



**ANALYSIS OF WORKING CAPITAL MANAGEMENT AT ELGI
EQUIPMENTS LIMITED, COIMBATORE.**

SUMMER PROJECT REPORT

Submitted to the

Faculty Of Management Sciences, Anna University

In partial fulfillment of the requirement

For the award of the degree of

MASTER OF BUSINESS ADMINISTRATION

BY

B.SWAMINATHAN

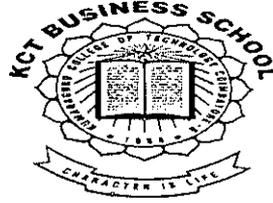
(0820400052)

September 2009

DEPARTMENT OF MANAGEMENT STUDIES

KUMARAGURU COLLEGE OF TECHNOLOGY

COIMBATORE - 641006.



**DEPARTMENT OF MANAGEMENT STUDIES
KUMARAGURU COLLEGE OF TECHNOLOGY (AUTONOMOUS)
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BONAFIDE CERTIFICATE

Certified that this project titled “ANALYSIS OF WORKING CAPITAL MANAGEMENT AT ELGI EQUIPMENTS LIMITED, COIMBATORE” is the bonafide work of MR. B.SWAMINATHAN(082040052) who carried out this project under my supervision. Certified further, that to the best of my knowledge the work reported herein does not from part of any other project report or dissertation on the basis of which a degree or award was conferred on an earlier occasion on this or any other candidate.

Ms.S.Sangeetha
Faculty Guide

Prof. Dr. S. V. Devanathan
Director

Evaluated and viva-voce conducted on11/09/2006.....

Examiner I

Examiner II

DECLARATION

I hereby declare that the dissertation entitled "A STUDY ON WORKING CAPITAL MANAGEMENT AT ELGI EQUIPMENTS LIMITED, COIMBATORE" submitted for the MASTER OF BUSINESS ADMINISTRATION degree is my original work and the dissertation has not formed the basis for the reward of any Degree, Associate ship, Fellowship or any other similar titles.

Place : Coimbatore

Date : 11/09/2009



(B.SWAMINATHAN)



CERTIFICATE
WITHOUT PREJUDICE
TO WHOMSOEVER THIS MAY CONCERN

This to certify Mr. Swaminathan . B, Roll No: 08 MBA 52 of KCT Business School, Coimbatore – 641 006 did a Summer Project on Working Capital Management in our organization during the period 15th June 2009 to 31st July 2009.

The conduct and enthusiasm of the student during the period of project was exemplary.

This certificate is issued on the request of the candidate for academic purposes and has no binding on the organization or any of its employees at present or in future.

For ELGI EQUIPMENTS LIMITED

AUTHORISED SIGNATORY



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ACKNOWLEDGEMENT

I thank the GOD, Almighty for his blessings bestowed upon me, which gave strength, confidence and health for completing this project.

I express my sincere gratitude to our beloved correspondent **Mr.M.Balasubramaniam, M.Com, MBA (U.S.A)**, the prime guiding spirit of Kumaraguru College of Technology.

I wish to express my deep sense of gratitude to our principal **Prof. Joseph V.Thanikal, M.E, Ph.D, PDF, CEPIT**, for his guidance and encouragement to complete my project work.

I wish to express my sincere thanks to Prof. **Dr.S.V.Devanathan, Ph.D**, Director, KCT Business School, for his continuous encouragement throughout my project.

I wish to express deep sense of obligation to **MS.S.Sangeetha, MBA, M.Phil**, Lecturer, KCT Business School, for her intensive guidance throughout my project.

I am greatly indebted to thank all other faculty members of KCT Business School for their kind patronage.

I thank all my friends for their help, and moral support of need.

I thank **Mr.G.Balasubramaniam** ,Company Secretary ELGI EQUIPMENTS Ltd for his valuable guidance throughout my project.

I thank **Mr. VINOD KUMAR** Head FINANCE Department ELGI EQUIPMENTS Ltd for giving permission to carry out the project.

ABSTRACT

The study entitled “ANALYSIS OF WORKING CAPITAL MANAGEMENT” of ELGI Equipments LMT, Coimbatore has been undertaken by the researcher in ELGI Equipments Ltd for a duration of 45 days.

Managing working capital is a matter of balance. A department must have sufficient Cash on hand to meet its immediate needs while ensuring that ideal cash is invested to the organisation's best possible advantage. This report provides some guidelines to good management of working capital.

Later chapters offer an overview of working capital management, explore ratio analysis, and describe recommendations for managing the various components of working capital.

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CHAPTER 1

INTRODUCTION

1. INTRODUCTION

1.1 BACKGROUND OF STUDY

Working capital constitutes part of the crown's investment in a department. Associated with this is an opportunity cost to the crown. If a department is operating with more working capital than is necessary, this over investment represents an unnecessary cost. Hence the working capital must be ideal to meet the demand.

1.2 PROBLEM OF THE STUDY

Working capital management takes place on two levels:

- Ratio analysis can be used to monitor overall trends in working capital and to identify areas requiring closer management.
- The individual components of working capital can be efficiently managed by using various techniques and strategies.

1.3 LITERATURE REVIEW

The focus of working capital management in UK small firms

Abstract

Working capital management routines of a large random sample of small companies in the UK are examined. Considerable variability in the take-up of 11 working capital management routines was detected.

Principal components analysis and cluster analysis confirm the identification of four distinct 'types' of companies with regard to patterns of working capital management. The first three 'types' of companies focused upon cash management, stock or debtors routines respectively, whilst the fourth 'type' were less likely to take-up any working capital management routines.

Influences on the amount and focus of working capital management are discussed. Multinomial logistic regression analysis suggests that the selected independent variables successfully discriminated between the four 'types' of companies.

The results suggest that small companies focus only on areas of working capital management where they expect to improve marginal returns. The difficulties of establishing causality are highlighted and implications for academics, policy-makers and practitioners are reported.

- Carole Howorth , and Paul Westhead
- Nottingham University Business School, Jubilee Campus, Wollaton Road, Nottingham NG8 1BB, UK
- Received 16 March 2001;
- Accepted 3 March 2003. ;
- Available online 8 April 2003.

Article Information:

Liquidity - profitability tradeoff:

An empirical investigation in an emerging market

Abstract:

This study empirically examines the relation between profitability and liquidity, as measured by current ratio and cash gap (cash conversion cycle) on a sample of joint stock companies in Saudi Arabia. Using correlation and regression analysis the study found significant negative relation between the firm's profitability and its liquidity level, as measured by current ratio.

This relationship is more evident in firms with high current ratios and longer cash conversion cycles. At the industry level, however, the study found that the cash conversion cycle or the cash gap is of more importance as a measure of liquidity than current ratio that affects profitability. The size variable is also found to have significant effect on profitability at the industry level. Finally, the results are stable over the period under study.

Author(s) : Abuzar M.A. Eljelly
Journal : International Journal of Commerce and Management
Year : 2004
Volume : 14
Issue : 2
Page : 48 - 61
ISSN : 1056-9219
Publisher : Emerald Group Publishing Limited

1.4 OBJECTIVES OF THE STUDY

The primary objective of working capital management is to maintain the optimum balance of each of the working capital components. This includes making sure that funds are held as cash in bank deposits for as long as and in the largest amounts possible, thereby maximizing the interest earned.

The secondary objectives of the study are:

- 1) To study the causes and consequences of the various components of the various components of the financial statement in relation to the productivity and profitability of the company.
- 2) To analyze the financial stability and overall performance of ELGI EQUIPMENTS LIMITED in general.
- 3) To analyze and interpret the trends as revealed by various ratios of the company in particular.

1.5 SCOPE OF THE STUDY

The scope of the study is to determine the working capital management of ELGI. The study will be useful for improvement of performance of the firm. The study covers a period of 5 years from 2004-05 to 2008-09.

1.6 RESEARCH METHODOLOGY ADOPTED

Primary data and secondary data are used for the study. Primary data was collected by direct contact with officers and managers. Sources of secondary data were annual report of ELGI EQUIPMENTS LIMITED.

1.7 LIMITATIONS OF THE STUDY

The present study is subject to the following limitations

- The study is based only on the secondary data contained in the published annual reports of ELGI EQUIPMENTS for the study period.
- Current ratio considers only the quantity of current assets and ignored the quality of current assets. The current asset may consist of obsolete stock or defaulting debtors.
- The period of study is limited to 5 years from 2004-05 to 2008-09.
- Project duration was also a constraint.

CHAPTER 2

COMPANY PROFILE

2. COMPANY PROFILE

ELGI was established in 1960 as a service station equipment and reciprocating compressor manufacturing company. Over the years ELGI has become a multi-product, multi-market company manufacturing technically superior products.

The ELGI product lines today, broadly comprise, Rotary Compressors, Reciprocating Compressors Centrifugal Compressors, Automotive Equipment, Diesel Engines and Manufacturing and engineering services.

ELGI has two manufacturing locations in Coimbatore, India, with 22 acres of land and 352,000 sq ft of built up factory area.

With a vast network of sales & service outlets manned by well-trained, highly qualified and motivated engineers and marketers, ELGI aims to conquer the domestic market and be a meaningful global player in its core products.

ELGI endeavors to continuously improve processes, products and technology, with the objective of serving people better.

This in turn has made ELGI the undisputed leader in the products it manufactures with a strong reputation for quality and service.

ELGI's core competencies are serviced by five major Divisions:

- Rotary Compressor Division
- Reciprocating, Railways and Original Equipment Division
- Automotive Equipment Division
- Engines Division
- Manufacturing and Engineering Services

Compressor Technology at ELGI is classified into reciprocating compressors, screw compressors, centrifugal compressors and oil-free compressors. ELGI manufactures all these types of compressors covering a range from 0.75HP to 1500HP for volumes from 1.8 cfm (cubic feet per minute) to 80000 cfm. While selling individual products can meet the objectives of a customer's requirement, ELGI's marketing strategy has always been to partner with a customer and provide total air solutions to industries that require compressed air for their operations.

