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WORKING CAPITAL

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ABSTRACT

Every business needs investment to procure fixed assets, which remain in use for a longer period. Money invested in these assets is called 'Long term Funds' or 'Fixed Capital'. Business also needs funds for short-term purposes to finance current operations. Investment in short term assets like cash, inventories, debtors etc., is called 'Short-term Funds' or 'Working Capital'. The 'Working Capital' can be categorized, as funds needed for carrying out day-to-day operations of the business smoothly. The management of the working capital is equally important as the management of long-term financial investment. Every running business needs working capital. Even a business which is fully equipped with all types of fixed assets required is bound to collapse without (i) adequate supply of raw materials for processing; (ii) cash to pay for wages, power and other costs; (iii) creating a stock of finished goods to feed the market demand regularly; and, (iv) the ability to grant credit to its customers. All these require working capital. Working capital is thus like the lifeblood of a business. The business will not be able to carry on day-to-day activities without the availability of adequate working capital.
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MEANING

Working capital refers to that part of firm's capital which is required for financing current assets such as cash, debtors, marketable securities and inventories.

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

CONCEPT OF WORKING CAPITAL

There are two interpretations of working capital:

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i. Gross Working Capital
ii. Net Working Capital

In the broad sense, the term working capital refers to the gross working capital and represents the funds invested in current assets. In other words, the gross working capital is the capital invested in total current assets of the enterprise.

In the narrow sense, the term working capital refers to the net working capital. Net working capital is the excess of current assets over current liabilities.
In other words:
Net Working Capital = Current Assets – Current Liabilities

Current assets are those assets which in the ordinary course of business can be converted into cash within a short period of normally one accounting year. Some examples of current assets are: cash, bills receivables, sundry debtors, short term loans and advances inventories, prepaid expenses and accrued incomes.

Current liabilities are those liabilities which are intended to be paid in the ordinary course of business within a short period of normally one accounting year. Some examples of current liabilities are: bills payable, creditors, accrued expenses, short term loans, dividend payable and bank overdraft.

As per the general practice, net working capital is referred to simply as working capital.

POSITIVE OR NEGATIVE WORKING CAPITAL

Net Working Capital may be positive or negative. When the current assets exceed the current liabilities, the working capital is positive. If the current liabilities are more than the current assets, the working capital is negative.

NEED OF WORKING CAPITAL

The need for working capital cannot be over emphasized. Every business needs some amount of working capital. The need for working capital arises due to the time gap between production and realization of cash from sales. There is an operating cycle involved in the sales and realization of cash. There are time gaps in purchase of raw materials and production;

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Production and sales; and sales and realization of cash. Thus, working capital is needed for the following purpose:

1. For the purchase of raw material, components and spares.
2. To pay wages and salaries.
3. To incur day-to-day expenses and overhead costs such as fuel, power and office expenses, etc.
4. To meet the selling costs as packing, advertising, etc.
5. To provide credit facilities to the customers.
6. To maintain the inventories of raw material, work-in-progress, stores and spares and finished stock.

For studying the need of working capital in a business, one has to study the business under varying circumstances such as a new concern, as a growing concern and as one which has attained maturity. A new concern requires a lot of liquid funds to meet initial expenses like promotion, formation, etc. these expenses are called preliminary expenses and are capitalized. The amount needed as working capital in a new concern depends primarily upon its size and the ambitions of its promoters. Greater the size of the business unit, generally, larger will be the requirements of working capital. The amount of working capital needed goes on increasing with the growth and expansion of business till it attains maturity. At maturity the amount of working capital needed is called normal working capital.

IMPORTANCE OF WORKING CAPITAL

Working capital is the life blood and nerve center of business. Working capital is very essential to maintain smooth running of a business. No business can run successfully without an adequate amount of working capital. The main advantages or importance of working capital are as follows:

1. Strengthen the Solvency

Working capital helps to operate the business smoothly without any financial problem for making the payment of short-term liabilities. Purchase of raw materials and payment of salary, wages and overhead can be made without any delay. Adequate working capital helps in maintaining solvency of the business by providing uninterrupted flow of production.

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2. Enhance Goodwill

Sufficient working capital enables a business concern to make prompt payments and hence helps in creating and maintaining goodwill. Goodwill is enhanced because all current liabilities and operating expenses are paid on time.

3. Easy Obtaining Loan

A firm having adequate working capital, high solvency and good credit rating can arrange loans from banks and financial institutions in easy and favorable terms.

4. Regular Supply of Raw Material

Quick payment of credit purchase of raw materials ensures the regular supply of raw materials from suppliers. Suppliers are satisfied by the payment on time. It ensures regular supply of raw materials and continuous production.

5. Smooth Business Operation

Working capital is really a life blood of any business organization which maintains the firm in well condition. Any day to day financial requirement can be met without any shortage of fund. All expenses and current liabilities are paid on time.

