Chapter IV

Working Capital Management

4.1 Concept of Working Capital

There are two concepts of working capital viz. gross concept and net concept .The gross working capital simply called as working capital refers to the firm's investment in current assets. Current assets are the assets which can be converted into cash within an accounting year (or operating cycle). The term net working capital refers to the difference between current assets and current liabilities. Current liabilities are those claims of outsiders which are expected to mature within an accounting year and include creditors, bills payables, bank overdraft and outstanding expenses. Net working capital can be positive or negative. A positive working capital will arise when current assets exceed current liabilities. A negative working capital occurs when current liabilities are in excess of current assets.

Gross working capital refers to the investment in current assets. It focuses attention on two aspects of current assets management.

A) Optimum Investment in current assets

B) Financing of current assets

A firm should try to avoid the situation of the either excessive investment or inadequate investment in current assets. The investment in current assets should be just adequate, according to the needs of the firm. Excessive investment in current assets should be avoided because it affects firm's profitability, as idle investment earns nothing. On the other hand, inadequate amount of working capital can affect the solvency of the firm, if it fails to meet its current obligations. It should be realized that the working capital needs of firms fluctuate with changes in business activity and the nature of operation. This may cause excess or shortage of working capital frequently. The management should be very prompt to initiate an action and correct the imbalances.

I) Gross Working Capital

Gross working capital management points to the need of arranging funds according to the increasing level of business activity and making the recovery arrangement quickly to exploit the opportunities. Similarly if suddenly some surplus funds arise, they should not be allowed to remain idle but should be invested in the short-term securities. Thus, the financial manager needs to have knowledge of firms, sources of working capital as well as its application.

II) Net Working Capital

Net working capital represents the excess of current assets over current liabilities. It indicates two things as follows.

a) The current liabilities position of the firm.
b) The extent to which working capital needs may be financed by permanent sources of funds.

The quality of current assets should be considered in determining the level of current assets vis-a-vis current liabilities. A weak liquidity position poses a threat to the solvency of the company and makes it unsafe and unsound. On other hand a strong liquidity position results in blocking of funds and affects, the profitability. Therefore, timely action should be taken by the management to expected level. Correct the imbalance in the liquidity position of the firm and bring liquidity position to the expected level.

The net working capital concept also covers the questions of proper mix of long-term and short-term funds for financing current assets. For every firm there is a minimum amount of net working capital which is required on permanent basis. Therefore, a portion of the working capital should be financed by the permanent sources of funds such as owners' capital, debentures, long-term debt, preference capital or retained earnings. Management must, therefore, decide the extent to which current assets should be financed by equity capital and by borrowed capital.

Thus, gross and net concepts of working capital are two important aspects of the working capital management. There is no precise way to determine the exact amount of gross or net working capital for every firm. There is no specific rule according to which current should be financed. It is not feasible in practice to finance current assets by short-term sources only. Keeping in view the constraints of the individual company a judicious mix of long- term and short- term finances should be decided upon.

4.2 The Need for Working capital

The need for working capital to run the day -to-day business activities depends on a number of factors like nature of business, scale of operation, length of manufacturing cycle terms of credit etc. The need varies from firm to firm.

4.3 Estimating Working Capital Requirements

For a trading organization the following factors should be taken into consideration while estimating the working capital requirements.

1. Scale of operation
2. The amount of credit allowed to customer and the period of credit.
3. Day- to-day expenses.
4. The amount of credit and average period of credit allowed by suppliers.
5. Time lag in the payment of wage and other recurring expenses.
6. Size of inventory.

4.4 Dimensions of Working Capital Management

Any firm should maintain a sound working capital position, and there should be optimum investment in working capital. Thus, there is need of proper management of working capital. Working capital management refers to the administration of all aspects of current assets, namely cash, marketable securities, debtors and inventories and current liabilities. The financial manager must determine the ideal composition of current assets. He must ensure that right sources are used to finance current assets and current liabilities are paid in time.

Working capital management is necessary to maintain proper balance between solvency and profitability of the firm.

