# CHAPTER 2

THEORETICAL ASPECTS OF WORKING CAPITAL MANAGEMENT

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2.1 Introduction

Management of working capital is an extremely important area of financial management as current assets represent more than half of the total assets of a business. Fixed assets through essential for a business organization, does not by itself produce revenue or income. Fixed assets act with current assets to generate revenue or income. Therefore, working capital is necessary for utilizing the productive capacity of fixed capital.

Working capital is the lifeblood and nerve centre of a business. Just as circulation of blood is essential in the human body for maintaining life, working capital is very essential to maintain the smooth running of a business. No business can run successfully without an adequate amount of working capital.

Every business needs funds for two purposes. Long-term funds are required for creation of production facilities such as plant and machinery, land, building and furniture, etc. Investment in these assets represents that part of firm’s capital, which is permanently blocked on a permanent or fixed basis and is called fixed assets. The form of these assets does not change, in the normal course.

Funds are, also, needed for purchase of raw materials, payment of wages and other day-to-day expenses, etc. These funds are known as working capital. Funds invested in these assets keep revolving fast. These assets are converted into cash and, again, cash is converted into current assets. So, working capital is also called revolving or circulating capital. The assets change the form on a continuous basis.

The term circulating capital is frequently used to denote those assets which are changed with relative rapidity from one form to another. Working capital is essentially circulating capital. In fact, it is often referred to as such. This has been admirably summed up by Brown and Howard, who compare it with a river which is always there but whose water level is constantly changing. In other words, working capital refers to that part of the firm’s capital, which is required for financing short-term or current assets such as cash, debtors, inventories and marketable securities, etc.

The importance of working capital management is reflected in the time most spent by financial managers in managing current assets and current liabilities. Maintenance of
adequate working capital is necessary in order to discharge day-to-day liabilities and protect the business from adverse effects in times of emergencies. It aims at protecting the purchasing power of assets and maximizing the return on investment. In other words, the goal of working capital management is to minimize the cost of working capital while maximizing a firm’s profits. Management is required to be vigilant in maintaining appropriate levels in the various working capital accounts. The working capital management is concerned with determination of relevant levels of current assets and their efficient use as well as the choice of the financing mix.

The efficiency of a firm to earn profits depends largely on its ability to manage working capital. In other words, working capital management policies have a crucial effect on firm’s liquidity and profitability. Thus, working capital plays a crucial role in earning a reasonable rate of return. Hence, working capital has to be effectively planned, systematically controlled and optimally utilized.

2.2 Meaning of Working Capital

The term working capital originated with the old Yankee Peddler, who would load up his wagon with goods and then go off on his route to peddle his wares. The merchandise was called working capital because it was what he actually sold, or “turned over”, to produce his profits. The wagon and horse were his fixed assets. He generally owned the horse and wagon, so they were financed with “equity” capital, but he borrowed the funds to buy the merchandise. These borrowings were called working capital loans, and they had to be repaid after each trip to demonstrate to the bank that the credit was sound. If the Peddler was able to repay the loan, then the bank would make another loan, and banks that followed this procedure were said to be employing “sound banking practices.”

The word ‘working capital’ is the combination of two words ‘working’ and ‘capital’. In business, the word ‘working’ with reference to capital means circulation of capital from one form to another form during day-to-day operations of the business, whereas, the word ‘capital’ refers to the monetary values of all the assets (tangible and intangible) of the business.
The term working capital literally means the capital required for day-to-day working in a business concern such as for purchasing raw material.

The term Working Capital refers to

- Those current assets, which are convertible into cash, within a period of one accounting year and
- Those funds needed for meeting day-to-day operations.

Working Capital means the funds (i.e. capital) available and used for day-to-day operations (i.e. working) of an enterprise.

Working capital is defined as the excess of current assets over current liabilities and provisions.

In accounting, “Working capital is the difference between the inflow and outflow of funds.”

H G Guthmann, “Working capital is the excess of current assets over current liabilities.”

C W Gerstenberg defines, “The excess of current assets over current liabilities.”

A Ramamoorthy, “Working capital refers to the funds, which a company must possess to finance its day-to-day operations.”

V E Ramamoorthy has rightly pointed out that working capital is but one segment of the capital structure of a business and constitutes an inter-woven part of the total integrated business system. It may not, therefore, be regarded as an independent, unrelated entity; nor can working capital decisions be taken in isolation.

In the words of E W Walker, “Working capital provides the net resources with which a company can finance day-to-day operations. A firm’s profitability is determined by the way its working capital is managed.”

According to Michael Firth, “Almost every activity of business or everything that happens in the business is related to working capital decisions. In fact, the reason for
working capital not being able to optimize itself is that there are various functional areas influencing it, and these primarily take care of their own needs.”

In the words of Shubin, “Working capital is the amount of funds necessary to cover the cost of operating the enterprise.”

According to Dr Colin Park and Professor J W Gladson, “Most commonly working capital is defined as the excess of current assets of a business (cash, accounts receivable, inventories) over current items owed to employees and others (such as salaries, wages, accounts payable, taxes owed to Government).”

The definition gives in the Annual Survey of Industries for Working Capital is as under:

“Stocks of materials, stores, fuels, semi-finished goods and byproducts, cash in hand and bank and the algebraic sum of sundry creditors as represented by (a) outstanding factor payments e.g., rent, wages, interest, dividend; (b) purchase of goods and services; and (c) short-term loans and advances and sundry debtors comprising amount due to the factory on account of sale of goods or services and advances towards purchase and tax payments.”

Accounting Principles Board of the American Institute of Certified Public Accountants, U S A defines working capital as, “Sometimes called net working capital, is represented by the excess of current assets over current liabilities and identifies the relatively liquid portion of total enterprise capital which constitutes a margin or buffer for maturing obligations within the ordinary operating cycle of the business.”

According to National Council of Applied Economic Research of India, the role of working capital in industry has two aspects: a) optimum increase in the volume of the output, b) optimum allocation of the available volume of working capital to different items of current assets. Effective management of working capital demands that its incremental requirement would be less in proportion to increase the volume of output. In the other words, the acceleration of the flow of working capital should be such that there is a constant economy in its use.
2.3 Meaning of Working Capital Management

Working Capital Management has been defined in a number of ways, some of which are mentioned below:

1. According to Prof. K.V. Smith, “Working Capital Management is concerned with the problems that arise in attempting to manage the current assets, the current liabilities and the inter-relationship that exists between them.”

2. Weston and Brigham opine that, “Working Capital Management refers to all aspects of the administration of both current assets and current liabilities.”

3. James C. Van Horne is of the view that, “Current assets, by definition, are assets normally converted into cash within one year. Working Capital Management is concerned with the administration of these assets - namely cash and marketable securities, receivables and inventories.

2.4 Concepts of Working Capital

Working capital is that part of the total assets of the business that change from one form to another form in the ordinary course of business operations. But, there is no unanimity with the interpretation of working capital. There is a lot of difference of opinions among accountants, financial experts, entrepreneurs and economists. Therefore, it is essential to understand the different concepts of working capital, important among them are:

1. Traditional or balance sheet concept
2. Operating cycle concept

According to the traditional or balance sheet concept, working capital depicts the position of the firm at certain point of time. It is calculated on the basis of the balance sheet prepared at a specific date. With this point of view, working capital is of two types i.e. (i) gross working capital, and (ii) net working capital as discussed below:
Figure 2.1: Concepts of Working Capital

(i) Gross Working Capital: The gross working capital refers to the firm’s investment in current assets. Current assets are the assets which can be converted into cash within an accounting year. Here working capital comprises the sum of current assets, however obtained. “It takes into consideration all current resources of the enterprise and their application for the current and future activities.”

These include cash and bank balance, short-term investments, debtors, bills receivable, loans and advances, inventory (raw materials, spare parts, work-in-progress, finished goods) etc.

The term “working capital” has also attracted a few debatable interpretations. According to some authors (Kenneth, 1938; Baker and Mallet, 1949; Meed, 1933) working capital is nothing but the total current assets. They advocate that current assets should be considered as working capital because it is the current assets which help to earn profits. Financing aspects should not be mixed up with working capital. Working capital is required for operational purpose, so total current assets are more meaningful. How much capital is employed in supporting operations is a different issue. This kind of opinion continued till the fifties (Meed, 1933; Bogen, 1957).

