Presentation on

WORKING CAPITAL MANAGEMENT

Part-I

For the students

of

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B.Com.(Hons. & General)

By

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Meaning of Working Capital

Business organization requires adequate capital to establish business and operate their activities. The total capital of a business can be classified as fixed capital and working capital. Fixed capital is required for the purchase of fixed assets like building, land, machinery, furniture etc. Fixed capital is invested for long period, therefore it is known as long-term capital. Similarly, the capital, which is needed for investing in current assets, is called working capital.

For day-to-day operations, a business needs to carry certain amount of raw material of all sorts so that commencement of production is not delayed, certain amount of work-in-process so that production operations go smoothly, certain amount of finished goods so that supply to market is not hampered by fluctuations in production, certain amount of book debts so that sales take place continuously and certain amount of cash and bank balance for meeting daily routine payments and for providing for any unforeseen contingencies.

Working capital means that part of capital, which is needed for the regular business activities like for the purchase of raw materials, for the payment of wages, payment of rent and of other expenses. Working capital is maintained in the form of cash, debtors, raw materials inventory, stock of finished goods, bills receivable etc. to keep the flow of production smooth and continuous. **Working capital** is also referred to as revolving capital or floating capital as current assets and current liabilities are converted from one form to other in the ordinary course of business, i.e. from cash to inventory, inventory to work in progress (WIP), WIP to finished goods, finished goods to receivables and from receivables to cash i.e. back to original form.

Classification of Working Capital

(1) On the Basis of Concept

(i) Gross Working Capital

(ii) Net Working Capital

(2) On the Basis of time or Need

(i) Permanent Working Capital

(ii) Temporary Working Capital

I. On the basis of concept

Gross working capital is the capital invested in total current assets of the enterprise. Current assets mean the assets which can be converted into cash easily or within one accounting period. Examples of current assets are : cash in hand and bank balances, Bills Receivable, Short term loans and advances, prepaid expenses, Accrued Incomes etc. The gross working capital is financial or going concern concept. It helps in determining the return on investment in working capital and providing correct amount of working capital at right time.

Net working capital is also defined as accounting concept. It means excess of current assets over current liabilities. It helps in finding out firm's capability to meet short term liabilities as well as indicates the financial soundness of the enterprise.

Net Working Capital = Current Assets – Current Liabilities

When current assets exceed the current liabilities the working capital is positive and negative working capital results when current liabilities are more than current assets. Examples of current liabilities are Bills Payable, Sunday debtors, accrued expenses, Bank Overdraft, Provision for taxation etc.

II. On the basis of time or need

Permanent Working Capital refers to the minimum amount of all current assets that is required at all times to ensure a minimum level of uninterrupted business operations. Some minimum level of raw materials, working process, bank balance, finished goods, etc. a business has to carry all the time irrespective of the level of manufacturing/marketing operations. This level of working capital is referred to as core working capital or core current assets. Permanent working capital is defined as the “amount of current assets required to meet a firm’s long-term minimum needs”. You should note, that the level of core current assets is not, however, a constant sum all the times.

Initial Working Capital: In the initial period of its operation, a firm must need enough money to pay certain expenses before the business yields cash receipt. In the initial years the banks may not grant loans or overdrafts, sales may have to be made on credit and it may be necessary to pay the creditors immediately. Therefore the owners themselves have to provide necessary funds in the initial period, which may be known as initial working capital.

Regular Working Capital: The firm is always required to keep certain funds with it to continue the regular business operations, which is called as Regular Working Capital. It is required to maintain regular stock of raw materials and work-in-progress and also of the finishes goods, which must be maintained permanently at a definite level. Regular working capital is the excess of current assets over current liabilities. It ensures smooth operation of business.

2. Temporary or Varying Working Capital varies with the volume of operations. If fluctuates with scale of operations. This is additional working capital required during up seasons over the above the fixed working capital. During seasons more production/sales take(s) place resulting in larger working capital needs. The reverse is true during off-seasons. As seasons alternate, temporary working capital moves up and down like tides. Temporary working capital is defined as the "amount of current assets that varies with seasonal requirements". Temporary working capital can be financed through short term funds, i.e. current liabilities. When the level of temporary working capital moved up, the business might use short-term funds and when the level of temporary working capital recedes, the business might retire its short term loans.

- **Seasonal Working Capital:** Some business operations require additional working capital during a particular season. For example, the groundnut oil producers may have to purchase groundnut in a particular season and have to employ additional labor for that purpose. These may require additional funds for a temporary period, which may be called as seasonal working capital.
- **Special Working Capital:** In all enterprises, some unforeseen events do occur like sudden increase in demand, downward movement of prices of raw materials, strike or natural calamities, when extra funds are needed to tide over such situation. Such type of extra funds is called as Special working capital.

