**Topic: Marginal Costing**

# Some Important Definition:

* **Marginal Cost:** Marginal Cost is the additional cost incurred for increase in one additional unit of output. Marginal cost is nothing but the variable cost.
* **Marginal Costing:** Marginal Costing is the method of ascertaining marginal cost and it evaluates the effect of fixed and variables costs on profit due to change in volume of production.

# Distinguish features of Marginal Costing are:

1. Only variable costs are charged to the cost unit. Fixed costs are recovered from contribution;
2. All costs including semi variable costs are divided into two parts, fixed and variable;
3. Closing inventories are valued at variable cost only;
4. Break-even Analysis and Cost-volume-profit Analysis are integral parts of this costing technique.

# Marginal Costing technique is having many advantages, such as:

* 1. It provides useful data for managerial decision- making;
  2. It is a very effective tool of profit planning;
  3. Its facilities control over variable costs by avoidance of arbitrary apportionment or allocation of fixed costs;
  4. Problems on computation of accurate fixed factory overhead rate can be avoided as fixed overheads are charged against contribution;
  5. It provides the management with many useful techniques for decision – making like Break – even Analysis, etc.

# Limitations of Marginal Costing are:

* 1. It assumes the semi- variables costs can be segregated into two parts, fixed and variable elements. In practice, however, such segregation of semi- variable costs is very difficult;
  2. It excludes fixed cost for decision – making, which sometimes may lead to wrong conclusion;
  3. It fails to reflect the impact of increased fixed costs due to development of technology on production costs;
  4. Variable cost technique cannot be successfully applied in “Cost plus contract”.
* **Cost-volume-profit (CVP) Analysis** examines the relationship of costs and profit to the volume of production to maximize profit of the firm. The method of studying the relationship between the cost, volume of production, sales and their impact on profit is called as ‘Cost-volume-profit Analysis’. CVP Analysis is a logical extension of marginal costing and is used as a very powerful tool by the management in the process of budgeting and profit planning.

# Objectives of CVP Analysis are:

* 1. It helps to forecast profit fairly and accurately;
  2. It acts as an effective tool of profit planning to the management;
  3. It helps in ascertaining break-even point of the product produced and sold.
  4. It is very much useful in setting up flexible budget;
  5. It assists the management in the process of performance evaluation for the purpose of control;
  6. It helps in formulating price policies by projecting the effect of different price structures on costs and profits.

# Underlying assumption of CVP Analysis are:

* 1. Total cost consists of two components – fixed cost and variable cost;
  2. Selling price per unit remains constant at different volume of sales;
  3. Only one product is sold by the concern or if it sells multiple product, the sales mix remains constant at different volume of sales;
  4. Volume of production is equal to the sales volume.
* In CVP Analysis, costs are classified in two parts – fixed cost and variable cost. Semi – variable cost is not separately recognized in CVP Analysis. Fixed portion of semi – variable cost is clubbed with the fixed cost and its variable portion is clubbed with the variable cost.

