Chapter - 7

FINANCING OF WORKING CAPITAL

7.1 INTRODUCTION:

One of the important tasks of the financial manager is to select an appropriate source to finance the current assets. A business firm has various sources to meet its financial needs. Normally, the current assets are financed by a combination of long term and short term sources of financing. The long term sources of finance provide support for a small part of current assets requirement which is called the net working capital or working capital margin. The short term sources of finance, referred to also as current liabilities, provide the major support for current assets. While selecting a particular source of finance, a firm has to consider the merits and demerits of each source in the contest of prevailing constraints.

"With reference to an appropriate financing mix the term hedging or matching approach can be said to refer to a process of matching maturities of debt with the maturities of financial needs". According to this approach, the maturity of sources of funds should match the nature of the assets to be financed. For the purpose of analysis, the assets can broadly be divided into two classes:

(a) Those which are required in a certain amount for a given level of operation and hence, do not vary in the overtime.
(b) Those which fluctuate in the overtime.

Thus, when the business concern follows the matching approach, "Long-term financing will be used to finance fixed assets and permanent current assets and short-term financing will be used to finance temporary or variable, current assets".

The chapter deals with the theoretical aspect of sources of
finance, nature of working capital etc. The financing pattern of current assets and component of current liabilities are also discussed in this chapter.

7.2 SOURCE OF FINANCE:

The source of finance may be classified broadly into two categories from the viewpoint of the time element. Long term sources and short term sources. Each these can be further divided into internal and external sources which are as under:

[1] Long Term Sources:

(A) Internal Sources
   I. Retained Earnings
   II. Depreciation Provisions

(B) External Sources
   I. Equity Share Capital
   II. Preference Share Capital
   III. Debentures and Bonds
   IV. Long Term Loans from Financial Institutions Including Commercial Banks

[2] Short Term Sources:

(A) Internal Sources
   I. Proposed Dividends
   II. Provision for Taxation

(B) External Sources
   I. Trade Creditors
   II. Bank Credit
   III. Public Deposits
   IV. Miscellaneous Sources such as Deposits from Stockists and Contractors, Liabilities of expenses etc.
7.3 NATURE OF WORKING CAPITAL:

Working capital is subject to fluctuations. It is influenced by the type, size and length of the operating cycle of a firm. The amount of working capital differs not only in different industries, but also from one firm to another firm in the same industry. Working capital may be divided into two parts, permanent and temporary. Permanent working capital means the minimum level of working capital required all the time for business operation. Any excess over the permanent working capital (current assets) is termed as temporary working capital. It fluctuates with the changes in operational activity. The permanent working capital never leaves a business and remains gainfully employed all the times while temporary working capital is occasionally unutilised during the year. However, permanent as well as temporary working capital has a continues circulating and changing shape from one form to another such as cash to inventory, inventory to receivables and receivables to cash and so on.

The concept of permanent and temporary working capital helps in determining the level of funds to be obtained from various sources of finance. It has been emphasized by financial experts that "The permanent working capital should be financed by equity capital or other long term sources, while temporary working capital should be generally financed by short term sources". But the distinction between temporary and permanent working capital is that the minimum level of working capital (current assets) must be determinable precisely which, in practice is difficult, for an external analyst. However, the external analyst may consider the working capital margin (excess of current assets over current liabilities) as a crude estimate of permanent working capital. Accordingly, an attempt has been made in the
present study to analyse the pattern of working capital financing in cement and pharmaceutical industries in India.

