Working Capital

What is the meaning of working capital & role of working capital

- Working capital typically means the firm’s holding of current or short-term assets such as cash, receivables, inventory and marketable securities.
- These items are also referred to as circulating capital
- Corporate executives devote a considerable amount of attention to the management of working capital.

Working capital management

Working capital management is term specified the manage of the resource for used with the others.

Working capital management is concerned with the problems that arise in attempting to manage the current assets, the current liabilities and the interrelations that exist between them.

Current assets

Current assets refer to those assets which in the ordinary course of business can be, or will be, converted into cash within one year without undergoing a diminution in value and without disrupting the operations of the firm.

Examples- cash, marketable securities, accounts receivable and inventory.

Current liabilities

Current liabilities are those liabilities which are intended, at their inception, to be paid in the ordinary course of business, within a year, out of the current assets or the earnings of the concern.

Examples- accounts payable, bills payable, bank overdraft and outstanding expenses.

Definition of Working capital

Working Capital refers to that part of the firm's capital, which is required for financing short-term or current assets such a cash marketable securities, debtors and inventories.

Funds thus, invested in current assets keep revolving fast and are constantly converted into cash and this cash flow out again in exchange for other current assets.

Working Capital is also known as *revolving or circulating capital or short-term capital*

Concepts of Working Capital

There are two possible interpretations of working capital concept:

1. Balance sheet concept

2. Operating cycle concept

Balance sheet concept

There are two interpretations of working capital under the balance sheet concept.

- Excess of current assets over current liabilities
- gross or total current asset

Concepts of Working Capital

1. Gross working capital (GWC)

GWC refers to the firm's total investment in current assets.

Current assets are the assets which can be converted into cash within an accounting year (or operating cycle) and include cash, short-term securities, debtors, (accounts receivable or book debts) bills receivable and stock (inventory).

Concepts of Working Capital

Net working capital (NWC)

- NWC refers to the difference between current assets and current liabilities.
- Current liabilities (CL) are those claims of outsiders which are expected to mature for payment within an accounting year and include creditors (accounts payable), bills payable, and outstanding expenses.
- NWC can be positive or negative.
  - Positive NWC = CA > CL
  - Negative NWC = CA < CL

Concepts of Working Capital

- GWC focuses on
  - Optimisation of investment in current
  - Financing of current assets
- NWC focuses on
  - Liquidity position of the firm
  - Judicious mix of short-term and long-tern financing

Operating Cycle

Operating cycle is the time duration required to convert sales, after the conversion of resources into inventories, into cash. The operating cycle of a manufacturing company involves three phases:

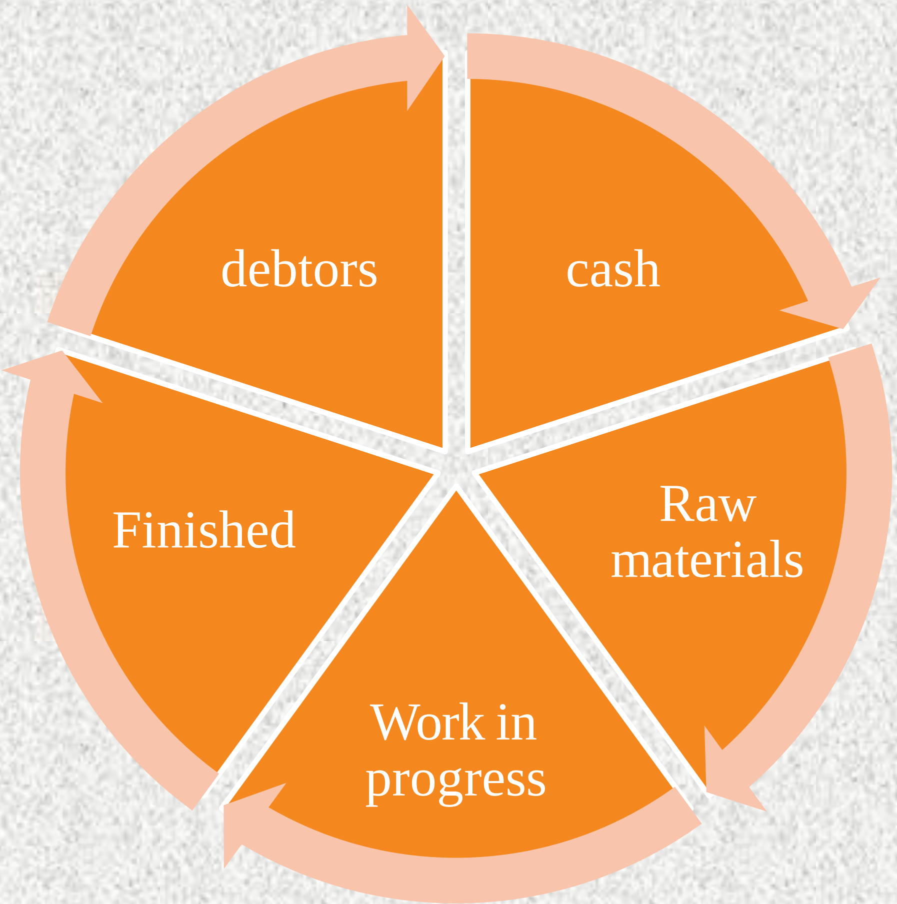
- *Acquisition of resources* such as raw material, labour, power and fuel etc.
- *Manufacture of the product* which includes conversion of raw material into work-in-progress into finished goods.
- *Sale of the product* either for cash or on credit. Credit sales create account receivable for collection.

