Working Capital
A Theoretical Backdrop
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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. It is a vital input for the smooth functioning of any business enterprise, irrespective of size and status, in order to carry out its operations and reach its goal. Without adequate working capital and its effective use, no business unit can achieve its targets¹. 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 which, very much required to start business by the owners is coupled with the accumulated profits of the business. The enterprises have some other source of capital provided 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 (ii) Working capital. Long term funds are needed for production and trading facilities through purchase of fixed assets such as Plant, Machinery, Land, Buildings, Furniture etc. Investment in these fixed assets of the business is called Fixed Capital. Funds can be invested in current assets i.e., working capital and these can be used for purchases, payment of wages and some other day to day expenses. 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. This is a process 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 business organization is shown here under.

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 blocking up of funds or interrupting the smooth flow of the cash cycle. The main objective of working capital management is to ensure smooth and rapid flow of funds over the operating cycle. The working capital management efficiency and profitability of the firm would be increased by it. Efficient management is needed for management of current funds, proper control and estimation of the required working capital fetches the profitability of the business enterprise. This concept of operating cycle or cash cycle is useful to estimate the working capital requirements of a firm.
The ratio of working capital to fixed capital also influences the profitability of a firm. The management should possess the maintaining ability of equilibrium state between fixed capital and working capital. All the other things being equal, when the fixed capital is held constant, the increase of working capital leads to decline of profits. Therefore the management should maintain the correct ratio between working capital and fixed capital. Fixed capital investment generates production capacity. The firms fixed assets produce the goods for sale, create operational base and earning capacity where as working capital makes possible the effective use of fixed assets. Yasaswi compared the skeleton with fixed capital and flesh and blood with working capital.

Management of working capital is a very delicate area in the field of financial management. The manner of management of working capital to a very large extent determines the success of operations of a concern. Constant watch is required to maintain appropriate levels in the various working capital accounts. Working capital determines the appropriate levels of current assets and their efficient use as well as the choice of financing mix for raising the current resources. The goal of working capital management is to manage the current assets and current liabilities of a firm in such a way that a satisfactory level of working capital is maintained. The main theme of the theory of working capital management is to have healthy interaction between current assets and current liabilities. Any how it can be said that working capital is a double

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2 Srinivasan S., cash and working capital management, Vikas Publishing House, New Delhi, 1998 P-2
3 Yasaswy N.J. Finance for non financial executives, allied publishers pvt. Ltd., New Delhi, 1983, P-87
5 S.P.Vijaya Saradhi, working capital management, A complete overview the Management Accounts, June 1981, P-273.
edged sword. Because both excessive and inadequate working capital positions are very dangerous for business enterprises. Insufficient working capital reduces the firms profitability and badly effects the production and trading. Therefore there should be control over the working capital to ensure proper functioning of a business unit.

Regarding the concept of working capital, there are several views. Generally concepts of Gross and Net working capital are in vogue. The gross working capital is defined as the current assets of the firm includes cash, marketable securities, account receivables and inventory. Under the “Gross” concept, working capital represents the investment of funds in different items of current assets, which are circulating in nature and get converted into cash within an accounting year. It is also known as circulating capital and revolving capital because of its nature. Current Assets are limited, by accounting convention to those that are expected to be converted into cash within a year.

According to ‘Net’ working capital concept the total of all current assets minus the current liabilities and provisions is Net working capital. This concept implies that Net working capital represents the amount of current assets, which remain if all the current liabilities are paid. And hence the current assets must exceed current liabilities. If the current liabilities exceed the current assets, working capital shows deficit balance.

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10 IBID.
Current Assets are defined by Friedland and William as the assets which include operating cash, accounts receivable and inventory should meet the rate of return on present value hurdle applied to non-liquid assets such as plant and equipment\textsuperscript{11}.

According to Fitzerald current assets are “Cash or other assets which are expected to be converted into cash in ordinary course of business within one year or with such longer period in the normal operation cycle of a business constitutes\textsuperscript{12}. In his view “Current liabilities are those liabilities whose liquidation is reasonably expected and classified to require the use of existing resources properly as current assets or the creation of other current assets, or the creation of other current liabilities\textsuperscript{13}.