7.4 FINANCING OF CURRENT ASSETS:

The concern must ascertain the sources of funds to finance its current assets. It can adopt various financing policies. Mainly, there are two types of financing policies viz. (I) Long Term Financing (II) Short Term Financing. The major sources of long term financing are equity shares, debentures, preference shares, long term loans and retained earnings. Short term financing includes creditors, bills payables and short term loan and advances. A concern should decide the sources of financing current assets. If short term financing is to be used, the concern must determine its proportion in total financing. This decision will be based upon the risk-return trade off. It should be noted in this connection that on the one hand short-term financing is less costly than long term financing. While on other hand, it is more risky than long-term financing. The policies adopted in financing current assets in the cement and pharmaceutical industries in India have been portrayed in Table No. 7.1 and 7.2.
2.4.1 Financing of Current Assets by Short-term and Long-term Sources

Table 7.1

Cement Industry:


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<th>Sr.No.</th>
<th>Year</th>
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<th>Tot. Short term Sources</th>
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=================================================================

Average  5.56  86.44  92.00  8.00

=================================================================
Pharmaceutical Industry:


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<th>Sr. No.</th>
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<th>Long term Sources</th>
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</table>

Average: 6.17  68.22  74.39  25.61

CEMENT INDUSTRY:

It is evident from Table No. 7.1 that the financing of current assets in the cement industry in India for the period from 1980-81 to 1993-94 from total short term sources varied from 72.37% in 1992-93 to 104.29% in 1989-90. It had fluctuating trend. On the whole the average proportion of short term sources in cement industry was 92%. And during major part of the study period this actual proportion was higher than average proportion. In the year of 1982-83, 1988-89 and 1989-90, the total short term sources were more than the total current assets, due to external sources. In short term financing, the proportion of internal sources had a specific trend during some span of time. The trend of internal sources to total sources was decreasing from 1980-81 to 1988-89 except in the year of 1984-85 compared to previous year. From 1989-90 to 1993-94, the trend of internal short term
sources was rising. On the other hand, the proportion of external short term sources of financing had fluctuating trend. It fluctuated every year irregularly but it had registered some trend during some part of the study period. The trend of short term external sources was rising from the beginning to the year of 1988-89 except in the year of 1984-85 and after words, it showed downward trend unto the end of study period and it sharply decreased during the last four years of study i.e. from 1990-91 to 1993-94. Thus trend of external short term sources was just opposite than the trend of internal sources in financing the current assets. The short term external sources were more than the total current assets in the year of 1982-83, 1988-89 and 1989-90, which resulted in higher level of total short term sources in these years. The average of 86.44% of external short term sources was maintained during major part of the study period. On the whole, the proportion of short term internal sources of financing increased and the proportion of short term external sources decreased towards the end of study period i.e. from 1989-90 to 1993-94, which indicated that the cement industry becomes less and less dependent on short term external sources towards the end of study periods than in the beginning year of the study period. It means that the cement industry followed the policy of mixing this particular source of financing which is always preferable as it does not bear any interest cost.

The financing of current assets from long term sources in the cement industry marked a fluctuating trend throughout the study period. But during specific span of period it had shown specific trend. i.e. from 1980-81 to 1989-90, the trend of long term sources of financing was downward compared to previous year except in the year of 1983-84 where it was 7.55% of total
current assets. Towards the end of study period, from 1990-91 to 1993-94, this trend was upward and becomes highest share of 27.63% in financing of current asset in the year of 1992-93. The average financing of long term sources was 8% and during major part of the study period, the actual proportion of it was lower than average proportion. The long term sources in financing of current assets were negative in the year of 1982-83, 1988-89 and 1989-90 which indicated that short term sources are more than the requirement and used in financing the fixed assets in those years.

It is observed from the above analysis that cement industry used short-term sources in financing current asset as 92% average of financing during study period. Normally the contribution of internal sources in financing current assets is lower than external sources. This pattern in financing also seen here. But during last four years - particularly from 1990-91, the increasing trend of short-term internal sources indicated good sign for financial health. This may due to change in regulation of price policy in cement industry from Feb. 1989.

