Optimizing SMEs' treasury income

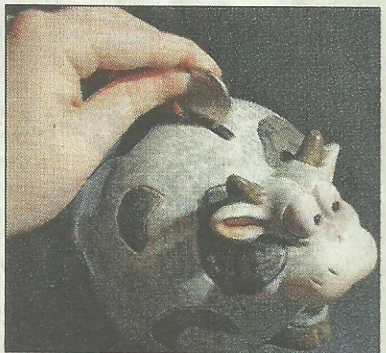
Jayant Jain & Niranjan Govindekar

In an increasingly turbulent and globalised world, where fierce emphasis is laid on optimum utilization of existing resources, treasury management has moved up the finance value chain from a purely administrative role to an imperative tool of finance. Treasury management encompasses strategic tasks of management of treasury surplus, deficit management and financial risk management. While it is advantageous for any company to possess a cash surplus, too much conservationism can also be harmful as opportunity costs are an inherent part of highly liquid assets.

The unenviable task of maintaining liquidity, minimizing the finance risk and cost of resources, and maximizing the return on cash surpluses falls squarely on the shoulder of the treasury department. Nowhere is this function more important than in the small and medium enterprise (SME) sector where low advantages of scale mean that each rupee has to be stretched to its maximum possible capacity. The return on liquid assets is lower than the return on productive assets. Hence, it is a good business practice to maintain the optimum amount of float and invest the balance in more remunerative avenues which also provide a good measure of liquidity.

While there are various options like equities, deposits, mutual funds, etc, available to the treasury manager for investing the treasury surplus, there are certain tax implications and inherent costs involved in every investment transaction.

Two of the more tax efficient investment opportunities for treasury surplus are liquid funds and fixed maturity plans (FMPs). Liquid funds, as the name suggests, are highly liquid investments which can be redeemed in less than 24 hours, subject to any minimum lock-in period. The returns from such investments range between 5% and 8% and are in the form of dividends which are tax-free in the hands of the investor. Apart from this tax benefit, the other advantageous features of liquid funds are good liquidity and low interest rate risk.



TAX EFFICIENCY

Another viable option for investment is FMPs. These are closed-ended mutual funds, in that one can only invest in them during the fund offer and they can only be redeemed at maturity. The difference between redemption price and the offer price of FMPs is taxable as capital gains. Since a number of funds offer FMPs with maturity period of slightly over a year, depending on the date of acquisition of these FMPs, the company can take advantage of double indexation benefit and thus face lower capital gains taxation. The post-tax returns on FMPs are greater as compared to fixed deposits since the returns on FMPs are characterized as capital gains which enjoy a concessional rate of tax (flat 10%, or 20% with indexation). As opposed to this, the interest income from FDs is liable to be taxed at the maximum marginal rates.

However, although relatively safe, like any mutual fund scheme, the returns on FMPs are not guaranteed.

According to latest available data, nearly 90% of industrial units in India belong to the SME sector which contributes nearly 40% of the entire output of the country. Optimal treasury management would enable this sector to reach greater heights and a treasury manager would be well advised to evaluate all the options available to him.

Jayant Jain is executive director, and Niranjan Govindekar is associate director at PwC India