Chapter 6

Working Capital Management
6.0 WORKING CAPITAL MANAGEMENT:

Every business needs funds for two purposes—for its establishment and to carry out its day-to-day operations. Long-term funds are required to create production facilities through purchase of fixed assets such as plant and machinery, land, building, furniture, etc. Investments in these assets represent that part of firm’s capital, which is blocked on a permanent or fixed basis and is called fixed capital. Funds are also needed for short-term purposes for the purchase of raw materials, payment of wages and other day-to-day expenses, etc. These funds are known as working capital.

In simple words, working capital refers to that part of the firm’s capital, which is required for financing short term or current assets such as cash, marketable securities, debtors and inventories.

6.0-1 DEFINITION:

According to Genestenberg, “Circulating capital means current means current assets of a company that are changed in the ordinary course of business from one form to another, as for example, from cash to inventories, inventories to receivables, receivables into cash.”
According to Shubin, "Working capital is the amount of funds necessary to cover the cost of operating the enterprise."

6.0-2 THE NEED OF WORKING CAPITAL:

Every business needs some amount of working capital. The need for working capital arises due to the time gap between production and realization of cash from sales. Thus, working capital is needed for the following purposes:

a) For the purchase of raw materials, components and spares.

b) To pay wages and salaries.

c) To incur day-to-day expenses and overhead costs such as fuel, power and office expenses, etc.

d) To meet the selling costs as packing, advertising, etc.

e) To maintain the inventories of raw material, work-in-progress, stores and spares and finished stock.

6.1 CLASSIFICATION OF WORKING CAPITAL:

Working capital may be broadly classified into Permanent or Fixed Working Capital and Temporary or Variable working capital. Detailed description of these is as follows:

6.1-1 PERMANENT WORKING CAPITAL:

Permanent or fixed working capital refers to the minimum level of
investment in the form of working capital, which is required permanently to operate at a minimum level of activity. Permanent working capital is generally financed from long-term sources. It is permanently locked up in current assets.

Permanent working capital is of two kind's:

(a) Initial working capital; and

(b) Regular working capital.

6.1-1-I Initial working capital:

Initial working capital refers to that part of permanent working capital, which is required at the time of commencement of a business to meet its initial operating expenditure. During the initial year, the business usually does not get credit from the market. Hence, there is a need for initial working capital as all operating expenses have to be incurred in cash.

6.1-1-II Regular working capital:

Regular working capital refers to that part of permanent working capital, which is required for the continuous operations of the business of a company. It refers to excess of current assets over current liabilities. In other words, regular working capital signifies
(i) Enough cash to meet short-term obligations (i.e., liabilities); and

(ii) enough finished goods in hand to ensure quick delivery of good.

6.1-2 TEMPORARY (OR VARIABLE) WORKING CAPITAL:

Temporary working capital refers to that part of the total working capital that is needed over and above, the permanent working capital. It is fluctuating in nature and is also know as variable working capital. The amount of temporary working capital depends on:

(a) The extent of extra demand during season time, and

(b) The exigencies of the urgent circumstances. Temporary working capital is generally financed from short-term sources of capital.

Temporary working capital can be of two kinds:

(i) Seasonal working capital, and

(ii) Special working capital.

6.1-2-I Seasonal working capital:

Seasonal working capital refer to financial requirements that arise during a particular season. Firms dealing with products that are seasonal in nature require more seasonal working capital (i.e. woolen garments, cold drinks, umbrellas, etc.) It is always difficult to predict the requirements of seasonal working capital.
6.1-2-II special working capital:

Special working capital refers to financial requirements that crop up to meet future uncertain contingencies, which may arise in the course of an operation. The business must set aside additional funds to cope with unforeseen eventualities (like, extra demand, extra purchase, additional expenses; increased labour cost etc). It is advisable to set up a reserve working capital to act as a cushion in times of emergencies.

6.2 IMPORTANCE (OR NECESSITY) OF WORKING CAPITAL:

The importances of adequate working capital to an enterprise are enumerated as follows:

(i) **Timely payment of dues:** Timely payment of dues to parties and credit is possible, if the business has adequate working capital. The absence adequate working capital leads to stagnation of business. Thus, adequate working capital of a business may enhance the goodwill of the business.

