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Working Capital management

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Abstract

Every business needs substantial working capital for its survival as well as smooth operation of its business and to maintain the leval of its efficiency. On the one hand, a business invests a major portion of its resources in long terms assists, such as land, Building, and machinery etc., so that the business may earn sufficiently for a longer period. These are called fixed assists. On the other hand the prime objective of investment in working capital is to utilizes the fixed assists efficiently and effectively. For example, if a manufacturing concern purchase a machine, It is its fixed capital investment because it will be used in production to earn profits. But the raw material, which will be used in production, is not the fixed capital of the firm, but it was purchased just for resale after conversion into finished goods. Hence, investment in raw materials will be as working capital management.

Key-Words : Capital Investment, Working Capital.

Definition of Working Capital

"Any acquisition of funds which increases the Current Assists increases Working Capital, for they are one and the same." –Bonnevilla and Deway

Concepts of Working Capital

There are 2 concepts of working capital.1. Gross working capital.2. Net working Capital.

Gross Working Capital in fact, working capital means Gross Working Capital. It means the firm's investment in current assist. Current assets are the assists which be converted into cash within an accounting period or one year (normally).

Net Working Capital Net working capital means the difference between current assets and current liabilities. Current liabilities means the l inabilities which the firm has to pay within the one year (e.g.-creditors, outstanding expenses, Bill payable, bank overdraft etc.). The result of net working capital may be positive or also be a negative.

Difference Between Gross Working Capital And Net Working Capital

Gross Working Capital	Net Working Capital
1. All Current Assets	1. Current Assets – Current Liabilities
2. How to Finance Current Assest to meet Current Liabilities	2. Appropriate amount of Current Assets
3. Zero (0) or plus (+)	3. Zero (0), or Plus (+) or Negative(-)

Classification of Working Capital some portion of working capital is fixed natured and some portion fluctuates for some time. In the view point working capital classified in to 2 classes,

a. Fixed or permanent working capital
b. Variable or temporary working capital

Fixed or Permanent Working Capital The fund , which is required to produce a certain amount of goods or services at a certain period of time, is called fixed working capital. The minimum amount of cash money, A/R, which are kept to operate the business is called fixed working capital.

Variable working capital When extra working capital is required then a addition to fixed working capital due to seasonal causes or increased production or sales, this working capital is variable working capital. So, the working capital which fluctuates with keeping the relation between production & sales is variable working capital.

Management of Working Capital

The goal of working capital management is to manage the current assests and current liabilities of a firm in such way that working capital is maintained at a satisfactory level. The current assets should be large enough to pay the current liabilities in time while not keeping too high a level of any one of them. The interaction between current asset and current liabilities is, therefore, the main objective of management of working capital.

Objective of Working Capital Management

1. **To determine the adequate or optimum quantum of investment in working capital** investment in working capital should neither be excessive nor inadequate.

2. **To determine the structure of current assets** The financial management is required to determine the composition or current assests. It should decide how much amount should be invested in each individual current assests.
3. **To determine the policy or means of finance for current assets** Another important aspects of working capital management is to determining the financing mix i.e. what will be the sources of financing the current assets. There are mainly two sources from which funds can be raised for current assets financing.

a) **Short Term Sources** Such as short term bank loans and other current liabilities such as creditors, bills payable etc.

b) **Long Term Sources** Such as share capital, long term borrowings, retained earnings etc.

Sources of Working Capital

The current assets which are used in running daily operation of a business is called working capital. Working Capital may be classified as Fixed working capital and Variable working capital. Both types of working capital help in running firm's daily operation. Fixed working capital should be financed from long-term source & variable working capital from short term source. So variable from the following sources are as financed

a) **Short Term Bank Loan (STBC) –** It is a big source of w.cap. Usually firm finance through STBL to meet the need of variable WC and need in excess of FWC. Commercial banks gives bank O/D, cash credit etc.

b) **Non Bank Short Term Loan** Relatives, Bankers, Govt. Institute are the non bank S.T. Loan

c) **Internal Source**One of the main sources w. Cap for a firm in Internal Sources. This is also called Self-financing.

d) **Long term Sources (LTS)** Sometimes W.Cap is financed through LTS. Usually fixed working capital are share, debenture LT loan etc.

e) **Money Lenders** When Firms can't finance short-term need of w.cap form anywhere, they take loan form moneylenders.

f) **Trade Credit** When firms purchase on credit & pay the money according to credit term, it is called Trade Credit. Normally Trade credit is used as a source of variable W.Cap.

g) **Selling out Excess of Fixed Asset** If any fixed asset is considered as extra than need, then that idle fixed asset is sold for working capital.

Other than the above sources, firms finances their working capital though paying debts in late (as much as possible) & Accrual etc.

Collect money/Receivable in the earliest time, pay as late as possible.

Determinants of Working Capital

1. **Small or Large Business** It is the first determinant of working capital that it is affected with the nature of business. Business may be small or large. In small business, company need high working capital because, small business is relating to trading of goods, for starting small business, you need very small fixed capital but need high working capital for paying day to day expenses. But in large business, we require more fixed capital than working capital.
2. **Small or Large Demand** Nature of demand also absolutely affects the working capital need. Some product can be easily sold by businessman, in that business; you need small amount of working capital because your earned money from sale can easy fulfill the shortage of working capital. But, if demand is very less, it is required that you have to invest large amount of working capital because you all fixed expenses must be paid by you.
3. **Production Policy** Production policy is also main determinant of working capital requirement. Different company may different production policy. Some companies stop or decrease the production level in off seasons, in that time, company may also reduce the number of employees or decrease the purchasing of new raw material, so, it will certainly decrease the amount of working capital but on the side, some company may continue their production in off season, in that case, they need definitely large amount of working capital.
4. **Credit Policy** Credit policy is relating to purchasing and selling of goods on credit basis. If company purchases all goods on credit and sells on cash basis or advance basis, then it is certainly company need very low amount of working capital. But if in company, goods are purchased on cash basis, and sold on credit basis, it means, our earned money will receive after sometime and we require large amount of working capital by taking short term loan for paying uncertain liability.
5. **Dividend Policy** Dividend policy also effect working capital requirement. Company can distribute major part of net profit. But, if there is no reserve, we have to invest large amount in working capital because, lacking of reserve will affect on adversely on fulfill our liabilities. In that case, we have to yield working capital by taking short term loan for paying uncertain liability.
6. **Working Capital Cycle** Working capital cycle shows all starts from cash purchasing of raw material and then this converted into finished product, after this it is converted into sale, if it is credit sale, debtors will also the part of working capital cycle and when we gets money from our debtors, it is the final part of working capital cycle. If we receive fastly from our debtors, we need small amount working capital. Otherwise, for purchasing new raw material, we need more amount of working capital.

7. **Manufacturing Cycle** Manufacturing cycle means the process of converting raw material into finished product. Long manufacturing cycle will create the situation in which we require large amount of working capital. Suppose, we have to construct the building, for constructing colony of buildings, it may consume the time more than 5 years, so according to this we need working capital.
8. **Business Cycle** There are two main part of business cycle, one is boom and other is recession. In boom, we need high money or working capital for development of business but in recession, we need only low amount of working capital.

Disadvantage of Inadequate Working Capital

If a firm's level of working capital is very less or inadequate, then the firm has to face many problem is like the following

1. The business may be closed due to inadequate working capital.
2. Fixed assets cannot be utilized properly, even firm may face problem in repair and maintenance
3. Firm may lose attractive cash discount given by sellers due to lack of working capital.
4. Planning may not be implemented and the goal of profit is not achieve.
5. Growth of the firm is hampered; as a result, firm cannot take profitable project.
6. Liquidity is hampered due to inadequate capital.
7. Firm's goodwill is reduced if the firm cannot pay its short-term liabilities.
8. Firm may be failure in dividend payment. As a result, dividend policy may be badly affected.

Trade-Off between Profitability and Risk In evaluating a firm's net working capital, an important consideration is the tradeoff between profitability and risk. The term risk is defined as the possibility that a firm will become technically insolvent so that it will not be able to meet its obligation when become due for payment. Net working Capital, as measure of liquidity, is not only very useful evaluating the profitability – risk tradeoff, there are three assumptions:-

a) We are dealing with manufacturing him.'
b) Current assets are less profitable than fixed assets.
c) Short-term are less expensive than long term funds.

Four Components

a) Conversion of cash into inventory.
b) Conversion of Inventory into Finished Goods.
c) Conversion of Finished good into account receivable
d) Conversion of Account Receivable into cash.