Economists like Mead, Backer and Field, Bonneville, J S Mill and Smith are the proponents of this concept. According to this concept, all the current assets of the business, whether they have been financed either from long-term funds or from short-term funds, form the working capital of the firm. Hence, J S Mill has said, “the sum of the current assets is the working capital of the business.”
In the first sense, working capital refers to sum total of all current assets employed in the business process. This is known as ‘gross working capital’.

To quote Weston and Brigham, “Gross working capital refers to firm’s investments in short term assets such as cash, short term securities, accounts receivables and inventories.”

According to Walker, “Use of this concept is helpful in providing for the current amount of working capital at the right time so that the firm is able to realize the greatest return on investment.”

Mead, Malott and Field, “Working capital means current assets.”

Bonneville, “Any acquisition of funds which increases the current assets increases working capital, for they are one and the same.”

The gross of concept working capital is considerably useful in making correct estimate of working capital needs of a firm. The gross working capital concept is useful for an analytical insight into profitability with reference to the management of current assets. The gross concept of working capital is quantitative in character because it represents the total amount of funds used for current operating purposes.

Following arguments are placed in favour of this concept:

1. Financing of current assets, whether from long-term sources (shares and debentures) or from short-term loans or creditors, does not diminish their utility.
2. All current assets are used in the business and enhance the profit earning capacity of the firm; hence they should be treated as working capital.
3. As fixed assets represent fixed or permanent capital, similarly current assets should also represent working capital.
4. Financial managers are mainly concerned with management of current assets, i.e. gross working capital.
(ii) Net Working Capital: 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.

Working capital is also understood in terms of net concept according to which excess of current assets over current liabilities represents working capital.

Net working capital represents the amount of the current assets, which would remain after all the current liabilities were paid. Similar view is expressed by Guthmann and Dougall, Gerstenberg, Goel, Park and Gladson, Kennedy and Mc Mullen, and Myer in their distinguished works. “Accounts Handbook” has also fully supported this view. The famous economists like, Sailer Lincoln, and Stevens, fully supported this concept and viewed that the net working capital helps creditors and investors to judge financial soundness of a firm.

The excess of total current assets over current liabilities is called net working capital.

Net working capital is equal to current assets minus current liabilities. Current liabilities represent the amount of working capital provided mainly by trade creditors.

To quote Roy Chowdary, “Net working Capital indicates the liquidity of the business whilst gross working capital denotes the quantum of working capital with which business has to operate.”

Working capital viewed according to net concept is qualitative in character.

The following arguments are put in favour of this concept:

1. Excess of current assets over current liabilities is an indicator of financial soundness and the ability to face depression and contingencies firmly by an enterprise.
2. This concept is more suitable in ascertaining the true financial position of the firm. The current assets do not portray better financial position unless they are compared with current liabilities.
3. The excess of current assets over current liabilities provides better margin of protection to short-term creditors and investors.
From the foregoing description, it is clear that both the concepts of working capital i.e. the gross working capital and the net working capital have their own relevance. The financial manager should give due attention to both these concepts. A firm should maintain an optimum level of gross working capital. This will help in avoiding the unnecessary stoppage of work or chance of liquidation due to insufficient working capital. On the other hand, net working capital is the amount of funds that must be invested by the firm, more or less, regularly in current assets. This gives an idea of buffer available to current liabilities.

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.

2.5 Features of Working Capital

Following are the major features of working capital:

1. **Short Life Span**: Current assets like cash, bank balance, marketable securities, accounts receivable and inventories, etc. all are short lived. Usually their life span (or the conversion into some other form of CA) does not go beyond one year. Cash balances are usually held only for a week or so; accounts receivables are held not more than six months. Short life span of current assets depends upon the length of operating cycle of the firm. Time taken by various activities such as procurement of raw material, production process, sales and collection of bills; all these activities and their time duration decides the life span of current assets. Greater the time duration of operating cycle greater will be the life of current assets and vice-versa.
2. **Swift Transformation**: Swift transformation of current asset into other form of current asset is another major feature of working capital. The cash is utilized to procure raw material. Raw material is transformed into work on progress and then finished product which is usually sold on credit and creates accounts receivable which after collection are converted back into cash. Operating cycle is nothing but a transformation cycle of various current assets into other forms of current assets, sequence of transformation of one asset into other form of asset.

3. **Short-term Focus**: The other significant feature of working capital is its attention on the short-term financial position. The entire focus is on the procurement and management of assets in the short run i.e. usually one year or in other words present value of money is not significant for the purpose of analyzing financial condition here.

4. **Repetitive and Frequent**: Working capital management involves repetitive and frequent activities as explained in detail under the heading of operating cycle. Also, these activities are unsynchronized and non-instantaneous concerning production, sales and collection of accounts receivable. Had these activities been perfectly synchronized and instantaneous there would not have been any need for the study of working capital management.

5. **Liquidity**: The essence of working capital management is in providing liquidity all the time in business in such a way that neither the risk is very high nor the return on investment should fall. This is a difficult task for finance manager for the reason investment in CA keeps on changing and so does the financing required.

6. **Inter-relation among Assets**: Just as the current assets are swiftly transformed into other form of assets so they are also inter-related to each other. That is, current assets cannot be viewed in isolation because the decision related to these assets will also affect other current assets, for example the decision for investment in inventory cannot be taken without analyzing the expected level of sales and accounts receivable. Non-synchronization of production and sales give birth to inventory. Similarly, if there were cash sales only there would not have been any accounts receivable.
2.6 Types of Working Capital

The following chart depicts the broad classification of working capital:

![Diagram of Types of Working Capital]

**Figure 2.3: Types of Working Capital**

1. **Permanent or Fixed Working Capital**: Permanent or regular working capital represents the irreducible minimum amount which is permanently blocked in the business and that cannot be converted into cash in the normal course of business.

   When the size of firms grew, and the production and financing cycle became a continuous phenomenon, a certain volume of current assets had to be maintained throughout the year, this came to be known as permanent working capital.

   Permanent or fixed working capital is the minimum level of required current assets. It is permanent in the same way as the firm’s fixed assets are. It is required for permanent investment in holding minimum quantity of stock of raw materials and finished goods, debtors and cash. This amount is absolutely required throughout the year on a continuous basis for maintaining the circulation of current assets. As the business grows, the requirement of permanent working capital also increases due to increase in current assets. This portion of working capital is financed through long-term sources. Tandon Committee has identified this capital as CORE current assets.
Graph 2.1: Permanent or Fixed Working Capital

Characteristics of Permanent Working Capital

1. Continues to exist for a longer period of time in the business activities
2. Constantly changes in the business from one asset to another
3. Required to meet permanent obligations along with other fixed assets
4. Grows the size or volume of business operations
5. Classified on the basis of the time factor
6. Minimum level of working capital always required to be maintained
7. Depends on the nature of operating cycle of the firm.

The permanent working capital can further be classified in the following two categories:

(A) Regular Working Capital: The capital required to ensure circulation of current assets from cash to inventories, from inventories to receivables and from receivables to cash and so on.
(B) **Reserve Working Capital:** Reserve working capital is the excess amount over the requirement for regular working capital which may be provided for contingencies that may arise at unstated periods such as strikes, rise in prices, depression, etc.

Minimum amount of current assets are kept by a firm over the entire year to ensure uninterrupted course of operation. This minimum level of current assets is referred to as permanent working capital. It is also termed as regular working capital or core working capital or fixed working capital. It may be noted that this amount of fixed working capital varies from year to year depending upon the changes in production and sales as a result of seasonal changes.

2. **Temporary or Variable Working Capital:** Any additional working capital apart from permanent working capital required to support the changing production and sales activities is referred to as temporary or variable working capital.

In other words, any amount over and above the permanent level of working capital is temporary or variable or fluctuating working capital.

![Graph 2.2: Temporary or Variable Working Capital](image-url)
Characteristics of Temporary Working Capital

The following are the characteristics of temporary working capital:

1. It is an extra working capital needed for changing production and sales activities.

2. It is created to meet liquidity requirements.

3. Temporary working capital is fluctuating during the operating period.

4. It fluctuates according to the level of operations.

5. It is needed for shorter period.

The fluctuating working capital can further be classified in the following two categories:

(A) Seasonal Working Capital: The capital required to meet the seasonal demands of the enterprise is called seasonal working capital. For instance, a manufacture of woolen textiles, refrigerators or coolers may need extra funds to carry on production and to accumulate stock before the sales operations. Seasonal working capital being of short-term nature has to be financed from short-term sources like bank loan, etc.