# Elements of CVP Analysis are:

* Marginal Cost Equation;
* Contribution;
* Profit – Volume Ratio;
* Break-even Point;
* Margin of Safety
* **Marginal Cost Equation** exhibits the relationship between the contribution, fixed cost and profit. It explains that the excess of sales over variable cost is the contribution towards fixed cost and profit, i.e. S – V = F + P.
* **Contribution** is the excess of sales over variable cost, i.e. C = S – V. This contribution is available towards fixed cost and profit, i.e. C = F + P.
* **Profit – Volume Ratio (P/V Ratio)** is the ratio of contribution and sales. It is generally expressed in percentage. It exhibits % of contribution included in sales, i.e. P/V Ratio = C/S x 100. It indicates the effect on profit for a given change in sales.
* **Break - even Point (BEP)** is that level of sales where there is no profit or no loss. At break – even point, total sales revenue is equal to total cost. Any sales above this BEP, a concern earns profit, whereas any sales below this BEP, the concern suffers loss. At BEP, total fixed cost and variable cost up to that level of sales have been recovered from sales. Generally, at any other point of sales, contribution from sales is available towards fixed cost and profit. But as there is no profit or loss at BEP, Contribution from sales at BEP is available towards fixed cost only, i.e. at BEP, C = F.
* **Margin of Safety (MS)** is the level of sales made above the break – even point. In other words, Margin of Safety is the excess of actual sales over BEP sales. Generally, at any point of sales, contribution from sales is available towards fixed cost and profit. But as the total fixed cost has already been recovered at break – even point, contribution from sales at margin of safety is available towards profit only, i.e. at MS, C = P.
* CVP Analysis is popularly known as **Break – even Analysis,** although there exists a narrow difference between these two terms. CVP Analysis refers to the study of the effect on profit due to changes in cost and volume of output, whereas BE Analysis refers to the study of determination of that level of activity where total sales is equal to the total cost and also the study of determination of profit at any level of activity. However, the technique of BE Analysis is so popular for studying CVP Analysis that these two terms are generally used synonymously.
* **Break – even Chart (BE Chart)** is the graphical presentation of Break – even Analysis. It depicts the relationship between costs, sales and profits. BE Chart graphically shows the profit or loss at various levels of activity and also shows the level of activity where there is no profit no loss (i.e. total cost equals total sales)
* **Angle of Incidence** is the angle formed by intersection of sales line and total cost line at break – even point in the break – even chart. This angle exhibits the rate at which profits are being earned by a concern after reaching the break – even point. It shows the profit earning capacity of a concern. Wider angle of incidence exhibits higher profit earning capacity of the concern or vice – versa.

# Income Statement under Marginal Costing:

Rs.

Sales xxxx

Less: Variable Cost xxx

# Contribution xxxxx

Less: Fixed Cost (Operating) xxx

# Profit (EBIT) xxxxx

# Formula:

1. Contribution **(C) =** Sales – Variable Cost = Fixed Cost + Profit
2. Profit – Volume Ratio (P/V Ratio) = Contribution / Sales \* 100

= {(Change in profit) / (Change in sales)} \* 100

1. BEP Sales (in value) = Fixed Cost / (P/V Ratio)

BEP Sales (in units) = Fixed Cost / Contribution per unit

1. Margin of Safety (MOS) = Actual Sales – BEP sales

= Profit / (P/V ratio)

1. Required Sales (in value) = (Fixed Cost + Profit) / Contribution per unit Required Sales (in units) = (Fixed Cost + Profit) / (P/V Ratio).

# Topic : Budgetary Control

# Meaning of Budget and Budgeting

**Budget:** A budget is an instrument of management used as an aid in the planning, programming and control of business activity. The Chartered Institute of Management Accountants (CIMA), UK defines budget as “A financial and/or quantitative statement, prepared and approved prior to a defined period of time of the policy to be pursued during that period for the purpose of attaining a given objective. It may include income, expenditure and employment of capital” The budget is a blue-print of the projected plan of action expressed in quantitative terms for a specified period of time.

**Budgeting:** Budgeting is the process of designing, implementing and operating of budget. The main emphasis in budgeting process is the provision of resources to support plans which are being implemented. It is a means of coordinating the combined intelligence of an entire organisation into a plan of action based on past performance and governed by rational judgment of factors that will influence the course of business in the future.

**Types of Budgets**

## Classification on the basis of **Capacity or Flexibility**

These types of budgets are prepared on the basis of activity level or utilization of capacity. These are also known as “Budgets on the basis of flexibility”.

1. **Fixed Budget:** A budget prepared on the basis of standard or fixed level of activity is known as fixed budget. It does not change with a change in the level of activities. According to CIMA, “a fixed budget is a budget designed to remain unchanged irrespective of the level of activity actually attained”. A fixed budget shows the expected results of a responsibility center for only one activity level.

Once the budget is prepared, it is not changed, even if the level of activity changes.

### Essential conditions:

1. When the nature of business is not seasonal.
2. There is no impact of external factors on the business activities.
3. The demand of the product is certain and stable.
4. Supply orders are received and issued regularly.
5. The market of the product is normally domestic but it can also apply in respect of service export, where fairly regular export orders are received
6. There is no need of special labour or material in the production of the products.
7. Supply of production inputs is regular.
8. There is a trend of price stability.

