Govt Engineering College Jhalawar

Department of management Studies

Class: BBA III rd Year

Subject : Management Of Working Capital

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Model Question Paper With Answer

Q.1 Explain the Cash budget. Explain the Concept of Working Capital

Ans :-

Cash budget :

Definition: A cash budget is a budget or plan of expected cash receipts and disbursements during the period. These cash inflows and outflows include revenues collected, expenses paid, and loans receipts and payments. In other words, a cash budget is an estimated projection of the company's cash position in the future.

Meaning of Working Capital

Capital required for a business can be classified under two main categories viz.

(i) Fixed capital

(ii) Working capital.

Every business needs funds for two purposes for its establishment and to carry out its day-to-day operations. Long-term funds are required to create production facilities through purchase of fixed assets such as plant and machinery, land, Building etc. Investments in these assets represent that part of firm's capital which is blocked on permanent basis and is called fixed capital. Funds are also needed for short-term purposes for purchase of raw materials, payment of wages and other day-to-day expenses etc. These funds are known as working capital which is also known as *Revolving or circulating capital or short term capital*. According to Shubin, "Working capital is amount of funds necessary to cover the cost of operating the enterprise".

Concept of Working Capital

There are two concepts of working capital:

(i) Gross working capital

(ii) Net working capital.

Gross working capital is the capital invested in total current assets of the enterprise. Examples of current assets are : cash in hand and bank balances, Bills Receivable, Short term loans and advances, prepaid expenses, Accrued Incomes etc. The gross working capital is financial or going concern concept. ***Net working capital*** is excess of Current Assets over Current liabilities.

Net Working Capital = Current Assets – Current Liabilities

When current assets exceed the current liabilities the working capital is positive and negative working capital results when current liabilities are more than current assets. Examples of current liabilities are Bills Payable, Sunday debtors, accrued expenses, Bank Overdraft, Provision for taxation etc. Net working capital is an accounting concept of working capital.

Classification or Kinds of Working Capital

Working capital may be classified in two ways:

(a) On the basis of concept

(b) On the basis of time

On the basis of concept working capital is classified as gross working capital and net working capital. On the basis of time working capital may be classifies as Permanent or fixed working capital and Temporary or variable working capital.

Q. 2 **Explain the Working Capital . what are the Element Working Capital?**

Ans : **Managemant of Working Capital**

Working capital refers to excess of current assets over current liabilities. Management of working capital therefore is concerned with the problems that arise in attempting to manage current assets, current liabilities and inter relationship that exists between them. The basic goal of working capital management is to manage the current assets and current of a firm in such a way that satisfactory level of working capital is maintained i.e. it is neither inadequate nor excessive. This is so because both inadequate as well as excessive working capital positions are bad for any business. Inadequacy of working capital may lead the firm to insolvency and excessive working capital implies idle funds which earns no profits for the business. ***Working capital Management policies*** of a firm have a great effect on its profitability, liquidity and structural health of organization. In this context, evolving capital management is three dimensional in nature.

Elements of Working Capital Management

The working capital ratio, calculated as current assets divided by current liabilities, is considered a key indicator of a company's fundamental financial health since it indicates the company's ability to successfully meet all of its short-term financial obligations. Although numbers vary by industry, a working capital ratio below 1.0 is generally indicative of a company having trouble meeting short-term obligations, usually due to insufficient cash flow. Working capital ratios of

1.2 to 2.0 are considered desirable, but a ratio higher than 2.0 may indicate a company is not making the most effective use of its assets to increase revenues.

The collection ratio, also known as the average collection period ratio, is a principal measure of how efficiently a company manages its accounts receivables. The collection ratio is calculated as the number of days in an accounting period, such as one month, multiplied by the average amount of outstanding accounts receivables, with that total then divided by the total amount of net credit sales during the accounting period. The collection ratio calculation provides the average number of days it takes a company to receive payment, in other words, to convert sales into cash. The lower a company's collection ratio, the more efficient its cash flow.

The final element of working capital management is inventory management. To operate with maximum efficiency and maintain a comfortably high level of working capital, a company has to carefully balance sufficient inventory on hand to meet customers' needs while avoiding unnecessary inventory that ties up working capital for a long period of time before it is converted into cash. Companies typically measure how efficiently that balance is maintained by monitoring the inventory turnover ratio. The inventory turnover ratio, calculated as revenues divided by inventory cost, reveals how rapidly a company's inventory is being sold and replenished. A relatively low ratio compared to industry peers indicates inventory levels are excessively high, while a relatively high ratio indicates the efficiency of inventory ordering can be improved.

