UNIT 6 MAINTENANCE OF ACCOUNTS AND WORKING CAPITAL MANAGEMENT

Structure

6.0 OBJECTIVES

After reading this unit we will be able to explain:

- Major purposes of accounting information and working capital management;
- Concepts, components and significance of working capital;
- The need for and determinants of working capital;
- Sources of financing working capital; and
- Efficient management of working capital.

6.1 INTRODUCTION

You have learned in Unit 5 that, various branches of accounting cater to the information needs of various users such as shareholders, auditors, management, employees etc. But, when we talk about 'accounting information', we generally look at it in a broad sense, rather than in terms of its specific branches like financial accounting, management accounting, cost accounting etc. In this Unit, we shall deal with some illustrative uses of accounting information for the purpose of management of funds in the short-term, that is, for current operations of the business.

The term 'funds' here refer to **working capital (WC)**, which can be regarded as that portion of the firm's total capital, which is employed in short-term operation. In simple words, we can say that WC is the investment needed for carrying out day-to-day operations of the business smoothly. The management of WC is equally important as the management of long-term financial investments in a business. But before, we explain the significance of WC & approaches for its efficient management; let us take a brief look at the purpose of accounting information in general, and its role in WC management, in particular.

6.2 PURPOSES OF ACCOUNTING INFORMATION

Much of the modern business management has been made possible only by accounting information. Management is a process of converting information into action; and accounting is a source of most of the information that is used for this purpose.

We have already learned in the previous Unit that in accounting process, financial information i.e. information involving money matters of a business enterprise, is recorded, classified and summarized. These data on various transactions of the business entity are classified into different heads like revenue, expenditure, current assets, current liabilities, owner's equity, fixed assets, long-term liabilities etc.

The classification and presentation of the data in this way enables any interested person (manager, shareholder, creditor etc.) to analyse it for understanding and taking stock of the organisation's performance. This draws the attention of the user of accounting information to take a decision. For example, the annual financial report of the company can be used by the shareholders, to assess the actual performance of the company vis-à-vis their expectations, and hence make their future investment decisions accordingly.

Let us take another example, where the accounting information reports a fall in net profit of a dairy plant this year in relation to previous year's profit and/or profits of other dairy plants. This will immediately focus the attention of manager towards the need to arrest the decline in profit and trigger a whole series of actions in this direction like evaluation of reasons for the decrease in profits, remedial decision to be taken and so on. Thus, in nutshell, accounting information serves the purpose of focusing a manager's attention on operational deficiencies, weaknesses, the threats and opportunities of a business enterprise.

The role of accounting does not stop at attention directing but goes further to enable quantification of the different alternative solutions and their relative merits and demerits. For instance, the manager in our previous example can evaluate the alternative solutions to increase profits, like, drop least profitable product line, decrease administrative expenses, increase sales revenue etc., by quantifying the effect of each of the alternatives on profits using the accounting information.

Thus, important purposes of accounting information can be summarized as keeping score of the organizations performance, attention directing of users of the information and problem solving for growth of enterprise.

6.3 ACCOUNTING AND WORKING CAPITAL MANAGEMENT

In the previous section, we read about the usefulness of maintaining accounts for understanding and taking stock of the organisation's performance in order to carry out a SWOT (strength, weaknesses, opportunities and threat) analysis of organisation and make appropriate decision for the growth of the enterprise. In this section, we shall focus specifically on the role of accounting for working capital management.

We will hardly find a running business firm that does not require working capital. Since working capital is pre-requisite for a business enterprise, its management is an integral part of the overall corporate management. The goal of working capital management is to manage the firm's current assets and current liabilities in such a way that a satisfactory level of working capital is maintained.

We have already learned in Unit 5, what are current assets and current liabilities. To refresh our memory, let us define the same again. The term **current assets** refers to those assets which in the ordinary course of business can be, or will be, turned into cash within one year without undergoing a decrease in value and without disrupting the operations of a firm. The major current assets are cash, marketable securities, accounts receivable and inventory. **Current liabilities** are those liabilities that are intended at their inception to be paid in the ordinary course of business, within a year, out of the current assets, or earning of the business. The basic current liabilities are accounts payable, bills payable, bank over-draft and outstanding expenses.

