Model Answers

Subject –Working capital Management

Paper code-AS-2377

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(Note-These models answers are only depiction of important points, in order to secure high marks examinees are require to explain all the points and give proper notes to the practical question. The length of answer may vary as per interpretation and presentation of subject matter.)

No-1.(i) Impacts of inadequate working capital

(a) Due to non availability of sufficient working capital, company may loss investment in profitable opportunities.
(b) Firm may face difficulties in meeting its day to day obligations
(c) It may prevent the company from availing attractive credit opportunity.
(d) Company may face difficulties in implementing operating plans.

(ii) Concepts of net working capital:

Net working capital may be defined as excess of current asset over the current liabilities. In gross concept we are only considering the aggregate of current assets, while in net concept we taking net current asset i.e. current assets-current liabilities.

Net working capital=Current assets-current liabilities

Ex-

Liabilities	amount	Asset	amount
Share capital	50000	Fixed asset	40000
Long term loan	15000	Debtors	20000
creditors	10000	Short term investment	10000
short term loan	5000	cash	10000

Total	80000	Total	80000

Net working capital= CA-CL

=40000-15000

=25000

(iii) b=Rs.100

T=Rs.9000

I=6% p.a. so /12=0.5%

C= $\sqrt{\frac{2bT}{i}}$

= $\sqrt{\frac{2*100*90000}{0.005}}$

=Rs.60000, Average cash balance=60000/2=Rs.30000

(iv) Lock box system is used to eliminate processing float. Under this system the company hires a post office box on rent in each important trading centres, and customers of this area are instructed to remit their cheque directly to the post box arranged. The enterprise authorizes the bank to collect to collect the cheque from the lock box and deposit into the company's account. It is superior as compared to concentration banking system.

(v) Basic assumptions of Miller-Orr model:

(a) Firm has minimum required cash balance.

(b) Cash flows are normally distributed.

(c) Expected cash flows are zero.

(d) There is no auto correlation in cash flows.

(e) S.d of the cash flows does not change over a period of time.

(vi) (a) Excessive inventory increases the holding and carrying costs.

(b) Due to excessive inventory company's fund is being blocked. So opportunity cost increases.

(vii) V.E.D analysis:

This classification is based on the criticality of the inventory components as defined by the users. This classification is more relevant and applicable to the machinery spare parts which have a distinct behavior. From the criticality point of view the components may divided into Vital, Essential and Desirable. The vital parts are kept in adequate amount and some risk can be taken in case of essential and desirable part is kept if the lead time is not so high.

(viii) Credit standards:

It provides a base for deciding whether to grant credit to a customer or not. Credit standard may be classified as (i) conservative or strict and (ii) liberal or aggressive. In conservative policy credit is not provided to all customers and in aggressive policy it's opposite. Credit policy affects collection costs, average collection period, loss of bad debts and change in volume of sales.

(ix) Aggressive policy:

As per this policy company keep less amount of working capital. So the opportunity cost of holding of cash is minimized, but in other hand company losses the additional income from occasional opportunity.

(x) Cash cycle:

It is a term which is used to signify the entire process of cash flows through enterprises accounts. Cash is used to purchase the raw materials, this converts into finished goods and goods are sold for cash and credit. In cash sales cash are collected immediately and in credit sales cash is collected from the debtors as per the credit terms. Cash cycle=Conversion period Average collection period-Average payment period.

No-2. Positive working capital: It is the excess of current asset over the current liabilities.

Negative Working capital: it is excess of current liabilities over the current asset.

Importance of working capital:

(a) A considerable part of working fund is invested in current assets, which necessitates their management in an efficient manner.
(b) There is a direct relationship between sales and working capital.
(c) Credit worthiness of the company depends upon the adequate amount of working capital.
(d) With adequate liquidity company get benefit of cash discount by making prompt payment.
(e) Adequate working capital boosts morale of the workers.
(f) Adequate working capital improves goodwill and image of the firm.
(g) Adequate fund enables the management to take advantage of occasional opportunities.
(h) Over investment in current asset may improve the liquidity but it will affect the profitability so optimum level of working capital should be maintained in organization.

Note- Examples and brief explanation regarding above points are required by the4 students.