Generally, all above conditions are not found in practice. Hence fixed budget is not suitable in business concerns.

### Merits and Demerits of fixed budgets are tabulated below:

|  |  |
| --- | --- |
| Merits | Demerits |
| 1. Very simple to understand 2. Less time consuming | 1. It does not suite a dynamic organization and may give misleading results. A poor or good performance may remain un- noticed. |
|  | 2. It is not suitable for long period. |
|  | 3. It is also found unsuitable particularly when the business conditions are changing constantly. |
|  | 4. Accurate estimates are not possible. |

1. **Flexible Budget:** A flexible budget is a budget which, by recognising the difference in behaviour between fixed and variable costs in relation to fluctuations in output, turnover, or other variable factors, is designed to change appropriately with such fluctuations. According to CIMA, “a flexible budget is defined as a budget which, by recognizing the difference between fixed, semi-variable and variable costs is designed to change in relation to the level of activity attained.” Unlike static (fixed) budgets, the flexible budgets show the expected results of a responsibility center for different activity levels.

One can view a flexible budget as a series of static budgets for different levels of activity. Such budgets are especially useful in estimating and controlling factory costs and operating expenses. It is more realistic and practicable because it gives due consideration to behavior of revenue and cost at different levels of activity. While preparing a flexible budget, the expenses are classified into three categories viz.

1. Fixed,
2. Variable, and
3. Semi-variable.

Flexible budgeting may be resorted to under the following situations:

1. In the case of new business venture, due to its typical nature, it may be difficult to forecast the demand of a product accurately.
2. Where the business is dependent upon the fluctuations of nature e.g., a person dealing in wool trade may have enough market demand, if temperature goes below the freezing point and much less demand if the weather is relatively warm.
3. In the case of labour-intensive industry where the production of the entity is dependent upon the availability of labour.

### **Merits and Demerits of flexible budgets are tabulated below:**

|  |  |
| --- | --- |
| Merits | Demerits |
| 1. With the help of flexible budget, the sales, costs and profit may be calculated easily by the business at various levels of production capacity. 2. In flexible budget, adjustment is very simple according to change in business conditions. 3. It also helps in determination of production level as it shows budgeted costs with classification at various levels of activity along with sales. Hence the management can easily select the level of production which shows the profit predetermined by the owners of the business. | 1. The formulation of flexible budget is possible only when there is proper accounting system maintained, perfect knowledge about the factors of production and various business circumstances is available. 2. Flexible Budget also requires the system of standard costing in business. 3. It is very expensive and labour oriented. |
| 4. It also shows the quantity of product to be produced to earn determined profit. |  |

**Difference between Fixed and Flexible Budgets:**

|  |  |  |
| --- | --- | --- |
| **Sl. No.** | **Fixed Budget** | **Flexible Budget** |
| **1.** | It does not change with actual volume of activity achieved. Thus, it is known as rigid or inflexible budget. | It can be re-casted on the basis of activity level to be achieved. Thus, it is not rigid. |
| **2.** | It operates on one level of activity and under one set of conditions. It assumes that there will be no change in the prevailing conditions, which is unrealistic. | It consists of various budgets for different levels of activity. |
| **3.** | Here as all costs like - fixed, variable and semi-variable are related to only one level of activity so variance analysis does not give useful information. | Here analysis of variance provides useful information as each cost is analysed according to its behaviour. |
| **4.** | If the budgeted and actual activity levels differ significantly, then the aspects like cost ascertainment and price fixation do not give a correct picture. | Flexible budgeting at different levels of activity facilitates the ascertainment of cost, fixation of selling price and tendering of quotations. |
| **5.** | Comparison of actual performance with budgeted targets will be meaningless specially when there is a difference between the two activity levels. | It provides a meaningful basis of comparison of the actual performance with the budgeted targets. |

**Cash Budget**

Cash Budget is a detailed budget of cash receipts and cash payments incorporating both revenue and capital items for the budget period. This budget is usually of two parts giving detailed estimates of (i) cash receipts and (ii) cash disbursements. Estimates of cash-receipts are prepared on a monthly basis and depend upon estimated cash-sales, collections from debtors and anticipated receipts from other sources such as sale of assets, borrowings, etc. Estimates of cash disbursements are based on estimated cash purchases, payments to creditors, employees’ remuneration, bonus, advances to suppliers, budgeted capital expenditure for expansion, etc.