The information on each of these items of current assets and liabilities, sources and uses of working capital is contained in accounting statements. These statements provide an insight to the management on the following questions:

- What is the magnitude of current assets, current liabilities and hence working capital?
- What are the items causing changes in current assets and liabilities?
- What are the various sources of working capital and how they have changed over the years?
- To what uses the working capital has been put to?

A precise answer to the above questions in quantitative terms is the key to efficient management of working capital. Since accounting statements provide this information, undoubtedly, accounting is an essential input for working capital management.

Check Your Progress - 1

1) What are the three distinct activities to which accounting information addresses itself?

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2) List the typical items of current assets and current liabilities that you think can appear in the financial statement of a dairy plant.

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3) In what way are the accounting statements important for management of working capital?

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6.4 CONCEPTS AND NEED OF WORKING CAPITAL

i. **Concepts:** There are two concepts of working capital; namely, **Gross concept** and **net concept**.

Gross Working Capital: According to this concept, working capital represents the total of all current assets. In other words, this concept views working capital and aggregate of current assets as two interchangeable terms. Working capital so defined is also referred to as 'current capital' or 'circulating capital'.

This concept has the following advantages :

- Management is profoundly concerned with total current assets as they indicate the total funds available for operating purposes.
- It enables a firm to plan the use of funds for maximizing the returns to the enterprises.

Net Working Capital : The net working capital (NWC) is commonly defined as the difference between current assets and current liabilities. NWC is positive when current assets exceed current liabilities and it is negative when current liabilities are greater that current assets. From the point of view of working capital management, this is very important concept, as, to meet the contingencies in business, it is the excess of current assets over current liabilities which can be relied upon.

The concept of NWC is used to assess the liquidity position of the firm. The liquidity of a business firm is measured by its ability to satisfy short-term obligations as they become due. The greater the amount of NWC, the greater is the liquidity of the firm. Efficient working capital management seeks to ensure that an enterprise has sufficient NWC in order to be able to meet the claims of the creditors and other day-to-day needs of business. The amount of NWC that can be considered 'sufficient' vary from firm to firm and depends on a number of factors that we will discuss later.

The gross and net concepts of working capital are two important facets of working capital management. Both the concepts have operational significance for the management. The gross concept emphasizes the *quantitative aspect* while the net concept focuses on the *qualitative aspect*.

ii. **Need for WC :** The aim of the firm is to maximize the wealth of share-holders. For this purpose, firms should earn profits from its business operations. The extent to which profits can be earned will naturally depend upon the magnitude of the sales, among other things. To sustain, a successful sales activity sufficient working capital is necessary.

You are aware that a firm will be able to meet the customer's demand for its product only if it has finished goods in stock, that is, firms must have adequate inventory to guard against the possibility of not being able to meet a demand for their products. Adequate inventory, therefore, provides a cushion against being out of stock. In several instances, sales of firms do not convert into cash instantly; there is a time-lag between the sale of goods and the receipt of cash. This is particularly the case for sale of goods by a manufacturing firm to the wholesaler and also by wholesaler to retailer, as they often sell goods on credit, in a desire to increase their business activity. Thus, to remain competitive necessitates the holding of accounts receivables.

A manufacturing firm needs to maintain additional liquidity to meet the expenditure on several items, like raw material, fuel, power, wages, salaries etc. in the process of manufacturing the goods. Even if a business concern does not manufacture goods on its own, rather it purchases it from manufacturer or wholesaler, working capital in the form of cash is required to meet its routine requirement to finance the transactions which a firm carries out in its ordinary course of business. This is called **transactions motive** of requiring cash balances.

Besides transactions motive the firms need working capital in the form of cash in hand or bank for three other purposes, precautionary motive, speculative motive and compensation motive. **Precautionary motive** refers to the need of keeping cash balances in reserve for random and unforeseen circumstances e.g. strike, failure of important customers, cancellation of order etc.

Speculative motive refers to the desire of a firm to take advantage of opportunities which present themselves at unexpected moments and which are typically outside the normal course of business. For example, an opportunity to purchase raw materials at a reduced price on payment of immediate cash; a chance to speculate on interest rate movements by buying securities when interest rates are expected to decline etc. While the precautionary motive is defensive in nature in that, firms must make provisions to tide over expected contingencies, the speculative motive represents a positive and aggressive approach.

