CHAPTER II

Working Capital - A Theoretical Backdrop
Working capital may be regarded as the life-blood and nerve centre of any business enterprise. It is as essential to a business enterprise as the circulation of blood, is to the human body to keep it alive. It is a vital input for the smooth functioning of any business enterprise, irrespective of its size and status, so that it can carry out its operations and to reach its goals. Without adequate working capital and its effective use, no business unit can achieve its targets. Efficient management of working capital resources will make sure not only liquidity but also enhance profitability, which reflects on the growth of an enterprise.

Capital is the amount of money provided by the owners of the business to establish and operate it. In addition, it consists of the accumulated profits of the business. Apart from the capital, there is another source of capital, which consists of the funds lent by commercial banks, financial and other lending agencies. Funds so raised by the business can be classified under two main categories viz., (i) Fixed Capital and (ii) Working Capital. Every business requires funds for meeting the needs of its establishment and to carry out its day-to-day operations. Long-term funds are required for production and trading facilities through purchase of fixed assets such as plant, machinery, land, buildings, furniture etc. Investment in these fixed forms of assets of the business is called fixed capital. Funds may also be invested in current assets. Funds needed for the purchase of inventory, payment of wages and other day-to-day expenses is called “working capital.” Current assets will be in a state of continual change and involve constant movement of funds, where the original
form of cash gets transformed into various stages of inventory, debtors and back to cash. The process is popularly known as operating cycle or cash cycle. Operating cycle of working capital is a new concept, which has gained more importance in recent years. The operating cycle of a typical business organisation is shown in the following figure.

OPERATING CYCLE / CASH CYCLE

![Diagram of Operating Cycle/Cash Cycle]

The firm should maintain investment on various components of current assets at an optimal level to get maximum benefits. High or low levels of investment on various forms of current assets would lead to either the blocking up of funds or interrupting the smooth flow of the cash cycle. The objective of working capital management is to ensure smooth and rapid flow of funds over
the operating cycle, which would increase the working capital efficiency and profitability of the firm. It needs prudent management of current funds, proper control and estimation of the required working capital, which would decide the profitability of the business enterprise. This concept of cash cycle or operating cycle is also used for estimating the working capital requirements of a firm.

The profitability of a firm is also influenced by the ratio of working capital to fixed capital. All other things being equal, when the fixed assets held are constant, if the working capital increases, the enterprise's profitability will decline. Therefore, the management should have as one of its targets, maintenance of the correct ratio between working capital and fixed capital. The firm's assets actually produce the goods for sale, create operational base and earning capacity, whereas working capital actually makes possible the effective use of fixed assets. Yasaswy asserted that the fixed assets form the skeleton and working capital the flesh and blood.

The management of working capital is a very vital facet of financial management. Working capital is a double-edged sword. Both excessive and inadequate working capital positions are very dangerous from the viewpoint of the business unit. Paucity of working capital not only hampers the firm's profitability but also result in production and trading interruptions and inefficiencies. An overall control over the working capital can ensure a proper functioning of the business operations.
There are several views regarding the concept of working capital. Generally concepts of ‘Gross and Net’ working capital are in vogue. Under the “gross” concept, working capital represents the commitment of funds to different items of current assets, which are circulating in nature and which may be converted into cash within an accounting year. Because of its nature, gross working capital is also known as current capital or circulating capital. The assets include cash, short-term securities, debtors, bill receivable and stocks. Current assets are limited, by accounting convention, to those that are expected to be converted into cash within a year.

The other concept of ‘Net’ working capital, views working capital differently as the total of all current assets minus current liabilities and provisions. This concept implies that net working capital represents the amount of current assets, which remain if all the current liabilities were paid. According to this concept, current assets must exceed current liabilities, and then only there can be working capital. Contrarily, “A working capital deficit exists if current liabilities exceed current assets.”

Current liabilities are those claims of outsiders, which are expected to mature for payment within an accounting year, and would generally include creditors, bills payable, bank overdraft and outstanding expenses.