Cash budget represents the cash requirements of the business during the budget period. It is the plan of receipts and payments of cash for the budget period, analysed to show the monthly flow of cash drawn up in such a way that the balance can be forecasted at regular intervals.

The cash budget is one of the most important elements of the budgeted balance sheet. Information from the various operating budgets, such as the sales budget, the direct materials purchases budget, and the selling and administrative expenses budget, affects the cash budget.

### **The main objectives of preparing cash budget are:**

* 1. The probable cash position, as a result of planned operation, is assessed; and thus, the excess or shortage of cash becomes clear. This helps in arranging short-term borrowings in advance to meet the situations of shortage of cash or making investments when cash is in excess.
  2. Cash can be coordinated in relation to total working capital, sales investment and debt.
  3. A sound basis for credit for current control of cash position is established.
  4. The effect of sudden and seasonal requirements, large stocks, delay in collection of receipts, etc., on the cash position of the organization is revealed and things become under to the management.

### **Advantages of cash budget**

1. It aids in securing option working capital need for smooth running of the operation and planning for payments to the shareholders.
2. It eases strains of a cash shortage
3. It facilitates temporary cash investment wherever, and to whatever extent, found in excess
4. It provides for normal growth

**Topic : Financial Management**

**Financial Management**

“an application of general managerial principles to the area of financial decision-making”

**Objectives of Financial Management**

**Objectives of Financial**

**Management**

**Profit Maximisation**

**(Minimisation of loss)**

**Value/Wealth**

**Maximisation**

**Profit Maximization:** In the economic theory, the behaviour of a firm is analysed in terms of profit maximization. It implies that a firm either produces maximum output for a given amount of input or uses minimum input for producing a given output. So, profit is considered to be the main driving force in business. A firm should manage all aspects of the business in such a way that revenues are maximised and costs are minimised to obtain maximum profit. Arguments in favour and against of profit maximisation are discussed in subsequent section of this chapter.

**Value/ Wealth Maximization:** The earlier objective of profit maximization is now replaced by value/ wealth maximization. Since profit maximization is a limited one it cannot be the sole objective of a firm. Value creation is the driving force behind financial management. Creating wealth for shareholders by increasing the value for their investment is the key goal of financial management today. Maximising the market value of the firm can be calculated by using the formula

**MV= MVE+MVD**

Where,

MV = Market value of the firm

MVE = Market value of equity shares

MVD = Market value of debt; if any

**Scope of Financial Management**

Financial management is concerned with managing financial resources in the most optimal manner.

Modern financial management focuses three important decisions of a firm. These three decisions are discussed below:

* 1. **Investment Decision:** Investment decision of a firm includes two main aspects- where to invest and how much to invest or the amount of investment. This maximizes the wealth of a firm. There are two basic issues involved in investment decisions:
     1. Evaluation of alternative investment avenues so as to select the best option.
     2. Monitoring and implementation of the selected investment option.

Firms need to focus on optimum utilisation of funds with limited resources. The project with a higher return should be selected for investment. Capital Budgeting decisions helps in selecting the project with higher profitability and feasibility. For short-term investment decisions or the working capital management decisions the firm should ensure that there is neither excessive nor inadequate working capital.

* 1. **Financing Decision:** The objective of a financing decision of a firm should be to find out the optimum combination of debt – equity, where cost of capital will be minimum and return will be maximum. Financing decision involves decision regarding the financing pattern of the firm. There are mainly two sources of raising funds- internal source and external source. Internal source includes the owned fund of the firm

i.e the share capital. Whereas the external source includes the borrowed funds i.e loans from banks and other financial institutions, issuing debentures etc. Risk involved in borrowed funds is higher than the risk involved in owned funds. This is because borrowed funds entail a fixed payment commitment like interest, but the owned funds (equity capital) do not include any such fixed commitment except preference shares. So, reasonable care should be exercised while deciding upon the capital structure.

