

## **CHAPTER III**

### **THEORITICAL BACKGROUND OF WORKING CAPITAL IN SHREEM CAPACITORS PVT. LTD.**

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### THEORITICAL BACKGROUND OF WORKING CAPITAL IN SHREEM CAPACITORS PVT. LTD.

#### 3.1 Introduction:

Shreem Capacitors is a manufacturing company of capacitors which are heavily demanded by Government and Private electrical companies. The company is not seasonal company and activities are going on throughout the year. The company accepts the concept of Net Working Capital i.e. Current Assets less Current Liabilities.

The structure of Current Assets and Current Liabilities in Shreem Capacitors Pvt. Ltd. during the year 2004-2009

(Rs.in lakhs)

Sr,No,	Current Assets	2004-05	2005-06	2006-07	2007-08	2008-09
1.	Cash and Bank Balance	486.58	687.57	1071.24	1301.84	2859.18
2.	Inventories	100.18	122.40	161.52	410.15	463.53
3.	Debtors	2601.75	3771.83	4958.70	10569.74	12726.98
4.	Loans & Advances	640.05	806.32	-	2708.20	2430.15
	Current Liabilities					
1.	Creditors	1364.58	1832.70	2188.95	7124.40	6175.14
2.	Advance from Customers	-	-	10.51	315.92	1946.36
3.	Tax provision	8.000	10.000	109.00	445.00	37.18

All above current assets and current liabilities are broadly found in every organization. Many organizations as a policy matter keep minimum components of current assets and or current liabilities for the sake of better control over the components and better management of working capital.

### **3.2 Structure of current assets and current liabilities in Shreem Capacitors:**

The structure of current assets and current liabilities in the company is as :

#### **Components of Current Assets and Current Liabilities**

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

- Inventory
- Debtors
- Cash And Bank
- Short term Advance.

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

- Creditors
- Advance from customers
- Tax provision

The company has succeeded to maintain the minimum components which are helping a lot to the company to monitor each component. It makes them easy to reduce level of current liabilities and optimum investment in current assets.

In company's books of accounts, Current Assets comprise raw materials; work in process and finished goods. Short term advance includes advances to suppliers, employees etc. Whenever there are other components viz. deposits, advance income tax paid it is included under Loans and Advances.

During years under our study the company has shown above components of current assets and current liabilities as its main components, and any other miscellaneous components, in any of the years are also comprised therein.

The management of current assets and current liabilities is management of working capital. The efficiency of working capital management decides the company's solvency or bankruptcy. Time factor is very important factor in managing the working capital. All the above components are managed in such a way that the operating cycle should not become lengthy. Success of operating cycle is solely depended on how the components of working capital are monitored.

### **3.3 Operating Cycle in Shreem Capacitors:**

Operating cycle precisely measure the working capital fund requirement. Operating cycle traces its changes and determines optimum level of working capital requirement.

Shreem Capacitors is keen on reducing the length of operating cycle. Generally the operating cycle is prolonged because of following reasons –

- a) Purchase of raw material either in excess or in short.
- b) Purchase of defective or low quality merchandise
- c) Non availability of trade discounts
- d) Failure to take purchase decision during season
- e) Failure to take suitable decisions on inventory consumption
- f) Interrupted manufacturing cycle.
- g) Non availability of goods on credit
- h) Negligent approach towards internal and external environment.

Shreem Capacitors is taking adequate care to avoid the above reasons of prolongation of operating cycle. The company has formed inventory policy, Account collection policy and purchase policy.

In addition to the policies the staff at manufacturing department is sufficiently trained. Demand of consumables from manufacturing unit and supply of consumables from Go-down goes hand in hand. The company takes decision for upkeep and maintenance of machinery and building in time.

However, despite due care there may be occasions where the company needs to give special attention to reduce the operating cycle length. The company takes following remedial measures to reduce the length of operating cycle.

