Chapter - I

WORKING CAPITAL MANAGEMENT:
A CONCEPTUAL FRAMEWORK
Finance is the lifeblood of every business activity without which the wheels of modern business organization system cannot be greased. Finance is a scarce resource and it has to be managed efficiently for the successful functioning of any enterprise. Several enterprises have come to grief mainly because of inefficient financial management, in spite of other favourable conditions. Financial management is managerial activity which is concerned with planning and controlling of the firm's financial resources. The term financial management, in traditional approach, refers to the procurement of funds by corporate enterprises to meet financial needs. But in modern approach, it is viewed in a broadsense and provides a conceptual and analytical frame work for financial decision-making. The financial management, in the modern sense of the term, can be divided into three major decisions as functions of finance. They are (1) the financing decision (2) the investment decision and (3) the dividend decision.

A business organization requires funds to meet two objectives.

(1) To create productive capacities through purchase of fixed assets and
(2) To finance current assets required for day to day running of the business. Effective management of these two funds is very essential from the business organizational point of view.

Nowadays the emphasis is steadily shifting towards closer internal financial control. This would certainly make working capital management more and more important. The main object of working capital management is to ensure smooth functioning of the business and to get sufficient funds in time. Though the whole concept of financial management has been given great importance in economically advanced countries, it was not seriously considered and applied to many of the industries in India. Of late, a beginning has been made in well-established business organization houses and it is hoped that due importance to this aspect will be given by all business organizations.

The financial position of many industrial units in India was far from satisfactory and the Government has to take initiative to set certain norms of financial management of private enterprises for their healthy growth.

Now working capital management has assumed great importance for the last two decades. The implementation of the Tandon Committee report in the middle of 1970's the Chore Committee report and the Maratha Committee report in the beginning of 1980's has compelled the business units to efficiently manage their working capital.
FIXED Vs. WORKING CAPITAL

Fixed Capital normally refers to the investment in fixed as well as non-current assets in which funds are tied up for comparatively long periods. When fixed capital forms the body of an organization, working capital may be regarded as the blood which gives the strength and stamina to the body. Working capital activates fixed capital to ensure liquidity and profitability in the organization. The proportion between fixed and working capital varies with the nature of the industry. For every industry there could be a standard proportion between the two. The success or otherwise of the enterprise depends on how far this proportion is maintained correctly. In any case the relationship between the two is complementary. In most cases it is easier to plan for fixed capital than for working capital. A well equipped plant will be useless without sufficient working capital to supply materials to process or to meet the wage bill or to pay other current expenses. It may be sometimes possible that profitability could be increased by adding working capital under certain given conditions up to the full degree of utilization of capacity.

DEFINITIONS AND CONCEPTS OF WORKING CAPITAL

Working capital, in simple term, is the amount of funds which an enterprise should necessarily have to finance its day-to-day operations. It can also be regarded as that
proportion of the total capital which is employed in short-term operations.

In the Annual Survey of Industries, Working Capital is defined to include "stock of raw material, stores, fuels, semi-finished goods and by-products, cash in hand and bank and the algebraic sum of sundry creditors as represented by (a) Outstanding factor payments e.g., rent, wages, interest and dividend, (b) Purchase of goods and services (c) Short-term loans and advances and sundry debtors comprising amounts due to the factory on account of sale of goods and services and advances towards purchase and tax payments".¹

Nowadays efficient management of working capital has come to be recognized as one of the basic functions of finance for successful conduct of business activities. It not only influences the profit-earning capacity of business organization but also determines largely their scope and context of operations. As observed by Zenoff and Zwick, "Proper management of working capital is very important for the success of an enterprise. It aims at protecting the purchasing power of assets and maximising the return on investment".² The management of working capital is concerned with the management of the firm's current accounts, which include current assets (assets which can be converted into cash within an accounting year without undergoing diminution of value and without disrupting the enterprise) and current liabilities (those claims of outsiders which are expected to mature for payment (within
an accounting year) out of the current assets or the Income of the business). Working capital is one of the most important facets of the firm's over-all financial management. Working capital sphere throws open a welcome challenge and an opportunity for the Financial Manager to play a key role for effective planning, controlling, directing and utilizing the working funds in an enterprise.

CONCEPT OF WORKING CAPITAL

Total assets of a business unit can be divided into two main categories. The first has to do with the assets which are constantly changing form or working assets and the second includes fixed assets. In other words, capital can be divided into two main categories—fixed capital and working capital. Basically while the former is required to acquire fixed assets the latter is needed to finance current assets.