It can be said that Permanent working capital represents minimum amount of the current assets required throughout the year for normal production whereas Temporary working capital is the additional capital required at different time of the year to finance the fluctuations in production due to seasonal change. A firm having constant annual production will also have constant Permanent working capital and only Variable working capital changes due to change in production caused by seasonal changes. (See Figure 7.1.)

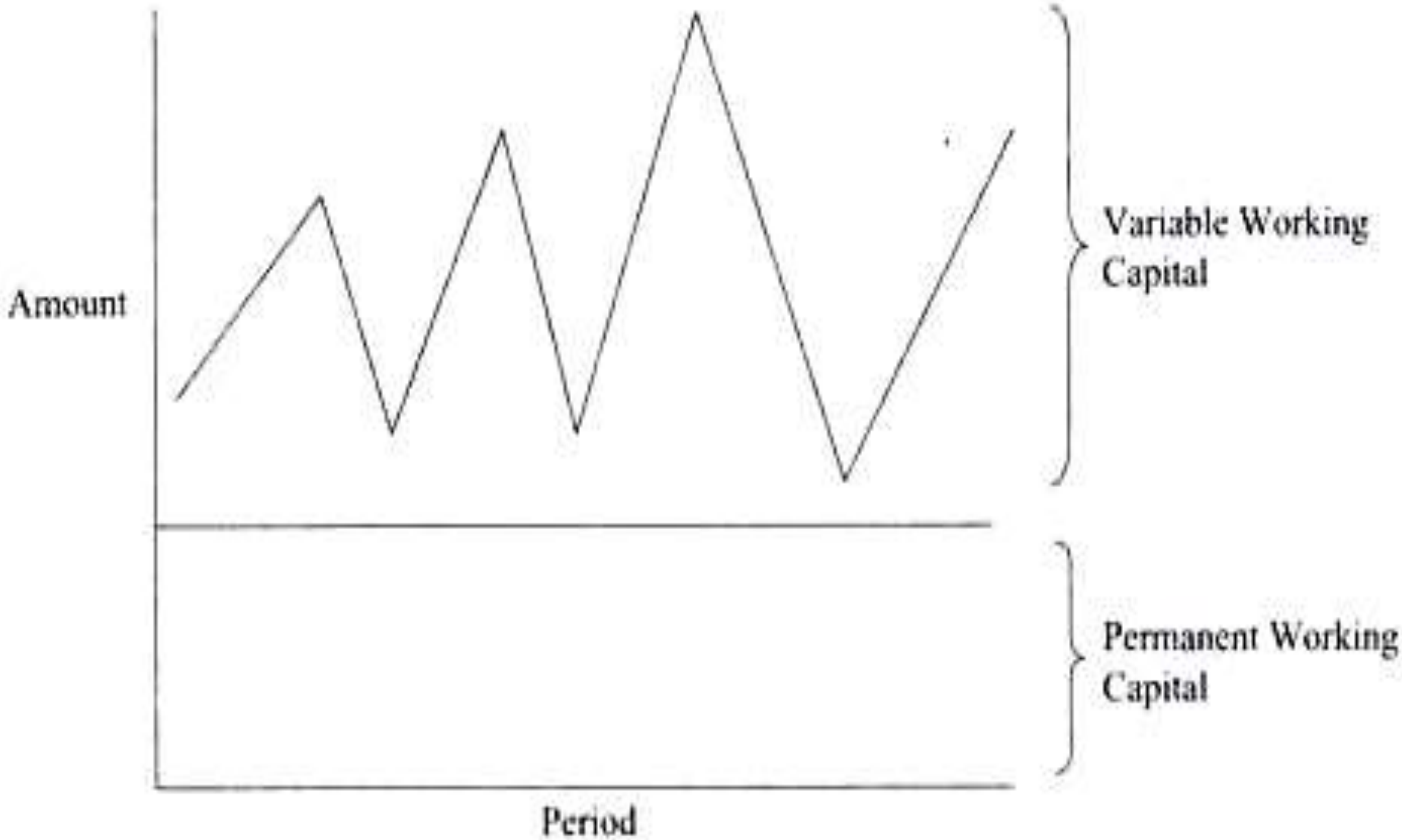

FIGURE 7.1 Working Capital of Firm having Constant Annual Sales

For a growing business the permanent working capital will be rising, for a declining business it will be decreasing and for a stable business it will be remaining more, or less stay-put. So permanent working capital is perennially needed one though not fixed in volume. This part of the working capital being a permanent investment, needs to be financed through long-term funds. Depending upon the changes in the production and sales, the need for working capital, over and above the permanent working capital, will fluctuate. (See Figure 7.2.)