Permanent or Fixed working capital

It is the minimum amount which is required to ensure effective utilisation of fixed facilities and for maintaining the circulation of current assets. There is always a minimum level of current assets which its continuously required by enterprise to carry out its normal business operations. As the business grows, the requirements of permanent working capital also increase due to increase in current assets. The permanent working capital can further be classified as regular working capital and reserve working capital required to ensure circulation of current assets from cash to inventories, from inventories to receivables and from receivables to cash and so on. Reserve working capital is the excess mount over the requirement for regular working capital which may be provided for contingencies that may arise at unstated periods such as strikes, rise in prices, depression etc.

Temporary or Variable working capital

It is the amount of working capital which is required to meet the seasonal demands and some special exigencies. Variable working capital is further classified as seasonal working capital and special working capital. The capital required to meet seasonal needs of the enterprise is called *seasonal working capital*. Special working capital is that part of working capital which is required to meet special exigencies such as launching of extensive marketing campaigns for conducting research etc.

Q.3 What are the Importance or Advantages and Disadvantages of Adequate Working Capital :

Ans : Working capital is the life blood and nerve centre of a business. Hence, it is very essential to maintain smooth running of a business. No business can run successfully without an adequate amount of working capital. The main advantages of maintaining adequate amount of working capital are as follows:

1. ***Solvency of the Business*:** Adequate working capital helps in maintaining solvency of business by providing uninterrupted flow of production.
2. ***Goodwill*:** Sufficient working capital enables a business concern to make prompt payments and hence helps in creating and maintaining goodwill.
3. ***Easy Loans*:** A concern having adequate working capital, high solvency and good credit standing can arrange loans from banks and others on easy and favourable terms.
4. ***Cash Discounts*:** Adequate working capital also enables a concern to avail cash discounts on purchases and hence it reduces cost.
5. ***Regular Supply of Raw Material*:** Sufficient working capital ensure regular supply of raw materials and continuous production.
6. ***Regular payment of salaries, wages and other day to day commitments*:** A company which has ample working capital can make regular payment of salaries, wages and other day to day commitments which raises morale of its employees, increases their efficiency, reduces costs and wastages.
7. ***Ability to face crisis*:** Adequate working capital enables a concern to face business crisis in emergencies such as depression.
8. ***Quick and regular return on investments*:** Every investor wants a quick and regular return on his investments. Sufficiency of working capital enables a concern to pay quick and regular dividends to is investor as there may not be much pressure to plough back profits which gains the confidence of investors and creates a favourable market to raise additional funds in future.
9. ***Exploitation of Favourable market conditions*:** Only concerns with adequate working capital can exploit favourable market conditions such as purchasing its requirements in bulk when the prices are lower and by holding its inventories for higher prices.
10. ***High Morale*:** Adequacy of working capital creates an environment of security, confidence, high morale and creates overall efficiency in a business.

Excess or Inadequate Working Capital

Every business concern should have adequate working capital to run its business operations. It should have neither excess working capital nor inadequate working capital. Both excess as well as short working capital positions are bad for any business.

Disadvantages of Excessive Working Capital

1. Excessive working capital means idle funds which earn no profits for business and hence business cannot earn a proper rate of return.

2. When there is a redundant working capital it may lead to unnecessary purchasing and accumulation of inventories causing more chances of theft, waste and losses.
3. It may result into overall inefficiency in organization.
4. Due to low rate of return on investments, the value of shares may also fall.
5. The redundant working capital gives rise to speculative transaction.
6. When there is excessive working capital, relations with banks and other financial institutions may not be maintained.

Disadvantages of Inadequate working capital

1. A concern which has inadequate working capital cannot pay its short-term liabilities in time. Thus, it will lose its reputation and shall not be able to get good credit facilities.
2. It cannot buy its requirements in bulk and cannot avail of discounts.
3. It becomes difficult for firm to exploit favourable market conditions and undertake profitable projects due to lack of working capital.
4. The rate of return on investments also falls with shortage of working capital.
5. The firm cannot pay day-to-day expenses of its operations and it created inefficiencies, increases costs and reduces the profits of business.

Q.4 What are the Need or Objects or Working Capital

Ans : Need or Objects or Working Capital

The need for working capital arises due to time gap between production and realisation of cash from sales. There is an operating cycle involved in sales and realisation of cash. There are time gaps in purchase of raw materials and production, production and sales, and sales and realisation of cash. Thus, working capital is needed for following purposes.

