

# **UNIT-5**

**WORKING CAPITAL**

# MEANING OF WORKING CAPITAL

- Working Capital is another part of the capital which is needed for meeting **day to day requirement of the business concern**. For example, payment to creditors, salary paid to workers, purchase of raw materials etc., normally it consists of recurring in nature. It can be easily converted into cash. Hence, it is also known as short-term capital.

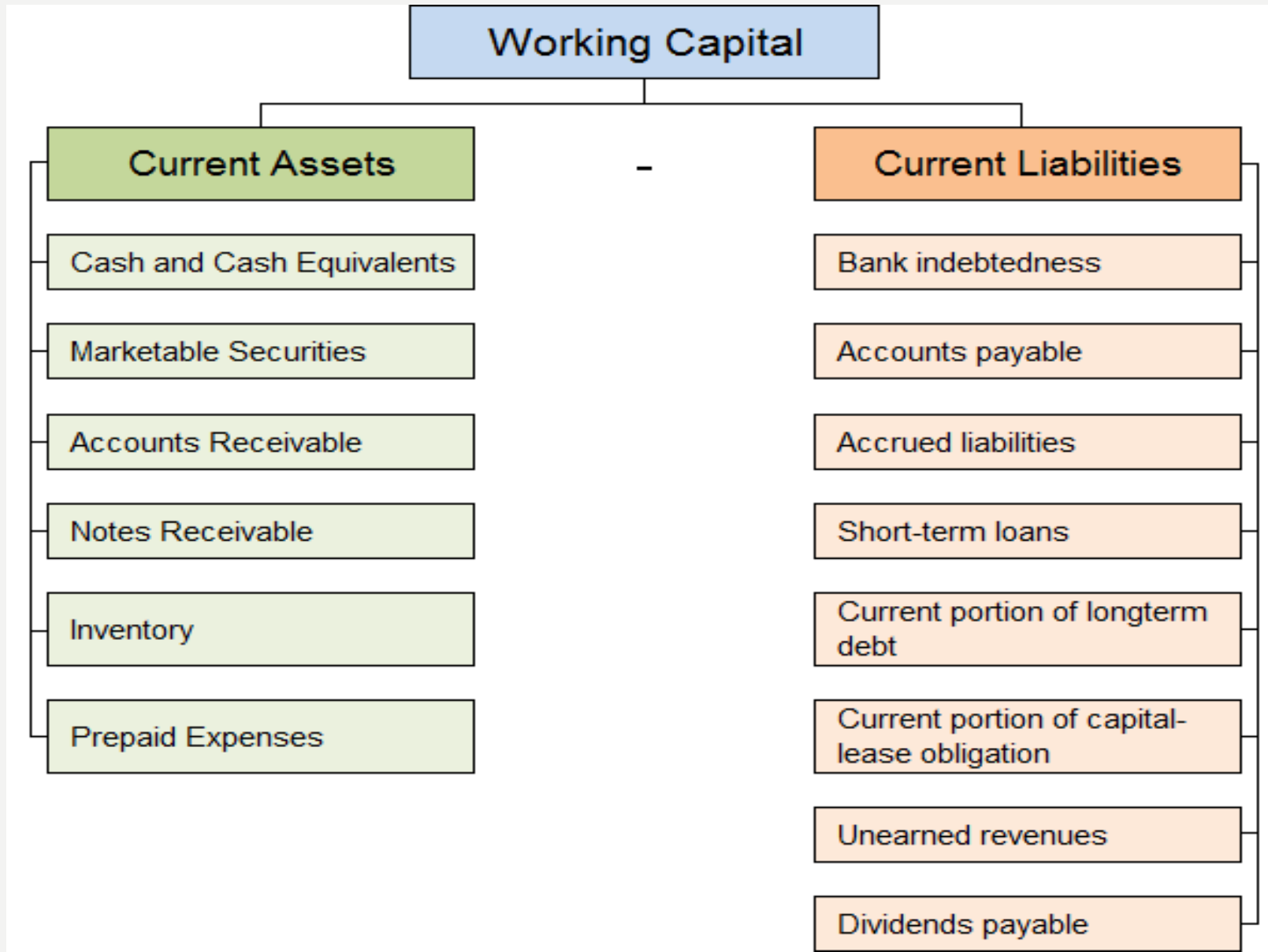
# DEFINITION OF WORKING CAPITAL

- According to the definition of J.S.Mill, “The sum of the current asset is the working capital of a business”.
- According to the definition of Weston and Brigham, “Working Capital refers to a firm’s investment in short-term assets, cash, short-term securities, accounts receivables and inventories”.