(ii) **Ensuring solvency of the business:** Adequate working capital ensures short-term solvency of the business. A running business might be closed want of sufficient working capital. Availability of enough liquid brings to the business a touch of doubtless solvency and strength.
(iii) **High credit-worthiness:** The credit status of a business depends on its ability to pay outsiders and the promptness with which payments are actually made. Credit-worthiness of a business is rated high if its working capital position is found satisfactory.

(iv) **Timely payment of dividends:** Liquid cash is necessary for the-payment of dividends. Due to scarcity of money, if dividends are not given to shareholders, an adverse reaction may be created among them. As a result, the business may lose its reputation. Therefore, adequate working capital is very much needed for timely payment of dividends.

(v) **Taking advantage of cash discounts:** A business having sufficient working capital is able to take advantage of cash discounts offered by suppliers in return for prompt payment.

(vi) **Meeting daily operating expenses:** It is necessary to purchase raw materials, pay wages and salaries, and incur various expenses in order to keep the flow of production uninterrupted. The smooth operations of the business largely depend on the adequacy of working capital.

(vii) **Possibility of getting loans:** A business with sound working capital is able to procure loans from banks on easy terms. Loans will not be available from – financial institutions
without proper financing for working capital.

(viii) Enhancing morale of employees: A business is able to pay wages and salaries regularly provided it has enough working capital. It enhances the morale of its workers. The sense of security and the confidence of the workers depend on the strength of the working capital of the business.

(ix) Executing special orders: Businesses having sufficient working capital can execute special orders by purchasing additional raw materials and employing additional staff.

(x) Availing of better marketing opportunities: Businesses with inadequate working capital lose their bargaining power during competition. On the other hand, businesses having enough working capital can wait for better market opportunities by holding up stocks in order to secure higher prices.

6.3 FACTORS DETERMINING THE AMOUNT OF WORKING CAPITAL:

The working capital requirements of an enterprise depend on a variety of factors, such as:

(i) Nature of business: The working capital needs are basically influenced the nature of business. Trading companies have to invest larger amounts funds in working capital. Public utility
undertakings have to invest more fixed assets and require lesser investment in working capital.

(ii) **Size of the business**: The size of the business may be measured in terms the scale of operations. The larger the scale of operation, the higher will the firm’s working capital requirements. On the contrary, small firms require comparatively small amounts of working capital.

(iii) **Production (or manufacturing) cycle**: This refers to the time involved in the production of goods. It covers the time span between the purchase of raw materials and the production of finished goods. The larger the manufacturing cycle, the higher will be the firm’s working capital requirements and vice versa.

(iv) **Business cycles**: Seasonal and cyclical fluctuations in demand for a product affect the working capital requirements. During the upswing of a business cycle, the need for working capital will grow and vice-versa.

(v) **Length of processing period (i.e. period of production)**: The longer the period (or process) of production, the larger is the requirement of amount of working capital. Whereas, for a short-range production process, there is no need for much working capital.
(vi) **Rapidity of turnover (or sales):** Turnover means the speed with which amount of working capital is recovered by the sale of goods. If the turnover is high, the amount of working capital required is rather small. If turnover is slow, then a large amount of capital gets blocked on unsold stocks.

(vii) **Terms of purchase and sale:** If goods and services are to be sold in cash, in such cases a comparatively small amount of working capital is required. When the firm is able to procure its raw materials and other needs on credit, it requires lesser working capital. On the other hand, if raw materials and other goods have to be purchased in cash and sales are to be made on credit basis, the firms will require larger amounts of working capital.

(viii) **Volume of production:** If production is undertaken on a large scale, a large amount of working capital is required. On the contrary, if production is made on a small scale, a smaller amount of working capital may be sufficient.

(ix) **Price level changes:** This affects the requirement of working capital. Rising prices would necessitate more funds for maintaining the same level activity. However, the firm may not face a severe working-capital problem during inflation, provided it can immediately revise the prices of its products.
(x) **Credit policy**: Credit policy of a firm depends on the industrial practice, current economic conditions and the management’s attitude. Higher working capital is required for a liberal credit policy. On the other hand, lower working capital is needed for a tight credit policy.

(xi) **Growth and expansion activities**: With the growth of business, a large amount of working capital is needed. Growing firms require more working capital than static firms.

