CHAPTER II

DETERMINANTS OF WORKING CAPITAL
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Inputs are needed to run an industry and to possess such inputs capital is needed. This capital may be either fixed capital or working capital or both. Industries like manufacturing, assembling ancillary etc., need both fixed capital and working capital, whereas service industries generally need only the fixed capital for investing in permanent assets. However, this trend has changed recently and it is found that the service industry also needs working capital for eg. Computer service units, Xerox Units, Radio and T.V. Services etc.

Working capital is the sum of the capital required to invest in raw materials, payments to creditors, collection from debtors, cash at bank, and cash on hand. The several analyses of the working capital conclude that the working capital is nothing but the excess of current asset over current liability. Therefore, the working capital bears all the characteristics of current asset. Hence, the importance of working capital identifies with the importance of current asset only. For proper working capital management, it is necessary to synchronize the cash receipt and cash payment rationally, in some of the cases the working capital management with the help of cash reserves.

Fixed capital is required to install plant and machinery to construct building etc. Working capital is required to maintain
those assets in a safe and proper condition. Therefore, working capital acts as circulation of blood in the human body. If the working capital properly circulates without any interruption, the fixed assets also go on functioning positively. Further, the nature of the fixed capital is almost permanent, whereas the working capital is temporary. As a result of this inherent quality, the fixed capital won't turnover during the normal period of time, whereas the working capital turnover is a common feature during accounting year. In the same way the sources of the fixed capital is always permanent but the sources of working capital is partly temporary and partly permanent. Because of this fixed characteristic, fixed assets cannot be easily encashed, however, working capital can be realised into cash within a short span of time.

There are two kinds of working capital (1) Permanent Working Capital and (2) Variable Working Capital.

Permanent working capital includes that portion of the working capital which remains constant in the industry as depicted in figure 1 and figure 2.

![Fig 1](image1.png)

![Fig 2](image2.png)
Variable Working Capital: It includes that part of the working capital which goes on increasing with corresponding increase in the volume of output, but there will always be a minimum level of working capital which will always be required by the organization to keep their operation on. Fig. No. 3 indicates the entire process of working capital.

![Diagram of working capital cycle]

The changes in the working capital occur due to the change in business cycles. This change in the volume of working capital is not always same. Tandon committee which studied the composition of working capital and its sources, strongly supported the view that for permanent working capital, the permanent sources should be tapped up and for the variable portion of the working capital, the other sources can be made use of. The quantum of the working capital is determined on the basis of the manufacturing activity undertaken, the business cycles, size of the business etc., perhaps external factors also influence the position of the working capital. The external factors include the technological...
changes, transportation facilities, supply of power, Govt policy with regard to tax assessment etc. International factors cover areas like production policy, manufacturing process, expansion activities, availability of specialization, dividend policy etc.

The determination of working capital is not so simple and cannot be customarily made. One has to go into details of the multifarious factors influencing the working capital which requires managerial skill and art of management. For determining the working capital the following points should be considered:

(1) Unforeseen effects of the contingencies like strikes, fire, abnormal hike in taxes etc, and their effects.

(2) Availing of the maximum discount facilities available for prompt and proper payment.

(3) Exploiting the opportunity to covert the inactive asset into active asset.

(4) Building up only the necessary reserve so as to avoid the loss of interest.

(5) Investing wisely in income yielding investment only and avoid filing up deadly investments.

(6) Avoiding wastages in handling men, money, material and machine.
(7) Fixing rationally, the level of inventory that the organization should possess.

(8) Generating the funds for working capital, more from internal sources rather than depending upon them from outside sources. In case of internal sources itself being regarded as the major source, the following guidelines are to be followed before accepting the decision of financing for working capital internally.

(a) The sales should be speeded up by introducing the attractive schemes like discount sales, gift schemes, price cut off etc.

(b) Maintain the timely and modern inventory as per the demands of the customers.

(c) Exercise proper control over inventory and dispose off unwanted inventories first.

(d) Avoid unnecessary buying of the raw material, spares etc.

(e) Adopt the purchases on hand to mouth system, provided the raw material supply is assured always.

(f) Make use of the most advantageous term in purchasing the materials.

(g) As far as possible procure the goods on deferred payment basis.
(h) Adopt changing methods of selling the goods like instalment basis by using the negotiable instruments, which can be discounted to finance for working capital.

(i) Speed up the rate of collection of dues from the customers, and apply only the delicate and modern procedures for collecting dues.

