essential as it has direct impact on profitability and liquidity. An attempt has been made in this paper to study the size and its components and liquidity management in factoring companies. The paper also makes an attempt to study the correlation between liquidity and profitability of factoring companies.SBI factors and CanBankFactors Ltd. were selected for the purpose of study. The study is based on secondary data collected from annual reports of SBI factors and Commercial Services Ltd. and CanBank Factors Ltd. Ratio analysis and percentage method and spearmans rank correlation have been used to analyse the data. T test was used to check the significance of correlations. It was observed from the study that the sundry debtors and amount due to creditors are the major components of current assets and current liabilities in determining the size of working capital. Liquidity and profitability are inversely related to each other in both factoring companies. The liquidity of Canbank factors is strongly related to profitability than SBI factors.

Working capital in business is considered as life blood in human body. It is a capital required to operate business on day to day basis and it varies according to the nature of business, production, sales policies, turnover, credit period, collection period, etc. Broadly working capital management can be described as the administration of all aspects of current assets and current liabilities. Liquidity means the capacity of the firm to convert the assets into realisable value in money. It measures the ability of the firm to honour all the maturing obligations. Profitability is the rate of return on firms investment. It implies that return made on investment of fixed and current assets.

Debasish Sur, Joydeep Biswas and Prasenjit Ganguly (2001) attempted to study the association between liquidity and profitability of Indian private sector enterprises as a case study of Aluminium producing industry. HINDALCO and INDAL were selected as major aluminium producing units. They observed that there is a very high degree of positive correlation between liquidity and profitability of these companies. They also observed that liquidity variables jointly influences on profitability of the selected two companies.

These variables are working capital ratio, acid test ratio, working capital to sales, debtor-turnover ratio, inventory turnover ratio, current assets to total assets.

R. L. HYDERABAD (1999) found that long terms funds were used for working capital and observed that flexibility and adjustment in the requirement of working capital depends on the availability and the cost of working cpital.

Working Capital in Factoring

Factoring is the process of selling debts by seller or client and factor collects the debts from the customer or buyers. Factor makes pre-payment of 70-80 percent as advance and balance anmount is paid after the debt received from customers. The length of recov-

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ery period of debts spends upon the terms and conditions between customers and clients. The length of recovery period is one of the vital factors determines the size of working capital in factoring. Requirement of working capital will vary as turnover or factored debts varies. Factor has to pay advance around 70-80 percent immediately to client. The need of working capital increases as debt purchase increases. Factor will receive cash from client as per the terms and conditions between client and customers.

The working capital cycle in factoring companies will be as follows

CASH — Purchase of — Recovery of — CASH Debts from clients — debts

The working capital cycle in factoring is short as compared to manufacturing and processing industries. Inadequate working capital may create low liquidity which may lead to low profitability and low profitability may lead to low liquidity. At the same time excessive working capital may create idle fund where no profit is earned which may result in to low return on investment.

SBI Factors and Commercial Service Ltd.

SBI Factors and Commercial Service Ltd. is the factoring company set up in India in February 1991 and commenced business operation in April 1991. The company was promoted by SBI jointly with SIDBI, Union Bank of India, State Bank of Indore and State Bank of Saurastra. SBI Factors undertakes the responsibility of debt collection on all invoice factored, maintainance of sales ledger, informing monthly customer payment reports. The company at present handling domestic factoring on recource basis.

Can Bank Factors Ltd.

CanBank Factors Ltd. is the factoring subsidery of the Canara bank, set up in 1991 in association with Andhra bank and Small Industries Development Bank of India (SIDBI). Canbank Factors is one of the leading company in factoring industry in India. The company has been providing factoring services to large number of clients, having wide diversified base.

Problem to be investigated

Working capital has acquired a great significance and sound position in recent years with an objective of profitability and liquidity. The success or failure of business enterprise largely depends upon the management of working capital. Higher amount of working capital will increase the liquidity at the same time will create impact on profitability. Lower amount of working capital will decrease the liquidity but day to day functioning of business will also affected. Adequate amount of working capital is required for the business. Working capital in factoring needs to be studies since factoring is a process of purchasing debts from clients. Large amount of cash required to purchase the book debts and also it depends upon the recovery of debts. Thus it is essential to study the management of working capital in factoring companies and association of liquidity and profitability with reference to SBI and CanBank Factors.