(B) Specific Working Capital: Specific working capital is that part of working capital which is required to meet special exigencies such as launching of extensive marketing campaigns for conducting research, etc.

Any amount over and above the permanent level of working is temporary or fluctuating or variable working capital. In other words, it represents additional current assets required to meet fluctuations during the operating year. As it fluctuates according to the level of operation, it is termed as fluctuating working capital. For example, due to seasonal variation, investment in inventories will fluctuate or fall. Practically, temporary working capital is required to meet the liquidity requirements for short term obligations.
2.7 Significance of Working Capital

One of the most important and intricate areas in the day-to-day management of a firm is the management of working capital. The working capital provides the firm with liquidity, which is essential for the efficacious use of the fixed assets and, thereby, for achieving the expected rate of return. Any error in working capital decision may entail upon the desired liquidity and thereby, on the efficient use of the fixed assets.

Howard Leslie R. (1971), “Working capital may be regarded as the blood circulating system of any business unit. Its effective management can do much more for the success of the business, while inefficient management will undoubtedly lead to ensured failure of the business.”

As pointed out by Kennedy Ralph D. (1958), “The inadequacy or ineffective management of working capital management is the leading cause of business failure.”

To carry on a business enterprise not only fixed capital is needed, but adequate working capital is also a must for the purchase of raw materials, meeting day-to-day expenses on salaries, wages, advertising, etc. and maintaining the fixed assets. If a firm is unable to manage the sufficient funds for these purposes, it cannot succeed. Working capital is as essential for smooth and efficient running of a business as circulation of blood is essential in the human body for maintaining life. As A S Dewing has said, “No single error in financial planning can work greater harm to a corporation than a failure to provide for adequate working capital.” Adequate working capital provides the following advantages to a business enterprise:
1. **Immediate Payment to Suppliers**: Adequate working capital enables a firm to pay its suppliers immediately and that ensures regular supply of raw materials and thereby continuous production.

2. **Benefit of Cash Discount**: The firm can avail the advantage of cash discount by paying cash for the purchase of raw materials and merchandise. This will result in
reducing the cost of production, whereby the firm can reduce its selling price and attract customers by allowing trade discount.

3. **Increase in Goodwill and Debt Capacity**: In business, promptness in payments to third parties creates goodwill and increases the debt capacity of the concerned firm. It enables a firm to raise loans, whenever needed, without any difficulty. Sound goodwill and high debt capacity also help in providing uninterrupted flow of production.

4. **Easy Loans from the Banks**: A firm having adequate working capital and liquid assets can arrange loans from the banks on easy and favorable terms, because the excess of current assets over current liabilities provides a good security for the unsecured loans. Banks favors in granting seasonal loans too, if business has a good credit standing and reputation.

5. **Exploitation of Favorable Opportunities**: Only firms with adequate working capital can exploit good opportunities and can earn handsome profits. For example, a firm can make seasonal purchases in bulk when the prices are lower or it can fetch big supply orders.

6. **Meeting Unforeseen Contingencies**: If a firm maintains adequate working capital, it can easily face small financial crises due to heavy losses, business oscillations etc.

7. **Increased Efficiency**: Adequate working capital has psychological effect on the directors and executives of the firm as it motivates them to work vigorously. Moreover, by timely payment of wages to employees, they work with more confidence and vigour. Thus, adequacy of working capital creates an environment of security, confidence, high morale and increases overall efficiency in the business.

8. **Increases Fixed Assets Productivity**: Adequate working capital increases the productivity or efficiency of fixed assets in the business. For instance, if raw material, labour, etc. are not available in proper quantity, the machines will not work to full capacity. Without working capital, fixed assets are like a gun which cannot shoot as there are no cartridges. It is, therefore, said “the fate of large scale investment in fixed assets is often determined by a relatively small amount of current assets.”

9. **Adequate Dividend Distribution**: Firms short of working capital plough back their profits into the business to make up the deficiency of working capital. Such firms cannot distribute adequate dividend to its shareholders despite sufficient profits. On the contrary, if a firm has adequate working capital, it can declare and distribute ample
dividend when there are sufficient profits. It creates satisfaction among shareholders and brings stability in the market value of shares.

10. Solvency of the Business: Adequate working capital helps in maintaining solvency of the business by providing uninterrupted flow of production.

11. Others:
   1. It protects a business from the adverse effects of shrinkage of the values of current assets.
   2. It ensures to a greater extent the maintenance of a company’s credit standing and provides for such emergencies as strikes, floods, fires, etc.
   3. It permits the carrying of inventories at a level that would enable a business to serve satisfactorily the needs of its customers.
   4. It enables a company to extent favorable credit terms to customers.
   5. It enables a business to withstand periods of depression smoothly.

Working capital’s role in the business can be compared with the function of blood in a body. Working capital must keep circulating in the business. Inadequate working capital is like a low blood pressure, which may deprive various organs of much needed oxygen and various business activities may suffer adversely. Excessive working capital is like a high blood pressure, which is equally bad for a body and so is true for working capital in the business.

Dangers of Inadequate Working Capital

Importance of working capital can further be judged from the fact that many a time the main cause of the failure of a business enterprise has been found to be the shortage of current assets and their mishandling. Inadequate working capital is a serious handicap in business.

Inadequate working capital is also bad and has the following dangers:
1. **Idle Fixed Assets**: Fixed assets require raw materials to function with full capacity. In the absence of adequate working capital, fixed assets may not be optimally utilized, resulting in reduced profits.

2. **Loss of Business Opportunities**: Despite having capacity to manufacture and potentialities to make profits, firm may lose its existing business opportunities just for not having the required working capital support.

3. **Frequent Stoppages**: Stoppage of machinery due to lack of raw materials may result in halt of production that may finally result in lower profits.

4. **Growth May Stagnate**: Commensurate increase in working capital is required to support growth of a firm. Firm may not be able to register even the normal growth that is prevalent in industry. In consequence, growth may come to a halt.

5. **Loss of Goodwill**: Goodwill of the firm may be affected if it is not in a position to meet the current liabilities as and when they fall due for payment.
6. **Cash Discount are Lost**: It is customary in trade to extend cash discounts to buyers, who are given credit, to encourage early payments. Normally, cash discount works out profitable to buyers than cost of funds borrowed. However, if the firm is already struggling even to make normal payments in time, it is impossible for such firm to avail such attractive offers in the absence of comfortable working capital position.

7. **Others:**

1. It cannot buy its requirements in bulk and cannot avail of discounts, etc.
2. It becomes difficult for the firm to exploit favourable market conditions and undertake profitable projects due to lack of working capital.
3. The rate of return on investments also falls with the shortage of working capital.
4. It is not possible for it to utilize production facilities fully for want of working capital.
5. The modernization of equipment and even routine repairs and maintenance facilities may be difficult to administer.
6. A company will not be able to pay its dividends because of the non-availability of funds.
7. A company may have to borrow funds at exorbitant rate of interest.
8. Its low liquidity may lead to low profitability in the same way as low profitability results in low liquidity.

**Dangers of Excessive or Redundant Working Capital**

The need for maintaining adequate working capital in an enterprise cannot be questioned because of its aforesaid advantages to the business. But, a firm should neither have excess or redundant working capital nor inadequate or shortage of working capital. Both of these situations are harmful to the business. Excess or redundant working capital refers to idle funds which do not earn any profit for the firm, whereas inadequate or shortage of working capital not only harms the profitability of the firm, but creates hurdles in production and enhances inefficiency. Therefore, it is said, “Inadequate working capital is disastrous, whereas redundant
working capital is a criminal waste.” In brief, a firm may suffer the following disadvantages from the redundant or excess working capital:

1. **Extending Liberal Credit**: Firm tends to extend liberal credit to its customers more than the market practice without any corresponding benefit to the firm. Credit may be provided to those customers who do not deserve credit.

2. **Adverse Influence on Performance of Management**: Several departments may function in a haphazard and lazy manner without the professional approach that would affect overall performance of the management of firm.