* 1. **Dividend Decision:** Dividend decision of a firm includes determining how much to distribute as dividend and how much to retain for future expansion programme. The objective of dividend policy is to maximise the market value of the equity shares. If the shareholders’ expectations are not fulfilled, ultimately it will have a negative impact on the market value of shares. On the other hand, if a firm fails to grasp or rather predict the reinvestment opportunities then it will have an impact on the future growth of the firm. So, for deciding on the dividend policy, a firm should strike a proper balance between the shareholders’ (equity) expectation and reinvestment opportunities.

**Capital Structure**

A firm needs funds for long-term requirements and working capital. These funds are collected through different sources both short-term and long term. The long-term funds required by a firm are mobilized through owner’s funds (equity share, preference shares and retained earnings) and long-term debt (debentures and bonds). A mix of various long-term sources of funds employed by a firm

is called capital structure.

According to Gerestenberg, ‘capital structure of a company refers to the composition or make-up of its capitalization and it includes all long-term capital resources, viz, loans, bonds, shares and reserves’. Thus, capital structure is made with debt and equity securities and refers to permanent financing of a firm.

Financial Manager has to plan the appropriate mix of different securities in total capitalization in such a way as to minimize the cost of capital and maximize the earnings per share to the equity shareholders.

There may be four fundamental patterns of capital structure as follows:

1. Equity capital only (including Reserves and Surplus)
2. Equity and preference capital
3. Equity, preference and long-term debt i.e. debentures, bonds and loans from financial institutions etc.
4. Equity and long-term debt.

Some authors use capital structure and financial structure interchangeably. But both are different concepts. Financial structure refers to the way in which the total assets of a firm are financed. In other words, financial structure refers to the entire liabilities side of the Balance Sheet. But capital structure represents only long-term sources of funds and excludes all short-term debt and current liabilities. Thus, financial structure is a broader one and capital structure is only part of it.

On the other hand, the capital stack is one of the most important concepts for investors interested in evaluating real estate risk and projected rate of return. Understanding the capital stack to assess trade-offs can protect your investment from undue risk, or insufficient gains.

**Sources of Finance**

Based on financial requirements, there are a number of ways of raising finance i.e. collection of funds for a business. The source of finance chosen depends on the nature of the business. Some other internal and external factors are there. However, financial sources of a business may be classified as follows:

1. Long-term sources e.g., shares, debentures, long-term loan, etc.
2. Medium-term sources, e.g., debentures, public deposits, bank loan/overdraft etc.
3. Short-term sources e.g., trade credit, advance from commercial banks, advances from customers etc. These three types of sources are mentioned below:

|  |  |  |
| --- | --- | --- |
| **Type of Funds** | **Owners Funds** | **Borrowed Funds** |
| **Long-Term** | 1. Equity Share Capital 2. Preference Share Capital 3. Retained Earnings   (Plough back of profits)   1. Capital Subsidy/Incentives | 1. Debentures/Bonds 2. Term Loans from financial institutions    1. Rupee Loan    2. Foreign Currency Loan 3. Term-loan from Banks 4. Venture Capital Financing 5. Interest free Sales Tax Loan 6. Asset/Debt securitization 7. Euro Equity Issues 8. New Debt Instruments |
| **Medium-Term** | Preference Share Capital | 1. Debentures / Bonds 2. Public Deposits 3. Loans from Financial Institutions 4. Loan from Commercial Banks 5. Lease Financing 6. Hire Purchase / Installment Financing Scheme. 7. Euro Debt Issue 8. New Debt Instruments |
| **Short-Term** | Part of Working Capital | 1. Credit from Trade and Expense Creditors.    1. Trade Credits    2. Advances from Customers    3. Short-term Provisions 2. Bank Advances 3. Factoring 4. Commercial Papers 5. Public Deposits 6. Inter-Corporate Deposits 7. Short-term Unsecured Debentures 8. Bridge Finance 9. Certificate of Deposits |

###### **Long Term Sources**

Long-term financing means capital requirements for a period of more than 5 years to 10 or 15 or 20 years based on other factors. Long-term sources of finance are required for capital expenditures in fixed assets like plant and machinery, land and building, etc

###### **Equity Share Capital**

Equity share capital is a basic source of finance for any firm. It represents the ownership interest in the company. The characteristics of equity share capital are a direct consequence of its position in the company’s control, income and assets. Equity share capital does not have any maturity and there is no compulsion to pay dividend. The equity share capital provides funds, more or less, on a permanent basis. It also works as a base for creating the debt and loan capacity of the firm.

