CHAPTER **II**

CONCEPTUAL FRAME WORK

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FRAMEWORK OF THE CONCEPTUAL BACKGROUND

2.1. MEANING OF WORKING CAPTAL:-

Working capital is that part of total capital which is required for daily working of the business. It is the capital with which the business is worked over. The term working capital means the capital consumed during the fiscal period in creating current income.

2.2. DEFINITION OF WORKING CAPITAL:-

According to Shub in " Working capital is the amount of funds required by the business for conduting the day to day operations". 1

Ex:- Purchase of raw materials or finished goods, payment of expenses like salary, wages, freight, rent etc., and carrying out production for investment in stocks and stores, receivables and cash on hand etc., from the working capital of the business.

This capital is also known as circulating capital because it starts with cash and ultimately results in cash after completing the cycle.

For Ex:- Cash - Stock of goods - Sale of goods - Debtors and bill receivables - Cash.

In the words of Gerstenberg "Circulating capital means current assets of a company that are changed in the ordinary course of buniness from one form into another".2.

For Ex:- From cash to inventories, inventories to receiables and receivables into cash.

The term working capital is also defined as " Excess of current assets over current liabilities".3

2.3. NEED FOR WORKING CAPITAL:-

Working capital is the lifeblood and nerve controlling centre of a business. No concern can be successful without an adequate amount of working capital. Although current liabilities are paid from funds generated by current assets, the working capital should be sufficient in relation to the current liabilities to afford a margin of safety. From whatever source the demand for current funds arises, the business that has ample funds to meet all needs may count itself fortune.

It is needed to finance the day to day operations of a concern to earn a steady amount of profit, successful sales activity is required. Therefore, every firm has to employ sufficient funds in current assets for the success of its sales activity.

2.4. IMPORTANCE OF WORKING CAPITAL:-

Working capital is lifeblood or heart of the buniness. Its inadequecy or weakness may prove to be detrimental to the successful working of the business. It keeps the wheels of the machinery moving or revolving, so it feeds the machinery and keeps them running.

In short it can be stated that every activity of the business is related to the availability of the working capital. It is like a main spring in the clock.

1. It creates a sense of security and confidence.
2. It is a must for maintaining solvency and continuous Production.
3. It enhances credit standing for goodwill.
4. It provides the availability of cash discounts.

5. It creates steady work and improves efficiency of workers.
6. It facilitates easy availability of bank loans.
7. It removes the financial strengency very easily.
8. It guarantees quick and steady returns to the investors.
9. It facilitates the purchase of requirements even at off-seasons.
10. It increases the efficiency of the management.
11. It helps borrowing at favourable rates of interest.
12. It boosts the managements moral and inspires it to meet the demand for additional funds promptly.
13. It helps the organisation to overcome periods of depression.
14. It ensures regular and assured production because of efficient and steady operations.

2.5. FACTORS DETERMINING REQUIREMENT OF WORKING CAPITAL:

The requirement of working capital is based on many factors. In the initial stage of business more working capital is required as compared to the requirement when production is out, sales and collection are started.

However, the requirement of working capital depends upon various factors. They are

1. Nature of type of business.
2. Size of the business.
3. Length of manufacturing and mercandising period.
4. Terms of purchases and sales.
5. Rapidity of turnover.

6. Time consumed between order and delivery.

7. Seasonal variations.

8. Cash requirements.

9. Expansion.

10. Management ability, attitude and efficiency.

2.6. CONCEPT OF WORKING CAPITAL:-

There are two concepts of working capital. Gross working capital and net working capital.

GROSS WORKING CAPITAL CONCEPT:-

This refers to the firms total investments in current assets, they are cash/Bank balance, stock, Debtors, Bills receivables, prepaid expenses, Temporary investments in surplus funds in marketable securities, Treasury bills.

This is said to be on the basis of going concern concept.

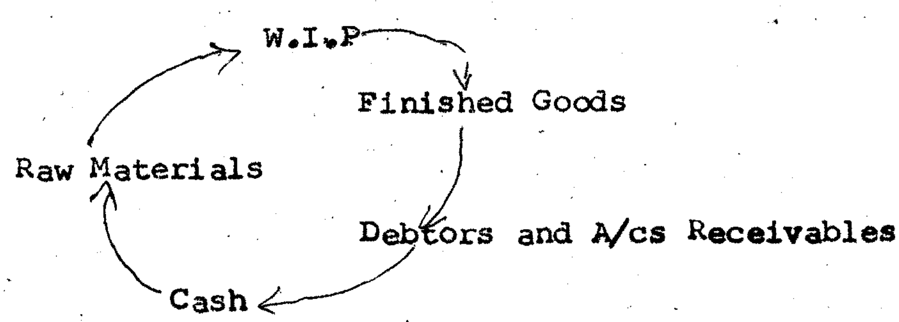
NET WORKING CAPITAL CONCEPT: -

The term net working capital concept refers to the difference between the total current assets and current liabilities.

