



## 19BAE711-WORKING CAPITAL MANAGEMENT

### Permanent and Temporary Working Capital

#### Introduction

Working capital refers to the funds that a business requires for its day-to-day operations. It is the difference between a company's current assets and current liabilities. Within the realm of working capital, there are two main types: permanent working capital and temporary working capital. Understanding the differences between these two types is crucial for effective financial management.

#### Permanent Working Capital

**Permanent working capital** refers to the minimum amount of working capital that a company needs to maintain to ensure smooth operations regardless of fluctuations in sales or production levels. It is the baseline level of working capital that remains invested in the business over a long period.

#### *Characteristics of Permanent Working Capital*

- 1. Long-Term Investment:**
  - Permanent working capital is considered a long-term investment in the business as it is consistently required throughout the year.
- 2. Stability:**
  - The amount of permanent working capital remains relatively stable over time, regardless of seasonal or cyclical changes in the business.
- 3. Core Operational Needs:**
  - It covers the core operational needs of the business, such as maintaining minimum inventory levels, covering essential operating expenses, and supporting a base level of accounts receivable.

#### *Importance of Permanent Working Capital*

- 1. Ensures Continuity:**
  - Permanent working capital ensures that the business can continue its operations without interruptions, providing stability and predictability.
- 2. Supports Creditworthiness:**
  - Maintaining adequate permanent working capital enhances the company's creditworthiness, making it easier to obtain financing and favorable credit terms from suppliers.
- 3. Facilitates Long-Term Planning:**
  - Having a stable base of working capital allows for better long-term planning and strategic decision-making.

### *Determinants of Permanent Working Capital*

1. **Nature of Business:**
  - The nature and type of business significantly influence the level of permanent working capital. Manufacturing businesses generally require more permanent working capital compared to service-oriented businesses.
2. **Production Cycle:**
  - Businesses with longer production cycles need higher permanent working capital to finance the ongoing production process.
3. **Sales Volume:**
  - Companies with high and consistent sales volumes require more permanent working capital to support their continuous operations.
4. **Credit Policy:**
  - A company's credit policy affects its permanent working capital requirements. Lenient credit terms to customers increase accounts receivable, thereby increasing permanent working capital needs.

### **Temporary Working Capital**

**Temporary working capital** refers to the additional working capital required to meet seasonal or cyclical demands. It fluctuates with changes in business activity levels and is often tied to specific short-term needs.

### *Characteristics of Temporary Working Capital*

1. **Short-Term Nature:**
  - Temporary working capital is required for a short period, often to meet seasonal or cyclical increases in business activity.
2. **Variable:**
  - The amount of temporary working capital varies based on changes in sales volume, production levels, and market conditions.
3. **Flexible:**
  - Temporary working capital is flexible and can be adjusted based on current operational needs.

### *Importance of Temporary Working Capital*

1. **Supports Seasonal Operations:**
  - Temporary working capital is essential for businesses that experience seasonal fluctuations in sales and production, ensuring they can meet increased demand during peak periods.
2. **Manages Cyclical Variations:**
  - It helps businesses manage cyclical variations in their operations, such as economic cycles or industry-specific cycles.
3. **Optimizes Resource Utilization:**
  - By adjusting working capital levels based on demand, businesses can optimize the utilization of their resources and avoid excess carrying costs.

### *Determinants of Temporary Working Capital*

- 1. Seasonal Demand:**
  - Businesses with seasonal demand patterns, such as retail businesses during holidays or agricultural businesses during harvest seasons, require temporary working capital to handle peak periods.
- 2. Market Conditions:**
  - Changes in market conditions, such as increased competition or shifts in consumer preferences, can impact the need for temporary working capital.
- 3. Economic Cycles:**
  - Economic cycles, including periods of growth or recession, affect the level of temporary working capital required to maintain operations.

## **Managing Permanent and Temporary Working Capital**

### *Strategies for Managing Permanent Working Capital*

- 1. Maintaining a Cash Reserve:**
  - Keeping a cash reserve ensures that the business has sufficient funds to cover its core operational needs without relying heavily on external financing.
- 2. Efficient Inventory Management:**
  - Implementing effective inventory management practices helps maintain optimal inventory levels, reducing the amount of capital tied up in stock.
- 3. Streamlining Receivables:**
  - Implementing strict credit policies and efficient collection procedures helps reduce the amount of capital tied up in accounts receivable.
- 4. Leveraging Long-Term Financing:**
  - Using long-term financing options, such as equity or long-term debt, can provide a stable source of funds for permanent working capital needs.

### *Strategies for Managing Temporary Working Capital*

- 1. Short-Term Financing:**
  - Utilizing short-term financing options, such as lines of credit, trade credit, or short-term loans, can help meet temporary working capital needs during peak periods.
- 2. Adjusting Inventory Levels:**
  - Adjusting inventory levels based on demand forecasts ensures that the business has enough stock to meet increased demand without overstocking.
- 3. Flexible Credit Terms:**
  - Offering flexible credit terms to customers during peak periods can help manage cash flow and ensure timely collections.
- 4. Cash Flow Forecasting:**
  - Regularly forecasting cash flows helps anticipate temporary working capital needs and plan accordingly.

## Example: Managing Permanent and Temporary Working Capital

**Company:** XYZ Apparel

**Background:** XYZ Apparel is a clothing manufacturer that experiences seasonal fluctuations in demand, with peak sales during the holiday season and lower sales during the rest of the year.

### Permanent Working Capital:

- XYZ Apparel maintains a base level of working capital to cover its core operational needs, such as maintaining a minimum level of raw materials, paying for fixed operating expenses, and supporting a base level of accounts receivable.

### Temporary Working Capital:

- During the holiday season, XYZ Apparel requires additional working capital to finance increased production, purchase extra raw materials, and manage higher inventory levels. The company uses short-term financing options, such as a line of credit, to meet these temporary needs.

### Management Strategies:

- **Inventory Management:** XYZ Apparel implements just-in-time inventory practices to reduce holding costs during off-peak periods and increases inventory levels based on demand forecasts for the holiday season.
- **Receivables Management:** The company offers early payment discounts to encourage timely collections during peak periods and implements strict credit policies during off-peak periods to reduce accounts receivable days.
- **Cash Flow Forecasting:** Regular cash flow forecasting helps XYZ Apparel anticipate its working capital needs and plan for both permanent and temporary requirements.

## Conclusion

Effective management of permanent and temporary working capital is crucial for maintaining the financial health and operational efficiency of a business. While permanent working capital ensures the continuity of core operations and supports long-term stability, temporary working capital addresses short-term fluctuations and seasonal demands. By implementing appropriate strategies for managing both types of working capital, businesses can optimize resource utilization, maintain liquidity, and enhance profitability. Understanding the characteristics, importance, and determinants of permanent and temporary working capital is essential for making informed financial decisions and achieving sustainable growth.