**Figure 2.6: Dangers of Excessive or Redundant Working Capital**

- Extending Liberal Credit
- Adverse Influence on Performance of Management
- Unnecessary Stockpiling
- Defective Credit Policy
- Dissatisfaction among Shareholders
- Promotes Speculation
- Effect on Profitability
- Others
3. **Unnecessary Stockpiling**: Redundant working capital or surplus money may lead to unnecessary purchasing and accumulation of inventories causing more chances of mishandling of inventories, theft, waste, losses, etc.

4. **Defective Credit Policy**: Excessive working capital implies excessive debtors and defective credit policies. This causes higher incidence of bad debts that ultimately affects profits of the firm.

5. **Dissatisfaction among Shareholders**: Excessive working capital is an indicator of inefficient management. Hence, shareholders believe that they are not getting proper return on their investments. On account of this low rate of return on investments, the value of shares may also go down, causing discontentment among the shareholders.

6. **Promotes Speculation**: Excessive working capital promotes profits of speculative nature by stockpiling. It results in liberal dividend policy, but the management has to face difficulties in future when there are no speculative profits.

7. **Effect on Profitability**: Excessive working capital remains idle and earns no profits for the firm, even though interest has to be paid on it. This reduces the amount of profits.

8. **Others**:

1. There may be an imbalance between liquidity and profitability.

2. A company may enjoy high liquidity and, at the same time, suffer from low profitability.

3. Excessive working capital may be as unfavorable as inadequacy of working capital because of the large volume of funds not being used productively. Ralph Kennedy and Mc Mullen have observed that the availability of excess working capital may lead to carelessness about costs, and therefore, to inefficiency of operations.

4. Unjustifiable expansion may be stimulated.
It is evident from the aforesaid description that a firm must have adequate working capital pursuant to its requirements. It should neither be excessive nor inadequate as both these situations are dangerous. In the words of Guthmann and Dougall, “Adequate working capital is the first requirement for preserving good trade and bank credit, for meeting all expenses and liabilities promptly and for taking care of emergency and special needs. On the other hand, redundant current funds reduce the return on investment and encourage waste and manipulation.”

2.8 Objectives of Working Capital Management

The goal of working capital management is to manage a firm’s current assets and current liabilities in such a way that a satisfactory level of working capital is maintained. The interaction between current assets and current liabilities, therefore, is the main thing of the theory of working capital management.

Procurement of required amount of working capital and its effective utilization is the important function of working capital management. To ensure that the working capital financial plan serves as a guide to the future course of action of the financial department, the financial manager will keep in mind the following objectives which preparing the working capital financial plan.

![Figure 2.7: Objectives of Working Capital Management](image_url)
1. **Availability of Adequate Funds:** A sound working capital financial plan must ensure the supply of adequate amount of working capital needed by the business enterprises, both for current and future needs.

2. **Minimum Cost:** The fund required by the firm should be made available at the lowest cost. It is made possible through planning - considering in advance various cost factors and trends of capital market and suggesting the best course of action.

3. **Matching (Balance) Between Profitability and Liquidity:** A judicious balance between profitability and liquidity is one of the fundamental principles of successful finance planning. Profitability and liquidity are inversely related. The working capital financial plan must ensure sufficient amount of investment in those assets which are liquid cash and near-cash assets.

4. **Flexibility:** The working capital financial plan should be dynamic in nature. In other words, it should provide sufficient scope for change and re-adjustment in the financial structure. Such changes become necessary due to changes in business conditions in future.

5. **Optimum Use of Funds:** An important focal point of a financial working capital plan is the best use of the funds raised through various sources. All the possible efforts should be made that funds do not remain idle.

### 2.9 Determinants of Working Capital

There are numerous factors which affect the working capital requirements of a concern. An efficiency appraisal of these factors assists the management in formulating sound working capital policies and estimating its requirements rightly. As there occur continuous variations in economic environment, it is a very delicate exercise to decide the level of current assets required at a time, after making due adjustments for changes that have taken place. Though it is difficult to quantify the influence of each of the factors affecting working capital, one can appreciate their significance. Realizing the complications involved in working capital estimates, Gerstenberg observes, “Although no definite rule can be established for determining working capital requirements, we can arrive at some general principles. Certain influences, some inherent in the nature of the business and the others arising out of business management policies, affect each of the items of current capital.”
The amount of working capital required depends upon a large number of factors and each factor has its own importance. In order to determine the proper amount of working capital of a firm, the following factors should be considered carefully:

**Determinants of Working Capital**

- Nature of enterprise
- Size of business
- Access to money market
- Expansion and growth of business
- Profit margin and dividend policy
- Depreciation policy
- Operating efficiency of firm
- Co-ordination activities of firm
- Technological Development
- Environment Factors
- Taxation Policy
- Seasonal nature of the business
- Terms of purchase and sale
- Business cycles
- Working capital turnover
- Production policy
- Working capital cycle
- Price level changes
- Market Conditions
- Conditions of Supply
- Cash Requirements
- Volumes of Sales
- Inventory Turnovers
- Receivables Turnover
- Attitude of Risk
- Demand of Industry
- Value of Current Assets
- Credit Control
- Liquidity and Profitability
- Repayment Ability
- Cash Reserve
- Activities of the Firm
- Availability of credit
- Other factors

Figure 2.8: Determinants of Working Capital
Here is a brief description of the above factors:

1. **Nature of Enterprise:** The working capital requirements of a firm are basically influenced by the nature of the firm. For example, trading and financial firms require a large amount of investment in working capital but a significantly smaller amount of investment in fixed assets. But in the case of a manufacturing concern one has to invest substantially in working capital and a normal amount in fixed assets. In contrast public utilities have a very limited need for working capital, while a merchandising department which depends generally on inventory and receivables need a large amount of working capital. Needs for working capital are thus determined by the nature of an enterprise or business.

2. **Size of Business:** The size of the firm is also an important factor for requirement of working capital. The firm requires a smaller amount of working capital on the basis of its production activities and vice-versa in the opposite case.

3. **Access to Money Market:** Working capital requirements of a firm are conditioned by the firm’s access to different sources of money market. Thus, a firm with readily available credit from banks and trade credit facilities at liberal terms will be able to get by with less working capital than a firm without such facilities.

4. **Expansion and Growth of Business:** It is obvious that, as business expands, it will require more working capital in terms of sales or fixed assets. In the case of growth and expansion, there will be an all round increase in investment. That is to say, with the increase in fixed assets for increasing sales, the requirement of working capital will be expanded not only for financing increased volume of raw material but also to finance maintenance of inventory stock and grant credit to customers.

5. **Profit Margin and Dividend Policy:** Magnitude of working capital in a firm depends upon its margin and dividend policy. As a matter of fact, a high net profit margin reduces the working capital requirements of the firm because it contributes towards working capital pool. Similarly, distribution of high proportion of profits in the form of cash dividend results in a drain on cash resources and thus reduces company’s working capital to that extent. Where the management follows
constructive dividend policy and retains larger portion of the net profits, the company’s working capital position is strengthened.

6. Depreciation Policy: The depreciation policy influences the level of working capital by affecting tax liability and retained earnings of the enterprise. Since depreciation is a tax deductible expense item, this will affect the firm’s tax liability and retained earnings and thus strengthen the firm’s working capital position.

7. Operating Efficiency of Firm: The operating efficiency of management is also an important determinant of the level of working capital management which can contribute to a sound working capital position through operating efficiency. Efficiency of operations accelerates the pace of the cash cycle and improves the working capital turnover.

8. Co-ordination Activities of Firm: In addition, absence of co-ordination in production and distribution policies in a company results in a high demand for working capital. Where production and distribution activities are co-ordinated, pressure on working capital will be minimized.

9. Technological Development: Changes in technologies may lead to improvements in processing raw materials, minimizing wastages, greater productivity, more speed of production. All these improvements may enable the firm to reduce investment in inventory. Thus changes in technology affect the requirements of working capital. If the firm decides to go for automation, this will reduce the requirements for working capital. If the firm adopts a labour intensive process, the requirement for working capital will be larger.

10. Environment Factors: Political stability in its wake brings in stability in money market and trade world, and things mostly go smooth. Risk ventures are possible with enhanced need for working capital finance. Similarly, availability of local infrastructure facilities, road, transportation, storage and market, etc. influence business and working capital need as well.

11. Taxation Policy: Taxes must be paid out of profits. Tax liability is unavoidable and adequate provision should be made for it in working capital
planning. If the tax liability increases, it will impose an additional strain on working capital. The finance manager must do tax planning in order to avail the benefits of all sorts of tax concessions and incentives.