The Automotive Service Equipment Division manufactures lubrication equipment, two-wheeler and four-wheeler hoists, paint booths, AC recovery units, crash repair systems, wheel balancers and various other diagnostic equipments. Most of the modern garages are fitted with ELGI's garage equipment. As a result, today our customers have increased their speed of analyzing faults, reducing wastage of resources.

CHAPTER 3

DATA ANALYSIS AND INTERPRETATION

3. DATA ANALYSIS AND INTERPRETATION

3.1 STUDY ON WORKING CAPITAL EFFICIENCY

ELGI Equipments Limited under takes several measures to maintain adequate working capital for the effective operation of its day-to-day business. In order to maintain the required working capital ELGI Equipments co- ordinates the goal and functioning of various departments and brings it in line with the vision of ELGI.

At the end of every fiscal year a target is set by the Managing Director. This target will in-turn be the goal to be achieved for all the departments. Mutual understanding and teamwork play a vital role in achieving the set target.

To obtain an effective working capital the right suppliers have to be selected in order to procure the required materials at the right place, price and time, the inventory level should be apt so that excess cash is not blocked in the form of stock, the production of goods should be in line with the demand and availability of Raw- Materials to avoid excess quantity of finished goods and finally the right Dealers and Customers have to be picked to receive payments on time.

Functioning of the Various Departments

The various departments of ELGI namely Finance, Marketing, Production, Purchase, Bill Discounting Department, Vendor Development Department, Internal audit Department and the Commercial department are the major contributors for the effective management of working capital at ELGI.

The responsibilities and functions of the various departments that play a part in the management of working capital are given below.

Marketing Department

ELGI markets its products through five verticals, they are:

1. Channels
2. Direct Sales
3. DPSAC C and N (Diesel Power Screw Air Compressor C and N)
4. Railways
5. Spares

Channels- Dealers

ELGI has about hundred dealers across India. The products of ELGI can be classified into Standard Products and Customized Products. The Standard Products are sold only through the Dealers and the Customized Products are directly sold by ELGI.

The Dealers are selected based on their

- Capacity
- Knowledge based on products
- Financial Statement
- Ability to increase man power and capital in order to ELGI products
- Territory that the dealer can handle
- Payment track records
- Reference from bank
- Turn over of the dealer
- Personal assets of the dealer
- Efficiency etc

Direct Sales

Direct sales are done only for customized products, which are worth above 30-40 lakhs. ELGI pursues a particular method for evaluating its customers before accepting the order. The branch office first evaluates the customer's and their views and judgment's will be put forth to the Head Office. The Head Office will then verify the credit rating, check the customer's bank for reference, analyze the customer's Financial position and then conclude based on the results, if the order has to be accepted or not.

Once the order is accepted the Head of Direct Sales prompts the Head of production on the Tuesday meeting to initialize the production of the product based on the date of delivery to the customer. Only when the customer pays the advance the order will be processed.

DPSAC and Railways

They function similar to channels and the direct sales. DPSAC and Railways have their own team lead by a Head of DPSAC and a Head of Railways. The demand is estimated through the Branch Office and during the Tuesday meet the Production Department will be informed regarding the number and type of products required.

After Sales and Spares

The performance of after sales services is very essential for retaining the customers. ELGI promises to attend to the after sale request of the customers within 48 hours. The customer's contact the toll free number of ELGI incase there is any problem caused by ELGI products that is to be rectified. The call centre immediately roots the information to the dealer located near the customer's premises. The dealer will visit the site and analyze the problem. The dealer can rectify only a few types of errors but if the problem is beyond his scope the service engineers will be prompted to take over the

matter. If the problem is not solved even at this stage the information will be passed on the Managing Director.

The materials required by the after sales Department will be brought to the notice of the purchase department. The purchase department procures the required material at the right time and price and hands it over to the After Sales Department. The after sales service of the products is a key area that a customer looks forward to while purchasing a product. The efficient after sales service facilitates ELGI to generate higher demand, which in turn enables a higher cash flow and an efficient working capital.

Sales Meetings

ELGI holds a sales meeting at the end of every year. The members of the meeting will include the managing director, representatives from every Department and few prominent dealers. During this meeting a sales target will be set for the fourth coming year. With the target in mind an anticipated amount of sales can be calculated region wise and then dealer wise. Therefore every dealer will be aware of the target that he has to meet during that year. This provides the dealers adequate time to put together a sales plan for the fourth coming year.

The MIS system at ELGI updates and analyzes the performance of the company and generates reports every month. The department heads and the Managing Director scrutinize these reports. This allows timely correction of errors and improves the efficiency of the company.

At every vertical of marketing department the purchase of raw material is done only when the purchase order is received. The product is produced according to the date of delivery. Therefore excess inventory is not held at ELGI. This procedure followed by the marketing team to reduce Over- Heads and cost of inventory. This allows ELGI to maintain an efficient Working capital since funds are not blocked in the form of stock.

Finance Department

The Finance Department has two Sub- Departments. The contribution of these two sub departments for the management of working capital is as follows.

Commercial and Excise Duty Department

The Selection of Apt Dealers and monitoring the agreement of dealers play a crucial role in increasing sales which will in-turn boost up the turn over of ELGI. ELGI also monitors the payments from the dealers, which aids them in having an effective working capital. With this aim in mind, the following procedure is adopted to regulate the functioning of the dealers and improve the working capital.

Credit Limit

For every dealer a credit limit will be set according to the turnover of the dealer's organization. ELGI has a very effective ERP system that keeps track of three important criteria. They are:

- Credit Limit - the maximum amount of credit that ELGI will extend to its dealer.
- Invoice Amount - it is the outstanding amount of the dealer
- Order Balance - it is the requested purchase order by the dealer.

Dealers Discount given to Customers

The dealers offer discount to their customers based on the quantum of sale and the product type.

Turn- Over Discount (TOD)

The dealers are entitled for TOD. The discount varies from 1%-6% based on the turn over of the dealer. TOD is given on every invoice of the dealer. This is mainly done to avoid paying excess excise duty.

This method avoids increase in working capital for the customer as he receives a discount on every invoice and it also reduces expenditure for ELGI, as they do not have to reimburse a high amount as excise duty.

Bill Discounting Department

Bill discounting is very essential for working capital management. There are two categories of bill discounting they are:

- ***Dealer Discounting***
- **Supplier Discounting**

Vendor Development Department

The Vendor Development Department was formed as an extension of Purchases Department. The compressor industry is highly volatile. For manufacturing a compressor there are about 800 components required as raw materials.

Sourcing these raw materials is a tedious task, as various suppliers are required to source all the components. ELGI has about 277 suppliers.

For manufacturing a compressor every component is required in very small quantities. Due to these reasons most of the suppliers are hesitant to supply the required materials on a regular basis.

Therefore, this department was developed to maintain a good relationship with all the vendors and to procure the materials required by the production department on time.

The main objective of this department was to ensure capacity management.

Capacity Management

Capacity Management is the function of establishing, measuring, monitoring and adjusting limits or levels of capacity in order to execute all manufacturing schedules, that is, the production plan, master production plan and material requirement plan.

Production department and Inventory Management at ELGI

Production Department

The objective of the production department is PQCDMS that is Production, quality, cost, delivery, morale and safety. In order to achieve this objective control points are set for every individual. The control points are targets that every individual has to achieve.

Weekly meetings are held to analyze the weekly progress in the production department. For example: if an analysis proves that due to lack of inventory the orders from the customers were canceled. The situation is analyzed and fine-tuned.

Inventory Management

ELGI has 277 suppliers supplying about 800 components. Just in time methodology is one of the most proven efficient systems of managing inventory. Implementation of just in time is extremely difficult to be implemented at ELGI due to high volatility of the market.

Therefore ELGI tries to minimize the lead- time of suppliers. Lead Time is the amount of time between the placing of an order and the receipt of the goods ordered. Lead Time is very essential for maintaining adequate working capital. For example- if a supplier is given an advance but the lead- time for that supplier is high then the cash gets locked up which in turn effects the working capital.

Purchase Department

The purchase department receives a demand budget from the marketing department in the "1+ 2" format, that is, a one month firm schedule and two month tentative schedule.

This schedule is forwarded to the suppliers via emails. The schedules are not to be considered as purchase orders. An advance notice is sent to the suppliers so that they can make the necessary production plans for the components.

The material requirement planning department (MRP) creates a monthly plan, with the aid of which the production department provides a daily plan to the purchase department.

Once this plan is received the purchase is done accordingly. As the components are purchased based on the requirement of the production department it reduces inventory and thereby increasing the inventory turnover ratio.

3.2 Operating Cycle

Operating Cycle, also known as cash cycle or cash conversion cycle or asset conversion cycle, is the cycle of business activity in which cash is used to buy resources, which are converted into products or services and then sold for cash. Operating Cycle has three components of payable turnover days, inventory turnover days and accounts receivable turnover days.

The time lag between the purchase of raw materials and the collection of cash for sales is referred to as the Operating Cycle for the company. The time lag between the payment for raw materials purchases and the collection of cash from sales is referred to as the cash cycle.

Operating Cycle of the company

The entire sequence of operations of the company can be summarized as follows:

- The Operating Cycle primarily begins with the purchase of raw materials, which are paid for after a delay representing the creditor's payable period.
- These purchased raw materials are then converted by the production unit into finished goods and then sold. The time lag between the purchase of raw materials and the sale of finished goods is known as the inventory period.
- Upon sale of finished goods on credit terms, there exists a time lag between the sale of finished goods and the collection of cash on sale. This period is known as the accounts receivables period

Applications

Operating Cycle indicates a company's true liquidity. By tracking the historical record of a company's Operating Cycle and comparing it to its peer groups in the same industry, it gives investors investment quality of a company. A short Operating Cycle is preferable since a company realizes its profits quickly and allows a company to quickly acquire cash that can be used for reinvestment. A long Operating Cycle means it takes longer time for a company to turn purchases into cash through sales. In general, the shorter the cycle, the better a company is since less time capital is tied up in the business process.

