

14/4/2020

Lecture → 18

BCA I Year 2 Sem

Subject → FAM

Unit → 5

Topic → Concept of Working Capital

On the basis of time

The another aspect of working capital management is to analyze the total working capital needs of the firm in order to find out the permanent and temporary working capital.

Permanent or fixed working capital.

There is always a minimum level of working capital which is continuously required by a firm in order to maintain its activities.

The permanent working capital can further be classified as regular working capital and reserve working capital.

Regular working capital: This is the amount of working capital required for the ~~permitted~~ continuous operations

of an enterprise :

(iii) Reserve Working Capital: This is the amount of working capital required for contingencies that may arise at unstated period such as strikes, rise in price, depression etc.

Temporary or variable W.C

The firm may also require additional W.C in order to meet the requirements arising out of fluctuations in ~~which~~ sales volume.

Variable working capital can be further classified as Seasonal working capital and Special working capital.

(i) Seasonal working Capital: Seasonal working capital is required to meet the seasonal needs of the enterprise. Such as a woolen dealer would require large amount of funds in winter season.

(ii) Special working Capital:- Special working Capital is that part of working Capital which is required to meet Special emergency such as launching of extensive marketing campaigns for conducting research etc.

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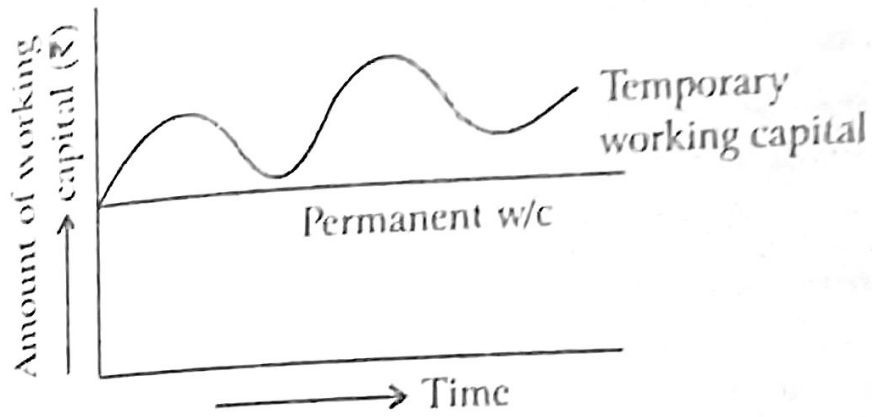


Fig. 2: (a) Shows constant permanent w/c

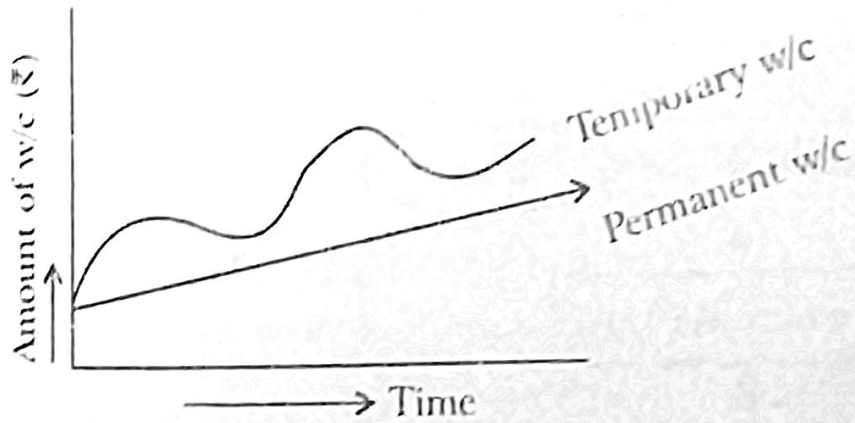


Fig. 2: (b) Shows increasing permanent w/c

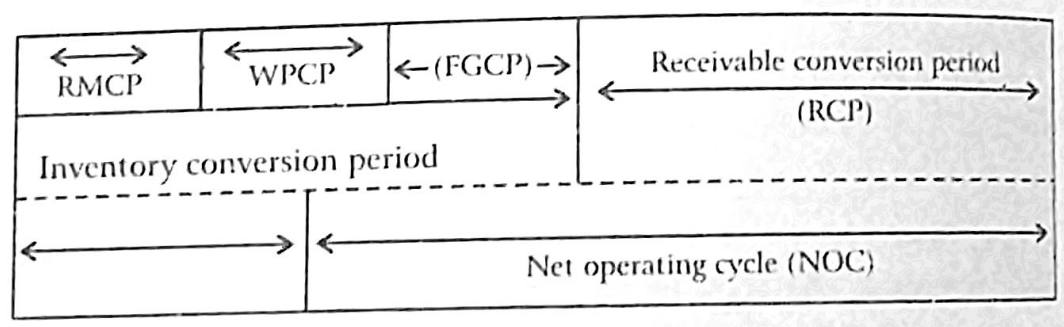
6. Operating Cycle/Working Capital Cycle

The operating cycle may be defined as the time duration starting from the procurement of goods or raw materials and ending with the sales realization. The length and nature of the operating cycle may differ from one firm to another depending upon the size and nature of the firm.

The operating cycle of a firm consists of the time required for the completion of the sequence of some or all of the following:

1. Procurement of raw materials and services.
2. Conversion of raw materials into work-in-progress.
3. Conversion of work-in-progress into finished goods.
4. Sale of finished goods (Cash or credit).
5. Conversion of receivables into cash.