Current liabilities are the claims of outsiders, which are expected to be matured for payment within an accounting year. They include creditors, bills payable, bank overdraft and outstanding expenses.

Obviously the inference is that both concepts are equally important. The gross concept is quantitative in nature since its focuses its attention on the level of current assets. This is supported by economists as the current assets helps to earn profits. They have also viewed the similarity in both fixed assets and current assets. According to them:

1) The profit is the outcome of complementary and mutual roles played by fixed and current assets. There is similarity in between these two. Fixed


\textsuperscript{12} V.L. Gole and Fitzerald, analysis and pretation of financial statement, Sidney; Botter worth, 1966, P-51

\textsuperscript{13} Ibid. “5”.
assets represent fixed capital and current assets represent working capital. Both types are borrowed capitals and earn returns over and above the interest cost. As the current assets vary constantly it requires regular review and close evaluation of the account balances consistent with the objectives of the firm.

2) Further argument is the net working capital does not consider the increase in borrowings. Actually with every increase in borrowing, working capital also increases proportionately. When the firm borrows cash, there will be an increase in cash as well as in current liabilities. Both get leveled. The total current assets form the total funds for the purpose of operation. The current assets should very much be concentrated and sufficient time must be allocated for managing them. This is the concept very interestingly followed by the going concern.

3) The gross concept of working capital is well suited to sole proprietorship and partnership firm organizations, where the net worth of the business is reflected in proprietor’s capital account or total of the partner’s account. In both the cases there is a close contact between ownership and management. But it is different in joint stock companies, because the entity and shareholders are separated i.e. Ownership, Management and control are separate. As a result, much importance has not been paid to the control of fixed and current assets.
Gross working capital consists of the investment of funds in various components of current assets like Cash, Inventory, Bills receivables, Short term securities, prepayments, short term loans and advances. Current assets may also be conceived as those assets which in the normal course of business can be into cash within a short time span may be one year, without undergoing diminution of value and without disrupting the organization.14


Adam Smith rightly points out, that "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.21 In fact, what people term current assets, Smith called circulating capital.

The problems of managing individual current assets in business operations are dealt by gross working capital management. These assets constitute more than half of the total assets of the concern. In consumer co-operative societies, current assets constitute nearly

21 IBID.
50-60 percent of the investment. The financial executive will be free enough to evaluate the financial constraints and financial offerings with the help of Management of working capital. But the problem with management of current assets is that it consumes a lot of time and energy and demands greater efforts to man it profitably. As the size of current assets increases, both risk and return would decrease and vice-versa. So it is understood that the risk and return of business unit is decided by the level of current assets.

The management expects to keep current assets active and investment in them is relatively volatile. These assets flow continuously and regularly out of cash and realize 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.

Particularly in a trading concern the current assets are generally a controllable segment of investment. If the investments are optimized in various components of these assets, there would certainly be a savings on avoidable outlays which ultimately leads to profitability. To maximize the return and minimize the risk, it is desired to have an optimum investment in current assets. Failing to do so, it has a deliterious impact on the concern, resulting in an uneconomic business operations leading to losses and it would buffet the liquidity position of

23 Lawrence J. Gitman, Principles of Managerial Finance, Harper and Row publishers, New York (3rd Edition 0, P-27.)
the concern also. Therefore it is necessary to strike a balance between liquidity and profitability.

There should be a smooth flow of current assets in any enterprise. If this is not maintained the operations of the concern will be adversely affected and there will be a sudden downfall of current assets and at times an over abundance of assets. These will be ineffective for the operations of the enterprise. It will be the duty of an efficient financial manager to play an active role to gear up the flow of current assets. So that there will be a Qualitative production and satisfying service to the customers. Consequently his care 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. For all these things financial executives should possess good knowledge in financing short term investment avenues and in tapping the financial resources in such a way to maximize the returns.

Components of Gross Working Capital

Current assets include cash, inventories, accounts receivable and market securities. They are discussed in detail.