Operating Cycle Calculation

Particulars	Formula
Raw Material Turn Over Period	$\frac{\text{Raw Material Inventory}}{\text{Raw Material Consumption}} * 365$
Work in Progress Turn Over Period (WIP)	$\frac{\text{WIP Inventory}}{\text{Cost of Production}} * 365$
Finished Goods Turn Over Period	$\frac{\text{Finished Goods Inventory}}{\text{Cost of Goods Sold}} * 365$
Debtors Turn Over Period	$\frac{\text{Debtors}}{\text{Credit Sales}} * 365$
Creditors Turn Over Period	$\frac{\text{Creditors}}{\text{Credit Purchases}} * 365$
Operating Cycle	Raw Material Turn Over Period + Work in Progress Turn Over Period + Finished Goods Turn Over Period + Debtors Turn Over Period - Creditors Turn Over Period

Diagrammatic Representation of Operating Cycle

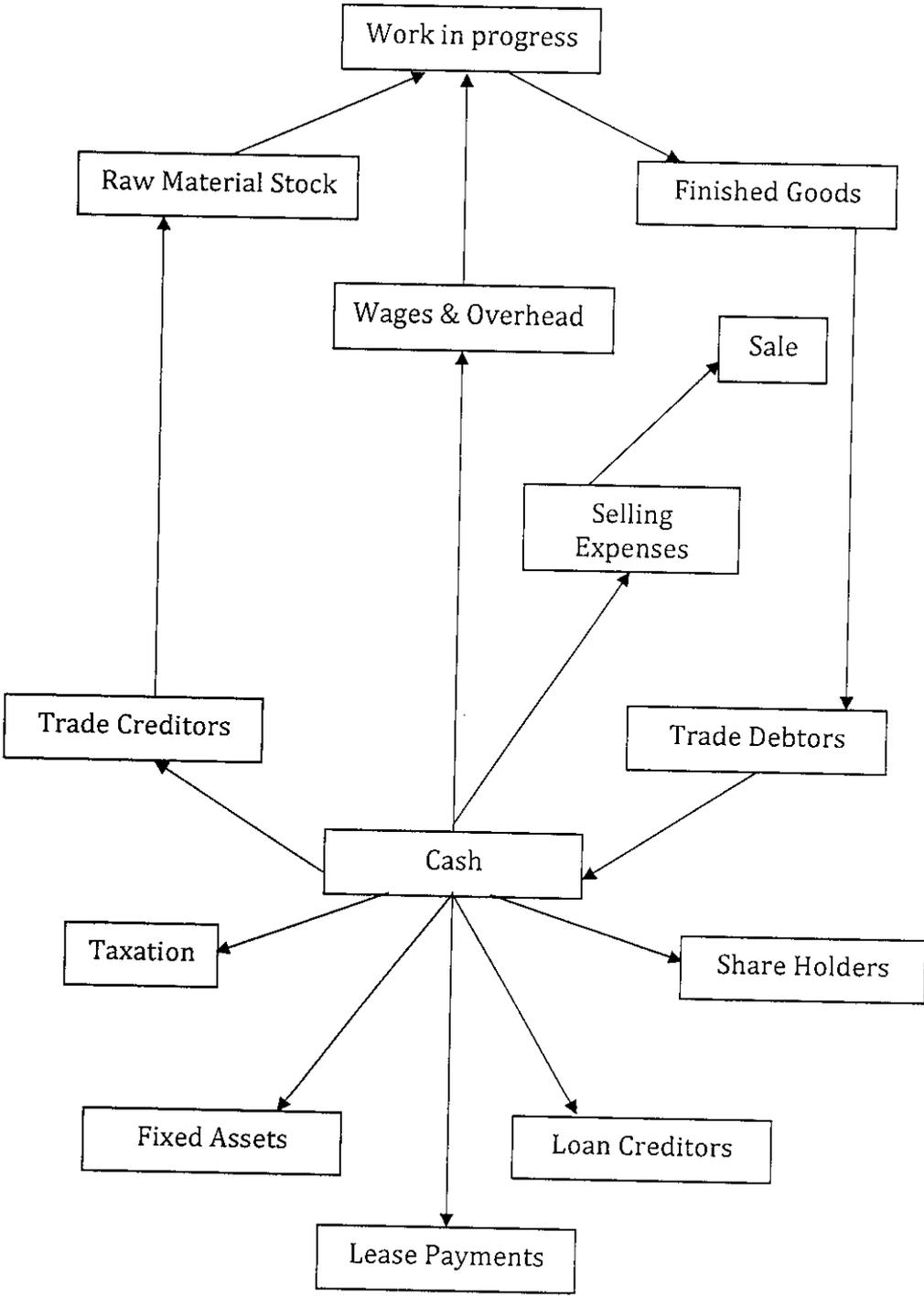
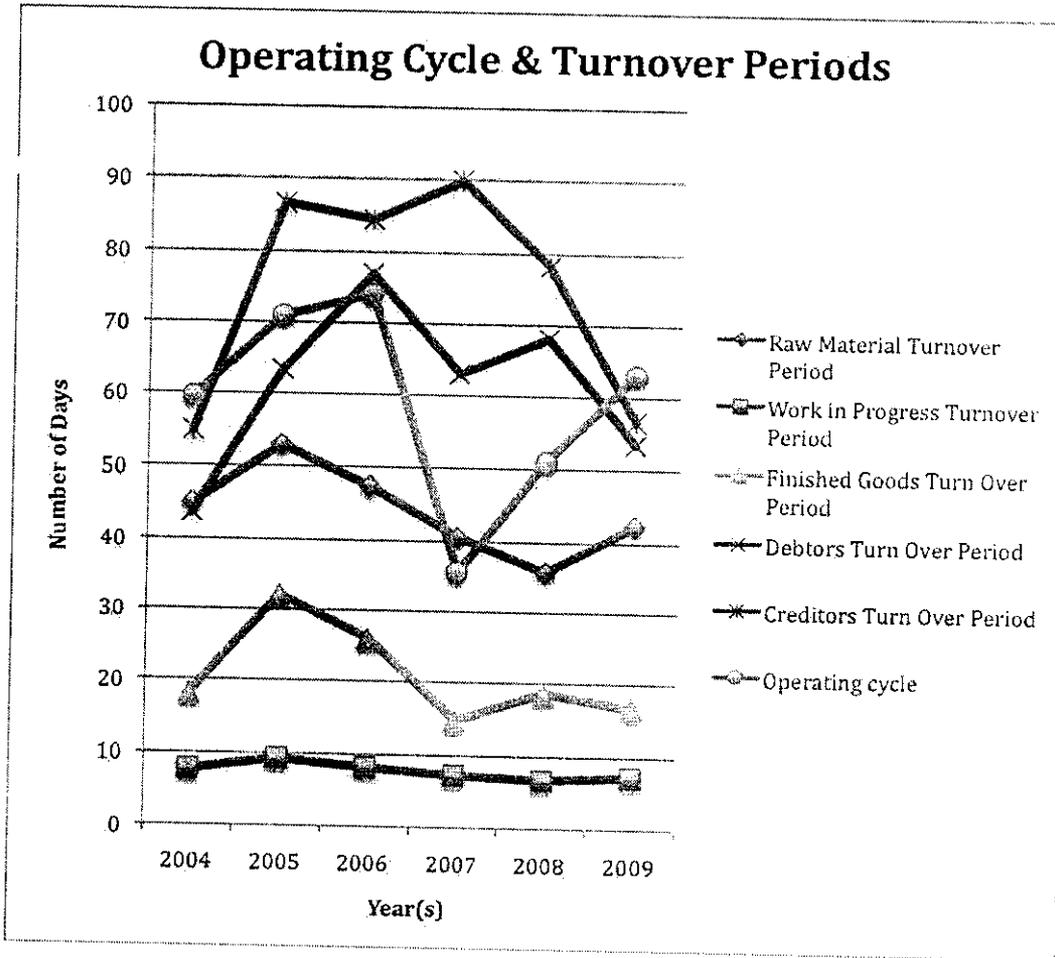


TABLE NO : 3.1.OPERATING CYCLE CALCULATION

Particulars	2004	2005	2006	2007	2008	2009(Upto April)
Opening Stock of Raw Materials	192.090	247.650	258.440	241.800	305.390	345.670
Closing Stock of Materials	247.650	258.440	241.800	305.390	345.670	429.240
Average Raw Materials	219.870	253.045	250.120	273.595	325.530	387.455
Purchases	1842.210	1755.830	1909.350	2528.290	3365.720	3429.020
Raw Materials Consumed	1786.650	1745.040	1925.990	2464.700	3325.440	3345.450
Raw Material Turnover Period	44.918	52.928	47.401	40.517	35.730	42.273
Opening Stock of Work in Progress	42.830	62.700	61.360	60.630	73.010	87.800
Closing Stock of Work in Progress	62.700	61.360	60.630	73.010	85.990	93.660
Average Work in Progress	52.765	62.030	60.995	66.820	79.500	90.730
Salary and Wages	185.050	183.970	227.290	238.120	283.400	357.870
Manufacturing Expenses	539.080	506.420	553.830	657.040	705.910	868.810
Total Cost of Production	2490.910	2436.770	2707.840	3347.480	4301.770	4566.270
Work in Progress Turnover Period	7.732	9.291	8.222	7.286	6.745	7.252
Opening Stock of Finished Goods	90.010	150.610	126.690	100.010	164.990	259.740
Closing Stock of Finished Goods	150.610	258.440	241.800	164.990	261.540	164.240
Average Finished Goods	120.310	204.525	184.245	132.500	213.265	211.990
Cost of Goods Sold	2430.310	2328.940	2592.730	3282.500	4205.220	4661.770
Finished Goods Turn Over Period	18.069	32.054	25.938	14.733	18.511	16.598
Sales	2905.070	2852.600	3120.700	3785.800	5040.300	5509.560
Debtors	347.120	495.080	658.080	653.090	941.200	806.340
Debtors Turn Over Period	43.613	63.347	76.970	62.966	68.158	53.419
Creditors	276.650	416.630	441.570	622.770	721.210	531.130
Creditors Turn Over Period	54.813	86.609	84.413	89.907	78.213	56.536
Operating cycle	59.519	71.012	74.118	35.596	50.932	63.006