Both concepts outlined above are equally important. The gross concept is quantitative in nature since it focuses attention on the levels of current assets. Economists supported this view because current assets actually help to earn
The proponents of the quantitative approach viewed that there is similarity in both fixed and current assets. According to them:

(i) The amount of profit is the resultant of complementary and mutual roles played by fixed and current assets. There is similarity between them. Fixed assets are meant to represent fixed capital, and current assets are understood as representing working capital. Both the types of capital are being borrowed, and earn returns over and above the interest cost. Current assets may vary from day to day and require regular review, and close evaluation of the account balances consistent with the objectives of the firm.

(ii) It is further argued that net working capital does not take into account the increase in borrowings. Because, if the firm borrows cash, there would be an increase in cash as well as in current liabilities. Both get levelled. Actually, with every increase in borrowing, working capital also increases proportionately.

(iii) This concept is of interest to the firm as a going concern. Since total current assets constitute the total funds available for operating purposes, the management has to concentrate current assets and allocate more time for managing them.

(iv) The gross concept of working capital is more applicable when the form of organisation is sole proprietorship, where the net worth of the business is reflected in the proprietor's capital account or partnership, where the
whole of 'net worth' is the total of the partner's account. In both cases, there is a close contact between ownership and management. This is not so in the case of a joint stock Company, which is as an entity separate, from its shareholders. There is a separation of ownership, management and control and, as a result, much importance has not been paid to the control of fixed and current assets.

Gross working capital represents the investment of funds in various components of current assets such as cash, short-term securities, receivables, prepayments, short-term loans, advances and inventories. They are limited by the accounting convention to those that are expected to be converted into cash within a year. Current assets may also be conceived as those assets, which in the normal course of business can be converted into cash within a short time span normally one year, without undergoing diminution of value, and without disrupting the organisation.


In the words of Adam Smith, "the goods of the merchant yield him no revenue or profit unless he sells them for money, and the money yields him a little till it is again exchanged for goods. His capital is continuously going from him in one shape and returning to him in another shape, and it is only by means of such circulation, or successive exchanges, that it can yield him any profit."
Such capital, therefore, very properly be called circulating capital. In fact what we call current assets, Smith called ‘circulating capital’.

It is clear that gross working capital management deals with the problems of managing individual current assets in the day-to-day business operations. Generally these assets constitute more than half of the total assets of the concern.

In consumer co-operatives, current assets constitute nearly 50 - 60 per cent of the investment. Management of working capital helps the financial executive in evaluating various existing or proposed financial constraints and financial offerings. Moreover, the management of current assets consumes a lot of time and energy and demands greater effort to man it profitably. The level of current assets decides the risk and return of the business unit. As the size of current assets increases both risk and return would decrease and vice-versa.

Current assets are assets, which a management expects to keep active, and investment in them is relatively volatile. In a going concern these assets flow regularly and continuously out of cash and realise back into cash. Every concern aims at speeding this conversion process, as a higher conversion rate involves lesser investment in current assets and results in lesser working capital needed.

Current assets by their nature are generally a controllable segment of investment, particularly in a trading concern. And the effort to optimise the investment in various components of these assets would certainly ensure savings on avoidable outlays and eventually lead to profitability. Every concern desires to have an optimum investment on current assets as it maximises the return and

52
minimises the risk. Failing to do so, it has a deleterious impact on the concern, resulting in an uneconomic business operation leading to losses and it would buffet the liquidity position of the concern also. Therefore it is very necessary to strike a balance between liquidity and profitability.

Any enterprise should ensure a smooth flow of current assets, failing which its operations will be adversely affected. As a consequence, sometimes there will be an acute dearth of current assets and at times an overabundance of others, both being ineffective for the enterprise’s operations. An astute financial manager will play a prompt and active role to gear up the flow of current assets, without sacrificing the quality of production or service to customers. In turn the care he takes reflects on the firm’s profitability. These assets are to be kept under continuous scrutiny to keep pace with the operations of the business and these are to be properly planned, directed and appropriate action is to be initiated. All these necessitate that the financial executives possess a good knowledge of finance of the short-term investment avenues and tap the financial resources in such a way to maximise the returns.