PHARMACEUTICAL INDUSTRY:

It is evident from the Table No. 7.1 that the internal short term sources, external short term sources and as a result total short term sources varied every year in financing the current assets. The trend of internal short term sources in financing current assets was declining from the year of 1980-81 to 1990-91 and it was upward from 1991-92 to 1993-94. It means major part of the study period the trend of short term internal sources were downward compared to previous year. The average of short term internal sources in financing current assets was 6.17% due to
higher percentage in some years of beginning of study period. And during major part of the study period the actual proportions of internal sources were lower than average proportion particularly from 1985-86 to the end of study period. It was highest in first year of 1980-81 at 17.74 % and lowest at 1.58 % in 1990-91.

The external short term sources had shown upward trend during major part of the study period. The external short term sources at 66.38 % in 1980-81 were increased upto 74.26 % in 1991-92 continuously except in the year of 1983-84 and 1984-85. The trend of short term external sources were downward during last two years and became minimum at 59.01 % of current assets in last year 1993-94. On the whole, the average of short term external sources was 68.22 % and during major part of the study period the actual proportions of external short term sources were lower than average proportion.

The total short term sources varied irregularly due to opposite trend of internal and external short term sources during the study period. The total short term sources was 84.12 % of current assets in 1980-81 which decreased to 83.51 % in 1981-82 but during 1982-83 it increased to 89.14 % and during next two years continuously decreased to 75.57 % and 71.47 % in the year of 1983-84 and 1984-85 respectively. It further increased to 71.91 % in 1985-86 and now it again decreased to 69.68 % in 1986-87. From 1987-88 to 1991-92 it continuously increased except in the year of 1990-91 compared to previous year. During last two years of 1992-93 and 1993-94 it continuously decreased and registered at 60.83 % as minimum proportion. The average of total short term sources were 74.39 % and about half times of study period was more than that average.

On the whole, the proportion of internal short term sources decreases in total short term sources but trend of internal
short term sources was increasing towards the end of study period, which indicated that the pharmaceutical industry tended to rely more and more on internal short term sources than external short term sources towards the end of study period. It can be observed from the above analysis that the proportion of overall short term sources in financing current assets was higher during initial years of the study from 1980-81 to 1983-84 as compared to the proportion during later years of the study from 1992-93 to 1993-94, which indicates that during the initial years of the study the pharmaceutical industry was comparatively less dependent upon long term sources than in the later years.

The proportion of long term sources of financing current assets was 15.08 % in 1980-81, which increased to 16.49 % in 1981-82 and than it declined to 10.86 % in 1982-83 and again it increased in next two years to 24.43 % and 28.53 % in the year of 1983-84 and 1984-85 respectively. Then it slightly decreased to 28.09 % in 1985-86. Next year in 1986-87 it increased to 30.32 % and after that next three years it declined and registered 30.22 %, 26.50 % and 25.01 % in the year from 1987-88 to 1989-90 continuously. During last 3 years out of four years it increased and registered at 39.17 % in last years as the highest level in the study period. Profit retained as the long-term sources is routine in business. Therefore naturally this is a part of profit retained and compensate deficit in financing current assets.

Above analysis indicated that pharmaceutical industry was less dependent on long-term sources than short-term sources in financing current assets during major part of the study period. But it become more dependent on long term sources towards the end of study period which is not good sign. The trend of internal
short-term sources in financing current assets was increasing towards the end of study period, which is good for financial health.

A comparative study of the financing of current assets reveals that the proportion of total short term sources was higher in major part of the study period in cement industry than pharmaceutical industry. It means long term sources are more used in financing current assets in pharmaceutical industry. In cement industry, the short term sources were more than current assets in some years i.e. 1982-83, 1988-89, 1989-90. It means short term sources were used in financing fixed assets. If current assets are financed by long term sources is advisable but fixed assets are financed from short term sources is not accepted. Therefore it is not good for cement industry. Further the proportion of internal short term sources was higher during major part of the study period in pharmaceutical industry than cement industry. Towards the end of the study period it was opposite but having increasing trend in internal short term sources in both the industries is good sign for financial health. As this particular source of financing does not create any liability in the form of interest.

