MBA 4th Semester

Solution

Working Capital Management (KMB-FM04)

Duration: 1hour 30 minutes **Max. Marks: 30**

<u>Note: Attempt all the Questions.</u>

Q. No.		Question	Marks	CO	BL
		Section-A (5*1=5)			
1.	**a.**	What is liquidity vs. profitability? **Ans.** An important aspect of a working capital policy is to maintain and provide sufficient liquidity to the firm. The decision on how much working capital is maintained involves a trade-off i.e., having a large net working capital may reduce the liquidity-risk faced by the firm, but it can have a negative effect on the cash flows. Therefore, the net effect on the value of the firm should be used to determine the optimal amount of working capital.	**1**	**1**	**1**
	b.	What is marketable security? **Ans.** Once the optimum level of cash balance of a firm has been determined, the residual of its liquid assets is invested in marketable securities. Such securities are short-term investment instruments which help to obtain a return on temporarily idle funds. The basic characteristics of marketable securities affect the degree of their marketability/liquidity. To be liquid, a security must have two basic characteristics: a ready market and safety of principal value.	**1**	**1**	**1**
	c.	Discuss the objectives of working capital management? **Ans.** The following objectives are: **a.** The goal of working capital management is to manage the firm's current assets and current liabilities in such a way that a satisfactory level of working capital is maintained. **b.** The interaction between current assets and current liabilities is, therefore the main theme of the theory of the working capital management.	**1**	**1**	**2**
	d.	Discuss the two concept of working capital? **Ans.** The two concepts of working capital are: **a. Gross working capital:** It means the total current assets. **b. Net working capital:** It can be defined in two ways: • The difference between current assets and current liabilities. • The portion of current assets which is financed with long term funds.	**1**	**1**	**2**

	e.	Define the cash budget method of working capital? **Ans.** It is based on procurement and cash inflow. It is mainly used for Seasonal Industries like Sugar, Rice, Textiles, Tea, Tobacco, Fertilizers, Contractors, Real Estate Developers , Educational Institutions, etc.	**1**	**4**	**1**

Section-B		**(4*5=20)**			
Q. No.		**Question**	**Marks**	**CO**	**BL**
2.	**a.**	Suppose the projected sales of a particular business is ₹ 1,00,00,000. The minimum working capital demanded by the firm is 70% of projected sales. The margin contribution fixed by bank is 20%. Find out the amount of minimum working capital to be funded by the bank on the basis of turnover method. The working capital cycle of only one month is provided. **Ans.** Projected Sales = ₹ 1,00,00,000 Minimum Working Capital demanded = 70% of ₹ 1,00,00,000 = ₹ 70,00,000 Margin as contributed by owner = 20% of ₹ 1,00,00,000 = ₹ 20,00,000 Minimum Working Capital as funded by bank = 20% of ₹ 70,00,000 = ₹ 14,00,000.	**5**	**2**	**3**
	b.	"Working capital must be adequate but at the same time not excessive." Comment? **Ans.** Excessive Working Capital means idle funds which earn no profits for the business and hence the business cannot earn a proper rate of return on its investments. When there is a redundant working capital, it may lead to unnecessary purchasing and accumulation of inventories causing more chances of theft, waste and losses. Excessive working capital implies excessive debtors and defective credit policy which may cause higher incidence of bad debts. It may result into overall inefficiency in the organisation. When there is excessive working capital, relations with banks and other financial institutions may not be maintained. Due to low rate of return on investments, the value of shares may also fall. A concern which has inadequate working capital cannot pay its short-term liabilities in time. Thus, it will lose its reputation and shall not be able to get good credit facilities. It cannot buy its requirements in bulk and cannot avail of discounts, etc. It becomes difficult for the firm to exploit favourable market conditions and undertake profitable projects due to lack of working capital. The firm cannot pay day-to-day expenses of its operations and it creates inefficiencies, increases costs and	**5**	**2**	**5**

<table>
<tr><td></td><td></td><td>reduces the profits of the business. It becomes impossible to utilize efficiently the fixed assets due to non-availability of liquid funds. The rate of return on investments also falls with the shortage of working capital. The redundant working capital gives rise to speculative transactions.</td><td></td><td></td><td></td></tr>
<tr><td></td><td>c.</td><td>Differentiate between working capital and fixed capital?
Ans.
<table>
<tr><th>Basis for Comparison</th><th>Fixed Capital</th><th>Working Capital</th></tr>
<tr><td>Meaning</td><td>Fixed capital is the investments done by the business for accruing long-term benefits.</td><td>Working capital is the daily requirement pumped into the business.</td></tr>
<tr><td>Acquiring types of assets</td><td>Fixed capital is used to acquire non-current assets of the company.</td><td>Working capital is used to acquire the current assets of the company</td></tr>
<tr><td>How liquid it is?</td><td>Not at all liquid.</td><td>Very much liquid</td></tr>
<tr><td>Conversion</td><td>It can’t be converted into cash or kind immediately.</td><td>It can be converted into cash or kind immediately</td></tr>
<tr><td>Term</td><td>Serves the business for a long period of time</td><td>Serves the business for a very short period of time</td></tr>
<tr><td>Accounting period</td><td>It offers benefits for more than one accounting period</td><td>It offers benefits for less than one accounting period</td></tr>
<tr><td>Objective</td><td>Strategy-oriented.</td><td>Operational.</td></tr>
<tr><td>Consumption</td><td>It doesn’t directly get consumed by the business but serves the business indirectly.</td><td>Business needs working capital to operate.</td></tr>
</table></td><td>5</td><td>1</td><td>2</td></tr>
<tr><td></td><td>d.</td><td>Explain drawing power method to assess working capital?
Ans. Drawing power is arrived at on the basis of valuation of current assets charged to the bank in the shape of hypothecation and assignment, after deducting the stipulated margin
Illustration:
<table>
<tr><th>Name of Stock</th><th>Quantity of Stock</th><th>Margin</th><th>Drawing Power (DP)</th></tr>
</table></td><td>5</td><td>4</td><td>2</td></tr>
</table>