Cash

Cash is the most liquid and important component of working capital, as every transaction of business is a result of either inflow or outflow of cash. As the blood stream in the entire body, the funds should be circulated for survival, growth and
development of the enterprise. Improper usage of cash leads not only to failure in meeting
with maturing obligations but also in disrupting production process. As R.R. Basi said
"Cash is an important component of working capital. Its importance in the composition of
working capital of any enterprise hardly needs no emphasis. Cash is the life blood of a
business enterprise. As blood gives life and strength to the human body, cash imparts life,
strength, solvency and profits to the business.24

Excess or shortage of cash levels should be avoided, because excess cash balance
would tend to bring down the profitability and cash shortage leads to serious situation of
disrupting the operations of the enterprise. Therefore an optimum amount of cash balance is
to be maintained as per the needs. This arrangement keeps up both liquidity and profitability
intact.

Inventory

Inventory is a physical stock of goods stored for the smooth operations of the
concern and it accounts for a major portion of the gross working capital. It consists of
raw material, work-in-process, finished goods, goods in transit and in the warehouse
ready for sale. According to Kohler, inventory is any class or group of material or
supplies not yet expressed, or capitalized as maintenance supplies or construction
materials.25 It acts as a buffer between supplier and consumer. Without inventory the
organizations are affected adversely.

Inventory management basically involves balancing between the carrying cost and loss arising out of reduced sales due to interrupted production programme. Higher level of maintenance of inventory leads to higher interest and storage costs. This adversely affects the profitability of the concern. The resources which are kept idle can be used elsewhere productively. The excessive amount of investment on inventory will always be dangerous to the organisation. Low level of inventory may result in frequent interruption in the production process. It results in under utilisation of production capacity and uneconomic sales volume. Therefore an optimum investment on inventory, which minimises the cost and maximises the return is needed. And hence proper attention must be bestowed to manage inventory.

Accounts Receivables

In commercial and manufacturing firms, accounts receivables represents credit allowed to its customers. The credit and collection policies of the firm decides the size of investment in debtors of a firm. It involves bringing in of the trade-off between the gains arising out of incremental sales due to the liberal credit facilities offered by the firm and the additional cost in realizing these debts. The cost of collection of debts, interest charges and incidence of bad debts are involved in the liberal credit policies of the firm. A stringent credit policy leads to reduction in sales volume, because some customers may be attracted by competitors who offer more liberal terms. This affects the profitability of the firm adversely.
Besides determining the credit policy of a firm, the management of debtors should have required knowledge in-depth and study the risk associated with the grant of credit to various parties. It should have a vigorous follow up action against debtors and prompt credit collection policy.

**Short Term Investments (Marketable Securities)**

The surplus cash balances can be used to invest in short term marketable securities, which are easily convertible into cash within a short span of time. This investment generates some return which augments the profits without affecting liquidity.

**Other Current Assets**

Pre payments, loans and advances, interest accrued, tax paid in advance come under this category.

**Net Working Capital**

Net working capital is the excess of current assets over the current liabilities. This is supported by Lincoln, Sailors, Stevens, Harry G. Guttmann and Herbert E. Dougall.

Ralph D. Kennedy and Stewart Y. Mc Muller have defined 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.” They have also confirmed the

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30 Kennedy R.D. & Mc Muller, S.Y., OP.Cit., P-226
views of Lawrence J. Gitman, that working capital is the portion of a firm’s current assets financed with long term funds\textsuperscript{31}. And with the definition given by Leslie R. Howard “Working capital is the 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\textsuperscript{32}.

In support of their contentions regarding the net working capital, Saliers and Stevens have given the following arguments.

1) Working capital is only the excess of current assets over current liabilities in the long run.

2) This will be helpful to judge the financial soundness of the enterprise for the creditors and investors. The margin of safety at different points of time would be known or indicated to the creditors and investors. So that the creditors can have the knowledge regarding the financial position of the enterprise. To create confidence about the security of the amounts, the creditors should be provided the financial position of the enterprise.

3) The excess of current assets 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.

4) If some amount of current assets and current liabilities are with the concern, the exact financial position of the enterprise is known.

\textsuperscript{31}Lawrence J. Gitman, Op cit., P-255
The net aspect of working capital should be furnished by the owners of the business in the form of permanent capital i.e. by means of borrowing on long or medium terms or by internally ploughing back profits.

