Date 12/3/09

UNIT - III

Working Capital Management

Introductions :-

The main objective of any management is to earn profit. For achieving the earnings objective how the business firm is managing the working capital is important. Working capital management is considered as management of current assets namely: Cash, Debtors, and Inventory).

(Management of fixed assets comes with in the jurisdiction of capital budgeting, while the management of working capital is a continuous function which involving control of financial resources circulating in the enterprise. As a matter of fact a business can't survive in the absence of satisfactory ratio between current assets and current liabilities. Therefore, management is setting various policies with respect to purchasing, financing, expansion and declaration of dividend with in the limitations of working capital.)

Definitions :-

(1) "The Sum of the Current assets is the working capital of a business"

— J.S. Mill.

(2) "Working capital is the difference between current assets and current liabilities"

— C.W. Gerstenberg

(3) "Working capital refers to firms investment in short term assets ~~like~~ like Cash, a/c's receivable and stock"

— Brigham

Explain capital Budgeting methods ... superior than traditional ...

Concepts of working Capital :-

(1) There are two concepts of working Capital

(1) Gross Concepts

(2) Net concept

(1) Gross concept :-

Gross concept (or) Gross working capital simply called as working capital refers to total of Current assets.

(2). Net concept :-

The Net concept (or) Net working capital is the excess of Current assets over Current liabilities.

Gerstenberg

Kinds of working Capital :-

2) According to C.W. Gerstenberg working capital can be classified in to two types which is mentioned below:

working Capital

- Regular (or) Permanent working Capital
- Variable working Capital
  - Seasonal working Capital
  - Special working Capital

(1) Regular working Capital :-

It is the minimum amount which should always maintained by the business firm in order to meet day to day operations. It is also known as "Fixed working capital (or) Permanent working capital"

(2) Variable working Capital :-

The amount of working capital over and above the regular working capital is called as "variable working capital". It may be further divided in to 2 types. Namely

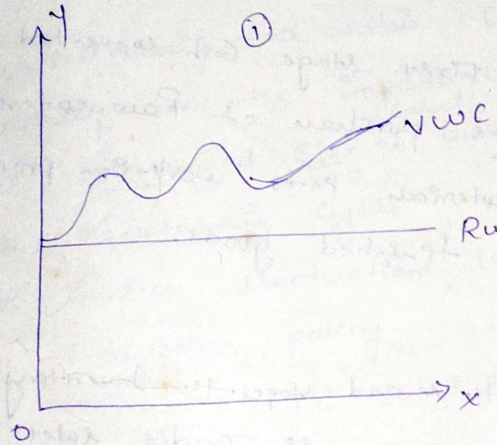
(A) Seasonal working capital, and

(B) Special working capital

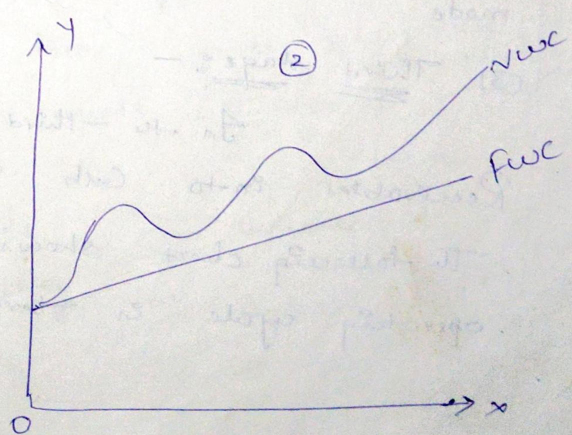
Seasonal and Special working Capital :-

Seasonal working capital is required to meet the seasonal demands. and special working capital is required to meet unforceen conditions

The following (chart) graph shows the nature of regular working capital and variable working capital.



Normal concern



Growing concern

Need for working Capital:-

Generally the business firm has to invest sufficient funds in current assets for the success of sales activity. Current assets are required because when the sales don't converting into cash immediately. There is always an operating cycle involving the conversion of sales into cash.

Operating cycle:-

The time required to complete the sequence of events in the case of manufacturing firm is called "operating cycle".) There are 3 stages in the operating cycle. In

(1) First stage:-

In the first stage cash converted into stock. This includes purchase of Rawmaterials, conversion of Rawmaterials into work-in-process, and work-in-process into finished goods.

