e. Last but not the least is the aspect of *'Timing'.* A clear plan about the time when the funds will be needed for the project and matching the same with the expected receipt of the funds, is a must. Mismatch of time would unnecessarily delay the project, would lead to an over-run and add to costs.

f. Financing a project and deciding the capital structure is not a one-time issue. For meeting the expansion plans & growth, a running company also needs funds and hence capital structuring needs to be looked at. It is a good practice to Review the Capital Structure Periodically to bring about changes that are possible and desirable in this fast changing financial market.

Points to Ponder

1. What is an 'ideal' capital structure?
2. Would it vary from industry to industry?
   * from unit to unit?
   * from time to time?
3. As loans have their 'cost' by way of 'interest' and 'repayments'... does equity have its cost? What bearing would that have on deciding capital structure?
4. What role does 'subsidy' play in financing a project?
5. What is the importance of working capital assessment in project financing?
6. Does a promoter need more funds than what is contemplated in the overall project financing shceme? If Yes, why?

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WORKING CAPITAL MANAGEMENT

INTRODUCTION

Efficiency in working capital management has acquired great significance in the Indian industry, particularly in view of dear money conditions prevailing in the country, and also due to the restrictive credit policy of the Reserve Bank of India.

'Working Capital' means the difference between total current assets and total current liabilities. As the definition itself suggests, to ascertain working capital requirements, one will have to estimate the amount that will have to be kept invested in stocks of raw material, stores, finished goods, work-in-progress, debtors, advances, etc. and one will also have to estimate the amount of credit that one can enjoy from suppliers of goods and services.

Coming to think of it, working capital would cover almost the entire operation of the company.

Best illustration to understand the working capital would be to draw parallel with a pipeline. The moment business starts, raw material will have to be fed continuously every day. It will take roughly 15 days to one month (depending upon the production process) to convert raw material into finished goods.

Even after producing these goods, it will take some time to sell these goods, and even after selling these goods, it will take some time to receive money from debtors. Continuously throughout this period, raw material will have to be pumped in, stores and spares will have to be used and various expenses will have to be incurred. Besides, adequate inventory of raw material, finished goods, stores and work-in-process will have to be maintained. Summation of all these, in other words, would be the gross working capital requirement.

However, all this money will not necessarily be financed by the company itself. The company will get some credit from the suppliers of goods and services. The balance will be called '*Working Capital Requirement*' of the company.

FINANCING OF WORKING CAPITAL

As mentioned earlier, one of the major sources to finance working capital is Suppliers' Credit.

Another important source is credit available from the Commercial Banks. Commercial banks operate within their own limits and constraints. *Tandon Committee norms* and *Chore Committee norms* clearly outlined the maximum limits upto which working capital can be financed by the banks. Each bank also determines its policy and method of financing the working capital needs of industry.

Balance of the working capital will requirement have to clearly be financed by the Owners Themselves. One should understand that the requirement of working capital is a permanent one and therefore, if the working capital is financed through medium/long term sources of finance (say for 5 years or 10 years term loan) this fund is available only for a specific period. Once the repayment of this loan begins, drain on the working capital will immediately be felt. In order to combat this eventuality, management should ensure that the unit will make adequate profits to repay these installments. If this is not done, replacement funds at that point of time should be tied up. This is the most crucial aspect of the management of working capital.

Many a times, it is also seen that working capital is financed by short term sources of finance, like supplier credit, short term deposits, etc. This is done with a hope that either these creditors will continue to extend the credit or the company will earn enough profits or make some arrangement to repay them. If the companies fail to make adequate profits or if these credits are withdrawn, or no other arrangement is done, then drain on working capital begins.

Even when a company is earning profits, it is necessary to plan the way in which the surplus is to be utilized. Ultimately the profits generated do get reflected as an increase in the working capital. But no useful purpose will be served if these funds lie idle, in unnecessary piling up of inventory, debtors, etc. of in creation of nonproductive assets.

After repaying the term loan instalments, etc., the surplus if any, can be used in creation of fixed assets (for expansion, etc).

It should be noted that such use of working funds in fixed assets creation, should not result into shortage of liquid funds! Because an investment in fixed assets is not going to be released in near future.

Such cases of investing funds from short term sources (by squeezing-out the same from working capital) into long term uses (of buying fixed assets) create serious working capital problems.

The working capital management becomes even more important in situation of losses! As profits lead to increase in available working capital surplus, correspondingly losses tend to reduce the working funds. But still, certain bare minimum current assets have to be maintained. Naturally, there will be delays in making payments to parties (by demanding more credits from market sources). Excessive borrowings from banks friends and relatives etc., are resorted to, in order to meet the pressing needs. These funds usually come at strister terms and higher costs. When it comes to 'loss' making units, it is absolutely necessary to find out the real reasons for the losses. Is it that the *market is bad* or is it that the *product is not acceptable* in market at the quality and price at which it is offered or is it that the *input costs* are too high or the technology is obsolete?

Whatever the reason of the losses, it is a feel that losses lead to shortage of funds in almost all cases. so before pumping in funds for working capital, resolve the reasons of losses. Otherwise *good money will chase bad money!*

If the company fortunately turns the corner in a year or two, this 'Squeeze' or 'Tightness' of working funds is released. If not, then obviously it worsens. Short term temporary sources of financing these losses are risky and unreliable. It is prudent to pump in long term or permanent sources of funds in such situations.

