

UNIT: III- WORKING CAPITAL

SHORT ANSWERS:

Q.1. What are the various types of working capital?

- ❖ **Gross working capital:** Total or gross working capital is that working capital which is used for all the current assets. Total value of current assets will equal to gross working capital.
- ❖ **Net Working Capital:** Net working capital is the excess of current assets over current liabilities.

$$\text{Net Working Capital} = \text{Total Current Assets} - \text{Total Current Liabilities}$$

This amount shows that if we deduct total current liabilities from total current assets, then balance amount can be used for repayment of long-term debts at any time.

- ❖ **Permanent Working Capital:** Permanent working capital is that minimum amount of capital which must be in cash or current assets for continuing the day-to-day activities of business.
- ❖ **Temporary Working Capital:** 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.

Q.2. What is the importance of working capital?

Every company needs working capital to meet its short-term expenses. It keeps the business moving. Without it, the business will stop and the company will become sick.

Importance of working capital:

- i. Continuity of business operations.
- ii. Dividend Payment.
- iii. Repayment of long-term loans.
- iv. Increases Creditworthiness.
- v. Boosts Efficiency and Productivity.
- vi. Helps to fight competition.
- vii. Helps to withstand Seasonal Fluctuations
- viii. Increase Goodwill.

Q.3. Write a short note on Operating Cycle.

The movement of cash into different forms of current assets ultimately once more taking on the form of cash is known as Operating Cycle. The circular flow concept of working capital is based upon this operating or working capital cycle of a firm.

It involves purchase of raw material and stores, its conversion into stock 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 realisation of cash and this cycle continues again from cash to purchase of raw material and so on.

The speed/time duration required to complete one cycle determines the requirements of working capital-longer the period of cycle, larger is the requirement of working capital.

Q.4. What are the needs of working capital?

Working Capital is an essential part of the business concern. Every business concern must maintain certain amount of Working Capital for their day-to-day requirements and meet the short-term obligations

Working Capital is needed for the following purposes.

- 1) **Purchase of raw materials and spares:** The basic part of manufacturing process is, raw materials. It should purchase frequently according to the needs of the business concern. Hence, every business concern maintains certain amount as Working Capital to purchase raw materials, components, spares, etc.
- 2) **Payment of wages and salary:** The next part of Working Capital is payment of wages and salaries to labour and employees. Periodical payment facilities make employees perfect in their work. So, a business concern maintains adequate the amount of working capital to make the payment of wages and salaries.
- 3) **Day-to-day expenses:** A business concern has to meet various expenditures regarding the operations at daily basis like fuel, power, office expenses, etc.
- 4) **Provide credit obligations:** A business concern responsible to provide credit facilities to the customer and meet the short-term obligation. So, the concern must provide adequate Working Capital.

Q.5. Explain the importance or advantages of Adequate Working Capital?

Working capital is the life blood 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.

The main advantages of maintaining adequate amount of working capital are as follows:

1. **Solvency of the business.** Adequate working capital helps in maintaining solvency of the business by providing uninterrupted flow of production.
2. **Goodwill.** Sufficient working capital enables a business concern to make prompt payments and hence helps in creating and maintaining goodwill.
3. **Easy loans.** A concern having adequate working capital, high solvency and good credit standing can arrange loans from banks and others on easy and favourable terms.
4. **Cash discounts.** Adequate working capital also enables a concern to avail cash discounts on the purchases and hence it reduces costs.
5. **Regular supply of raw materials.** Sufficient working capital ensures regular supply of raw materials and continuous production
6. Regular payment of salaries, wages and other day-to-day commitments
7. Exploitation of favourable market conditions
8. Ability to face crisis
9. Quick and regular return on investments.
10. High morale.

Q.6. Explain the disadvantages or dangers of inadequate working capital?

1. A concern which has inadequate working capital *cannot pay its short-term liabilities in time*. Thus, it will lose its reputation and shall not be able to get good credit facilities.
2. It *cannot buy its requirements in bulk* and cannot avail of discounts, etc.
3. It becomes *difficult for the firm to exploit favourable market conditions* and undertake profitable projects due to lack of working capital.
4. The firm *cannot pay day-to-day expenses of its operations* and it creates inefficiencies, increases costs and reduces the profits of the business.
5. It becomes *impossible to utilise efficiently the fixed assets* due to non-availability of liquid funds.
6. The *rate of return on investments also falls* with the shortage of working capital.