To have a clarity, the definition of S.C. Kuchhal\textsuperscript{33} helps us a lot. He suggests that gross working capital refers to total current assets and net working capital to the excess of current assets over current liabilities. Another advanced clarification by Husband & Dockeray\textsuperscript{34}, authorities on business finance is "the total current assets concept refers to the Quantitative aspect and the concept of net working capital to Qualitative aspect".

**Kinds of Working Capital**

Working capital can 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**

Every firm has to maintain minimum level of current assets, which is called permanent or fixed working capital, as this part of capital is permanently blocked in current assets. Fixed working capital is to be maintained for maintaining the circulation of current assets and the effective utilization of fixed assets. As business grows the requirement of Permanent working capital can again be classified as regular working capital and reserve working capital. Regular working capital is the amount kept for the circulation of current assets from

\textsuperscript{33} Kuchhal, S.C., Corporation Finance — Principles and problems, Chaitanya publishing house, Allahabad (2nd Edition), 1958, P-311.

\textsuperscript{34} Husband, William H. and Dockeray, James C., Modern Corporation Finance, Richard D. Irwin Illions, (4th Edition), 1957, P-507
cash to inventories, inventories to receivables, and receivables to cash and so on. Reserve
working capital is the excess amount over the requirement of regular working capital and this
can be used for unexpected and extraordinary needs such as strikes, rise in prices, depression
etc.

Temporary or Variable Working Capital

Variable working capital is specially utilized to meet seasonal demands and in
emergencies. As quoted by Butchest and Hicks "Working capital which is temporarily
or intermittently employed should be called variable working capital."

It can further be classified as seasonal working capital and special working
capital. Seasonal working capital is the amount to meet the seasonal needs of the
enterprise and special working capital is that part of working capital which is required
to meet the special exigencies such as launching of extensive marketing campaigns
and to conduct research etc.

Temporary working capital is different 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.

In Figure 3.2 permanent working capital is stable or fixed over time while temporary or variable working capital fluctuates. In Fig 3.3 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 some times increases and some times 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 categories36, viz.,

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

Long Term Financing

The sources for long term financing are Equity shares, Debentures, Preference shares, internally generated profits and long term debt from financial institutions.

Short Term Financing

This refers to those sources of short term credit that the firm must arrange for payment, within the span of one year. These sources include Commercial papers, Receivables, Short-term Bank loans, Trade credit and Public Deposits and factoring. For exports Banks also advance special purpose short-term loans like packing credit. Commercial papers and factoring are now taking roots in India.

Spontaneous Financing

In the normal course of business need for automatic sources of short term funds arises and those are called spontaneous finance. The major sources of such financing are

36 Srinivasan S., Op.Cit., P-155
outstanding wages, other expenses, provisions and dividends. A firm finance its current assets with spontaneous sources to the maximum possible as these sources are cost free. Thus the choice of financing current assets is between short-term and long-term financing.

Financing Approaches

Depending on the mix of short term and long term financing there are three basic approaches for determining an appropriate working capital financing mix:

1) The Hedging or Matching Approach

The term hedging usually refers to two off-selling 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. This approach reveals that 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 the assets. If the firm follows this approach, long-term financing can be used to finance fixed assets and

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permanent current assets, and short-term financing to finance temporary or variable current assets. But due to uncertainty of life expectancy of the assets, the exact matching is not possible in practice. This approach is illustrated in graphic representation in Fig. 3.5 given below.

Fig. 3.5

The cited approach clarifies that the firms fixed assets and permanent current assets are financed with long-term funds. The increase in the level of these assets, leads to increase in level of long-term financing. 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. The short term financing will not be used to meet the fixed working capital needs under the matching plan. There will be three important aspects in this approach. This process implies low cost, high profit and high risk.

2) Conservative Approach

This approach maintains 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. This approach implies high cost, low profit and low risk. This is shown in Fig. 3.6.

Fig. 3.6

3) Aggressive Approach

In this approach, the entire estimated requirements of current assets are financed from short-term sources and even a part of the fixed assets is also met from short-term sources. This approach makes the finance mix more risky, less costly and more profitable. This approach is aggressive and non-conservative. This approach is followed by a number of Indian companies. These undertakings face the potential risk of loan renewal problems. This can be seen in the following Fig. 3.7.

