CHAPTER 11: MANAGEMENT OF WORKING CAPITAL

Question No.1 – November 2016

Following information relates to ABC company for the year2016:

(i) Projected sales (in lakhs)

Month	August	September	October	November	December
Sale	35	40	40	45	46

(ii) Gross profit margin will be 20% on sale.

(iii) 10% of projected sale will be cash sale. Out of credit sale of each month, 50% will be collected in the next month and the balance will be collected during the second month following the month of sale.

(iv) Creditors will be paid in the first month following credit purchase. There will be credit purchase only.

(v) Wages and salaries will be paid on the first day of the next month. The amount will be ₹ 3 lakhs each month.

(vi) Interim dividend of ₹ 2 lakhs will be paid in December 2016.

(vii) Machinery costing ₹ 10 lakhs will be purchased in September 2016. Repayment by instalment of ₹ 50,000 p.m. will start from October 2016

(viii) Administrative expenses of ₹ 1,00,000 per month will be paid in the month of their incurrence.

(ix) Assume no minimum cash balance is required. Opening cash balance as on 01.10.2016 is estimated at ₹ 10 lakhs

You are required to prepare the monthly cash budget for the 3 month period (October 2016 to December 2016).

A trade whose current sales are ₹ 4,20,000 per annum and on average collection period of 30 days. Wants to pursue a more liberal policy to improve sales. A study made by a management consultant reveals the following information:

Credit policy	**Increase in collection Period**	**Increase in Sales**	**Present default anticipated**
I	10 days	₹ 21,000	1.5%
II	30 days	₹ 52,500	3%
III	45 days	₹ 63,000	4%

The selling price per unit is ₹ 3. Average cost per unit is ₹ 2.25 and variable cost per unit is ₹ 2. The current bad-debts loss is 1% Required return on additional investment is 20%. Assume a 360 days year.

Which of the above policies would you recommend for adoption? (8 Marks)

Question No.3 – November 2015

A firm has a total sales of ₹ 200 lakhs of which 80% is on credit. It is offering credit terms of 2/40, net 120. Of the total, 50% of customers avail of discount and the balance pay in 120 days. Past experirnce indicates that bad debt losses are around 1% of credit sales. The firm spends about ₹ 2,40,000 per annum to administer its credit sales. These are avoidable as a factor is prepared to buy the firm's receivables. He will change 2% commission. He will pay advance against receivables to the firm at an Interest rate of 18% after with holding 10% as reserve.

(i) What is the effective cost of factoring? Consider year as 360 days.

(ii) If bank finance for working capital is available at 14% interest. Should the firm avail of factoring service? (8 Marks)

<u>Question No.4 (May 2012 exam – 8 Marks)</u>

A company is presently having credit sales of ₹12 lakh. The existing credit terms are 1/10 net 45 days and average collection period is 30 days. The current bad debts loss is 1.5%. In order to accelerate the collection process further as also to increase sales, the company is contemplating liberalization of its existing credit terms to 2/10, net 45 days. It is expected that sales are likely to increase by 1/3 of existing sales, bad debts increase to 2% of sales and average collection period to decline to 20 days. The contribution to sales ratio of the company is 22% and opportunity cost of investment in receivables 15 percent (pre-tax), 50 per cent and 80 percent of customers in terms of sales revenue are expected to avail cash discount under existing and liberalization scheme respectively. The tax rate is 30%.

Should the company change its credit terms? (Assume 360 days in a year).

<u>Question No.5 (May 2012 exam – 8 Marks)</u>

STN Ltd. is a readymade garment manufacturing company. Its production cycle indicates that materials are introduced in the beginning of the production phase: wages and overhead accrue evenly throughout the period of cycle. The following figures for the 12 month ending 31st December 2011 are given.

Production of shirts	54,000 units
Selling price per production cycle	₹ 200
Duration of the Production cycle	1 month
Raw material inventory held	2 month's consumption
Finished goods stock held for	1 Month

Credit allowed to debtors is 1.5 months and credit allowed by creditors is 1 month

Wages are paid in the next month following the month of accrual.

In the work-in-progress 50% of wages and overheads are supposed to be conversion costs.

The ratios of cost to sales price are-raw materials 60% direct wages 10% and overheads 20%. Cash is to be held to the extent of 40% of current liabilities and safety margin of 15% will be maintained.

Calculate amount of working capital required for the company on a cash cost basis.

Question No. 6 (May 2013 exam – 8 Marks)

The following information is provided by the DPS Limited for the year ending 31st March, 2013.

Raw material storage period	55 days
Work-in-progress conversion period	18 days
Finished Goods storage period	22 days
Debt collection period	60 days
Annual Operating cost	₹ 21,00,000
(Including depreciation of 2,10,000)	
[1 year = 360 days]	

You are required to Calculate:

(i) Operating Cycle period

(ii) Number of Operating Cycle in a year.

(iii) Amount of working capital required for the company on cash basis

(iv) The company is a market leader in its product, there is virtually no competitor in the market. Based on a market research it is planning to discontinue sales on credit and deliver products based on Pre-payments. Thereby, it can reduce its working capital requirement substantially.

What would be the reduction in working capital requirement due to such decision?