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Working Capital

Introduction

Finance is required for two purpose viz. for it establishment and to carry out the day-to-day operations of a business. Funds are required to purchase the fixed assets such as plant, machinery, land, building, furniture, etc, on long-term basis. Investments in these assets represent that part of firm's capital, which is blocked on a permanent of fixed basis and is called fixed capital. Funds are also needed for short-term purposes such as the purchase of raw materials, payment of wages and other day-to-day expenses, etc. and these funds are known as working capital. In simple words working capital refers that part of the firm's capital, which is required for financing short term or current assets such as cash, marketable securities, debtors and inventories. The investment in these current assets keeps revolving and being constantly converted into cash and which in turn financed to acquire current assets. Thus the working capital is also known as revolving or circulating capital or short-term capital.

Concept of working capital

There are two concepts of working capital:

1. Gross working capital
2. Net working capital

1. Gross working capital

In the broader sense, the term working capital refers to the gross working capital. The notion of the gross working capital refers to the capital invested in total current assets of the enterprise. Current assets are those assets, which in the ordinary course of business, can be converted into cash within a short period, normally one accounting year.

Examples of current assets:

1. Cash in hand and bank balance
2. Bills receivables or Accounts Receivables
3. Sundry Debtors (less provision for bad debts)
4. Short-term loans and advances.
5. Inventories of stocks, such as:
   (a) Raw materials
   (b) Work – in process
   (c) Stores and spares
   (d) Finished goods
6. Temporary Investments of surplus funds.
7. Prepaid Expenses
8. Accrued Incomes etc.

2. Net working capital

In a narrow sense, the term working capital refers to the net working capital. Networking capital represents the excess of current assets over current liabilities. Current liabilities are those liabilities, which are intend to be paid in the ordinary course of business within a short period, normally one accounting year out of the current assets or the income of the business. Net working capital may be positive or negative. When the current assets exceed the current liabilities net working capital is positive and the negative net working capital results when the liabilities are more than the current assets.

Examples of current liabilities:

1. Bills payable
2. Sundry Creditors or Accounts Payable.
3. Accrued or Outstanding Expanses.
4. Short term loans, advances and deposits.

5. Dividends payable
6. Bank overdraft
7. Provision for taxation etc.

Classification or kinds of working capital

Working capital may be classified in two ways:

a. On the basis of concept.
b. On the basis of time permanency

On the basis of concept, working capital is classified as gross working capital and net working capital is discussed earlier. This classification is important from the point of view of the financial manager. On the basis of time, working capital may be classified as:

1. Permanent or fixed working capital
2. Temporary of variable working capital

1. Permanent or fixed working capital: There is always a minimum level of current assets, which is continuously required by the enterprise to carry out its normal business operations and this minimum is known as permanent of fixed working capital. For example, every firm has to maintain a minimum level of raw materials, work in process; finished goods and cash balance to run the business operations smoothly and profitably. This minimum level of current assets is permanently blocked in current assets. As the business grows, the requirement of permanent working capital also increases due to the increases in current assets. The permanent working capital can further be classified into regular working capital and reserve working capital. Regular working capital is the minimum amount of working capital required to ensure circulation of current assets from cash to inventories, from inventories to receivables and from receivable to cash and so on. 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 period such as strikes, rise in prices, depression etc.

2. Temporary or variable working capital: Temporary or variable working capital is the amount of working capital, which is required to meet the seasonal demands and some special exigencies. Thus the variable working capital can be further classified into seasonal working capital and special working capital. While seasonal working capital is required to meet certain seasonal demands, the special 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. Temporary working capital differs from permanent working capital in the sense that it is required for short periods and cannot be permanently employed gainfully in the business. Figures given below illustrate the different between permanent and temporary working capital.

Importance of working capital

Working capital is refereed to be the lifeblood and nerve center of a business. Working capital is as essential to maintain the smooth functioning of a business as blood circulation in a human body. No business can run successfully with out 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. Good will: Sufficient working capital enables a business concern to make prompt payment and hence helps in creating and maintaining good will.
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 favorable 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 payments of salaries wages and other day to day commitments: A company which has ample working capital can make regular payment of salaries, wages and other day to day commitments which raises the morale of its employees, increases their efficiency, reduces wastage and cost and enhances production and profits.

7. Exploitation of favourable market conditions: The concerns with adequate working capital only can exploit favourable market conditions such as purchasing its requirements in bulk when the prices are lower.

8. Ability to face crisis: Adequate working capital enables a concern to face business crisis in emergencies.

9. Quick and regular return on Investments: Every investor wants a quick and regular return on his investment. Sufficiency of working capital enables a concern to pay quick and regular dividends to its investors, as there may not be much pressure to plough back profits. This gains the confidence of its investors and creates a favourable market to raise additional funds in the future.

10. High morale: Adequacy of working capital creates an environment of security, confidence, and high morale and creates overall efficiency in a business. Every business concern should have adequate working capital to run its business operations. It should have neither redundant excess working capital nor inadequate shortage of working capital. Both, excess as well as short working capital positions are bad for any business. However, out of the two, it is the inadequacy of working capital which is more dangerous from the point of view of the firm.

The need or objectives of working capital

The need for working capital arises mainly due to the time gap between production and realization of cash. The process of production and sale cannot be done instantaneously and hence the firm needs to hold the current assets to fill-up the time gaps. There are time gaps in purchase of raw materials and production; production and sales: and sales and realization of cash. The working capital is needed mainly for the following purposes:

For the purchase of raw materials.

1. To pay wages, salaries and other day-to-day expenses and overhead cost such as fuel, power
2. and office expenses, etc.
3. To meet the selling expenses such as packing, advertising, etc.
4. To provide credit facilities to the customers and
5. To maintain the inventories of raw materials, work-in-progress, stores and spares and finishes stock etc.

Generally, the level of working capital needed depends upon the time gap (known as operating cycle) and the size of operations. Greater the size of the business unit generally, larger will be the requirements of working capital. The amount of working capital needed also goes on increasing with the growth and expansion of business. Similarly, the larger the operating cycle, the larger the requirement for working capital. There are many other factors, which influence the need of working capital in a business, and these are discussed below in the following pages.

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