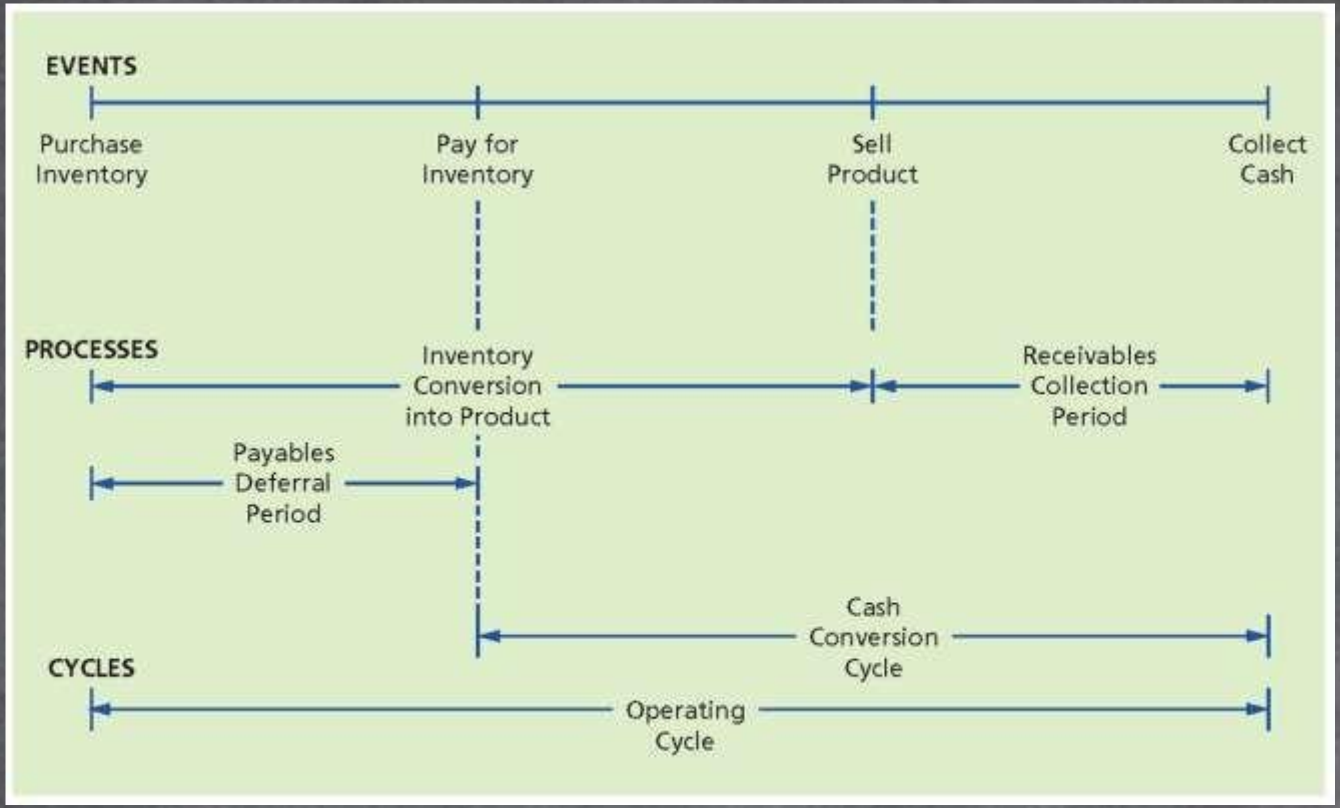
Definition

According to Genstenberg;

“Circulating capital means current assets of a company that are changed in the ordinary course of business from one form to another, as fore example, from cash to inventories, inventories to receivables , receivables into cash”

Working Capital Cycle.