There are two concepts of working capital, namely Gross concept and Net concept.

GROSS WORKING CAPITAL

According to this concept, working capital refers to the firm's investment in current assets. The amount of current liabilities is not deducted from the total of current assets. This concept views working capital and aggregate of current assets as two interchangeable terms.
This concept is also referred to as 'Current Capital' or 'Circulating Capital'

Some experts are of the opinion that total current assets requirements should measure the total working needs of the concern. Economists like Mead, Malott, Baker and Field approve of gross or quantitative concept. They argue that:

(a) Profits are earned by the help of whole assets which are partly fixed and partly current. Fixed assets represent the fixed capital. So total of current assets should be taken to mean the working capital of a corporation.

(b) The management is more concerned with the total of current assets as they constitute the total funds available for operating purposes than with the sources from which the funds come.

(c) The net concept of working capital had relevance when a close contact was involved between the ownership of capital and its management. But nowadays when a separation is involved between management, ownership and the control of the concerns and consequently the ownership of current and fixed assets is not given so much importance as in the past.

(d) This concept takes into account the fact that every increase in funds will increase the working capital but according to net concept there will be no change.
(e) The gross concept is used since one of the principal functions of a manager is to provide the correct amount of working capital at the right time in order to enable a firm to realise the greatest return on its investment.

**NET WORKING CAPITAL**

The net working capital refers to the difference between current assets and current liabilities. (Current liabilities are those claims of outsiders which are expected to mature for payment within an accounting year and include creditor's dues, bills payable, bank over-draft, and outstanding expenses). Net working capital can be positive or negative. A positive net working capital will arise when current assets exceed current liabilities. A negative net working capital occurs when current liabilities are in excess of current assets. In other words, net working capital is that portion of a firm's current assets financed with long-term funds. Since current liabilities represent sources of short-term funds, as long as current assets exceed the current liabilities, the excess must be financed with long-term sources. The net concept of working capital has been adopted by the Accounting Principles Board of the American Institute of Certified Public Accountants, U.S.A. It defined working capital thus: "Working Capital, sometimes called Net working capital, is represented by the excess of current assets over current liabilities and identified as the
relatively liquid portion of total enterprise's capital which constitutes a margin or buffer for maturing obligations within the ordinary cycle of the business".9

Another group of economists like Lincoln10 and Saliers11 approve of the net working capital or qualitative approach and argue that:

(a) Net concept enables the investors to judge the financial soundness of a concern.

(b) In the long run what matters is the surplus of current assets over current liabilities.

(c) This approach helps to find out the correct financial position of the concerns having the same amount of current assets.

(d) The excess of current assets over current liabilities is the only amount that can be relied upon to meet contingencies and emergencies.

CIRCULATION SYSTEM OF WORKING CAPITAL

The funds in a business are obtained by issuing Shares and Debentures, making other long-term arrangements and providing from operations of business. A large amount of generated funds is used to acquire fixed assets like plant and machinery, land and buildings and some other fixed assets, while the remaining part of the generated funds is used for day to day operations of the business i.e., to pay
creditors for raw materials purchased and to pay wages and overhead expenses for the raw materials processed. This makes possible the stocking of finished goods by whose sales either accounts receivables are created or cash is received. In this process profits are generated. A part of the profit is used to pay tax, interest and dividends and the remaining part of profits are ploughed back into the business. The method goes on constantly throughout the life of business.

CLASSIFICATION OF WORKING CAPITAL

According to Gerstenberg the working capital can be conveniently divided into permanent or regular working capital and variable working capital. The variable working capital can further be subdivided into seasonal and special working capital.

1. Fixed, Regular or Permanent Working Capital

Regular or Permanent working capital is the minimum investment kept in the form of inventory of raw materials, stores and spares, work-in-process, finished products and book debts to facilitate uninterrupted operations in an enterprise. Though this investment is stable in short run, it certainly varies in long run depending upon the expansion programmes undertaken by the firm. It is not always the same, it increases or decreases over time. The minimum level of current assets maintained in a firm is usually known as Fixed, Regular or Permanent working capital.
2. Variable Working Capital

In addition to permanent working capital, a business enterprise is required to maintain additional working capital temporarily over and above permanent working capital to satisfy cyclical demands. O.M. Joy observes: "Any amount over and above the permanent level of working capital is temporary, fluctuating or variable working capital". 13

(i). Seasonal Working Capital

Seasonal working capital is needed to meet the seasonal demands of busy periods occurring at stated intervals. In other words seasonal working capital is additional amount of current assets which is required during the more active business seasons of the year.

