Business Finance

Unit 4

“Working Capital is the excess of Current Assets over Current Liabilities.”

Working Capital

Working Capital refers to firm's investment in short-term assets, viz. cash, short-term securities, accounts receivable (debtors) and inventories of raw materials, work-in process and finished goods. It can also be regarded as that portion of the firm's total capital, which is employed in short-term operations. It refers to all aspects of current assets and current liabilities. In simple words, we can say that working capital is the investment needed for carrying out day-to-day operations of the business smoothly. The management of working capital is no less important than the management of long-term financial investment.

Current assets: It is rightly observed that “Current assets have a short life span. These types of assets are engaged in current operation of a business and normally used for short– term operations of the firm during an accounting period i.e. within twelve months. The two important characteristics of such assets are, (i) short life span, and (ii) swift transformation into other form of assets. Cash balance may be held idle for a week or two; account receivable may have a life span of 30 to 60 days, and inventories may be held for 30 to 100 days.

Current liabilities: The firm creates a Current Liability towards creditors (sellers) from whom it has purchased raw materials on credit. This liability is also known as accounts payable and shown in the balance sheet till the payment has been made to the creditors. The claims or obligations which are normally expected to mature for payment within an accounting cycle (1 year) are known as current liabilities. These can be defined as “those liabilities where liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current assets, or the creation of other current liabilities.”

Significance of Working Capital

The main compensation of maintaining ample amount of working capital is as under:

1. **Solvency of the Company:** Sufficient working capital helps in maintaining solvency of the company by providing continuous flow of manufacture.
2. **For Goodwill of business:** Sufficient working capital enables a business concern to make punctual payments and hence helps in creating and maintaining goodwill.
3. **Easy availability of loans:** A business having sufficient working capital, high solvency and good credit standing can assemble loans from banks and other on easy and positive terms.
4. **To avail cash discounts:** Enough working capital also enables a concern to avail cash discounts on the purchases and hence it reduces costs.
5. **Normal supply of raw materials:** Enough working capital ensures usual supply of raw materials and regular production.
6. **Usual payment for day-to-day commitments:** A company which has plenty working capital can make usual payment of salaries, wages and other day-to-day commitments which raises the confidence of its employees, increases their competence, reduces wastages and costs and enhances manufacture and profits.

7. **Utilization of favourable market situation:** Only concern with sufficient working capital can exploit positive market conditions such as purchasing its necessities in bulk when the prices are lesser and by holding its inventories for upper prices.
8. **Capability to face crisis:** Sufficient working capital enables a concern to face company crisis in emergency periods such as gloominess because during such periods, usually, there is much pressure on working capital.
9. **Rapid and regular return on investments:** Every sponsor wants a quick and regular return on his investments. Adequacy of working capital enables an organization to pay quick and usual dividends to its investors as there may not be much force to plough back profits. This gains the assurance of its investors and creates a positive market to raise additional funds in the prospect.
10. **High confidence:** Sufficiency of working capital creates surroundings of safety, confidence, and high self-esteem and creates overall competence in a business.

Factors Affecting Working Capital Requirements

The following factors significantly influence the working capital requirements:

1. **Nature of Business:** The working capital necessity of a firm fundamentally depends upon the nature of the business. Public usefulness activities like electricity water supply and railways require very restricted working capital because they offer cash sales only and provide services, not products and as such no funds are coupled up in inventories and receivables. Usually speaking it may be said that public utility activities require small amount of working capital, trading and financial firms necessitate comparatively very large amount, whereas manufacturing activities require considerable working capital between these two limits.
2. **Scale of Operations:** The working capital necessity of a concern is directly influenced by the size of its company which may be calculated in terms of scale of operations.
3. **Production strategy:** In certain organizations the require is subject to wide fluctuations due to seasonal variations. The necessities of working capital in such cases depend upon the production strategy.
4. **Manufacturing procedure:** In manufacturing company the necessity of working capital increases in direct proportion of length of manufacturing procedure. Longer the procedure period of produce, larger is the amount of working capital required.
5. **Seasonal disparity:** In certain companies' raw material is not obtainable throughout the year. They have to buy raw materials in bulk in the season to make sure and continuous flow and process them during the entire year.
6. **Rate of stock proceeds:** There is a high degree of inverse co-relationship between the quantum of working capital; and the rapidity or speed with which the sales are affected. A firm having a high rate of stock turnover will need lesser amount of working capital as compared to a company, having a low rate of proceeds.
7. **Credit strategy:** The credit strategy of a company in its dealing with debtors and creditors influence significantly the necessity of working capital. A company that purchases its necessity on credit and sell its products/services on cash require smaller amount of working capital.
8. **Business rotation:** Business cycle refers to alternate development and contraction in common business actions. In a period of bang i.e., when the business is prosperous, there is a need of bigger amount of working capital due to amplify in sales, rise in prices, optimistic expansion of business contracts sales decline, difficulties are faced in collection from debtors and organisations may have a large amount of working capital lying inactive.