1. For purchase of raw materials, components and spares.
2. To pay wages and salaries.
3. To incur day-to-day expenses and overhead costs such as fuel, power etc.
4. To meet selling costs as packing, advertisement
5. To provide credit facilities to customers.
6. To maintain inventories of raw materials, work in progress, stores and spares and finished stock.

Greater size of business unit large will be requirements of working capital. The amount of working capital needed goes on increasing with growth and expansion of business till it attains maturity. At maturity the amount of working capital needed is called normal working capital.

Q.5 What Are the Factors Determing the Working Capital Requirements

Ans : The following are important factors which influence working capital requirements:

1. ***Nature or Character of Business*:** The working capital requirements of firm depend upon nature of its business. Public utility undertakings like electricity, water supply need very limited working capital because they offer cash sales only and supply services, not products, and such no funds are tied up in inventories and receivables whereas trading and financial firms require less investment in fixed assets but have to invest large amounts in current assets and as such they need large amount of working capital. Manufacturing undertaking require sizeable working capital between these two.

2. ***Size of Business/Scale of Operations*:** Greater the size of a business unit, larger will be requirement of working capital and vice-versa.

3. ***Production Policy*:** The requirements of working capital depend upon production policy. If the policy is to keep production steady by accumulating inventories it will require higher working capital. The production could be kept either steady by accumulating inventories during slack periods with view to meet high demand during peak season or production could be curtailed during slack season and increased during peak season.

4. ***Manufacturing process / Length of Production cycle*:** Longer the process period of manufacture, larger is the amount of working capital required. The longer the manufacturing time, the raw materials and other supplies have to be carried for longer period in the process with progressive increment of labour and service costs before finished product is finally obtained. Therefore, if there are alternative processes of production, the process with the shortest production period should be chosen.

5. ***Credit Policy*:** A concern that purchases its requirements on credit and sell its products/services on cash requires lesser amount of working capital. On other hand a concern buying its requirements for cash and allowing credit to its customers, shall need larger amount of working capital as very huge amount of funds are bound to be tied up in debtors or bills receivables.

6. ***Business Cycles*:** In period of boom i.e. when business is prosperous, there is need for larger amount of working capital due to increase in sales, rise in prices etc. On contrary in times of depression the business contracts, sales decline, difficulties are faced in collections from debtors and firms may have large amount of working capital lying idle.

7. ***Rate of Growth of Business*:** The working capital requirements of a concern increase with growth and expansion of its business activities. In fast growing concerns large amount of working capital is required whereas in normal rate of expansion in the volume of business the firm may have retained profits to provide for more working capital.

8. ***Earning Capacity and Dividend Policy*.** The firms with high earning capacity generate cash profits from operations and contribute to working capital. The dividend policy of concern also influences the requirements of its working capital. A firm that maintains a steady high rate of cash dividend irrespective of its generation of profits

need more working capital than firm that retains larger part of its profits and does not pay so high rate of cash dividend.

9. ***Price Level Changes*:** Changes in price level affect the working capital requirements. Generally, the rising prices will require the firm to maintain large amount of working capital as more funds will be required to maintain the same current assets. The effect of rising prices may be different for different firms.

10. ***Working Capital Cycle*:** In a manufacturing concern, the working capital cycle starts with the purchase of raw material and ends with realisation of cash from the sale of finished products. This cycle involves purchase of raw materials and stores, its conversion into stocks of finished goods through work in progress with progressive increment of labour and service costs, conversion of finished stock into sales, debtors and receivables and ultimately realisation of cash and this cycle again from cash to purchase of raw material and so on. The speed with which the working capital completes one cycle determines the requirements of working capital longer the period of cycle larger is requirement of working capital.

Q.6 **Explain the Principal of Working Capital management ?**

Ans : Principles of Working Capital Management

Principles of Working Capital Management

***1. Principle of Risk Variation*:** Risk refers to inability of firm to meet its obligation as and when they become due for payment. Larger investment in current assets with less dependence on short-term borrowings increases liquidity, reduces risk and thereby decreases opportunity for gain or loss. On other hand less investment in current assets with greater dependence on short-term borrowings increases risk, reduces liquidity and increases profitability.

There is definite direct relationship between degree of risk and profitability. A conservative management prefers to minimize risk by maintaining higher level of current assets while liberal management assumes greater risk by reducing working capital. However, the goal of management should be to establish suitable trade off between profitability and risk. The various working capital policies indicating relationship between current assets and sales are depicted below:-

***2. Principle of Cost of Capital*:** The various sources of raising working capital finance have different cost of capital and degree of risk involved. Generally, higher the risk lower is cost and lower the risk higher is the cost. A sound working capital management should always try to achieve proper balance between these two.