(ii). Special Working Capital

The special working capital is required to meet extraordinary needs or contingencies like strikes and lock-outs, cut-throat competition, rising prices or launching of advertisement etc., Fire and price hike tendencies, contingencies may arise requiring additional working capital which is usually known as special working capital.

Purpose of classification

Classification of working capital as permanent and variable is important in deciding the source of the working
capital. For example, permanent working capital being permanent in character should be provided through long term sources like equity or long term borrowings from financial institutions. The Tandon Committee subscribed to this idea when it stated that "the hard core part of current assets requirements should be financed by the industry out of equity or long term borrowings from term financial institutions". Similarly variable working capital is mostly financed through short term credits by banks. Sometimes a small portion may be provided by creditors for supplies, expenses and provisions.

**NEED FOR WORKING CAPITAL FINANCE**

The need for working capital to meet the operating needs of a business organization need not be over-emphasised. A business unit needs working capital funds to perform its activities of production and sale of its products. Funds are generally needed to fulfil the following objectives:

1. To purchase and stock necessary quantities of raw materials and stores.
2. To make advances for goods and services.
3. To meet all incidental expenses related to production.
4. To carry the finished goods till sales are made.
5. Some times sales have to be made on credit basis thus creating accounts receivables. The funds would
be needed to carry the receivables also as sales do not convert into cash instantaneously.

IMPORTANCE OF ADEQUATE WORKING CAPITAL

Working capital is considered as the central nervous system of a business organization. Adequacy or inadequacy of these funds would determine the efficiency with which the day to day business may be carried on. Management of working capital is an essential task of the financial manager. He has to ensure that the amount of working capital available with his concern is neither too large nor too small for its requirements. "Working capital management has been looked upon as the driving seat of a Financial Manager".  

"Constant management is required to maintain appropriate levels in the various working capital accounts". A huge amount of working capital would mean that the company has idle funds. Since the funds are kept idly the company has to pay large amounts as interest on such funds. The various studies conducted by the Bureau of Public Enterprises have shown that one of the reasons for poor performance of Public Sector undertakings in our country has been the locking up of large amount of funds in working capital. This results in over capitalisation. Over capitalisation implies that a company has too large funds for its requirements, resulting in a low rate of return, a situation which implies a less than optimal use of resources
Inadequate working capital is also bad since paucity of working capital only leads to a situation where the firm may not be able to meet its liabilities. Such firm runs the risk of insolvency. It is interesting to note that several firms which are otherwise prosperous having good demand for their products and enjoying profitable marketing conditions may fail because of lack of liquid resources.

Then the question of the optimum amount of working capital for a firm arises. A firm should have neither too high amount of working capital nor too low. It is the job of the financial manager to estimate the requirements of working capital carefully and determine the optimum level of investment in working capital.

Theoretically a universally applicable rule cannot be framed for all types of industries. The working capital requirements vary from industry to industry. For obvious reasons, this is true with seasonal industries also. For example the working capital requirements of an Iron and Steel Industrial Unit will certainly be different from that of a Sugar Mill. But what is important is that irrespective of the nature of industry or its financial structure, the working capital should be properly managed.

DETERMINANTS OF WORKING CAPITAL

As a general policy a company wants to hold small balance of working capital so long as undue solvency risks are not imposed on it. This is a logical approach
indicating that working capital is a means to an end and not an end in itself.

There are no set rules or formulas to determine the working capital requirements of the firms. But the business firm should plan its operations in such a way that it should have neither too much nor too little working capital. A large number of factors influence the working capital needs of the firms. All factors are of different importance. Also the importance of the factors change for a firm over-time. Therefore an analysis of the relevant factors should be made in order to determine the total investment in working capital. The following is the description of the factors which generally influence the working capital requirements of a firm.

1. Nature and size of business

The working capital requirements of a firm are basically influenced by the nature of its business. Trading and financial firms have a very less investment in fixed assets, but require a large amount of money to be invested in working capital. Some manufacturing business firms have to invest substantially in working capital and a nominal amount in fixed assets. For example, construction firms and public utilities have to invest abundantly in fixed assets. Their working capital requirements are nominal because they have cash sales only. Thus no funds will be tied up in debtors and stock. The working capital needs of
most of the manufacturing concerns fall between the two extreme requirements of trading firms and public utilities.