CHART NO : 3.1

OPERATING CYCLE AND TURNOVER PERIODS OF ELGI EQUIPMENTS



Interpretation of Table

The above table contains the Operating Cycle for the years 2004-2009. The Operating Cycle is observed to have very high fluctuation during this period. The above table indicates that

- The Raw Materials Turnover Period has been the least during the year 2008 and the highest during the year 2005.
- There has been a very slight fluctuation in the Raw Material Turnover Period.
- Even though the Raw Materials purchased in the year 2005 is lesser than the quantum purchased in the year 2004 the Raw Material Turn Over Period has increased considerably in the year 2005 due to high average stock of raw materials.
- The purchase of Raw Material has increased again in the year 2006, but the Raw Material Turn Over Period has decreased due to increase in consumption of raw materials.
- The Work In Progress has been more or less stable during this period.
- The Finished Good Turn Over Period has increased considerably during the year 2005 and 2006 due to fluctuation in Average Finished Goods and Cost of Goods Sold.
- The Debtors Turnover Period was the least during the year 2004 and the highest during the year 2006.
- A high fluctuation in the Debtors Turnover Period is observed.
- Debtor's payment has not been made within the credit period allowed by ELGI during the period 2005-2009.
- The Creditors Turnover Period has been the least during the year 2004. It is observed to have had high fluctuations from the year 2005-2009.
- The Creditors Turnover Period has always been higher than the Debtors Turnover Period, indicating that the payment to creditors has been made only when the debtors make their payment.

- The difference between the Creditors Turnover Period and the Debtors Turnover Period is an average of 10 to 27 days.
- This means the payment received from debtors is held in reserve by ELGI for an average of 10 to 27 days before payment is made to creditors. This helps in enhancing the cash flows of the company.
- The Operating Cycle has been the least in the year 2004 due to quick Work in Progress Turn Over Period, Finished Goods Turn Over Period and Debtors Turn Over Period.
- From the year 2004 there has been a steady increase in the Operating Cycle during the years 2005 and 2006 due to rapid escalation in the Raw Material Turn Over Period, Work in Progress Turnover Period, Finished Goods Turn Over Period and Debtors Turn Over Period and Creditors Turnover Period.
- The Operating Cycle is observed to have dipped down during the year 2007 due to decrease in the Raw Material Turn Over Period, Work in Progress Turn Over Period, the Finished Goods Turn Over Period and Debtors Turnover Period.
- The Operating Cycle increased again during the years 2008 and 2009 due to fluctuation in Raw Material Turn Over Period, Work in Progress Turn Over Period, the Finished Goods Turn Over Period and Debtors Turnover Period and Creditors Turnover Period.
- Compared to the period 2004-2006 the Operating Cycle has declined in the years 2008 and 2009. This was achievable due to decrease in Raw Material Turnover Period, increase in Average Work in Progress, average finished goods and Cost of Goods Sold.
- During the year 2009 the Operating Cycle has increased. The payment to creditors has been the least among all years and there has been a slight increase in the Raw Material Turn Over Period and the Work in Progress Turn Over Period.
- Any difference in the closing balance of one year and the opening balance of the next year in Raw Materials, Work in Progress and Finished Goods is due to the movement of materials to ELGI' s subsidiary units.

Interpretation of Chart

From the above chart we can observe that

- The Raw Material Turn Over Period was the highest during the year 2005 and it has been decreasing constantly and reached its lowest during the year 2008.
- There is no high fluctuation in the Work in Progress Turn Over Period during this period.
- The Finished Goods Turn Over Period has increased during the year 2005 and has stabilized over the years.
- It is observed that there is a high fluctuation in the Debtors Turnover Period during the years 2004-2009.
- There is a constant fluctuation in the Creditors Turn Over Period during this period. The Creditors Turn Over Period has been the highest during the year 2007 and the least during the year 2009.
- It is observed that the Creditors Turn Over Period has always been above the Debtors Turn Over Period.
- The Operating Cycle increased during the years 2005 and 2007 followed by a considerably decrease during the year 2007. The Operating Cycle increased again during the year 2007 and 2009.
- It is observed to have a very high fluctuation especially during the years 2005 and 2006 due to the increase in Raw Material Turn Over Period, Finished Goods Turn Over Period and Debtors Turn Over Period.
- The Operating Cycle decreased considerably during the year 2007 due to decrease in Raw Material Turnover Period, Finished Goods Turnover Period and Debtors Turnover Period.

3.3 Ratio Analysis and interpretation

Ratio Analysis

A ratio is a simple arithmetical expression of one number to another. Ratio analysis is the process of determining and presenting the relationship of items and group of items in the statements.

According to Batty J. Management Accounting “Ratio can assist management in its basic functions of forecasting, planning coordination, control and communication”. It is helpful to know about the liquidity, solvency, capital structure and profitability of an organization. It is helpful tool to aid in applying judgment, otherwise complex situations.

Ratio may be expressed in the following three ways:

1. **Pure Ratio or Simple Ratio:-** It is expressed by the simple division of one number by another. For example, if the current assets of a business are Rs.200000 and its current liabilities are Rs.100000, the ratio of ‘Current assets to current liabilities’ will be 2:1.

2. **‘Rate’ or ‘So Many Times:-** In this type , it is calculated how many times a figure is, in comparison to another figure. For example, if a firm’s credit sales during the year are Rs.200000 and its debtors at the end of the year are Rs.40000, its Debtors Turnover Ratio is $200000/40000 = 5$ times. It shows that the credit sales are 5 times in comparison to debtors.

3. **Percentage:-** In this type, the relation between two figures is expressed in hundredth. For example, if a firm’s capital is Rs.1000000 and its profit is Rs.200000 the ratio of profit capital, in term of percentage, is $200000/1000000*100 = 20\%$.

Advantage of Ratio Analysis

1. Helpful in analysis of Financial Statements.
2. Helpful in comparative Study.
3. Helpful in locating the weak spots of the business.
4. Helpful in Forecasting.
5. Estimate about the trend of the business.
6. Fixation of ideal Standards.
7. Effective Control.
8. Study of Financial Soundness.

Limitations of Ratio Analysis

1. Comparison not possible if different firms adopt different accounting policies.
2. Ratio analysis becomes less effective due to price level changes.
3. Ratio may be misleading in the absence of absolute data.
4. Limited use of a single data.
5. Lack of proper standards.
6. False accounting data gives false ratio.
7. Ratios alone are not adequate for proper conclusions.
8. Effect of personal ability and bias of the analyst.

The technique of ratio analysis can be employed for measuring short-term liquidity or working capital position of a firm. The following ratios can be calculated for these purposes:

A. Liquidity Ratio

- Current Ratio
- Quick Ratio or Acid Test Ratio

B. Activity Ratio or Turnover Ratio

- Inventory turnover Ratio
- Inventory Conversion Period
- Creditors Turnover Ratio
- Payable turnover ratio
- Working capital turnover ratio
- Net Working Capital Ratio
- Debtors Turn Over Ratio
- Average Collection Period

LIQUIDITY RATIO

It refers to the ability of the firm to meet its current liabilities. The liquidity ratio, therefore, are also called 'Short-term Solvency Ratio'. These ratios are used to assess the short-term financial position of the concern. They indicate the firm's ability to meet its current obligation out of current resources.

In the words of Saloman J. Flink, "Liquidity is the ability of the firms to meet its current obligations as they fall due".

Liquidity ratio include two ratios:-

- Current Ratio
- Quick Ratio or Acid Test Ratio

Current Ratio

This ratio explains the relationship between current assets and current liabilities of a business.

Formula:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Current Assets- 'Current assets' includes those assets, which can be converted into cash within a year's time.

Current Assets = Cash in Hand + Cash at Bank + B/R + Short Term Investment + Debtors (Debtors – Provision) + Stock (Stock of Finished Goods + Stock of Raw Material + Work in Progress) + Prepaid Expenses.

Current Liabilities - 'Current liabilities' include those liabilities, which are repayable within a year's time.

Current Liabilities = Bank Overdraft + B/P + Creditors + Provision for Taxation + Proposed Dividend + Unclaimed Dividends + Outstanding Expenses + Loans Payable within a Year.

Significance:- According to accounting principles, a current ratio of 2:1 is supposed to be an ideal ratio.

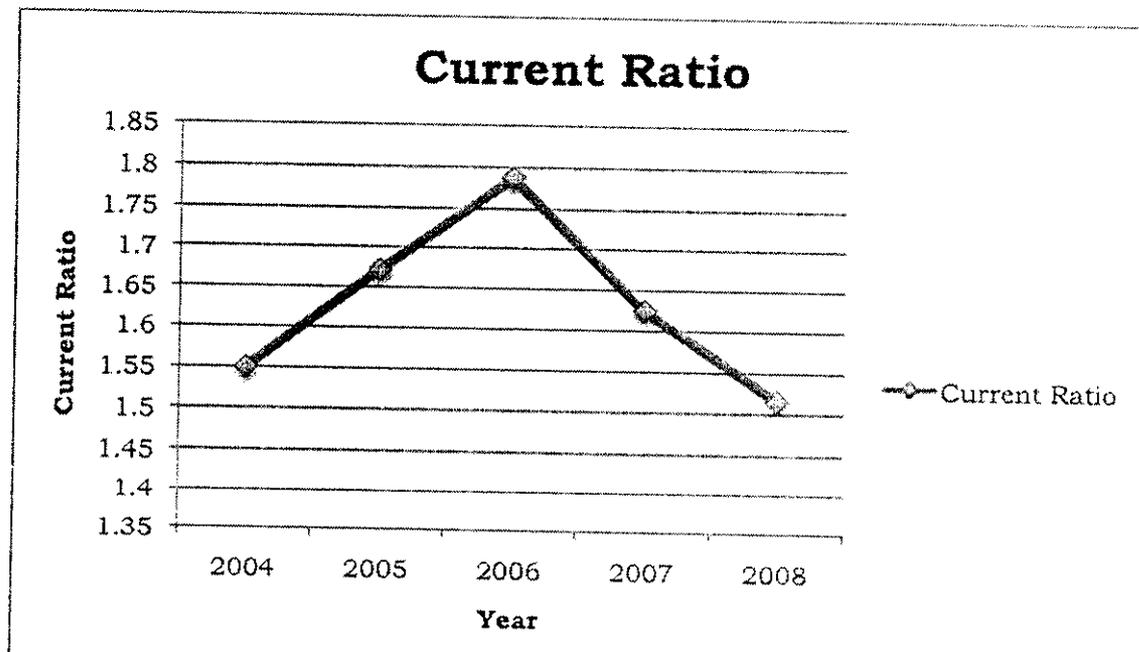
It means that current assets of a business should, at least, be twice of its current liabilities. The higher ratio indicates the better liquidity position; the firm will be able to pay its current liabilities more easily. If the ratio is less than 2:1, it indicates lack of liquidity and shortage of working capital.