***3. Principle of Equity Position*:** This principle is concerned with planning the total investment in current assets. According to this principle, the amount of working capital invested in each component should be adequately justified by firm's equity position. Every rupee invested

in current assets should contribute to the net worth of firm. The level of current assets may be measured with help of two ratios.

(i) Current assets as a percentage of total assets and

(ii) Current assets as a percentage of total sales.

***4. Principle of Maturity of Payment*:** This principle is concerned with planning the sources of finance for working capital. According to this principle, a firm should make every effort to relate maturities of payment to its flow of internally generated funds. Generally, shorter the maturity schedule of current liabilities in relation to expected cash inflows, the greater inability to meet its obligations in time.

Q.7 **Eplain the different types Approach of working capital.**
Ans:

(1) The Hedging or Matching Approach: The term 'hedging' refers to two off-selling transactions of a simultaneous but opposite nature which counterbalance effect of each other. With reference to financing mix, the term hedging refers to 'process of matching of maturities of debt with maturities of financial needs'. According to this approach the maturity of sources of funds should match the nature of assets to be financed. This approach is also known as 'matching approach' which classifies the requirements of total working capital into permanent and temporary working capital.

The hedging approach suggests that permanent working capital requirements should be financed with funds from long-term sources while temporary working capital requirements should be financed with short-term funds.

***(2) The Conservative Approach*:** This approach suggests that the entire estimated investments in current assets should be financed from long-term sources and short-term sources should be used only for emergency requirements. The distinct features of this approach are:

(ii) Liquidity is greater

(iii) Risk is minimised

(iv) The cost of financing is relatively more as interest has to be paid even on seasonal requirements for entire period.

Trade off Between the Hedging and Conservative Approaches

The hedging approach implies low cost, high profit and high risk while the conservative approach leads to high cost, low profits and low risk. Both the approaches are the two extremes and neither of them serves the purpose of efficient working capital management. A trade off between the two will then be an acceptable approach. The level of trade off may differ from case to case depending upon the perception of risk by the persons involved in financial decision making. However, one way of determining the trade off is by finding the average of maximum and the minimum requirements of current assets. The average requirements so calculated may be financed out of long-term funds and excess over the average from short-term funds.

(3). Aggressive Approach: The aggressive approach suggests that entire estimated requirements of current asset should be financed from short-term sources even a part of fixed assets investments be financed from short-term sources. This approach makes the finance – mix more risky, less costly and more profitable.

Hedging Vs Conservative Approach

Hedging Approach	***Conservative Approach***
1. The cost of financing is reduced.	1. The cost of financing is higher
2. The investment in net working capital is nil.	2. Large Investment is blocked in temporary working capital.
3. Frequent efforts are required to arrange funds.	3. The firm does not face frequent financing problems.
4. The risk is increased as firm is vulnerable to sudden shocks.	4. It is less risky and firm is able to absorb shocks.

Q..8 **Summarised income and expenditure forecasts for the month of march to August ,2017 are given below.**

Month	Sales	Purchase	Wages	overhead
March	**60,000**	**36,000**	**9,000**	**10,000**
April	**62,000**	**38,000**	**8,000**	**9,000**
May	**64,000**	**33,000**	**10,000**	**11,500**
June	**58,000**	**35,000**	**8,500**	**9,000**
July	**56,000**	**39,000**	**9,5,00**	**9,5,00**
August	**60,000**	**34,000**	**8,000**	**8,500**

You are required to prepare a cash budget for 3 months starting on ist may 2017 keeping in vew the following information:

1) cash Balance as on ist may2017 Rs. 8,000
2) sales and purchase all on credit
3) plant costing Rs. 16,000 is due for Delivery in july payable 10% on delivery and the blance after 3 month
4) advance tax installment of Rs. 8,000 each are Payable in March and June
5) the period of Credit allowed by suppliers is 2 months and that allowed to customer is 1 month and
6) lag in payment of all expenses is one month.

Ans:-

Particular	April	May	june
Opening balance of cash:	8,000	16,500	13,000
Receipts:			
Cash collection from customer	62,000	64,000	58,000
Total Cash Available (A)	70,000	80,500	71,000
Payments:			
Account Payable	36,000	38,000	33,000
Wages	8,000	10,000	8,500
Overhead	9,500	11,500	9,000
Plat(10%)	……..	……..	1,600
Advance Tax	……..	8,000	……..
Total Payment (B)	53,500	67,500	52,100
Closing balance of cash (A-B)	16,500	13,000	18,900