# TYPES OF WORKING CAPITAL

- **Gross Working Capital** is the general concept which determines the working capital concept. Thus, the gross working capital is the capital invested in total current assets of the business concern. Gross Working Capital is simply called as the total current assets of the concern.  $GWC = CA$
- **Net Working Capital** is the specific concept, which, considers both current assets and current liability of the concern. Net Working Capital is the excess of current assets over the current liability of the concern during a particular period. If the current assets exceed the current liabilities it is said to be positive working capital; it is reverse, it is said to be Negative working capital.  $NWC = CA - CL$

# COMPONENTS OF WORKING CAPITAL



# NEEDS OF WORKING CAPITAL

- **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.
- **2. Payment of wages and salary:** The next part of Working Capital is payment of wages and salaries to labour and employees.
- **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.

# CAUSES AND EFFECTS OF EXCESSIVE WORKING CAPITAL

- (i) Excessive Working Capital leads to unnecessary accumulation of raw materials, components and spares.
- (ii) Excessive Working Capital results in locking up of excess Working Capital.
- (iii) It creates bad debts, reduces collection periods, etc.
- (iv) It leads to reduce the profits.

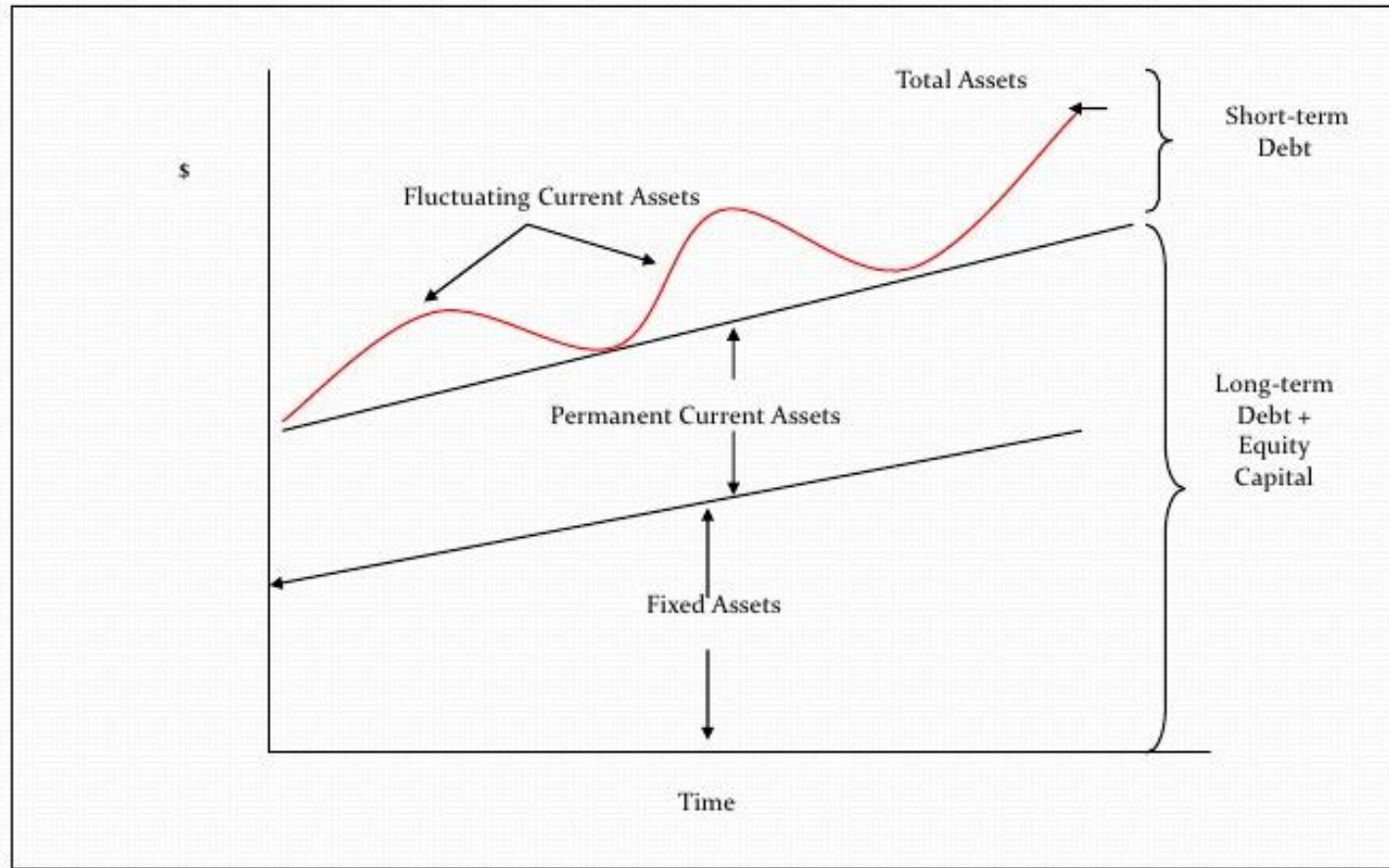
- **Causes and effects of inadequate working capital**
- (i) Inadequate working capital cannot buy its requirements in bulk order.
- (ii) It becomes difficult to implement operating plans and activate the firm's profit target.
- (iii) It becomes impossible to utilize efficiently the fixed assets.
- (iv) The rate of return on investments also falls with the shortage of Working Capital.
- (v) It reduces the overall operation of the business.