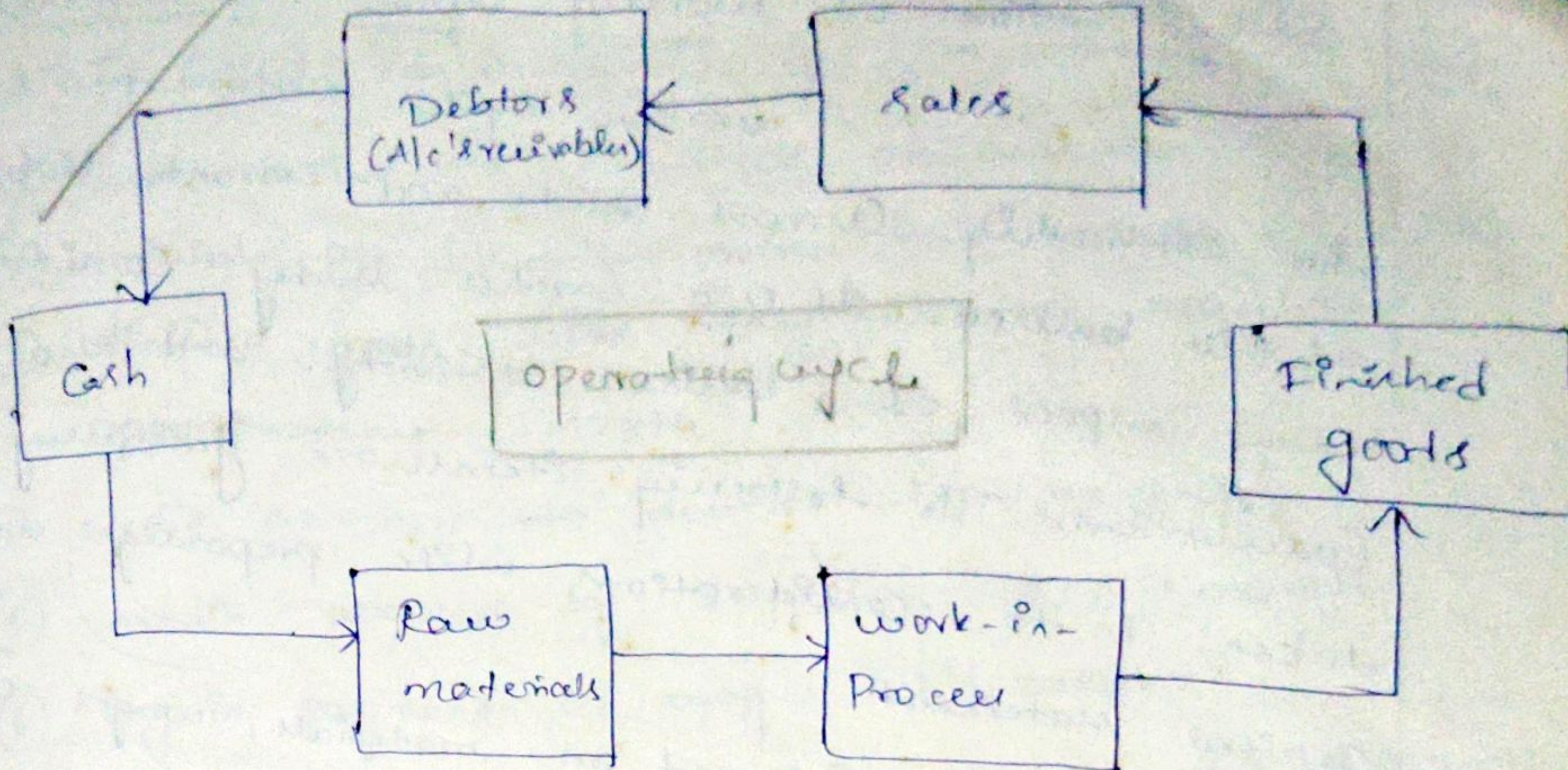
(2) Second stage:-

In the second stage the Inventory is converted into Receivables, if credit sales are made

(3) Third stage:-

In the third stage conversion of Receivables into cash after certain period.

The following chart shows the activities of operating cycle in three different stages.



Operating cycle

Estimatination of working capital requirements :-

A working capital statement is prepared for estimating current assets and current liabilities of the business. It is a careful study considering every aspect of business activity. and also necessary calculations. The following items are generally taken in to consideration while preparing working capital statement.

(1). Cost to be incurred on materials, wages and overheads. collected from Cost records.

(2). Length of time Rawmaterials will be available in the stores before issue to the production.

(3). Length of production cycle (or) Period required for manufacting the product.

(4). Period of time finished goods will stay in the warehouse before sale.

(5). period of credit allowed to the debtors.

(6) period of credit allowed by the Creditors (or) Suppliers.