Table 4.1

Statement of Working Capital in Abhyankar Footwear Pvt. Ltd.

(fig. in lakhs)

Particulars	2001-02	2002-03	2003-04	2004-05	2005-06
Current assets					
Inventories	16.57	21.66	24.46	28.83	33.92
Sundry Debtors	0.55	0.12	0.15	0.49	0.24
Cash and bank balance	0.55	0.23	0.32	0.57	1.37
Advance tax	1.19	1.53	1.67	--	--
Telephone Deposit	0.016	--	--	--	0.016
MSEB Deposit	0.35	--	---	--	0.35
Loans and Advances	---	--	---	1.08	0.1
Other current Assets	---	--	---	---	0.78
Gross working capital	**19.23**	**23.55**	**26.61**	**30.98**	**36.78**
Current Liabilities					
Current Liabilities	7.93	0.46	0.05	0.49	0.18
Provisions	1.3	4.64	3.97	4.29	3.86
Total current liabilities	**9.23**	**5.1**	**4.02**	**4.78**	**4.04**
Net working Capital	**10.00**	**18.45**	**22.59**	**26.20**	**32.74**

Source : Company records.

4.5 Interpretation

An attempt is made to analyze the working capital management of Abhyankar Footwear Pvt. Ltd. Chart 4.1 shows the statement of working capital of the Company for the period of study. It is seen from this chart that the gross working capital increased from Rs. 19.23 lakhs in 2001-2002 to Rs. 36.78 lakhs in 2005-2006. Where-as the net working capital increased from Rs. 10 lakhs to Rs. 32.74 during the same period. The current assets increased from 19.23 lakhs to Rs. 36.78 lakhs. The current liabilities reduced from Rs. 9.23 lakhs to Rs. 4.04 lakhs.

The break up of current assets composition shows that inventories account for 86 percent in 2001-2002, 92 percent in 2002-2003 and 93 percent in 2003-2004, 93 percent in 2004-2005 and 96 percent in 2005-2006.

The proportion of cash and bank balances to the total current assets was found to be 2.8 percent in 2001-2002 it slightly increased to 3.8 percent in 2005-2006. This shows that liquid assets were kept of low level.

The proportion of sundry debtors to total current assets was 2.8 percent in 2001-2002 and it reduced to 0.7 percent in 2005-2006. This indicates that the company followed cash sales policy. The excess proportion of inventories in total assets has created a matter of concern.

4.6 Meaning Funds Flow Statement

Funds flow statement is therefore a statement shows changes in the working capital. It is also known as a 'Statement of sources of application of funds', 'Statement of changes in working capital'. In the words of

According to Anthony "Funds flow statements prepared to indicate increase in the cash resources and the utilization of such resources not a business during the accounting period".

According to Floulke "A statement of sources and application of funds is technical device designed to analyses the changes in the financial condition of a business enterprise between the two dates".

Thus funds flow statement is a report of the financial operations of business undertakings. It includes how a fund has been used in business and sources available for creating funds. Funds flow statement useful for creditors/ bankers, investors and management.

4.7Concept of Funds

However, for the purpose of funds flow statement the term 'Funds' means net working capital also known as 'Net current assets'

Thus Funds = Current .Assets - Current Liabilities

It becomes necessary to understand the terms of 'Current Assets', 'Current liabilities'. Current assets are those which in ordinary course of business can be converted into cash within a short period of normally as one accounting year, current liabilities of business which are paid in ordinary course of business within short period of normally one accounting year out of current assets or income of business.

4.8 Procedure of Funds Flow Statement

Funds Flow statement method by which we study changes in the financial position of a business enterprise between beginning and ending financial statement dates. Hence the funds flow statement is prepared by comparing two balancesheet dates and with the help of such other information derived from the accounts as may be needed. The preparation of Funds Flow Statement consists of three parts

1. Statement of schedule of changes in working capital.
2. Calculation of funds from operation.
3. Statement of sources and application of funds.