The advantages and disadvantages of equity share capital may be summarized as follows:

###### **Advantages of Equity Share Financing**

* 1. It is a permanent source of funds.
  2. The new equity share capital increases the corporate flexibility for the point of view of capital

structure planning.

* 1. Equity share capital does not involve any mandatory payments to shareholders.
  2. It may be possible to make further issue of share capital by using a right offering. In general, selling right

shares involves no change in the relationship between ownership and control.

###### **Disadvantages of Equity Share Financing**

1. Cost of capital is the highest of all sources.
2. Equity share capital has a burden of Corporate Dividend Tax (CDT) on the company.
3. New issue of equity capital may reduce the EPS.

###### **Term Loans**

Term loans are also known as term or project finance. This is also an important source of long-term financing for expansion, diversification and modernization of business. There are different financial institutions like banks and other financial institutions to provide term loans. The maturity period of term loans is typically longer in the range of 6-10 years in comparison to 3-5 years of bank advances.

Sometimes, the funds are required in foreign currency to make payment for acquisition and import of plants and equipments. In 1992, the Government of India permitted Indian companies with good track record of 3 years or more to raise funds by issue of equity/debt capital in international market. There are different means of arranging long-term finance in foreign currency.

###### **Debenture/Bond**

A bond or a debenture is the basic debt instrument which may be issued by a borrowing company for a price which may be less than, equal to or more than the face value. A debenture also carries a promise by the company to make interest payments to the debenture holders of specified amount, at specified time and also to repay the principal amount at the end of a specified period. Since the debt instruments are issued keeping in view the need and cash flow profile of the company as well as the investor, there have been a variety of debt instruments being issued by companies in practice.

###### **Retained Earnings**

The portion of profits not distributed among the shareholders but retained and used in the business is called retained earnings. It is also known as ploughing back of profit or retained capital or accumulated earnings.

###### **Venture Capital**

Venture capital is a form of equity financing especially designed for funding high risk and high reward projects. There is a common perception that venture capital is a means of financing high technology projects. However, venture capital is investment of long-term financial made in:

1. Ventures promoted by technically or professionally qualified but unproven entrepreneurs, or
2. Ventures seeking to harness commercially unproven technology, or
3. High risk ventures.

The term ‘venture capital’ represents financial investment in a highly risky project with the objective of earning a high rate of return.

**Short Term Sources**

From the financing point of view, short-term financing means financing for a period of less than 1 year. The need for short-term finance arises to finance the current assets of a business like an inventory of raw material and finished goods, debtors, minimum cash and bank balance etc. Short-term financing is also named as working capital financing.

Any organisation requires working capital margin to take up day-to-day operations. The working capital amount is divided into two parts – (a) Permanent Working Capital, and (b) Temporary Working Capital. The permanent working capital should be financed from long-term sources and temporary working capital should be financed from short-term sources.

###### **Trade Credit**

When a firm buys goods from another, it may not be required to pay for these goods immediately. During this period, before the payment becomes due, the purchaser has a debt outstanding to the supplier. This debt is recorded in the buyer’s balance sheet as creditors; and the corresponding account for the supplier is that of debtors. The amount of such financing depends on the volume of purchases and the payment timing. Small and new firms are usually more dependent on the trade credit, as they find it difficult to obtain funds from other sources. Trade credit may take form of open account or bills payable.