The biggest drawback of the current ratio is that it is susceptible to “window dressing”. This ratio can be improved by an equal decrease in both current assets and current liabilities.

Table No: 3.2 Current Ratio of ELGI Equipments

Current Ratio					
Particulars	2004 - 2005	2005 - 2006	2006 - 2007	2007 - 2008	2008 -2009
Current Assets	121.780	142.130	166.470	207.570	242.170
Current Liabilities	78.640	85.040	93.150	127.820	159.890
Current Ratio	1.549	1.671	1.787	1.624	1.515

Chart No: 3.2. Current Ratio of ELGI Equipments



Interpretation of Table and Chart

- The Current Ratio for the period 2004-2008 is evaluated on the Table No: 3.2 and the diagrammatic representation of the Current Ratio is on Chart No: 3.2 .
- The ideal ratio for Current Ratio is 2:1.
- During the period 2004-2008 there has been a sudden increase followed by a decrease in the Current Ratio.
- In the year 2004 the ratio was 1:1.5, the apt ratio is not achieved.
- The ratio increased during the years 2005 and 2006 making the ratio almost ideal.
- The ratio dipped again during the years 2007 and 2008.
- The ratio during the year 2008 was 1:1.5, which makes this ratio the least among all years.
- Even though there is excess of current assets when compared to current liabilities, the ratio has to be improved.

Quick Ratio

Quick ratio indicates whether the firm is in a position to pay its current liabilities with in a month or immediately.

Formula:

$$\text{Quick Ratio} = \frac{\text{Quick assets}}{\text{Quick Liabilities}}$$

‘Quick Assets’ means those assets, which will yield cash very shortly.

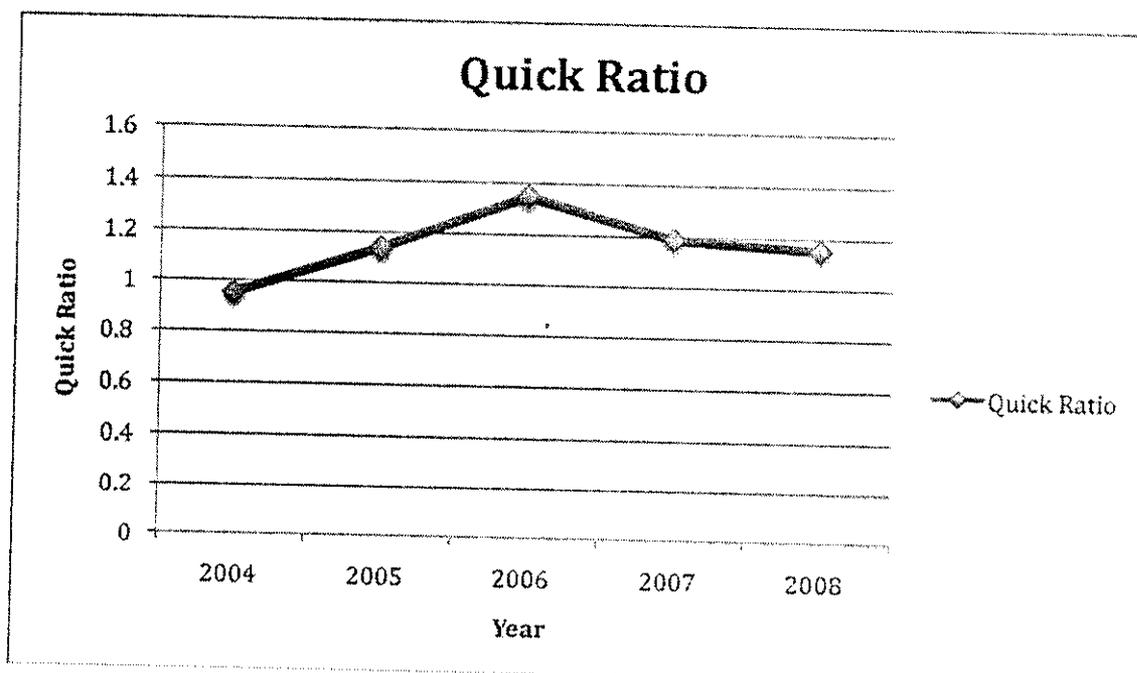
$$\text{Quick Assets} = \text{Current Assets} - \text{Stock} - \text{Prepaid Expenses}$$

Significance:- An ideal quick ratio is said to be 1:1. If it is more, it is considered to be better. This ratio is a better test of short-term financial position of the company.

Table No: 3.3. Quick Ratio of ELGI Equipments

Quick Ratio					
Particulars	2004 - 2005	2005 - 2006	2006 - 2007	2007 - 2008	2008 - 2009
Total Current Assets	121.780	142.130	166.470	207.570	242.170
Inventory	47.120	45.510	41.040	55.680	58.020
Quick Assets	74.660	96.620	125.430	151.890	184.150
Quick Liabilities	78.640	85.040	93.150	127.820	159.890
Quick Ratio	0.949	1.136	1.347	1.188	1.152

Chart No: 3.3. Quick Ratio of ELGI Equipments



Interpretation of Table and Chart

- The Quick Ratio for the period 2004-2008 is evaluated on the Table No: 3.3 and the diagrammatic representation of the Quick Ratio is on Chart No: 3.3.
- The ideal ratio for Quick Ratio is 1:1
- During the period 2004- 2008 the ratios have had very mild fluctuations.
- The ratio was the highest during the year 2006.
- In the year 2004 the Quick Assets was lower than the Quick Liabilities, which makes the Quick Assets insufficient to cover the Quick Liabilities.
- Quick Ratio for the period 2005- 2008 has been ideal.
- During the year 2004-2007 it is observed that a major constituent of the Quick Assets is Sundry Debtors. During this period the Sundry Debtors form almost half of the Quick Assets, which has boosted up the Quick Ratio.
- In the year 2008 the proportion of Sundry Debtors in the Quick Assets has reduced considerably.
- The company can effortlessly pay and cover the current liabilities.

B. ACTIVITY RATIO OR TURNOVER RATIO

These ratios are calculated on the bases of 'cost of sales' or sales, therefore, these ratios are also called as 'Turnover Ratio'. Turnover indicates the speed or number of times the capital employed has been rotated in the process of doing business. A higher turnover ratio indicates the better use of capital or resources and in turn leads to higher profitability. It includes the following:

Inventory Turn Over Ratio

This ratio indicates the relationship between the cost of goods during the year and average stock kept during that year.

Formula:

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

Here, Cost of goods sold = Net Sales – Gross Profit

Average Stock = Opening Stock + Closing Stock/2

Significance:- This ratio indicates whether stock has been used or not. It shows the speed with which the stock is rotated into sales or the number of times the stock is turned into sales during the year. The higher the ratio, the better it is, since it indicates that stock is selling quickly. In a business where stock turnover ratio is high, goods can be sold at a low margin of profit and even than the profitability may be quit high.

Inventory Conversion Period

The Inventory Turnover often is reported as the inventory Conversion Period, which is the number of days worth of inventory in hand.

Formula:

$$\text{Inventory Conversion Period} = \frac{365}{\text{Inventory Turnover Period}}$$

Table No: 3.4 Inventory Turnover Ratio and Inventory Conversion Period of ELGI Equipments

Inventory Turnover Ratio and Inventory Conversion Period					
Particulars	2004 - 2005	2005 - 2006	2006 - 2007	2007 - 2008	2008 - 2009
Cost of Goods Sold	291.940	286.510	313.090	379.490	452.420
Average Inventory	47.120	45.510	41.040	55.680	58.020
Inventory Turnover Ratio	6.196	6.296	7.629	6.816	7.798
Inventory Conversion Period	58.912	57.978	47.844	53.554	46.809