The study revealed that a wide variation exists in the use of long term funds for the financing of current assets required by both the industries. However, during major part of the study both the industries registered an upward trend in the share of long term funds over the years mainly due to restricted bank credit.

7.4.2 COMPONENT WISE ANALYSIS:

Financing of current assets by current liabilities in component wise are depicted in Table No. 7.2.
Table 7.2

Pharmaceutical Industry:

Financing of Current Assets by Individual Short Term Component: 1980-81 to 1993-94

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Average: 0.9200 24.53 44.94 5.56 16.97

Average: 0.7439 30.84 27.45 6.17 9.93

Average: 0.7439 30.84 27.45 6.17 9.93
CEMENT INDUSTRY:

Current assets should be financed from current liabilities. An average of financing of current liabilities by current assets was 92% and from 1980-81 to 1989-90, continuous nine year, the contribution of current liabilities in financing current assets was more than average but last four years from 1990-91 to 1993-94 it was less than average. The trend of finance by this means was increasing during first ten years of study and from 1990-91 to 1992-93 the trend was reverse and further the trend marked increased in last year 1993-94. It is cleared that trend of current liabilities in financing current assets was increasing during most of the year under study. In the year of 1982-83, 1988-89 and 1989-90, the current liabilities were more than the current assets, which were 103.58%, 104.20% and 104.29% respectively. It showed that this years short-term sources are used in financing fixed assets.

Component wise Analysis:

(A) Loan and Advances:

They are considered short term borrowed funds. The relation of short term borrowed funds to current assets has its special importance in financing current assets, because short term borrowed funds bear the cost of interest unlike other short term sources of funds. It is evident from the Table that ratio of loan and advances to current assets varied between 18.59% in 1992-93 and 33.78% in 1988-89. But the trend of this ratio was not specific. It fluctuate irregularly. In 1980-81 it was 18.82% and increased to 27.08% in 1981-82, then from 1982-83 to 1984-85, three years continuously this ratio marked in downward trend compared to previous year But from 1985-86 to 1988-89,
continuously four years, the ratio of loan and advances to current assets registered upward trend compared to previous year. Which was 23.78 %, 26.89 %, 30.20 % and 33.78 % respectively. Further, from 1989-90 to 1992-93, the trend was decreased and registered 30.37 %, 23.16 %, 18.72 % and 18.59 % respectively and further in last year of 1993-94, the trend of it marked upward which was 21.05 %. Thus trend was fluctuating irregularly. The average of this ratio was 24.53 %. A decrease in this ratio is considered to be good for the industry as it reduces the cost of capital.

(B) Sundry Creditors:

Sundry creditors are generally liabilities of goods purchased on credit. The ratio of sundry creditors to current assets varied from 31.31 % in last year to 54.45 % in 1989-90. The trend of this ratio was increasing from 1980-81 to 1989-90 except in the year of 1981-82 and 1985-86 and from 1990-91 to 1993-94 the trend was declining and a minimum ratio was registered at 31.31 % in last year of 1993-94. The average of this ratio was 44.94 % and the actual proportion of sundry creditors to current assets was high than average proportion during major part of the study period which is benefited to industry but decreasing trend of this ratio towards the end of study was not good.

(C) Provision for Taxation:

Provision for taxation, an internal source of short term financing to current assets ratio varied from 1.12 % in 1988-89 to 12.90 % in 1980-81. The trend of this ratio was declining from 1980-81 to 1988-89 except in the year of 1984-85 compared to previous year. It was highest at 12.90 % in 1980-81 and
lowest at 1.12% in 1988-89. However, it had rising trend from 1989-90 to 1993-94 except in 1992-93. It was 1.87% in 1989-90 and 12.50% in 1993-94. Thus trend of this ratio was downward during major part of the study period. The increasing trend of this ratio is good because this source of finance has not cost of interest. The average of this ratio was 5.56% and during major part of the study period, the proportion of tax provision to current assets was lower than average proportion.