Compensation motive to hold cash balances is for compensating the banks for providing certain services to business firms like clearance of cheque, supply of credit information, transfer of funds etc. You may be knowing that for some services, like making bank drafts, banks cheque, a commission or fee, is there but do you know that for several other services, banks seek indirect compensation? Let us tell you how banks do this. Usually, clients are required to maintain a minimum balance of cash at the bank. Since this balance cannot be utilized by the firms for transactions purposes, the banks themselves can use the amount to earn a return. To be compensated for their services indirectly in this form, they require the clients to always keep a bank balance sufficient to earn a return equal to the cost of services. Such balances are compensating balances.

Check Your Progress - 2

1) Discuss the concept of working capital.

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2) Why working capital is also called 'circulating capital'?

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3) Fill in the blanks:

   a) When current liabilities exceed current assets, there is ____________ working capital.

   b) Firms sell goods on credit and thereby hold accounts receivables to _________________.

   c) A firm needs working capital in form of cash for ____________, __________, ____________ and_____________ purposes.

6.5 IMPORTANCE OF WORKING CAPITAL MANAGEMENT

It must be amply evident to us by now, that working capital has close relationship with day-to-day operations of a business. Inefficient working capital management may cause either shortage or excessive working capital; each of such situations is dangerous for the company and leads to business failure.

When working capital is inadequate, a company faces the following problems:

- A company shall find it difficult to take advantage of profitable business opportunities due to shortage of funds.

- It is not possible for it to utilize production facilities fully and consequently the firm's profit goals shall not be achieved.

- A company shall not be able to take advantage of cash discount facilities.

- The credit-worthiness of the company shall be adversely affected, that is, the firm loses its reputation when it is not in a position to honour its short-term obligations.

- Fixed assets shall not be efficiently utilized due to lack of working fund for routine repairs and maintenance.

Too much working capital is as dangerous as too little of it. Excessive working capital raises the following problems:

- Excessive working capital in the form of very big inventories, increases the chances of inventory mishandling, waste and theft.

- It may lead to firms selling large quantity of goods on credit causing higher chances that more amount of money will be lost in form of bad debts.

- The company shall suffer from low profitability as its working capital is either not invested or is invested in low interest bearing securities.

Thus, we see that working capital management is like a tug-of-war between liquidity and profitability. A successful entrepreneur/manager, therefore, should keep the right balance between liquidity and profitability by maintaining the right amount of working capital on a continuous basis.

Check Your Progress - 3

1) What shall be the effect of following on the firm a) shortage of working capital and b) excess working capital?

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6.6 FACTORS DETERMINING WORKING CAPITAL

The amount of working capital that a firm would need is affected both, by the **endogenous** and **exogenous** factors. The endogenous factors are associated with the firm itself while the exogenous factors are attributable to economic, monetary and general business environment. Among the various factors, the following are important ones:

i. Endogenous Factors

Nature and Size of business: Enterprises fall into some broad categories depending on the nature of their business. For instance, a dairy farm engaged only in producing dairy products is a manufacturing firm while one engaged only in selling the products is a trading firm. The working capital requirements of an enterprise are basically related to the conduct of the business. The manufacturing firms have to invest substantially in working capital for purchasing raw material, paying wages and salaries, incurring expenses on fuel and power etc. The working capital requirement of dairy products manufacturer increases, if his firm is a manufacturing-cum-trading firm. In that case, besides manufacturing expenses, firm must incur marketing and sales expenses on items such as advertising, opening retail outlets, commission to sales agents etc. The working capital needs of solely trading dairy concerns fall between the requirements of manufacturing firms and manufacturing-cum-trading firms. This is so because the shelf life of dairy products is short and hence trading firm does not carry large stock of the same. The size of business also has an important impact on its working capital needs. Size may be measured in terms of the scale of operations. A firm with larger scale of operations will need more working capital than a small firm.

Production Cycle: The production cycle starts with the purchase of raw materials and is completed with the production of finished goods. If the manufacturing cycle involves a longer period, the need for working capital will be more, because an extended manufacturing time span means a larger tie-up of funds in inventories. For instance, the working capital need for manufacturing cheese is higher than that pasteurization of milk due to longer time required for manufacturing cheese. Besides, the normal length of the production cycle, the working capital requirement is also affected by any delays in the manufacturing process. A delay at any stage results in accumulation of work-in-process, thus enhancing the requirement of working capital.