Chart No: 3.4. Inventory Turnover Ratio of ELGI Equipments

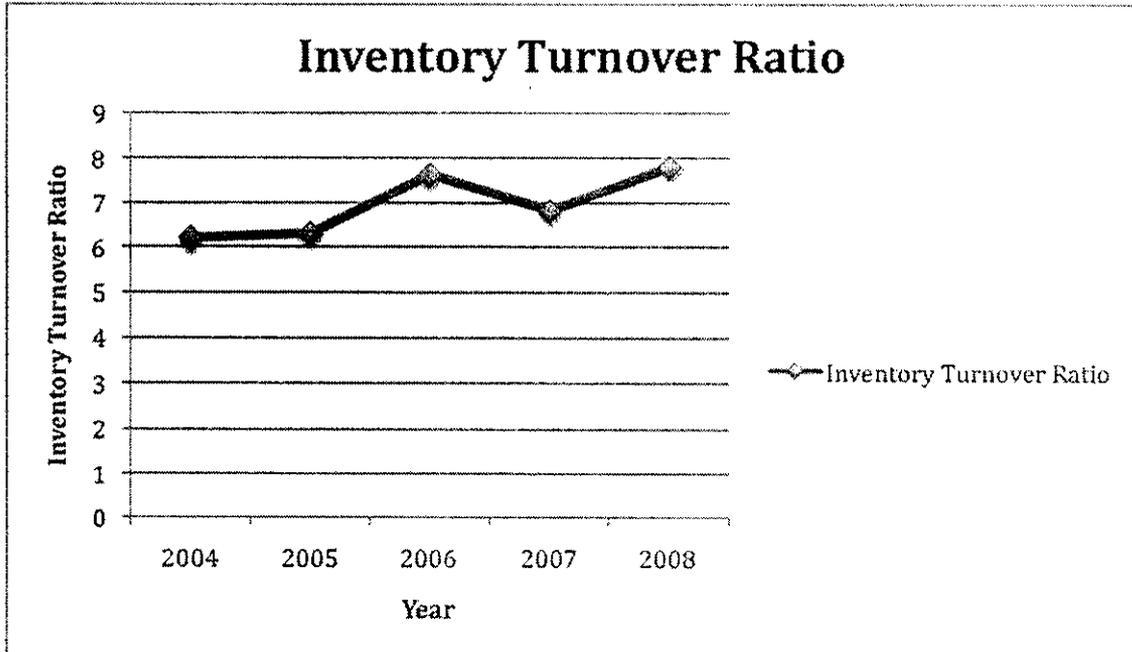
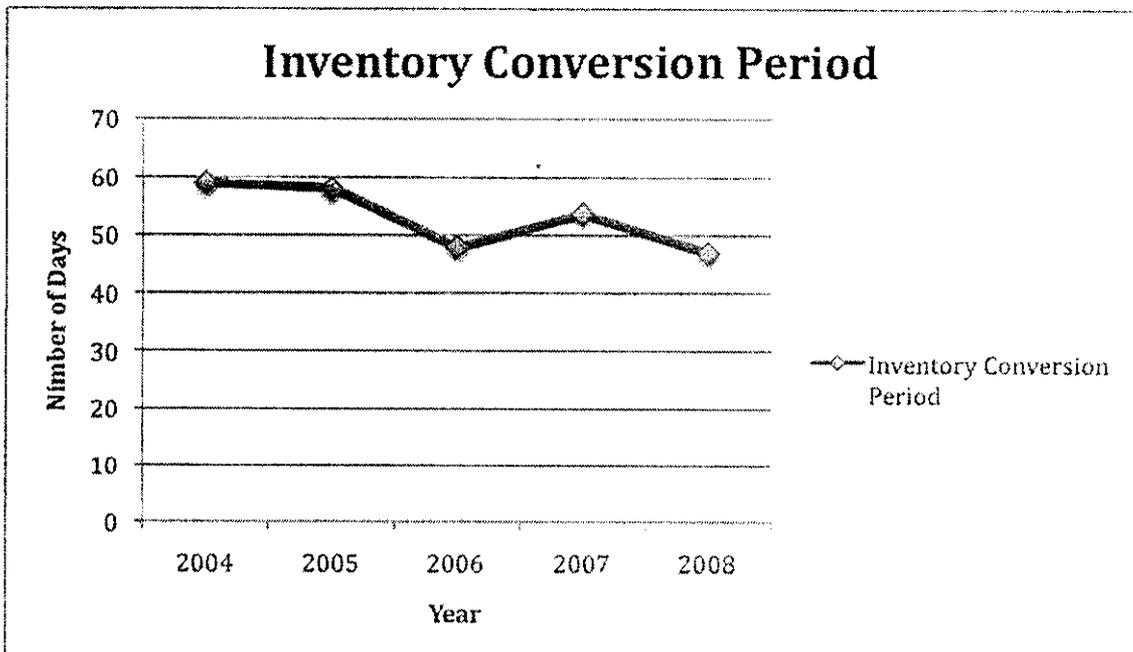


Chart No: 3.5. Inventory Conversion Period of ELGI Equipments



Interpretation of Table and Charts

- The Inventory Turnover Ratio and Inventory Turnover Period for the period 2004-2008 are given in Table No: 3.4 and the diagrammatic representation of the Inventory Turnover Ratio and Inventory Turnover Period is on Chart No: 3.4 and 3.5 respectively.
- The Inventory Turnover Ratio was the least during the year 2004 and the highest during the year 2008.
- The Inventory Turnover Ratio is satisfactory.
- The Inventory is observed to have turned six to eight times during this period.
- This means that an average of one Rupee invested in stock will turn into six or eight times in sales.
- In the Chart No: 3.4 it is observed that there is a very mild fluctuation in the Inventory turnover Ratio.
- The Inventory Turnover Period for the period 2004- 2008 was between 47-59 days.
- The inventory Turnover Period was the highest in the year 2004 and the least in the year 2008.
- In the Chart No: 3.4 it is observed that there is a very mild fluctuation in the Inventory turnover Period.

Creditors Turnover Ratio

This ratio indicates the relationship between credit purchases and average creditors during the year.

Formula

$$\text{Creditors Turnover Period} = \frac{\text{Credit Purchases}}{\text{Average Creditors}}$$

Significance :- This ratio indicates the speed with which the amount is being paid to creditors. The higher the ratio, the better it is, since it will indicate that the creditors are being paid more quickly which increases the credit worthiness of the firm.

Average Payment Period

This ratio indicates the period, which is normally taken by the firm to make payment to its creditors.

Formula

$$\text{Average Payment Period} = 365 / \text{Creditors Turnover Period}$$

Significance:- The lower the ratio, the better it is, because a shorter payment period implies that the creditors are being paid rapidly.

Table No. 3.5. Creditors Turnover Ratio and average payment period of ELGI Equipments

Creditors Turnover Ratio and average payment period					
Particulars	2004 - 2005	2005 - 2006	2006 - 2007	2007 - 2008	2008 - 2009
Sundry Creditors	276.650	416.630	441.570	622.770	721.210
Average Accounts Payable	313.885	346.640	429.100	532.170	671.990
Purchases	1842.210	1755.830	1909.350	2528.290	3365.720
Creditors Turnover Ratio	5.869	5.065	4.450	4.751	5.009
Average Payment Period	62.191	72.059	82.029	76.827	72.875

Chart No: 3.6. Creditors Turnover Ratio of ELGI Equipments

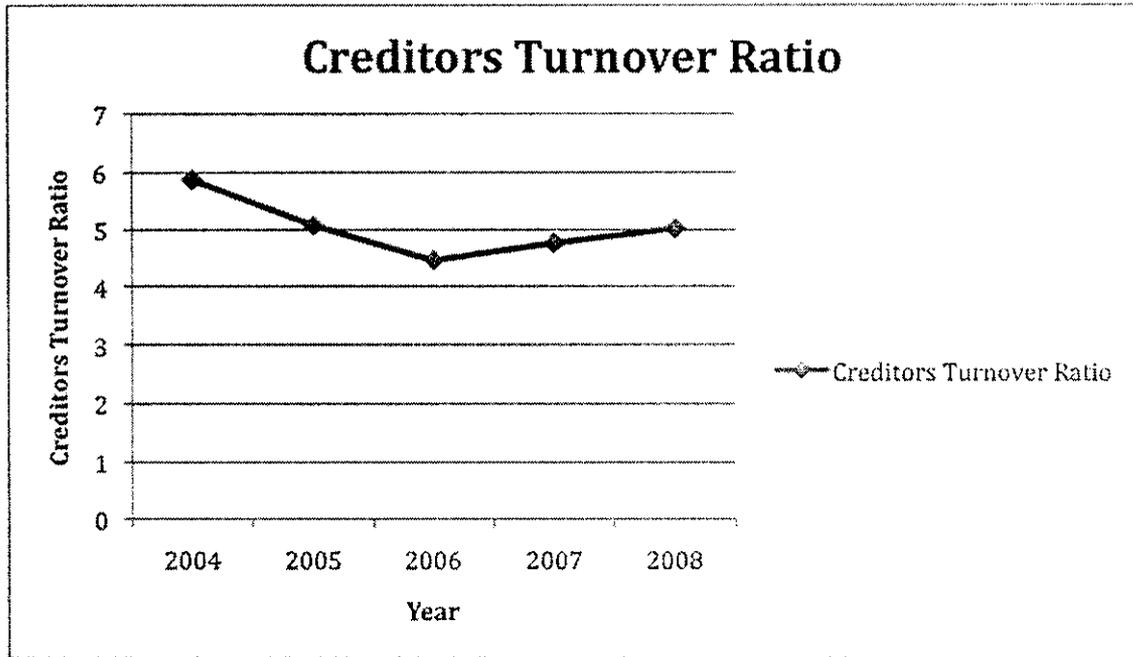
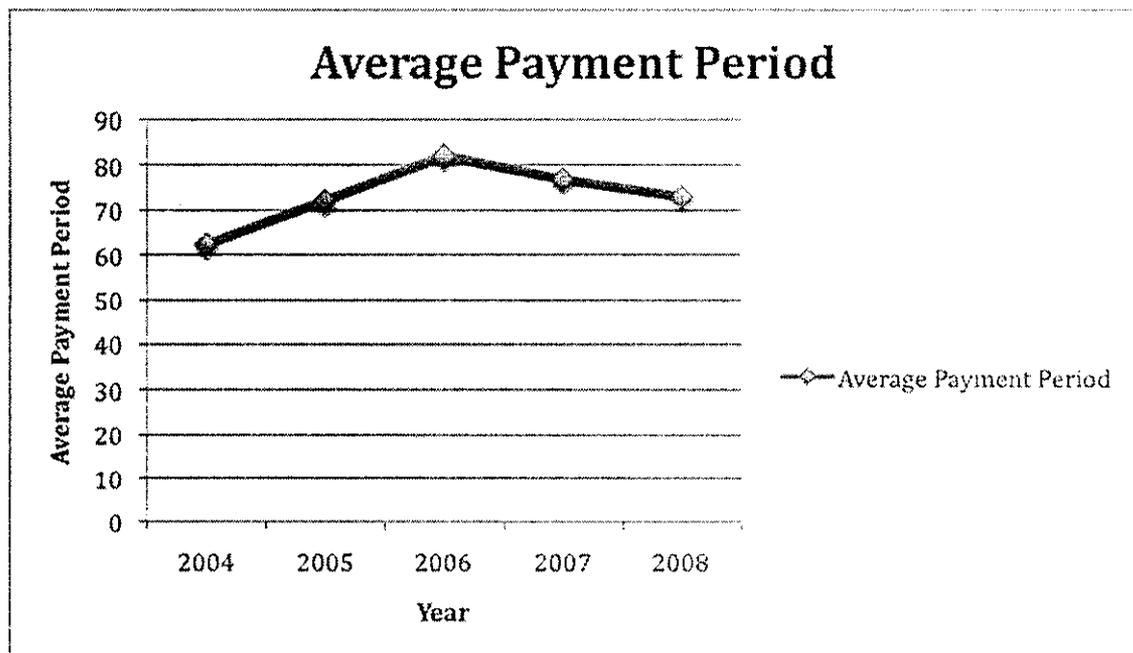