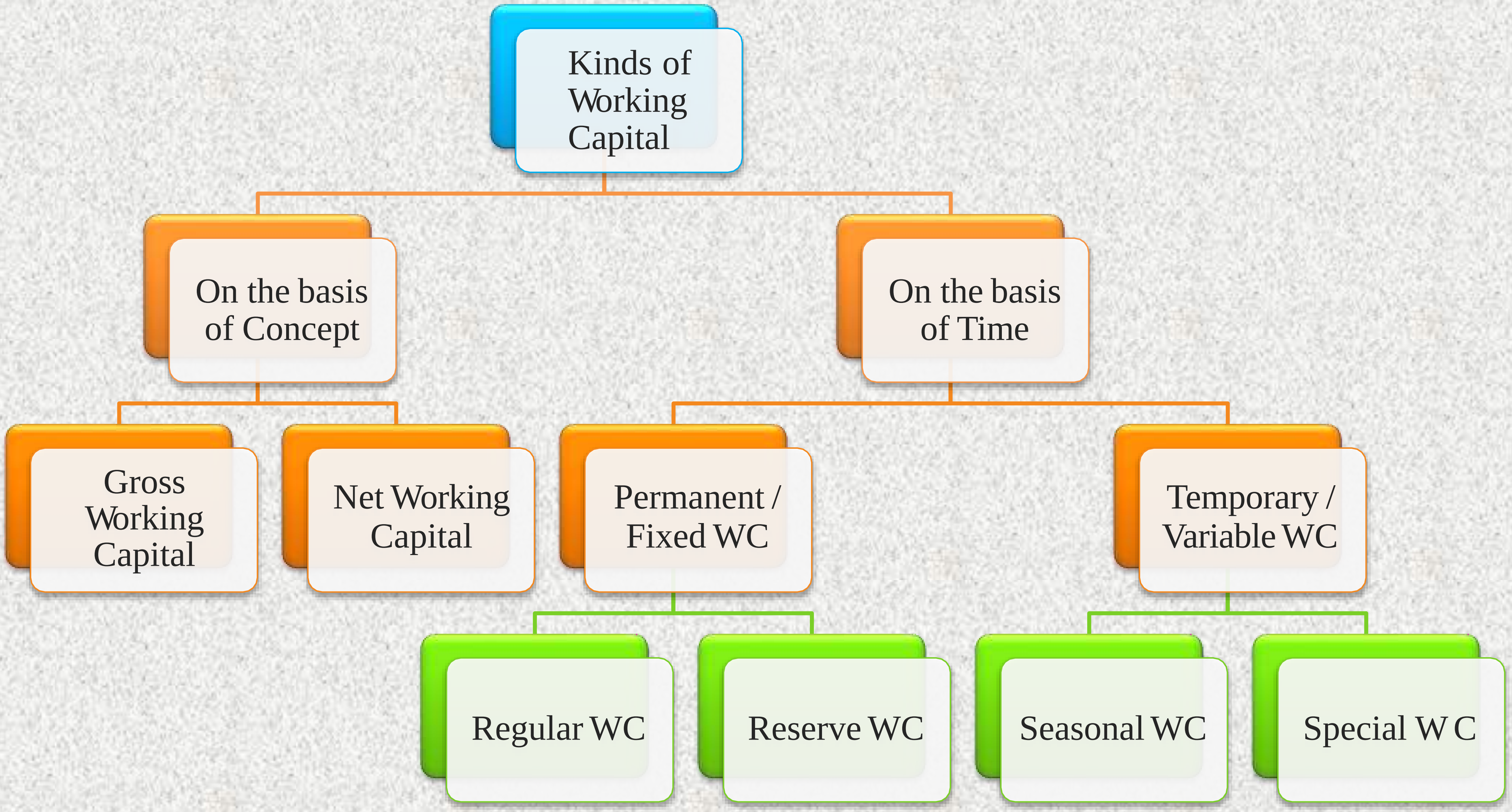

EVENTS
Purchase Inventory
Pay for Inventory
Sell Product
Collect Cash
PROCESSES
Inventory Conversion into Product
Receivables Collection Period
Payables Deferral Period
Cash Conversion Cycle
CYCLES
Operating Cycle

- RMCP – Raw material Conversion Period
- WIPCP – Work in progress conversion period
- FGCP – Finished goods conversion period
- RCP – Receivables Conversion period

Operating Cycles

- Gross Operating Cycle = RMCP + WICP + FGCP+RCP
- Net Working Capital = Gross Working Capital –Payable deferral period

Classification or Kinds of Working Capital



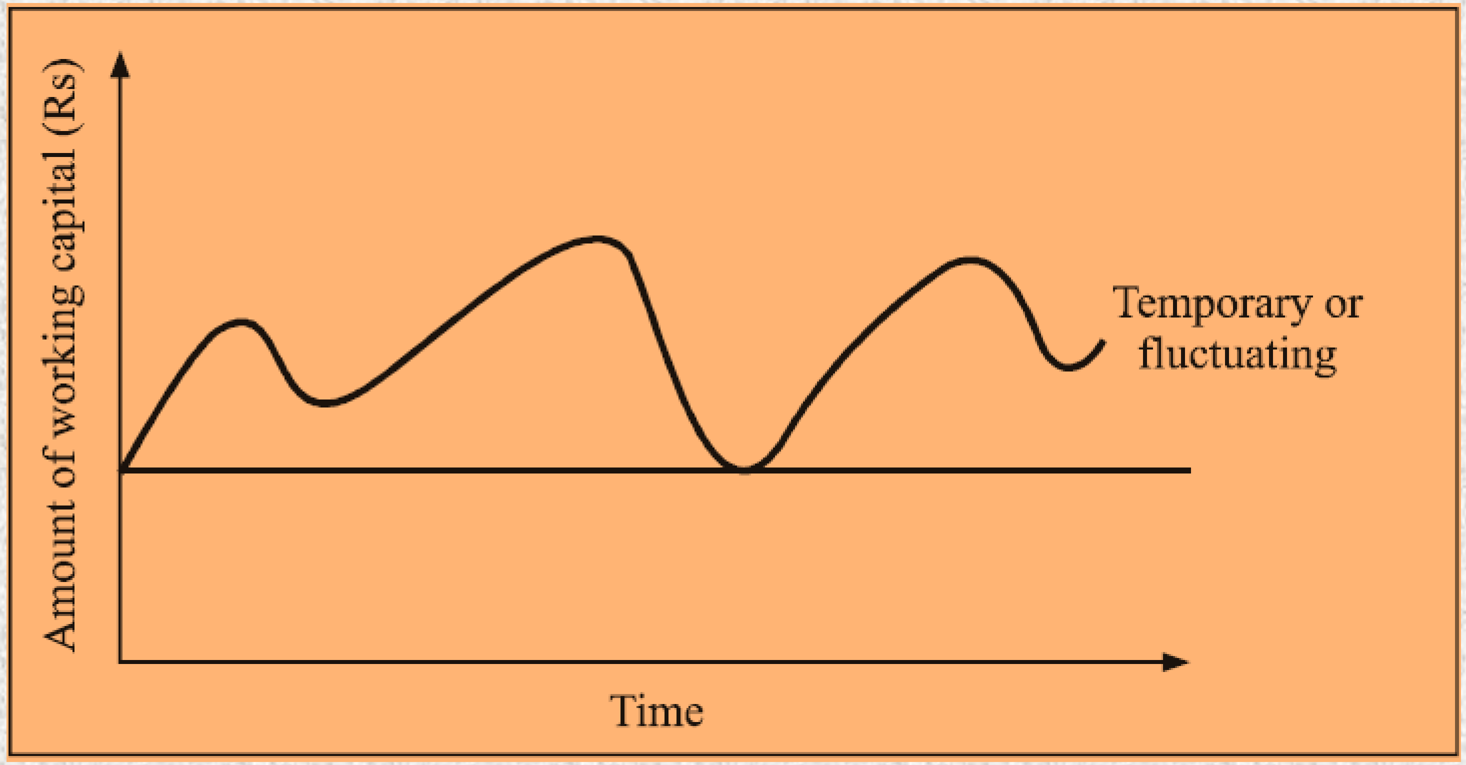
Permanent And Variable Working Capital

- **Permanent** or **fixed working capital**

  A minimum level of current assets, which is continuously required by a firm to carry on its business operations, is referred to as permanent or fixed working capital.