Fig. 3.7
Need for Working Capital

Working capital is an essential input for any enterprise irrespective of its size and nature. Owing to the time gap between production and realization of cash from sales, the need for working capital arises. There exists an operating cycle involved in the sales and realization of cash. There is a time gap in the purchase of Raw material and production, production and sales, and sales and realization of cash\(^38\). In a competitive environment it is necessary to make ready the stock to meet the demand. When the demand is less than supply, credit offer should be given to the customers for the goods purchased. In such a stage, there arises the necessity of additional funds. At the same time, the cash and bank balances are to be maintained for daily expenses. At the time of inflationary situation, working capital is also needed to protect the business from adverse affects.

Prudent management of working capital is very essential for the success of the enterprises. For maintenance of working capital, efficient management is required to protect the purchasing power of assets and maximizing the return on investment. The firm should maintain the balance in its various needs to achieve the objectives of profit maximization, wealth maximization and maintaining sound liquidity.

Ram Kumar says "There is a great part for working capital in complementary proportional and technical roles to earn a reasonable rate of return\(^39\). Applying working capital resource is most important for any business organization to develop and to

\(^38\)Sharma, R.K., Shashi K.Gupta, Op cit P-20.7

\(^39\)Ram Kumar Mishra, problems of working capital (with special reference to selected public undertaking in India), Somaiya Publications Pvt. Ltd., New Delhi, 1975, P-12.
operate it. Fixed assets play an important role for success of the organization. That's why the required fixed assets should be provided and employed for their effective operation. Working capital has a significant role to earn maximum returns on the capital employed in the business enterprise. If the working capital is added to fixed capital, the firm's profitability increases, provided the firm does not exceed the hundred percent capacity.\textsuperscript{40}

The way of administration of current assets influence the success of the enterprise. 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 their maturity. This can be achieved by controlling the flow of funds upward through the current assets and by controlling the availability of funds from debt sources. The firm has to keep sound liquidity without affecting profitability. If it fails to do so, it has to face technical insolvency and Bankruptcy.

All current assets occupy a major share in the total assets structure of a business. Particularly accounts receivables and inventories are relatively volatile and more important among all the current assets. The magnitude of current assets changes with the fluctuation in the sales volume. Therefore it is imperative to monitor and control the current assets. The access to long-term capital market is limited in small and growing firms. Hence, they have to invest a larger portion of money in current assets

\textsuperscript{40} Ibid P-13
Where as in a rapidly growing firm, the additional finance is required to meet the increased investment needs, particularly in inventories and accounts receivables.

It has been found that the largest portion of financial manager’s time is utilized in the management of working capital. To maximize the profit, financial executives of a company have to spend more time in managing the working capital\textsuperscript{41}. Not only the financial executives, but other functional departmental executives also have to spend more time on working capital management. The Management of cash, Marketable securities, Accounts receivables, Accounts payable, Wages, Taxes and Maintenance of Bank relations centre around working capital Management.

Every business enterprise should have adequate working capital to carry its activities on most economical lines and then meet all the current obligations promptly without any financial stringency. So the adequate working capital of business enterprise can fetch good service and supplies without facing recurring credit constraints.

**Importance of Adequate Working Capital**

A Business Enterprise should plan and maintain a sound working capital position. Otherwise it has to face the problems of excessive or insufficient working capital positions. These two are very dangerous and damage the economic health of any business enterprise.

Inadequate working capital may arise due to shortage of cash, under investment in receivables, Marketable Securities and Inventories. This can be disastrous to the enterprise.

\textsuperscript{41} Motall E.L.Abd., working capital : Its role in the short run liquidity policy of Industrial concern, Accounting research, Vol.IX, 1958, P-226.
Because this inadequacy of funds leads to low profitability, low liquidity, higher interest charges and under utilization of production capacity. So the working capital should be carefully planned. If not it leads to bankruptcy and early liquidation of the firm.

