WORKING CAPITAL MANAGEMENT

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CAPITAL

- FIXED CAPITAL : The capital which is required for purchase of fixed asset is called Fixed Capital. These are financed through long term borrowings
- WORKING CAPITAL: Capital required for meeting day-to-day expenditure is called working capital.

  Example: Wages, Rent, Advertising etc..

Components of Working Capital

- Current Assets: Current assets are those assets can be turned into cash within an accounting period (not exceeding one year)

  Example: Cash, Debtors, bills receivable, inventories, bank prepaid expenses

- Current Liabilities: Current liabilities are those liabilities intended to be paid within ordinary course of business.

  Example: creditors, loans and advances, short-term borrowings.

Characteristics of Working Capital

- Short-term Needs
- Circular Movement : Cash is used to purchase current assets are transferred into cash
- Element of Permanency : As long as production continues
- Element of Fluctuation

Need and Objects of Working Capital

- Every business needs some amount of working capital
- The need for working capital arises due to the **time gap** between production and sales, sales and realisation of cash.
- This time gap is termed to as “operating cycle”

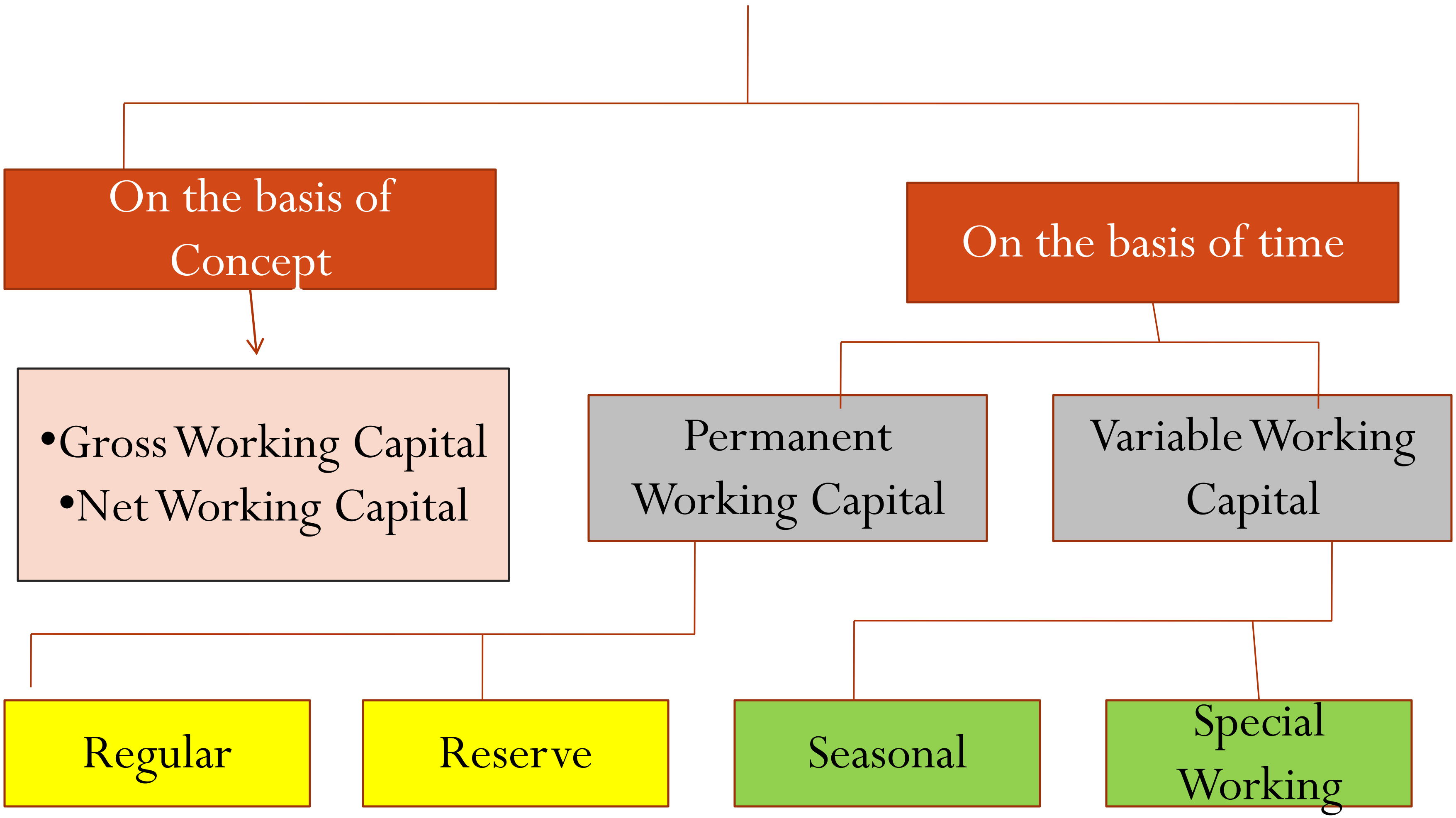
Operating Cycle

- Conversion of Cash into Raw materials
- Conversion of Raw materials into work-in-progress
- Conversion work-in-progress into finished goods
- Conversion of finished goods into debtors through sales
- Conversion of debtors into cash

Objectives/Need of Working Capital

- To purchase raw materials, spares and component parts
- To pay wages and salaries
- To incur day to day expenses
- To meet selling costs such as packaging, advertising
- To provide credit facilities to customers
- To maintain inventories of raw materials, work-in-progress and finished goods

Classification of Working Capital



On Basis of Concepts

- Gross Working Capital: In broad Sense, working capital refers to the gross working capital. This refers to amount of funds invested in current assets.
- **Significance** :

-- Optimum Investment in current asset : Not be inadequate or excessive

-- financing of current assets : Need arises due to increase increasing level of business activity. Therefore, there is a need to arrange it quickly. Sometimes surplus funds may arise, it should be invested properly

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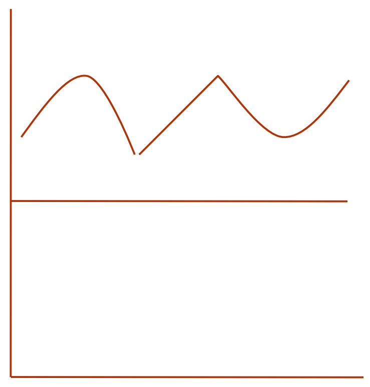
- Net Working Capital: In narrow sense, working capital refers to net working capital. Net working capital is the excess of current assets over current liabilities
- Net working capital may be positive or negative
- Significance: Liquidity
- Negative and Excess working capital both are bad to the firm

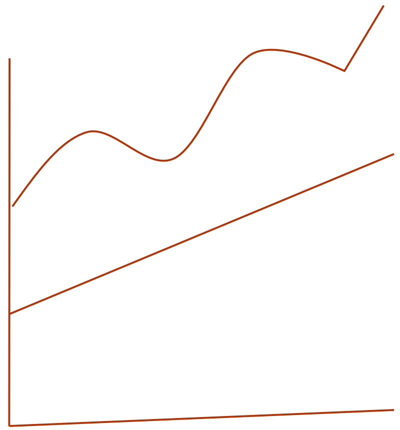
On Basis of Time

- Permanent or Fixed Working Capital: A minimum amount of working capital which is required to carryout its normal operations. **For Example**: A firm must have a minimum level of raw material, work in progress, finished goods & cash
- Temporary or Variable Working Capital: It is amount required by the business over and above the permanent working capital

  Additional capital required for unforeseen events like floods, strikes, fire, price hike tendencies