Production Policy: In the case of certain lines of business, the demand for products is seasonal, for example, ice-cream will be purchased largely during summer season. If a firm follows a steady production policy, that is, continues to manufacture the product during off-season also, then there will be large accumulation of finished goods (inventories) during the off-season. The progressive accumulation of stock will naturally require an increasing amount of working capital which will remain tied-up till sales pick up during peak season.

However, it is not necessary that all firms follow a steady production policy. Firms whose physical facilities can be utilized for manufacturing a variety of products can have the advantage of diversified activities. Such firms manufacture a few products throughout the year, while certain other products are manufactured only in specific season e.g., a dairy plant, producing pasteurized milk throughout the year, produces ice-cream also in summers. Thus, production policies may differ from firm to firm depending upon the circumstances. Accordingly, the need for working capital will also vary.

Operating Efficiency: Operating efficiency means optimum utilization of resources by eliminating waste, improving co-ordination and a fuller utilization of existing resources etc. Management can contribute to a sound working capital position through efficiency of operations that increases the working capital turnover.

Credit Terms: You must have observed that not all the sales of a firm are cash sales, but often firms sell goods to its customers on credit. If the firm offers liberal credit terms to its customers, its working capital in form of receivables increases. A long collection period will generally mean tying of larger funds in debts and may even increase the chances of non-receipts of the money due (bad debts).

Though the credit terms granted to customers, largely depend upon the prevailing trade practices and changing economic conditions, yet it may be treated as an endogenous factor within the control of the firm. On the other hand, the credit terms available to the firm from its creditors is a exogenous factor affecting the working capital requirement of the firm. A firm enjoying liberal credit terms will need less working capital. The other exogenous factors influencing working capital needs are discussed as under.

ii. Exogenous Factors

Business Cycle: Business expands during periods of prosperity and declines during the period of depression. An upward swing in the economy during periods of prosperity leads to increased sales and hence higher working capital requirement to meet the greater demand for its product. The downswing phase of the business cycle will have exactly an opposite effect on the level of working capital requirements.

Price Level Changes: A general rise in the price level leads to higher requirement of working capital for carrying out existing level of business activity. However, in cases where firm increases the price of the product in proportion to general increase in price level, the working capital needs remain more or less unchanged.

Other Factors : There are some other factors like profit level, tax rates, dividend policy and depreciation policy which affect the working capital of a firm. Higher net profits contribute positively to working capital while higher tax rate decreases working capital. Similarly, a firm's policy of paying higher dividends to its shareholders means decrease in cash available with the firm and thus reduces the firm's working capital to that extent.

Check Your Progress - 4

1) Discuss some factors that a firm can control to contain its working capital needs.

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2) How do seasonal and cyclical fluctuations in demand for a product affect the working capital requirement?

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3) Discuss how the growth and expansion prospects of a firm influence working capital needs of a firm.

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6.7 MEASURING WORKING CAPITAL

In the previous section we have discussed the factors that influence the quantum of working capital in a business enterprise. Now let us attempt to determine the amount of working capital that an enterprise, say, dairy plant, would need by taking up an illustration.

Illustration

Objective: To determine the magnitude of working capital for a newly set up ghee manufacturing unit using given information:

a) The proforma cost sheet provides following particulars:

Elements of cost	**Amount per kg. (Rs.)**
Raw materials	60
Power & Fuel	10
Direct labour	30
Overhead	40
Total cost	**140**
Profit	20
Selling Price	160

b) Annual Production is estimated to be 24,000 kgs.

c) Raw material, parts and components are expected to remain in stores for average period of two days.

d) Materials are in process on average one day and at 50% completion stage.

e) Finished goods remain in stock on average 30 days.

f) Credit allowed by suppliers is 30 days.

g) Credit allowed to debtors is 60 days. Half of the sales are likely to be on credit.

h) Average time lag in payment to labour is 15 days and 30 days in overhead & fuel expenses.

i) Assume that sales and production follow a consistent pattern.

j) 10% of the computed figure is kept for buffer cash and contingencies.

Solution:

Working notes: (a) The yearly production is 24,000kg., half of the sales are on credit, therefore, 12,000 kg. are sold on credit and 12,000 kg. on cash.

(b) Amount locked up in stock of raw material = (Annual production x Unit raw material cost x period for which stock required)/No. of days in year.

(c) Work in process stock = {(Annual production x Unit raw material or labour or overhead cost x period for which stock required)/No. of days in year}x 50% (because work in progress is assumed to be at 50% completion stage).