# APPROACHES FOR DETERMINING AN APPROPRIATE WORKING CAPITAL FINANCE MIX

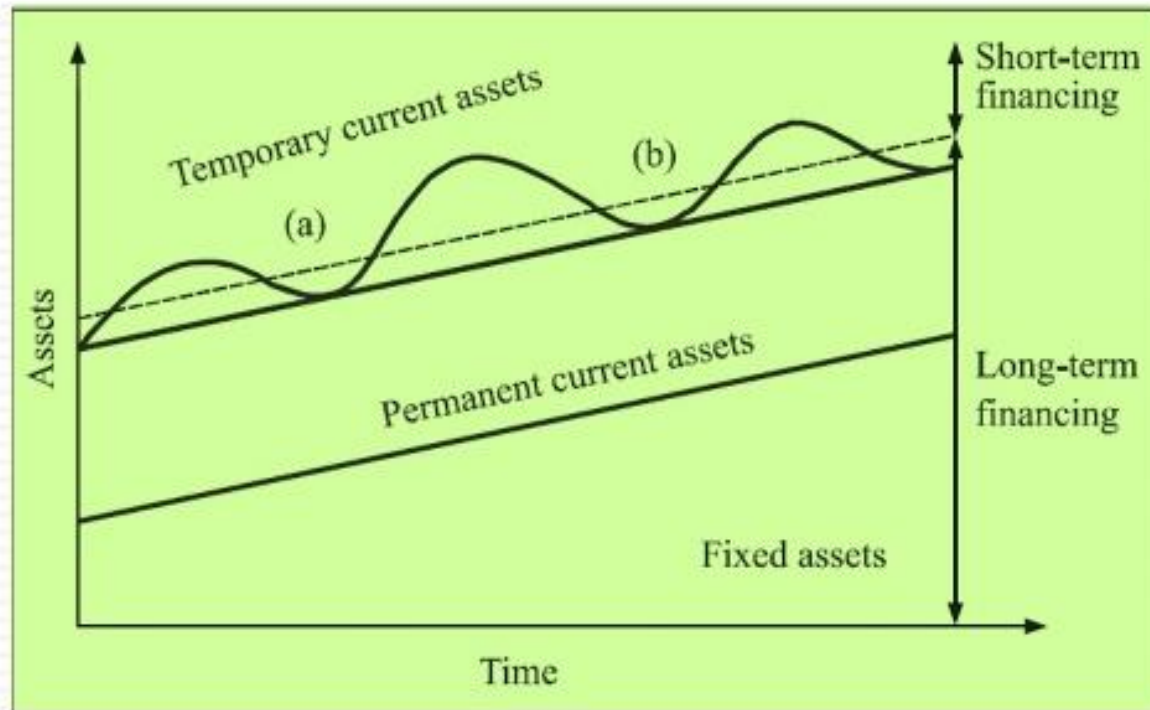
- **Hedging Approach** is also known as matching approach.
- Under this approach, the business concern can adopt a financial plan which matches the expected life of assets with the expected life of the sources of funds raised to finance assets. When the business follows matching approach, long-term finance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

