

Financial Management

WORKING CAPITAL ANALYSIS

Meaning of Working Capital:

Capital required for the business can be of two types:

1. Fixed Capital
2. Working Capital

Fixed capital is required to create the production facilities through purchase of fixed assets like Land, Machinery, and Building etc. Investment in these assets represents that part of firm's capital, which is blocked on permanent or fixed basis and is called fixed capital. Funds are also needed for short-term purpose for the purchase of Raw material, Payment of Wages etc. these funds are known as Working Capital. In simple words, working capital refers to that part of firm's capital, which is required for financing short-term assets.

Operating Cycle / Need for Working Capital:

Every business needs some amount of working capital. The need for working capital arises due to the time gap between the production and realization of cash from sales. Thus working capital is needed for the following purposes:

1. For the purchase of raw material, components and spares parts.
2. To pay wages and salaries
3. To incur day-to-day expenses.
4. To meet the selling costs s packing, advertising.
5. To provide the credit facilities to the customers.
6. To maintain the inventories of Raw material, work in progress, finished stock

Illustration 1: You are required to prepare a statement showing the working capital required to finance the level of activity of 18,000 units per year from the following information:-

Particulars	Rs.
Raw material	Per Unit 12
Direct labor	Per Unit 3
Overheads	per Unit 9
Total cost	Per Unit 24

Financial Management

Profit	per Unit 6
Selling price	Per Unit 30

Additional Information:

1. Raw material is in stock on an average for 2 months.
2. Materials are in process on an average for half-a- month.
3. Finished goods are in stock on an average for two months.
4. Credit allowed by creditors is two months in respect of raw materials supplied.
5. Credit allowed to debtors is three months.
6. Lag in payment of wages is half month. Cash on hand and at bank is expected to be Rs. 7,000.
7. You are informed that all activities are evenly spread out during the year.

Solution:

Estimation of Working Capital:

Current Assets:	Rs.
1. Stock-in-Trade	
a. Raw materials $18,000 \times 12 \times 2/12 =$	36,000
b. Work in progress $18,000 \times 18 \times 1/2/12 =$	13,500
c. Finished goods $18,000 \times 24 \times 2/12 =$	72,000
TOTAL	1, 21,500
2. Sundry debtors $18,000 \times 30 \times 3/12 =$	1, 35,000
3. Cash on hand and at bank $18,000 \times 30 \times 3/12$	7,000
	2, 63,500
Less: Current liabilities:	
4. Sundry creditors $18,000 \times 12 \times 3/12 =$	36,000
5. Wages $18,000 \times 3 \times 1/2/12 =$	2250
Estimated Working Capital Requirement	2, 25,250

Working Notes:

(1) Cost of each unit of Work in process	Rs.
Raw materials	12
Labour (50% of Rs. 3)	1.50
Overhead (50% of Rs. 9)	4.50
Total	18

Financial Management

Illustration 2: Baba Ltd. had annual sales of 5,000 units at Rs.100per unit. The company works for 50 weeks in the year. Cost details of the Company are as given below:

Particulars	Rs.
Raw material	Per Unit 30
Labour	Per Unit 10
Overheads	per Unit 20
Total cost	Per Unit 60
Profit	per Unit 40
Selling price	Per Unit 100

Additional Information:

1. The Company has the practice of storing raw materials for 4weeks requirements.
2. The wages and other expenses are paid after a lag of 2 weeks.
3. Further the debtors enjoy a credit of 10 weeks and Company gets a credit of 4 weeks from suppliers.
4. The processing time is 2 weeks and finished goods inventory is maintained for 4 weeks. From the above information prepare a working capital estimate, allowing for a 15% Contingency.

Solution:

Estimation working Capital:

Current Assets:	Rs.
1. Stock-in-Trade	
a. Raw materials $(5,000 \times 30 \times 4/50) =$	12,000
b. Work in progress $(5,000 \times 45 \times 2 /50)=$	9,000
c. Finished goods $(5,000 \times 60 \times 4/50) =$	24,000
	45,000
2. Sundry debtors $(5,000 \times 100 \times 10/50) =$	1,00,000
	1,45,000
Less: Current liabilities:	
3. Sundry creditors $(5,000 \times 30 \times 4/50) =$	12,000
4. Wages $(5,000 \times 10 \times 2/50) =$	2,000
1. Overhead $(5,000 \times 20 \times 2/50) =$	4,000
	1,27,000
Add: 10 % for contingencies 1, 27,000	12,700
Estimated Working Capital Requirement	1,39,700

Financial Management

Working Notes:

(1) Cost of each unit of Work in process	Rs.
Raw materials	30
Labour (50% of Rs. 10)	5
Overhead (50% of Rs. 20)	10
Total	45

Illustration 3: From the following information, you are required to estimate the net working capital. Particulars

. Raw material	Per Unit 40
Labour	Per Unit 15
Overheads	per Unit 30
Total cost	Per Unit 85

Additional information:

1. Selling Price Rs. 100per unit
2. Output 52000 units per annum
3. Raw material in stock Average 4 weeks
4. Work in progress (Assume 50% of stage with full material consumption) Average 2weeks
5. Credit allowed by the Suppliers Average 4 weeks
6. Credit allowed to debtors Average 8 weeks
7. Cash at bank expected to be Rs. 5,000

Assume that production is sustained at an even pace during the 52 weeks of the year. All sales are on credit basis. State any other assumptions that you might have make while computing.

Solution:

Statement of Working Capital Estimation

Current Assets:

1. Stock-in-Trade
 - a. Raw materials $52,000 \times 40 \times 4/52 =$ 1,60,000
 - b. Work in progress $52,000 \times 62.5 \times 2/52 =$ 1,25,000
 - c. Finished goods $52,000 \times 85 \times 4/52 =$ 3,40,000
2. Sundry debtors $52,000 \times 85 \times 8/52 =$ 6,80,000
3. Cash at bank = 5,000

Financial Management

	13,10,000
Less: Current liabilities:	
4. Sundry creditors $52,000 \times 40 \times 4/52 =$	1,60,000
Net working capital	11,50,000

RECEIVABLES MANAGEMENT

Receivables constitute a significant portion of the current assets of a firm. But, for investments in the receivables, a firm has to incur certain costs. There is also 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 amount owed to the firm as a result of sale of goods or services in the ordinary course of business these are the claims of firm against its customers and form a part of the current assets. Receivables are also known as accounts Receivables; trade Receivables, customer Receivables, etc. the Receivables are carried for the customers. The period of credit and extent of Receivables depend upon the credit policy followed by the firm. The purpose of maintaining or investing in Receivables is to meet competition, and to increase the sale and profits of the business.

1 Costs of maintaining Receivables

1. **Cost of Financing Receivables.** When a firm maintains receivables, some of the firm's resources remain blocked in them because there is a time lag between the credit sale to customer and receipt of cash from them as payment. Whether this additional finances is met from its own resources or from outside, it involves a cost to the firm in terms of interest (if financed from outside) or opportunity costs (if internal resources are used).

2. **Administrative costs.** When a company maintains receivables, it has to incur additional administrative expenses in the form of salaries to clerks who maintain records of debtors, expenses on investigating the creditworthiness of debtors etc. 167

3. **Collection costs.** These are costs, which the firm has to incur for collection of the amount at the appropriate time from the customers

. 4. **Defaulting cost:** When customers make default in payment not only is the collection effort to be increased but the firm may also have to incur losses from bad debts.

Financial Management