6. Ability to Face Crisis

Adequate working capital enables a firm to face business crisis in emergencies such as depression.

7. Cost Reduction

Adequate working capital also enables a firm to avail cash discounts on the purchases and therefore it reduces cost.

8. Exploitation of favorable market conditions

Only concerns with adequate working capital can exploit favorable market conditions such as purchasing its requirements in bulk when the prices are lower and by holding its stock/inventories for higher prices.

9. Regular payment of salaries and other expenses

A company which has adequate working capital can make regular payments of salaries, wages and other day to day commitments which raises the morale of its employees, increases their efficiency, reduces cost , reduces wastage and increases profits and production.

10. Quick and regular return on investments

Every investor wants a quick and regular return on his investments. 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 favorable market to raise additional funds in the future.

11. High morale

Adequacy of working capital creates an environment of security confidence, high morale and creates overall efficiency in a business.

FACTORS AFFECTING THE SIZE OF WORKING CAPITAL

Requirements Of working capital depend upon various factors such as nature of business, size of business, the flow of business activities. However, small organization relatively needs lesser working capital than the big business organization. Following are the factors which affect the working capital of a firm:

1. Size of Business

Working capital requirement of a firm is directly influenced by the size of its business operation. Big business organizations require more working capital than the small business organization. Therefore, the size of organization is one of the major determinants of working capital.

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2. Nature of Business

Working capital requirement depends upon the nature of business carried by the firm. Normally, manufacturing industries and trading organizations need more working capital than in the service business organizations. A service sector does not require any amount of stock of goods. In service enterprises, there are less credit transactions. But in the manufacturing or trading firm, credit sales and advance related transactions are in large amount. So, they need more working capital.

3. Business Cycle

The need for the working capital is affected by various stages of the business cycle. During the boom period, the demand of a product increases and sales also increase. Therefore, more working capital is needed. On the contrary, during the period of depression, the demand declines and it affects both the production and sales of goods. Therefore, in such a situation less working capital is required

4. Seasonal Factors

The working capital requirement is constant for the companies which are selling goods throughout the season whereas the companies which are selling seasonal goods require huge amount during season as more demand, more stock has to be maintained and fast supply is needed whereas during off season or slack season demand is very low so less working capital is needed

6. Production Cycle

Production cycle means the time involved in converting raw material into finished product. The longer this period, the more will be the time for which the capital remains blocked in raw material and semi-manufactured products. Thus, more working capital will be needed. On the contrary, where period of production cycle is little, less working capital will be needed.

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7. Storage Time or Processing Period

Time needed for keeping the stock in store is called storage period. The amount of working capital is influenced by the storage period. If storage period is high, a firm should keep more quantity of goods in store and hence requires more working capital. Similarly, if the processing time is more, then more stock of goods must be held in store as work-in-progress.

8. Changes in Price Level

Change in price level also affects the working capital requirements. Generally, the rise in price will require the firm to maintain large amount of working capital as more funds will be required to maintain the sale level of current assets.

9. Operating Efficiency

The operating efficiency of a firm also affects the firm's need of working capital. The operating efficiency of the firm results in optimum utilization of assets. The optimum utilization of assets in turn results in more fund release for working capital.

10. Level of Competition

If the market is competitive then company will have to adopt liberal credit policy and to supply goods on time. Higher inventories have to be maintained so more working capital is required. A business with less competition or with monopoly position will require less working capital as it can dictate terms according to its own requirements

CONSEQUENCES OF UNDER ASSESSMENT OFWORKING CAPITAL

1.Growth may be stunted. It may become difficult for the enterprise to undertake profitable projects due to non-availability of working capital.

2. Implementation of operating plans may become difficult and consequentlythe profit goals may not be achieved.

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3. Cash crisis may emerge due to paucity of working funds.

4. Optimum capacity utilization of fixed assets may not be achieved dueto non-availability of the working capital.

5. The business may fail to honor its commitment in time, therebyadversely affecting its credibility. This situation may lead to businessclosure.

6. The business may be compelled to buy raw materials on credit and sellfinished goods on cash. In the process it may end up with increasingcost of purchases and reducing selling prices by offering discounts.Both these situations would affect profitability adversely.

7. Non-availability of stocks due to non-availability of funds may resultin production stoppage.

8. While underassessment of working capital has disastrous implicationson business, over assessment of working capital also has its owndangers.

CONSEQUENCES OF OVER ASSESSMENT OF WORKING CAPITAL

1.Excess of working capital may result in unnecessary accumulation ofinventories.

2. It may lead to offer too liberal credit terms to buyers and very poorrecovery system and cash management.

3. It may make management complacent leading to its inefficiency.

4. Over-investment in working capital makes capital less productive andmay reduce return on investment.

Working capital is very essential for success of a business and, therefore,needs efficient management and control. Each of the components of the workingcapital needs proper management to optimize profit.

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