CHAPTER: 2

MANAGEMENT OF WORKING CAPITAL: AN INTEGRATED VIEW

Working capital management is the administration of the company’s current assets and the financing needed to support current assets. “Working capital management is an act of planning, organizing and controlling the components of working capital like cash, bank balance, inventory, receivables, payables, overdraft and short-term loans”

2.1 DEFINITION

According to Smith K. V, “Working capital management is concerned with the problems that arise in attempting to manage the current assets, current liabilities and the interrelationship that exist between them”.

According to Weston and Brigham, Working capital generally stands for excess of current assets over current liabilities. Working capital management therefore refers to all aspects of the administration of both current assets and current liabilities”.

The objective of working capital management is to manage the company’s current assets and liabilities in a way that a reasonable level of working capital is maintained. If a company is unable to keep up a suitable level of working capital; it is likely to turn out to be bankrupt and may even be forced into insolvency. The current assets must be adequate to cover up its current liabilities in order to make sure a rational margin of well being. Each of the current assets must be managed effectively in order to keep up the liquidity of the company whilst not retaining too high level of any one of those. Every short term sources of financing should be incessantly managed to make sure that these are acquired and utilized in most excellent and potent method. The interaction amid current assets and current liabilities is, consequently, the foremost subject matter of the assumption of working capital
management. Working capital management is related with the steps which take place in managing the current assets, current liabilities and interrelationship that strike between them. In a straightforward terminology, management of working capital means to make decisions for maintaining components of working capital at most advantageous level. Working capital management not only manages current assets but also manages current liabilities as well. It is a science and art by which we organize its various factors and determinants which affect working capital. Working capital management is effective employment of liquid sources for short term liabilities. Working capital management is useful for maintaining adequate cash flow in order to meet its short-term liabilities and working expenditure.

“Management of Working Capital is also an important part of financial manager. The main objective of the Working Capital Management is managing the Current Assets and Current Liabilities. Simply it is called Administration of Current Assets and Current Liabilities of the business concern”  

2.2 SIGNIFICANCE OF MANAGEMENT OF WORKING CAPITAL

To run an operation of a company smoothly, adequate amount of working capital is extremely indispensable. Effective management of working capital can facilitate exploitation of fixed assets advantageously, for reassurance of the company’s long-term accomplishments and attainment of long term objectives of maximization of the stakeholder’s funds. Poor management of cash may result in loss of not only cash concessions but that of goodwill as well owing to non-payment of payables by fixed time. Inadequate inventories may be the major reason of manufacturing delays and it may force the company to procure raw materials at exorbitant prices. Similarly facility of credit sale is also extremely necessary for increase of sales. It has been rightly experienced that on so many times a company’s breakdown occurs owing to inadequate working capital.
Sufficient working capital provides a cushion against cash crunch, as the company can tide over the period of depression, with no much complication. To keep away from disturbance in the production program and keep up the sales, an organization requires finances to invest in inventories and receivables.

The sufficiency of cash and current assets collectively with their proficient management practically determines the survival or failure of a company. A business concern should keep up satisfactory working capital for its high-quality performance. Disproportionate and insufficient working capital will damage both the productivity as well as general vigor of a company.

Resources are required in every company for operating everyday business. Working capital recourses are treated like life blood of a company. A company is able to live and continue to exist without making earnings but cannot survive if it lacks working capital. If a company is not earning income it may be treated as ‘ill’, but, not having working capital possibly will cause its bankruptcy. Therefore, every company must make a decision to keep the working capital at optimal level to face the menace of breakdown or closure.

Working capital has attained an immense implication in the recent times for the look-alike objectives of productivity and liquidity. In an era of increasing capital expenses and scarce resources, the working capital is one of the most vital parts requiring administration’s appraisal. Chiefly the victory of a company relies upon appropriate management of working capital; hence working capital management has been treated as the driving seat of financial executives.

Management of working capital consumes considerable time of executives in arrangement of current assets to increase profitability in addition to keep appropriate liquidity at smallest amount of threat. There are lots of aspects of management of working capital which formulate it as a significant task of the finance executives. In fact we should be
acquainted with, as to at what time to look for working capital sources, how to employ, evaluate, arrange and be in control of them.

2.3 ISSUES IN MANAGEMENT OF WORKING CAPITAL

Management of working capital is related to the administration of all facets of current assets, i.e. cash, marketable securities, receivables, inventory and payables. The financial executive is required to establish the levels and configuration of current assets. He ought to observe that accurate sources are tapped for funding current assets and current payment obligations are met in due course.

There are many facets of working capital management which attribute it as a significant role of the financial executive. Experimental observation, have shown that the financial executives have to devote a large part of their time to the day to day operations, concerning current assets and current liabilities of the companies. Because, the major part of the financial executive’s precious time is dedicated to working capital complications, it is essential to manage working capital effectively and efficiently to obtain the maximum benefits.

Outlay in current assets represents an extremely noteworthy segment of the total spending in assets. It undoubtedly indicates that the financial executive must pay due consideration to the administration of current assets on the long-run. Actions must be taken to restrict redundant outlay in current assets. Working capital management is significant for all companies, but for small companies it is all the more important. A small company may not have a large amount of outlay in fixed assets, but it has to invest in current assets. Small companies experience a harsh difficulty of collecting their receivables. Further, the function of current liabilities in financing current assets is crucial in case of small companies, unlike large companies, which experience difficulties in raising funds on the
long term basis.

There is a direct linkage between a company’s development and its working capital requirements. As turnover grows, the company wants to invest more in inventory and receivables. These requirements turn out to be extremely recurrent and speedy when turnover grows continuously. The financial executive is supposed to be conscious of such requirements and funding them rapidly. Uninterrupted growth in turnover may also have the need of further investment in fixed assets.

It may, thus, be inferred that all safety measures ought to be taken for the effectual and proficient administration of working capital. The finance executives need to pay meticulous attention to attain adequate levels of current assets and the funding of current assets. To make a decision relating to the levels and funding of current assets, the risk-return implications have to be analyzed.

The following issues should be kept in mind by financial executives while managing the working capital:-

2.3.1 Current Assets to Fixed Assets Ratio

The financial executives must decide the most advantageous level of current assets so that the worth of shareholders is maximized. A company requires fixed and current assets to maintain a pre-decided level of output. However, to maintain the same level of production, the company is able to contain various levels of current assets. As the company’s production and sales increases, the requirement for current assets also goes upward. Generally, current assets does not increase in direct proportion to production level, current assets may increase in inverse proportion to production level. This relationship is based upon the concept that it takes a larger relative outlay in current assets when only a small number of units of production are manufactured than it does afterward when the company can utilize its current assets more efficiently and effectively.
The level of the current assets can be computed by dividing amount of current assets by amount of fixed current assets which gives CA/FA ratio. Keeping high level of CA/FA ratio shows conservative current assets practices and a lesser CA/FA ratio means aggressive current assets practices assuming other factors to be unchanged. A conservative policy depicts high level of liquidity and lesser risk; whereas an aggressive policy depicts higher risk and low level of liquidity. The current assets practices of the majority of companies possibly will fall between these two extreme policies.

