Operating cycle

The way working capital moves around the business is modeled by the working capital cycle. This shows the cash coming into the business, what happens to it while the business has it and then where it goes. the term operating cycle otherwise known as “ cash cycle”. In order to earn sufficient profits, a firm has to depend on its sales activities apart from others. The continuing flow from cash to suppliers, to investors, to debtors and back in cash. The time gap is technically termed as operating cycle.

In other words, the duration of the time required to complete the following sequence of events, in case of a manufacturing firm, Is called operating cycle. 1)Conversion of cash into raw materials 2)Conversion of raw materials into work-in-progress 3)conversion of work-in-progress into finished goods 4)conversion of finished goods in debtors 5)conversion of debtors to cash Bewteen each stage of this working capital cycle there is time delay. For some business this will be very long where it takes them a long time to make and sell the product. They will need a substantial amount of working capital to survive.

Others though may receive their cash very quickly after paying out for raw materials etc. They will need less working capital. For all businesses though they need to plan how much cash they are going to have. The best way of doing this is a CASH FLOW FORECAST.

WORKING CAPITAL CYCLE

From the above chart, it can be observed that the firm’s liquidity of a minifacturing firm depends an operating cycle involved in the conversion process from raw materials into finished goods and then sales into cash. In

case of non-maifacturing firms, the operating cycle will include the length of the time required to convert:)Cash into inventories b)Inventories into debtors c)debtors nto cash To determine the operating cycle period, time lag associated with all the individual activities of working cycle are to be determined first. Then summing up all the individual time lags working capital cycle is to be ascertained. Determine of individual time lags are shown as follows Raw Materials Conversion Period The RMCP denotes the period for which the raw materials are generally are kept in stores before it is issued to the production department. It is calculated as : RMCP= Average inventory of raw materials and stores.

Averahe daily consumption of raw materials Work-In-Progress conversion period(WPCP) It refers to the period for which the raw materials remain in the production process before it is taken out as finished products. WPCP being done in the following ways : WPCP= Average work-in-progress.

Average daily factory cost of production Finished Goods Conversion Period(FGCP) It refers to the period for which finished goods remain in stores before being sld to the customers. It is measured as : FGCP= Average stock of finished goods.

Average cost of goods sold per days Receiveable Collection Period(RCP) It is the time required to convert the credit sales into cash realizations, i. e. , the time allowed to debtors after credit sales for making the payment. RCP= Average debtors. Average daily credit sales Payment Deferral Period(PDP) The firm may get sum credit facilities from the suppliers of raw materials, wage earners etc. As the firm enjoys credit, this period has the effect of the

reducingmoneylock period in the operating cycle. CPP= Average creditors. Average daily credit purchase.

COMPUTATION OF WORKING CAPITAL IN BIRLA CORPORATION LIMITED

Ratio analysis can be used by financial executives to check upon the efficiency with which working capital is being used in the enterprise. The following are the important ratios to measure the efficiency of working capital. The following, easily calculated, ratios are important measures of working capital utilization. The working capital ratio. The working capital ratio is calculated as: Positive working capital means that the company is able to pay off its short-term liabilities.

Negative working capital means that a company currently is unable to meet its short term liabilities with its current assets(cash, accounts receiveable, inventory). If a company’s current asset do not exceed its current liabilities, then it may run into trouble paying back creditors in the short term. The worst case scenario is bankruptcy. A dceclining working capital ratio over a longer time period could be that the companys sale volumes are decreasing, and as a result, its accounts receiveables number continues to get smaller and smaller. Working capital also gives investors an idea of the company’s underlying operational efficiency .

Money that is tied up in inventory or moey that customers still owe to the company cannot be used to pay off any of the company’s obligations. So if a company is not operating in the most efficient manner(slow collection), it will show up as an increase in the working capital. athis can be seen by

comparing the wotking captal from one period to another; skow collection may signalan underlying problem in the company’s operations.

INTERPRETATION

This ratio reflects the financial stability of the enterprise. The standard of the normal ratio is 2: 1 but in most of companies standard is taken according to Tandon Committee which is taken as 1. 33: 1. Now if we analyze the three years data it can be predicted that it holds a stable position all through out period but it is seen that it holds a low position than the standard one and the company is required to improve its position.

It is the ratio between quick liquid assets and quick liabilities. The normal value for such ratio is taken to be 1: 1. It is used as an assessment tool for testing the liquidity position of the firm. It indicates the relationship between strictly liquid assets whose realizable value is almost certain on one hand and strictly liquid liabilities on the other hand. Liquid assets comprise all current assets minus stock. By analyzing the three years data it can be said that its position was weak in the year 2006 but itimproved significantly in the next two years and was stable during that year.

But it is to be said thatit does not meet with the standard but in the year 2007 & 2008 it was very close to the standardand it can be said that its liquidity position on an average is stable. As on 31. 03. 08 As on 31. 03. 07 As on 31. 03. 07 Working capital ratio 0. 06 0. 07 0. 01

This ratio indicates whether the investments in current assets or net current assets (i. e. , working capital) have been properly utilized. In order words it shows the relationship between sales and working capital.

Higher the ratio lower is the investment in working capital and higher is the profitability. But too high ratio indicates over trading. This ratio is an important indicator about the working capital position. Now if we analyze the three years data, we find that it follows an increasing trend which means that its investment in working capital is lower and the company is utilizing more of its profit. But we find that ratio is increasing at a very fast rate which is not a good sign for the company and the company is required to look into these matters closely.

The gross profit margin reflects the efficiency with which management produces each unit of the product. This ratio of the gross profit to net sales of the business. This ratio gives information about the movement of stock and earning capacity of the business. A high gross profit margin ratio is a sign of good management. it increases higher sale price. As on 31. 03. 08 As on 31. 03. 07 As on 31. 03. 07 Net profit ratio 22. 2% 20. 82% 10. 35%

A net profit ratio establishes a relationship between net profit and sales and indicates management efficiency in manufacturing, administrating and selling the products. The ratio is very helpful for measuring the profitability of the business. If the net froit margin is inadequate, the firm will fail to achieve satisfactory return on shareholders fund. As on 31. 03. 08 As on 31. 03. 07 As on 31. 03. 07 Oprating profit ratio 19% 16. 27% 3.. 50%

The ratio shows the relation between the entire operating cost and net sales. It indicates the efficiency of the management in operating the business.

As on 31. 03. 08 As on 31. 03. 07 As on 31. 03. 07 Debtors turnover ratio 5. 72 days 5. 53 days 5. 79days [pic] Debtors turnover indicates the number of

times of debtors turnover each year. generally the higher value of debtors turnover, the more efficiency in management credit. the shorter the average collection period, the better the quality of debtors. A short collection period implies the prompt payments by debtors.

The ratio reveals the number of days the business or the company enjoys as credit period from its sundry creditors. A very largr credit period in this case indicates over-trading by the company.