- **Fluctuating** or **variable working capital**

  The extra working capital needed to support the changing production and sales activities of the firm is referred to as fluctuating or variable working capital.



Permanent and temporary working capital

Importance or advantages of adequate working capital

1. Solvency of business
2. Goodwill
3. Easy loans
4. Cash discounts
5. Regular supply of rawmaterials
6. Regular payment of salaries, wages and other day to day expense
7. Exploitation of favourable market condition
8. Ability face crisis
9. Quick and regular return on investment

Dis-advantages of redundant or excessive WC

- ✓ Idle funds – earns no profit
- ✓ Leads to unnecessary purchase
- ✓ Implies Excessive debtors and defective credit policy
- ✓ Leads to overall inefficiency of the firm
- ✓ Bad relationship with bank and financial inst.
- ✓ Due to low return , share price may fall
- ✓ Paves way for speculative transactions

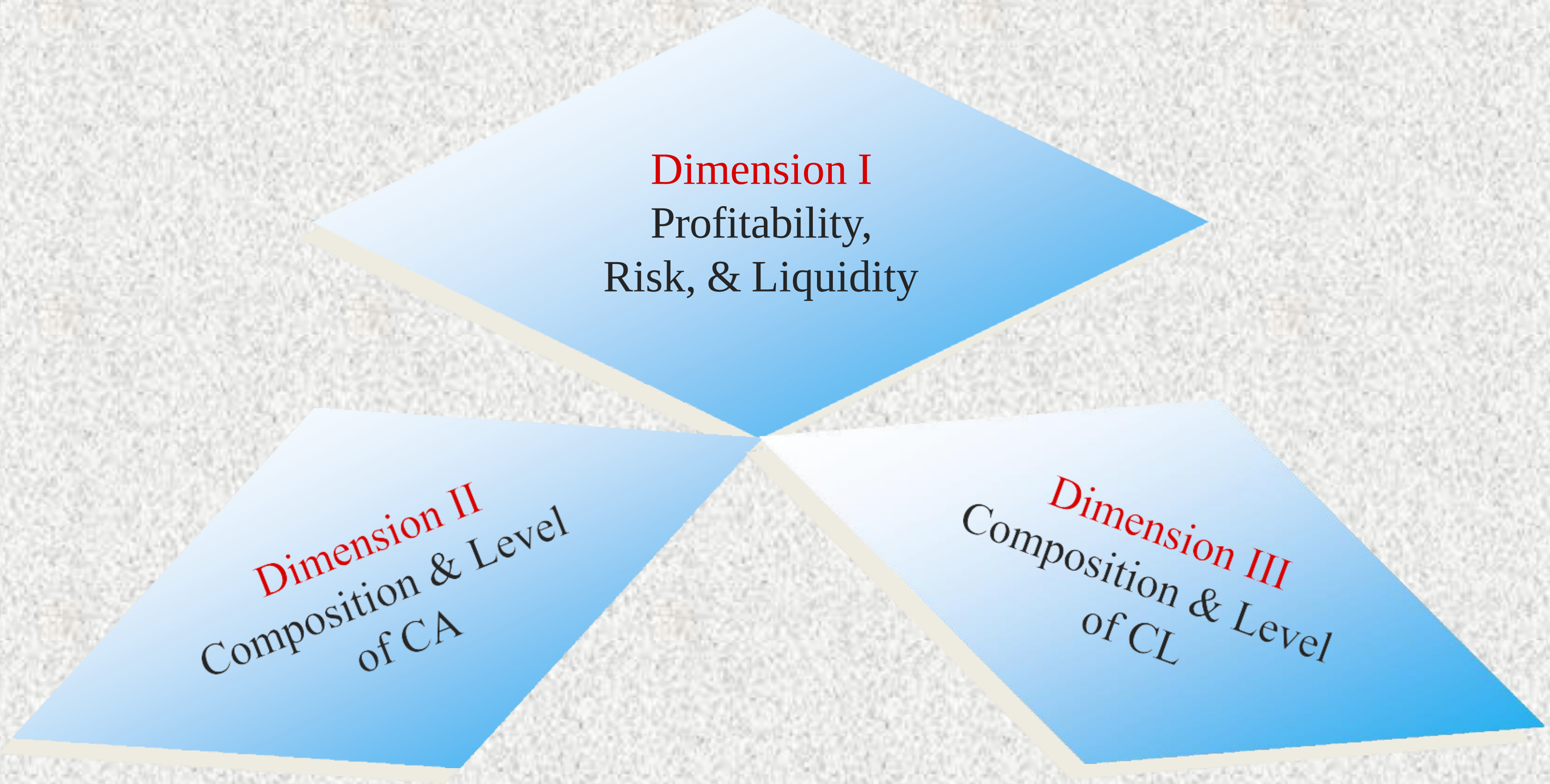
Dis advantages of Inadequate WC

- Cannot pay short term obligations in time
- Loose of goodwill
- Cannot avail discounts and other benefits (Economies of scale)
- Difficult for the firm to exploit favorable market condition
- Rate of return on investment fall with the shortage of working capital
- Difficult to pay day to day expenses of operations

