

Ch. 3: Estimation of Working Capital

Working capital is the fund require to conduct day to day business activities.

To estimate means calculation of the requirement in advance.

Working capital estimate means calculation of requirement of working capital for the next year on the basis of available information.

Working capital estimation should be properly done because in case of shortage of working capital there may be interruption in business activities similarly if it is estimated at a higher side then it may lead to unnecessary expenses and increase in the interest burden.

Factors Determining Working Capital Requirement.

- 1 **Level of Activities:** No. of units produced and sold.
- 2 **Credit Period and time lag:** It is the time allowed to debtors or time allowed by creditors that is collection period or payment period respectively.

	Current Assets and Current Liabilities	Depend on
1)	Debtors and Bills Receivable	Credit Sales
2)	Stock of	
	a) Raw material	Raw Material consumed
	b) Finished goods	Cost of Production
	c) Work in Progress	Proportional cost of Production
	d) Creditors and Bills Payable	Credit Purchases of RMC

Important points:

- 1) We assume that all business activities like purchase production sale etc. are evenly (same) distributed throughout the year.
- 2) We calculate Debtors at selling price we can calculate Debtors at total cost only if it is asked in the question.

Debtors depend on credit sales if we cannot calculate credit sales then assume that given sales are on credit basis and find out the amount of Debtors.

- 3) For stock of Raw Material we take into account amount of Raw material consumed.
- 4) For finding out amount of finished goods. we take into account of Raw material consumed.
- 5) For calculating WIP we assume that entire requirement of Raw Material is introduced at the beginning and wages and overheads are paid as per the completion stage. In the absence of information we take the completion stage at 50% and therefore with respect to processing time full requirement of Raw Material is taken (100%) But only 50% of wages and overheads are consider.

- 6) Creditors and Bills payable are calculated on the basis of credit purchases but if we cannot get the information about purchases than Raw Material consume is consider for calculating creditors and Bills Payable.
- 7) For finding out Debtors and Creditors we have to ignore cash sales and cash Purchases.

Outstanding Expenses and Wages:

- 1 Wages are paid at a time lag of 1 month outstanding wages 1 month.
- 2 Wages are paid 1 month in Arrears – outstanding wages 1 month.
- 3 Wages are paid on the month end OR at the beginning of next month OR 15th on every month etc. – outstanding wages average half month.

*** Working Capital Cycle / Operating Cycle:**

In the business Raw Material is purchased is converted through process into finished goods. Goods are sold to Debtors and money is recovered from Debtors conversion of cash into different types of current assets and their reconversion into cash is called operating cycle.

Net Working Capital = Total duration of CA – Total duration of CL

Gross Working Capital = Total Current Assets

How to Estimates components of working capital

- **Stock of Raw material = Raw material purchase x No. of months required**
- **Stock of WIP = Raw material + 1/2 (wages + overheads) x No. of months required**
- **Stock of Finished Goods = (RM + Wages + OH) x No. of months required**
- **Debtors = Credit sales x Credit period**
- **Creditors = Credit Purchase x Credit period**
- **Prepaid Expenses = Expenses x Period of Pre payment**
- **Outstanding Expenses = Expenses x Time lag**