Components of Gross Working Capital

An outline of the elements of the gross working capital will help us to understand the components of current assets, and they are discussed below.

Inventory

Inventory is a physical stock of goods stored for the smooth operation of a business and it accounts for a major portion of the gross working capital.
Inventory may be in the form of raw material, work-in-process, finished goods, goods in transit and in the warehouse ready for sale. It acts as a buffer between the supplier who generally supplies material in large amounts at a steady rate and the consumer. Without inventory, the organisations may be buffeted adversely.

Managing inventory basically involves balancing between the carrying cost and loss arising out of reduced sales due to an interrupted production programme. An inventory maintained at a higher level leads to higher interest and storage costs and a low level of inventory, on the other hand, may result in frequent interruptions in the production process resulting in under-utilisation of production capacity and uneconomic sales volume. Further, the larger the amount of investment locked up in inventory, the higher is the cost involved and it adversely affects the profitability of the concern and keeps its resources idle which could be utilised elsewhere productively. The situations wherein the organizations, which have excessive and heavy amount of investment on inventory are very dangerous. What is needed is to have an optimum investment on inventory, which certainly minimises the cost and maximises the returns. Thus it requires a careful attention to be paid to managing inventory.

Accounts receivable

In any commercial and manufacturing firm, accounts receivable generally represent credit allowed to its customers. The size of investment in debtors depends upon the credit and collection policies of the firm in particular and
funds for discharging the firm's obligations promptly and something more than maintaining safe cash balances.

Since cash is the least productive and the most liquid asset, any excess or shortage in its level is unwarranted and it should be avoided. Excessive cash balance would tend to bring down profitability, whereas a cash shortage may lead to a more serious situation of disrupting the operations of the enterprise. In a nutshell, an optimum amount of cash balance is to be maintained and provided whenever the need arises. This arrangement in fact keeps up both liquidity and profitability intact.

**Other current assets**

These assets include pre-payments, loans and advances, interest accrued, taxes paid in advance and so on.

Net working capital is the excess of current assets over the current liabilities. Lincoln, Sahers and Stevens support the net working capital concept.

"Working capital, according to the time honoured definition", say Harry G Guthmann and Herbert E Dougall, "is the excess of current assets over current liabilities."

Leslie R Howard defines working capital as "those assets held for current use within a business, less the amount due to those who await settlement in the short term of value supplied in whatever form."

56
Lawrence J. Griman gives another, alternate definition. He observes that working capital is "that portion of a firm's current assets financed with long term funds".

Ralph D. Kennedy and Stewart Y. Mc Mullen seem to be in complete conformity with the views expressed above when they define working capital as "the excess of current assets over current liabilities, the amount of assets that has been supplied by the long term creditors and the stock holders".

Economists like Lincoln, Safets and Stevens support the concept of net working capital and advance the following arguments in support of their contention:

(i) In the long run, it is only the excess of current assets over current liabilities that matters.

(ii) This concept is useful to the creditors and investors to judge the financial soundness of the enterprise. It indicates the margin of safety for them concerning a particular enterprise at different points of time, as these people as outsiders want to know the exact position of the enterprise at various points of time. They must be given assurance regarding the financial position of the enterprise. It creates confidence among the creditors about the security of the amounts.

(iii) The excess of current asset over current liabilities is to be financed from long-term sources, which is not returned. So the creditors can rely upon these surplus amounts to meet the contingencies.
Sometimes the concern may have some amount of current assets and current liabilities. In such a case, this definition is useful to know the exact financial position of the enterprise.

The net aspect of working capital is of particular relevance as it is the sum, which must be furnished by the owners of the business, in the form of permanent capital, that is, by means of borrowing on long or medium terms, or by internally ploughing back profits.