SMOOTH FLOW OF WORKING CAPITAL

It is quite evident that the working capital requirement will certainly depend upon the nature of industry in which the unit is. Peculiar trade practices of various industries lay down a broad parameter within which requirement of the working capital will fluctuate. However, this does not mean that the working capital management is totally beyond control.

Certain important aspects to be kept in mind are:

1. Ensure that Flow of Goods takes place in a smooth manner. In other words, there should not be any excess building-up of inventory either at the stage of raw material or work-in-process or finished goods, or outstanding debtors.

2. Reduce the Length of Operating Cycle. In other words ensure that the time taken in converting the raw material into sales realisation is minimised.

3. Control the overheads and other expenses.

4. Many Strategic and Policy Decisions particularly on product development, Pricing Policy, Distribution Policy, make or buy decision, expansion of activities, Purchasing Policy, deposit policy, product-mix policy, production planning etc. have their own impact on the working capital. The impact of these decisions on the working capital must be studied at the time of taking these decisions. The total funds available with the company for the working capital is usually limited. Within this limit, the unit has to operate. If because of any of these decisions, total requirement of working capital goes beyond the funds available, then stringency of finance is felt.

5. At the initial stage of a new venture or an expansion, it is very necessary to assess the working capital requirement on a realistic basis. Because if one starts off on a wrong foot, it becomes almost impossible to catch up later. This is extremely important to be kept in mind while setting up new projects. Many projects have suffered because of the fact that they did not correct estimate the working capital requirement and its financing for smooth running of the operations.

6. Capital Expense Decision should be taken with tremendous imagination. Many a times, non-productive assets are created by the company. These are known as *'Idle Assets'*. These assets do not help the company in increasing their turnover and profit. These assets are even created out of borrowed funds and these funds have to be returned. This would be a clear drain on the limited funds available to maintain a smooth flow of working capital. Idle assets therefore should be controlled carefully.

7. A Prudent Policy should be followed while finalizing the sources of funds to finance working capital. In other words,

   a. Too much of dependence on market credit should be avoided.

   b. Financing of fixed assets from temporary short term funds should be avoided.

   c. Substantial and continuing losses in operations should be financed by long term sources of finance.

   d. Repayment of term loans, etc. should not be effected merely out-of already scarce working funds. If working funds are already scarce, some other long term funds should be arranged.

The above are only some broad and illustrative guidelines towards safety and security to ensure good working capital management. They are certainly subject to change and variations, depending upon situations.

SICK UNITS AND WORKING CAPITAL TRAP

Once the difficulty on working capital is felt, the unit is trapped into a Cycle of Sickness. As a result of shortage of finance (as it is popularly known) payments to creditors are not made in time, suppliers therefore increase their prices, profitability of unit therefore, suffers. Bankers therefore refuse to give further loans. Deposit holders looking at the bad performance, ask for more interest or refund of their deposits, and this leads to further shortage of working capital.

It is further interesting to note that usually a *'sickness' in industry is identified only when there is a crisis of working funds.*

Many of these entrepreneurs say that if they have little more *'Working Funds'*, they will start earning profits.

Even after obtaining extra funds, many have failed . The reason is simple.

The *'Shortage of Funds'* was a symptom of some greater defect in production or marketing or management and so on.

Ideally, therefore, whenever *'Shortage of Funds'* is felt, one should have a hard look at the entire business cycle. Failing which, you will follow the same route of good-money chasing bad-money.

Ideally there should be no shortage of working funds, but, some shortage on working capital is always good. That makes all the managers of the company run harder, and forces them to introduce economics. Many a times, in many successful units, artificial shortage of working capital is created. But then these are planned, and not forced, shortages.

Points to Ponder

1. Many a times a profit earning company also faces working capital shortages. Why?
2. Please study the impact of
   a. better technology, and
   b. pricing policy on working capital.
3. Can shortage of working capital always be solved by pumping in additional funds?
4. What is a sick unit? Why do units go sick? What are the remedies?

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ANALYSIS OF FINANCIAL STATEMENTS

We have, in the earlier chapters, tried to understand how accounts are to be maintained.

The output of the whole exercise, as we saw, are the profit & loss account and balance-sheet. Added thereto are the Auditor's report and the Directors' report which finally makes the *'Annual Report'*.

The end-users receive these annual reports, as an official document from the company. Various end-users, i.e., Shareholders, Investors, Bankers, Government Departments, etc. use them as guidelines while taking decisions.

How would one look at these annual reports?

Naturally, the reader will have his own reasons for reading it (perhaps just to find out how much salary does Mr. X draw from the company!). For the purpose of Financial Analysis, Various Tools and Techniques have been developed to analyse these Financial Statements. Two of the most commonly used techniques are:

A. Ratio Analysis.
B. Fund Flow Analysis.

A. RATIO ANALYSIS

A '*Ratio*' is an expression of a relationship between two numbers . It can be expressed as a percentage or as a proportion or as a relation.

Theoretically, therefore, a ratio can be worked out between any two numbers. So one has to select the numbers, whose relationship would carry some meaning, would throw some light on the financial bearings of the company. Some such numbers (ratios) are given below: