

SHERSHAH COLLEGE, SASARAM

FINANCIAL MANAGEMENT

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WORKING CAPITAL

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WORKING CAPITAL MANAGEMENT

The term working capital is commonly used for the capital required for day-to-day working in a business concern, such as for purchasing raw material, for meeting day-to-day expenditure on salaries, wages, rents rates, advertising etc.

DEFINITION AND CLASSIFICATION OF WORKING CAPITAL:

Working capital refers to the circulating capital required to meet the day to day operations of a business firm. Working capital may be defined by various authors as follows:

1. According to Weston & Brigham - —Working capital refers to a firm's investment in short term assets, such as cash amounts receivables, inventories etc.
2. According to Mead, Baker and Malott -Working capital means current assets.
3. According to J.S.Mill - The sum of the current assets is the working capital of the business. Working capital is defined as the excess of current assets over current liabilities and provision.

Working capital has been described as the —life blood of any business which is apt because it constitutes a cyclically flowing stream through the business.

Concepts of working capital

1. **Gross Working Capital:** It refers to the firm's investment in total current or circulating assets.
2. **Net Working Capital:** The term —Net Working Capital has been defined in two different ways:

i. It is the excess of current assets over current liabilities ($WC = CA - CL$). This is, as a matter of fact, the most commonly accepted definition. Some people define it as only the difference between current assets and current liabilities. The former seems to be a better definition as compared to the latter.

ii. It is that portion of a firm's current assets which is financed by long-term funds.

3. Permanent Working Capital: This refers to that minimum amount of investment in all current assets which is required at all times to carry out minimum level of business activities. In other words, it represents the current assets required on a continuing basis over the entire year. Tandon Committee has referred to this type of working capital as —Core current assets. The following are the **characteristics** of this type of working capital:

I. Amount of permanent working capital remains in the business in one form or another. This is particularly important from the point of view of financing. The suppliers of such working capital should not expect its return during the life-time of the firm.

II. It also grows with the size of the business. In other words, greater the size of the business, greater is the amount of such working capital and vice versa Permanent working capital is permanently needed for the business and therefore it should be financed out of long-term funds.

4. Temporary Working Capital: The amount of such working capital keeps on fluctuating from time to time on the basis of business activities. In other words, it represents additional current assets required at different times during the operating year. For example, extra inventory has to be maintained to support sales during peak sales period. Similarly, receivable also increase and must be financed during period of high sales. On the other hand investment in inventories, receivables, etc., will decrease in periods of depression. Suppliers of temporary working capital can expect its return during off season when it is not required by the firm. Hence, temporary working capital is generally financed from short-term sources of finance such as bank credit.

5. Negative Working Capital: This situation occurs when the current liabilities exceed the current assets. It is an indication of crisis to the firm. Need for Working Capital Working capital is needed till a firm gets cash on sale of finished products. It depends on two factors:

i. Manufacturing cycle i.e. time required for converting the raw material into finished product; and

ii. Credit policy i.e. credit period given to Customers and credit period allowed by creditors. Thus, the sum total of these times is called an Operating cycle and it consists of the following six steps:

- Conversion of cash into raw materials.
- Conversion of raw materials into work-in-process.

- Conversion of work-in-process into finished products.
- Time for sale of finished goods—cash sales and credit sales.
- Time for realization from debtors and Bills receivables into cash.
- Credit period allowed by creditors for credit purchase of raw materials, inventory and creditors for wages and overheads.

DETERMINANTS OF WORKING CAPITAL:

The factors influencing the working capital decisions of a firm may be classified as two groups, such as internal factors and external factors. The internal factors includes, nature of business size of business, firm's product policy, credit policy, dividend policy, and access to money and capital markets, growth and expansion of business etc. The external factors include business fluctuations, changes in the technology, infrastructural facilities, import policy and the taxation policy etc. These factors are discussed in brief in the following lines.