Excessive working capital is also undesirable as the idle funds cannot earn profit for the business. Consequently the business can’t earn proper return on its investment. This problem arises due to unnecessary purchasing and accumulation of inventories and credit policy followed by the firm. The situation of excess working capital, sometimes, is exploited by the directors of the firm for their personal benefits by giving Liberal dividends which are not justified\(^2\). It leads to overall inefficiency in the organization. So, adequate working capital should be maintained. Adequate working capital means maintaining sound bank credit, trade credit, maintaining solvency, availing of discount facilities offered by suppliers and finally achieving profitability. With sound working capital position, it can tide over a period of recession.

**Forecast of Working Capital Requirements**

Working capital is a critical part of the total finances of any business enterprise. The success of the firm depends upon the working capital only. Adequate working capital assures the firm to get its success. It facilitates to meet its obligations promptly

as and when they arise. But to meet its obligations in time the firm has to forecast the working capital requirements of the firm well in advance. This estimation of working capital requirement enables the firm to get the finance from the right source in right time. But the estimation of working capital is not an easy task. It is influenced by a great many factors.

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

Some of the methods which determine the working capital requirements are mentioned here under.

Percent of Sales Method

Good sales forecast is fundamental for effective forecasting of financial requirements43. According to this method, the study of historical data is a base to find-out the fundamental relationship between sales and working capital. If stability is found in this relationship, this may be taken as the base for forecasting working capital. But there is a drawback in this method, as it is based on the assumption that a linear relationship exists between sales, current assets and current liabilities.

43 Ramamoorthy, V.E., working capital management, Institute for Financial Management and Research, Madras, 1978, P-85
Correlation Analysis

Correlation method is a very popular and widely used technique. It helps to make projections after establishing the relationship in the past years in between sales and current assets or other relevant items in 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 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 situations44.

Operating Cycle Approach

The operating cycle decides the cash needs of a firm for its day to day operations.

The operating cycle is the “Average time intervening between the acquisition of materials and services entering the production-distribution process and the final cash realisation45. So working capital is essential to meet the needs i.e. the operating expenses to carry on manufacturing, trading and sales activities.

The operating cycle consists of the sequential time periods. They are

a) Acquisition / Storage of materials

b) Conversion process

c) Finished goods storage and

d) Collection of receivables

The conversion period is absent in a pure trading concern. The operating cycle is the sum of total days involved in these four stages. To find out the exact

44 Ibid P-95
operating cycle period, the creditors payment period should be deducted from the four cited. In the process of manufacture as one cycle completes, another one starts. So it can be said that the cycle is continuous. Every firm will not have the same life span of operating cycle. It differs from firm to firm and industry to industry. The cycle may be made shorter by efficient and trained personnel who look after credit department, purchases and production process in large organizations when compared to small firms. This approach is the best one when compared with other methods to meet the operating expenses to complete a cycle. The operating cycle concept will enable us to determine the working capital requirement more accurately in banking sector in an economy like ours.

Determinants of Working Capital Requirements

The working capital of a firm should be maintained in such a way that it should not have neither excess nor inadequate funds for its operations. A wide variety of factors will play an important role to determine the total working capital requirement. However, the affect of these factors are different from enterprise to another and vary from time to time. The following are some of the important factors which influence the working capital requirements.46

General Nature of The Business

The nature of the business decides the working capital requirements of a firm. Trading and financial firms requires less investment in fixed assets and large amount of investment in current assets like inventories, receivables and cash as they need large amounts of working

capital, where as the public utility organisations like electricity, water supply and Railways require limited working capital as they offer cash sales only and supply services. In such firms no funds are tied up in inventories and receivables, whereas a sizable working capital along with fixed capital is required by the manufacturing units.

Large amount of working capital is needed to trading and financial firms and public utility organisations need small amount of working capital whereas sizable working capital neither too large nor too small is required for manufacturing undertakings.

Size of The Business / Scale of Operations

The size of business influences the working capital requirement for a concern. It may be measured in terms of the scale of operations. More working capital is required for a firm with large scale operations 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 sources and other economic disadvantages of small size.