9. **Rate of expansion of company:** The working capital requirement of a concern increase with the growth and expansion of its business activities. Though it is difficulties to decide the relationship between the expansion in the volume of a company and the increase in the working capital of a business, yet it may be accomplished that of normal rate of expansion in the volume of business, we may have retained profits to provide for additional working capital but in fast growth in concern, we shall require bigger amount of working capital.
10. **Price stage change:** Changes in the price stage also result on the working capital necessity. Generally, the increasing prices will require the firm to maintain bigger amount of working capital as more funds will be essential to maintain the same current assets.

Liquidity Vs. Profitability

All decisions of the financial manager are assumed to be geared to maximization of shareholders wealth, and working capital decisions are no exception. Accordingly, risk-return trade-off characterizes each of the working capital decision. There are two types of risks inherent in working capital management, namely, liquidity risk and opportunity loss risk. Liquidity risk is the non-availability of cash to pay a liability that falls due. It may happen only on certain days. Even so, it can cause not only a loss of reputation but also make the work condition unfavourable for getting the best terms on transaction with the trade creditors. The other risk involved in working capital management is the risk of opportunity loss i.e. risk of having too little inventory to maintain production and sales, or the risk of not granting adequate credit for realizing the achievable level of sales. In other words, it is the risk of not being able to produce more or sell more or both, and, therefore, not being able to earn the potential profit, because there were not enough funds to support higher inventory and book debts. Thus, it would not be out of place to mention that it is only theoretical that the current assets could all take zero values. Indeed, it is neither practicable nor advisable. In practice, all current assets take positive values because firms seek to reduce working capital risks. However, if more funds are deployed in current assets, the higher would be the cost of funds employed, and therefore, lesser the profit.

The current assets holdings of the firm will depend upon its working capital policy. It may follow a conservative or an aggressive policy. These polices have different risk-return implications.

A conservative policy means lower return and risk, while an aggressive policy produces higher return and risk.

The two important aims of the working capital management are: profitability and solvency.

Solvency, used in the technical sense, refers to the firm's continuous ability to meet maturing obligations. Lenders and creditors expected prompt settlement of their claims as and when due. To ensure solvency, the firm maintains a relatively large investment in current assets holdings. If the firm maintains a relatively large investment in current assets, it will have no difficulty in paying the claims of the creditors when they become due and will be able to fill all sales orders and ensure smooth production. Thus, a liquid firm has less risk of insolvency; that is, it will hardly experience a cash shortage or stock-outs.

However, there is a cost associated with maintaining a sound liquidity position.

A considerable amount of the firm's funds will be tied up in current assets. And to the extent this investment is idle, the firm's profitability will suffer.

To have high profitability, the firm may sacrifice solvency and maintain a relatively low level of current assets. When the firm does so, its profitability will improve as less funds are tied up in idle current assets, but its solvency would be threatened and would be exposed to greater risk of cash shortage and stock-outs.

Therefore, the firm should balance the profitability solvency tangle by minimizing the total cost of liquidity and cost of illiquidity.

The Cost Trade-off:

A different way of looking into the risk-return trade of is in terms of the cost of maintaining a particular level of current assets. There are two different kinds of costs involved.

First there is the cost of liquidity. If the firm carries too much liquidity, the firm's rate of return will be low. Funds tied up in idle cash and excess inventory earn nothing, and receivables levels that are too large also reduce the firm's profitability. Thus, the cost of liquidity increases with the level of current assets.

There is the cost of liquidity, which is the cost of having too little invested in current assets. If the firm carries too little cash, it may not be able to pay bills promptly at they mature. This may force the firm to borrow at high rates of interest. This will also adversely affect the creditworthiness of the firm and it will face difficulties in obtaining funds in future. This all may force the firm into insolvency.

If the firm's inventory level too low, sales may be lost, and customers may shift to competitors. Also, low level of book debts may be due to tight credit policy, which would impair sales further. Thus, the low level of current assets involves cost which increases as this level falls.

Operating Cycle

The time between purchase of inventory items (raw material or merchandise) and their conversion into cash is known as operating cycle or working capital cycle. A perusal of the operating cycle would reveal that the funds invested in operations are re-cycled back into cash. The cycle, of course, takes some time to complete. The longer the period of this conversion the longer is the operating cycle. A standard operating cycle may be for any time period but does not generally exceed a financial year. Obviously, the shorter the operating cycle, the larger will be the turnover of funds invested for various purposes. The channels of the investment are called current assets. Sometimes the available funds may be in excess of the needs for investment in these assets, e.g., inventory, receivables and minimum essential cash balance. Any surplus may be invested in government securities rather than being retained as idle cash balance.