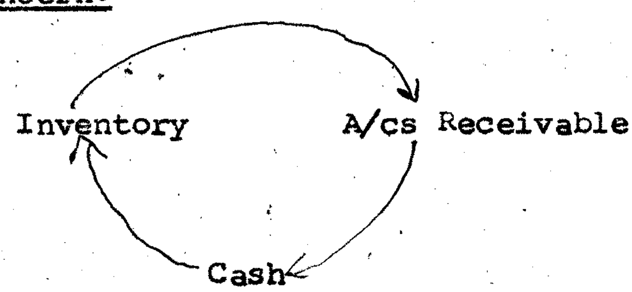
This concept may be positive or negative. When current assets exceed current liabilities it is a positive net working capital. When current liabilities exceed current assets it is a negative net working capital.

The concept of working capital of different concerns are shown below:-

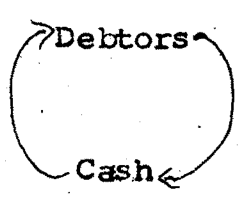
a) <u>Manufacturing Concern:-</u>



b) <u>Trading Concern:-</u>



c) <u>Financing Firm:-</u>



2.7. ELEMENTS OF WORKING CAPITAL

A. CURRENT ASSETS:-

Current assets are those assets which can be converted into cash with in short span of time (generally with in one year) without undergoing diminution of value and without disturbing the organisation. The current assets are:-

1. Cash in Hand.
2. Cash with Bank.
3. Bills Receivables.
4. Sundry Debtors.
5. Temporary investiments of surplus funds in marketable securities.
6. Treasury Bills.
7. Prepaid expenses.
8. Inventories: Raw materials, Work-in-progress, Finished goods.
9. Advances on material purchases.

B. CURRENT LIABILITIES:-

Current liabilities are those liabilities which are to be repaid ~~with in~~ a years period, and which are paid out of current assets, or by creating current liabilities. Thus current liabilities include

1. Sundry Creditors.
2. Bills payable.
3. Bank Overdraft.
4. Outstanding Expenses.
5. Provision for Income Tax.
6. Proposed Dividend.
7. Unclaimed Dividend.
8. Accrued expenses such as

a) Accrued taxes b) Accrued salaries c) Accrued interest.

9. Short term Bank Loans.

2.8. DANGERS OF INADEQUATE WORKING CAPITAL:-

1. It is a contributing factor to business failures.
2. It frustrates the enterprises objectives through the lack of funds.

3. It stagnates growth.
4. It reduces the rate of return on total investment.
5. It gives rise to operating inefficiencies.
6. It renders the firm unable to avail attractive credit opportunities.
7. It influences the credit rating adversely as it is not able to honour its short-term obligations.
8. It influences dividend policy adversely.
9. It influences management morale adversely.

2.9. DANGERS OF EXCESSIVE WORKING CAPITAL:-

1. It results in unnecessary accumulation of inventories.
2. It results in management inefficiency through complacency.
3. It encourages speculation.
4. It may stimulate unnecessary expansion.
5. It may lead to liberal dividend policy.
6. It destroys the control of turnover ratio's.
7. It results in ineffecient utilisation of total investment.
8. More working capital indicates less current debts.
9. False in the eyes of Banks.
10. Excess working capital destroys control of turnover.

2.10. CLASSIFICATION OF WORKING CAPITAL

TYPES OF WORKING CAPITAL

Permanent/Fixed woring Capital	Variable working capital
a) Initial b) Reserve margin c) Regular	a)Seasonal b) Special

1. Permanent or Fixed Working Capital:-
   a) Initial working capital.
   b) Reserve margin or cuslion working capital.
   c) Regular working capital.

2. Variable Working Capital:-

a) Seasonal working capital.

b) Special working capital.

I. PERMANENT WORKING CAPITAL:-

The working capital which is permanently locked up in the circulation of current assets is called permanent working capital. This again sub-divided into three groups.