4.9 Statement of Sources and Application of funds

Funds Flow statement is a statement includes various sources from which funds (Working Capital) have been obtained during a particular period and uses or application of funds in that particular period

Table 4.2

Format of funds flow statement

Sources	Application
Funds from operation	Funds lost in operation
Issue of share capital	Redemption of preference share capital
Issue of Debentures	Redemption of debentures
Increase in of long term loans	Repayment of long- term loans
Sale of fixed assets	Purchases of long-term investment
Non trading receipts Such as dividend, Sale of long term investment Net decrease in working capital	Non trading payments such as Payment of dividend, Payment of tax Net increase in working capital

I) Sources of funds

Source of funds are indicated by increase in equities and decrease in assets

- **Issues of share capital**

Actual amount received from sale of shares of preference or equity shares is considered as sources of funds. The discount and premium amount of shares not be considered in funds flow statement.

- **Issues of Debenture**

Actual amount received from debenture holder is considered as sources of funds.

- **Increase in long-term loan**

Increases in the long-term loan will constitute the sources of fund. Long term loan i.e. Issue of debenture, cash credit arrangement, loan from banks, subsidiary companies etc.

- **Sale of fixed Assets and Investment**

Sale proceeds of fixed assets and long term investments will be treated as source of fund .Actual sale amount is called as inflow or source of funds. Profit and loss on sale of assets and investment not be consider in this statement.

- **Non trading receipt**

It includes dividend received, sale of long term investment and net decrease in working capital all this way funds arrived in business, it is sources of funds

II) Application of Funds

Uses of funds are indicated by increase and decrease in equities. Thus the funds obtained from the source described above may be applied different uses;

- **Redemption of preference share capital**

When cash paid for redeem preference share holder. Working capital to the extent is reduced and therefore is a use of funds.

- **Redemption of Debenture**

When cash paid to redeem debentureholder it means that funds gone out from business.

- **Redemptions of long-Term Borrowings**

A decrease in borrowings indicates that funds are being taken out of a business indicating use of funds.

- **Non trading payment**

It includes payment of dividend, tax and net increasing in working capital by this way funds goes out from business.

4.10 Advantages of Funds Flow Statement

Following are advantages of Funds Flow Statement

1. This statement shows changes in financial position or working capital position.
2. It helps in analysis of financial operations.
3. It is an instrument used for analysis of financial problem and determining the long range financial policies of the business enterprise.
4. It acts as guide for future.
5. It helps in analyzing past and future expansion plans.
6. It shows increase or decrease in working capital.
7. This statement gives information about operating efficiency of the business.

4.11 Limitations of Funds Flow Statement

Following are limitations of funds flow statement

1. Funds flow statement is not a substitute for income statement or balance sheet. It provides only some additional information such as changes in working capital.
2. It cannot provide changes on continued basis.
3. It is not an original statement but simply re-arrangement of data given in the financial statements.
4. It is historic in nature.
5. Some-times funds flow statement can not be prepared with much accuracy.
6. Changes in cash are more important and relevant for financial management than working capital.But the funds flow statement does not reveal there changes

Table 4.3

Funds Flow Statement of Abhyankar Footwear Pvt. Ltd. (fig. in lakhs)

Sources	2003	2004	2005	2006	Application	2003	2004	2005	2006
Long Term loan taken	2.49	5.5	---------	10.07	Purchase of fixed assets	---------	3.36	-------	4.37
Sale of fixed assets	4.06	---------	2.72	------	Repayment of Long term loan	---------	--------	1.22	--------
Funds from operations	**1.90**	**1.99**	**2.11**	**0.84**	Net increase in working capital	8.45	4.13	3.61	6.54
Total	**8.45**	**7.49**	**4.83**	**10.91**	**Total**	**8.45**	**7.49**	**4.83**	**10.91**

Source : Company records.

4.12 Interpretation

In the year 2003 the total sources of funds amounted to Rs. 84 lakhs. They were contributed by secured loans, sale of fixed assets and funds from operations. There was no application of funds in that year and hence net increase of Rs. 8.45 lakhs in working capital. In the year 2004 out of the total sources of Rs. 7.49 lakhs fixed assets were purchased to the extent of Rs. 3.36 lakhs and the remaining was net increasing in working capital.