2.3.2 Liquidity VS Profitability: Risk-Return Trade-off

The Company should make just adequate outlay in current assets if it were potential to estimate working capital requirements correctly. Under conditions of right certainty, current assets investment would be at the lowest level. High investment in current assets under conditions of certainty would mean a little pace of return on investment for the company, as surplus investment in current assets, on the contrary, would mean intermittent manufacturing and sales, because of recurrent stock-outs and incapability to make timely payments to creditors owing to restraining policy.

As it is not probable to approximate working capital requirements correctly, the company must make a decision regarding levels of current assets which have to be maintained. Its current assets holdings will rely on its working capital policy. It may perhaps pursue after a conservative or an aggressive policy. These policies contain risk-return trade-offs. A conservative policy means lesser returns and risk, whilst an aggressive policy means high returns and risk

2.4 OBJECTIVES OF MANAGEMENT OF WORKING CAPITAL

2.4.1 Profitability and solvency: Solvency, used in the scientific sense, refers to the company’s uninterrupted capability to meet its maturing liabilities within given time frame. Lenders and creditors look forward to timely settlements of their claims as and
when these mature. To make certain solvency, the company should be very liquid, which means huge current assets and bigger holdings. If the company maintains a comparatively huge investment in current assets, it will have absolutely no problem in repaying claims of creditors when they mature and will be able to honour all its sales orders and ensure stable production. Thus, a liquid company has fewer risks of insolvency; that is, it will barely experience a cash deficiency or a stock-out position. However, there is a cost connected with keeping a sound liquidity stage. A substantial quantity of the company’s sources will be blocked up in current assets, and to an extent this outlay is idle, the company’s productivity is likely to suffer.

To contain elevated profitability, the company may forgo solvency and contain a comparatively low level of current assets. When the company does so, its profitability will get better as less sources are blocked up in idle current assets, but its solvency would be in peril and would be uncovered to high risks of cash deficiency and stock outs.

2.4.2 The Cost Trade-off: An unlikely mode of looking into the risk-return trade-off is in terms of the cost of keeping an exacting altitude of current assets. There are two kinds of costs involved: the cost of liquidity and the cost of illiquidity. If the company’s altitude of current assets is extremely high, it has redundant liquidity. Its return on assets will be low, as sources are blocked up in idle cash and inventory do not produce anything and elevated levels of receivables decrease profitability. Therefore, the cost of liquidity increases with the increase of level of current assets.

The cost of illiquidity is the cost of maintaining inadequate current assets. The company will not be in a position to honour its commitments if it maintains insufficient cash. This possibility will compel the company to take a loan at exorbitant rates of interest. This will have an unfavorable effect on the creditworthiness of the company and it will encounter difficulties in getting funds in future. All this probably will push the company into
insolvency. Similarly, the low level of inventory will also result in loss of sales and customers who may switch over to competitors. Also, low level of receivables may be due to rigid credit policy, which would further weaken the sales. Therefore, the low levels of current assets attract costs which move up and up as this level come down.

In shaping the most advantageous level of current assets, the company can be expected to optimize the profitability-solvency relationship by reducing total costs-cost of liquidity and cost of illiquidity. It is very much clear that with the increase in the level of current assets the cost of liquidity increases while the cost of illiquidity decreases and vice versa. The company must keep its current assets at that level where the sum of these two costs is decreased.

2.5 APPROACHES TO MANAGEMENT OF WORKING CAPITAL

Below mentioned approaches are normally adopted by the companies for the management of working capital:-

2.5.1 The Conventional Approach: According to this approach the individual constituent of working capital i.e. inventory, receivables, cash and loan & advances etc; should be managed competently and cost-effectively as a result of which there are neither redundant sources nor scarcity of sources. Methods have been developed for the management of all of these constituents. Generally much importance is prearranged to the management of receivables since these normally comprise the major chunk of the outlay in working capital. Conversely, inventory control has not been practiced fully, possibly due to insufficiency of commodities and constantly increasing prices.

2.5.2 The Operating Cycle Approach: According to this approach working capital is viewed as a function of the quantity of operational expenditure. As per this approach the working capital is ascertained by the period of the operating cycle and the operating
expenditure required for finishing the cycle. The period of the operating cycle is the number of days consumed at different levels, beginning with acquiring of raw materials to the receipt of money from debtors. The credit time granted by creditors will have to be set off in the process. The most advantageous level of working capital will be the prerequisite of operating expenditure for an operating cycle, measured on the basis of operating expenditure necessary for a particular period, usually a year.

Most of the companies used to go after the conventional approach previously, but in these days the practice is changing in favour of the operating cycle approach. The banks generally use this approach whilst giving credit services to their customers.

2.6 PRINCIPLE OF MANAGEMENT OF WORKING CAPITAL

The management of working capital is based on some principles which are as under:-

2.6.1 Principle of risk deviation: Risk at this point refers to the incapability of company to keep adequate current assets to disburse its liabilities. In case working capital variance is due to change in sales, the quantity of risk that a company anticipates is varied and the chance for profit or loss is greater than before. That means, here is an exact affiliation between the extent of risk and the velocity of return. As a company anticipates more risk, the chance of profit or loss increases. As the level of working capital relative to sales decreases, the degree of risk increases. When the degree of risk increases, the opportunity for gain and loss also increases. Consequently, if the altitude of working capital goes upward, quantum of risk goes downward, and vice-versa and the chances for profit become unfavorably exaggerated.

2.6.2 Principle of equity situation: As per this principle, the sum of working capital blocked in every constituent must be sufficiently reasonable as per equity position of company. Each rupee blocked in the working capital should influence the net worth of the
company.

2.6.3 Principle of cost of capital: As per this principle various sources of financing have various costs of capital. It should be kept in mind that the cost of capital changes inversely with risk. Therefore, additional working capital, results in decline in the cost of capital.

2.6.4 Principle of maturity of payment: A company should create each effort to correlate due date of payments to its flow of generated sources. There should be the slightest inequality between the maturities of a company’s short-term debt sources and its flow of within generated sources, since a larger danger is generated with larger inequality. A periphery of protection ought to, though, be made available for any short-term loan disbursement.

2.7 PROCESS OF MANAGEMENT OF WORKING CAPITAL

In order to manage the working capital following steps will have to be followed:-

2.7.1 Anticipation of requirement of current assets: Frequent changes in the operations of a company are able to have approximately instant impact on the working capital requirement i.e. if suppliers raise the cost of raw material, more cash will be required to run and manage the inventory than before. Yet, if the company is able to boost the price of its finished goods, it will require additional working capital to support its sales endeavor. A vigilant administrator will scrutinize working actions and estimate the level of working capital needed for further period.

2.7.2 Arranging funds according to requirement: Once the requirements have been anticipated the administrator has to arrange the required funds from the most excellent resource, at the cheapest rate and intended for the time involved. The effectual management of working capital is the most important source of achieving the company’s purpose of sufficient liquidity. Sufficient funds should be on hand to disburse bills and other liabilities.
It is the net working capital—surplus of current assets above current payables—that helps assess the level of safeguard against troubles that might create a deficiency of money.

### 2.8 MONITORING OF MANAGEMENT OF WORKING CAPITAL

Monitoring of working capital management requires following procedure:-

**2.8.1 Monitoring of components of working capital:** Concerned manager should know as to how much funds have been blocked in cash, receivables, inventory, loan and advances on daily or weekly basis. He should also see whether funds blocked in components of the working capital are at optimal level, are as per firm’s standard and as per industry norms. If there is any deviation, the reasons of the same should be analyzed for taking corrective measures.

**2.8.2 Calculating the percentage of funds invested in working capital:** In most of the companies huge funds are invested in working capital. Manager should make equilibrium between funds invested in fixed assets and working capital. He should know the affiliation between current and fixed assets and any deviation in the percentages of these funds may be analyzed accordingly for taking corrective measures.

**2.8.3 Recording time spent in managing of working capital:** In most companies substantial time is spent by the financial manager in managing of working capital. He should know as to how much time is being devoted by the members of finance department in managing working capital. This type of monitoring will assist him to propose an insight into the effective management of working capital.

### 2.9 STUDY OF MANAGEMENT OF WORKING CAPITAL

Study of working capital management occupies a very prominent position in fiscal administration. It has not been acknowledged as so a good deal as in recent years. Working
capital management is an essential ingredient of overall fiscal administration. The field of working capital throws a welcome challenge and prospect to a financial manager. Working capital management has been looked at as the energetic place of a financial manager.

The management of working capital is identical to the management of short period monetary liquidity. The magnitude of short time liquidity can most excellently be measured by investigating the repercussions which move from a lack of capability to short-term liabilities.

Inadequacy of liquidity implies lack of self-sufficiency of alternatives in addition to restrain management’s liberty of progress. If deficiency of liquidity continues to be in trouble, it may eventually result in bankruptcy and economic failure. Thus, working capital management is associated with the sustained survival of a company, not withstanding production of quality goods, effectual selling, proficient manufacturing, and shrewd permanent resources management. Many organizations have lost the control of ownership since liquidity problem causes them to be captured by creditors, enforced amalgamation or insolvency. An admirable long run viewpoint for a company becomes irrelevant if control disappears in the short run. Working capital practices influence marketing, human resources, manufacturing and all that happens in the company is interrelated to working capital decisions. Working capital management, as an area, is connected with carrying out working capital functions. In each company, the working capital task ought to subsist in some form or the other.

A study of working capital management is extremely significant for inside and outside professionals. Sales growth, dividend announcement, plant’s extension, adding fresh merchandise line, enhancing of remuneration and increasing price level, et cetera, place additional burden on working capital management. Breakdown of every company is unquestionably due to pitiable management and nonexistence of managing proficiency.
Significance of management of working capital is due to considerable segment of whole investments which is positioned in current assets and altitude of current assets and current liabilities will alter rapidly with the deviation in sales. Nevertheless fixed assets outlay and long-term borrowing too will retort to the changes in sales, however its retort will be feeble.

2.10 CONCEPTUAL FRAMEWORK OF WORKING CAPITAL

In order to understand conceptual framework of management of working capital it is necessary to go through principle of working capital, accounts receivable management, inventory management, cash management, payable management and financing of working capital.

2.10.1 Working capital-meaning and definitions

Money is required equally for purchasing fixed assets as well as for operating functions of a company. For operating day-to-day business activities money is used for procuring raw materials, processing these into completed goods and finally handing over the same to the customers. The finance for meeting such working expenditure is frequently referred to as ‘working capital’. Working capital also refers to the circulating capital essential to meet the routine operations of a company.

Working capital defined by some of authors is as follow:-

1. “Working capital refers to a firm’s investment in short term assets such as cash amounts receivables, inventories etc”.-- **Weston & Brigham**

2. “Working capital means current assets”-- **Mead, Baker and Malott**

3. “The sum of the current assets is the working capital of the business”. -- **J.S. Mill**

4. “Working capital is the amount of funds necessary to cover the cost of operating the enterprise. Working capital in a going concern is a revolving fund; it consists of cash receipts from sales which are used to cover the cost of current operations”--
Johan A. Shubin

5. “Working capital is made up of combination of several current assets, such as cash, inventory, and accounts receivable, and is used to identify a business’s liquidity condition”--Steve Martin.

6. “Working capital, in simple term, is the amount of funds which a company must have to finance its day to day operations. It can be regarded as that proportion of company’s total capital which is employed in short term operations”—V.E.Ramamoorthy.

Working capital is surplus of the current assets in excess of current liabilities and provisions. However as stated in accounting terminology, it is variation between the inflow and outflow of money. Working capital includes stocks of material, fuels, work in progress, completed commodities, by-products, cash in hand, bank balance, loan & advance and receivables. The term “working capital” is frequently referred to “circulating capital” which is often used to indicate those possessions which are altered with relative velocity from one form to another i.e. beginning from cash, altering to raw materials, converting into work in progress and completed goods, sale of finished goods and finally back to cash with receipt of cash from debtors. Working capital has been described as the “life blood” of any business which is appropriate since it constitutes a clockwork-like flowing watercourse throughout the business.

2.10.2 Working capital-Concept

There are two concepts of working capital, that is to say gross concept and net concept, which are elaborated as under:-

**Gross working capital:** According to this concept, gross working capital refers to the company’s outlay in current assets. Current assets are those assets which can be transformed into cash during an accounting period and comprise cash, short-term
securities, receivable, loan & advance and inventory. The sum of current liabilities is not subtracted from the total of current assets. This concept views Working Capital and total of Current Assets as two identical terms. This concept is also treated as \textit{`Current Capital'} otherwise \textit{`Circulating Capital'}. One additional facet of the gross working capital points to the call for arranging finances to funding current assets. Whenever a requirement for working capital funds occurs owing to the escalating intensity of company operation or for any supplementary reason, funding arrangement ought to be made immediately. Similarly, if suddenly, some spare sources occur these should not be permitted to stay idle, but must be invested in temporary securities. Thus the financial executive is supposed to have information about the origin and sources, of working capital funds as well as alternative outlay where redundant sources may be for the time being, are invested.

