Semester VI (Program)
Financial Management
Unit 4 working Capital Management

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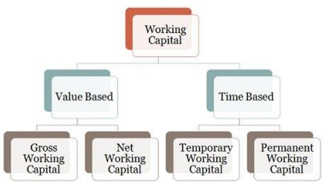
Concept of working capital :-

Working capital, also known as net working capital (NWC), is the difference between a company's current assets, such as cash, accounts receivable (customers' unpaid bills) and inventories of raw materials and finished goods, and its current liabilities, such as accounts payable. Net operating working capital is a measure of a company's liquidity and refers to the difference between operating current assets and operating current liabilities. In many cases these calculations are the same and are derived from company cash plus accounts receivable plus inventories, less accounts payable and less accrued expenses.
Working capital is a measure of a company's
liquidity , operational efficiency and its short-term financial health. If a company has substantial positive working capital, then it should have the potential to invest and grow. If a company's current assets do not exceed its current liabilities, then it may have trouble growing or paying back creditors, or even go bankrupt.

Working capital Management :-

Working capital management involves the relationship between a firm's short-term assets and its short-term liabilities. The goal of working capital management is to ensure that a firm is able to continue its operations and that it has sufficient ability to satisfy both maturing short-term debt and upcoming operational expenses. The management of working capital involves managing inventories, accounts receivable and payable, and cash.

Classification Of Working Capital :-



1. **On the basis of value :-**

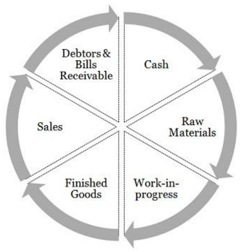
Gross Working Capital : It denotes the company's overall investment in the current assets.
Net Working Capital : It implies the surplus of current assets over current liabilities. A positive net working capital shows the company's ability to cover short-term liabilities, whereas a negative net working capital indicates the company's inability in fulfilling short-term obligations.

2. **On the basis of Time**

Temporary working Capital : Otherwise known as variable working capital, it is that portion of capital which is needed by the firm along with the permanent working capital, to fulfil short-term working capital needs that emerge out of fluctuation in the sales volume.
Permanent Working Capital : The minimum amount of working capital that a company holds to carry on the operations without any interruption, is called permanent working capital.

Other types of working capital include Initial working capital and Regular working capital. The capital required by the promoters to initiate the business is known as initial working capital. On the other hand, regular working capital is one that is required by the firm to carry on its operations effectively.

WORKING CAPITAL CYCLE :-



Working Capital Cycle or popularly known as operating cycle, is the length of time between the outflow and inflow of cash during the business operation. It is the time taken by the firm, for the payment of materials, wages and other expenses, entering into stock and realizing cash from the sale of the finished good.
In short, the working capital cycle is the average time required to invest cash in assets and reconverting it into cash by selling the assets produced.
The working capital cycle may vary from enterprise to enterprise depending on various factors, such as nature and size of business, production policies, manufacturing process, fluctuations in trade cycle, credit policy, terms and conditions for purchase and sales, etc.

Importance Of Working Capital Management :-

The management of working capital is essential for the proper and smooth working of any business. Working capital management is important in various organization due to the following reasons –
1. Improvement in the Credit Profile and Solvency of th Company
2. Use of Fixed Assets Efficiently
3. Ability to Face Crises
4. Expansion
Let us discuss these in detail one by one.

#1 – Improvement in the Credit Profile and Solvency of the Company

If the company pays off the debts on time while generating revenues, then it ensures that the operating cycle of the company is properly funded, which will likely to boost the credit score of the company. Whereas if the company is unable to repay its debts on time and still it is running the business with the low operating costs then the creditors will try to get back their funds and this would lead to a decrease in the credit score.
The pre-requisite to the long-term solvency is the ability for the company of meeting its short-term obligations and the adequate management of the working capital will make the business to pay all of its short-term obligations on timely basis like the salary payment, payment against the purchase of the raw materials , and other such operating expenses of the company.

#2 – Use of Fixed Assets Efficiently

Proper management of the working capital and availability of adequate working capital all the time will enable the company to effectively and efficiently use the fixed assets present. In case because of the unavailability or paucity of working capital, the fixed assets of the company remains idle then in that case also the depreciation has to be charged and the interest on capital borrowed is to be paid on fixed assets i.e., the company have to incur the fixed expenses on the fixed assets unnecessarily even though it is not using it. So, with the help of working capital management, fixed assets can also be managed and used in an effective manner.

#3 – Ability to Face Crises

In case there is proper management of the working capital then the business concern will be able to face crises properly during the emergency period like depression. Generally, the companies keep don’t have the adequate amount of working capital in case of an emergency which will affect the business negatively in can any emergency occurs.

#4 – Expansion

If any company is planning to expand its business then that would require the additional capital. In case there adequate management of working capital then that could lead to the implementation of the expansion program successfully.