Objectives of the study

1) To study the size composition of working capital in factoring companies.
2) To evaluate the liquidity management through ratio analysis.
3) To examine the relationship between liquidity and profitability of factoring companies.

Data and Methodology

The SBI and CanBank Factors are the factoring company considered for the proposed study. The study is based on purely secondary data collected from the annual reports of SBI and CanBank Factors from 1991-92 to 2000-01. The available data were properly analysed by using

a) Trend percentage

Size of working capital and its composition is analysed by using percentage method.

b) Ratio analysis

To examine the liqudity management of SBI and CanBank Factors various ratios are computed. The required ratios were computed as follows.

$$1)\ \text{Working capital ratio} = \frac{\text{Current Assets}}{\text{Current liabilities}}$$

Current Assets include sundry debtors, cash and bank balance and loans and advances. Current liabilities includes sundry creditors, amount due to clients on factored debts and provisions.

$$2)\ \text{Acid test ratio} = \frac{\text{Liquid Assets}}{\text{Current liabilities}}$$

Liquid Assets includes all current assets less prepaid expenses.

$$3)\ \text{Working capital turnover} = \frac{\text{sales}}{\text{working capital}}$$

Sales is considered as factored debts. Working capital includes net working capital derived by deducting current liabilities from current assets.

$$4)\ \frac{\text{Current Asset to}}{\text{Total Assets}} = \frac{\text{Current Assets}}{\text{Total Assets}} \times 100$$

$$5)\ \text{Debtor turnover ratio} = \frac{\text{Sales}}{\text{Average receivables}}$$

Average receivables is computed by taking debt receivables at the opening plus losing and dividing it by two.

To examine the association between liquidity and profitablilty Spearmens Rank correlation is used. The rank correlations were calculated as under

$$R = 1 - \frac{\sigma - [\Sigma d^2]}{n(n^2 - 1)}$$

Analysis & Discussion

The statement of working capital of SBI and CanBank Factors Ltd. is presented in table 1 and 2. It is observed from the table that the that sundry debtors, loans and advances and cash balance determines the composition of current assets whereas amount due to debts purchased, sundry creditors and provisions are the components of current liabilities. It can be seen from the table that sundry debtors is the major components of current assets and it contributes more than 95 percent of the size of the working capital whereas remaining assets fall below 5 percent of debts. The amount due for debt purchased is major component in current liabilities. The net working capital is derived by deducting current liabilities from current assets. It can be seen from the table that the size of working capital of SBI factors shows mixed trend. It is decreased in the year 92-93 and 93-94 where as increased from 94-95 to 2000-01 except in the year 98-99. The size of working capital of Canbank Factors Ltd. increase from 91-92 to 2000-01 except in the year 98-99. The increased in working capital in factoring companies is either due to increase in purchase of debts or due to delay in receiving of debts from the customers.

Working Capital Ratio

It is an yardstick for measuring short term solvency of the company i.e. its ability to meet short term obligations. It indicates the rupees of current assets available for each rupees of current liabilities/obligations. The sound working capital Ratio is considered as 2:1. It is observed from the table that WCR in SBI ranged from 2.14 to 12.2 times. This ratio establishes a relationship between quick or liquid assets and current liabilities. It is a widely used device for judging short-term debt repaying ability of concern. It is observed from the table that overall average ATR of SBI is 2.37 and canbank factors is 4.16 which is higher than the standard norm of 1:1. Higher liquidity in canbank factors signifies idle funds which will reduce profitability but in factoring business certain degree of liquidity is required since purchase of debts requires immediate funds.