# Matching approach to asset financing



- **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.

# Conservative Approach

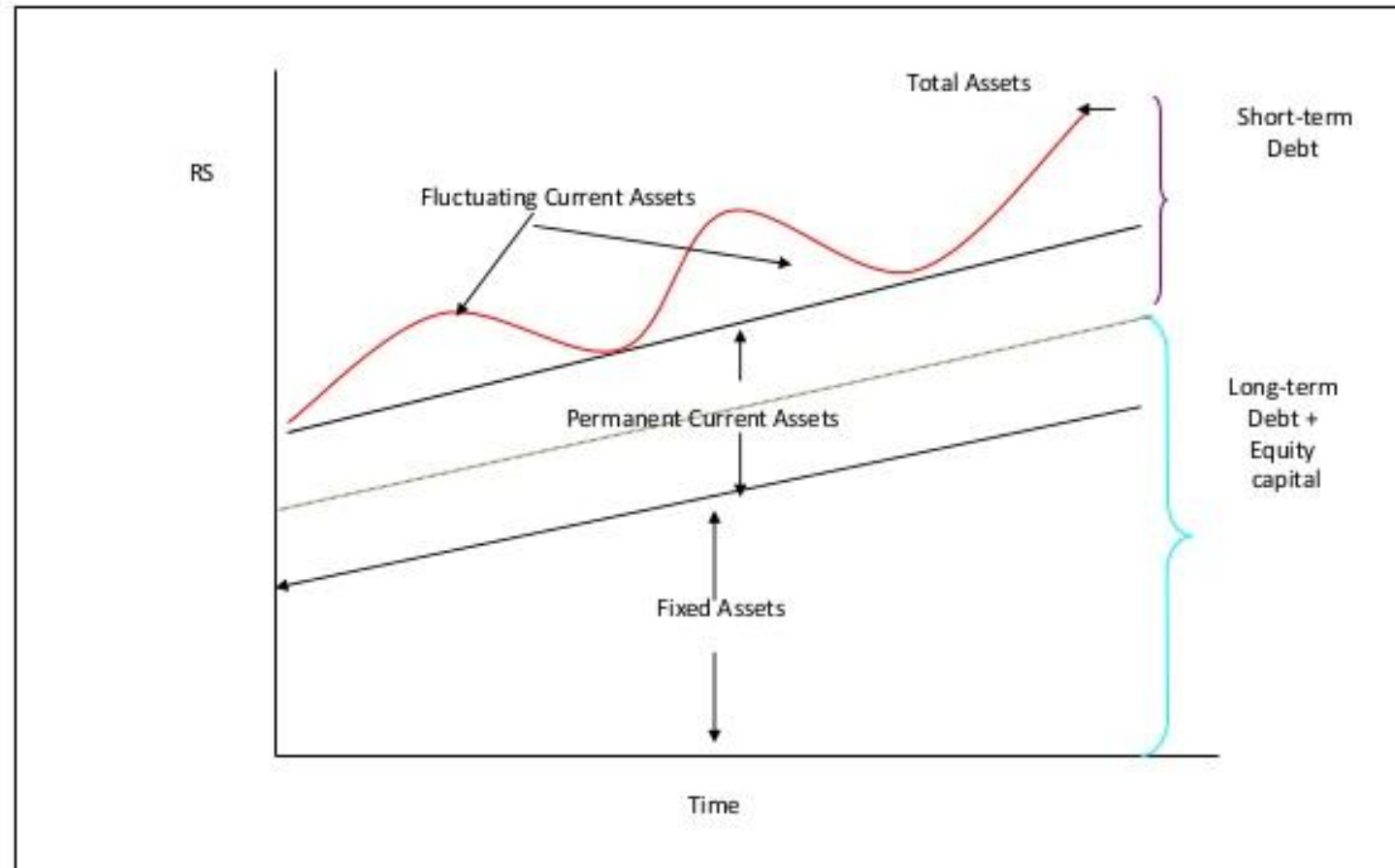


***Conservative financing***

- **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 **more risky, less costly and more profitable**.

# Aggressive approach to asset financing



# WORKING CAPITAL MANAGEMENT

- 1. Inventory Management
- 2. Cash Management
- 3. Receivables management

# INVENTORY MANAGEMENT

- A proper planning of **purchasing of raw material, handling, storing and recording is to be considered as a part of inventory management.** Inventory management means, management of raw materials and related items. Inventory management considers what to purchase, how to purchase, how much to purchase, from where to purchase, where to store and when to use for production etc.



# OBJECTIVES OF INVENTORY MANAGEMENT

- To efficient and smooth production process.
- To maintain optimum inventory to maximize the profitability.
  - To meet the seasonal demand of the products.
- To avoid price increase in future.
- To ensure the level and site of inventories required.
  - To plan when to purchase and where to purchase
- To avoid both over stock and under stock of inventory.

