

COOL-AID PRIVATE LIMITED

Radhemohan Gupta and Manmohan Gupta, two brothers, promoted Cool-Aid Private Limited (CAPL) near Delhi in 2008. They contributed an initial capital of Rs. 80 lakh in addition to the contributions from their near relatives. The two brothers, however, owned about 60 per cent of the capital and are solely responsible for running the business. They are engineering graduates from one of the technology institutes in India. They entered the air-cooler market and developed a unique model called, Cool-Aid, to cater to the needs of the customers located in Delhi, Haryana and Rajasthan. Unlike most of their competitors, they manufactured all the components of an air-cooler in their factory. Both of them are competent engineers with good understanding of marketing.

PRODUCT AND MARKET

Cool-Aid is an excellent high-tech product. Unlike other available coolers in the market, it has an elegant look like an air-conditioner. It makes less noise. Cool-Aid delivers 3,500 cubic feet of cool air per minute and its water tank has a capacity of 50 litres which keeps air cool for about eight hours. The model is reasonably priced as compared to the competitive models; it costs about Rs. 5,000 including all taxes. Thus, CAPL has been able to sell well and expand rapidly. It sold 4,992 coolers in 2009, which increased to 6,140 units in 2010, and further to 7,350 units in 2011. The summarized balance sheet and profit and loss account are given in Exhibits I and II.

FINANCE OF OPERATIONS

CAPL has made judicious use of equity and debt capital to finance its growth during the last three years. Its debt-equity ratio is about 1:4. The lenders are not prepared to extend further loan to the company unless it increases its equity capital. Neither Radhemohan and Manmohan nor the other shareholders of the company have personal funds to invest in the business. Nor do they want to become public for fear of dilution of ownership.

Both the brothers have no training in finance. To take care of the financial activities of the company's operations, they had been relying on their accountants. Their bank and other lenders

have indicated to them that their management of funds was not up to the mark. Particularly the management of accounts receivables was very poor. The company's average collection period of last three years had been around 93 days. However, it has a tight control over inventory.

CREDIT POLICY

The company has about 1,080 small and medium sized enterprises as dealers, spread over the cities and main towns of Haryana, Rajasthan and Delhi. The company has a policy of extending a credit of 60 days, but most of its dealers in the recent period have stretched payments. The average collection period of the company last year, based on year-end figures, was about 120 days. In addition to the salesmen who also do the job of collection, CAPL has employed three collection officers. The total collection expenses which include salaries, travel, etc. amount to about Rs. 2 lakh per year. Ninety per cent of the firm's sales are on credit basis. Out of this, 15 per cent is sold to the customers whose financial position is not very sound. In fact, the entire bad debt losses which amounted to about 2 per cent of sales to these customers and three-fourth of the collection expenses are attributable to these accounts. The company's sales are highly seasonal in character; about two-thirds of the sales take place during the period from January to April.

The company is expecting a 20 per cent increase in sales over last year's sales. The company's cost of goods sold is 80 per cent. After consulting the marketing and accounting staff and analyzing the status of competition, the company has decided to change its credit policy. Given the acute competition and availability of cheaper models, the company did not want to change the credit period for its prompt customers. However, it has decided to offer cash discount to motivate customers to pay early. The new credit terms would be "2/15, net 60". A quick study of sample customers indicated that about two-thirds of them might like to avail cash discounts. This change in policy would not change the expected sales, but the average collection period of the prompt customers is likely to reduce to 80 days.

The company has also decided to relax its credit standards to expand its sales. This is expected to increase sales by 10 per cent. The marginal customers, which would also include new customers, are not expected to take advantage of cash discounts and are likely to continue to take on an average 150 days to pay. In the case of these customers, bad debt losses are expected to increase to 2.5 per cent. The company would enforce collections with more vigour. It is expected that collection expenses would increase by Rs. 50,000 per annum. The company generally requires a rate of return of 15 per cent from its investments.

DISCUSSION QUESTIONS

1. Why CAPL has a high investment in accounts receivables? Should the company reduce its sales to the marginal accounts to improve its profitability?
2. What are the peculiar features of CAPL's credit policy changes? Discuss the implications of these changes. What credit policy would you recommend to Mr. Gupta? What are

the implications of your suggested policy on company's profitability and financing requirements?

3. If you are CAPL's financial advisor, would you recommend
 - (a) relaxation of its credit standards to 75 days and thus increasing sales by 10 per cent, or
 - (b) introduction of cash discount of "2/15 net 60"? Show your calculations.
4. Do you think average collection period is relevant criterion for monitoring CAPL's accounts receivables?