(d) Cost of finished good = (Annual production x Unit cost of finished good x period for which stock held)/No. of days in year.

(e) Debtors = (Credit sales x Selling Price x period of credit)/No. of days in year.

(f) Creditors for purchase of raw material = (Annual production x Unit raw material cost x period for which credit available)/No. of days in year.

(g) Av. lag in payment of labour = (Annual production x Unit labour cost x lag period for payment)/No. of days in year.

(h) Av. lag in payment of overhead = (Annual production x Unit overhead cost x lag period for payment)/No. of days in year.

Statement showing determination of net working capital.

		Amount (Rs.)
(A) Current Assets:		
(i) Stock of materials for two days:	(24000x60x2)/365	7890
(ii) Work in progress for 1 day		
(a) Raw material	{(24000x60x1)/365}x50%	1973
(b) Labour	{(24000x30x1)/365}x50%	986
(c) Overhead	{(24000x40x1)/365}x50%	1315
(iii) Finished goods for 30 days	(24000x140x30)/365	276164
(iv) Debtors 60 days credit	(12000x160x60)/365	315616
Total investment in Current assets		603945
(B) Current Liabilities:		
(i) Creditors 30 days	(24000x60x30)/365	118356
(ii) Av. time lag in payment of		
(a) Labour 15 days	(24000x30x15)/365	29589
(b) Overheads 30 days	(24000x50x30)/365	98630
Total estimates of Current liabilities		246575
(C) Net Working Capital (A-B)		357370
Add 10% for buffer cash and contingencies		35737
Average Working Capital Required		393107

6.8 SOURCES OF FINANCING WORKING CAPITAL

After determining the level of working capital, as illustrated in the preceding section, a firm has to decide how it is to be financed. The sources of finance for working capital can be broadly divided into four categories

1. Trade credit

2. Bank credit

3. Internal financing

4. Issue of share capital or debenture

The first three sources of finances are available to any type of firm viz. single proprietorship/partnership firms, private/public limited company etc., but raising funds through public issue of share capital or debenture is an option that only a public limited company can resort to.

Trade credit is the primary source of working capital finance for Indian firms. It comprises mainly of obtaining raw material or goods on credit and short-term borrowings from trading partners.

Short term bank credit is another important source of working capital. To obtain short-term bank credit, working capital requirements have to be estimated by the borrowers and the banks are approached with the necessary supporting data. The banks determine the maximum credit based on the margin requirements of the security offered against credit grant. For example, if the margin requirement of a particular item is 60%, the bank will be prepared to provide credit upto Rs.40 thousand against the security of an asset worth Rs.1lakh.

Besides providing credit for short-term through loan, overdraft, purchasing and discounting bills and cash credit; banks also advance term loans for working capital for 3-7 years repayable in yearly or half-yearly installments.

A company also raises funds for WC from its business operations, which is called internal financing. For example, receipts from sales are used to replenish the working capital invested, to pay operating costs and also to generate new working capital.

With a view to financing additional working capital needs, issue of additional shares or floating of debentures is another way. The companies eligible to raise capital through this option are required to follow the guidelines issued by the Government in this regard. Also, most of such companies are listed in the stock exchange.

6.9 APPROACHES TO MANAGING WORKING CAPITAL

Generally two approaches are followed for the management of working capital : (i) the conventional approach and (ii) operating cycle approach.

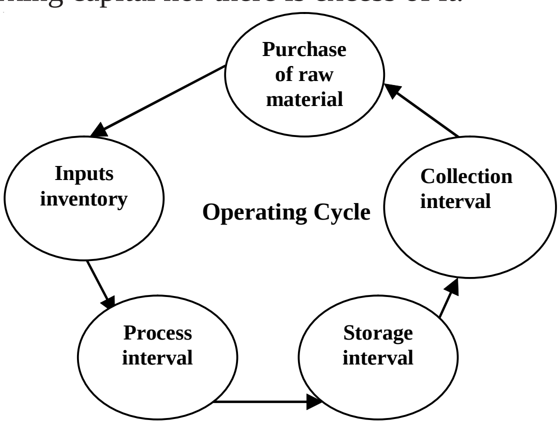
The Conventional Approach: In this approach, each individual component of working capital viz. cash, inventory, receivables, payables etc. are managed efficiently such that, neither there is shortage of funds nor there is accumulation of excess funds. Since the cash position of the forms is affected by the management of the other items of working capital, the basic strategies that can be employed for the management of cash are (i) efficient inventory management (ii) speedy collection of accounts receivables and (iii) stretching accounts payment without affecting the credit of the firm.