\textbf{Net working capital:} According to this concept, net working capital refers to the difference between current assets and current liabilities. Current liabilities are those claims of outsiders, which are likely to be paid within a financial year and usually comprise creditors, bills payable, bank loans and outstanding expenditure. Net working capital may be positive or negative. When current liabilities are in excess of current assets, then negative working capital arises. Net working capital is a qualitative concept. It shows the liquidity situation of the company and presages the level to which working capital requirements will possibly be financed by fixed sources of funds. Current assets supposed to be adequately in surplus of current liabilities to provide an edge or buffer for meeting obligations within the normal operating cycle of a company’s operation. Sequentially to defend their interests, short-term creditors always like a company to preserve current assets at an upper level than current liabilities. However the eminence of current assets ought to be well thought-out in deciding the stage of current liabilities. However, the superiority of
current assets ought to be measured in deciding the level of current assets vis-a-vis current liabilities. Poor liquidity situation poses a danger to the solvency of the company and makes it insecure. A negative working capital leads to negative liquidity, and possibly will confirm to be dangerous for the company’s goodwill. Too much liquidity is also not good. It possibly will be owing to negligence in management of current assets. Therefore, without delay and appropriate action ought to be taken by administration to get better and correct the imbalances in the liquidity position of a company. Net working capital concept also covers the query of well judged blend of long-term and short-term sources for funding current assets. For each company, there is a small amount of net working capital which is fixed. Therefore, a segment of the working capital ought to be funded with the equity share capital, debentures, long-term loans, preference share capital or plough back of profits. Administration may, therefore, take a decision to the extent by which current assets ought to be funded with equity capital and/or on loan capital.

The two concepts of working capital—gross and net are not exclusive; relatively these have equivalent importance from the administration viewpoint. The gross working capital concept concentrates notice on aspects of current assets management as to how to optimize outlay in current assets and how to finance the current assets. The contemplation of the altitude of outlay in current assets should be just at optimal level, not more nor less, to the requirements of the company. Too much outlay in current assets ought to be avoided since it impairs the company’s viability, as inoperative outlay produces nothing. Alternatively, insufficient amount of working capital can intimidate solvency of the company since its incapability to pay its current liabilities. It ought to be sensed that the working capital requirements of the company may be changeable with varying operational activities. It possibly will cause surplus or scarcity of working capital recurrently. The administration
should be quick to kick off an action and set the imbalances right.

In a nutshell it may be pertinent, to note that both gross and net concepts of working capital are evenly significant for the resourceful administration of working capital. There is no short cut way to decide the accurate quantity of gross or net working capital for any company. The data and problems of every company ought to be analyzed to decide the quantity of working capital. There is no precise regulation as to how current assets ought to be funded. It is not viable to put into practice, the financing of current assets by short-term funds only. Keeping in mind the parameters of the company, a well judged blend of long and short-term funds ought to be invested in current assets. In view of reality, those current assets occupy cost of funds; these ought to be put to creative use.

2.10.3 Kinds of working capital

Generally, working capital is of two types; fixed working capital and fluctuating working capital. Both these types of working capital; permanent and temporary-are needed to make possible production and sales by the operating cycle, but temporary working capital is maintained by the company to fulfill the liquidity necessities that are expected to be temporary.

**Fixed working capital:** The necessity for current assets is connected with the operating cycle, which is an uninterrupted course of action. As such, the requirement for current assets is felt continuously. The amount of investment in current assets on the other hand may not all the time be the same. The requirement for investment in current assets may possibly go up or down over a period of time according to the altitude of production. However, there is a definite minimum level of current assets all the time, which is necessary for the company to maintain in its business irrespective of the level of business activities. This is the fixed minimum level necessary for keeping the flow of the current
assets. This minimum level of investment in current assets is everlastingly blocked up in business and is for that reason called as permanent or fixed or regular working capital. It is fixed in the same way as investment in the company’s fixed assets is.

**Fluctuating working capital:** Requirement for working capital, over and above the fixed working capital, will rise and fall in relation to variations in production and sales of the company. The requirement for working capital may also differ on account of cyclic variations, irregular and unexpected situations. An increase in the price possibly will lead to an increase in the volume of funds invested in stock of raw materials in addition to finished products. Extra quantum of working capital may possibly be needed to face aggressive contest in the market or other emergencies like strikes and lockouts. Any extraordinary publicity campaigns arranged for increasing sales or other promotional operations may have to be funded by extra working capital. The additional working capital required to face the fluctuating business activities is called the fluctuating or variable working capital.

**2.11 NEED OF WORKING CAPITAL**

The requirement of working capital to operate the day-to-day activities relating to the business of the company hardly needs to be overemphasized. We will barely come across a company which does not have need of any sum of working capital. Definitely companies vary in their necessities of the working capital. We are familiar with the fact that a company should endeavor to maximize the possessions of its stakeholders. In its attempt to do so, a company ought to produce adequate return from its business. Earning a stable amount of income requires flourishing sales activities. The company has to put enough funds in current assets for creating sales. Current assets are required since sales do not translate into cash immediately. There is an eternal operating cycle caught up in the
process of the alteration of sales into cash.

There is dissimilarity between current and fixed assets in expressions of their liquidity. A company requires a lot of years to recuperate the preliminary outlay in fixed assets such as plant and machinery or land and building. On the other hand, outlay in current assets is turned over several times in a year. Outlay in current assets such as inventories and accounts receivable is realized during the company's operating cycle which is typically less than a year. Operating cycle is the time period requisite to convert raw material into finished goods, finished goods to sale and sale to cash.

The operating cycle concept is not only linked to manufacturing companies. Non-manufacturing companies such as wholesalers and retailers will not comprise the manufacturing stage. They will obtain inventory of finished products and change them into receivables and receivables into cash. Further, service and financial sector companies will not have stocks of goods. Their inventory will be cash. Their operating cycles will be the shortest. They require obtaining cash, then lending to the debtors and again converting lending back into cash.

The requirement of current assets emerges due to operating cycle. The operating cycle is an uninterrupted course of action and, therefore, the requirement of current assets is felt continuously. However the degree of current assets required is not the same for all time, it goes upward and downward during the operation. However, there is forever a small amount of current assets which are always needed by the company to carry on its business activities. This smallest level of current assets is referred to as fixed working capital. It is fixed in the same way as the company’s permanent assets are. Depending on the changes in manufacturing and sales, the requirement for working capital, over and above the fixed working capital, will fluctuate.