(7). lag in payment of (outstanding) wages and overhead expenses

☆ Factors influencing working capital requirement (or)
10m Determinents of working capital Explain ?

Meaning :-

The size of working capital required in an organisat depends on different policies that the firm wishes t fallow with respect to it's management. The amount working capital required in an organization would n only be affected by factors specific to the operat of the firm but also in general

Factors influencing working capital requirements :-

1. Nature and ~~sa~~ size of the Business.

The size of working capital needed in an organizati is determined by the nature and size of business Trad oriented enterprizes like Retail shops, showrooms and

and financing companies need more working capital.
The manufacturing enterprizes like steel, cement and electronic companies Relatives maintain lower Balance of current assets when compared to fixed assets
The w.c needs public utilities and service business units like transport, operators, maintain limited w.c.

(2) Manufacturing cycle:-

Firms having longer manufacturing cycle need to maintain large Balance of w.c. manufacturing heavy mechines, cargovessels, aircrafts find their inventory Tied up in larger doses of w.c.

manufacture of food products, perishable products like vegetable, fruits etc...
Circulate their investment in with in days. no need for large balance.

3) production policies:-

In the light of higher cost and larger requirements for w.c Firms may adopt the policy of changing production shedules. The production manager has take Responsibility to adjusting his working staff.

4) Growth and expansion activities:-

Growth in the operations of an enterprise may demand more stock, more cash, Resource to finance, Day to Day activities. It needs large funds.

Increased operations double the charge in coo~~o~~parate practices may also determine the size of w.c Required in a growing firm.

5) Business Fluctuations:-

The overall business environment influences the fortune of an enterprize Business cycle influences the psychology of management piling up a biglot of Raw materials.

An upword swing in the entire economy leads to increased sales which would demand for large balance of w.c.

6) Value of current Assets:-

It is the major influence factor of working capital Requitment because of Total current assets will be increased, Total w.c is also highly required.

Total current assets will be minimum the w.c is also minimum.

7) Credit standards :-

Factors influencing working capital requirement role They are five "c" are credit controll.standards.

1. Character
2. capacity
3. Collateral
4. Capital
5. condition.

10m Explain the sources of working capital?

A Firm Can use 2 types of sources to Finance in working capital

sources of working capital

long Term source | short Term sources

long Term source :-

Every business organisation is required to maintain a minimum balance of cash and other current assets at all times, irrespective of the ups and downs in the level of activity. The portion working capital which is continuously maintained by the business at all times to carry minimum level of activity is called permanent working capital.

Fallowing are the long Term sources of Finance

1. issue of equity shares
2. Issue of preference shares.

3. Retained earnings.
4. Issue of debentures
5. long Term loans-Taken from financial institution

2. short Term sources:-

The short Term financing of working capital is generally used to support the Temporary working capital.

various short Term sources of financing are

1. Bank credit [cash credit, letter of credit, overdraft etc---
2. Trade credit
3. public deposits.
4. outstanding exp
5. provision for Taxation, and Depreciation
6. loans from directors.
7. Advances from customers etc--

(or)
5m Inventory Management? Explain about accounting for
most inventory?

A) Inventory management refers to the process of ordering, storing, useing and selling a company stock this includes the management of Raw materials, components and Finished products as well as wharehousing and processing such items

Accounting for Inventory:-

Inventory Represent a current asset, a company to sell it finished goods within a short period of time that is 1 Year. Inventory has to be measured to put on a balance -sheet. Inventory is accounted for useing one of 3 methods

1. FIFO [First-in-First-out]
2. LIFO [last-in-First out]

3. weighted average costing

Methods for Accounting of inventory :-

An inventory account it consist of 4 Types

1. Raw material
2. work in process (or) progress
3. Finished goods

Raw material :-

This Reprasent various materials of a company purchase in a production process it works before a company can Transform Them into finished good it ready for sale

work in process :-

This reprasent raw material in the process of transfo-red into finished products

Finished goods :-

This are Completed products readyly available for sale a customer

10m 1 Explain Inventary Management Methods ?

A) Depending on the type of business a company will use various inventory management methods they are

1. JIT [Just in Time]
2. MRP [materials Requirement planning]
3. EOQ [economic order quantity]

1. JIT [Just-in-Time]

This manufacturing model originated in Japan in the 1960's and 1970's Toyato motor contributed the most To it's development. The method allows Company's to save amounts of money and reduce waste by keep only the inventory the need to produce and sell

product. This methods requess storage and insurance cost as well as cost of liquidating or discarding excess inventory.
JIT management can be risky if the demand unex. The manufactural may not be able to source the inventory to meet the demand

ii) MRP [Materials Requirement planning]
This inventory management is sales four caste dependend, manufacturals must have accurate sales records to unabl unable accurate planning of inventory.