12. Seasonal Nature of the Business: In certain industries, demand is subject to wide fluctuations due to seasonal characteristics or production policies. The working capital requirements of such industries vary with seasonal variations.

In this connection, Nemmers and Grunewald have observed, “If a firm has the choice of maintaining steady production throughout the year, it will require a higher average amount of working capital to finance the longer holdings of inventory. Similarly, if a firm has the choice of concentrating production during a few months just before delivery time, it will require lower average amount of working capital.”

13. Terms of Purchase and Sale: The terms of purchase and sale followed by the firm also affect the quantum of working capital. A firm buying raw materials and other services on credit and selling the finished goods on cash bases will require less investment in current assets. On the other hand, a firm which purchases raw materials on cash bases but sells the finished products on credit bases will need larger amount of working capital. The period of credit and the efficiency in collection of debts also influence amount of working capital in a firm. The terms and conditions of purchase and sale are generally governed by prevailing trade policies and by changing economic conditions.

14. Business Cycles: Business cycles refer to alternate expansion and contraction in general business activities. In a period of boom when the business is prosperous, there is need for larger amount of working capital due to increase in sales and rise in prices of raw materials. The expansion of business units caused by the inflationary conditions creates demand for more working capital. On the contrary, in times of depression, the business contracts, sales decline and a large amount of working capital is locked because the inventories remain unsold and the book debts uncollected. In such cases, shortage of working capital develops and the firm requires more working capital.
15. **Working Capital Turnover:** It implies the speed with which the working capital circulates in the business. The rate of turnover of working capital is measured by the ratio of sales to current assets. The faster the sales, the larger is the turnover, consequently lesser will be the need for working capital and vice-versa.

16. **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 slack periods with a view to meet high demand during the peak season or production could be curtailed during the slack season and increased during the peak season. If the policy is to keep production steady by accumulating inventories it will require higher working capital.

17. **Working Capital Cycle:** In a manufacturing concern, the working capital cycle starts with the purchase of raw material and ends with the realization of cash from the sale of finished products. This cycle involves purchase of raw materials and stores, its conversion into stocks of finished goods through work-in-progress with progressive increment of labour and service costs, conversion of finished stock into sales, debtors and receivables and ultimately realization of cash, and this cycle continues again from cash to purchase of raw material and so on. The speed with which the working capital completes one cycle determines the requirements of working capital; the longer the period of cycle, the larger is the requirement of working capital.

18. **Price Level Changes:** Changes in the price level also affect the working capital requirements. Generally, the rising prices will require the firm to maintain larger amount of working capital as more funds will be required to maintain the same 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.

19. **Market Conditions:** The working capital requirements are also determined by the market conditions. In case of the high degree of competition prevailing in the market the firm has to maintain larger inventories as customers are not inclined to
wait for the product. This needs higher working capital requirements. If there is good demand for the product and the competition is weak, a firm can manage with smaller inventory of finished goods, as customers can wait for the product if it is not available in the market. Thus, a firm can manage with low inventory and will need low working capital requirements.

20. **Conditions of Supply:** The availability of raw materials and spares also determine the level of working capital. If there is ready availability of raw materials and spares, a firm can maintain minimum inventory and need less working capital. If the supply of raw materials is unpredictable, then the firm has to acquire stocks as and when they are available for ensuring continuous production. Thus, the firm needs to maintain larger inventory average and needs larger requirement of working capital.

21. **Cash Requirements:** Cash is one of the current assets which is essential for successful operation of the production cycle. Cash should be adequate and properly utilized. It would be wasteful to hold excessive cash. A minimum level of cash is always required to keep the operations going. Adequate cash is also required to maintain good credit relations. Richards Osborn has pointed out that “Cash has universal liquidity and acceptability. Unlike liquid assets, its value is clear-cut and definite.”

22. **Volume of Sales:** This is the most important factor affecting the size and components of working capital. A firm maintains current assets because they are needed to support the operational activities which result in sales. The volume of sales and size of the 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, in inventories and in receivables.

23. **Inventory Turnover:** If the inventory turnover is high, the working capital requirements will be low. With a better inventory control, a firm is able to reduce its working capital requirements. While attempting this, it should determine the minimum level of stock which it will have to maintain throughout the period of its operations.
24. **Receivables Turnover:** It is necessary to have an effective control of receivables. A prompt collection of receivables and good facilities for settling payables results in low working capital requirements.

25. **Attitude of Risk:** The greater the amount of working capital, the lower is the risk of liquidity.

26. **Demand of Industry:** Creditors are interested in the security of loans. They want their obligations to be sufficiently covered. They want the amount of security in assets which are greater than the liability.

27. **Value of Current Assets:** A decrease in the real value of current assets as compared to their book value reduces the size of the working capital. If the real value of current assets increases, there is an increase in working capital.

28. **Credit Control:** Credit control includes such factors as the volume of credit sales, the terms of credit sales, the collection policy, etc. With a sound credit control policy, it is possible for a firm to improve its cash inflow.

29. **Liquidity and Profitability:** If a firm desires to take a greater risk for bigger gains or 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 its working capital. However, this policy is likely to result in a reduction of the sale volume and, therefore, of profitability. And so a firm should choose between liquidity and profitability, and decide about its working capital requirements accordingly.

30. **Repayment Ability:** A firm’s repayment ability determines level of its working capital. The usual practice of a firm is to prepare cash flow projections according to the plans of repayment and to fix working capital level accordingly.

31. **Cash Reserve:** It would be necessary for a firm to maintain some cash reserves to enable it to meet contingent disbursements. This would provide a buffer against abrupt shortages in cash flows.
32. **Activities of the Firm:** A firm’s stocking on heavy inventory or selling on easy credit terms calls for a higher level of working capital for it than for selling services or making cash sales.

33. **Availability of Credit:** The need for working capital in a firm will be less, if it avails liberal credit facilities. Similarly, the availability of credit from banks also influences the working capital needs of the firm. A firm enjoying bank credit facilities can secure funds to finance its working capital requirement very easily whenever it requires. It can, therefore, perform its business activities with less working capital than a firm without such credit facility.

34. **Other factors:** In addition to the above factors there are a number of other factors, which affect the requirement of working capital. Some of them are: close coordination between production and distribution policies, an absence of specialization in the distribution of products, the means of transportation and communication, the hazards and contingencies inherent in a particular type of business, credit policy of RBI, inventory policies, management attitude and wages, government policies and so on.

**2.10 Approaches to Working Capital**

The financing of working capital is very crucial to management of working capital as it makes a significant impact on the firm’s profitability and liquidity position. There are three types of sources of working capital finance, such as short-term financing, long-term financing and spontaneous financing. But working capital should be financed with two sources i.e. short-term and long-term.

The mix of short-term and long-term sources of working capital financing varies in each approach and consequently, the impact of each of the following four approaches on the profitability and liquidity position of the business also varies.
The above approaches can be explained in detail as below:

**A Hedging Approach or Matching Approach:** The term “hedging” is used in the sense of a risk-reducing investment strategy involving transactions of a simultaneous but opposing nature. The counter balances the effect of each other with reference to finance-mix, the term hedging can be said to refer to the process of matching of debt with the matching of financial needs.

The hedging approach is also known as matching approach. This approach states that permanent assets should be financed with long-term capital (long-term liabilities + equity), and temporary assets should be financed with short-term credit.

Permanent working capital exists for a comparatively longer period of time and it is thus difficult to finance with short-term funds as they have a shorter maturity. According to this approach, the maturity of the source of funds should match with the nature of the assets to be financed.

We may graphically illustrate the hedging approach as depicted in graph 2.3:
B. Conservative Approach: When the percentage of funds obtained from long-term sources are larger, it can be said that the firm is following the conservative financial policy. This approach suggests that the estimated requirement of total funds should be met from long-term sources; the use of short-term funds should be restricted to only emergency situations or when there is an unexpected outflow of funds.

Under a conservative plan, the firm finances its permanent assets and also a part of temporary current assets with long-term financing. In the period when the firm has no need for temporary current assets, the idle long-term funds can be invested in the tradable securities to conserve liquidity. The conservative plan relies heavily on long-term financing and, therefore, the firm has less risk of facing the problem of shortage of funds.