Chart No: 3.7. Creditors Turnover Ratio of ELGI Equipments



Interpretation of Tables and Charts

- The Creditors Turnover Ratio and Creditors Turnover Period for the period 2004-2008 are given in Table No: 3.5 and the diagrammatic representation of the Creditors Turnover Ratio and Creditors Turnover Period is on Chart No: 3.6 and 3.7 respectively.
- The Creditors Turnover Ratio has had a decreasing trend from the year 2004-2006, followed by increase in Creditors Turnover Ratio during the years 2007-2008.
- The Creditors Turnover Ratio was the least during the year 2006 and the highest during the year 2004.
- The payment made to the creditors during this period was done between 62-82 days, which means the payment is on an average of two or three months.
- The Credit Period allowed by suppliers is 30 days.
- The Payment Period is well above the credit period allowed by suppliers.

Working Capital Turnover Ratio

This ratio reveals how efficiently working capital has been utilized in making sales.

Formula

$$\text{Working Capital Turnover Ratio} = \frac{\text{Cost of Sales}}{\text{Net Working Capital}}$$

Here,

Cost of Sales = Opening Stock + Purchases + Carriage + Wages + Other Direct Expenses - Closing Stock

Working Capital = Current Assets – Current Liabilities

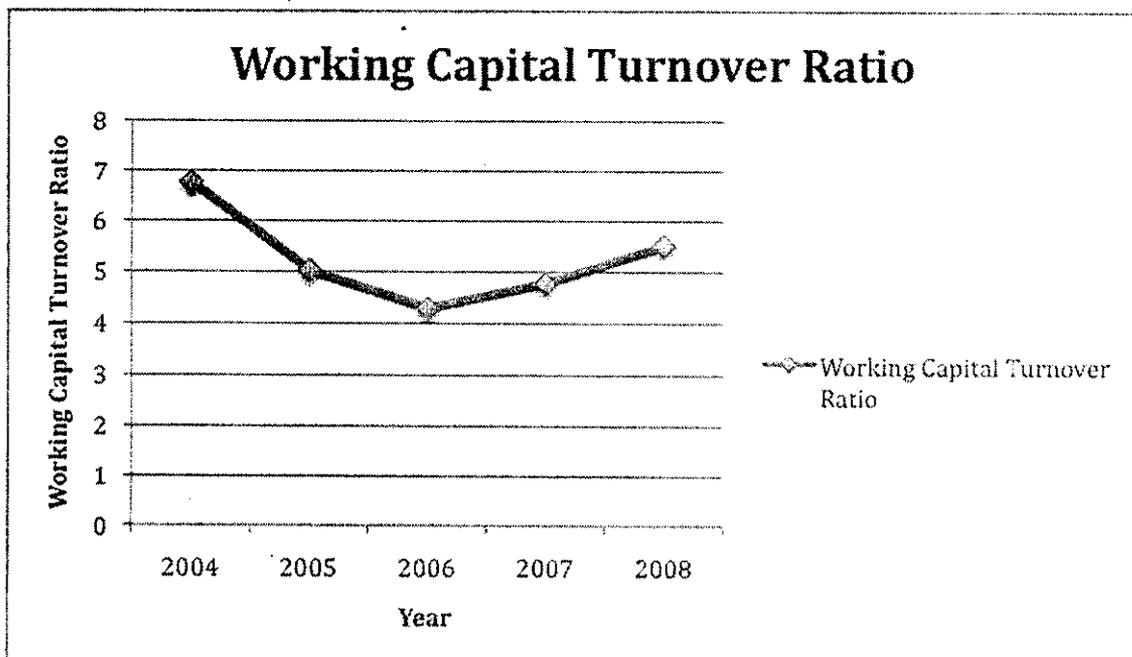
Significance:- This ratio is of particular importance in non-manufacturing concerns where current assets play a major role in generating sales. It shows the number of times working capital has been rotated in producing sales. A high working capital turnover ratio shows efficient use of working capital and quick turnover of current assets like stock and debtors.

A low working capital turnover ratio indicates under-utilisation of working capital.

Table No: 3.6. Working Capital Turnover Ratio of ELGI Equipments

Working Capital Turnover Ratio					
Particulars	2004 - 2005	2005 - 2006	2006 - 2007	2007 - 2008	2008 - 2009
Cost of Sales	291.940	286.510	313.090	379.490	452.420
Net Working Capital	43.140	57.090	73.320	79.750	82.280
Working Capital Turnover Ratio	6.767	5.019	4.270	4.758	5.499

Chart No: 3.8. Working Capital Turnover Ratio of ELGI Equipments



Interpretation of Table and Chart

- The Working Capital Turnover Ratio for the period 2004-2008 is given in Table No: 3.6 and the diagrammatic representation of the Working Capital Turnover Ratio is on Chart No: 3.8
- The Working Capital Turnover Ratio was the highest during the year 2004.
- The Working Capital Turnover Ratio decreased constantly after the year 2004 and increased again during the year 2008.
- The Working Capital Turnover Ratio is between four to seven times during this period.
- This means that the working capital is turned four to seven times during a year.
- The high Working Capital Turnover Ratio indicates efficient utilization of working capital.

Net Working Capital Ratio

This ratio reveals how efficiently working capital has been utilized in terms of total assets.

Formula

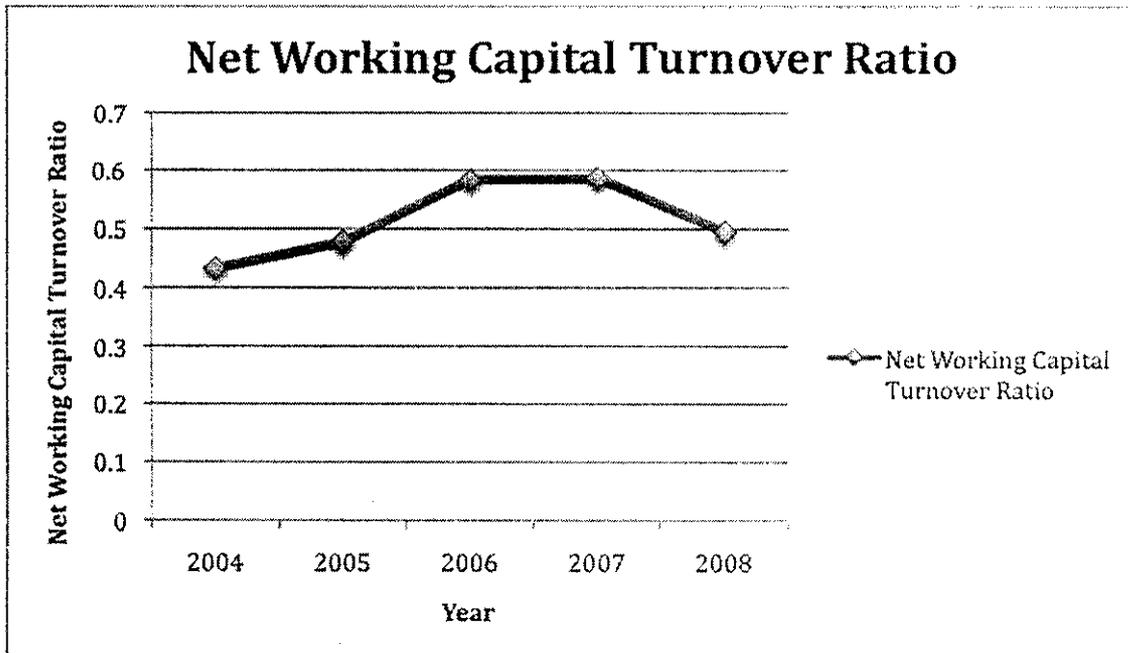
$$\text{Net Working Capital Turnover Ratio} = \frac{\text{Net Working Capital}}{\text{Total assets}}$$

Table No: 3.7 Net Working Capital Turnover Ratio of ELGI Equipments

Net Working Capital Turnover Ratio					
Particulars	2004 - 2005	2005 - 2006	2006 - 2007	2007 - 2008	2008 - 2009
Net Working Capital	43.140	57.090	73.320	79.750	82.280
Total Assets	99.970	119.760	126.000	136.350	166.900
Net Working Capital Ratio	0.432	0.477	0.582	0.585	0.493

Chart No: 3.9

Net Working Capital Turnover Ratio of ELGI Equipments



Interpretation of Table and Chart

- The Net Working Capital Turnover Ratio for the period 2004-2008 is given in Table No: 3.7 and the diagrammatic representation of the Net Working Capital Turnover Ratio is on Chart No: 3.9
- There is no high fluctuation in the Net Working Capital Turnover Ratio during this period.
- The Net Working Capital Turnover Ratio was the least during the year 2004 and was the highest during the year 2007.
- The above table indicates the number of turns in working capital in terms of utilization of fixed assets lies between 0.4- 0.6.

Debtors Turnover Ratio

This ratio indicates the relationship between credit sales and average debtors during the year:

Formula:

$$\text{Debtors Turnover Ratio} = \frac{\text{Credit Sales}}{\text{Average Debtors}}$$

While calculating this ratio, provision for bad and doubtful debts is not deducted from the accounts receivables, so that it may not give a false impression that debtors are collected quickly.