(iii) EOQ [economic order quantity]
This model is used in calculating the no. of units of a company, should add the inventory with each order to reduce the total cost of its inventory.

The EOQ model ensures the right amount of stock is ordered per batch so orders are frequently is not an excess of inventory. It assumes that there is a trade of between inventory holding cost and setup cost.

2) cash Management Explain the functions of cash management

cash management is required by all kinds for organization of their size, Type and location fallowing are the main functions of cash management

1. Investing of Idle cash
2. controlling cash flows.
3. planning of cash
4. optimising cash level
5. Managing cash flows

i) Investing of Idle cash:-
The company needs to various short term investment to utilize surplus funds.

ii) controlling cash flows
Restruct in the cash out flow and accelerating the cash inflow

(iii) Planning of cash :-
It is the Important Function to plan and decision mak.. in terms of maintaing cash in hand and Investments

iv) optimising cash levels
The organisation should continuously to main the level of liquidity and cash for business operation

(v) Managing ~~Cash~~ cash Flows
maintaing a proper flow of cash in the organisation through cost-cutting and profit generation from Investments

3 Explain the models of cash management ?
cash management requesies a strong base to determin the requirement of cash by the organization to meet it's daily expenses for this some models were designed to determine the level of money on different parameter

The 2 models are cash management
1. The Baumol's EOQ model
2. The "miller - orr" model

The Baumol's EOQ model
These model is based on the EOQ in the year 1952 william J. Baumol gave the Baumol's EOQ model, which influences The cash management of the company.

This model Impoitant on maintaining the optimum cash balance in a year to meet the Business expenses on the one hand and grab the profitable investment opportunities on the other side

The fallowing formula of the Baumol's EQU model Determines the level of cash which is to be maintaine -d by the organisation

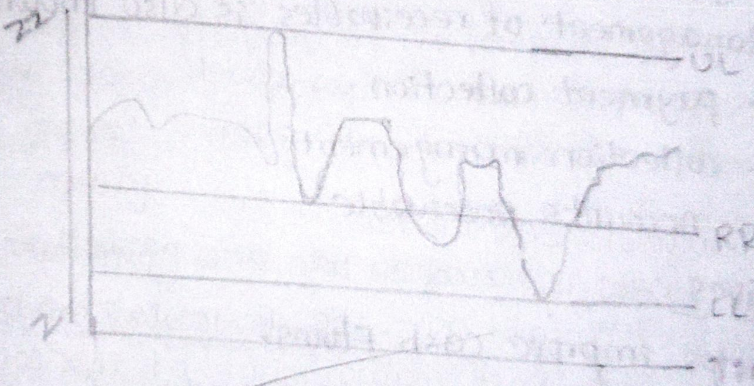
$$C = \sqrt{\frac{2FT}{I}} \qquad C = \sqrt{\frac{2FT}{I}}$$

where
"C" is the optimum cash balance
"F" is the fixed transaction cost
"T" is the total requirement of that period
"I" is the rate of interest during the period

2 The "Miller - Orr model"

merton H miller and Daniel Orr, sound's model determines the cash withdrawals cash is the most uncertain element of business

Many times when the business have surplus cash, Thus discouraging withdrawls instead it may require to make investment. Therefore the Company needs to decide the level of money to be maintain instead of the money the with determined the withdrawl money



Z = spread of cash
UL = upper limit of maximum level
LL = lower limit of minimum level
RR = Return point cash.

we can see that above graph a lower limit which is the minimum cash a business requires to function, After spread cash [ZZ] lower limit gives retain point on Average cash requirement output is generally referred to as the length

Miller orr

For :- $z = 3\sqrt[3]{\frac{3TV}{4i}}$

z = spread across the minimum level & maximum level

T = Transaction cost per transfer

V = variance of daily cash flows

i = daily interest rate.

What is receivable management (or) Accounts Receivables explain its objectives?

Account receivable refers to the outstanding invoice (or) money which is to be paid by over customers. until it is paid such money is accounted as account receivables (or) Bills Receivable. you need cash all the time to keep your business running smoothly and the accounts receivable are paid on time is essential to manage cash flows efficiently

Management of receivables is also known as

1. payment collection
2. collection management
3. Accounts Receivable.

Objectives :-

1. It helps improve cash flows.
2. Reduces losses due to bad debts.
3. Improved customer satisfaction.
4. Boostup sales ~~value~~ volume
5. keep a close eye on long pending bills