Current Assets to Total Assets (CATA)

This ratio indicates the fund invested as working capital. It indicates the proportion of current assets to total assets. The overall average CATA of SBI factors recorded as 98.83 percent where as in CanBank Factors it was 96.82 percent. It indicates that the investment in current asset of both the companies is higher compared to investment in fixed assets. It reveals that SBI factor has given greater emphasis on working capital investment as compared to canbank factors. Higher investment in current asset will increase the liquidity and decrease the profitability. When the firms curent assets is very high it has excessive liquidity. Its return on assets will be low, as funds tied up in idle cash and high levels of debtors reduce profitability. Thus the cost of liquidity (through low rates of return) increases with the level of current assets. The cost of illiquidity is the cost of holding insufficient current asset. The firm will not be in a position to honour its obligations if it carries too little cash. This may force the firm to borrow at very high cost. The optimum level of current asset should be maintained by considering the concept of profitability , liquidity and solvency. In SBI Factors and CanBank Factors the cost of liquidity is more than illiquidity. This indicates that the level of current assets are higher which signifies that more investments are in current assets.

Working Capital To Sales

The working capital to sales ratio is calculated by dividing the amount of net sales by the amount of net working capital. A close relationship exists between sales and working capital. This ratio also helps to assess the degree of efficiency in the use of short term funds for operating sales. It is observed from the table that the overall average working capital to sales ratio of SBI factors is 6.75 and canbank factors is 6.30. Thus it indicates that for generating sale of one rupee the Rs 0.14 and Rs0.15 investment in working capital required in SBI factors and CanBank factors.

Debtor - Turnover Ratio

It can be observed from the table that Debtor -Turnover ratio of SBI factor and CanBank Factors is low. Low debtor - turnover ratio indicates inefficiency of management in collection of payments against credit sale in time or payments by debtors are delayed. Higher Debtor-turnover ratio indicates efficiency in collection of debts. Debtor -turnover ratio in SBI Factors and CanBank Factors 4.87 and 4.89 respectively. It indicates that credit management of canbank factors is efficient then SBI Factors.

The correlation between liquidity and profitability in the companies is computed by using spearmans rank correlations coefficient. Return On Investment(ROI) and Current Assets to Total Assets (CATA) were used as profitability and liquidity parameters. T -test was applied to test the significance of these coefficients. It canbe observed in the table that rank correlation coefficient between liquidity and profitability of SBI factors registered at -0.60 and T value at 77.447. The rank correlations of canbank factors recorded at -0.73 and T value at 133.127. It is observed in both companies that the liquidity and profitability is inversely related to each other. As liquidity increases the profitability decreases. The rank correlations of canbank factors is stonger-0.73 then SBI factor-0.60.It implies that the degree of liquidity is strongly related to profitability.

Conclusion

From the foregoing analysis it can

be concluded that the sundry debtors and amount due to creditors are three major components of current assets and current liabilities respectively in determining the size of working capital. The working capital ratio of canbank factors is higher then SBI factors. It implies that the ability of the canbank factors to settle the liabilities is higher then SBI factors. The Acid test ratio of Canbank Factors is higher then SBI Factors. Thus it indicates that the higher liquidity is maintained in canbank factors than SBI factors. The working capital turnover of SBI factors is higher then canbank factors. Thus it indicates that, to generate the sale of one rupee lesser amount is required in canbank factors then SBI factors. Debtor- Turnover ratio of canbank factors is higher than SBI factors thus it indicates the credit management of canbank factors is effective in collection of debts than SBI tactors. The rank correlations of liquidiiy and profitability observed to be inversely related to each other It implies that as the liquidity increases the profitability decreases.It was found that the Rank correltions of Canbank factors is stronger than SBI factors.

Suggestions

The investment in current asset is much higher in both the companies which should be reduced. The level of sundry debtors should be decreased by giving more stress on recovery of debts.Delay in recovery increases the amount of working capital which results in additional cost through increase in borrowing.

TABLE: 1

Statement of Working Capital (SBI Factors Ltd)

(Amount in Crs)