	2009	2010	2011
Sales	251.45	306.96	357.20
Less: Cost of goods sold	203.85	243.15	287.10
Gross profit	47.60	63.81	70.10
Less: Interest	6.03	14.57	10.00
Provision charges	1.67	1.86	1.80
Bad debt losses	0.69	0.93	0.80
Other expenses	6.46	8.89	10.70
Profit before tax	17.31	18.30	20.70
Profit after tax	15.44	19.26	17.30

	2009	2010	2011
1. All collection charges are fixed	44.76	10.04	87.50
2. During the year 2010-11, 60 percent of other expenses were fixed and the remaining 40 per cent were variable	67.96	42.47	109.87
Total	114.70	52.44	197.37

Exhibit I

COOL-AID PRIVATE LIMITED

Summarized Balance Sheet

as on March 31

(Rupees in lakh)

	2009	2010	2011
ASSETS			
Cash	3.35	5.26	7.14
Accounts receivables	40.47	72.94	107.10
Inventory	20.12	42.95	70.00
<i>Current assets</i>	63.94	121.15	184.24
Net fixed assets	100.40	124.15	142.80
<i>Total assets</i>	<u>164.34</u>	<u>245.30</u>	<u>327.04</u>
LIABILITIES			
Creditors	10.04	14.00	17.90
Accruals	3.35	4.20	5.40
Bank borrowing	10.04	44.76	63.90
<i>Current liabilities</i>	23.43	62.96	87.20
Long-term debt	45.47	67.64	109.61
Share capital	95.44	114.70	130.23
<i>Total liabilities</i>	<u>164.34</u>	<u>245.30</u>	<u>327.04</u>

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Exhibit II**COOL-AID PRIVATE LIMITED****Summarized Profit and Loss Account
for year ending on March 31**

(R) (lakh)

(Rupees in lakh)

	2009	2010	2011
Sales	251.45	306.96	357.10
Less: Cost of goods sold	203.85	243.15	285.10
Gross profit	47.60	63.81	72.00
Less: Interest	6.03	14.57	26.84
Collection charges	1.67	1.86	2.14
Bad debt losses	0.69	0.93	1.02
Other expenses	6.46	8.89	10.61
Taxes	17.31	18.30	15.89
Profit after tax	15.44	19.26	15.50

Note:

- All collection charges are fixed.
- During the year 2010-11, 60 per cent of other expenses were fixed and the remaining 40 per cent were variable.

The company has grown consistently over the period. The traditional look of the products, coupled with durability and richness in colours and attractive designs, has significantly contributed to its growth. The company has made it possible that its prices are lower than the traditional silk products. The main reason why the demand for the company's products has been growing is that they can be used more frequently, particularly sarees which are lighter than the traditional silk sarees. Quality control regarding the texture, design and colour combination, fastness of colours, and durability gets the top priority in the production process.

The company is experiencing a significant increase in demand for silk products. The demand for the modern silk (different from the traditional silk) has been estimated around Rs. 400 crore by an independent agency on Silk Industry. The company, however, was finding it very difficult to cope up with the increasing demand.

STSML'S PROBLEMS

The company is being squeezed for liquidity. For arriving at cash credit limit, the STSML's bank uses norm for composite textile mills for accounts receivable and finished goods inventory.

Exhibit III

COOL-AID PRIVATE LIMITED

Monthly Sales

for year ending on March 31

(Rupees in lakh)

	2010	2009	Actual 1997-98	2010	Projected 1998-99
July	306.80		8.87		10.00
August	243.12	3.35	8.50	5.26	10.00
September	18.88	40.47	8.62	72.94	10.00
October	14.27	20.12	7.79	42.95	10.00
November	18.1	63.94	8.12	121.15	10.00
December	89.0	100.40	6.95	124.15	10.00
January	88.8	164.34	39.57	245.30	50.00
February	18.30		80.67		95.00
March	19.26		86.15		100.00
April		10.04	73.74	14.00	87.00
May		3.35	19.00	4.20	21.00
June		10.04	9.12	44.76	10.00
Total		<u>23.43</u>	<u>357.10</u>	<u>62.96</u>	<u>423.00</u>
Share capital		95.44		114.70	150.23
Total liabilities		<u>164.34</u>		<u>245.30</u>	<u>327.04</u>