		Paid Stock	4	25%	3		
		Semi-finished Goods	4	50%	2		
		Finished Goods	4	25%	3		
		Book Debts	4	50%	2		
		Total DP			10		

Section-C (2*5=10)					
Q. No.		**Question**	**Marks**	**CO**	**BL**
3.	**a.**	Differentiate between permanent and temporary working capital? **Ans.** ▪ Permanent working capital refers to a level of current assets which is to be maintained and vital for the firm to carry its business regardless of the operation levels. While Temporary working capital refers to the working capital which is over and above the permanent working capital. It is required to meet seasonal needs and temporary requirements. ▪ Permanent working capital is also known as fixed or hardcore working capital. Temporary working capital is also known as fluctuating or variable or seasonal working capital. ▪ Permanent capital does not depend upon any factors while temporary working capital depends upon several factors as it is keep on fluctuating from period to period. ▪ Permanent working capital is stable while temporary working capital is fluctuating i.e., sometimes increasing and sometimes decreasing.	**5**	**1**	**2**
	b.	How the conservative approach of working capital policy differ from hedging approach? **Ans.** The hedging approach implies low cost, high profit and high risk while the conservative approach leads to high cost, low profits and low risk. Both the approaches are the two extremes and neither of them serves the purpose of efficient working capital management. A trade-off between the two will then be an acceptable approach. The level of trade off may differ from case to case depending upon the perception of risk by the persons involved in financial decision-making. However, one way of determining the trade off is by finding the average of maximum and the minimum requirements of current assets or working capital. The average requirements so calculated	**5**	**3**	**2**

		may be financed out of long-term funds and the excess over the average from the short-term funds.			

Section-C		(2*5=10)			
Q. No.		**Question**	**Marks**	**CO**	**BL**
4.	**a.**	"An aggressive approach results greater profitability but lower liquidity while a conservative approach results in lower profitability but higher liquidity." Explain? **Ans.** A working capital policy is called an aggressive policy if the firm decides to finance a part of the permanent working capital by short term sources. The aggressive policy seeks to minimize excess liquidity while meeting the short term requirements. The firm may accept even greater risk of insolvency in order to save cost of long term financing and thus in order to earn greater return. The trade-off between risk and profitability depends largely on the financial manager's attitude towards risk, yet while doing so he must take care of the following factors- **a.** Flexibility of the mix **b.** Cost of financing **c.** Risk attached with financing mix	**5**	**3**	**2**
	b.	Explain the method given by Tandon Committee II related to working capital? **Ans.** It can be applicable for limits of more than ₹ 6.00 crores. Working capital gap: Current assets – Current liabilities (other than bank borrowings). Minimum stipulated net working capital= 25% of current assets (excluding exports receivables).	**5**	**4**	**2**

Section-C		(2*5=10)			
Q. No.		**Question**	**Marks**	**CO**	**BL**
5.	**a.**	Discuss the method of working capital assessment as given by Naik Committee? **Ans.** The WC requirements may be worked out on the basis of Naik Committee recommendations for working capital limit upto ₹ 6 crores from the banking system, on the basis of minimum of 20% of their projected annual turnover for new as well as existing units. Beyond which WC be computed on the basis of WC cycle, after fixing stipulated margins, on each component of the WC. In case of borrowers desiring facilities under Naik Committee recommendations and having a WC cycle of more than 3 months in a year, the WC requirements will be funded after assessing his requirements on the basis of his WC cycle, after fixing proper margins.	**5**	**4**	**2**

		Example: Applicable for limits upto ₹ 6 crores a. Projected sales = ₹ 10,00,000 b. Working capital requirements: 25% of projected sales i.e. ₹ 2,50,000 c. Margin (contribution of Owner): 5% of projected sales i.e. ₹ 50,000 d. Minimum working capital to be funded by bank i.e. ₹ 2,00,000			
	b.	Define working capital cycle? Discuss the various factors help to determine working capital? **Ans.** Working Capital cycle (WCC) refers to the time taken by an organization to convert its net current assets and current liabilities into cash. It reflects the ability and efficiency of the organization to manage its short-term liquidity position. In other words, the working capital cycle (calculated in days) is the time duration between buying goods to manufacture products and generation of cash revenue on selling the products. The shorter the working capital cycle, the faster the company is able to free up its cash stuck in working capital. If the working capital cycle is too long, then the capital gets locked in the operational cycle without earning any returns. Therefore, a business tries to shorten the working capital cycles to improve the short-term liquidity condition and increase their business efficiency. The working capital cycle focuses on management of 4 key elements viz. cash, receivables, payables and inventory (stock). A business needs to have complete control over these four items in order to have a fairly controlled and efficient working capital cycle. The various factors help to determine working capital are: ▪ Nature of the business ▪ Production cycle ▪ Business cycle ▪ Production policy ▪ Growth and expansion ▪ Profit level ▪ Price level changes	**5**	**2**	**2**