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Working Capital Management

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By: *Anand Prakash Srivastava*

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WORKING CAPITAL MANAGEMENT

Sample Preview of the Solved Sample Question Papers

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Sample

QUESTION PAPER-1

(Solved)

WORKING CAPITAL MANAGEMENT

M.M.P.F-01

Time: 3 Hours] *[Maximum Marks: 100*

Note: *Attempt any* ***five*** *questions. All questions carry equal marks.*

Q. 1. Why is working capital considered a liquidation concept?

Ans. Ref.: See Chapter-1, Page No. 8, Q. No. 2.

Q. 2. How do you assess the credit worthiness of customers?

Ans. Ref.: See Chapter-4, Page No. 54, Q. No. 3.

Q. 3. Alpha Trading Corporation requires Rs 2.5 mn in cash for meeting its transaction needs over the next 6 months. It currently has the amount in the form of marketable securities. The cash payments will be made evenly over the 6-month planning period. It earns 10% annual yield on the marketable securities. The conversion of marketable securities intocash entails a fixed cost of Rs 1200 per transaction. What is the optimal conversion size as per the Baumol Model?

Ans. Ref.: See Chapter-6, Page No. 90, Q. No. 11.

Q. 4. Compare Manufacturing Companies against Service Firms in terms of Credit Policies.

Ans. Ref.: See Chapter-9, Page No. 132, Q. No. 5.

Q. 5. Explain briefly the nature of Bank Lending.

Ans. Ref.: See Chapter-10, Page No. 150, Q. No. 1.

Q. 6. How are the working capital activities in large companies different from SMEs?

Ans. Ref.: See Chapter-13, Page No. 190, Q. No. 2.

Q. 7. How does the Working Capital Management of an MNC differ from a domestic company?

Ans. Ref.: See Chapter-14, Page No. 199, Q. No. 1.

Q. 8. Do you propose any changes in the Accounting Policies of the company for better management of Receivables? You can draw a comparison between the Indian GAAP and IFRS.

Ans. Ref.: See Chapter-15, Page No. 211, Q. No. 6.

■ ■

Sample

QUESTION PAPER-2

(Solved)

WORKING CAPITAL MANAGEMENT M.M.P.F-01

Time: 3 Hours] *[Maximum Marks: 100*

Note: *Attempt any **five** questions. All questions carry equal marks.*

Q. 1. Trace out the Interest Rate policy in India. Can you identify what would be the impact of interest rates on financial decision making?

Ans. Ref.: See Chapter-2, Page No. 22, Q. No. 3.

Q. 2. Management of InfoTech Limited seeks your assistance on assessing the working capital requirements for an activity level of 1,00,000 units of output for the year 2020. The cost details of the product are as Follows:

Particulars	Cost per Unit (Rs.)
Raw materials...	20
Direct labor...	5
Overheads...	15
Total cost...	40
Profit...	10
Selling price...	50

The other details are:

1. **In order to ensure smooth flow of production 2 months raw material inventory is to be held in the stores.**
2. **Finished goods remain in stores for one month.**
3. **Credit allowed for purchase of raw material is one month.**
4. **Credit allowed to customers is 2 months.**
5. **Cash Balance to be maintained is Rs.25,000.**
6. **Assuming that the product process is uninterrupted and even, compute the amount of working capital required for the given level of activity.**

Ans. Ref.: See Chapter-3, Page No. 39, Q. No. 6.

Q. 3. How do you measure the uncertainty associated with cash flows? Discuss the methods available to manage the uncertainty of cash flows?

Ans. Ref.: See Chapter-5, Page No. 72, Q. No. 5.

Q. 4. How is value created through working capital management?

Ans. Ref.: See Chapter-8, Page No. 121, Q. No. 2.

Q. 5. Why are banks major investors in Commercial Paper?

Ans. Ref.: See Chapter-11, Page No. 166, Q. No. 6.

Q. 6. How do you manage the working capital effectively in SMEs?

Ans. Ref.: See Chapter-12, Page No. 182, Q. No. 8.

Q. 7. "Accounts Receivables Management is not a big deal for an MNC". Do you agree?

Ans. Ref.: See Chapter-14, Page No. 202, Q. No. 7.