###### **Bank Credit**

Credit facility provided by commercial banks to meet the short-term and working capital requirements has been important short-term sources of finance in India. The bank credit, in general, is a short-term financing, say, for a year or so. This short-term financing to business firm is regarded as self-liquidating in the sense that the uses to which the borrowing firm is expected to put the funds are ordinarily expected to generate cash flows adequate to repay the loan within a year. Further, these loans are called self-liquidating because the bank’s motive to provide finance is to meet the seasonal demand, e.g., to cover the seasonal increase in inventories or receivables. In principle, the bank credit is intended to carry the firm through seasonal peaks in financing need. The amount of credit extended by a bank may be referred to as a credit limit which denotes the maximum limit of loan which the firm can avail from the bank. Sometimes, the bank may approve separate limits for peak season and non-peak season.

###### Types of Bank Credit

In India, banks may give financial assistance in different shapes and forms. The usual form of bank credit is as follows:

* 1. Overdraft
  2. Cash Credit
  3. Bills Purchasing and Bills Discounting
  4. Letter of Credit
  5. Working Capital Term Loan
  6. Funded Interest Term Loan

###### **Bill Discounting**

Generally, a trade bill arises out of a genuine credit trade transaction. The supplier of goods draws a bill on the purchaser for the invoice price of the goods sold on credit. It is drawn for a short period of 3 to 6 months and in some cases for 9 months. The buyer of goods accepts the same and binds himself liable to pay the amount on the due date. In such a case, the supplier of goods has to wait for the expiry of the bill to get back the cost of the goods sold. It involves locking up of his working capital which is very much needed for the smooth running of the business or for carrying on the normal production process. It is where the commercial banks enter into as a financier.

###### **Factoring**

Factoring may be defined as the relationship between the seller of goods and a financial firm, called the factor, whereby the latter purchases the receivables of the former and also administer the receivable of the former. Factoring involves sale of receivable of a firm to another firm under an already existing agreement between the firm and the factor.

**Working Capital**

The term working capital also called gross working capital refers to the firm’s aggregate of current assets. Current assets are those assets which can be convertible into cash within an accounting period, generally a year. Therefore, they are cash or mere cash resources of a business concern. However, we can understand the meaning of working capital from the following:

* + - 1. “Working capital means the funds available for day-to-day operations of an enterprise. It also represents the excess of current assets over current liabilities including short-term loans”. — Accounting Standards Board, The Institute of Chartered Accountants of India.
      2. “Working capital is that portion of a firm’s current assets which is financed by short-term funds.”— Gitman,

L.J.

From the above definitions, we can say that the working capital is the firm’s current assets or the excess of current assets over current liabilities. However, the later meaning will be more useful in most of the times as in all cases we may not find excess of current assets over current liabilities.

###### Concept of Working Capital

Working capital has two concepts:

* + - * 1. Gross working capital and
        2. Net working capital

Gross working capital refers to the total of the current assets.

Net working capital refers to the excess of the current assets over current liabilities. Net working capital (NWC) can alternatively define as the part of the current assets which are financed with the long-term funds. Since, current liabilities represent sources of short-term funds, as long as the current assets exceeds the current liabilities, the excess must be financed with the long-term funds.

Though both concepts are important for managing it. Gross working capital is more helpful to the management in managing each individual current assets for day-to-day operations. But, in the long run, it is the net working capital that is useful for the purpose.

###### Concept of Zero Working Capital

The zero-working capital (ZWC) differs from the commonly used working capital i.e., current assets minus current liabilities.

The zero-working capital is inventory plus receivables minus payables.

###### **Current Assets**

An asset is classified as current asset when:

it is expected to be realised or intends to be sold or consumed in normal operating cycle of the organisation;

the asset is held primarily for the purpose of trading;

it is expected to be realised within twelve months after the reporting period;

it is non- restricted cash or cash equivalent.

Generally current assets of an organisation, for the purpose of working capital management can be classified into

the following main heads:

Inventory (raw material, work-in-process and finished goods)

Receivables (trade receivables and bills receivables)

Cash or cash equivalents (short-term marketable securities)

Prepaid expenses

###### **Current Liabilities**

A liability is classified as current liability when:

it is expected to be settled in normal operating cycle of the organization

the liability is held primarily for the purpose of trading;

it is expected to be settled within twelve months after the reporting period.