### **3.4 Measures to reduce the length of operating cycle in Shreem Capacitors -**

#### **3.4.1 Purchase Management –**

The company adopts the policy of six 'R' i.e. ensuring right type of materials in right quantity of right quality at right price on right time and right place.

#### **3.4.2 Production Management –**

The company believes that longer the manufacturing cycle longer will be operating cycle and higher will be working capital requirement. Hence the company adopts following measures –

- i) Proper maintenance of plant, machinery and other infrastructural facilities
- ii) Proper planning and coordination at all levels of activity
- iii) Up-gradation of manufacturing system, technology

#### **3.4.3 Marketing Management –**

The company has adopted marketing policies. Mismatch in Production and Sales is avoided. Advertisement, sales promotion activities are handled effectively. Every care is taken to avoid the storage period of finished goods.

#### **3.4.4 Discreet Collection and Credit Policies –**

Finance manager minimizes the blockage of investment in form of book debts by adopting discreet collection and credit policies. Finished goods are given on credit to the customers with goods track record. Normally reasonable period is given to debtors and then-after interest is charged for delay in payment.

#### **3.4.5 Careful monitoring of External Environment -**

The company takes note of each every change in external environment. The internal policies and decisions are adapted according to changes in Fiscal policies, Exim policies, Govt. orders etc. It emancipates the company from statutory dues and helps to fulfill legal obligations. It also helps to avoid blockage of funds with Govt. Department by taking suitable decisions in time.

Apart from this the company has framed recruitment, selection, training and placement policies which helps the company to avoid wastages in manufacturing process, delay in purchases, production of defective product etc and this all contribute to lesser cash outflow.

#### **3.5 Practical utility of Operating Cycle in Shreem Capacitors –**

Shreem Capacitors is a manufacturing company. The operating cycle starts with purchases of raw materials. Raw materials are not consumed immediately. There involves 'Raw Material Conversion Period' (RMCP).

The raw materials put in to work in process for finished goods which involves some time gap between supply and production. This time gap is called as 'Work-in-progress Conversion Period' (WIPCP).



Though the company is undertaking jobs as per specification of orders many a times to meet market challenges / competition finished goods with advanced techniques. The new product may get demand after successful marketing and product promotion campaign. Till that the innovated products are produced and kept in store until it is demanded. Further some parts are manufactured in advance for assembly purpose. Such parts also remain in store for some time until other parts required for assembly get ready. This time period is called as 'Finished goods conversion period' (FGCP).

The finished products are sold to customers on credit to retain the customer, to cope up with competition or some other relevant reasons. The cash realization of goods sold on credit takes some time. This time gap is called as 'Book debt conversion period.'

Similar to above, the company is getting raw materials on credit from its suppliers. Payment of such credit purchases is made after some time as per terms of purchases. Thus the payment is deferred for some time and it reduces the length of operating cycle. This deferred payment is called as 'Payment deferral period'.

Based on above notion Gross Operating Cycle and Net Operating Cycle is calculated with following formula –

Gross Operating Cycle = RMCP + WICP + FGCP + BDCP

Net Operating Cycle = RMCP + WICP + FGCP + BDCP - PDP

The practical utility of calculating net operating cycle is to know the time gap between investment of cash in operating cycle and its realization. The

Finance Manager of the company is getting idea of length of operating cycle and based on it he approaches to the bankers for working capital requirement. The company believes that the length of operating cycle is an indicator of operating cycle management performance.

### **3.6 Factors determining working capital requirement in Shreem Capacitors –**

Working capital requirement depends upon organization and vary from organization to organization. There is no fixed pattern of factors determining the working capital. The factors determining the working capital at one point of time may not be the factors determining the working capital of the same organization in another point of time. Grossly following factors are pointed out as factors determining working capital in Shreem Capacitors.

#### **3.6.1 Nature of business -**

Working capital requirement in manufacturing organization is always at high side compare to that of in trading organization and service organization. The reason is stages involved in completion of operating cycle. In manufacturing organization if manufacturing cycle is prolonged the working capital will be increased and vice versa. The same is noticed in Shreem Capacitors.