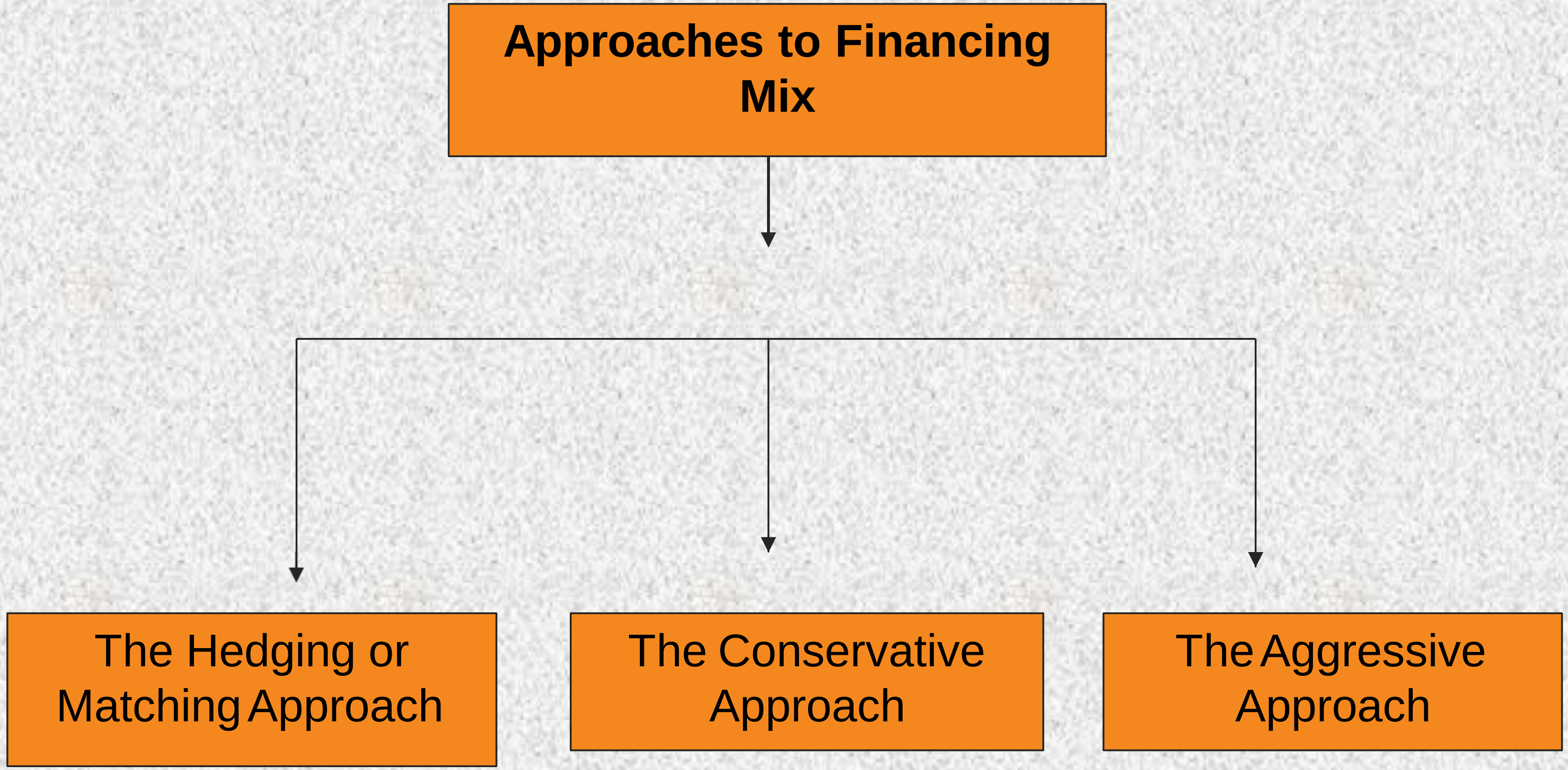
Determinants of Working Capital

1. Nature or Character of business
2. Size of the business and scale of operation
3. Production policy
4. Length of production cycle
5. Seasonal variation
6. Working capital cycle
7. Rate of stock turnover
8. Credit policy
9. Business cycles
10. Rate of growth of business
11. Price level changes