SOURCES OF PERMANENT WORKING CAPITAL:-

1. Issuing of Shares.
2. Floating Debentures.
3. Public deposits.
4. Long term Institutors Finance.
5. Self finance reserve.
6. Sale of non-required assets.
7. Retained profits.

permanent working capital again sub-divided into three groups, they are:-

a) INITIAL WORKING CAPITAL:-

Every business enterprises needs a certain amount of initial working capital such capital has the permanent nature which creates a new ground for the business activity.

b) RESERVE MARGIN OR CUSHION WORKING CAPITAL:-

It is excess over the need for the regular working capital that whould be provided for - contngencies that arise at unstated intervals, they are:-

1. Raising prices
2. Business Depression.
3. Straikes
4. Special operations.

c) REGULAR WORKING CAPITAL:-

It is the minimum amount of liquid capital necessary for maintaining the circulation of the current assets it never leaves the business process and its size increases with growth.

Financing of regular working capital on permanent basis is done by:-

1. Issuing of shares and debentures.
2. Ploughing back of profits (retained profits) through additional deprication allowance.

2. VARIABLE WORKING CAPITAL:-

The capital which fluctuates with the volume of business is called variable working capital most of the business enterprises will have to procure additioal working capital to meet seasonal and special needs.

It changes its ~~from~~ from cash to inventory and from inventory to receivables and then to cash.

FINANCING OF VARIABLE WORKING CAPITAL:-

1. Short term credits from indegenous bankers.
2. Direct advances from commercial banks.
3. Receiving the deposits from the public.
4. Ploughing back of company profits.
5. Special finance corporationslike I.F.C., S.F.C., (I.D.B.I.) etc.
6. Sale of shares or long term debt.
7. Part of variable needs from trade creditors.
8. Offering favourable credit terms to customers. Ex:- Cash discounts for prompt payment.
9. Bank loan against hypothecation orpledge of inventory.

Variable working capital is further devided into two types.

a) SEASONAL WORKING CAPITAL:-

The capital which is used for specific seasons on the nature of operations that capital is called seasonal working capital.

b) SPECIAL WORKING CAPITAL:-

This type of capital is useful for financing the special operations such as the inaugharations of some executions of productions and distributions.

2.11. ESTIMATION OR FORECASTING OF WORKING CAPITAL:-

In computing the working capital requirements there cannot be any mathematical formula but at the same time resultant figures could be of great use in assessing the current needs and in judging the current position. The total requirement of working capital is computed in the following manner.

1. Imported raw materials consumption.
2. Imported raw materials for the period.
3. Indegenous raw material consumption for period.
4. Stock in process.
5. Finished goods.
6. consumable stores and spares consumption.
7. Receivables (- - - - - - month sales).
8. Advance payment for purchase.

total of these items, it is to be deducted:-

1. Advance payment received.
2. Credit received on purchases.

Thus, we get the balance amount representing working capital requirements.

BANKS ARE MEETING WORKING CAPITAL NEEDS THROUGH: -

1. Advances against inventory.
2. Inventory under pledge.
3. Inventory under hypothecation.
4. Advances against raw material inventory.
5. Advances against work in progress inventory.
6. Advances against finished goods inventory.

2.12. PLANNING OF WORKING CAPITAL:-

The successful planning of working capital involves:-

1. Preparation of budgeted trading, profit and loss Accounts. This shows the required quantum of purchases, production, sales and other expenses.
2. Preparation of budgeted balance sheet. This shows components of assets and liabilities. This lays more importance on gross and net working capital.
3. Preparation of cash budget.

A cash budget is a detailed estimate for some future period of time or cash inflows from all sources, cash disbursements for all purposes and the resultant cash balances.

MAJOR FUNCTIONS OF CASH BUDGET:-

1. Determination of minimum cash balances.
2. Ensuring effective borrowing.
3. Profitable investment of excess cash.
4. Enable acceleration of cash flow.

2.12. CONTROL OF WORKING CAPITAL: -

The control of working capital involves the following techniques and these e will help smooth functioning of the business cycle. The techniqhes include:-

1. Budgetory control.
2. Cost control.
3. RAtio Analysis.
4. Funds flow statement.
5. Internal audit.

2.13. MEASURING WORKING CAPITAL:-

It is measured from the financial data of corporate Balance Sheet. Working capital analysis can be done by comparing current assets with current liabilities over a period.

2.14. RATIO ANALYSIS OF WORKING CAPITAL: -

RATIO ANALYSIS:- When relation between two figures is expressed Arthmatically is called as ratio mainly ratio's are based upon the figures in Balance Sheet. Trading A/c and profit and loss A/c.

This is used as a means of understanding the efficiency of working capital. Behaviour of ratio's over a period of years determines the trends. These trends indicate the rise, decline or stability of working capital.

The following ratio's have relevance to the working capital:-

1. Liquidity ratio's.
2. Turnover ratio's.
3. Working capital ratio's.

1. LIQUIDITY RATIO'S:-

a) CURRENT RATIO:-

$$\text{Formation of Ratio} = \frac{\text{Current Assets}}{\text{Current liabilities.}}$$

This ratio is to findout whether the current assets, which are expected to be realised during the operational cycle are able to cover the Current Liabilities which are to be met with in the years. Standard ratio is considered to be 2:1.