(j) Rationalize the production procedure, thereby the period of production may be cut down.

(k) Ensure the continuous flow of production and see the jobs moving always from raw material into sales.

(l) Introduce the manufacturing of the by-products which could be profitably sold and contribution can be made for the strong sales policy.

(m) Dispose of the investment and assets which are not pertinent to the regular operation.

(9) Consider the nature and size of the business: This is one of the most important factors determining the amount of working capital in the business. The concerns engaged in manufacturing of heavy engineering equipments need a very high investment in the fixed assets and as a result their requirement of working capital will be less, whereas the trading financial institutions, service rendering
organizations need less amount of fixed assets and very high investment in working capital.

(10) Manufacturing Process Set up: The Working Capital required depends directly upon the number of manufacturing processes introduced in the concern. Too many processes need too much working capital and vis-a-vis. The manufacturing process commences right from the purchase of raw material till it is converted into the final product. The question of manufacturing process does not arise in the case of service industry. Even then the working capital required by them is high as they invest in fixed capital.

(11) Ups and downs in the business: Business is not a silent valley but is a roaring sea with many disturbing tides. Therefore, fluctuation in the business should be properly taken into account while calculating the amount of working capital. The sales are always subject to increase or decrease with every phase of the trade cycle. In case of a boom period the sales are extremely high and book debtors also increase but the working capital position also improves if the sales are made more on cash basis. This case will be reverse in case of depression of the economy.

(12) Production Policy: The concern may engage in the production either on single shift, double shift or triple
shift depending upon the sales expected. The working capital fluctuates directly with the production policy adopted by the organization. There are some seasons where every entrepreneur would like to increase his production by following double or triple shifts.

(13) The Credit Policy : Two major policies advented to effect the sales, are cash sales and credit sales. Either of them cannot be introduced 100 per cent. Instead, it is found invariably that the credit sales policy to some extent, must be adopted. This credit policy affected positively the working capital, having its influence on the increase or decrease in the book debtors. While introducing the credit policy, the creditworthiness of the customer must be necessarily considered. It will help in adopting the discriminatory credit policy also depending upon the individual customers.

(14) Creditors' Attitudes : Where the creditors' supplying the raw material or granting the loan, adopt liberal policy, the working capital requirement will be less. It also depends upon the period and the extent of, amount for which credit is granted.

(15) Diversification Policy of the Firm : In case the firm is restricted to any particular policy, the working capital will remain static. If it goes on diversifying its activity, the working capital also increases.
(16) Profit Margin: The profit margin fixed by the entrepreneur will be achieved if the products manufactured by him are readily sold and accepted by the customers in the market. The working will be increased if the sales and the profit percentage increases. In addition to the profit margin, the availability of the cash for financing the working capital is controlled by the taxation policy, dividend policy, depreciation methods etc. Sometimes it may so happen that profit margin is high but there may not be any contribution to the working capital, because of the conservative policy of Govt. If the entire profit is appropriated for the payment of dividends, nothing may be left for working capital.

(17) Fluctuation in Price Level: The fluctuation in the price level shall have corresponding effects on the working capital. If the price fluctuation is extreme, the working capital requirement also will be more. This problem will be severe in case of small scale industries.

(18) Operating Efficiency: Generating of working capital is not an end in itself but its utilization depends upon the operating efficiency in the business. The operating efficiency is related to the maximum utilization of the available resources at the minimum costs. If the working capital is effectively utilized the productivity is maximised.
and profit is maximised. The working capital management aims at achieving the profitability and the solvency. These aims can be attained by maintaining a rational ratio between the sources of fund and their application.

Solvency stands for the ability of the concern to meet the obligation in time, specially the lenders' financial institutions, creditors expect prompt settlement of their claims as and when they are due. To ensure solvency it is indispensable that the concern should possess sufficient current assets. There cannot be any danger of losing the business prestige, if the solvency ratio is properly maintained. Because of the business fluctuation it is not possible to maintain adequate working capital.

The cost of liquidity and the cost of illiquidity are the two important conditions, which determine the amount of working capital in the business. If only liquidity aspect is considered then profitability suffers and business prestige is maintained by meeting the outside obligations promptly and vice-versa. Therefore, the working capital management throws a challenge on the proper ratio to be maintained between liquidity and illiquidity. Neither only the profitability nor the business integrity could be seen. Instead, the success of working capital lies in achieving both.