Nature of Working Capital Management



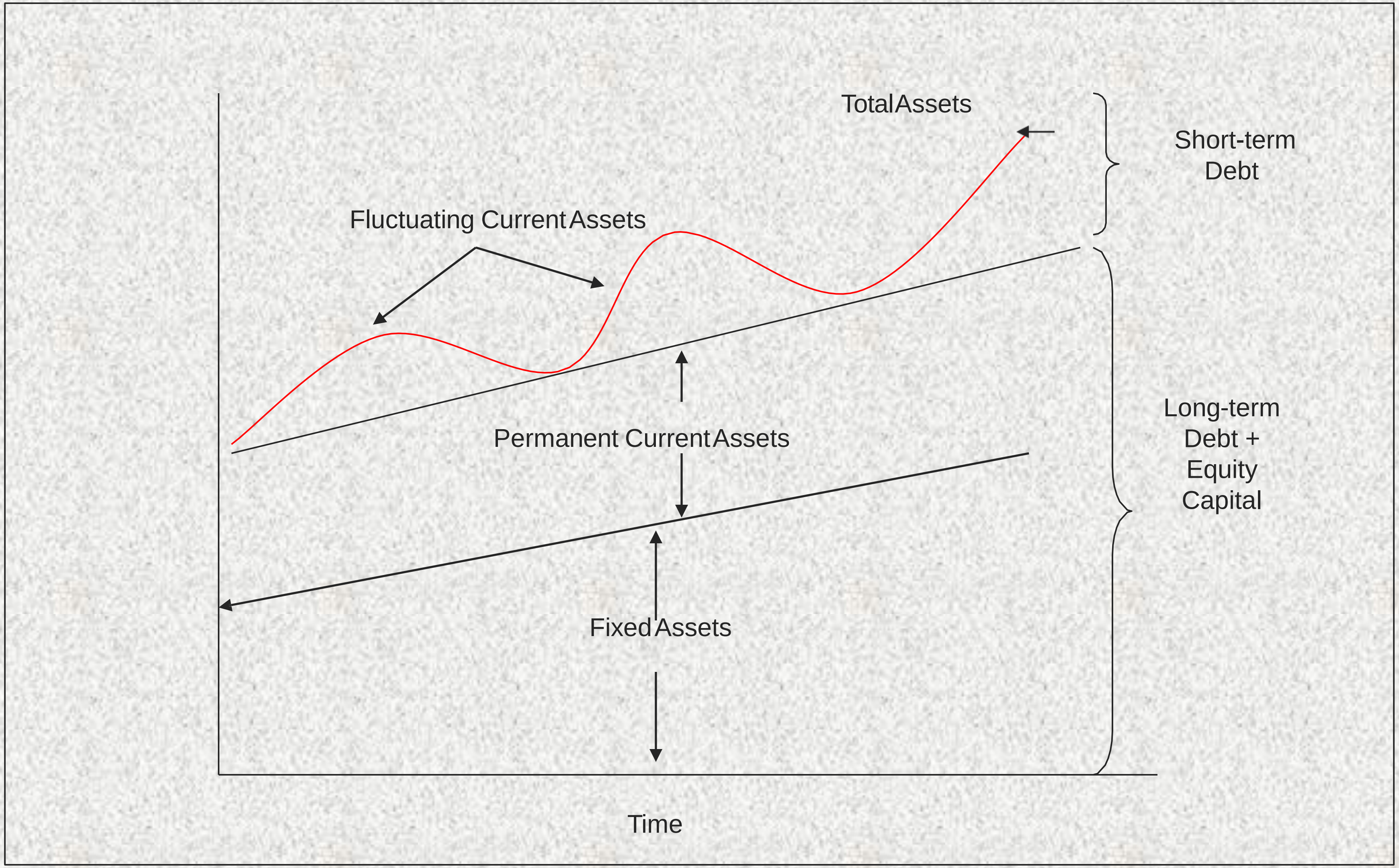
Working Capital Financing Mix



The Hedging approach

- Hedging approach refers to a process of matching maturities of debt with the maturities of financial need . In this approach maturity of source of fund should match the nature of asset to be financed
- This approach is also known as matching approach.
- The hedging approach suggests that the permanent working capital requirement should be financed with fund from long term sources while the temporary working capital requirement should be financed with short term funds.

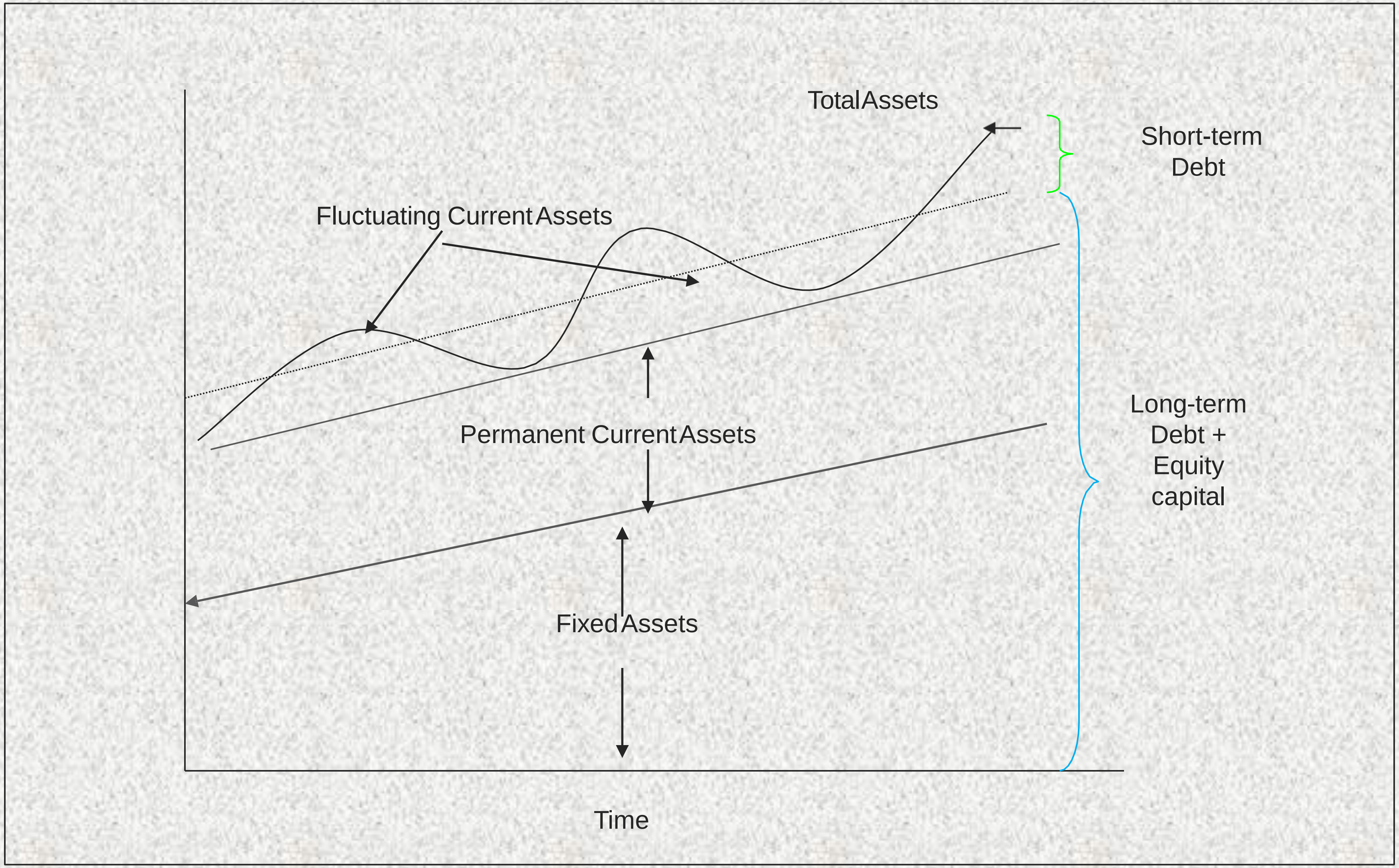
Hedging approach to asset financing



Conservative Approach

- This approach suggested that the entire estimated investments in current asset should be finance from long term source and short term should be use only for emergency requirement