In the year 2005 some fixed assets were sold to repay the loan and there was net increase in working capital was Rs. 3.62 lakhs. In the year 2006 heavy funds were borrowed to purchase fixed assets. Out of the total sources of Rs. 10.92 lakhs funds applied for purchase of fixed assets amounted to Rs. 4.37 lakhs and net increase in working capital was Rs. 6.54 lakhs.

The funds from operations increased from Rs. 1.90 lakhs in 2003 to Rs. 2.11 lakhs in 2005 but declined sharply to Rs. 0.84 lakhs in the year 2006. The decline in the funds from operation was attributed by management to increased material and labur cost. The researcher has observed that remuneration of directors has increased in year 2006 to Rs. 6.96 lakhs and this is the main reason of decline in the funds from operation.

4.13 Meaning Cash flow statement

Cash plays an important role in smooth conducted of business. In any business there is a constant inflow and outflow of cash. A major responsibility of financial management of firm is to maintain an adequate balance of cash. The essential function of finance manager is the provision of sufficient cash amount and in proper time to meet the needs of the business.

A cash flow statement can be prepared for a particular period of time. It shows the causes of changes in the cash portion of a business between two balance sheet dates. This statement is useful for the management in assessing the capability of business to meet its short term commitments towards creditors for goods and expenses.

Cash flow statement is very much similar to the statement of changes in the financial position prepared on working capital basis i.e. a funds flow statement except that a cash flow statement focuses attention on cash. Cash flow statement is prepared from the data available in comparative balance sheets, profit and loss account and additional information.

4.14 Advantages of Cash flow statement

The following are the advantages of cash flow statement

1. It is helpful in evaluating the current cash position of business.
2. Cash flow statement is useful to the management in preparing cash budget. The management knows how much funds are needed, how much can be generated internally and how much it should arrange from outside.
3. A cash flow statement explains the position of cash in business and enables management to take immediate and corrective action if required.
4. Cash flow statement helps in the planning of the repayment of loans, purchase or replacement of fixed assets.
5. For short-term analysis of financial position, cash flow analysis is more useful than funds flow analysis. It is because in short period it is the

cash which is more relevant than the working capital for forecasting the ability of the firm to meet its current needs

4.15 Limitations of cash flow statement

Cash flow statement suffers from following limitations.

1) Cash balance as per the cash flow statement may not give the real picture as it can be manipulated by postponing purchase and other payments.
2) The exclusion of near cash items from the cash flow statement may not be correct and may result into misleading conclusion.
3) Funds flow statement presents a more complete picture than cash flow statement as working capital is a wider concept of funds.

Table 4.4

Cash Flow Statement of Abhyankar Footwear Pvt. Ltd. (fig. in lakhs)

Inflow	2003	2004	2005	2006	Outflow	2003	2004	2005	2006
Decrease in debtors	0.43	-------	------	0.26	Increase in Inventories	5.08	2.80	4.37	5.08
Decrease in provisions	-------	0.67	-------	0.43	Increase in debtors	------	0.03	0.35	-----
Short term loan taken	-------	------	1.08	------	Increase in prepaid expenses	0.35	0.13	------	------
Increase in current liabilities	-------	------	0.44	0.31	Decrease in current liabilities	7.47	0.41	------	-----
Insurance claim received	------	------	------	0.28	Increase in provisions	3.34	------	0.32	------
Due amount received from Tata teleservices	------	------	------	0.02					
Income tax refund				0.48					
Cash from operations	**15.81**	**2.70**	**3.52**	**3.30**					
Total	**16.24**	**3.37**	**5.04**	**5.08**	**Total**	**16.24**	**3.37**	**5.04**	**5.08**

Source : Company records.

4.16 Interpretation

The Cash flow statement for the period from 2003 to 2006 shows that cash from operations has decreased from Rs. 15.82 lakhs in the year 2003 to Rs. 3.30 lakhs in the year 2006. The outflow of cash was mainly for inventories and repayment of loans. The debtors of company are very less and the amount due from them is very meagre.