Production Policy

Where there are fluctuations in demand due to seasonal variations, the requirement of working capital in certain industries depend upon the production policy. The firm can keep the production either steady by accumulating inventories during the slack periods to meet high demand in peak seasons or curtail in the slack season and increase during the peak season. Higher working capital is required to keep the production steady by accumulating inventories.
Manufacturing Cycle

The time taken to convert raw material into finished stock is termed as manufacturing or production cycle. The requirement of working capital increases in direct proportion to length of manufacturing process. The longer the production cycle, the larger are the firm's working capital requirements. By that the funds get tied up in inventories. To come out of this problem, alternative ways of production process should be found out by the management to complete the cycle within the specified period. This requires an effective organization and coordination at all levels of the business enterprise.

Supply of Raw Materials

Some materials are so seasonal that they create many problems to the firm in procurement and holding. That's why they have to be purchased and held in bulk quantity to ensure smooth flow of business operation. So more funds are to be invested to increase inventory level.

Growth and Expansion Activities

Growth in business requires additional working capital to avoid interruptions to the production sequence. It is very difficult to draw up firm rules for the relationship between the growth in the volume of business and increase in its working capital. In fact, the need of additional working capital funds does not follow the growth in business activity but precedes it. So the investment of funds in fixed assets corresponding to the increased investment in current assets is inevitable for a growing concern i.e. the firm need more funds continuously.

Volume of Sales

The volume of sales is an affecting factor for the size of working capital. Current assets are very essential for successful operational activities which result in good sales. As the volume of sales increases, there is an increase in the investment of working capital in the cost of operations, inventories and receivables. So the volume of sales and size of working capital are directly related to each other.

Credit Policy

The need of working capital is influenced by the credit policy of a firm which deals with debtors and creditors. Buying the requirement on credit and selling its products or services on cash requires lesser amount of working capital. On the other hand purchasing the requirements for cash and allowing credit to its customers, needs a larger amount of working capital, as a larger amount of working capital will held up with debtors and bills receivables.

Inventory Turnover

Inventory turnover 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 requirement is low. With efficient inventory control, it will be able to reduce the working capital requirements. So minimum level of stock should be purchased and maintained throughout the period of its operations, while attempting the inventory control.
Receivable Turnover

The receivable turnover is an important factor to determine the working capital requirements of a business firm. Receivables of a firm have to be controlled effectively. The working capital requirements can be low when there is prompt collection of receivables and good facilities for settling payables and vice-versa.

Business Cycle

During the period of prosperity working capital requirement is more and it will be less during the depression period. Therefore the prosperity and depression have a greater effect on the requirements of working capital of a business enterprise. There arises a need for larger amount of capital to cover the lag between collection and increased sales and to finance purchase of additional materials during marked upswings of activity. There may be a brief period in down swing of the cycle, when there are collection difficulties and declining sales together. This leads to replenish cash. At the time of depression, the concern may have larger amount of working capital than its current business volume.

Liquidity and Profitability

A firm should choose its working capital requirements basing on its liquidity and profitability. The firm can reduce the size of working capital in relation to its sales, if it desires to take a greater risk for larger gains and losses. If it is desired to improve its liquidity, which will likely to result in a reduction of sales volume and profitability, the level of working capital has to be increased.
Price Level Changes

The impact of change in the price can be more on the working capital requirement. A rise in the price, generally causes the firm to maintain larger amount of working capital. Because to maintain the current assets the firm requires more funds. 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 rising in prices.

Seasonal Fluctuations

The level of variable working capital is mainly affected by the seasonal fluctuations in sales. The demand for some products are of a seasonal nature. Then during certain seasons the inventories have to be increased. Therefore, the size of working capital may be greater in one period than in the other.

Profit Planning and Control

Basing on the policy of profit planning and control the level of working capital may be decided by the management of a business unit. Adequate profit helps in generation of the cash. It makes it possible for the management to plough back a part of its earnings in the business to buildup internal financial resources. The dividend policy of a firm often depends on the availability of cash.

Environmental Factors

There is stability in money market and trading world, when there is political stability. Risk ventures are possible with enhanced need for working capital finance. The availability
of local infrastructure facilities like road, transport, storage and market also influence the business and working capital needs.

Other Factors

Competition from rival business units and other aspects related to the business unit strongly influence the working capital requirement of the business enterprise.

The so far discussed theoretical backdrop of working capital helps us go deeper into the chosen subject of investigation, **The working capital management in selected 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 oil, 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 analyze the components of working capital of super bazaars like inventory, cash and receivables.