In order to clear up the ambiguity in the definitions of working capital, S.C. Kuchhal has suggested that “gross working capital” may be used to refer to total current assets and “net working capital” to the excess of current assets over current liabilities. Husband and Dockeray, authorities on business finance, further clarifies this issue by advancing the view that the total current assets concept may be referred to as the “quantitative” aspect and the concept of net working capital as the “qualitative aspect.”

Working capital may also be classified on the basis of time into two categories:

1. Fixed or Permanent Working Capital
2. Variable or Temporary Working Capital

Fixed Working Capital

Fixed or permanent working capital is the minimum amount, which is required to ensure effective utilisation of fixed facilities and for maintaining the circulation of current assets. There is always a minimum level of current assets.
which is continuously required by the enterprise to carry out its normal business operation. Every firm has to maintain a minimum level of current assets, which is called permanent or fixed working capital, as this part of capital is permanently blocked in current assets. As business grows, the requirement of permanent working capital can further be classified as regular working capital and reserve working capital, to ensure circulation of current assets from cash to inventories, from inventories to receivables, and receivables to cash and so on. Reserve working capital is the excess amount over the requirement for regular working capital, which may be provided for contingencies that may arise unexpectedly such as strikes, rise in prices, depression, etc.

Variable Working Capital

Variable or temporary working capital is the amount of working capital, which is required to meet seasonal demands and some special exigencies. Variable working capital can be further divided as seasonal working capital and special working capital. Most enterprises have to provide additional working capital to meet seasonal and special needs. The capital required to meet the seasonal needs of the enterprise is called seasonal working capital. Special working capital is that part of the working capital which is required to meet special exigencies such as launching of extensive marketing campaigns, for conducting research, etc.

Temporary working capital differs from permanent working capital in the sense that it is required for short periods and cannot be permanently employed.
gainfully in the business. The figures given below illustrate the difference between permanent and temporary working capital.

**Working Capital in Stable Company**

*Fig. 2.2*

Amount of Working Capital

Temporary or Variable Working Capital

Permanent or Fixed Working Capital

**Time**

**Working Capital in Growing Company**

*Fig. 2.3*

Amount of Working Capital

Temporary or Variable Working Capital

Permanent or Fixed Working Capital

**Time**
In Fig 2.2 permanent working capital is stable or fixed over time while temporary or variable working capital fluctuates. In Fig 2.3, permanent working capital also increases with the passage of time due to expansion of business but even then it does not fluctuate as variable working capital sometimes increases and sometimes decreases.

WORKING CAPITAL FINANCING STRATEGIES

The sources of finance for working capital may vary from firm to firm, from country to country, and from time to time depending on the prevailing economical environment. It may be classified into four categories viz.,

1. Long-term Financing
2. Short-term Financing
3. Spontaneous financing, and
4. Mix of the above financings

Important sources of long-term financing are equity shares, debentures, preference shares, internally generated profits and long term debt from financial institutions; Short-term financing refers to those sources of short term credit that the firm must arrange for payment within the span of one year. These sources include short-term bank loans, commercial papers, factoring, receivables, trade credit and public deposits. Banks also advance special purpose short-term loans like packing credit for export. Commercial papers and factoring are just taking roots in India. Spontaneous financing refers to automatic sources of short-term funds arising in the normal course of business. The major sources of such
financing are outstanding wages other expenses, provisions and dividends. Spontaneous sources of finances are cost free. Therefore, a firm would like to finance its current assets with spontaneous sources as much as possible. Every firm is expected to utilise spontaneous sources to the fullest extent. Thus, the real choice of financing current assets is between short-term and long-term financing.

FINANCING APPROACHES

Depending on the mix of short and long term financing there are three basic approaches for determining an appropriate working capital financing mix.\(^{28}\)

<table>
<thead>
<tr>
<th>Approaches to Financing Mix</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Hedging or Matching Approach</td>
</tr>
<tr>
<td>The Conservative Approach</td>
</tr>
<tr>
<td>The Aggressive Approach</td>
</tr>
</tbody>
</table>

1. **The Hedging or Matching Approach**

   The term 'hedging' usually refers to two offsetting transactions of a simultaneous but opposite nature, which counter-balance the effect of each other. With reference to financing mix, the term hedging refers to a process of matching with the maturities of financial needs. According to this approach, the firm can adopt a financial plan, which matches the expected life of assets with the expected life of the source of funds raised to finance assets. When the firm follows this approach, long term financing will be used to finance fixed assets.
and permanent current assets, and short-term financing to finance temporary or variable current assets. But in practice, exact matching is not possible because of the uncertainty of life expectancy of the assets. This approach has been explained in graphic representation in Fig. 2.5, given below.