Methods of Estimating Working Capital

The following methods are used to calculate the amount of working capital requirement in a business

1. **Operating cycle concept:** In this method, the estimates of working capital requirements on the basis of average holding period of current assets and relating them to costs based on company's expectations and experiences. This value of total current assets is known as gross working capital. From gross working capital, the expected current liabilities like sundry creditors for raw materials, expenses, etc are deducted to find net working capital. This is the most appropriate method of calculating working capital.
2. **Current assets holding period Method:** This method is based on operating cycle period. Here, the working capital requirement equals to gross working capital requirement.

3. **Ratio to sales method:** The working capital requirements are estimated as a ratio of sales for each component of working capital.
4. **Ratio of fixed investment method:** The working capital is estimated as a percentage of fixed investment.

Current Assets Financing Policy

Working capital can be financed by different source like – long term sources, short term sources or transaction sources (like credit allowances, outstanding labour and other expenses).

In general, **the short-term assets should be financed through short term funds and long-term assets through long term funds.**

As far as financing of working capital is concerned it depends on the policy of the firm that what sources (and mix) of finance the firm want to use.

Several strategies are available to a firm for financing its working capital requirement.

Strategy A/Conservative Approach:

Long term financing is used to meet fixed asset requirement as well as peak working capital requirement.

In case the WC requirement is less than the peak value, the surplus will be invested in liquid assets like cash and marketable securities.

Here the firm do not want to take any risk. Larger the portion of long-term sources used to finance the working capital; more conservative the firm will be.

Strategy B/Moderate Approach:

Long term financing is used to meet fixed asset requirements, permanent WC requirement an a portion of fluctuating WC.

During seasonal upswings, short term financing is used; during seasonal downswing, surplus is invested in liquid assets.

Strategy C/Hedging Approach/Matching Approach:

According to this approach, **the maturity of sources of financing should match the maturity of assets being financed.**

Thus, long-term financing is used to meet fixed asset requirement and permanent working capital requirement. Short-term financing is used to meet fluctuating WC requirement.

Strategy D/Aggressive Approach:

Long term financing is used to meet fixed asset requirement and a part of Permanent WC requirement. Rest of the part of PWC and all fluctuating WC will be financed by short term financing.

This policy seeks to minimize excess liquidity while meeting short term requirement.

The firm may accept even greater risk of insolvency in order to save cost of long term financing.

Short-Term Finance

Short-term Finance/Capital refers to financing for a small period normally less than a year. It is also known as Working Capital Financing. Short-term Finance is used for working capital requirement. The availability of short-term funds is essential. Inadequacy of short-term funds may even lead to closure of business.

Following are the sources of raising short-term finance:

i. Trade Credit
ii. Bank Credit
iii. Factoring
iv. Advance from Customers
v. Instalment Credit

Trade Credit

Trade credit refers to credit granted to manufactures and traders by the suppliers of raw material, finished goods, components, etc. Usually, business enterprises buy supplies on a 30 to 90 days credit. It is the credit extended by the accounts payables.

Bank Credit

Commercial banks grant short-term finance to business firms which are known as bank credit. When bank credit is granted, the borrower gets a right to draw the amount of credit at one time or in instalments as and when needed. Bank credit may be granted by way of loans, cash credit,overdraft and discounted bills.

i. **Loans & Advances:** When a certain amount is advanced by a bank repayable after a specified period, it is known as bank loan. Such an advance is credited to a separate loan account and the borrower has to pay interest on the whole amount of loan irrespective of the amount of loan actually drawn. Usually, loans are granted against security of assets.
ii. **Cash Credit:** It is an arrangement whereby banks allow the borrower to withdraw money upto a specified limit. This limit is known as cash credit limit. Initially this limit is granted for one year. This limit can be extended after review for another year. However, if the borrower still desires to continue the limit, it must be renewed after three years. Rate of interest varies depending on the amount of limit.
iii. **Overdraft:** When a bank allows its depositors or account holders to withdraw money in excess of the balance in his account up to a specified limit, it is known as overdraft facility. This limit is granted purely on the basis of creditworthiness of the borrower. Banks generally give the limit up to Rs.20,000. In this system, the borrower has to show a positive balance in his account on the last Friday of every month. Interest is charged only on the overdrawn money. Rate of interest in case of overdraft is less than the rate charged under cash credit.

Factoring

Factoring is a similar arrangement like invoice discounting where the accounts receivables of a business are sold to a third party at a price which is lower to the realizable value of the accounts receivable. This purchasing party is commonly known as a factor. These factoring services are provided by both banks and other financial institutions. There are many types of factoring like with recourse or without recourse etc.

Advance from Customers

Customers' advance refers to advance made by the customer against the value of order placed. It is, thus, a part payment of the value of goods to be supplied later.

Instalment Credit

Instalment credit is a system under which a small payment is made at the time of taking possession of the goods and the remaining amount is paid in instalments. Instalment money is inclusive of interest.