Q. 8. How do you analyze the Business Model of Paytm? Do you have any suggestions?

Ans. Ref.: See Chapter-15, Page No. 209, Q. No. 1.

■■

Sample Preview
of
The Chapter

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WORKING CAPITAL MANAGEMENT

BLOCK 1: CONCEPTS AND DETTERMINATION

Conceptual Framework 1

INTRODUCTION

The management of long-term capital and the management of short-term cash, or working capital, are the two main components of financial management. The control of every ebb and flow of financial resources moving through the firm in one way or another is a continual function of working capital management, which is a key area of decision-making for financial managers. It also describes how current assets and liabilities are managed. The successful functioning of a business enterprise and increasing its rate of return on the capital invested in short-term assets both depend on effective working capital management. In actuality, a company unit's operational effectiveness is wholly dependent on the careful management of working capital.

Working capital is referred to by a number of words, including working money, circulating capital, and temporary funds.

However, because to its familiarity and simplicity, the term "working capital" is chosen by many.

CHAPTER AT A GLANCE

DEFINITION OF WORKING CAPITAL

There are two ways to define working capital as the sum of current assets or as the difference between the sum of current assets and the sum of current liabilities. For monetary terms different authors use the term "working capital" to mean different things. Consequently, the following two ideas on working capital were developed:

(*i*) Gross working capital concept,

(*ii*) Working capital net concept.

Gross Concept: Total current assets and working capital are used interchangeably by authors including Mehta, Archer, Bogen, Mead, and Baker. For the following grounds, they contend that working capital is nothing more than the sum of current assets:

(*i*) Assets that are partially fixed and partially current are used to generate profits. Fixed and current assets are somewhat comparable in that both are partially borrowed and provide income above and beyond interest expenses.

(*ii*) The gross working capital will increase with every increase in funds, but the operating manager's access to funds won't change in line with the net idea of working capital.

(*iii*) The management is less interested with the origins of the cash than they are with the overall amount of current assets, which represent the total amount of funds available for operating purposes.

(*iv*) When an organization was a sole proprietorship or partnership, the net idea of working capital applied. In other words, there was close coordination between the enterprise's ownership, management, and control; as a result, the ownership of current and fixed assets is not as significant as it formerly was.

Net Concept: Writings by Smith, Guthmann, Dougall, Howard, and Gross, in contrast to the aforementioned viewpoint, view working capital as just the gap between current assets and current liabilities.

A larger definition of working capital, according to Keith V. Smith, would include include current liabilities like accounts payable, notes payable, and other accruals.

The following justifications are given in favour of the net concept:

(*i*) The excess of current assets over current liabilities is what counts in the long run.

(*ii*) This idea aids creditors and investors in determining the company's financial stability.

Since it is not to be repaid, the excess of current assets over current obligations may always be counted on to cover unforeseen circumstances. Additionally, this definition aids in determining the accurate financial situation of businesses with the same amount of current assets.

Since assets are used to calculate a rate of return, the Gross Concept is also known as the Economics concept. More significant than the calculated gap between assets and liabilities is the rate of return produced by various assets. The net notion, on the other hand, is supposedly from the perspective of an accountant.

CONSTITUENTS OF WORKING CAPITAL

Working capital, as well as what current assets and liabilities are. For this aim, let's look at the Lupin Laboratories Ltd. balance sheet.

Existing Assets: The Company lists the following items as current assets:

(1) Inventories:

(a) Raw materials and packing materials,

(b) Work-in-progress,

(c) Finished/Traded goods,

(d) Stores, Spares and fuel.

(2) Sundry Debtors:

(a) Debts outstanding for a period exceeding six months,

(b) Other debts.

(3) Cash and Bank balances:

(a) With Scheduled Banks:

(*i*) In Current accounts,

(*ii*) In Deposit accounts.

(b) With others in:

(*i*) Current accounts.

(4) Loans and advances:

(a) Secured Advances,

(b) Unsecured (considered good):

(*i*) Advances recoverable in cash or kind for value to be received,

(*ii*) Deposits,

(*iii*) Balances with customs and excise authorities.

Current Liabilities: The following items are included under this category.