Items	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01
Current assets										
sundry Debtors	5.69 (19.7)	31.88 (93.)	28.15 (75.02)	64.09 (99.47)	91.43 (96.06)	92.92 (98.77)	117.17 (8.95)	132.3 (99)	137.7 (98.58)	133.14 (97.30)
Loans and Advances	3.34 (11.6)	2.00 (5.89)	4.09 (10.09)	0.11 (0.17)	0.70 (0.73)	0.51 (0.54)	0.82 (0.69)	0.81 (.60)	1.36 (0.97)	3.05 (2.22)
Cash&bank balances	1.7 (5.90)	.05 (0.14)	5.22 (13.91)	0.11 (0.17)	3.05 (3.20)	0.64 (0.68)	0.42 (0.35)	0.64 (0.47)	0.62 (0.44)	0.64 (0.46)
Other current assets	18.04 (62.70)		0.06 (0.15)	0.12 (0.18)						
Total	**28.77**	**33.93**	**37.52**	**64.43**	**95.18**	**94.07**	**118.41**	**133.8**	**139.69**	**136.83**
Current liabilities										
Amount due for debts purchased	1.80 (80.40)	10.69 (98.50)	14.36 (89.58)	27.85 (92.83)	49.41 (95.62)	34.49 (93.16)	46.54 (99.72)	43.02 (95.4)	42.77 (99.23)	42.36 (99.55)
Sundry creditors	0.27 (11.73)	0.03 (0.27)	0.15 (0.93)	0.15 (0.50)	0.10 (0.19)	0.19 (0.51)	0.08 (0.17)	0.15	0.32 (0.74)	0.12 (0.28)
Other liabilities	0.16 (6.95)	0.13 (1.19)	0.14 (0.87)	0.05 (0.16)	0.30 (0.58)	0.13 (0.35)	0.05 (0.10)	0.03 (.06)	0.01 (0.02)	0.07 (0.16)
Provisions		0.09 (0.82)	1.38 (8.60)	1.95 (6.50)	1.86 (3.59)	2.21 (5.96)		1.87 (4.1)		
Total current liabilities	2.27 (100)	10.8 (100)	16.03 (100)	30 (100)	51.67 (100)	37.02 (100)	46.67 (100)	45.07 (100)	43.10 (100)	42.55 (100)
NetWorking capital	**26.47**	**23.08**	**21.49**	**34.43**	**43.51**	**57.05**	**71.74**	**45.07**	**96.59**	**94.28**

Source: Annual Reports of SBI Factors Ltd.

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TABLE: 2

Statement of Working Capital (CAN BANK FACTORS LTD.) (Amount in Crs)

Items	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01
Current Assets										
SundryDebtors	12.50 *87.50*	45.29 *90.11*	73.06 *92.34*	91.63 *90.99*	94.42. *84.66*	106.1 *86.61*	110.6 *77.85*	117.43 *82.82*	123.30 *90.09*	156.86 *91.15*
Loans and Advances	0.23 *1.61*	1.49 *2.96*	3.59 *4.53*	6' *5.95*	8.86 *7.94*	12.6 *10.27*	12.97 *9.12*	11.22 *8.39*	12.06 *8.81*	14.31 *8.31*
Cash & Bank Balances	1.53 *10.72*	3.48 *6.92*	2.44 *3.08*	2.89 *2.86*	8.06 *7.22*	3.10 *2.52*	16.99 *11.95*	3.97 *2.97*	0.47 *0.34*	.003
Other Current Assets			0.03	0.18 *0.17*	0.18 *0.16*	0.71 *0.57*	1.50 *1.05*	1.08 *0.80*	1.03 *0.75*	0.91 *0.5*
Total	14.26 100	50.26 100	79.1 100	100.7 100	111.5 2 100	122.6 0 100	142.0 6 100	133.67 100	136.86 100	172.08 100
Current Liabilities										
Amount due for debts purchased	3.80 92.90	12.64 *80.56*	19.55 *77.82*	27.04 *76.2*	30.42 *69.70*	36.09 *70.10*	34.36 *67.43*	53.24 *77.14*	------	-----
Sundry Creditors	0.04 *0.97*	0.23 *1.46*	0.24 *0.95*	0.01 *0.02*	0.01 *0.02*	0.16 *0.31*	0.18 *0.35*	0.19 *0.27*	0.60 *4.42*	2.49 *13.23*
Other liabilities	0.040 0.97	0.51 *3.25*	0.83	1.08 *3.04*	1.60 *3.66*	1.31 *1.84*	2.02 *3.96*	3.00 *4.34*	1.55 *11.43*	1.22 *6.48*
Provisions	0.21 *5.13*	2.31 *14.72*	4.50 *3.30*	7.32 *20.64*	11.61 *26.60*	13.92 *27.03*	14.39 *28.24*	12.58 *18.22*	11.40 *84.13*	15.11 *80.28*
Total Current Liabilities	4.09 *100*	15.69 *100*	25.12 *100*	35.45 *100*	43.64 *100*	51.48 *100*	50.95 *100*	69.01 *100*	13.55 *100*	18.82 *100*
Working Capital	10.17	34.57	54	65.25	67.88	71.12	91.11	64.66	123.31	153.26

Source: Annual Reports of Can Bank Factors Ltd.

