

# Working Capital Management

## Meaning of Working Capital

Working capital is that part of the total capital of an enterprise which is required to be invested in the short term or current assets. This capital is needed in an enterprise to meet its day to day expenses.

Working capital shows the strength of a business in a short period of time. If a company has some amount of working capital, it means that the company has certain amount of liquid assets out of which it can meet its day to day expenses.

Working capital is also known as short term capital or operating capital or circulating capital.

## Concept of Working Capital

There are two concepts of working capital working capital. They are as follows:

### 1. Gross Working Capital

### 2. Net Working Capital

#### 1. Gross Working Capital

Gross working capital is the total current assets of an enterprise. In this concept, we do not deduct current liabilities from current assets, but we use current liabilities as a source of fund. When we buy goods on credit, it means we save our cash to the extent of the value of goods purchased on credit and we can use this as working capital for paying other expenses. The mathematical formula for calculating the gross working capital is as follows:

Gross Working Capital = Total Current Assets

Current assets are those assets which can be converted into cash within one accounting year. For example, cash, bank, debtors, bill receivables, closing stock, prepaid expenses, accrued incomes, marketable securities etc.

## **2. Net Working Capital**

Net working capital is difference between the total current assets and total current liabilities of an enterprise. The excess of current assets over current liabilities is also called net current assets. In this concept, a business enterprise has to maintain the minimum level of working capital for smooth operation of the business activities. This concept of working capital is used for the preparation of balance sheet. In the vertical form of balance sheet, we show excess of current assets over current liabilities. The mathematical formula for calculating the net working capital is as follows:

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

Current Liabilities are those liabilities which can be paid within one accounting year. For example, creditors, outstanding expenses, bank overdraft, bills payable, short term loans, income tax payable, incomes received in advance, dividend payable etc.

### **Importance of / Need for Working Capital**

A business enterprise needs working capital for various reasons. When creditors demand their money from a company, its high working capital saves the company from this situation. Selling of current assets is easy in small period of time but a company can not sell their fixed assets within small period of time. So, if a company has sufficient working capital, it can easily pay off its creditors and create his reputation in market. But if a company has zero working capital, then it can not pay its creditors in time. In this situation, the company may either become bankrupt or take a loan at higher rate of interest. In both the

conditions, it is very dangerous. Therefore, the company's finance manager tries to keep some amount of working capital for creating goodwill in market.

Positive working capital enables the company to pay its day to day expenses like payment of wages, salaries, raw materials or goods and other operating expenses. Adequate working capital not only enables the company to pay its matured liabilities but also to pay its outstanding liabilities without any delay.

### **Determinants of Working Capital Requirements/Factors Influencing Working Capital Requirements**

**The following are the various factors that determine the working capital requirements of a company:**

#### **1. Size of Business**

The amount of working capital required in a business firm is largely affected by its size or scale of business operations. The business of a firm may be small or large. In small business, the company needs smaller amount of working capital, but in large business, it requires larger amount of working capital.

#### **2. Nature of Business**

The amount of working capital required in a business firm is largely affected by the nature of its business. Manufacturing concerns require larger amount of working capital, whereas trading concerns require smaller amount of working capital.

#### **3. Nature of Demand**

Nature of demand also absolutely affects the working capital need. Some product can be easily sold by businessman, in that business; you need small amount of working capital because your earned money from sale can easy

fulfill the shortage of working capital. But, if demand is very less, it is required that you have to invest large amount of working capital because your all fixed expenses must be paid by you.

#### **4. Production Policy**

Production policy is also main determinant of working capital requirement. Different company may different production policy. Some companies stop or decrease the production level in off seasons, in that time, company may also reduce the number of employees or decrease the purchasing of new raw material, so, it will certainly decrease the amount of working capital but on the side, some company may continue their productions in off season, in that case, they need definitely large amount of working capital.

#### **5. Credit Policy**

Credit policy is relating to purchasing and selling of goods on credit basis. If company purchases all goods on credit and sells on cash basis or advance basis, then it is certainly company need very low amount of working capital. But if in company, goods are purchased on cash basis, and sold on credit basis, it means, our earned money will receive after sometime and we require large amount of working capital for continuing our business.

#### **6. Dividend Policy**

Dividend policy also effect working capital requirement. Company can distribute major part of net profit. But, if there is no reserve, we have to invest large amount in working capital because, lacking of reserve will affect on adversely on fulfill our liabilities. In that case, we have to yield working capital by taking short term loan for paying uncertain liability.

## **7. Working Capital Cycle**

Working capital cycle shows all steps which starts from cash purchasing of raw material and then this converted into finished product, after this it is converted into sale, if it is credit sale, debtors will also the part of working capital cycle and when we gets money from our debtors, it is the final part of working capital cycle. If we receive fastly from our debtors, we need small amount working capital. Otherwise, for purchasing new raw material, we need more amount of working capital.

## **8. Manufacturing Cycle**

Manufacturing cycle means the process of converting raw material into finished product. Long manufacturing cycle will create the situation in which we require large amount of working capital. Suppose, we have to construct the building, for constructing colony of buildings, it may consume the time more than 5 years, so according to this we need working capital.

## **9. Business Cycle**

There are two main part of business cycle, one is boom and other is recession. In boom, we need high money or working capital for development of business but in recession, we need only low amount of working capital.

## **10. Price Level Changes**

If there is increasing trend of products prices, we need to store high amount of working capital, because next time, it is precisely that we have to pay more for purchasing raw material or other service expenses. Inflation and deflation are two major factors which decide the next level of working capital in business.

## **11. Effect of External Business Environmental Factors**

There are many external business environmental factors which affect the need of working capital like fiscal policy, monetary policy and bank policies and facilities.



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