Analysis of Working Capital

Dr. Ghazala Shaheen
Guest Faculty
Vanijya Mahavidyalaya

TECHNIQUES OF ANALYSIS OF WORKING CAPITAL

The analysis of working capital can be conducted through a number of devices such as

- Ratio analysis
- Fund flow analysis
- Working capital Budgeting
- Ratio analysis : A ratio is a simple arithmetical expression of the relationship of one number to another , this technique can be employed for measuring short term liquidity or working capital position of a firm.

THE FOLLOWING RATIOS MAY BE CALCULATED FOR THIS PURPOSE

- Liquidity Ratio

a) Current Ratio

b) Acid test ratio/quick ratio/liquid ratio

c) Cash Position ratio/absolute liquid ratio

- Inventory turnover ratio
- Receivable turnover ratio
- Payable turnover ratio
- Working capital turnover ratio

- Current ratio may be define as the relationship between CA and CL
- This ratio is also known as WCR. (Working capital ration).
- It is helpful to measure short – term financial position or liquidity of a firm
- $$\text{Current ratio: } \frac{\text{Current asset}}{\text{Current liabilities}}$$

CURRENT ASSETS	CURRENT LIABILITIES
Cash in hand	
	Bills Payable
Cash at bank	Sundry Creditors
Sundry Debtors	Accrued or Outstanding Expenses
Marketable securities (Short term)	**Short term loan and advances**
Bills Receivable	Dividend payable
Inventories of Stock	Bank Overdraft
Work in progress	
Finished goods	
Prepaid Expenses	

Quick or Acid test or Liquid Ratio

- An asset is said to be liquid if it can be convert into cash with in a short period with out loss of value
- Inventory cannot be termed to be liquid asset because they cannot be convert into cash immediately
- The quick ratio can be calculated

Quick ratio: $\frac{\text{liquid asset}}{\text{Current liabilities}}$

Quick or liquid	**Current Liabilities**
Cash in hand	Bills Payable
Cash at bank	Sundry Creditors
Sundry Debtors	Accrued or Outstanding Expenses
Marketable securities	**Short term advances**
Temporary Investments	Dividend payable
	Bank Overdraft
	Income tax payable

Convection quick ratio of 1:1 is consider satisfactory

Cash Position ratio/Absolute liquid ratio

- Absolute Liquid assets include cash in hand and cash at bank and marketable securities or temporary investments
- The acceptable norms for this ratio is 50% or .05%

$$\text{Cash ratio: } \frac{\text{Cash \& bank + Short –term securities}}{\text{Current liabilities}}$$

Calculate all the three ratio

Liabilities	Rs	Assets	Rs
9% preference share	500000	Goodwill	100000
Equity share capital	1000000	Land and building	650000
8% debentures	200000	Plant	800000
Long term loan	100000	Furniture and fixtures	150000
Bills payable	60000	Bills receivable	70000
Sundry creditors	70000	Sundry debtors	90000
Bank over draft	30000	Bank balance	45000
Outstanding expenses	5000	short term investments	25000
		Prepaid expenses	5000
		Stock	30000
	1965000		1965000

CONCLUSION:

- Current ratio of the company is not satisfactory because the ratio 1:6 is much below then the expected Standards .
- Acid test ratio on the other hand is more than the normal standard of 1:1
- Absolute ratio is slightly low because it is 0.42 where as the accepted standard is 0.5
- In this company need to improve its short term financial position

CONT…

- Inventory conversion period

$$\text{Inventory conversion period} = \frac{\text{Days in a year}}{\text{Inventory Turnover Ratio}}$$

- Debtor/Receivable turnover ratio /Debtor velocity

$$\text{Debtor(Receivable)} = \frac{\text{Net credit Annual sales}}{\text{Average Trade debtors}}$$

Average Collection Period

The average collection period represent the average number of days for which a firm has to wait before its receivable are converted into cash

Average Collection period =

$$\frac{\text{Average Trade Debtors (Drs + B/R)}}{\text{Sales per day}}$$

$$\text{Sales Per day} = \frac{\text{Net Sales}}{\text{No of working days}}$$

Or

Average collection period

$$= \frac{\text{average trade debtors}}{\text{net sales}} * \frac{\text{no. of}}{\text{working days}}$$

If period is in months :

$$\text{average collection period} = \frac{\text{no.of working days}}{\text{Debtors turnover ratio}}$$

The two basis component of the ratio are debtors and sales per day

Creditor/Payable turnover ratio

The analysis for credit turnover is basically the same as of debtors turnover ratio except that in place of trade debtor, the trade creditor are taken and in place of sales , average daily purchase are taken as the other component of the ratio.

Creditors turnover ratio

$$= \frac{\text{Net credit annual purchase}}{\text{Average Trade creditors}}$$

Average Payment period Ratio

= Average Trade Creditors(Creditors+ Bills payable)/Average Daily purchases.

Average daily purchase = Annual Purchase /No of working days in a year.

Average Payment Period = Trade creditor * No of working days / Net annual purchase.

Average Payment Period = No of working days / Credit turnover Ratio.

Working capital turnover ratio

Working capital of a concern is directly related to sales and current asset like debtors , bills receivable , cash , stock etc .

Working capital turnover ratio = Cost of Sales / Average working capital

Average working capital = Opening working capital + Closing Working capital/2

** If cost of sales is not given , then the figure of sale can be used . O n the other hand if opening working capital is not disclosed then working capital at the end of the year will be used.

Cost of sale /Net working capital

Fund flow analysis : Fund flow analysis is a technical device designated to study the sources from which additional fund were derived and the use to which these sources were put . It is an effective management tool to study change in the financial position of business

The fund flow analysis consists of

- Preparing schedule of change in working capital
- Statement of sources and application of funds

- Working capital Budgeting : Working capital budget as a part of total budgeting process of a business , is prepared estimating future long term and short term working capital need and the sources of finance them .
- The objective of a working capital budget is to ensure availability of fund as and when needed and to ensure effective utilization of these resources .