No.3. In this answer student has to give introduction. The sources of finance can be classified into two categories: (1) Long term Sources

(2) short term sources

Further long term souce can be classified into following types

A. Owned sources
(i) Issue of shares

(ii) Retained earnings

(iii) Reserves

(iv) Sale of fixed assets

B. Borrowed sources

(i)Debentures

(ii) Long term loans

Short term sources:

(i)Trade credit
(ii) Bank credit
(iii) Certificate of deposits
(iv) Public deposits
(v) inter corporate deposits
(vi) Advances from cu8stomer
(viii) Internal sources
(ix) commercial papers
(x) Convertible debentures
(xi) Factoring

Explanations of above points are required.

No-4. Factors affecting investment in receivables:

In this answer students are required to write the meaning of receivables and give brief introduction. Then Factors are to be explained. Factors are as follows:

(a) General Factors
(b) Specific factors
    i. Level of credit sales
    ii. Credit terms
    iii. Terms of sale
    iv. Stability of sales

No-5. (a) Cash Budget:

An estimation of the cash inflows and outflows for a business or individual for a specific period of time. Cash budgets are often used to assess whether the entity has sufficient cash to fulfill regular operations and/or whether too much cash is being left in unproductive capacities.

A cash budget is extremely important, especially for small businesses, because it allows a company to determine how much credit it can extend to customers before it begins to have liquidity problems.

For individuals, creating a cash budget is a good method for determining where

their cash is regularly being spent. This awareness can be beneficial because knowing the value of certain expenditures can yield opportunities for additional savings by cutting unnecessary costs.
Cash budget is a mere forecast of cash position of an undertaking for a definite period.

Methods of preparing cash budget:

i. Receipts and payments method
ii. Projected balance sheet
iii. Profit cash forecast method

(b)Miller-Orr Model

(a) Firm has minimum required cash balance.

(b) Cash flows are normally distributed.

(c) Expected cash flows are zero.

(d) There is no auto correlation in cash flows.

(e) S.d of the cash flows does not change over a period of time.

Based on the above assumptions, Miller-Orr cash model is basically an application of control limits theory to the cash decision. In other words this model is based on control principle. Two control limits (Upper and Lower) are determined. When the cash balance goes beyond the upper control limit, some cash is invested in short term securities to bring the cash balance to the return point.

Along with above students are required to Draw the diagram and write the formulas of Miller orr model.

No-6.

Estimate of working capital requirements			
(a) Current Assets		amount	
Debtors	1920000*1/12	160000	
Raw materials	900000*1/12	75000	
Finished goods	1920000*1/12	160000	

Cash & bank balance				40000	
Total(a)				435000	
(b) current liabilities					
Creditors		900000*2/12		150000	
Manufacturing expenses		1080000*1/12		90000	
Wages		720000*1/24		30000	
Admn expenses		240000*1/12		20000	
Total(b)				290000	
Working capital(a-b)				145000	
Add: 20% for contigencies				29000	
Total working capital				174000	
Working note:					
Cost of sales					
Sales	2400000				
Less: 20% gross profit	480000				
	1920000				

- Working note is required

No-7.

Cash Budget			
Particulars	April	May	June
Receipts:			
Opening cash balance	15000	26200	-18300
Cash sales	18000	17000	16000
Collection from debtors	66000	70000	66000
Total	99000	113200	63700
Payments:			
Cash Purchases	5000	4500	3500
payment to creditors	37800	45000	40500
Wages	23000	22000	19000

Rent	500	500	500
Expenses	6500	59500	4500
Total	72800	131500	68000
Closing balance	26200	-18300	-4300

- Working note is required

No-8. Given C=5000 Kgs

O= Rs.30 per order

I=30% of purchase price

=Rs.1 when order is placed for less than 2500 kgs

=Rs.0.90 when order is placed for 2500 kgs.

= Rs.0.80 when order is placed for 5000 kgs.

E.O.Q= $\sqrt{\frac{2CO}{I}} = \sqrt{\frac{2*5000*30}{1*30\%}}$

=1000 Kgs.

Total inventory cost on basis of E.O.Q

=5000*1+5000/1000*30+1000/2*0.30

=Rs.5300

Total inventory on basis of order placed for 2500 Kgs.

=5000*0.90+5000/2500*30+2500/2*0.27

=Rs.4897.50

Total inventory cost on basis of order is placed for 5000 Kgs.

=5000*0.80+5000/5000*30+5000/2*0.24

=Rs.4630