Q.7. What is the objective of Cash Management?

Two prime objectives for the firm's cash management system, as follows:

- i. Meeting the cash outflows:** It means that the firm should have sufficient cash to meet the payment schedules and disbursement needs.
- ii. Minimizing the Cash Balance:** Investment in idle cash balance must be reduced to a minimum. The funds locked up in cash balance is a dead investment and has no earning.

These objectives seem to be contradictory in nature and hence the financial manager has to achieve a trade-off between them. He has to ensure that the minimum cash balance being maintained by the firm is not affecting the payment schedule and meeting all disbursement needs.

Q.8. What is the objective of Receivables Management?

Following are the objectives of receivables management which will help us to understand the purpose of receivables:

1. To optimize the amount of sales
2. To minimize cost of credit
3. To optimize investment in receivables.
4. To increase credit sales.

Therefore, the main objective of receivable management is to create a balance between profitability & cost.

Q.9. What is Economic Order Quantity?

EOQ refers to the level of inventory at which the total cost of inventory is minimum. Determining an optimum Ordering quantity involves two types of cost such as Ordering cost and Carrying cost. The EOQ is that inventory level that minimizes the total of ordering & carrying cost.

EOQ can be calculated with the help of the mathematical formula:

$$EOQ = \sqrt{2UO/C}$$

Where,

U = Annual usage of inventories (units)

O = Buying cost per order

C= Carrying cost per unit

Q.10. What is A-B-C Analysis?

A-B-C Analysis is the inventory management techniques that divide inventory into three categories based on the value and volume of the inventories.

- ❖ 10% of the inventory's item contributes to 70% of value of consumption and this category is known as **A category**.
- ❖ About 20% of the inventory item contributes about 20% of value of consumption and this category is called **category B**, and
- ❖ 70% of inventory item contributes only 10% of value of consumption and this category is called **C category**.

Essay Questions:

Q.1. Define the term working capital. What are the factors determining working capital requirements?

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Definition:

Shubin, "Working capital is the amount of funds necessary to cover the cost of operating the enterprise".

Factors determining the working capital requirements:

1. Nature or Character of Business: Public utility undertakings require small amount of working capital, trading and financial firms require relatively very large amount, whereas manufacturing undertakings require sizable working capital between these two extremes.

2. Size of Business/Scale of Operations: Greater the size of a business unit, generally larger will be the requirements of working capital.

3. Production Policy: In certain industries the demand is subject to wide fluctuations due to seasonal variations. If the production policy is to keep production steady by accumulating inventories it will require higher working capital.

- 4. Manufacturing Process/Length of Production Cycle:** Longer the process period of manufacture, larger is the amount of working capital required.
- 5. Seasonal Variations:** In certain industries raw material is not available throughout the year. They have to buy raw materials in bulk during the season to ensure an uninterrupted flow and process them during the entire year. Generally, during the busy season, a firm requires larger working capital than in the slack season.
- 6. Working Capital Cycle:** The speed with which the working capital completes one cycle determines the requirement of working capital, longer the period of the cycle larger is the requirement of working capital.
- 7. Rate of Stock Turnover:** A firm having a high rate of stock turnover will need lower amount of working capital as compared to a firm having a low rate of turnover.
- 8. Credit Policy:** The firm following liberal credit policy to all customers require large working capital. On the other hand, the firm adapting strict credit policy and grant credit facilities to few potential customers will require less amount of working capital.
- 9. Business Cycles:** Business cycle refers to alternate expansion and contraction in general business activity. In a period of boom i.e., when the business is prosperous, there is a need for larger amount of working capital due to increase in sales, rise in prices, optimistic expansion of business, etc.
- 10. Rate of Growth of Business:** The working capital requirements of a concern increase with the growth and expansion of its business activities.
- 11. Earning Capacity and Dividend Policy:** Firms with high earning capacity may generate cash profits from operations and contribute to their working capital. A firm that maintains a steady high rate of cash dividend irrespective of its generation of profits needs more working capital.
- 12. Price Level Changes:** 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.
- 13. Other Factors:** Certain other factors such as operating efficiency, management ability, irregularities of supply, import policy, asset structure, importance of labour, banking facilities, etc. also influence the requirements of working capital.