It reveals that the firm's fixed assets and permanent current assets are financed with long-term funds. If the level of these assets increases, the long-term financing level will also increase. Temporary or variable current assets are financed with short-term funds. The level of short-term financing increases with the increase of variable working capital, under the matching plan, no short-term financing will be used to meet the fixed working capital needs. This approach implies low cost, high profit and high risk.

*Fig. 2.5*

![Graph showing the relationship between assets and financing](image-url)
2 Conservative Approach

This approach suggests that the entire estimated investment in current assets should be financed from long-term sources and short-term sources should be used only for emergency requirements. The conservative approach implies high cost, low profit and low risk. It is depicted in Fig. 2.6

*Fig 2.6*

3 The Aggressive Approach

In the Aggressive approach, the entire estimated requirements of current assets is financed from short-term source and even a part of the fixed assets from short-term sources. This approach makes the finance mix more risky, less costly and more profitable. This is actually aggressive non-conservative, and a number of Indian companies have resorted to this approach. These undertakings are subject to the potential risk of loan renewal problems. This is shown in the following Fig 2.7
Fig 2.7

Temporary Current Assets

Short-term Financing

Permanent Current Assets

Long-term Financing

Fixed Assets

Time

Need for Working Capital

Working capital is an essential input, which cannot be over emphasized. Every business needs a certain amount of working capital, irrespective of its size and nature. The need for working capital arises due to the time gap between production and realisation of cash from sales. There exists an operating cycle involved in the sales and the realisation of cash. There is a time gap in the purchase of raw materials and production, production and sales, and sales and realisation of cash. Moreover, business operations in a competitive environment, necessitate ready stock to meet the demand. In addition to cash sales, when the demand is less than supply, the customers are to be given credit for the worth of goods purchased. In such instances, the credit mechanism operates, and it necessitates additional funds. Moreover, cash and bank balances are to be
maintained for routine daily expenses. Working capital is also needed to protect the business from adverse effects in times of inflationary situations.

Prudent management of working capital is very essential for the success of an enterprise. It aims at protecting the purchasing power of assets and maximizing the return on investment. So, while managing its working capital efficiently and effectively, a firm should balance its various needs and requirements to achieve the objectives of profit maximization, wealth maximization and to maintain sound liquidity. According to Ram Kumar Mishra, "In earning a reasonable rate of return the functional, complementary, proportional and technical roles of working capital play a great part." Moreover, it is impossible to operate a business without applying its working capital resources. A firm may acquire the required fixed assets, and employ them for its effective operation. Further working capital has a significant role to play in earning maximum returns on the capital employed in the business enterprise. The firm's profitability may be increased as working capital is added to the fixed capital, provided the firm does not exceed the hundred per cent capacity.

The manner in which current assets of a business enterprise are administered would greatly influence its success. Sales expansion, dividend declaration, plant expansion, new product line, increased salaries and wages, rising price levels etc., put additional strain on working capital management. The firm must be able to meet its financial obligations on its maturity. This can
be achieved by the firm only when it can control the flow of funds upward through the current assets and at the same time control the availability of funds from debt sources. This implies that the firm has to keep sound liquidity without affecting profitability. If it fails to do so, it faces technical insolvency and bankruptcy.

Current assets constitute the lion's share in the total assets structure of a business. Particularly account-receivables and inventories, which are the more important among them, are relatively volatile. The magnitude of current assets changes with fluctuations in the sales volume. Therefore, it is imperative to monitor and control the current assets. In small and growing firms, then, access to long-term capital market is limited. So, they would generally invest a larger proportion of money in current assets. Similarly, in a rapidly growing firm, additional finance is required to meet the increased investment needs, particularly in inventories and accounts receivables.