Diagrams illustrate Permanent and Temporary Working Capital





Determinants of Working Capital

- Nature of Business (manufacturing firms – require large working capital)
- Size of Business : Scale of Operations
- Production Process : Time involved in manufacturing goods
- Production Policy : Continuous or Seasonal Demand for products
- Availability of Raw Material : Easy Availability – less working capital
- Speed of turnover : If sales is slow, more working capital
- Credit Policy relating to sales and purchase

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- Labour Intensive Vs. Capital Intensive Industries
- Growth and Expansion : growth industries require more WC.
- Price level changes
- Dividend Policy
- Profit Level: A firm with high profit level requires less WC
- Operating Efficiency
- Availability of credit

Advantages of Adequate WC

- Continuous Production
- Solvency of the Business : prompt payment to creditors
- Goodwill
- Easy Loans
- Cash Discounts
- Regular Payment of expenses
- Exploitation of market condition
- Quick and Regular Return

Disadvantages of Excess WC:

- Excessive working capital means **idle funds** which earn no profits for the business and cannot earn a proper rate of return on its investments
- Due to **low rate of return**, value of shares will fall
- Redundant working capital may leads to unnecessary purchasing and accumulation of inventories
- It implies excessive debtors
- It may result in overall inefficiency

Disadvantages of Inadequate WC

- Unable to adapt to changes
- Difficult to meet day to day expenses
- Financial Reputation is lost
- Cannot avail cash discount
- Insolvency
- Fixed Assets cannot be effectively utilized

ISSUES IN WORKING CAPITAL

A. CAPITAL POLICY/STRATEGY

B. PROFITABILITY-LIQUIDITY TRADE-OFF

A. APPROACHES OF WC/POLICY/STRATEGY

- MATCHING STRATEGY
- CONSERVATIVE STRATEGY
- AGGRESSIVE STRATEGY
- ZERO WOKING CAPITAL STRATEGY

1. MATCHING STRATEGY

- The basic idea under this approach is to match the needs with appropriate sources
- In short, short term needs must be matched with short term financing
- Long term needs with long term financing
- An asset which is having an expected life of 15 years, should be financed through 15 year loan, 15 year debenture

2. CONSERVATIVE APPROACH

- Under this approach, a firm depends more on long term funds
- In this plan, a firm finances its regular or permanent current assets and a part of temporary current assets with long term sources of funds

3. AGGRESSIVE APPROACH

- A Firm finances part of its regular or permanent current assets with short-term sources of funds
- A firm which follows this approach, is under more risk, but it will prove to have more returns

4. ZERO WORKING CAPITAL STRATEGY:

- Total Current Assets = Total Current liabilities
- Total Current Assets -Total Current liabilities = Zero

B.PROFITABILITY-LIQUIDITY TRADE-OFF

- To maximise the shareholders wealth optimum level of current assets should be determined
- If there is **more** current assets more than required one, **profitability is eroded**
- If there is **less** current assets than required one, **solvency is threatened**
- Therefore, **proper balance** is to be maintained so that **profit** is maximized **without solvency**

ESTIMATION OF WORKING CAPITAL

- Total quantity of units to be produced throughout the year
- The total cost incurred on raw material, labout and overheads
- The length of time raw materials are to remain in stores before they are issued to production
- The length of production cycle time
- The length of sales cycle. That is, period during which finished goods remain in warehouse
- Average credit to debtors
- Amount required for day to day expenses
- Amount of credit allowed by creditors
- Time lag in payment of wages

Methods for estimating WC

- **By determining current assets and current liabilities**: In order to estimate the requirements of working capital one has to forecast the amount of current assets and current liabilities
- **Operating cycle method**: O=(R+W+F+D)-C
- **Percentage of sales method :** working capital requirement is calculated on the basis of percentage of sales.
- The criticism of this method is that it assumes a linear relationship between sales and working capital

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- Percentage of total assets or fixed assets

  -- Working capital requirements are determined on basis of fixed assets

  -- Example: A firm is expecting to have 20% of its total assets in form of current assets and expects to have a total assets of Rs.50,00,000

  -- Then the current assets should be Rs.10,,00,000