Significance:- This ratio indicates the speed with which the amount is collected from debtors. The higher the ratio, the better it is, since it indicates that amount from debtors is being collected more quickly. The more quickly the debtors pay, the less the risk from bad- debts, and so the lower the expenses of collection and increase in the liquidity of the firm. By comparing the Debtors turnover ratio of the current year with the previous year, it may be assessed whether the sales policy of the management is efficient or not.

Average Collection Period

This ratio indicates the time with in which the amount is collected from debtors and bills receivables. Average collection period can be calculated on the bases of 'Debtors Turnover Ratio'.

Formula:

$$\text{Average collection period} = \frac{365}{\text{Debtors Turnover Ratio}}$$

Significance :- This ratio shows the time in which the customers are paying for credit sales. A higher debt collection period is thus, an indicator of the inefficiency and negligence on the part of management. On the other hand, if there is decrease in debt collection period, it indicates prompt payment by debtors, which reduces the chance of bad debts.

Table No: 3.8 Debtors Turnover Ratio and Average Collection Period of ELGI Equipments

Debtors Turnover Ratio and Average Collection Period					
Particulars	2004 - 2005	2005 - 2006	2006 - 2007	2007 - 2008	2008 - 2009
Total Sales	291.940	286.510	313.090	379.490	452.420
Debtors	34.710	49.510	65.810	65.310	73.960
Average Debtors	32.360	42.110	57.660	65.560	69.635
Debtors Turnover Ratio	9.022	6.804	5.430	5.788	6.497
Average Collection Period	40.458	53.646	67.220	63.057	56.180

Chart No: 3.10 Debtors Turnover Ratio of ELGI Equipments

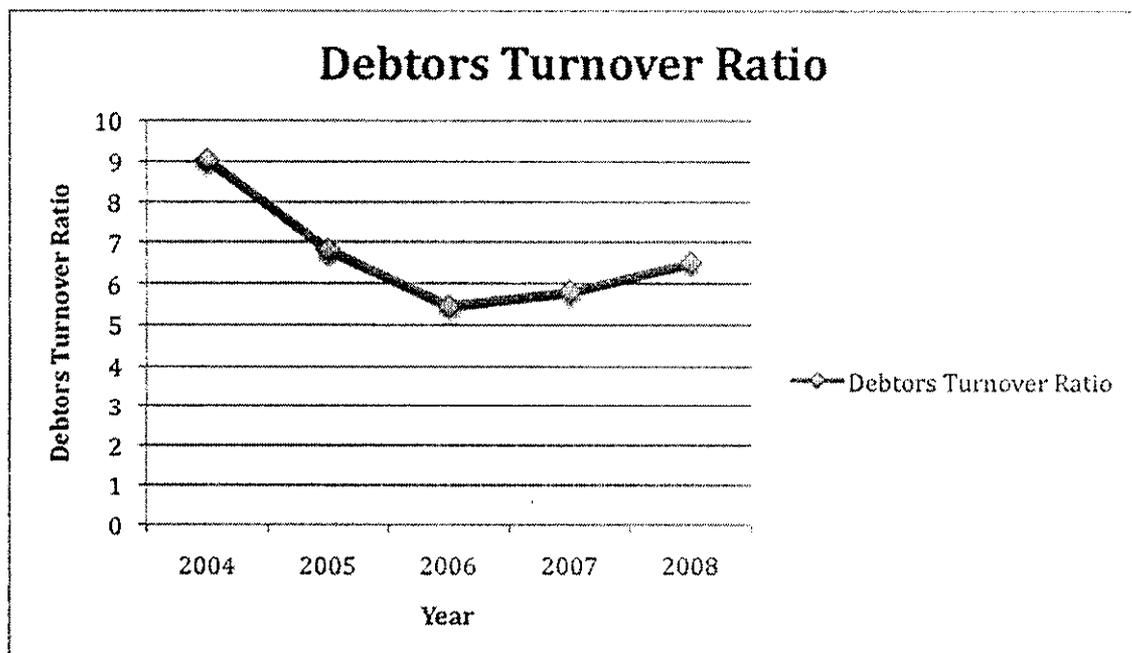
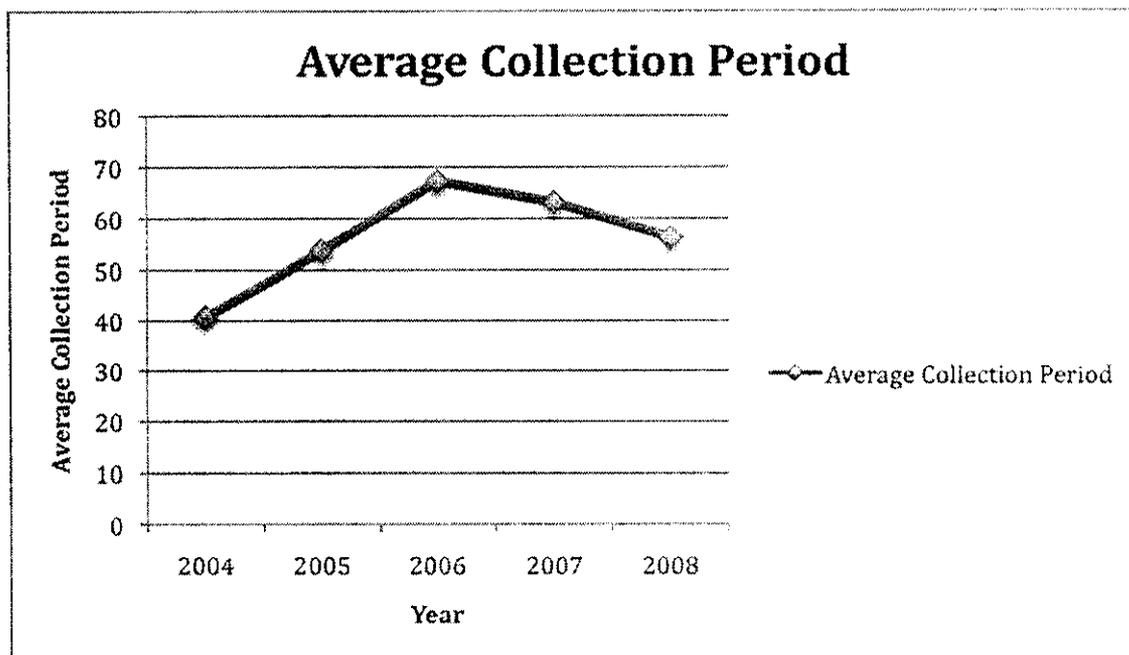


Chart No: 3.11 Debtors Average Collection Period



Interpretation of Table and Charts

- The Debtors Turnover Ratio and the average collection period for the period 2004-2008 is given in Table No: 3.8 and the diagrammatic representation of the Debtors Turnover Ratio and the average collection period is shown on Chart No: 3.10 and Chart No: 3.11 respectively.
- The Debtors Turnover Ratio was the highest during the year 2004 and the lowest during the year 2006.
- The Debtors Turnover Ratio in the above table indicates that the ratio turns about five to nine turns during a year for this period.
- In the year 2004 the Debtors Turnover Ratio turned 9 times, which means the repayment period by the customers was very quick.
- From the year 2004 there has been a decrease in the Debtors Turnover Ratio.

- In Chart No: 3.10 the Debtors turnover Ratio is almost u-shaped, indicating a dip in the ratio from the year 2004 and a slow increase from the year 2006.
- The Average Collection Period for the period 2004-2008 has been 40-67 days.
- The credit period allowed to customers is 40-45 days.
- The average collection period during the year 2004 falls within the credit period allowed to customers.
- From the year 2005- 2008 the average Collection Period does not fall under the permitted credit period.
- The Average Collection Period was the highest during the year 2006 and the lowest during the year 2004.
- From the year 2004 there has been an increase in the Average Collection Period till the year 2006.
- From the year 2006 there is a decrease the Average Collection Period.

CHAPTER 4

RECOMMENDATIONS & CONCLUSION

4. RECOMMENDATIONS AND CONCLUSION

4.1 Recommendations and Conclusion for Operating Cycle

- The Raw Material Turnover Period has reduced considerably from the year 2005. It is therefore recommended to maintain the same in future periods.
- The payment from the debtors should be improved. If the debtors pay within the credit period the operating cycle of ELGI can be reduced.
- The payment made to creditors has been above the credit limit allowed by suppliers.
- The payment to suppliers can be made on time only when the Debtors Turnover Period is reduced. An initiative for quick collection of payments from debtors is advisable.
- Over the years the Operating Cycle has had very high fluctuations. Stability in Operating Cycle should be set up.

4.2 Recommendations and Conclusion for Ratio Analysis

The current liabilities are found to be high which has to be reduced to improve the Current Ratio.

- The Quick Ratio has been ideal for the period 2005-2008. It is suggested that the company continues to maintain the ratio.

- The creditor Turnover Ratio is 4-5 times in a year. This ratio has to be increased so that payments can be made quickly.
- The Credit period allowed by customers is 30 days. The Average Payment Period for the period 2004-2008 has been 62-73 days. The Average Payment Period has to be reduced so that the payment is made within the Credit Period allowed to ELGI.
- The Working Capital Turnover Ratio in the year 2004 was 6.7 and in the year 2008 it was 5.4. The ratio has comparatively reduced. An increase in this ratio will enable better utilization of Working Capital and quick turnover of assets like stocks and debtors.
- The Debtors Turnover Ratio for the year 2004 was 9.02 whereas in the year 2008 it is only 6.49. This clearly indicates that the Debtors Turnover Ratio can be increased. An increase in this ratio will reduce the risk of bad debts and reduce collection expenses and therefore increase the liquidity of the firm.
- The credit Period allowed to customers is between 40-45 days. The credit period between the years 2005-2008 has been higher than the credit period allowed by ELGI. The Average Payment Period has to be reduced so that the payments are received within the credit period.

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