Determinants of Working Capital Requirement
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1. Nature of business:

It is an important factor for determining the amount of working capital needed by various companies. The trading or manufacturing concerns will require more amount of working capital along-with their fixed investment of stock, raw materials and finished products. Public utilities and railway companies with huge fixed investment usually have the lowest needs for current assets, partly because of cash, nature of their business and partly due to their selling a service instead of a commodity. Similarly, basic and key industries or those engaged in the manufacture of producer's goods usually have less proportion of working capital to fixed capital than industries producing consumer goods.

2. Length of period of manufacture:

The average length of the period of manufacture, i.e., the time which elapses between the commencement and end of the manufacturing process is an important factor in determining the amount of the working capital.
If it takes less time to make the finished product, the working capital required will be less. To give an example, a baker requires one night time to bake his daily quota of bread. His working capital is, therefore, much less than that of a shipbuilding concern which takes three to five years to build a ship. Between these two cases may fall other business concerns with varying periods of manufacture requiring different amounts of working capital.

3. Volume of business:

Generally, the size of the company has a direct relation with the working capital needs. Big concerns have to keep higher working capital for investment in current assets and for paying current liabilities.

4. The proportion of the cost of raw materials to total cost:

Where the cost of raw materials to be used in manufacturing of a product is very large in proportion to the total cost and its final value, working capital required will also be more. That is why, in a cotton textile mill or in a sugar mill, huge funds are required for this purpose. A building contractor also needs huge working capital for this reason. If the importance of materials is less, as for example in an oxygen company, the needs of working capital will be naturally not more.

5. Use of Manual Labour or Mechanisation:

In labour intensive industries, larger working capital will be required than in the highly mechanized ones. The latter will have a large proportion of fixed capital. It may be remembered, however, that to some extent the decision to use manual labour or machinery lies with the management. Therefore, it is possible in most cases to reduce the requirements of working capital and increase investments in fixed assets and vice versa.

6. Need to keep large stocks of raw materials of finished goods:

The manufacturing concerns generally have to carry stocks of raw materials and other stores and also finished goods. The larger the stocks (whether of raw materials or finished goods) more will be the needs of working capital.
In certain lines of business, e.g., where the materials are bulky and have to be purchased in large quantities, (as in cement manufacturing), stock piling of raw-material is used.

Similarly, in public utilities, which must have adequate supplies of coal to assure regular service, stock piling of coal is necessary. In seasonal industries finished goods stocks have to be stored during off seasons. All these require large working capital.

7. Turnover of working capital:

Turnover means the speed with which the working capital is recovered by the sale of goods. In certain businesses, sales are made quickly and the stocks are soon exhausted and new purchases have to be made. In this manner, a small amount of money invested in stocks will result in sales of much larger amount.
Considering the volume of sales, the amount of working capital requirements will be rather small in such type of business. There are other businesses where sales are made irregularly. For example, in case of jewellers, a costly jewellery may remain locked up in the show-window for a long period before it catches the fancy of a rich lady.
In such cases, large sums of money have to be kept invested in stocks. But a baker or a news-hawker may be able to dispose of his stocks quickly, and may, therefore, need much smaller amounts by way of working capital.

8. Terms of Credit:

A company purchasing all raw-materials for cash and selling on credit will be requiring more amount of working capital. Contrary to this, if the enterprise is in a position to buy on credit and sell it for cash, it will need less amount of working capital. The length of the period of credit has a direct bearing on working capital.
The essence of this is that the period which elapses between the purchase of materials and sale of finished goods and receipts of sale proceeds, will determine the requirements of working capital.

9. Seasonal Variations:

There are some industries which either produce goods or make sales only seasonally. For example, the sugar industry produces practically all the sugar between December and April and the woollen textile industry makes its sales generally during winter.
In both these cases the needs of working capital will be very large, during few months {i.e., season). The working capital requirements will gradually decrease as and when the sales are made.

10. Requirements of Cash:

The need to have cash in hand to meet various requirements e.g., payment of salaries, rents, rates etc., has an effect on the working capital. The more the cash requirements the higher will be working capital needs of the company and vice versa.

11. Other Factors:

In addition to the above mentioned considerations there are also a number of other factors which affect the requirements of working capital. Some of them are given below.
(i) Degree of co- ordination between production and distribution policies.
(ii) Specialisation in the field of distribution.
(iii) Developments of means of transportation and communications.
(iv) The hazards and contingencies inherent in the type of business.

Strategies Of Financing Current Assets :-

There are three current assets financing strategies:

1. **Maturity Matching financing Strategy :** This strategy finances permanent current assets and fixed assets with long term sources and temporary current assets with short term sources
2. **Conservative Financing strategy :-** In this strategy only a portion of temporary current assets ate financed with short term sources. Long term financing is used to fund the other portion of temporary current assets along with the permanent current assets and fixed assets.
3. **Aggressive Financing Strategy :-** Using an aggressive financing strategy, a company will finance a portion of permanent current assets and all temporary current assets with short term sources. Long term financing is used to fund the other portion of permanent current assets and fixed assets.

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