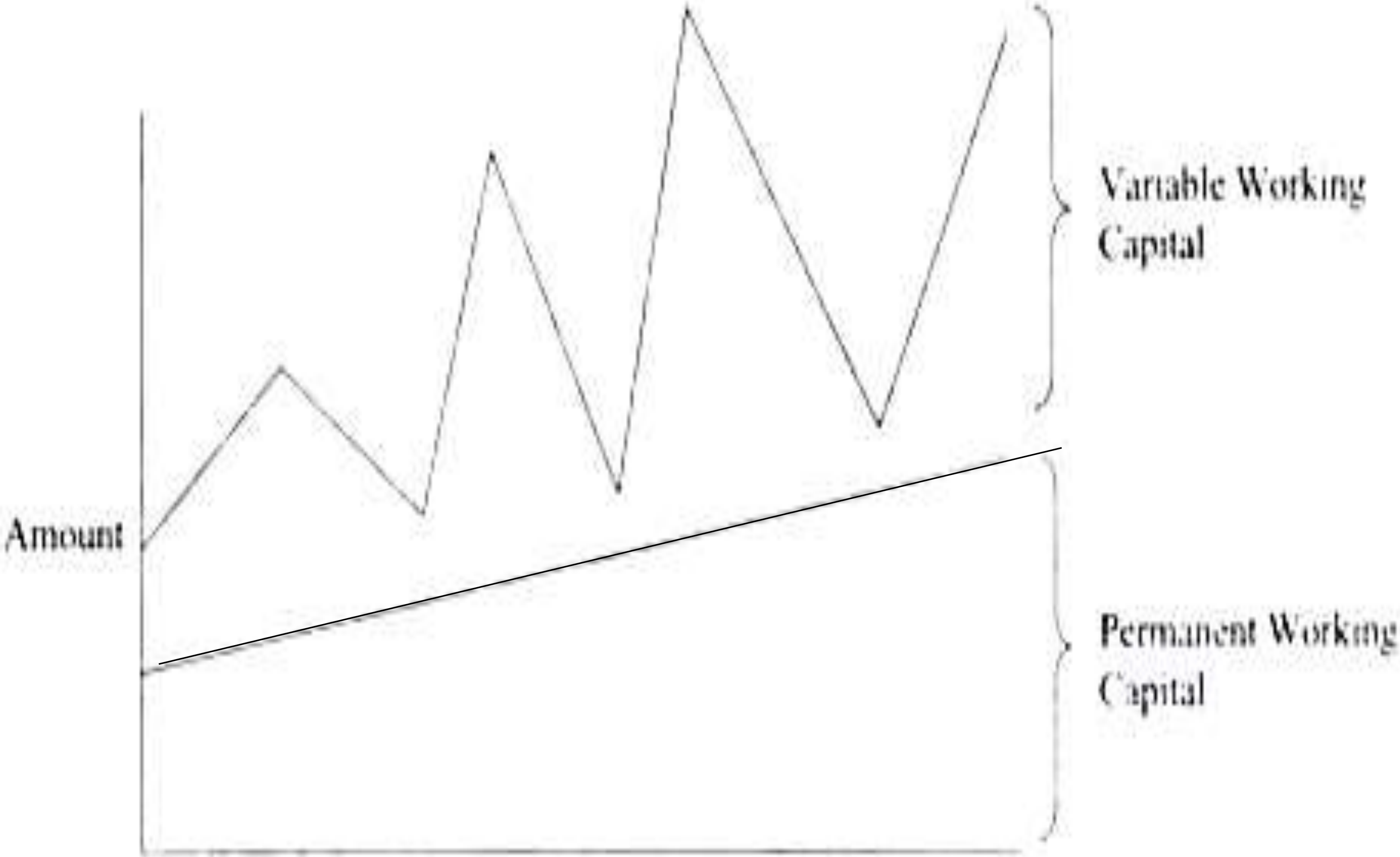

FIGURE 7.2 Working Capital of a Growth Firm

The Need or Objects or Working Capital

Working capital is needed for the following purposes.

1. For purchase of raw materials, components and spares.
2. To pay wages and salaries.
3. To incur day-to-day expenses and overhead costs such as fuel, power etc.
4. To meet selling costs as packing, advertisement
5. To provide credit facilities to customers.
6. To maintain inventories of raw materials, work in progress, stores and spares and finished stock.