The additional working capital, required to carry the varying manufacturing and sales
operations is called fluctuating, or variable, or provisional working capital. Both types of working capitals—permanent and provisional—are essential to make possible manufacturing and sale through the operating cycle, but provisional-working capital is formed by the company to meet liquidity necessities that will last only temporarily.

2.12 OPTIMAL LEVEL OF WORKING CAPITAL

The company ought to keep a sound working capital position. It should have sufficient working capital to operate its business activities. Both redundant as well as insufficient working capital positions are hazardous from the company’s viewpoint. Redundant working capital means inactive funds which produce no gains for the company. Scarcity of working capital not only impairs the company’s productivity but also leads furthermore to manufacturing hindrances and inefficiencies.

2.12.1 Advantage of maintaining working capital at optimal level

Some of the major advantages of keeping working capital at optimal level are as under:-

**Solvency of the company:** Satisfactory working capital helps in keeping solvency of the company by supplying continuous flow of production.

**Reputation:** Adequate working capital enables a company to disburse timely payments and therefore, helps in creating and keeping reputation.

**Unproblematic Loans:** A company having sufficient working capital, high solvency and excellent credit position is able to get loans from banks and other sources on friendly and constructive terms.

**Cash discounts:** Adequate working capital furthermore enables a company to get benefit of cash discounts on the procurements and therefore, it reduces costs.

**Uninterrupted delivery of raw material:** Adequate working capital assures uninterrupted receipt of raw material for the nonstop production.

**Uninterrupted disbursement of salaries wages and other day-to-day obligations:** A
A company which has sufficient working capital will be able to make usual disbursement of salaries, wages and other day-to-day obligations which raise the spirits of its employees, increase their effectiveness, decrease wastages, save costs and increase profits.

**Utilization of positive market conditions:** Simply a company which has sufficient working capital can utilize positive market situation such as procuring its necessities of material in bulk when the prices are low and by holding its inventory for privileged prices.

**Capability to face crisis:** Sufficient working capital makes a company able to face business crisis in emergencies such as depression for the reason that during such periods, generally, there is much burden on working capital.

**Rapid and interrupted return on investment:** Every saver desires a rapid and interrupted return on his savings. Adequacy of working capital makes a company able to disburse dividends rapidly to its investors as there possibly will not be much force to plough back earnings. This increases the self-confidence of its investors and creates an encouraging market to acquire further funds.

**Sky-scraping morale:** Sufficiency of working capital makes an atmosphere of safety, confidence, high morale and creates effectiveness in a company, on the whole.

### 2.12.3 Redundant or insufficient working capital

Every company ought to have sufficient working capital to operate its business activities. It ought to contain neither redundant nor insufficient working capital. Redundant as well as inadequate working capital positions are awful for any company. However, out of the two, it is the insufficiency of working capital, which is more hazardous from the point of view of the company.

**Disadvantages of redundant working capital**

Redundant working capital means idle sources which make no earnings for the company and therefore the company cannot make an appropriate profit on its investments.
• When there is an excessive working capital it possibly will lead to the needless procurement and buildup of inventory attracting more probability of burglary, waste and losses.

• Redundant working capital implies too much debtors and faulty credit practices which may create elevated occurrence of bad debts.

• It may lead to incompetency of the company, on the whole.

• Owing to less rate of return on funds the worth of shares may as well decrease.

• The excessive working capital may raise speculative transactions.

**Disadvantages or dangers of insufficient working capital**

• A company which has insufficient working capital will not be able to meet its short-term obligations in time. Therefore, it will lose its goodwill and shall not be capable of getting superior credit facilities.

• It cannot procure its necessities in bulk and cannot avail discounts.

• It becomes difficult for the company to take advantage of positive market situation and take on lucrative projects owing to lack of working capital.

• The company will not be able to disburse day-to-day expenditure of its business activities and this may lead to inefficiencies and inflated expenses and finally decrease the earning of the company.

• It becomes infeasible to exploit competently the fixed assets owing to non-availability of liquid sources.

**2.13 Determinants of working capital**

Indian Industries nowadays have worth maximization as the main purpose and to attain it one ought to be competent of anticipating the necessities of working capital correctly. Both unnecessary and insufficient investments in working capital components are dangerous for a company. Therefore, the finance executive has to scrutinize all the factors which decide
the working capital necessities within the hypothetical and realistic points of view. The hypothetical considerations from time to time control the tactic of assessment; whilst the company is forced to follow the restrictions forced by the borrowers. The finance executive, therefore, ought to think all the factors that have a bearing on the working capital as well as on the cash, receivables and inventory.

There are no laid down regulations or formulae to decide the working capital necessity of a company. A huge number of factors, every one having a diverse significance, affect the working capital requirement of a company. Also, the magnitude of factors varies for a company over time. Therefore, a study of applicable factors ought to be made in turn to settle on total investment in working capital. It is not probable to grade determinants of working capital since all such factors are of various degrees of significance and the power of individual factor may vary for a company over time. The following are vital factors normally affecting the working capital necessities of a company: -

- Environment of Business
- Sales and Demand Conditions
- Technology and production policy
- Credit Policy
- Availability of Credit
- Working effectiveness
- Changes in price level
2.14 ESTIMATING WORKING CAPITAL REQUIREMENTS

As working capital is treated as livelihood and controlling nerve centre of operational activities of a company, no business lacking a sufficient quantity of working capital can be run effectively. To avoid the scarcity of working capital continuously, an approximation of working capital needs ought to be prepared beforehand so that preparations can be made to acquire ample working capital. Main befitting technique of estimating the working capital requirements of a business concern is the theory of operating cycle. On the other hand, various other techniques in practice can be applied to decide working capital needs. Under mentioned, are some of techniques which are currently being applied effectively:-

- Ratio of sales technique
- Regression analysis technique
- Cash forecasting technique
- Operating cycle technique
- Projected balance sheet technique

2.15 MANAGEMENT OF COMPONENTS OF WORKING CAPITAL

2.15.1 Management of inventory

Most important part of working capital is inventory in majority of companies of India. On an average, inventories are roughly sixty per cent of working capital in Indian companies. For the reason that large volume of inventories are kept by companies, a substantial sum of funds is necessary to be devoted to them. It is, consequently, extremely important to administer inventories efficiently and effectively in order to keep away from needless investment. A company ignoring the management of inventories will be jeopardizing its
long-run productivity and may fall short ultimately. It is likely for a company to decrease its levels of inventories to a substantial degree, without any unfavorable impact on production and sales, by using simple inventory planning and control techniques. The reduction in ‘too much’ inventories carries a favorable effect on profitability of company.

**Components of inventory**

Inventories are stock of the goods a company is producing for sale and various ingredients which make up that product. The different forms in which inventories subsist in a manufacturing company are:-

- Raw materials
- Work-in-process
- Finished goods
- Stores and spares

**Need for inventory**

Some quantity of inventory on one hand is required for day-to-day operations of a company, and on the other hand, keeping unwarranted inventory will obstruct the sources and cost more to the company. There are many other related costs of keeping unwarranted inventory. Managers should estimate the level of inventory for day-to-day operation of the company’s activities. Following are some of the prime reasons for keeping inventories which are applicable to various ingredients of inventory:

**Objectives of inventory management**

Major objectives of inventory management are: a) to keep inventory at optimal level for well-organized and smooth operation of production and sales. b) To invest smallest amount in inventories to maximize profitability.

Unnecessary and insufficient inventories are not advantageous. These are two risky levels
within which the company ought to function. The purpose of inventory management ought to be decided and kept at most favorable level of inventory outlay. The optimum level of inventory will lie between the two risky points of redundant and insufficient inventory.

The company must forever keep away from a situation of over-investment or under-investment in inventory. The foremost danger of over investment is needless hold-up of the company’s sources and loss of earnings. Second danger of redundant inventory is burden of carrying costs, and risk of liquidity. The unnecessary level of inventory consumes sources of the company, which cannot be used for any other purpose, and therefore, it contains an opportunity cost. Inventory carrying expenses, such as the expenses of storage space, handling, insurance and check up, also increase in percentage to the quantity of inventory. These expenses will weaken the company’s productivity. Too much inventory carried for long-period increase probability of failure of liquidity. It may not be likely to sell products in due course and at full worth. Raw materials are usually more difficult to sell as compared to finish products even as the holding time increases. There are extraordinary situations when it possibly will cost the company dearly for holding stocks of raw materials. This is possible under situation of price increase and shortage. Work-in-progress is far more complicated to sell. Likewise, problems may be faced to sell off completed products inventory as period extends. The descending shifts in market and the cyclic factors may result in selling finished products at low rates. One other risk of keeping too much inventory is the physical corrosion of inventory whilst in warehouse.

Keeping an insufficient level of inventory is quite risky. The foremost risk of under-investment in inventory includes production hold-ups and breakdown to meet supply commitments. Insufficient raw materials and work-in-progress inventory will result in recurrent manufacturing interruptions. Likewise, if completed product inventory is not adequate to meet the requirements of purchasers smoothly, they possibly will move to the
products of competitors, which will amount to an everlasting loss to the company.

The objective of inventory management, therefore, ought to be to kept away from unnecessary and insufficient levels of inventory and to keep adequate inventory for the smooth manufacturing and sales activities. Efforts ought to be carried out to give a requisition at the proper time with the accurate source to procure the correct size at genuine rates and quality.

2.15.2 MANAGEMENT OF RECEIVABLES

Tendency of taking goods and services on credit is progressively gaining significance in the way of livelihood of the Indians. Alternatively, customer credit has turned out to be the main selling factor. When customers wait for credit, trade units in turn wait for credit from their vendors to go with their investment in credit extended to customers. An effective administrative control requires suitable administration of liquid assets and inventory. These assets are an ingredient of working capital of the company. A well-organized utilization of fiscal sources is essential to keep away from financial problems.

Receivables take place when a company sells its goods or services on credit and does not get cash immediately. It is an indispensable marketing instrument, performing as a link for the movement of products in the course of manufacturing and delivery stages to consumers. A company allows trade credit to defend its sales from the competitors and to be a focus for the possible customers to purchase its goods at favorable conditions. Trade credit creates receivable which the company is estimated to accumulate in the near future. The receivable arising out of credit has three unique features; first, it contains an aspect of risk which ought to be vigilantly analyzed. Second, it is based on monetary worth to the purchaser, the economic value in goods or services passes instantly on the occasion of sale, whilst the seller expects an equal worth to be received afterwards. Third, it implies futurity.
The cash disbursement for products or services received by the purchaser will be made by him in an upcoming period. The customers from whom receivable or book debts have to be collected in the future are called trade debtors or plainly as debtors and stand for the company’s claim on asset.

Receivables occupy a considerable segment of current assets of several companies. In India, receivables, after inventories, comprise the main ingredient of current assets. They constitute about one-third of current assets. Allowing credit and creating receivables tantamount to the blocking of the company’s sources. The gap between the date of sale and the date of receipt of payment has to be financed out of working capital. This necessitates the company to get funds from banks or other sources. Therefore, receivables represent investment. As considerable amounts are blocked-up in receivables, it requires vigilant investigation and appropriate management.

**Factoring of receivables**

Receivable management is a focused activity, and requires a lot of time and hard work from financial executives of the company. Realization of receivables creates a trouble, mainly for small companies. Banks have the strategy of funding receivables. On the other hand, this help is obtainable for a limited time and the sellers of products and services have to tolerate the danger of non-payment by debtors. Work relating to receivable management may be assigned to a specialist of an organization for efficient and effective realization of receivables. This type of activity is called factoring. Factoring is a well-known method of administrating, funding and realizing receivables. In India some banks and financial institutes and their subsidiaries use it to make available factoring services to their clients.

**2.15.3 MANAGEMENT OF CASH**

Cash is essential input to establish a business unit. Initially cash is invested in fixed assets like plant and machinery, which facilitates the company to manufacture products and
produce cash by selling them. Cash is the significant component of working capital for the operational activities of a company. Cash is the indispensable input required to keep the business going on an uninterrupted basis; it is also eventual output anticipated to be realized by selling the service or goods produced by the company. The company ought to maintain adequate cash, neither extra nor inadequate. Cash scarcity will disturb the company’s production activities whereas unnecessary cash will merely stay idle, with no contribution towards the profitability of the company. Therefore, the main task of the financial manager is to keep sound cash position.

Cash is the currency which a company can pay out instantly with no constraint. The word cash includes coins, currency and cheques in custody of the company, and balances in its bank accounts. Sometimes near-cash items, such as marketable securities or time deposits of the banks, are also incorporated in cash. The essential feature of near-cash property is that these can willingly be transformed into cash. Normally, when a company has surplus cash, it invests it in marketable securities. This type of outlay contributes some profit to the company.

In the framework of working capital management, cash management refers to optimizing the benefits and expenditure linked with keeping cash. As described previously, if the cash is not put into use, there is no advantage derived out just by maintaining it. Further, keeping cash with no purpose as well costs the company either directly in the shape of interest or opportunity profits that could be earned out of the cash. At the same time, it is not possible to operate the company without keeping cash.