Internal Factors

1. Nature and size of the business - The working capital requirements of a firm are basically influenced by the nature and size of the business. A firm with larger scale of operations will need more working capital than a small firm. Similarly, the nature of the business influence the working capital decisions. Trading and financial firms have less investment in fixed assets. But require a large sum of money to be invested in working capital. Retail stores, business units require larger amount of working capital, whereas, public utilities need less working capital and more funds to invest in fixed assets.

2. Firm's production policy - The firm's production policy is an important factor to decide the working capital requirement of a firm. The production cycle starts with the purchase and use of raw material and completes with the production of finished goods. On the other hand production policy is uniform production policy or seasonal production policy etc., also influences the working capital decisions. Larger the manufacturing cycle and uniform production policy –larger will be the requirement of working capital. The working capital requirement will be higher with varying production schedules in accordance with the changing demand.

3. Firm's credit policy - The credit policy of a firm influences credit policy of working capital. A firm following liberal credit policy to all customers require funds. On the other hand, the firm adopting strict credit policy and grant credit facilities to few potential customers will require less amount of working capital.

4. Availability of credit - The working capital requirements of a firm are also affected by credit terms granted by its suppliers i.e. creditors. A firm will need less working capital if liberal credit terms are available to it. Similarly, the availability of credit from banks also influences the working capital needs of the firm. A firm, which can get bank

credit easily on favourable conditions, will be operated with less working capital than a firm without such a facility.

5. Growth and expansion of business - Working capital requirement of a business firm tend to increase in correspondence with growth in sales volume and fixed assets. A growing firm may need funds to invest in fixed assets in order to sustain its growing production and sales. This will, in turn, increase investment in current assets to support increased scale of operations. Thus, a growing firm needs additional funds continuously.

6. Profit margin and dividend policy - The magnitude of working capital in a firm is dependent upon its profit margin and dividend policy. A high net profit margin contributes towards the working capital pool. To the extent the net profit has been earned in cash, it becomes a source of working capital. This depends upon the dividend policy of the firm. Distribution of high proportion of profits in the form of cash dividends results in a drain on cash resources and thus reduces company's working capital to that extent. The working capital position of the firm is strengthened if the management follows conservative dividend policy and vice versa.

7. Operating efficiency of the firm - Operating efficiency means the optimum utilisation of a firm's resources at minimum cost. If a firm successfully controls operating cost, it will be able to improve net profit margin which, will, in turn, release greater funds for working capital purposes.

8. Coordinating activities in firm - The working capital requirements of a firm is depend upon the co-ordination between production and distribution activities. The greater and effective the co-ordinations, the pressure on the working capital will be minimized. In the absence of co-ordination, demand for working capital is reduced.

External Factors

1. Business fluctuations - Most firms experience fluctuations in demand for their products and services. These business variations affect the working capital requirements. When there is an upward swing in the economy, sales will increase, correspondingly, the firm's investment in inventories and book debts will also increase. Under boom, additional investment in fixed assets may be made by some firms to increase their productive capacity. This act of the firm will require additional funds. On the other hand when, there is a decline in economy, sales will come down and consequently the conditions, the firm try to reduce their short-term borrowings. Similarly the seasonal fluctuations may also affect the requirement of working capital of a firm.

2. Changes in the technology - The technological changes and developments in the area of production can have immediate effects on the need for working capital. If the firm wish to install a new machine in the place of old system, the new system can utilise less expensive raw materials, the inventory needs may be reduced there by working capital needs.

3. Import policy - Import policy of the Government may also effect the levels of working capital of a firm since they have to arrange funds for importing goods at specified times.

4. Infrastructural facilities - The firms may require additional funds to maintain the levels of inventory and other current assets, when there is good infrastructural facilities in the company like, transportation and communications.

5. Taxation policy - The tax policies of the Government will influence the working capital decisions. If the Government follow regressive taxation policy, i.e. imposing heavy tax burdens on business firms, they are left with very little profits for distribution and retention purpose. Consequently the firm has to borrow additional funds to meet their increased working capital needs. When there is a liberalized tax policy, the pressure on working capital requirement is minimised. Thus the working capital requirements of a firm is influenced by the internal and external factors.