(D) Miscellaneous Current Liabilities:

Remaining other short term liabilities are included in miscellaneous current liabilities. The ratio of miscellaneous current liabilities to total current assets varied from 8.90% in last year 1993-94 to 28.61% in 1982-83. The average of this ratio was 16.97% and during major part of the study period this ratio was higher than average ratio. The ratio fluctuated every year irregularly. It was 12.69% in 1981-82 and increased to 22.24% and 28.61% in 1981-82 and 1982-83 respectively. Then it highly dropped and registered 17.07% in 1983-84. From 1984-85 to 1988-89, the trend of this ratio was increasing except in the year of 1987-88. Where it was 17.65%, from 1989-90 to the end of study year 1993-94, the trend was downward and registered lowest ratio in last year 1993-94. Thus the ratio showed a specific trend during some span of time and marked downward trend during major part of the study period.

From the above analysis it is observed that in 1990's decade major part of the current assets were financed about 95% from current liabilities particular from borrowed short term money and trade credit and from the ending year 1990 decade to the year at end of study period this proportion was decreased.
The financing from internal sources was not significant but increasing trend of this source towards the end of study period is a good sign. The financing of current assets from current liabilities was average 92 %, therefore long term sources are used 8 % in financing current assets. The ratio of long term liabilities to current assets was in opposite trend of current liability to current assets ratio's trend.

It is concluded that current assets should be financed from short term sources (current liabilities) but here current assets are financed from short term sources about 92 % is also good because permanent working capital may also included in current assets which should be financed from permanent capital (long term capital). The decreasing trend of external short term borrowing funds and increasing trend of internal short term fund towards the end of the study period are good.

PHARMACEUTICAL INDUSTRY:

Financing of current assets from short term sources (current liabilities) in pharmaceutical industry is presented in Table No. 7.2.

It is evident from the Table that total current assets are financed by short term liabilities average 74.31 %. The ratio of total current liabilities to total current assets varied from 60.83 % in 1993-94 to 89.14 % in 1982-83. The trend of this ratio was not specific. It fluctuated every year irregularly. The ratio was 84.12 % in 1980-81, which decreased to 83.51 % in 1981-82, then this ratio was increased to 89.14 % in 1983-84. Further the ratio was decreased next two years of 1984-85 and 1985-86 and reached to 75.57 % and 71.47 % respectively. Then
this ratio was slightly increased to 71.91 % in 1985-86. Further the ratio was decreased to 69.60 % in 1986-87 and from 1987-88 to 1991-92. The trend of this ratio was increasing except in 1990-91, where it was 73.92 %. During last two years of study period, the proportion of current liabilities to current assets had decreased and registered 60.83 % as minimum in 1993-94.

Component Wise Analysis:

(A) Loan and Advances:

Loan and advances are considered short term borrowed funds. It has cost of interest, therefore its utilisation should be as minimum as possible. The ratio of loan and advances to total current liabilities presented in Table No. 7.2 varied from 23.97% in 1984-85 to 44.55 % in 1982-83. This ratio was fluctuated every year irregularly and not marked a trend during the study period. The ratio of 32.73 % in 1980-81 was increased to 38.82 % and 44.55 % in the year of 1981-82 and 1982-83 respectively. Then during next two years the ratio was decreased and registered 23.97 % in 1984-85. From 1985-86 to 1989-90 except 1987-88 the ratio marked in upward trend and reached 32.50 % in 1989-90. From 1990-91 to 1993-94, except in 1991-92, the trend of this ratio was downward. Thus this ratio had fluctuated every year, but towards the end of the study period this ratio decrease is a good sign for industry because the cost of interest bearing by loan and advances was decreasing. The average of this ratio was 30.84 % and during major part of the study period the actual ratio was lower than average ratio.
(B) Sundry Creditors:

Sundry creditors represent the trade credit. The ratio of sundry creditors to total current assets varied from 20.91% in 1993-94 to 34.18% in 1988-89 having an average of 27.45%. The trend of this ratio was variable. It was 21.85% in 1980-81 and increased to 24.86% in 1981-82. Then it decreased to 22.31% in 1982-83. But from 1983-84 to 1988-89, (except in 1984-85) the trend of this ratio was upward and marked at highest peak of 34.18% in 1988-89. From 1990-91 to 1993-94, the trend was opposite of the above trend and registered at 20.91% as minimum in last year 1993-94. The average ratio was not maintained during major part of the study period. Thus the trend of this ratio was ups and downs during some span of the year of study. The company should use maximum availability of trade credit. The proportion of trade credit to total current assets towards the end of the study period is not good. Because the trend of this ratio was decreasing towards the end of the study period.

(C) Provision for Taxation:

Provision for taxation is considered internal short term sources. The use of internal sources as more as possible is good for the company. The ratio of tax provision to total current liabilities varied from 17.74% in 1980-81 to 1.58% 1990-91. The average ratio was 6.17% which was not maintained during major part of the year. From 1980-81 to 1990-91, (the 1990’s decade) the trend of this ratio was downward and from 1991-92 to 1993-94 the trend of this ratio was upward. But the share of internal sources in financing current assets was more during first ten year than last four years. Towards the end of the study period.
period, the use of the internal sources was marked increasing is a good sign for the industry because it does not carry the cost of interest.

(D) Miscellaneous Current Liabilities:

Remaining Liabilities other than trade credit, short term borrowing and internal short term sources are classified in miscellaneous current liabilities. The financing of current assets from miscellaneous current liabilities varied from 14.28% in 1984-85 to 6.62% in 1990-91. The average of this ratio was 9.93% and during major part of the study period this ratio was lower than average. The trend of the ratio of miscellaneous current liabilities to total current assets was downward during major part of the study period. The ratio was 11.80% in 1980-81, which decreased to 7.59% in 1981-82. From 1982-83 to 1984-85 the trend of this ratio was increasing and registered highest ratio in 1984-85 at 14.28%. From 1985-86 to 1990-91, the trend of this ratio was marked downward and registered at 6.62% as minimum ratio in 1990-91. Towards the end of the study period, in 1991-92 and 1992-93 further the trend of this ratio was increased and during last year of 1993-94 the ratio was decreased slightly to 8.67%. Thus the proportion of miscellaneous current liabilities to total current assets was in particular trend (downward or upward) during some year of study.

It is observed from the above analysis that loan and advances and trade creditors are major components in financing the current assets. The total current liabilities were maximum in the year of 1982-83 due to maximum amount of loan and advances in that year and the total liabilities were minimum in the year of 1993-94 due to minimum amount of trade credit in this year. Thus
current liabilities affected by change in short term borrowed funds and trade credit.

Working capital margin was financed by long term liabilities and average 25.61% of current assets are financed by long term liabilities in pharmaceutical industry.

A comparative study of financing current assets by current liabilities in total and component wise reveals that current assets financed by current liabilities on an average of 92% and 74.39% in cement and pharmaceutical industry respectively. Therefore remaining portion financed from long term sources particularly from retained earnings because reinvestment of profits in the business is routine phenomena. The loan and advances and trade creditors are major component of current liabilities in financing the current assets.

It can be concluded that cement industry was less dependent on long term sources in financing current assets than pharmaceutical industry. Both the industries used more internal short term sources and trade creditors in financing current assets.

The analysis revealed in financing current assets, that contributions of loans and advances and sundry creditor were found decreasing in both industries during the study period. But rate of decreasing was greater in loans and advances than sundry creditors. It indicated that over the years, it may be due to recommendation of committees on credit authorisation scheme of commercial bank.

Since last some years, Government also wants to restrict the advances to industries by the bank and other financial institutes. And this policy also supported by both the industries in financing current assets.
REFERENCES


3. op. cit. p. 95.

[Note Above all References are quoted by Archna Verma, Managing Working Capital, Arihant Pub. Jaipur 1994 pp 193-196 and same are used here.]