**Aspects of management of cash**

Management of cash is related to the managing of inflow and outflow of cash, cash balances kept by the company, financing deficit or investing surplus cash. Cash is generated by sales and disbursed for purchases and other expenses. Management of cash
requires to complete this cycle at the lowest and to maintain adequate liquidity. Cash management assumes extra significance than other components of working capital since cash is the most important but the least industrious component of working capital. It is important since it is utilized to disburse the company’s commitments. On the other hand, cash is infertile. Contrasting fixed assets or inventory, it does not manufacture products for sale. For that reason, the endeavor of management of cash is to keep ample control over cash position to maintain the adequate liquidity and to utilize surplus cash in a number of lucrative opportunities. Cash management is also significant since it is not easy to forecast cash flows, exactly, mainly the inflows, and there is no coincidence amid the receipt and disbursement of cash. Cash management is equally essential because cash constitutes the nominal segment of the whole current assets; however management’s substantial time is required to manage it.

During some periods, cash outflows will exceed cash inflows, because payments for taxes, dividends, or seasonal inventory build up. At other times, cash inflow will be more than cash payments because there may be large cash sales and debtors may be realized in large sums promptly. In the recent past, a large number of innovations have been undertaken in cash management techniques. An obvious aim of the firm now-a-days is to manage its cash affairs in such a way as to keep cash balance at a minimum level and to invest the surplus cash in profitable investment opportunities.

**Objectives of keeping cash**

Investment in cash is the least industrious asset. Over and over again, company is not reliant on this asset in the production procedure nor is necessary for creating inventory or selling. Therefore, the essential query is as to why companies keep cash.
Management of surplus cash

Profit making companies have to generate extra cash at the end of operating cycle because the cash received from debtors is larger than cash invested at the start. Though, actually, many profit making companies observe impact of negative flow of cash. There are numerous reasons for this position. The disparity between inflows and outflows and transfer of short-term funds for long-term requirements are two main reasons for this situation. Although it is not advantageous to use the short term funds for long-term requirements, often companies choose their route to transfer if there is some delay in getting funds from long-term sources. The position is set right once the company receives the long-term funds. In other words, profit-making companies occasionally create spare cash even though they face heaviness on cash flows in other times. The question is how to deal with such spare cash. Surplus cash balance is the least creative asset of the company and therefore, should be minimized.

Cash needs that are obtained from defensive or speculative motives can typically be fulfilled in the shape of liquid financial investments, that is, savings that can be easily transformed into cash. Though, many companies experience cyclic cash needs, which may end result from cyclic payments and/or collections those are not coordinated with each other, finance managers are often anxious about finding well-organized ways of stocking surplus cash. That's why, there are positions in which company finds it optimal to invest part of their cash balances in the shape of marketable securities, which give a certain profit and can be transformed into cash at very little notice. As the reasons for these investments are strongly related to the purpose for maintaining liquidity, those investments which satisfy the parameters of protection and liquidity, should be well thought-out.
2.15.4 MANAGEMENT OF PAYABLES

Purchases of goods and services create a commercial credit for both the sellers and the buyers. Account payables generally stand for a huge segment of company’s liabilities. A considerable segment of procurement of products and services in a company are on more credit conditions to a certain extent than against cash payment. Whereas the seller of products and services is likely to recognize credit as a force for increasing sales or as a shape of non-price tool of competition, the purchaser is likely to look upon it as a loaning of products or inventory. The seller’s credit is called as Accounts Payable, Trade Credit, Trade Bill, Trade Acceptance, Commercial Draft or Bills Payable depending on the character of credit granted. Trade credits or payables comprise the main part of current liabilities in a lot of business companies. And they are mainly funding the inventory which forms the most important chunk of current assets in a lot of companies.

Stretching of payables

It is usually understood that the payment to the seller is disbursed within due time. On the other hand, a company may put off payment ahead of due date. This kind of deferment is called stretching on the trade. The cost of stretching accounts payable is two-fold: the cost due to loss of cash discount and the likely worsening in the credit ranking. If a company stretches its payables exceptionally, so that its payables are considerably offending, its credit rating will suffer. Seller will analyze the company with uneasiness and may be firm or quite stern on conditions of sale. Even though it is not easy to calculate, there is definitely an opportunity cost to a worsening in the company’s quality of payment.

Effectual management of payables

Significant points to be kept in mind for effectual management of payables are as under:-

- Bargain and get the most positive credit conditions consistent with the existing business practice relating to the concerned merchandise line.
Where cash discount is obtainable for timely payments, take benefit of the offer and obtain the savings from that.

Where cash discount is not obtainable, clear up the payable on its due date and not in advance. It pays benefit of full credit time.

Do not extend payables outside the due date, except in unavoidable circumstances, as such delays in meeting obligations have unfavorable effects on purchaser’s trustworthiness and may affect more rigorous credit conditions, refutation of credit or high prices on products and services purchased.

Maintain strong financial position and a good follow up of past record of transactions with the seller so that it would maintain his self-belief. The quantum and the conditions of credit are mostly impacted by seller’s appraisal of buyer’s fiscal wellbeing and capability to meet maturing commitments quickly.

During extreme aggressive position, seller may be eager to extend credit restrictions and times. Evaluate your power to negotiate and get the most excellent potential transaction.

Avoid tendency relating to diverting payables. Keep the self liquidating nature of payables and do not utilize the means acquired therefrom for purchasing fixed assets. Payables are intended to flow through current assets and quickly get transformed into cash from sales for meeting those short term commitments which are likely to mature in the near future.

Maintain a regular check on cases of negligence. Delays in finalization of payables within the stipulated time can be classified into age groups to spot delays by more than one month, two months, three months, etc. Once overdue payables are given main concern of concentration for payment, the negligence rate can be decreased or eliminated totally.
2.16 FINANCING OF WORKING CAPITAL

2.16.1 Practices of financing of working capital

A company generally applies following type of practices for financing of working capital:-

**Long-term financing:** The resource of long-term funding comprises ordinary share capital, preference share capital, debentures, long-term loans from financial institutions/banks and retained earnings.

**Short-term financing:** The short-term funding is taken for a time less than one year. It is taken in advance from banks and other lenders of short-term funding in the money market. Short-term funding comprises working capital loan from banks, public deposits, commercial papers, factoring of accounts receivables, etc.

**Spontaneous financing:** Spontaneous financing refers to the unplanned sources of short-term funding arising in the ordinary course of a business. Trade supplier’s credit and outstanding expenditures are examples of spontaneous funding. There is no clear cost of spontaneous funding. A company is likely to make use of these sources of funding to the fullest level. The actual option of funding current assets, once the spontaneous means of funding have been entirely used, is between the long-term and short-term sources of funding.