ADEQUATE WORKING CAPITAL

The firm should maintain a sound working capital position. It should have adequate working capital to run its business operations. Both excessive as well as inadequate working capital positions are dangerous from firm's point of view. Excessive working capital means holding costs and idle funds which earn no profit for the firm. Paucity of working capital not only impairs the firm's profitability but also results in production interruptions and inefficiencies and sales disruption

Importance or Advantages of Adequate Working Capital

1. ***Solvency of the Business***: Adequate working capital helps in maintaining solvency of business by providing uninterrupted flow of production.
2. ***Goodwill***: Sufficient working capital enables a business concern to make prompt payments and hence helps in creating and maintaining goodwill.
3. ***Easy Loans***: A concern having adequate working capital, high solvency and good credit standing can arrange loans from banks and others on easy and favourable terms.
4. ***Cash Discounts***: Adequate working capital also enables a concern to avail cash discounts on purchases and hence it reduces cost.
5. ***Regular Supply of Raw Material***: Sufficient working capital ensure regular supply of raw materials and continuous production.

6. ***Regular payment of salaries, wages and other day to day commitments*****:** A company which has ample working capital can make regular payment of salaries, wages and other day to day commitments which raises morale of its employees, increases their efficiency, reduces costs and wastages.
7. ***Ability to face crisis*****:** Adequate working capital enables a concern to face business crisis in emergencies such as depression.
8. ***Quick and regular return on investments*****:** Every investor wants a quick and regular return on his investments. Sufficiency of working capital enables a concern to pay quick and regular dividends to is investor as there may not be much pressure to plough back profits which gains the confidence of investors and creates a favourable market to raise additional funds in future.
9. ***Exploitation of Favourable market conditions*****:** Only concerns with adequate working capital can exploit favourable market conditions such as purchasing its requirements in bulk when the prices are lower and by holding its inventories for higher prices.
10. ***High Morale*****:** Adequacy of working capital creates an environment of security, confidence, high morale and creates overall efficiency in a business.

EXCESSIVE AND INADEQUATE WORKING CAPITAL

A business enterprise should maintain adequate working capital according to the needs of its business operations. The amount of working capital should neither be excessive nor inadequate. If the working capital is in excess if its requirements it means idle funds adding to the cost of capital but which earn no profits for the firm. On the contrary, if the working capital is short of its requirements, it will result in production interruptions and reduction of sales and, in turn, will affect the profitability of the business adversely.

Disadvantage of Excessive Working Capital

(1) Excessive Inventory:-

Excessive working capital results in unnecessary accumulation of large inventory. It increases the chances of misuse, waste, theft etc.

(2) Excessive Debtors:-

Excessive working capital will results in liberal credit policy which, in turn, will results in higher amount tied up in debtors and higher incidence of bad debts.

(3) Adverse Effect on Profitability:-

Excessive working capital means idle funds in the business which adds to the cost of capital but earns no profits for the firm. Hence it has a bad effect on profitability of the firm.

(4) Inefficiency of Management:-

Management becomes careless due to excessive resources at their command. It results in laxity of control on expenses and cash resources.

Disadvantage of Inadequate Working Capital

(1) Difficulty in Availability of Raw-Material:-

Adequacy of working capital results in non-payment of creditors on time. As a result the credit purchase of goods on favorable terms becomes increasingly difficult. Also, the firm cannot avail the cash discount.

(2) Full Utilization of Fixed Assets not Possible:

Due to the frequent interruption in the supply of raw materials and paucity of stock, the firm cannot make full utilization of its machines etc.

(3) Difficulty in the Maintenance of Machinery:

Due to the inadequacy of working capital, machines are not cared and maintained properly which results in the closure of production on many occasions.

(4) Decrease in Credit Rating:

Because of inadequacy of working capital, firm is unable to pay its short-term obligations on time. It decays the firm's relations with its bankers and it becomes difficult for the firm to borrow in case of need.

(5) Non Utilization of Favorable Opportunities:

For example, a firm cannot purchase sufficient quantity of raw materials in case of sudden decrease in the prices. Similarly, if the firm receives a big order, it cannot execute it due to shortage of working capital.

(6) Decrease in Sales:

Due to the shortage of working capital, the firm cannot keep sufficient stock of finished goods. It results in the decrease in sales. Also, the firm will be forced to restrict its credit sales. This will further reduce the sales.

(7) Difficulty in the Distribution of Dividends:

Because of paucity of cash resources, firm will not be able to pay the dividend to its shareholders.

(8) Decrease in the Efficiency of Management:

It will become increasingly difficult for the management to pay its creditors on time and pay its day-to-day expenses. It will also be difficult to pay the wages regularly which will have an adverse effect on the morale of managers.

Factors Determining the Working Capital Requirements

1. ***Nature or Character of Business***
2. ***Size of Business/Scale of Operations***
3. ***Production Policy***
4. ***Manufacturing process / Length of Production cycle***
5. ***Credit Policy***
6. ***Business Cycles***
7. ***Rate of Growth of Business***
8. ***Earning Capacity and Dividend Policy***
9. ***Price Level Changes***
10. ***Working Capital Cycle***


Thank
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