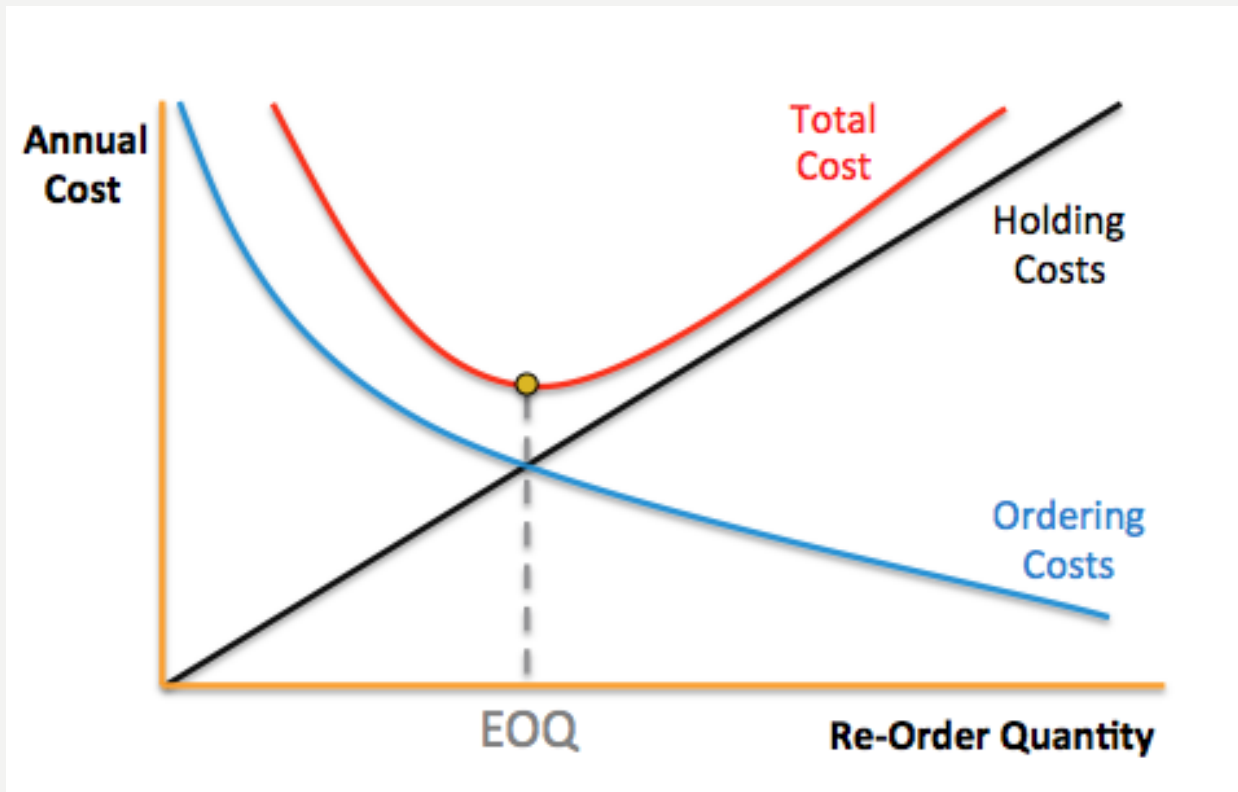
# ADVANTAGE/IMPORTANCE OF INVENTORY CONTROL

- 1.Smooth Functioning of Production process.
- 2.Increase in Profit.
- 3.Minimum spoilage of material.
- 4.Effective system of records.

# TECHNIQUES OF INVENTORY MANAGEMENT

- **Economic Order Quantity (EOQ)**
- EOQ refers to the level of inventory at which the total cost of inventory comprising ordering cost and carrying cost. Determining an optimum level involves two types of cost such as ordering cost and carrying cost. The EOQ is that inventory level that minimizes the total of ordering of carrying cost. EOQ can be calculated with the help of the mathematical formula:  
$$EOQ = \sqrt{2ab/c}$$
- Where,
- a = Annual usage of inventories (units) b = Buying cost per order c = Carrying cost per unit

- The concept of EOQ was first developed by F.N. Harris in the year 1915.
- EOQ is the size of purchase order which minimizes total inventory cost under the assumed condition of certainty.



# TECHNIQUES BASED ON THE CLASSIFICATION OF INVENTORIES

- **A-B-C analysis**
- It 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.

- **VED Analysis**

- V = Vital item of inventories E = Essential item of inventories D = Desirable item of inventories

- **HML Analysis**

- H = High value of inventories M = Medium value of inventories L = Low value of inventories

- **FNSD analysis**

- F = Fast moving inventories N = Normal moving inventories S = Slow moving inventories D = Dead moving inventories

# CASH MANAGEMENT

- Business concern needs **cash to make payments for acquisition of resources and services for the normal conduct of business.** Cash is one of the important and key parts of the current assets.



# MOTIVES FOR HOLDING CASH

- **1. Transaction motive:** It is a motive for holding cash or near cash to meet routine cash requirements to finance transaction in the normal course of business. Cash is needed to make purchases of raw materials, pay expenses, taxes, dividends etc.
- **2. Precautionary motive:** It is the motive for holding cash or near cash as a cushion to meet **unexpected contingencies**. Cash is needed to meet the unexpected situation like, floods strikes etc.

- 3. **Speculative motive:** It is the motive for holding cash to quickly take advantage of opportunities typically outside the normal course of business. Certain amount of cash is needed to meet an opportunity to purchase raw materials at a reduced price or make purchase at favorable prices.
- 4. **Compensating motive :** It is a motive for holding cash **to compensate banks for providing certain services or loans.** Banks provide variety of services to the business concern, such as clearance of cheque, transfer of funds etc.