It is hard to imagine how this approach could actually be implemented, since certain short-term financing tools are virtually unavoidable. It would be quite difficult for a firm to keep accounts payable and accruals low. It would also be unwise, since accounts payable and accruals arise naturally in the process of doing business.
The following figure makes it clear:

Graph 2.4: Conservative Approach

C. Aggressive Approach: A firm is said to be aggressive, when it uses more short-term funds than that warranted by the matching approach. In other words, a firm finances a part of its regular current assets with short-term sources of funds.

Sometimes the firm’s management is aggressive, in which case it may make greater use of short-term funds and finance variable current assets and also a part of the permanent current assets with these short-term funds. Such funds are not only less costly but are more flexible and adaptable to the changing need for current assets. A firm, which follows this approach, is under more risk, but will provide more returns.
The following figure makes it clear:

![Graph 2.5: Aggressive Approach](image)

**Graph 2.5: Aggressive Approach**

It can be seen in the above figure that even when its investment in assets needs is lowest the firm must still rely on short-term financing. Such a firm would be subjected to increased risks of a cash short-fall in that it must depend on a continual rollover or replacement of its short-term debt. The benefit derived from following such a policy relates to the possible savings resulting from the use of lower-cost short-term debt as opposed to long-term debt.

**D. Highly Aggressive Approach**: Under this approach, a part of fixed assets may even be financed from short-term sources which are very much risky. Thus, long-term sources are used to acquire the major part of fixed assets plus a minor part of fixed assets and short-term sources are used to acquire a minor part of fixed assets plus the whole current assets (i.e. permanent and temporary). It is shown in figure 2.6:
Graph 2.6: Highly Aggressive Approach

It is evident from the Fig. that this approach is highly risky since the short-term sources are to be renewed on a continuous basis for financing the whole current assets plus a part of fixed assets. Working capital position under this method will always be negative. Therefore, when this approach is followed by a firm, along with other symptoms, it may be assumed that the firm is going to be a ‘sick’ one.

2.11 Principles of Working Capital
The following are the general principles of a sound working capital management policy:

Figure 2.10: Principles of Working Capital
1. **Principle of Risk Variation (Current Assets Policies):** Risk here refers to the inability of a firm to meet its obligations as and when they become due for payment. Larger investment in current assets with less dependence on short-term borrowings increases liquidity, reduces dependence on short-term borrowings, increases liquidity, reduces risk and thereby decreases the opportunity for gain or loss. On the other hand, less investment in current assets with greater dependence on short-term borrowings reduces liquidity and increases profitability. In other words, there is a definite inverse relationship between the degree of risk and profitability. A conservative management refers to minimize risk by maintaining a higher level of current assets or working capital while a liberal management assumes greater risk by reducing working capital. However, the goal of the management should be to establish a suitable tradeoff between profitability and risk. As stated by E. W. Walker, “If working capital is varied relative to sales, the amounts of risk that a firm assumes is also varied and the opportunity for gain or loss is increased.”

2. **Principle of Cost of Capital:** The various sources of raising working capital finance have different cost of capital and the degree of risk involved. Generally, higher the risk lower is the cost, and lower the risk higher is the cost. A sound working capital management should always try to achieve a proper balance between these two. As E. W. Walker has remarked, “The type of capital used to finance working capital directly affects the amount of risk that a firm assumes as well as the opportunity for gain or loss and cost of capital.”

3. **Principle of Equity Position:** This principle is concerned with planning the total investment in current assets. According to this principle, the amount of working capital invested in each component should be adequately justified by a firm’s equity position. Every rupee invested in the current assets should contribute to the net worth of the firm. The level of current assets may be measured with the help of two ratios: current assets as a percentage of total assets and current assets as a percentage of total sales. While deciding about the composition of current assets, the financial manager may consider the relevant industrial average.

4. **Principle of Maturity of Payment:** This principle is concerned with planning the sources of finance for working capital. According to this principle, a firm should make every effort to relate maturities of payment to its flow of internally generated
funds. Maturity pattern of various current obligations is an important factor in risk assumptions and risk assessments. Generally, shorter the maturity schedule of current liabilities in relation to expected cash inflows, the greater the inability to meet its obligations in time.

2.12 Elements of Working Capital

Working capital management refers to the administration of all aspects of current assets and current liabilities. The financial manager must determine the levels and composition of current assets. The following are the important elements of working capital.

![Elements of Working Capital](image)

**Figure 2.11: Elements of Working Capital**

1. **Inventories:** Inventories include all requirements in raw materials, work-in-progress, and consumable items, spare parts and finished goods. They constitute an important part of the current assets. The purchase of raw materials and stock of inventories involves investment which must be properly controlled. There are many aspects of inventory management which must be taken into consideration as:
(a) Fixing of level of inventories
(b) Determining economic ordering quantity
(c) Deciding the issue price of policy
(d) Setting up the procedure for receipts and issues
(e) Ensure proper storage facilities
(f) Setting up effective information system
(g) Determining the size of inventory to be carried
(h) Ensure cost control

2. **Account receivables:** One of the most commonly used methods of sales by the business organizations is the credit sales where in the companies sell their goods and services to the customers on credit basis in accordance with the credit policies formulated by them. The credit sales are recorded in the books of the selling company as debtors. The debtors are called book debts in accounting language. Further goods are sold on credit also said to the customers who agree to give their acceptance for the bills in consideration of sales payments. The bills so received from the customers are called bills receivable or notes receivable. Regarding accounts receivable in working capital management, the financial manager must take into consideration the following:

(a) Ensure liberal credit policies
(b) Cost of recovering debts
(c) Interest charges
(d) Risk associated with advancing credit
(e) Impact on promotion of sales
(f) Legal formalities
(g) Setting up the procedure for creation of bills

3. ** Marketable (temporary) investments:** Firm holds temporary investments for surplus cash flows arising either during seasonal operations or out of sale of long term securities. In other words, the amount of revenue realized from the sale of short term or temporary investment would be the cash inflow to the extent of actual sale proceeds. That means, the inflow of cash include even the profit on the sale of short-
term investments. If the firm needs to maintain sound working capital position, it should be consideration as:

(a) Determining the size of temporary investments
(b) Cash forecast
(c) Ensure the cash liquidity position
(d) Shortage of bank credit facilities
(e) Speculative needs
(f) Period of short-term investments
(g) Interest earned on investment
(h) Risk associated with short-term investments

4. **Cash:** Cash is the significant portion of the working capital. There must be adequate cash to meet the requirements of all segments of the organization. The major source of cash is the amount of profit earned during the year from its business operations. Similarly, whenever there is an increase in any existing liability or when a new liability is created, it results in cash inflow in the organization. On the other hand, when an organization purchases an asset or when a liability is discharged it would result in an outflow of cash. Therefore, it is necessary that every segment of the organization must consider the following:

(a) Sources of cash inflows
(b) Applications or uses of cash out flows
(c) Cash expenses
(d) Position of excess cash or less cash
(e) Cash forecast
(f) Cash requirements to meet its current obligations

5. **Creditors:** Creditors are one of the important elements of working capital. If the payment of creditors is delayed there is a possibility of saving of some interest but it can be very costly because it will spoil the goodwill of the concern in the market. If they try to get liberal credit loans the payment may be made at the stipulated time.
2.13 Sources of Working Capital

Every problem in industry has bearing on finance. “For without proper finance there will be neither efficient planning, nor purchase of materials, nor production, nor marketing, nor any fair profit, the latter in its turn forming the foundation of finance itself.”

The financial executives are always interested in obtaining the working capital at the right time, at a reasonable cost and on the best possible favourable terms.

The working capital requirements of a concern can be classified as:

(a) Permanent or Fixed working capital

(b) Temporary or Variable working capital

In any concern, a part of the working capital investments are as permanent investments in fixed assets. This is so because there is always a minimum level of current assets which are continuously required by the enterprise to carry out its day-to-day business operations and this minimum cannot be expected to be reduced at any time. This minimum level of current assets gives rise to permanent or fixed working capital as this part of working capital is permanently blocked in current assets.

Similarly, some amount of working capital may be required to meet the seasonal demands and some special exigencies such as rise in prices, strikes, etc. This proportion of working capital gives rise to temporary or variable working capital which cannot be permanently employed gainfully in business.