Financial executives of a company have to spend more time in managing the working capital owing to its importance of profit maximisation. It has been found that the largest portion of financial managers' time is utilized in the management of working capital. Not only the financial executives but other functional departmental executives also devote more time on working capital management. The management of cash, marketable securities, accounts receivable, accounts payable, wages, taxes and maintenance of bank relations, all these centre around working capital management.
Every business enterprise should have adequate to carry on its activities on most economical lines, so that it is without any financial stringency, and can meet all the current obligations promptly as and when they arise. It can work efficiently only if it has sufficient working capital to procure raw materials, services and supplies without facing recurring credit constraints.

Adequacy of Working Capital

A business enterprise has to plan for its working capital requirements with ample care and vision. Otherwise it may face the problem of inadequate or excess working capital, which, as noted already is a double-edged weapon, and would damage the economic health of the business enterprise.

Inadequate working capital may be due to shortage of cash, under-investment in receivables, marketable securities and inventories. This inadequacy will be disastrous to the enterprise, as it leads to low liquidity, low profitability, higher interest charges and under-utilisation of productive capacity. So, every concern should carefully plan its working capital. If not, it may lead to bankruptcy and early liquidation of the firm.

Excessive working capital, which is also equally undesirable, means idle funds, which earn no profits for the business, and hence, the business cannot earn proper return on its investment. The problem of excessive working capital arises due to unnecessary purchasing and accumulation of inventories and credit policy followed by the firm. Sometimes, the firm's directors exploit the situation of
excess working capital for their personal benefit by giving liberal dividends, which are not justified. It may result in overall inefficiency in the organisation.

**Forecast of Working Capital Requirements**

Working capital is a critical part of the total finances of any business enterprise. It is the deciding factor of the enterprise’s success. It has to be adequate to assure success. Therefore, an estimation of working capital requirements should be made well in advance. It facilitates to raise the required working capital as and when required. But the estimation of working capital requirements is not an easy task, and a number of factors should be considered before estimating it.

A number of methods, in addition to the operating cycle concept, such as percentage of sales, projection method, and regression analysis, may be used to determine the working capital needs in practice. It is an essential prerequisite for the success of any organisation, particularly consumer co-operatives, whose efficiency mainly depends upon the way they manage working capital.

Some of the methods in use to determine the Working Capital requirements of a typical concern, their merits and limitations, may be briefly examined.

a) **Percent—of—sales method**

The dominant role of sales in business underlines the conviction that good sales forecast is fundamental to effective forecasting of financial
requirements. In this method, the fundamental relationship between sales and working capital, basing on historical data is studied. And if this relationship is found to be stable, then this may be taken as the base for forecasting working capital. But this method suffers from a drawback, as it is based on the assumption that a linear relationship exists between sales, current assets and current liabilities.

b) Correlation analysis

The correlation method is a versatile statistical technique, which helps in making projections after establishing the average relationships in the past years between sales and components of current assets or other relevant items of the balance sheet. Scatter diagram provides a graphic portrayal of the trends, which can be projected for the future periods on the time of scale. The joint relation between sales on the one side, and the relevant balance sheet item on the other, can be simple and direct as perfect linearity or can also assume varying shades of complexity leading to simple regression, simple curve-linear regression and multiple regression situations.

c) Operating cycle approach

The cash needs of a firm for its day-to-day operations depend upon its "operating cycle" (or) "investment-disinvestment-reinvestment cycle." The operating cycle is "the average time intervening between the acquisition of materials and services entering the production-distribution process and the final
cash realization

In terms of this approach, working capital is needed to meet the operating expenses incidental to carrying on manufacturing, trading and sales activities.