(*i*) Current Liabilities:

(a) Sundry creditors,

(b) Unclaimed dividend warrants,

(c) Unclaimed debenture interest warrants.

(*ii*) Short-term credit:

(a) Short term loans,

(b) Cash credit from banks,

(c) Other short-term payables.

(*iii*) Provisions:

(a) For Taxation,

(b) Proposed Dividend,

(*i*) On preference shares,

(*ii*) On equity shares.

The same applies to invoices that need to be paid and money that has been received in advance for services that need to be provided.

However, there are divergent views on what is current. It is tied to the firm's operational cycle in the strictest sense of the word, and current assets are those that can be converted into cash during the operating cycle. The operating cycle's duration may be more or less comparable to the company's accounting period. For some businesses, the operating cycle duration could be brief, and there might be more than one cycle throughout a given accounting period.

TYPES OF WORKING CAPITAL

Working capital may occasionally be split into two categories as follows:

(*i*) Permanent Working Capital

(*ii*) Variable Working Capital

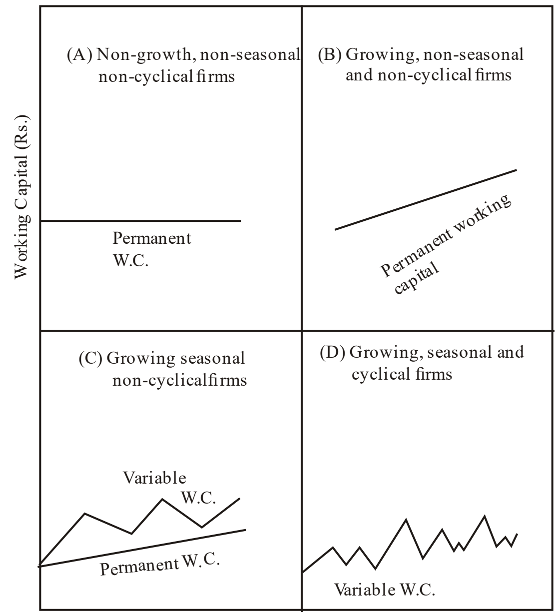
(*i*) Permanent Working Capital: While the lifespan of working capital is typically little longer than a year, in actuality some portion of the investment in that is always permanent. A portion of investment is always locked up in the form of raw materials, work-in-progress, finished stocks, book debts, and cash since enterprises have generally longer lifespans and production does not halt at the end of a certain accounting period. The expenditure on these working capital items is merely rolled over to the following year. The term "permanent working capital" refers to the minimal amount of current asset investment needed to run the business continuously. The Tandon Committee has acknowledged the necessity to maintain a certain level of investment in current assets while offering a way for commercial banks to finance their working capital requirements. As hard core current assets, it referred to them.

***(ii)* Variable Working Capital :** This is sometimes referred to as working capital that is in circulation or temporary. This is the sum of money needed to invest in order to cover changes in business activity. Variable working capital is supposed to cover the peaks in business activity, whereas permanent working capital is intended to cover the minimal investment in a variety of current assets. While the investment in the permanent portion of working capital can be predicted with some degree of certainty, the investment in the variable portion of working capital is more difficult to predict because unexpected changes in business activity can cause variations in this portion of working capital.

Working Capital Behaviour

Understanding working capital's behaviour over time is one of the implications of dividing it into two sorts. Sales volume and working capital investment are linked. A change in the working capital investment would result from a change in the sales volume over time.

Illustrates how various forms of working capital behave in various businesses that are impacted by seasonal and cyclical changes in production or sales. All working capital for non-growth, non-seasonal, and non-cyclical businesses can be viewed as permanent, as demonstrated in (A). Similar to this, expanding businesses need more working capital over time, but swings are not anticipated. As a result, there is no variable element of working capital in this instance either. There are two forms of working capital in the third scenario (rising seasonal and non-cyclical enterprises). On the other hand, it is considered that all working capital in growing, seasonal, and cyclical businesses is of diverse types.