# CASH MANAGEMENT TECHNIQUES

- **Speedy Cash Collections**

- Business concern must concentrate in the field of Speedy Cash Collections from customers. For that, the concern prepares systematic plan and refined techniques. These techniques aim at, the customer who should be encouraged to pay as quickly as possible and the payment from customer without delay.

- **Prompt Payment by Customers**

Business concern should encourage the customer to pay promptly with the help of offering discounts, special offer etc. It helps to reduce the delaying payment of customers and the firm can avoid delays from the customers.

- **Early Conversion of Payments into Cash**

- Business concern should take careful action regarding the quick conversion of the payment into cash. For this purpose, the firms may use some of the techniques like postal float, processing float, bank float and deposit float.

- **Concentration Banking**

- It is a collection procedure in which payments are made to regionally dispersed collection centers, and deposited in local banks for quick clearing. It is a system of decentralized billing and multiple collection points.

- **Lock Box System**

- Under the lock box system, business concerns hire a post office lock box at important collection centers where the customers remit payments. The local banks are authorized to open the box and pick up the remittances received from the customers. As a result, there is some extra savings in mailing time compared to concentration bank.

- **Slowing Disbursement**

- An effective cash management is not only in the part of speedy collection of its cash and receivables but also it should concentrate to slowing their disbursement of cash to the customers or suppliers. Slowing disbursement of cash is not the meaning of delaying the payment or avoiding the payment

- **1. Avoiding the early payment of cash**

- The firm should pay its payable only on the last day of the payment. If the firm avoids early payment of cash, the firm can retain the cash with it and that can be used for other purpose.

- **2. Centralised disbursement system**

- Decentralized collection system will provide the speedy cash collections. Hence centralized disbursement of cash system takes time for collection from our accounts as well as we can pay on the date.

# RECEIVABLE MANAGEMENT

- Management of account receivable is defined as the process of making decision resulting to the investment of funds in these assets which will result in maximizing the overall return on the investment of the firm.
- The objective of receivable management is to promote sales and profit until that point is reached where the return on investment in further funding receivables is less than the cost of funds raised to finance that additional credit.

- The costs associated with the extension of credit and accounts receivables are identified as follows:
- A. Collection Cost B. Capital Cost C. Administrative Cost D. Default Cost.
- **Collection Cost** This cost incurred in collecting the receivables from the customers to whom credit sales have been made.
- **Capital Cost** This is the cost on the use of additional capital to support credit sales which alternatively could have been employed elsewhere.

- **Administrative Cost** This is an additional administrative cost for maintaining account receivable in the form of salaries to the staff kept for maintaining accounting records relating to customers, cost of investigation etc.
- **Default Cost** Default costs are the over dues that cannot be recovered. Business concern may not be able to recover the over dues because of the inability of the customers.



# FACTORS CONSIDERING THE RECEIVABLE SIZE

- **1. Sales Level :** Sales level is one of the important factors which determines the size of receivable of the firm. If the firm wants to increase the sales level, they have to liberalise their credit policy and terms and conditions.
- **2. Credit Policy:** Credit policy is the determination of credit standards and analysis. It may vary from firm to firm or even some times product to product in the same industry. Liberal credit policy leads to increase the sales volume and also increases the size of receivable.

- 3. **Credit Terms** : Credit terms specify the repayment terms required of credit receivables, depend upon the credit terms, size of the receivables may increase or decrease.
- 4. **Credit Period** : It is the time for which trade credit is extended to customer in the case of credit sales. Normally it is expressed in terms of 'Net days'.
- 5. **Cash Discount** : Cash discount is the incentive to the customers to make early payment of the due date. A special discount will be provided to the customer for his payment before the due date.

# OBJECTIVES OF RECEIVABLES MANAGEMENT

- Maximise the return on investment in receivables.
- Maximise the sales to the extent the risk involved remains within the acceptable limit.
- Maintaining up-to-date record.
- Accurate billing.
- Establish the credit policies.

# SCOPE OF RECEIVABLES MANAGEMENT

## SCOPE OF MANAGEMENT OF RECEIVABLES