Conservative approach to asset financing



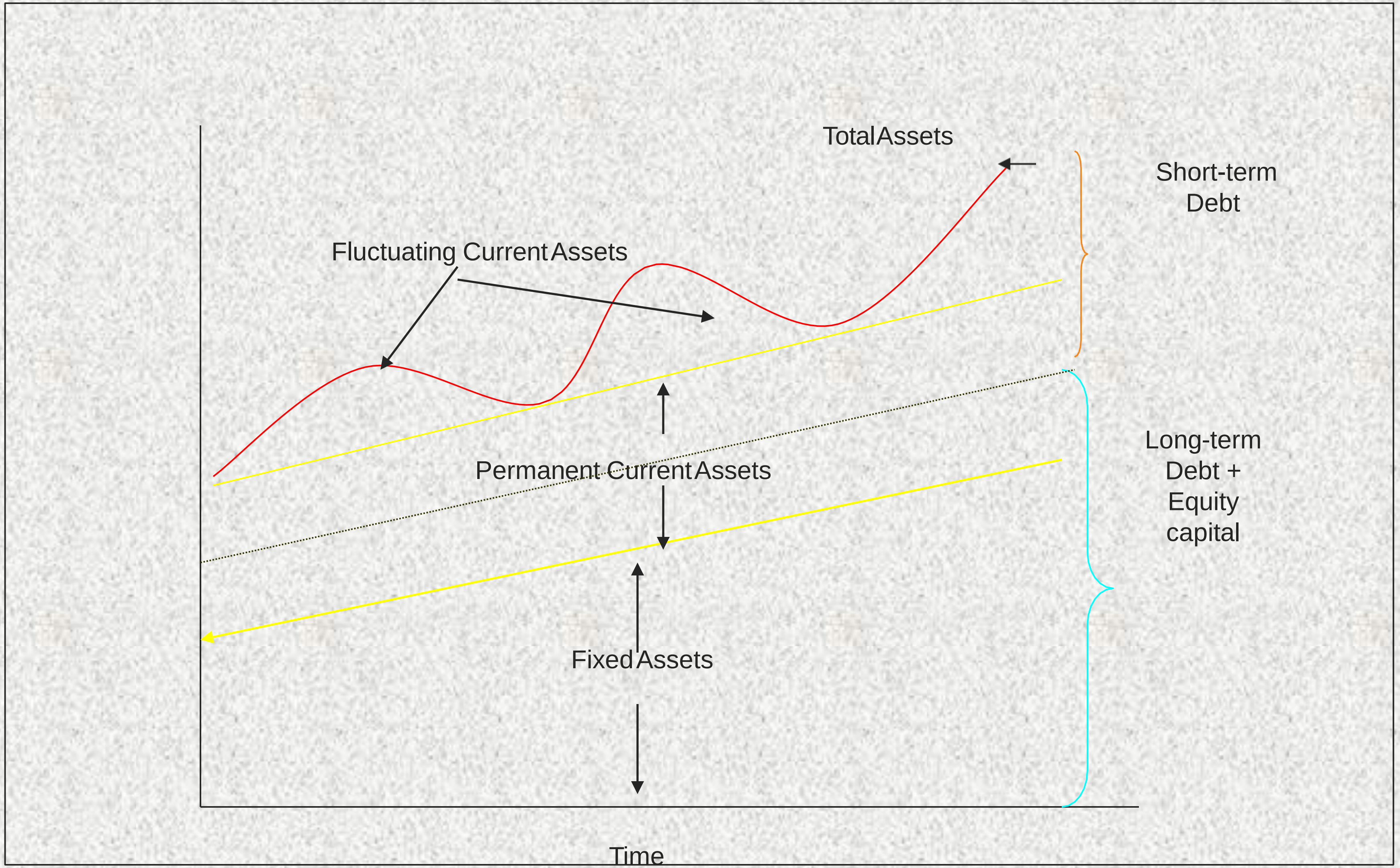
Aggressive approach

The aggressive approach suggests that the entire estimated requirement of current asset should be financed from short-term sources and even a part of fixed asset investment be financed from short - term sources

This approach make the finance mix :

- More Risky
- Less costly
- More Profitable

Aggressive approach to asset financing



FACTORS DETERMINING WORKING CAPITAL REQUIREMENT

- **NATURE OR CHARACTER OF BUSINESS**
- **SIZE OF BUSINESS/SCALE OF OPERATIONS**
- **PRODUCTION POLICY**
- **MANUFACTURING PROCESS/LENGTH OF PRODUCTION CYCLE**
- **SEASONAL VARIATION**
- **WORKING CAPITAL CYCLE**
- **RATE OF STOCK TURNOVER**
- **CREDIT POLICY**
- **BUSINESS CYCLE**
- **RATE OF GROWTH OF BUSINESS**
- **EARNING CAPACITY AND DIVIDEND POLICY**
- **PRICE LEVEL CHANGES**
- **OTHER FACTORS**

NATURE OR CHARACTER OF BUSINESS

- Public undertaking need very limited working capital since they offer cash sales only.
- Trading and finance firm require less investment in fixed capital and will have more investment in working capital.
- Manufacturing undertaking require sizable working capital between these two extremes

SIZE OF BUSINESS/SCALE OF OPERATIONS

- Working capital requirement is directly influenced by size of business.
- Greater the size larger will be the requirement of working capital.
- In some cases even small concern may need more working capital due to high overhead charges, inefficient use of available resources and other economic disadvantage of small size.