Behaviour of Working Capital

CYCLICAL FLOW AND CHARACTERISTICS OF WORKING CAPITAL

Every organization will have a regular cycle of activity. Working capital changes and shifts from one to the other as a result of the interaction of the many forces that have an impact on it. Therefore, it is the responsibility of the financial management to make sure that the flow moves through the various working capital stages at an efficient rate and at the proper time. However, depending on the characteristics of the various businesses, the subsequent moves in this cycle will vary from one to the next. For instance:

(i) If the company is a manufacturer, the cycle will go as follows:
Cash → (buying) →Raw Materials → (production) → Finished Goods → (sales on credit) Accounts Receivable → (Collections) → Cash.

(ii) The cycle is shortened as follows:
Cash → (buying) → Merchandise →(Sales) →Accounts Receivables→(Collections) → Cash.

(iii) If the business is solely focused on lending, the cycle is even shorter and can be represented as:
Cash→ (sanction of loans) →Debtors → (collections) → Cash.

Three crucial aspects of working capital are readily discernible:

1. Short-life Span: Working capital consists primarily of transient assets. Their lifespan is typically no longer than a year. In reality, though, some assets that don't meet this standard are nonetheless considered current assets.

2. Swift Transformation and Inter-related Asset Forms: Along with having a limited lifespan, each element of the existing assets is quickly converted into the other assets. As a result, cash is used to restock inventories. Sales reduce inventories, which raise accounts receivable, and the recovery of accounts receivable raises cash balances.

3. Assets Forms and Synchronization of Activity Levels: A third property of working capital components is that they have a lifespan that is influenced by how slowly and unevenly basic processes like manufacturing, distribution, and collecting occur.

PLANNING FOR WORKING CAPITAL

Many of the decisions can be made logically by first planning. It holds true for decisions about working capital as well. Working capital cannot be used as effectively as it should be unless we plan for its acquisition and utilization. In a sense, good planning results in the efficient distribution of resources across the various working capital components. Planning obviously integrates effectiveness by making a distinction of the sort made famous by Peter F. Drucker between efficiency (doing things correctly) and effectiveness (doing the right things). This is why the current conceptual framework discussion is thought to be extremely applicable and inclusive of working capital planning.

Tools of Planning for Working Capital

Treating the planning for working capital as part of financial planning, we can note down the following tools of analysis with respect to time-frame.

(*a*) **Short-term Planning:** Cash Budgeting.

(*b*) **Medium-term Planning:** Determination of appropriate levels of working capital items.

(*c*) **Long-term Planning:** Projected dividend payments and shareholder returns based on CVP and funds flow analysis.

Cash Budget: For short-term working capital planning, cash budgeting is seen as a useful tool. The use of the cash budget technique is thought to be superior to using proforma balance sheets or extrapolating from past experience when estimating the magnitude of the cash flows. The comparison of anticipated cash inflows and outflows for a specific time frame, such as a day, a week, a month, a quarter, or an entire year, is known as a cash budget. Typically, a cash budget is created to cover a year, with the year being divided into intervals. It can be prepared in a variety of ways, such as one based on cash receipts and outlays, the adjusted net income technique, the working capital difference approach, or another method based on net income. The Receipts and Payments approach is one of the numerous ways to create a cash budget and is used by many businesses. Since the entire budgetary structure is divided into income budgets, expenditure budgets, and cash budgets, the creation of cash budgets in organizations is a crucial step in the financial process. The organizations' cash budget was created by appropriating data from several different budgets, including the following:

(*i*) Production budgets.
(*ii*) Sales budget.
(*iii*) Cost of production estimates with its necessary subdivisions for example:
  (a) Materials purchase estimates,
  (b) Labour and personnel estimates,
  (c) Plant maintenance estimates, etc.
(*iv*) Manpower budget.
(*v*) Township and welfare estimates.
(*vi*) Profit and loss estimates.
(*vii*) Capital expenditure budget.

In order to track historical cash flows and plan for the future, a cash budget is created. Cash budgets are typically created annually with monthly breakdowns by all businesses.

Medium-term Planning: Finding the right level of working capital is seen as being important in the medium term.

CVP Analysis: Macro-level strategies like C-V-P and Funds Flow are thought to be beneficial in creating a successful long-term plan. These are beneficial for all aspects of financial planning, not just the planning of working capital. We are obliged to develop linkages between expenses, volume, and profits at the level of working capital planning. In the context of working capital, we can be cautious about the costs and revenues associated with working capital items such