Q.2. What do you understand by working capital? Discuss the various sources of working capital funds.

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

- (a) Permanent or Fixed working capital requirements.
- (b) Temporary or Variable working capital requirements.

The fixed proportion of working capital should be generally financed from the fixed capital sources while the temporary or variable working capital requirements of a concern may be met from the short-term sources of capital.

A. Sources of Permanent Working Capital:

- 1. Shares:** A company can issue various types of shares as equity shares, preference shares. As far as possible, a company should raise the maximum amount of permanent capital by the 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.
- 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 facilities.
- 4. Ploughing Back of Profits:** Ploughing back of profits means the reinvestments by concern of its surplus earnings in its business. It is an internal source of finance and is most suitable for an established firm for its expansion, modernisation and replacement etc.
- 5. Loans from Financial Institutions:** Financial institutions such as Commercial Banks, Industrial Development Bank of India, etc. also provide short-term, medium-term and long-term loans.

B. Sources of Temporary Working Capital:

- 1. Indigenous Bankers:** Private money-lenders and other country bankers used to be the only source of finance prior to the establishment of commercial banks.
- 2. Trade Credit:** Trade credit refers to the credit extended by the suppliers of goods in the normal course of business.
- 3. Instalment Credit:** This is another method by which the assets are purchased and the possession of goods is taken immediately but the payment is made in instalments over a pre-determined period of time.
- 4. Advances:** Some business houses get advances from their customers and agents against orders and this source is a short-term source of finance for them.
- 5. Factoring or Accounts Receivable Credit:** A commercial bank may provide finance by discounting the 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.
- 6. Accrued Expenses:** Accrued expenses represent a liability that a firm has to pay for the services already received by it. The most important items of accruals are wages and salaries, interest, and taxes.
- 7. Deferred Incomes:** Deferred incomes are incomes received in advance before supplying goods or services. They represent funds received by a firm for which it has to supply goods or services in future.

8. Commercial Paper: Commercial paper represents unsecured promissory notes issued by firms to raise short-term funds.

9. Working Capital Finance by Commercial Banks: Commercial banks are the most important source of short-term capital. The major portion of working capital loans are provided by commercial banks. The different forms in which the banks normally provide loans and advances are as follows:

(a) Loans (b) Cash Credits (c) Overdrafts (d) Purchasing and Discounting of bills.

Q.3. Discuss the various approaches to determine an appropriate financing mix of working capital.

Working Capital Management formulates policies to manage and handle efficiently; for that purpose, the management established three policies based on the relationship between Sales and Working Capital.

1. Conservative Working Capital Policy.
2. Moderate Working Capital Policy.
3. Aggressive Working Capital Policy

1. Conservative working capital policy: Conservative Working Capital Policy refers to minimize risk by maintaining a higher level of Working Capital. This type of Working Capital Policy is suitable to meet the seasonal fluctuation of the manufacturing operation.

2. Moderate working capital policy: Moderate Working Capital Policy refers to the moderate level of Working Capital maintenance according to moderate level of sales. It means one percent of change in Working Capital that is Working Capital is equal to sales.

3. Aggressive working capital policy: Aggressive Working Capital Policy is one of the high risky and profitability policies which maintains low level of Aggressive Working Capital against the high level of sales, in the business concern during particular period.

Determining the finance mix is an important part of working capital management. Under this decision, the relationship among risk, return and liquidity are measured and also which type of financing is suitable to meet the Working Capital requirements of the business concern. There are three basic approaches for determining an appropriate Working Capital Finance mix.

1. Hedging or matching approach
2. Conservative approach
3. Aggressive approach.

1. Hedging Approach: Hedging approach is also known as matching approach. Under this approach, the business concern can adopt a financial plan which matches the expected life of assets with the expected life of the sources of funds raised to finance assets. When the business follows matching approach, long-term finance shall be used to fixed assets and permanent current assets and short-term financing to finance temporary or variable assets.

2. Conservative Approach: Under this approach, the entire estimated finance in current assets should be financed from long-term sources and the short-term sources should be used only for emergency requirements. This approach is called as "Low Profit - Low Risk" concept.

3. Aggressive Approach: Under this approach, the entire estimated requirement of current assets should be financed from short-term sources and even a part of fixed assets financing be financed from short-term sources. This approach makes the finance mix riskier, less costly and more profitable.