It indicates the liquid position of a firm and is a measure of short term solvency.

b) ACID TEST RATIO OR QUICK RATIO:-

Formation of the Ratio $= \frac{\text{Quick Assets}}{\text{Quick Liabilities}}$

This ratio measures the liquidity ~~and~~ gives emphasis on the ability of immediate coversion of assets into cash. This gives a better ~~picture~~ of a firms ability to meet its short term debts out of short term assets.

Standard Quick ratio is considered to be 1:1.

2. TURNOVER RATION'S:-

a) INVENTORY TURNOVER RATIO:-

Formation of Ratio $= \frac{\text{Net Sales}}{\text{Inventory (Average)}}$

This ratio indicates the efficiency of inventory management. A high ratio is desirable showing efficient management of inventories.

b) RECEIVABLES TURN OVER RATIO:-

Formation ration $= \frac{\text{Net Sales}}{\text{Receivables}}$

This ratio matches net credit sales of a firm to receivables and indicates the rate at which cash is generated by turnover of receivables. A high ratio is desirable and it denotes the necessity of less working capital.

c. AVERAGE COLLECTION PERIOD:-

$$\text{Formation of ratio} = \frac{360}{\text{Receivables Turnover ratio}}$$

This finds out how many days average sales are held up in receivables and the average collection period. A low collection period is a desirable one and it depends on firms credit terms.

3. WORKING CAPITAL RATIO'S:-

a) WORKING CAPITAL RATIO:-

$$\text{Formation of the ratio} = \frac{\text{Gross Working Capital}}{\text{Average Inventory}}$$

It depicts the position of inventory in the working capital since inventory is the least liquid asset this ratio vividly states how much of gross working capital is occupied by the inventory. A ratio of 2:1 is desirable, but one has to take into account the nature of the business restrictions imposed by Government.

b) CURRENT ASSETS TO NET SALES RATIO:-

$$\text{Formation of ratio} = \frac{\text{Current Assets}}{\text{Net Sales}}$$

This is to indicate how efficiently the current assets are utilised to prop up sales. A lower ratio indicates efficient utilisation of current assets and its components efficient turnover.

c) RECEIVABLE SALES PERCENTAGES:-

$$\text{Formation of percentage} = \frac{\text{Receivable}}{\text{Sales}} \times 100$$

This states the percentage of receivables for sale of Rs.100. A low percentage reflects a desirable position.

d) PAYABLES PURCHASES PERCENTAGE:-

Formulation of percentate $= \frac{\text{Payables}}{\text{Purchases}} \times 100$

This shows the percentage of payables per Rs. 100 purchases. Higher ratio is desirable resulting in effective working capital management.

e) AVERAGE CREDIT DAYS RECEIVED:-

Formulation $= \frac{\text{Payables}}{\text{Purchases}} \times 360$

This indicates the credit worthiness of the firm. Higher number of current days received indicate a desirable position.

f) CASH TO CURRENT ASSESTS PERCENTAGE:-

Formulation of ratio $= \frac{\text{Cash}}{\text{Current Assets}} \times 100$

This depicts the percentage of ready cash being kept in the business to meet the day to day needs. Desirable percentage is 5 to 10 in a comfortably financed business.

A low percentage is an indicator of the quality of debtors.

g) RECEIVABLES TO CURRENT ASSETS PERCENTAGE:-

Formulation of ratio $= \frac{\text{Receivables}}{\text{Current Assets}} \times 100$

This depicts the position of receivables in the current assets. 30 to 40 percent - receivables are desirable and considered to be good.

h) WORKING CAPITAL LOANS TO GROSS WORKING CAPITAL:-

Formation of ratio $= \frac{\text{Working Capital Loans}}{\text{Gross Working Capital}} \times 100$

This indicates how the working capital loans are able to cater to the needs of gross working captail. A higher ratio indicates the efficiency of the management to finance the working capital with external borrowings.

2.15. RELATIONSHIP OF SALES WITH WORKING CAPITAL:-

A concern which tries to maximise its wealth should earn sufficient return from itsoperations for having a steady amount of profit successful sales activity is required. For increasing the sales activity. The firm will have to invest enough funds in the current assets. The increase in sales activity in turn increases the working capital too.

2.16. FUNDS FLOW STATEMENT:-

Funds flow statement is to report the flow of funds between various assets and equity items during an accounting period. It also highlights the changes in the financial structure of an undertaking. It points to the effectiveness of working capital management and the ability of an enterprise to generate working capital.

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