These activities create and necessitate cash flows or funds. These requirements of funds depend upon the operating cycle period of the firm and is also denoted as the working capital needs of the firm.



Operating cycle period

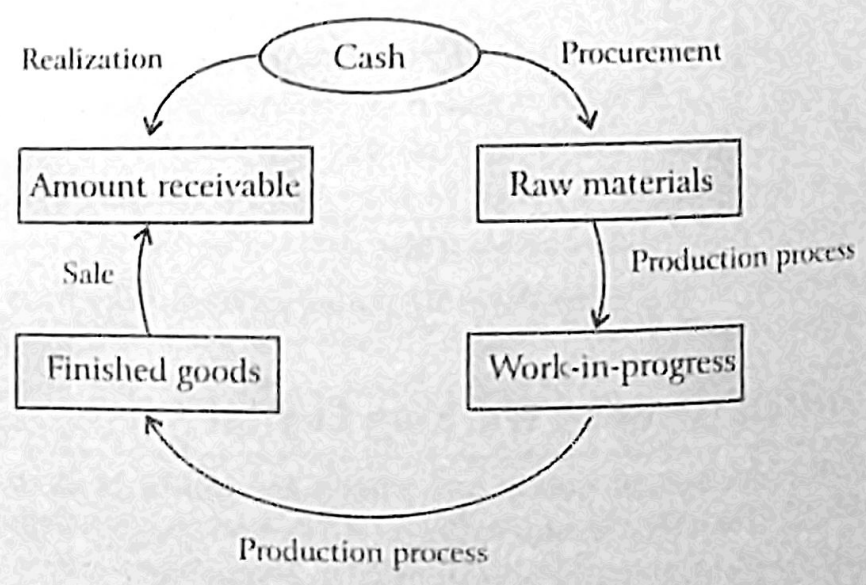


Fig. 3: Operating cycle

6.1 Operating Cycle Period

The length or time duration of the operating cycle of any firm can be defined as the sum of the inventory conversion period and receivable conversion period:

1. **Inventory conversion period:** It is the time required for the conversion of raw materials into finished goods sales. It includes:
 - (i) Raw material conversion period (RMCP)
 - (ii) Work-in-progress conversion period (WPCP)
 - (iii) Finished goods conversion period (FGCP)
2. **Receivables conversion period:** It is the time required to convert the credit sales into cash realization. It refers to the period between the occurrence of credit sales and collection of debtors. The total of inventory conversion period (ICP) and receivables conversion period (RCP) is known as **total operating cycle period (TOCP)**.

$$\text{TOCP} = \text{ICP} + \text{RCP}$$

The firm might be getting some credit facilities from the supplier of raw materials. This period to these parties are delayed is known as **Deferred Period (DP)**.

The **Net Operating Cycle (NOC)** of the firm is arrived at by deducting the DP from TOCP.

$$\text{NOC} = \text{TOCP} - \text{DP}$$

(i) Raw material conversion period

$$\text{RMCP} = \frac{\text{Average Raw Material Stock}}{\text{Total Raw Material Consumption}} \times 365$$

(ii) Work-in progress conversion period

$$\text{WPCP} = \frac{\text{Average Work - in - progress}}{\text{Total Cost of Production}} \times 365$$

(iii) Finished goods conversion period

$$\text{FGCP} = \frac{\text{Average Finished Goods}}{\text{Total Cost of Goods Sold}} \times 365$$

(iv) Receivables conversion period

$$\text{RCP} = \frac{\text{Average Receivable}}{\text{Total credit sales}} \times 365$$

$$\text{Deferral Period (DP)} = \frac{\text{Average Creditors}}{\text{Total Credit Purchase}} \times 365$$

Example 1: From the following taken from the books of a manufacturing concern, compute the operating cycle in days.

Period Covered	365 days
Average period of credit allowed by suppliers	16 days
	₹
Average debtors outstanding	4,80,000
Raw materials consumption	44,00,000
Total production cost	1,00,00,000
Total cost of goods sold	1,05,00,000
Sales for the year	1,60,00,000
Value of average stock maintained	
Raw materials	3,20,000
Work-in-Progress	3,50,000
Finished goods	2,60,000

Solution:

$$1. \text{ Raw Material Conversion Period} = \frac{\text{Average Raw Materials}}{\text{Raw Material Consumed}} \times 365$$

$$= \frac{3,20,000 \times 365}{44,00,000} = 27 \text{ days}$$

$$2. \text{ Work-in Progress Conversion Period}$$

$$\frac{\text{Average work-in-Progress}}{\text{Total Cost of Production}} \times 365 = \frac{3,50,000 \times 365}{1,00,00,000} = 13 \text{ days}$$

$$3. \text{ Finished Goods Conversion Period}$$

$$\frac{\text{Average Finished Goods}}{\text{Total Cost of Goods Sold}} \times 365 = \frac{2,60,000 \times 365}{1,05,00,000} = 9 \text{ days}$$

$$4. \text{ Debtors (Receivable Period)}$$

$$\frac{\text{Average Debtors}}{\text{Total Credit Sales}} \times 365 = \frac{4,80,000 \times 365}{1,60,00,000} = 11 \text{ days}$$

Total Operating Cycle Period

$$\text{TOCP} = \text{RMCP} + \text{WPCP} + \text{FGCP} + \text{RCP}$$

$$= 27 + 13 + 9 + 11 = 60 \text{ days}$$