The fixed proportion of working capital should be generally financed from the fixed capital (long-term) sources while the temporary or variable working capital requirements of a concern may be met from the short-term sources of capital.
The various sources for the financing of working capital are shown in the chart as follows:

Figure 2.12: Sources of Working Capital
Financing of Permanent / Fixed or Long-Term Working Capital

Permanent working capital should be financed in such a manner that the enterprise may have its uninterrupted use for a sufficient, long period. The five important sources of permanent or long-term working capital are:

1. **Shares:** Issue of shares is the most important source for raising the permanent or long-term capital. A company can issue various types of shares as equity shares, preference shares and deferred shares. According to the Company Act, 1956, however, a public company cannot issue deferred shares. Preference shares carry preferential rights in respect of dividend at a fixed rate and in regards to the repayment of capital at the time of winding up the company. Equity shares don’t have any fixed commitment charge and the dividend on these shares is to be paid subject to the availability of sufficient profits. As far as possible, a company should raise the maximum amount of permanent capital by issue of shares.

2. **Debentures:** A debenture is an instrument issued by the company acknowledging its debt to its holder. It is also an important method of raising long term or permanent working capital. The debenture-holders are the creditors of the company. A fixed rate of interest is paid on debentures. The interest on debenture is a charge against profit & loss account. The debentures are generally given floating charge on the assets of the company. When the debentures are secured they are paid on priority to other creditors. The debentures may be of various kinds such as simple, naked or unsecure debentures, secured or mortgage debentures, redeemable debentures, irredeemable debentures, convertible debentures and non convertible debentures. The debentures as a source of finance have a number of advantages both to the investors and the company. Since interest on debentures have to be paid on certain predetermined intervals at a fixed rate and also debentures get priority on repayment at time of liquidation, they are very well suited to cautious investors. The firm issuing debentures also enjoys a number of benefits such as Trading on equity, retention of control, tax benefits etc.

3. **Public Deposits:** Public deposits are the fixed deposits accepted by a business enterprise directly from the public. This source of raising short term and medium term finance was very popular in the absence of banking facility. In the past, generally,
public deposits were accepted by textile industries in Ahmedabad and Bombay for periods of six months to one year. But now-a-days even long term deposits for 5 to 7 years are accepted by the business houses. Public deposits as a source of finance have a large number of advantages such as very simple and convenient source of finance, taxation benefits, trading on equity, no need of securities and an inexpensive source of finance. But it is not free from certain danger such as; it is uncertain, unreliable, unsound and inelastic source of finance. The RBI has also laid down certain limits on public deposits. Non-Banking concerns cannot borrow by way of public deposits more than 25% of its paid-up capital and free reserves.

4. **Ploughing Back of Profits:** Ploughing back of profits means the reinvestments by concern of its surplus earning in its business. It is an internal source of finance and is most suitable for an established firm for its expansion, modernization and replacement etc. This method of finance a number of advantages as it is the cheapest rather cost-free source of finance, there is no need to keep securities, there is no dilution of control, it ensures stable dividend policy and gains confidence of the public. But excessive resort to ploughing back of profits may lead to monopolies, misuse of funds, overcapitalization and speculation, etc.

5. **Loans from Financial Institutions:** Financial Institutions such as commercial banks, LIC, IFCI, SFCs, SIDCs, IDBI, etc. Also provide short term, medium term and long term loans. This source of finance is more suitable to meet the medium term demands of working capital. Interest is charge at a fix rate and the amount of the loan is to be repaid by way of installments in a number of years.

**Financing of Temporary, Variable or Short-Term Working Capital**

The main sources of short-term working capital are as below:

1. **Indigenous Bankers:** Private money-lenders and other country banker use to be the only source of finance prior to the establishment of commercial banks. They use to charge very high rates of interest and exploited the customers to the largest extent possible. Now-a-days with the development of commercial banks they have lost their monopoly. But even today sum business houses have to depend upon indigenous banker for obtaining loans to meet their working capital requirements.
2. Trade Credit: Trade credit refers to the credit received by a customer from the supplier of goods, in the normal course of business.

In the words of Howard and Upton, trade credit is a, ‘credit extended by sellers to buyers at all levels of production and distribution process down to the retailer. It does not include consumer credit or installment credit. It arises out of transfer of goods and is unsecured.’

At present day commerce is built upon credit, the trade credit arrangement of a firm with its suppliers is an important source of short term finance. The credit-worthiness of a firm and the confidence of its suppliers are the main basis of securing trade credit. It is mostly granted on an open account basis whereby supplier sends goods to buyer for the payment to be received in future as per the term of sales the invoice. It may also take the form of bills payable whereby the buyer signs a bill of exchange payable on a specified future date.

When a firm delays the payments beyond the due date as per the terms of sales invoice, it is called stretching accounts payable. A firm may generate additional short term finances by stretching accounts payable, but it may have to pay panel interest charges as well as to forgo cash discount. If the firm delays the payments frequently, its adversely affects the credit worthiness of the firm and it may not be allowed such credit facilities in future.

The main advantages of trade credit as a source of short term finance include:

1. It is an easy and convenient method of finance.

2. It is flexible as the credit increases with the growth of the firm.

3. It is informal and spontaneous source of finance.

However, the biggest disadvantage of this method of finance is charging of higher prices by the supplier and loss of cash discount.

3. Installment Credit: This is another method by which the assets are purchased and possession of goods is taken immediately but the payment is made in installment over a pre-determined period of time. Generally, interest is charge on unpaid price or
it may be adjusted in the price. But, in any case, it provides funds for sometime and used as a source of short term working capital by many business houses which have difficult fund position.

4. **Advances:** Some business houses get advances from their customers and agents again orders and this source is a short term source of finance for them. It is a cheap source of finance and orders to minimize their investment in working capital, some firms having long production cycle, specially the firm manufacturing industrial products prefer to take advances from their customers.

5. **Factoring or Accounts Receivable Credit:** Another method of raising short term finance is through accounts receivable credit offer by commercial banks and factors. A commercial bank may provide finance by discounting bills or invoices of its customers. Thus, a firm gets immediate payment for sales made on credit. A factor is a financial institution which offers services relating to management and financing of debts arising out of credit sales. Factoring is becoming popular all over the world on account of various services offered by the institutions engaged in it. Factors render services varying from bill discounting facilities offered by commercial banks to a total takeover of administration of credit sales including maintenance of sales ledger, collection accounts receivable, credit control and protection from bad debts, provision of finance and rendering of advisory services to their clients. Factoring may be on recourse basis, where the risk of bad debts is borne by the client, on a non recourse basis, where the risk of credit is born by the factor.

At present, factoring in India is rendered by only a few financial institutions on a recourse basis. However, the Report of the Working Group on Money Market (Vaghul Committee) constituted by RBI has recommended that banks should be encourage to set up factoring divisions to provide speedy finance to the corporate entities.

In spite of many services offered by factoring its suffers from certain limitations. The most critical fall outs of factoring includes: (i) The high cost of factoring as compare to other sources of short term finance, (ii) The perception of financial weakness about the firm availing factoring services, (iii) Adverse impact of tough stance taken by
factor, against a defaulting buyers, upon the borrower resulting into reduced future cells.

6. **Accrued Expenses:** Accrued expenses represent a liability that a firm has to pay for the services which it has already received.

Accrued expenses are those expenses which the company owes to the other, but which are not yet due and not yet paid. Accruals represent a liability that a firm has to pay for the services or goods it has received. It is a spontaneous and interest free source of financing. Salaries and wages, interest and taxes are the major constituents of accruals. Salaries and wages are usually paid on monthly and weekly bases respectively. The amount of salaries and wages have owed but not yet paid and shown them as accrued salaries and wages on the balance sheet at the end of financial year. The longer the time lag in payment of these expenses, the greater is the amount of funds provided by the employees. Similarly interest and tax is another accrual, as source of short term finance. Tax will be paid on earnings. Income tax is paid to the government on quarterly basis and some other taxes may be payable half yearly or annually. The amount of taxes due as on the date of the balance sheet but not paid till then, they are showed as accrued taxes on the balance sheet. Like taxes, interest is paid periodically in the year but the funds are used continuously by a firm. All other such items of expenses can be used as a source of short term finance but shown on the balance sheet.

The amount of accrual varies with the level of activities of a firm. When the level of activity expands, accruals increase and automatically they act as a source of finance. Accruals are treated as “cost free” source of finance, since it does not involve any payment of interest. But in actual terms it may not be true, since payment of salaries and wages is determined by provisions of law and industry practice. Similarly tax payment is governed by laws and delay in payment of tax leads to payment of penalty. Hence, a firm must note that use of accruals as a source of working capital paying may not be possible.