2.16.2 Practices generally followed by companies to finance working capital

**Conservative approach:** A company in practice may apply a conservative approach in funding its current and fixed assets. The funding practices of the business is said to be conservative when it relies more on long-term sources for working capital needs. Under a conservative arrangement, the company funds its permanent assets and as well part of temporary current assets with long-term funds. In the periods when the company has no requirement for temporary currents assets, the redundant long-term funds can be utilized in
the marketable securities to preserve liquidity. The conservative practices depend a lot on long-term funds and, consequently, the company has less menace of facing the difficulty of deficiency of resources.

**Aggressive approach:** A company could be aggressive in funding its assets, when it is said to be followed by the company utilizing more short-term funds than required by the matching program. Under an aggressive strategy, the company funds a fraction of its permanent current assets with short-term sources. Some exceptionally aggressive companies may still finance a fraction of their fixed assets with short-term funds. More utilization of short-term funds makes the company more unsafe.

**Matching approach:** A company can apply a financial plan which matches the predictable life of assets with the projected life of the means of funds raised for funding assets. Thus, a long-term loan may be raised to fund a fixed asset with an anticipated life of more than one year; on the other hand current asset to be sold during a short period may be funded with a short-term source like commercial paper or a bank borrowing. The good reason for the exact matching is that, because the rationale of funding is to pay for assets, the method of funding and the asset should be relinquished at the same time. Utilizing long-term assets with short-term funding is expensive in addition to problematic as arrangement for the new short-term funding will have to be made on a routine basis. When a company adopts matching approach popularly known as hedging approach, long-term funds will be utilized to finance fixed assets and permanent current assets, short-term funds for funding provisional or changeable current assets. Though, it should be kept in mind that accurate matching is not feasible due to uncertainty regarding the projected life of assets.

**2.16.3 Type of short-term financing**

Funds which are presented for a period of one year or less than one year are called short-range finance. Short-term finances are utilized for funding of working capital. Most important short-
range means of funds for working capital are: business credit and bank loans. The utilization of business credit has been going upward over years in India. Bank loan is the subsequent significant means of working capital financing. Following are the main constituents of the short term financing:-

**Trade credit**

Business credit is that credit which a purchaser gets from seller of products in the usual course of business. Practically, the purchasing company does not have to disburse payment instantly for the procurement made. This deferment of payments is a short-term funding which is called trade credit. It is the most important means of funding working capital of company. Small companies are greatly reliant on business credit as a means of funding of working capital, because they find it complicated to have funds from other sources.

Business credit is typically a casual arrangement, and is arranged on an open account basis. A seller supplies products to the purchaser on credit which the buyer accepts, and therefore, in effect, agrees to pay the amount due as per sales condition in the bill. On the other hand, he does not officially concede it as a debt; he does not sign any official instrument. Once the trade links have been recognized between the buyer and the seller, they have each other’s mutual assurance, and business credit becomes a regular action which may be occasionally reviewed by the supplier. Open account trade credit appears as sundry creditors on the buyer’s balance sheet.

Business credit may also take the shape of bills payable. When the buyer signs a bill to obtain credit on trade, it appears on as bills payable on the buyer’s balance sheet. The bill has a particular upcoming date, and is regularly used when the seller is less confident about the buyer’s eagerness and capability to pay, or when the seller needs cash by discounting the bill for a bank. A bill is prescribed acknowledgement of a commitment to pay back the outstanding amount.
Accrued Expenses

Accrued expenses denote a liability that a company has to disburse for the service which it has previously received. Thus they denote spontaneous, without interest means of funding. The most significant constituent of accruals are wages and salaries, taxes and interest. Accrued wages and salaries denote obligations payable by the company to its employees. Accrued taxes and interest form one more means of financing. This is a delayed payment of the company’s commitment and therefore, is a mean of finance. It is a partial source of financing working capital.

Deferred Income

Deferred income denotes sources received by the company for products and services which it has contracted to supply in future. These proceeds increase the company’s liquidity in the shape of cash; as a result, they comprise a significant means of financing. Payments which were made by customers in advance comprise the major constituents of deferred income. These payments are ordinary in case of costly goods, where the product is in short supply and the seller has a tough bargaining power as compared to the buyer. These payments are not recorded as income until products and services have been supplied to the purchaser. They are, therefore, shown as a liability in the company’s balance sheet.

Bank loans

Banks are the most important source of financing working capital. After business credit, bank credit is the most significant means of financing working capital necessities of companies. A bank considers a company’s sales and production strategy and the advantageous levels of current assets in deciding its working capital necessities. The sum sanctioned by the bank for the working capital of company is called credit limit. Credit limit is the highest amount of funds which a company can acquire from the bank. In the case of company with cyclic businesses, bank may fix separate limits for the ‘peak level’
credit necessities and ‘normal non-peak level’ credit necessities representing the time during which the separate limits will be used by the borrower. Practically, banks do not provide cent percent credit limit; they subtract some margin money. Margin constraints are based on the principle of conservatism and it is intended to make sure safety measures are taken by the banks before extending loans.

Commercial papers

Commercial paper is a different way of acquiring short term finances by well rated corporate borrowers for the purpose of working capital. A commercial paper at the same time gives a chance to cash rich investors to invest their funds in short term investments. It is a significant money market mechanism for acquiring short term sources. The Reserve Bank of India introduced commercial paper in the Indian money market on the suggestions of the Working Group on Money Market (Vaghul Committee). Only big companies having good credit ranking and sound fiscal position are capable of issue commercial paper to acquire short-term sources. The Reserve Bank of India has issued a number of guidelines to decide the eligibility of a company for the issue of commercial paper. Only a company which is listed on the stock exchange has prescribed net worth and maximum allowable bank funding can issue commercial paper up to the fixed percentage of its working capital limit.

The maturity time of commercial paper, in India, generally ranges from 91 days to 180 days. It is sold at a concession from its face price and redeemed at face value on its due date. Hence, the cost of acquiring finances, through this source, is a role of the amount of concession and the time of due date and no interest rate is fixed by Reserve Bank of India for this purpose. Commercial paper is generally purchased by investors including banks, insurance companies, unit trusts and companies to invest spare funds for a short-time. A number of credit rating organizations like CRISIL, ICRA, CARE, DCR, SAMERA and
ONICRA etc; have been set up in India to rate commercial papers.

Commercial paper is a less costly source of raising short-term funds as compared to the bank credit and proves to be effectual even at the time of rigid terms of bank credit. On the other hand, it can be utilized as a source of funding only by big companies having high credit rating and sound financial position. One more drawback of commercial paper is that it cannot be redeemed earlier than the due date even if the issuing company has spare funds for repayments.