Cash Conversion Cycle

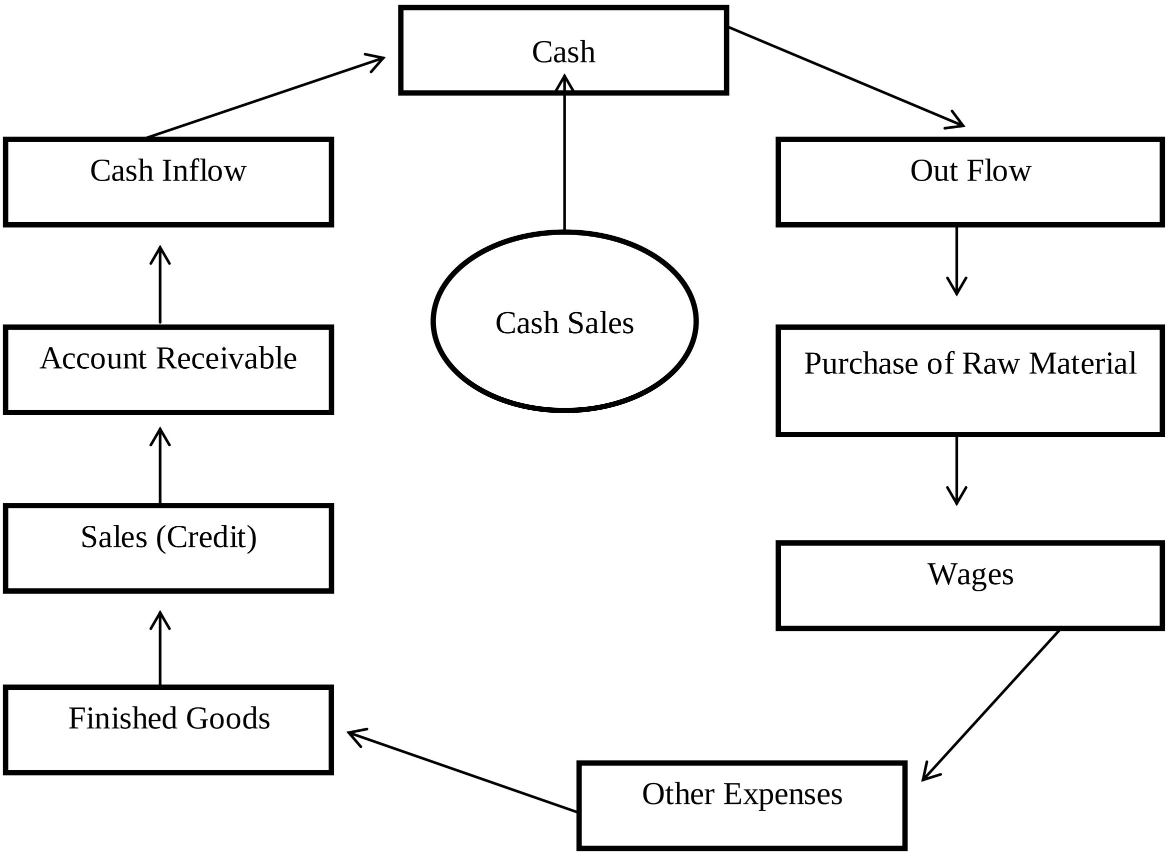

Fig: The Working Capital Cycle

Determination of Net Working Capital:

SL	Particulars	Amount	Total
	A. Current Assest		
	1. Cash in Hand/at Bank	xxx	
	2. Raw Materials	xxx	
	3. Work-In-Progress	xxx	
	i. Raw Material	xxx	
	ii. Direct Labour	xxx	
	iii. Overhead	xxx	Xxx
	4. Finished Goods	xxx	
	5.Debtors	xxx	
	6. Prepaid Expenses	xxx	
	7. Others		
	Total Current Assets (TCA)		Xxx
	B. Current Liabilities		
	1. Creditors	xxx	
	2. Accounts Payables	xxx	
	3. Arrear	xxx	Xxx
	4. Advance Income	xxx	
	Total Current Liablities (TCL)		Xxx
	Net Working Capital (A-B) (TCA-TCL)		Xxx

CCC = (Inventory Conversion Period + Receivable Conversion Period – Payable differed Period)

Adequate working capital is an index of the liquidity of business or capacity to make payment immediately. Following are the main causes which underline the need for working capital:

a) Payment of daily expenses.
b) Payment of current liabilities on time.
c) Taking advantage of cash discount.
d) Taking advantage of favourable opportunities of the market.
e) Continuity in production

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