(xii) **Operating efficiency**: The operating efficiency of a business means the optimum utilization of resources at a minimum cost. Better utilization of resources ensures reduction in operating costs. Thus, operating efficiency improves profitability and thereby releases the pressure on working capital.

(xiii) **Profit margin and profit appropriation**: High profit margins would generate more internal funds for contributing towards the working capital pool. The net profit is a source of working capital to the extent it has been earned in cash.

(xiv) **Convertibility of current assets into cash**: If the business possesses such current assets that can be quickly converted into cash, the amount of working capital requirement is less and vice-versa.
(xv) **Goodwill of the enterprise:** If the firm has a good reputation in the market, it can procure loans on easy terms.

### 6.4 Estimations of Working Capital Requirements:

"Working capital is the life-blood and controlling nerve center of a business." No business can be successfully run without an adequate amount of working capital. To avoid the shortage of working capital at once, an estimate of working capital requirements should be made in advance so that arrangements can be made to procure adequate working capital.
6.5 ANALYSIS OF WORKING CAPITAL

Q. What is the major source of working capital?

<table>
<thead>
<tr>
<th>Source</th>
<th>Proportion in (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank</td>
<td>64</td>
</tr>
<tr>
<td>Bills Disc./Factoring</td>
<td>20</td>
</tr>
<tr>
<td>Any other</td>
<td>16</td>
</tr>
</tbody>
</table>

Respondents (64%) generally rely on Banks for their short-term financing needs. 20% of respondents rely on Bills Discounting/Factoring but most of these activities are done by Banks. Very less (16%) respondents rely on other varied sources.
Q. Do you estimate Working Capital requirement time to time?

<table>
<thead>
<tr>
<th>Opinion</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>80</td>
</tr>
<tr>
<td>No</td>
<td>20</td>
</tr>
</tbody>
</table>

80% respondents estimate their requirement of Working Capital time to time.
Q. What is the estimated requirement of working capital for present level of operation in companies?

<table>
<thead>
<tr>
<th>Working capital (in lakhs)</th>
<th>Percentage of Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 – 20</td>
<td>40</td>
</tr>
<tr>
<td>20 – 40</td>
<td>18</td>
</tr>
<tr>
<td>40 – 60</td>
<td>16</td>
</tr>
<tr>
<td>60 – 80</td>
<td>12</td>
</tr>
<tr>
<td>80 – 100</td>
<td>4</td>
</tr>
<tr>
<td>100 – 120</td>
<td>2</td>
</tr>
<tr>
<td>120 – above</td>
<td>8</td>
</tr>
</tbody>
</table>

Requirement of working capital is varied and depends mostly on the turnover of the enterprises.
Q. Which method do you use for estimating working capital?

<table>
<thead>
<tr>
<th>Methods</th>
<th>Opinion in (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales methods</td>
<td>42</td>
</tr>
<tr>
<td>Operating cycle method</td>
<td>26</td>
</tr>
<tr>
<td>Regression analysis</td>
<td>0</td>
</tr>
<tr>
<td>No specific method</td>
<td>32</td>
</tr>
</tbody>
</table>

42% respondents use sales Method, 26% respondents use Operating Cycle Method and 32% of respondents don’t use any specific method of estimating Working capital.
Q. What is the proportion of Fixed and Variable working capital?

<table>
<thead>
<tr>
<th>Nature</th>
<th>Capital in (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed</td>
<td>68</td>
</tr>
<tr>
<td>Variable</td>
<td>32</td>
</tr>
</tbody>
</table>

On the averaging of answers obtained from all the respondents, researcher found that 68% of total W.C. is fixed and 32% W.C. is Variable in nature. This shows dependency on long-term sources more than the short-term. This reflects that companies are following moderate or conservative W.C. policy.
Q. What are the source of financing Fixed and Variable working capital?

**Fixed W. C.**

<table>
<thead>
<tr>
<th>Sources</th>
<th>Proportion in (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long term</td>
<td>80</td>
</tr>
<tr>
<td>Short term</td>
<td>20</td>
</tr>
</tbody>
</table>

**Variable W. C.**

<table>
<thead>
<tr>
<th>Sources</th>
<th>Proportion in (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long term</td>
<td>0</td>
</tr>
<tr>
<td>Short term</td>
<td>100</td>
</tr>
</tbody>
</table>