The size of business also has an important impact on its working capital needs. Size may be measured in terms of the scale of operations. A small firm may use extra current assets as a cushion against cash flow interruptions. Bigger firms which have many sources of funds will require less amount of working capital as compared to the smaller ones.

2. Manufacturing cycle

The manufacturing cycle starts with the purchase and use of raw materials and completes with the production of finished goods. The longer the manufacturing cycle, the larger will be working capital requirements. An extended manufacturing time span increase a larger tie-up of funds in inventories.

3. Business cycles

The requirements of working capital of a company vary with the business cycles. When there is an upward trend in the economy, sales will increase, correspondingly, the firm's investment in inventories and book-debts will also increase. Therefore, the firm requires large amount of working capital. Under boom periods, additional investment in fixed assets may be made by some firms to increase their productive capacity. This act of the firms will require
more working capital. On the other hand under recessionary conditions the firms try to reduce their working capital.

4. Credit policy

The credit policy of the firm affects working capital by influencing the level of book debts. The credit terms to be granted to the customers may depend upon the norms of the industry to which the firm belongs.

5. Availability of credit

The working capital requirements of a firm are also affected by credit terms granted by its creditors. A firm will need less working capital if liberal credit terms are available to it.

6. Attitude towards profits

A relatively large investment in current assets tends to reduce profit margins of a firm as the commitment of funds involves a high cost. However some firms desire to have an extra amount of working capital and are ready to sustain these costs. On the other hand other firms want to maintain minimum of working capital in order to earn larger profits.

7. Operating efficiency

If a firm operates efficiently to reduce wastage and higher turnover of inventories, it can reduce working capital to a minimum extent.
8. Terms of purchase and sale

The place given to credit by a company in its dealings with creditors and debtors affects considerably the amount of working capital. A firm purchasing materials on credit basis but likely to sell its finished products on cash, needs minimum level of cash balance and vice versa.

9. Growth and expansion activities

Working capital need arises when the firm is determined to expand their business and production. It can be anticipated when the prospects of the business are indicated in terms of sales. In such cases the firm has to depend on a large amount of working capital.

OPERATING CYCLE OF WORKING CAPITAL

The operating cycle can be said to be the core of the need for working capital. "The contributing flow from cash to suppliers, to inventory, then to accounts receivables and to bank or cash is what is called the operating cycle". In other words the duration of time required to complete the following sequence of events, in case of a manufacturing firm, is called the operating cycle.

(1) Conversion of cash into raw materials.
(2) Conversion of raw materials into work-in-process.
(3) Conversion of work-in-process into finished goods.
(4) Conversion of finished goods into debtors and bills receivables through sales.
(5) Conversion of debtors and bills receivables into cash
Operating cycle varies from one business to another depending upon the nature of business. For example service and financial concerns have the short operating cycle because there is no need of maintaining any inventory at all. The operating cycle for manufacturing and non-manufacturing firms is given in figure 1.1 and figure 1.2.

Fig 1.1

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Debtors -----> Sales
            |      |     |
            +----> Finished goods
Cash ------|---|-----|
          |   |
Raw materials ----> Work-in-process
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Fig 1.2

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Debtors

Cash ----> Debtors

Stock of Finished goods

Sales
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COMPONENTS OF WORKING CAPITAL

The components of working capital are

CURRENT ASSETS

(1) Cash and bank balance
(2) Short-term investments, (e.g. Government and other trust securities, Fixed deposits with banks for less than one year etc.,
(3) Receivables arising out of sales other than deferred investments.
(4) Inventories
   (a) Raw materials and components used in the process of manufacturing.
   (b) Work-in-process
   (c) Finished products
   (d) Other consumable spares
(5) Loans and advances
(6) Prepaid expenses and accrued income

CURRENT LIABILITIES

(1) Short-term borrowings
(2) Sundry creditors
(3) Public deposits maturing within one year
(4) Deposits from dealers, selling agents etc.,
(5) Outstanding expenses and income received in advance
(6) Statutory liabilities, provident fund dues, provision for taxation, statutory obligation towards workers etc.,
(7) Proposed and unclaimed dividends

(8) Interest and other charges accrued but not due for payment and

(9) Any other payments due within twelve months.
REFERENCES