Generally current liabilities of an organisation, for the purpose of working capital management can be classified into the following main heads:

Payables (trade payables and bills receivables)

Outstanding payments (wages and salary etc.)

**Sources of Working Capital**

**Sources of Working Capital Financing**

**Trade Credit**

**Bank Credit**

**Commercial Paper**

**Factoring**

The two important sources of finance for working capital are: (a) trade credit and (ii) bank credit or borrowings. Other sources of finance for working capital are (c) factoring and (d) commercial paper.

###### Trade Credit

Trade credit represents the credit extended by the supplier of goods and services. In practice, the purchasing firms do not have to pay cash immediately for the purchase made. This deferral of payments is a short-term financing that is called trade credit. Trade credit arises in the normal transactions of the firm without specific negotiations, provided the firm is considered creditworthy by its supplier. It is an important source of finance representing 25% to 50% of short-term financing in different industries. Trade credit is mostly an informal arrangement and is granted on an open account basis. Open account trade credit appears as sundry creditors known as accounts payable. Trade credit may also take the form of bills payable.

###### Bank Credit/ Borrowings

Working capital advances by commercial banks represents the most important source for financing current assets. In India, banks may give financial assistance in different shapes and forms. The usual form of bank credits are as follows:

* 1. Overdraft
  2. Cash Credit
  3. Loans
  4. Bills Purchased and Bills Discounting
  5. Letter of Credit
  6. Working Capital Term Loan
  7. Funded Interest Term Loan These are discussed below:

1. Overdrafts: Under the overdraft arrangement, a borrower is allowed to withdraw funds in excess of the balance in his current account up to a pre-determined limit for borrowing is specified by the bank. Though the overdraft amount is repayable on demand, it generally continues for a longer period by annual renewals of the limits. Interest is charged on daily balances on the amount actually withdrawn subject to some minimum charges. The borrower operates the account through cheques.
2. Cash Credit: The cash credit is a very popular method of bank finance for working capital in India. It is more or less similar to overdraft facility. Under this method, a borrower is allowed to withdraw funds from the bank up to a sanctioned credit limit.
3. Loans: These are advances of fixed amounts which are credited to the current account of the borrower or released to him in cash. The borrower is charged with interest on the entire loan amount, irrespective of how much he draws.
4. Purchase / Discounting of Bills: A bill arises out of a trade transaction. The seller of goods draws the bill on the purchaser. The bill may be either clean or documentary (a documentary bill is supported by a document of title to goods like a railway receipt or a bill of lading) and may be payable on demand or after a usance period which does not exceed 90 days. On acceptance of the bill by the purchaser, the seller offers it to the bank for discount / purchase. When the bank discounts / purchases the bill, it releases the funds to the seller. The bank presents the bill to the purchaser (the acceptor of the bill) on the due date and gets its payment.
5. Letter of Credit: Letter of Credit is a formal document issued by a bank on behalf of customer, mentioning the conditions under which the bank will honour the commitments of the customer. A letter of credit is an arrangement whereby a bank helps its customer to obtain credit from its (customer’s) suppliers. When a bank opens a letter of credit in favour of its customer for some specific purchases, the bank undertakes the responsibility to honour the obligation of its customer, should the customer fail to do so.
6. Working Capital Term Loan: At the time the computation of maximum permissible bank finance under the third method or new system of lending, in some cases the net working capital was negative while in others it was equal to 25 % of working capital gap. The Tandon Committee allowed this deficiency to be financed, in addition to the permissible bank finance, by banks. This kind of credit facility is called working capital term loan. The working capital term loan was not allowed to be raised in the subsequent years. For additional credit requirement arising in subsequent years, the borrower’s long-term sources were required to provide 25 % of the additional working capital gap. The banks could grant regular term loans against fixed assets.
7. Funded Interest Term Loan (FITL): As per the Reserve Bank of India, the unrealised portion of interest in the existing borrowal accounts may be funded and treated as funded interest term loan. The FITL will have a repayment period of 7 years inclusive of a moratorium period of 2 years.