

UNIVERSITY OF COLOMBO, SRI LANKA

FACULTY OF MANAGEMENT AND FINANCE

Bachelor of Business Administration Honours in Accounting (Semester V) Examination –
July, 2022

ACT 3210 – Working Capital Management

Two (02) Hours

This is an Open Book Examination

This Paper Consists of Four (04) Questions Printed in Six (06) Pages

Answer All Questions

Use of Calculators is Permitted

1. i. “Maintaining a satisfactory level of working capital ensures both short-term and long-term financial health of a firm”. Elaborate on this statement.

(05 Marks)

- ii. The following details are extracted from the Statement of Financial Position of Ceylon Trust Company.

Rs. ‘000

Assets	
Non-current assets	80,400
Current assets	<u>30,600</u>
Total Assets	<u>111,000</u>
Liabilities	
Long-term funds	86,200
Current liabilities	<u>24,800</u>
Total Liabilities	<u>111,000</u>

The company has found that its current assets earn 4%, non-current assets earn 9%, current liabilities cost 3%, and long-term funds cost 7%.

- a. Based on the above information, calculate the net profitability of the company.

(04 Marks)

- b. The company is considering to increase its net working capital by 20% by shifting non-current assets into current assets **or** short-term liabilities into long-term funds. Advise the company to select the most appropriate alternative by analyzing the above information.

(07 Marks)

- iii. Helping Finance Ltd has estimated its fund requirement for the last four (04) months of the year 2022 as follows.

Month	Rs. '000
September	3,500
October	2,400
November	3,900
December	4,200

Short-term and long-term financing costs are 3% and 7%, respectively.

The company has decided to assess the suitability of raising the above funds under three main approaches: hedging, conservative and mixed. As the Finance Manager of the company, you have been requested to prepare a report comparing the following;

- a. Cost of financing under each approach.

(06 Marks)

- b. The net working capital amount under each approach.

(03 Marks)

(Total 25 marks)

2. i. Briefly explain the impact of price level increases in the economy on the following.
- Working capital needs of a firm.
 - Obtaining bank borrowings.

(06 Marks)

- ii. Green Land PLC is producing and selling organic liquid fertilizers called “GL Super”. With the increasing demand for fertilizers, the company has decided to increase its production. However, the company’s current working capital amount is not sufficient to deal with this decision. Thus, Finance Manager of Green Land PLC is considering to apply a bank credit facility to finance the required working capital amount.

Before granting the bank credit facility, the bank has requested a statement showing the estimated working capital of the company.

The following particulars are abstracted from Green Land PLC.

- The unit cost structure of GL Super (one bottle) is identified as follows.

Item	Rs.
Raw materials	500
Direct labour	200
Manufacturing overheads	80
Selling overheads	20
Total cost	800

- The company expects to maintain the level of activity of 96,000 units of production for the year.
- Raw materials are purchased on one month and two weeks (1.5 months) credit period and are in stores for two months before being issued to production.
- Materials in process on average is one month and two weeks (1.5 months) (assume 80% completion in respect of materials and 50% completion stage in respect of conversion costs).
- Finished products in stock on average is one month.
- Credit allowed to customers on average is one month.
- The average time lag in payment of wages is one month.

- The average time lag in manufacturing overheads and selling overheads is three weeks.
- Cash at the bank is expected to be Rs. 350,000.
- The reservation of 1% for contingencies is a company policy in estimating working capital.

Assuming that you are the Finance Manager of the company, prepare a statement of working capital estimation as per the information above (clearly state your assumptions, if any).

(16 Marks)

iii. A firm is offered the credit term of '2/10 net 45'. Should the firm pay within the discount period if the short-term borrowing rate is 12%? Advise.

(03 Marks)

(Total 25 marks)

3. i. "It is always advantageous for a firm to accept a non-recourse factoring arrangement rather than a recourse factoring arrangement". Do you agree with this statement? Explain.

(03 Marks)

ii. Negombo City Ltd (NCL) offers 2/10 net, 30 credit terms for its customers. NCL's experience has been that, on average, 30% of customers avail of the discount, while the balance of the receivables is collected on an average of 60 days after the invoice date. Currently, NCL is managing its accounts receivable internally by its sales and credit department, and 2.5% of the sales turnover results in default. The company is financing its investment in receivables through bank finance with an interest rate of 10%. Also, the projected sales revenue for the next year is Rs. 60 million.

However, as an alternative to the in-house management of receivables, NCL is now considering a proposal for a non-recourse factoring service offered by Rapid Factors Ltd (RFL). According to the factoring proposal, the following details and terms are identified.

- The guaranteed payment period is within 30 days
- Charge a commission for services at 3% based on the total receivables
- Advance 85% on the total receivables
- The discount charge in advance (based on the eligible amount in each period) is 12%

If the factoring proposal is accepted, it is expected that the projected sales for the next year will increase by 10% due to the time available for sales promotions. The contribution of NCL on sales in the past has been 20%. Furthermore, there would be a saving in administrative overheads of Rs. 300,000 due to discontinuation of sales ledger administration and credit monitoring.

As a financial consultant, advise NCL whether they accept the factoring proposal offered by RFL (you may assume 360 days in a year for calculation purpose).

(22 Marks)

(Total 25 marks)

4. i. What do you mean by “delinquency costs” associated with accounts receivable? State any two (02) examples for delinquency costs.

(03 Marks)

- ii. Orex Lanka Ltd has a current sale of Rs. 6,000,000 per annum. The company is considering a more relaxed credit policy to increase sales further. The current average collection period offered to its customers is 30 days. The proposed increases in the collection period and their impacts on sales and default costs are listed below.

Credit Policy	Increase in the collection period	Increase in sales (Rs.)	Default rate (on total sales)
A	15 days	240,000	0.5%
B	30 days	620,000	1.0%
C	40 days	700,000	2.0%

Orex Lanka Ltd is selling its products at Rs. 100 each. The average cost per unit at the current level is Rs. 80, and the variable cost per unit is Rs. 60. If the cost of investment in accounts receivable is 20%, which credit policy do you recommend to Orex Lanka Ltd? Why?

(16 Marks)

- iii. S&J Company imports and sells automobile parts. The company is considering to use an ABC inventory classification because some automobile parts are more valuable and not readily available. The average number of items held, along with their unit costs, is listed in the table below.

Item No.	Average number of units in stock	Average cost per unit (Rs.)
M001	350	9,000
M002	630	2,200
M003	220	45,000
M004	220	1,100
M005	120	70,000
M006	320	1,800
M007	290	8,000

The company prefers to classify the number of items and inventory values as follows.

Group	No. of items (%)	Inventory values (%)
A	15	70
B	30	20
C	55	10
Total	100	100

Using the above information, you are required to prepare a breakdown of inventory items under ABC classifications.

(06 Marks)

(Total 25 marks)