An efficient inventory management is one that provides maximum customers service at a minimum cost. The optimum level of inventory is decided on the basis of the trade-off between cost of keeping inventory and benefits from it. As you know that inventory of a firm comprises of various items like, different types of raw materials, semi-finished goods in various stages of production, finished goods etc., it is not necessary for the manager to exercise same degree of control on all the items of inventory. The items which are most costly and/or converted into cash relatively slowly require more control. Hence, in the inventory control process, the inventory items are classified into three categories on the basis of the cost involved according to **A B C System** of classification. The items included in group A involve the largest investment and C group consists of cheapest items. Therefore, most rigorous and intensive control is required for A group of inventories and C deserve minimum attention. B group stands mid-way. It deserves less attention than A but more than C.

For receivable management, the firm has to decide whether or not to extend credit to a customer, how much credit to extend, what should be period for which credit is given, procedure for collection, in case of default etc. Similarly, the extent to which you can stretch your accounts payable will depend upon the credit policy, credit terms and collection policy of the creditor. There is no fixed norm for each of the above questions. The decision of the firm will be guided by the general nature of business, business environment and risk taking ability of the entrepreneur.

The Operating Cycle Approach: Under this approach, the working capital is determined by the duration of the operating cycle and the operating expenses needed for completing the cycle. In other words, this approach views working capital is a function of the volume of operating expenses.

The operating cycle has five major stages, (I) expenditure for purchasing raw material, stores etc. (II) inputs inventory (III) process interval (IV) warehouse (storage) interval and (V) collection interval. The operating cycle maintains circular flow of working capital from stage one through stage five as shown in the figure below. An effective management of working capital is that in none of these stages there is shortage of working capital nor there is excess of it.



Check Your Progress - 5

1) You want to apply for a short-term loan from a commercial bank for financing the working capital requirement of a small business unit producing 10,400 units annually. The financial particulars of the business unit are as follows:

a) **Elements of cost**

Elements of cost	**Amount per unit (Rs.)**
Raw materials	80
Direct labour	30
Overhead	60
Total Cost	170
Profit	30
Selling Price	200

b) Raw materials in stock, on average one month; Materials are in process, on average half a month; Finished goods in stock, on average one month

c) Credit allowed by suppliers is one month

d) Credit allowed to debtors is two months

e) Average time-lag in payment of wages is 1.5 weeks and one month in overhead expenses

f) One-fourth of the output is sold against cash

g) Cash in hand and at bank is expected to be Rs.36500

h) 20% of the computed figure is kept for buffer stock and contingencies.

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2) What are various sources of financing working capital needs of single proprietorship or partnership firms?

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3) What are the alternative approaches to managing working capital?

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2.10 LET US SUM UP

An enterprise needs funds to operate profitably. The working capital of a business signifies the short-term uses of funds. Management of working capital is an integral part of corporate management as short-term survival is pre-requisite to long-term success. An important aspect of the working capital management is the trade-off between profitability and liquidity. Too much of working capital is as harmful for the firm as too little of it. An efficient management of working capital implies maintaining the optimum amount of working capital.

The amount of working capital that a firm needs is affected by many factors and may fluctuate over a period of time. Manufacturing cycle, production policies, credit terms and inflation are some of the important factors influencing the determination of working capital.

Working capital management involves deciding upon the amount and composition of current assets and how to finance these assets. Among the various sources of financing working capital, trade credit is the primary source of working capital finance for Indian firms, followed by bank credit.

The two important approaches followed for the management of working capital are the conventional approach and the operating cycle approach.

6.11 KEY WORDS

Problem Solving : Role of accounting consists of supplying such information as would be useful to managers for taking a variety of routine and non-routine decisions.

Current Assets : Assets which can be converted into cash within a year.

Current Liabilities : Claims of outsiders against the firm that are required to be paid with a year.

Gross Working Capital : The aggregate of all current assets including cash.

Net Working Capital : Excess of current assets over current liabilities.

Transactions Motive : Refers to the holding of cash to meet day-to-day requirements of the firm.

Precautionary Motive : Of holding cash implies need to hold cash to meet unpredictable obligations.

Speculative Motive : Represents keeping of cash reserves by the firms with a aim to take advantage of profitable opportunities.

Liquidity : Ability to meet obligations when they become due. It is also called solvency.

Production Cycle : Refers to the time involved in the manufacture of goods.

It is the time gap between purchase of raw material and the completion of the manufacturing process leading to the production of finished good.

Operating Cycle : In a manufacturing firm is the time gap between purchase of raw material and sale of finished products.

Trade Credit : Credit obtained through purchases on credit.

6.12 SOME USEFUL BOOKS

Khan, M.Y. and Jain, P.K., 1998. Financial Management: Text and Problems, Tata Mcgraw Hill, N.Delhi (Chapters 15, 16 & 17).

Kuchhal, S.C., 1999. Financial Management: An Analytical and Conceptual Approach, Chaitanya Publishing House, Allahabad (Chapter 9).

Kulkarni, P.V. and Sathyaprasad, B.G., 2000. Financial Management, Himalaya Publishing House, Mumbai (Chapter 29).

6.13 ANSWERS TO CHECK YOUR PROGRESS

Your answer should use the following points

Check Your Progress - 1

1) Your answer should include the following points:

   - Score keepingà accumulating financial data to take stock of firm’s performance.
   - Attention directingà focusing attention on performance of the firm.
   - Problem solvingàproviding information to find solutions of the financial problems in the firm.

2) Include the following in your answer:

   - Current assetsàcash, sundry trade debtors, inventory of raw material, stores, supplies & spares, semi-finished and finished goods.
   - Current liabilitiesàraw milk purchased on credit, outstanding expenses on wages, electricity bills, tax etc., short-term borrowings.

3) Your answer should include the following points:

   - Provide information on current assets and liabilities
   - Inform about over time changes in sources and uses of working capital

Check Your Progress - 2

1) Your answer should include the following points:

- Gross working capital is total current assets
- Net working capital is current assets minus current liabilities

2) Include the following in your answer:

   - Within one year there is continuing cycle of gross working capital

3) (a) negative (b) remain competitive in the market (c) transactions, precautionary, speculative and compensating

Check Your Progress - 3

1) Build your answer along the following points:

   - Shortage causes setback to growth, liquidity crisis and risk of losing firm's reputation
   - Excess working capital leads to accumulation of inventories, higher chances of bad debts and loss on profitability

Check Your Progress - 4

1) Include the following factors in your answer:

   - Avoiding delay in production process
   - Production policy
   - Increasing operating efficiency
   - Credit terms offered to debtors

2) Focus on the following points:

   - Seasonal fluctuationsà accumulation of inventories in off-season and quick disposal in peak season
   - Cyclical fluctuationsà upward swing increases business activity, downward swing depresses business

3) Include the following points in your answer:

   - Growing firms require more funds than static ones
   - Need for increased working capital precedes growth and expansion rather than following it.

Check Your Progress - 5

1) Working capital requirement = Rs.424200

   Working notes: Take 52 weeks in a year and 4 weeks in a month

(A) Current Assets:		Amount (Rs.)
(i) Stock of materials for one month:	(10400x80x4)/52	64000
(ii) Work in progress for half month		
(a) Material	{(10400x80x2)/52}x50%	16000
(b) Labour	{(10400x30x2)/52}x50%	6000
(c) Overhead	{(10400x60x2)/52}x50%	12000
(iii) Finished goods for 1 month		
(a) Material	{(10400x80x4)/52}x50%	64000
(b) Labour	{(10400x30x4)/52}x50%	24000
(c) Overhead	{(10400x60x4)/52}x50%	48000
(iv) Debtors for 2 months	{(7800x170x8)/52}	204000
(v) Cash in hand and at bank 36500		
Total investment in Current assets		474500
(B) Current Liabilities:		
(i) Creditors 1month	(10400x80x4)/52	64000
(ii) Av. time lag in payment of		
(a) Labour 1.5 weeks	(10400x30x1.5)/52	9000
(b) Overheads 1month	(10400x60x4)/52	48000
Total estimates of Current liabilities		121000
(C) Net Working Capital (A-B)		353500
Add 20% for buffer cash and contingencies		70700
Average Working Capital required		424200

2) Your answer should include following points:
- Purchasing raw material or goods on credit
- Short-term borrowings from trading partners
- Short term bank loans
- Own funds

3) Frame your answer around following points:
- Conventional approach
- Operating cycle approach