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#### **3.6.2 Business Cycle –**

Business cycle revolves around different stages. The business cycle is affected with internal and external environment. Any fluctuation in business cycle fluctuates the working capital requirement. Thus working capital requirement is found depending upon business cycle.

The company is on growing stage and working capital requirement is also growing year by year.

### **3.6.3 Operation level and time –**

Higher scale of operations needs more working capital and lesser scale of operations need comparatively less working capital. Real time / Quick turnover makes immediate completion of operating cycle and reduces working capital requirement. And late turnover leads to increased working capital requirement. In Shreem Capacitors though the turnover is quick scale of operations is increasing with higher demand of working capital.

### **3.6.4 Credit Policy –**

Blocking of fund burdens the working capital demand. The policy of deciding terms and conditions of credit sales is of immense importance. Longer the period of credit more the blocking of funds and vice versa. Prima Facie the credit policy and terms and conditions of credit sales and credit purchases seems normal in Shreem Capacitors.

### **3.6.5 Expansion and Diversification Plans –**

When the organization is in boom period and at growing stage until it reaches the stagnancy / maturity stage the working capital requirement goes up though managed wisely. Accordingly the expansion plans of Shreem Capacitors and diversification plans adopted for backward integration posing high working capital requirement.

### 3.6.6 External Environment –

Alike all organizations Shreem Capacitor has also keep watch on its external environment, which includes legal environment, monetary environment, socio-cultural environment, etc. The Govt. policies on VAT, conservation of natural resources, policies on air pollution /give off factory toxic etc. makes the company obligatory to provide some funds for their compliance.

These are the broadly seen and discussed factors of determining working capital requirement in Shreem Capacitors.

### 3.7 Ratios in working capital requirement in Shreem Capacitors –

Normally, effective management of working capital is ensured with help of ratios which are classified in three categories.

- a. Efficiency Ratios
- b. Liquidity Ratios
- c. Structural health Ratios

In Shreem Capacitor more focus is on Liquidity Ratio and Structural health Ratio.

\*Liquidity Ratio:

$$\text{i) Current Ratio} = \frac{\text{Current assets, loans and advances}}{\text{Current liabilities and provisions}}$$

- j) This ratio indicates the extenet of the soundness of the current financial position of the company. A current ratio of 2:1 indicates a highly solvent position.

Current assets, loans and advances - Inventories

k) ii) Quick Ratio = -----

Current liabilities and provisions – Bank Overdraft

This ratio shows the extent of cushion of protection provided from the quick assets to the current creditors. A quick ratio of 1:1 is usually considered satisfactory.

- Structural health ratio :

Net assets

i) Current assets to total net assets = -----

Current assets

This ratio explains the relationship between current assets and total investments in assets.

Sales

ii) Debtors turnover ratio = -----

Debtors

This ratio shows the extent of trade credit granted and the efficiency in the collection of debts. It is an indicative of efficiency of trade credit management.

Bad Debts

iii) Bad debts to sales = -----

Sales

This ratio indicates the efficiency of the control procedures of the company. The actual ratio is compared with the target.

iv) Creditors turnover period ( in days ) = Creditors

----- \* 365

Purchases

The measurement of the creditor turnover period shows the average time taken to pay for goods and services purchased by the company.

Company believes that though the ratios show historical trend they guide to take suitable decision for effective management of company in future. However, the company is giving more stress on analysis of data rather than exercising on various ratios. Ratio analysis is viewed as additional tool for decision making.

Thus the theoretical background of Shreem Capacitor is based on concepts, assumptions, perception about working capital which is currently in vogue. Moreover the attitude of the experts who are managing the company seems more elastic in nature giving elbow room to make necessary amendments and adapt their set policies, procedures, tools, techniques to congruent with the changing scenario.

Ref: Annual Reports for years 2004-09