7. **Deferred Incomes:** Deferred income represents funds received by the firm for goods and services which it has agreed to supply in future. These receipts increase the
firm’s liquidity in the form of cash; therefore, they constitute an important source of financing.

These payments are not showed as revenue till the supply of goods or services, but showed in the balance sheet as income received in advance. Advance payment can be demanded by firms which are having monopoly power, great demand for its products and services and if the firm is manufacturing a special product on a special order.

8. **Commercial Papers (CPs):** Commercial paper represents a short term unsecured promissory note issued by firms that have a fairly high credit (standing) rating. It was first introduced in USA and it is one of the important money market instruments. In India, Reserve Bank of India introduced CP on the recommendations of the Vaghul Working Group on money market in 1989. It became an important source of working capital financing by the end of 1993.

Large well-known companies can bypass the banking system by issuing their own short-term unsecured notes. These notes are known as commercial papers (CP).

Commercial papers refer to notes issued by large, strong companies to borrow money from investors for relatively short periods. The paper itself is simply a promise to repay the money borrowed at a given date.

**Advantages of CP**

- It is an alternative source of finance and proves to be helpful during the period of tight bank credit
- It is a cheaper source of short-term finance when compared to the bank credit.
- It provides an opportunity to make a safe, short-term investment of surplus funds.

**Disadvantages of CP**

- It is available only for large and financially sound companies.
- It cannot be redeemed before the maturity date.
- It is an impersonal method of financing.
9. Inter-Corporate Deposits (ICDs): A deposit made by one firm with another firm is known as inter-corporate deposit (ICD). Generally, these deposits are usually made for a period upto six months. Such deposits may be of three types:

1. Call Deposits: These deposits are those expected to be payable on call, on just one day notice. But, in actual practice, the lender has to wait for at least 2 or 3 days to get back the amount. Inter corporate deposits generally have 12 per cent interest per annum.

2. Three Months Deposits: These deposits are more popular among companies for investing the surplus funds. The borrower takes this of deposits for meeting short-term cash inadequacy. The interest rate on these types of deposits is around 14 per cent per annum.

3. Six-Months Deposits: Inter-corporate deposits are made for a maximum period of six months. These types of deposits are usually given to ‘A’ category borrowers only and they carry an interest rate of around 16 per cent per annum.

Features of ICDs

(i) There are no legal regulations which make an ICD transaction very convenient.

(ii) Inter-corporate deposits are given and taken in secrecy.

(iii) Inter-corporate deposits are given based on borrower’s financial soundness, but in practice lender lends money based on personal contacts.

10. Commercial Banks: Commercial Banks are the major source of working capital finance to industries and commerce. Granting loan to business is one of their primary functions. After trade credit, bank credit is the most important source of financing working capital requirements. They provide a wide variety of loans tailored to meet the specific requirements of a concern.
Forms of Bank Finance

Commercial banks are the most important source of short-term finance. The banks provide secured and unsecured, both types of loans. The various forms in which the banks help in meeting short-term requirements of business firms are as follows:

1. **Loans:** Loan is an advance by a bank which may be either secured or unsecured. In case of a loan, a specified amount in lump-sum is sanctioned by the bank to the customer which is either paid to the borrower or is credited to his account. The borrower is required to pay interest on the entire amount of the loan from the date of sanction, whether the customer withdraws it or not from his account. A loan is repayable in lump-sum or in installments. Commercial banks generally provide short-term loans up to one year for meeting working capital requirements.

2. **Cash Credit:** A cash credit is an arrangement by which a bank allows his customer to borrow money up to a certain limit against some tangible securities or guarantees. The customer can withdraw from his cash credit limit according to his needs and he can also deposit any surplus amount with him. The interest in case of cash credit is charged on the daily balance and not on the entire amount of his account. Goods are hypothecated or pledged. In case of hypothecation goods remain in the customers’ godown. The goods equal to the amount of loan paid are delivered to the customer. In pledge, goods are under the custody of the bank and name of the bank is printed on the godown. It is the most favourite mode of borrowings by industrial and commercial firms in India.

3. **Overdraft:** It means an agreement with a bank by which a current account holder is allowed to withdraw more than the balance to his account up to a certain limit. Interest is charged on daily overdrawn balances. Overdraft facility is granted on the basis of customer’s promissory note with or without guarantee. The main difference between cash credit and overdraft is that overdraft is allowed for a short-term period and is a temporary accommodation whereas cash credit is allowed for a longer period.

4. **Discounting of Bills:** Commercial banks provide short-term finance to business firms by discounting their credit instruments like bills of exchange,
promissory notes and hundies, etc. The amount given to the holder of the instrument on discounting is lower than the face value of the instrument discounted, the difference being the amount of discount. At the maturity of credit instrument, if it is dishonored due to non-payment, the customer is responsible to the bank. The bank recovers the full amount of the credit instrument from the customer along with expenses in that connection. The word ‘discounting of bill’ is used for period bills and ‘purchase of bills’ for demand bills.

5. Letter of Credit: In addition to the above mentioned forms of finance, commercial banks help their customers in obtaining credit from their suppliers through the letter of credit arrangements. A letter of credit (L/C) is an undertaking by the bank to honour the liability of its customer up to a specified amount. In other words, a letter of credit is simply a guarantee by the bank to the suppliers that their bills up to a specified amount would be honoured. In case the customer fails to pay the bill on the due date to the suppliers, the bank assumes the liability of the customer for the purchases made under the letter of credit. Thus, letter of credit helps the customer to obtain credit from suppliers because it ensures that there is no risk of non-payment.

6. Working Capital Demand Loan (WCDL): In compliance of RBI directions, banks presently grant only a small part of the fund-based working capital facilities to a borrower by the way of running cash credit account; major portion is in the form of working capital demand loan. This arrangement is presently applicable to borrowers having working capital facilities of Rs. 10 crores or above. The minimum period of WCDL which is basically non-operable account keeps on changing. The WCDL is granted for a fixed term on the carrying of which it has to be liquidated, renewed of rolled over.

Security Required in Bank Finance:

No doubt bank finance is most important source of working capital finance. But getting bank finance without giving adequate security is impossible. In how many modes the borrower can give security? The following are the modes of security required by a bank.
(A) **Hypothecation:** Under this arrangement, the loan applicant is provided money against the security of movable property, usually inventories. The loan applicant does not transfer the possession of the property to the bank. Hypothecation is in the nature of floating charge. It is merely a charge against property for the amount of debt. This type of security is accepted for granting credit, only to the first class customers with highest liquidity. In other words, banks do not grant credit to new customer and low class customers with hypothecation. If the borrower fails to honor the dues to the bank, the banker may realize his due by sale of the goods hypothecated.

(B) **Pledge:** Under this arrangement, the loan applicant is required to transfer the physical possession of the goods/property to the bank as security. As per section 172 of the Indian Contract Act, pledge is a bailment of goods, as a security, for payment of a debt, or performance of a promise, against some advances. Transfer of possession of goods is a precondition for pledge. Once the goods are shifted to the lender or bank, bank is expected to take reasonable care of goods pledge with it. The lender has a right of lien and can retain the possession of goods pledge till the debt (including interest and expenses) is cleared. If the borrower defaults in paying his/her dues, the bank has the right to sell goods and recover the dues. But this should be done only after giving due notice to the borrower.

(C) **Mortgage:** Apart from the hypothecation and pledge sometimes banks ask for mortgage as collateral security. Mortgage is the transfer of legal or equitable interest in a specific immovable property for the payment of a debt. In this arrangement the possession of property remains with the loan applicant, but the full legal title is transferred to the bank. If the borrower fails to pay dues, the bank can get decree from the court to sell the immovable property given as security and it can recover its dues.

**Merits**

- Bank credit is a widely used source of financing short-term requirements of a business firm.
- It is a flexible source and cheaper too as compared to other sources of short-term finance.
• It is readily available and bears testimony to the satisfactory credit character, capital and financial conditions of the firm.
• Banks also play an advisory role in financial matters without interference in the management of the firm.

Demerits

• A number of formalities are to be completed in bank finance which results in wasting of cost and time.
• Sometimes, problems may arise in mortgaging assets or in executing a contract as banks impose stringent conditions.
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