The repetitive operating cycle of any business consists of the following sequential time periods:

1. Acquisition/Storage of materials
2. Conversion process
3. Finished goods storage and
4. Collection of receivables

In a purely trading concern, conversion period will be absent and is likely to be eliminated. The sum of the days involved in these four stages would yield the operating cycle. From these, the creditors payment period would be deducted to get at the exact operating cycle period. If one cycle completes, immediately another starts in the process of manufacture. In other words, this cycle is continuous.

The life span of the operating cycle differs from firm to firm, and industry to industry. In a large organisation where efficient and trained personnel look after credit department, purchases and production processes may have a shorter cycle as compared to small firms. This approach has an edge over the other methods because under this approach emphasis is placed on meeting operating expenses to complete a cycle. In an economy like ours, the operating cycle
concept will enable the banking sector to determine the requirement for working capital more accurately.

Determinants of Working Capital Requirements

A firm should plan its operation in such a way that it will have neither too much nor too little of working capital. The total working capital requirement is determined by a wide variety of factors. It should be, however, noted that these factors affect different enterprises differently. They also vary from time to time. The following are some of the important factors generally influencing the working capital requirements17

1. General Nature of the Business

Working capital requirements are basically affected by the nature of the business undertaken. Trading and financial firms require less investment in fixed assets but have to invest large amounts in current assets like inventories, receivables and cash, as they need large amounts of working capital. On the contrary, public utilities like Electricity, Water supply and Railways need very limited working capital because they offer cash sales only and supply services, not products and as such no funds are tied up in inventories and receivables. Manufacturing units also require a sizable working capital along with fixed investments. Generally, speaking it may be said that trading and financial firms require very large amounts of working capital and public utilities need small
amounts, whereas manufacturing undertakings require a sizable working capital, neither too large not too small.

2 Size of the Business/Scale of Operations

The working capital requirements of a concern are directly influenced by the size of its business, which may be measured in terms of the scale of operations. A firm with larger-scale operations needs more working capital and vice-versa. However, in some cases even a smaller concern may need more working capital due to high overhead charges, inefficient use of available resources and other economic disadvantages of small size.

3 Production Policy

In certain industries the demand is subject to wide fluctuations due to seasonal variations. The requirements of working capital in such cases depend upon the production policy. The production could be kept either steady by accumulating inventories during the slack periods with a view to meeting high demand during the peak season or it could be curtailed in the slack season and increased during the peak season. If the policy is to keep the production steady by accumulating inventories, it will require higher working capital.

4 Manufacturing Cycle

The time taken to convert raw materials into finished stock is termed as manufacturing or production cycle. Thus the longer the production cycle, the larger the firm's working capital requirements, i.e. more and more funds get tied
up in inventories. The management has to search with utmost care for alternate ways of manufacturing so as to complete the cycle within a specified period. This requires an effective organisation and coordination at all levels of the business enterprise.

5. Supply of Materials

Certain materials are seasonal. Some may pose a problem in the matter of procurement and holding. So, business concerns have to purchase in bulk and carry large reserves of these items to ensure smooth flow of business operations. Increasing inventory levels demand more funds to be invested.

6. Growth and Expansion Activities

As business grows, additional working capital is required to avoid interruption to the production sequence. It is difficult to draw up firm rules for the relationship between the growth in the volume of a company's business and the growth of its working capital. The critical fact is that the need for increased working capital funds does not follow the growth in business activity but precedes it. Since a growing concern has to invest funds in fixed assets, correspondingly an increased investment in current assets is inevitable. So growing firms need more funds continuously.

7. Volume of Sales

The volume of the sales is a vital factor affecting the size and components of working capital. A firm maintains current assets because they are very
essential to support the operational activities, which result in sales. The volume of sales and size of working capital are directly related to each other. As the volume of sales increases, there is an increase in the investment of working capital in the cost of operations, inventories and receivables.

8. Credit Policy

The credit policy of a firm in its dealings with debtors and creditors influences considerably its needs of working capital. A firm that buys its requirements on credit and sells its products or services on cash requires lesser amount of working capital. On the other hand, a firm purchasing its requirements for cash and allowing credit to its customers, needs a larger amount of working capital as very huge amount of funds are bound to be tied up in debtors or bills receivable.