PRODUCTION POLICY

- The production could be kept either steady by accumulating inventories during slack periods with a view to meet high demand during the peak season.
- The production could be curtailed during the slack season and increase during the peak season.
- If the policy is to keep production steady by accumulating inventories it will require higher working capital.

MANUFACTURING PROCESS/LENGTH OF PRODUCTION CYCLE

In manufacturing business the requirements of working capital increase in direct proportion of Length of manufacturing process.In manufacturing working capital increase in direct proportion length of manufacturing process.

- The raw materials and other supplies have to be carried for a longer period.

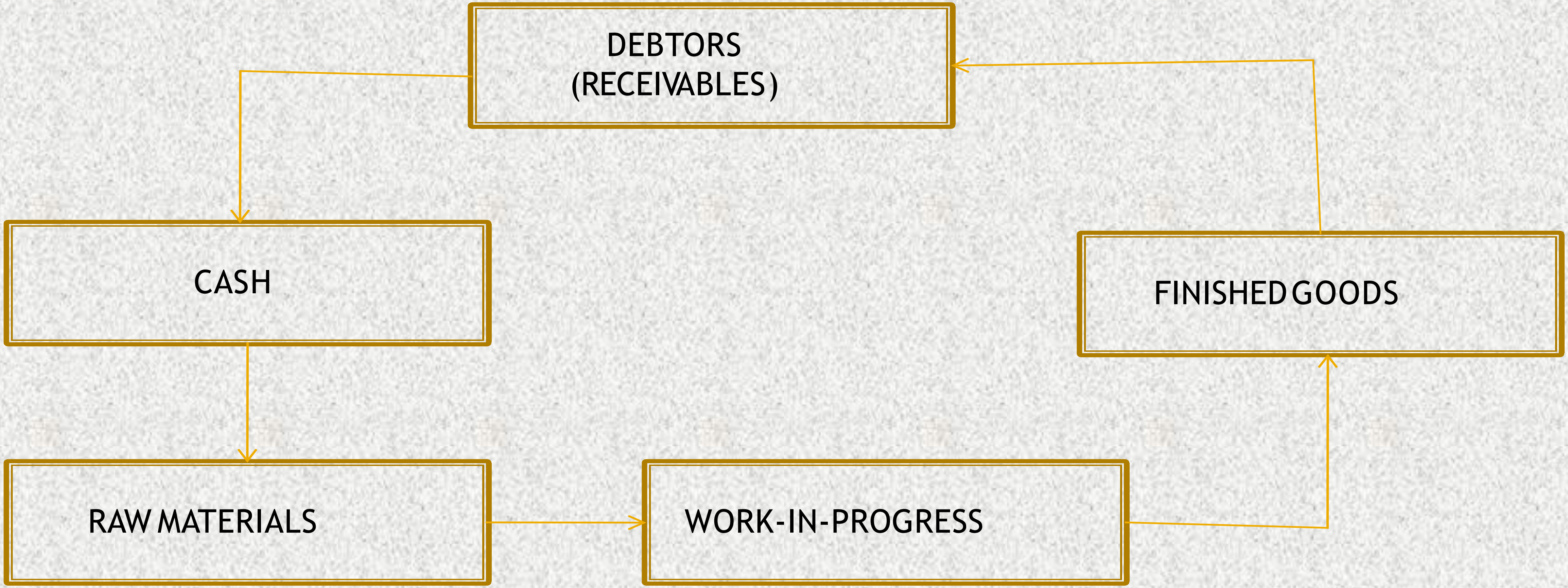
SEASONAL VARIATION

- In certain industries raw material is not available throughout the year.
- The raw materials is bought in bulk.
- Huge amount is blocked in the form of material inventories during such seasons demanding more working capital requirement.

WORKING CAPITAL CYCLE

- In manufacturing firm working capital cycle starts with the purchase of raw material and ends with the realisation of cash from the sale of finished products.
- The speed with which the working capital complete one cycle determines the requirement of working capital.
- Longer the period of the cycle larger the requirement of working capital.

WORKING CAPITAL/OPERATING CYCLE OF A MANUFACTURING CONCERN



RATE OF STOCK TURNOVER

- There is a high degree of inverse co-relationship between the quantum of working capital and the velocity with which the sale is effected.
- Firm with high stock turnover will need lower working capital compared to a firm having low rate of turnover.

CREDIT POLICY

- Credit policy of a concern means how firm deal with their debtors and creditors.
- Concern purchase on credit and sells its products/service on cash require less working capital.
- If the concern buy its requirements for cash and allow credit to its customers will require more working capital since huge fund will be tied up in debtors or receivables.

BUSINESS CYCLE

- Business cycle refers to alternate expansion and contraction in general business activity.
- during boom there is need for more working capital due to increase in sale, rise in prices, optimistic expansion of business etc.
- During depression the business contracts, sales decline, difficulties are faced in collection from debtors and will have large amount of working capital lying idle.

RATE OF GROWTH OF BUSINESS

- Working capital requirement increases with the growth and expansion of business activities.
- It may conclude that for normal expansion in the volume of business, we may have retained profit to meet working capital needs but in fast growing concerns require large amount of working capital.

EARNING CAPACITY AND DIVIDEND POLICY

- A firm that maintain a steady high rate of cash dividend irrespective of its generation of profits need more working capital.
- If the firm that retains larger part of its profit and does not pay so high rate of cash dividend the working capital requirement will be less.

PRICE LEVEL CHANGES

- The effect of rising prices may be different for different firms.
- Some firms may be affected much while some other may not be effected at all.
- Rise in price level will require the firm to maintain larger amount of working capital as more amount is required to maintain the same current assets.

OTHER FACTORS

- Operating efficiency
- Import policy
- Asset structure
- Banking facilities

CONCLUSION

- There are many factors which influence the amount of investment is to be made on working capital.
- The factors are to be considered while fixing the minimum working capital requirement which is un avoidable for the conduct of routine operations of a business.