Figures in italic shows the percentage to total

Table 3
LIQUIDITY MANAGEMENT OF FACTORING COMPANY

Period	SRI FACTORS LTD					CAN BANK FACTORS LTD :				
	WCR	ACR	WTR	CATR	DTR	WCR	ACR	WTR	CATR	DTR
91-92	12.2	3.21	1.11	95.13	---	0.28	3.41	----	97.8	----
92-93	3.10	0.29	5.18	86.75	5.85	3.20	3.10	4.69	98.97	5.61
93-94	2.34	2.08	7.56	83.86	5.41	0.31	3.00	5.82	98.54	5.31
94-95	2.14	2.14	5.88	95.45	4.39	2.83	2.66	7.28	96.59	5.76
95-96	1.84	1.82	9.97	99.24	5.58	2.55	2.34	7.26	96.51	5.29
	4.32	*1.90*	*5.94*	*92.08*	*5.30*	*1.83*	*2.90*	*6.26*	*97.68*	*5.49*
96-97	2.53	2.52	7.67	99.30	4.75	2.38	2.12	6.69	95.47	4.74
97-98	2.43	2.42	6.42	99.25	4.38	2.78	2.50	5.13	95.90	4.31
98-99	2.96	2.95	10.46	99.36	3.78	2.70	2.52	8.98	96.44	4.12
99-00	3.24	3.2	5.35	99.48	3.83	10.19	9.14	5.13	95.78	4.19
00-01	3.21	3.14	7.95	99.50	5.53	9.14	8.38	5.78	96.73	4.09
	2.80	*2.84*	*7.57*	*99.37*	*4.45*	*5.43*	*4.93*	*6.34*	*96.06*	*4.29*
Grand Mean	3.59	2.37	6.75	95.72	4.87	3.63	3.91	6.30	96.87	4.89

Source:- Annual Repots of SBI and CanBankFactors (various issues)

WCR- Working Capital Ratio CATR- Current Asset Total Assets Ratio

DTR- Debtor Turnover Ratio WCT - Working Capital Turnover

ATR - Acid Test Ratio

WCR, DTR, ATR, and WCT are expressed in no. of times whereas CATR is expressed in percentage

Figures in italic represent ratios over a peroid of five years

Table - 4

Rank correlation between liquidity and profitability of SBI factors and CanBank Factors

	SBI FACTORS				CANBANK FACTORS			
Period	CATA %	Liquidity rank	ROI %	Profitability rank	CATA %,	Liquidity rank	ROI %	Profitability rank
1991-92	95.13	10	8.03	3	97.80	3	4.52	9
1992-93	99.47	3	10.70	1	98.97	1	5.19	7
1993-94	98.50	9	8.37	2	98.54	2	3.21	10
1994-95	99.06	8	6.33	4	96.59	5	5.38	6
1995-96	99.17	7	4.06	7	96.51	6	6.10	3
1996-97	99.30	5	4.77	5	95.47	10	6.58	2
1997-98	99.25	6	4.71	6	95.90	8	5.60	5
1998-99	99.36	4	3.86	8	96.44	7	4.89	8
1999-00	99.48	2	2.94	9	95.78	9	7.33	1
2000-01	99.50	1	(0.15)	10	96.73	4	6.05	4

Source:- Annual Reports of SBI Factors and CanBank Factors (various issues)

Note: Rank correlation coefficient between liquidity and profitability of SBI factors (r_H) =-0.60 and T of (r_H) =77.447

Note: Rank correlation coefficient between liquidity and profitability of CanBank Factors is (r_H) =-0.73 and t value of (r_H)=133.127 significant at 0.05 level.