9. Inventory Turnover

Inventory Turnover of a business is an important tool to determine the requirements of the working capital of a business unit. If the inventory turnover is high, the working capital requirements will be low. With a prudent inventory control, a firm will be able to reduce its working capital requirements. While attempting this, it will have to determine the minimum level of stock that it has to maintain throughout the period of its operations.
10. Receivable Turnover

In determining the working capital requirements of a business unit the Receivable Turnover is an important factor. It is necessary to have an effective control of receivables of a firm. A prompt collection of receivables and good facilities for settling payables result in low working capital requirements, and vice-versa.

11. Business Cycle

Both the periods of prosperity and depression have an accountable effect on the requirements of working capital of a business enterprise. Consequently, more working capital is required during the period of prosperity and less during the depression period. During marked upswings of activity, there is usually a need for a larger amount of capital to cover the lag between collection and increased sales and to finance purchase of additional materials to support the growing business activity. In the downswing of the cycle, there may be a brief period when collection difficulties and declining sales together cause embarrassment by the resulting need to replenish cash. Later, as the depression runs its course, the concern may find that it has a larger amount of working capital on hand than current business volume may justify.

12. Liquidity and Profitability

The requirement of working capital of a business unit mainly depends on its liquidity and profitability position. If it desires to take a greater risk for larger
gains and losses, it reduces the size of its working capital in relation to its sales. If it is interested in improving its liquidity, it increases the level of working capital. However, this policy is likely to result in a reduction of the sales volume, and, therefore, of profitability. A firm, therefore, should choose between liquidity and profitability and decide about its working capital needs accordingly.

13. Price Level Changes

Changes in the price level also influence the working capital requirements. Generally, rising prices will require the firm to maintain larger amounts of working capital, as more funds will be required to maintain the current assets. The effect of rising prices may be different for different firms. Some firms may be affected much while some others may not be affected at all by the rise in prices.

14. Seasonal Fluctuation

Seasonal fluctuation in sales of a business unit mainly affects the level of the variable working capital. Often, the demand for products may be of a seasonal nature. Yet inventories have got to be purchased during certain seasons only. The size of the working capital in one period may, therefore, be greater than in another.
15. Profit Planning and Control

The management of a business may decide upon the level of working capital in accordance with its policy of profit planning and control. Adequate profit assists in the generation of cash. It makes it possible for the management to plough back a part of its earnings in the business and substantially build up internal financial resources. It is clear that often the dividend policy of a business may depend upon the amount of cash available to it.

16. Environmental Factors

Political stability in its wake brings in stability in money market and trading world. Things mostly go smooth. Risk ventures are possible with enhanced need for working capital finance. Similarly, availability of local infrastructure facilities, road, transport, storage, and market etc., influence business and working capital needs as well.

17. Other Factors

The other factors, which directly or indirectly, influence business enterprises, are competition from rival business units, and the other things surrounding the business.

The above theoretical backdrop of working capital helps to obtain an insight into the chosen subject of investigation, the Working Capital Management in Co-operative Super Bazaars in Andhra Pradesh. The super bazaars in the state are operating exclusively in trading activities in consumer
requirements of essential commodities like rice, wheat, sugar, edible oils, provisions, home appliances, cloth, etc. The components of working capital of super bazaars are the different inventories such as the articles in which they do their business, receivables and cash. An attempt is made in the following chapters to analyse the components of working capital of super bazaars like inventory, cash and receivables.
References:


6. Ibid

7. Burton, A Kolb, Op cit, p 152


15. Ibid


23. Lawrence J Gitman, Op cit., p 255


27. Srivasan S., Op cit., p 155


30 Ram Kumar Mishra, *Problems of Working Capital* (with special reference to selected public undertakings in India), Somaya Publications Pvt Ltd New Delhi, 1975, p 12

31 Ibid p 13


35 Ibid p 95

36 Colm, Park and John W Gladson, Op cit, p 22