

**WORKING CAPITAL**

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**MANAGEMENT**

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**NOTES**

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## **WORKING CAPITAL**

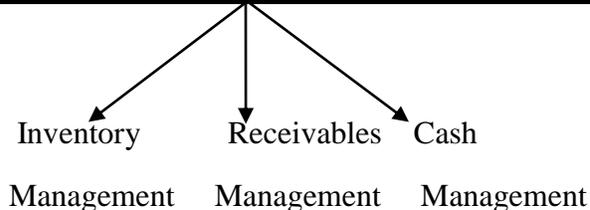
The capital of a business which is used in its day-by-day trading operations, calculated as the current assets minus the current liabilities. Working capital is also called operating assets or net current assets.

$$\text{WC} = \text{CA} - \text{CL}$$

## **WORKING CAPITAL MANAGEMENT**

Working capital management refers to a company's managerial accounting strategy designed to monitor and utilize the two components of working capital, current assets and current liabilities, to ensure the most financially efficient operation of the company.

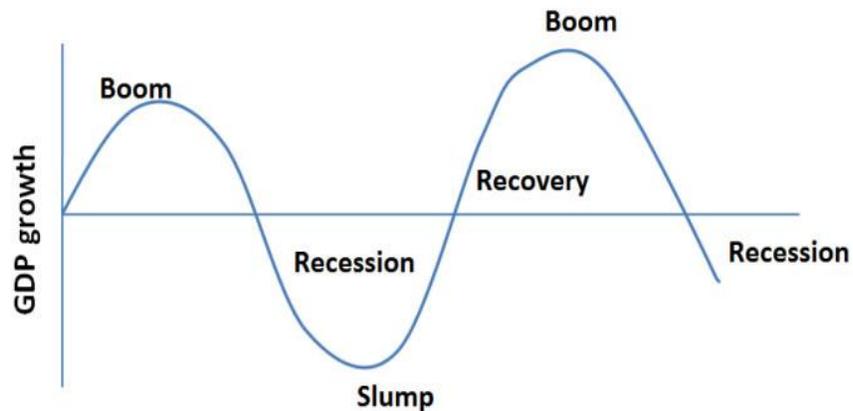
## **NEED OF WORKING CAPITAL MANAGEMENT**



## **FACTORS AFFECTING WORKING CAPITAL**

1. Nature of business
2. Production policy
3. Credit policy
4. Inventory policy
5. Abnormal factor
6. Market conditions
7. Conditions of supply
8. Business cycle
9. Taxation policy
10. dividend policy
11. Operating efficiency
12. Price level changes
13. Depreciation policy
14. Availability of raw material

## **BUSINESS CYCLE**



## **HOW MUCH WC IS NEEDED?**

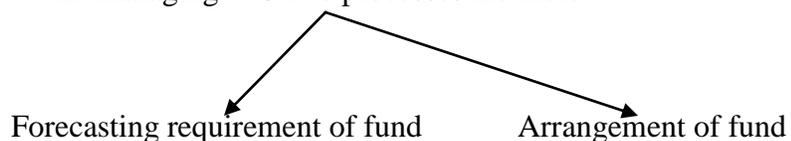
It depends on the following factors-

- Size of the firm
- Activities of the firm
- Availability of credits
- Attitudes towards profit
- Attitude toward risks
- Others

## **IMPORTANCE OF ADEQUATE WC/ OPTIMUM WC**

1. Smooth running of business
2. Profitability with manage risk
3. Growth and development possibility
4. Smooth payment
5. Increase in goodwill
6. Trade relationship better
7. Others

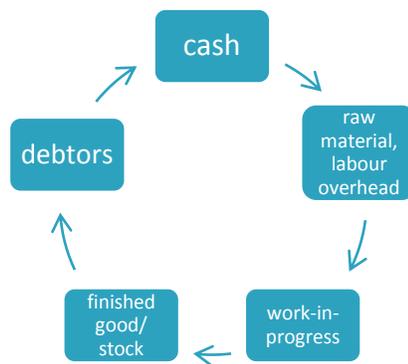
In managing WC two processes are there-



## SOME IMPORTANT ISSUES

- A. Monetary level of cash receivable & inventory
  - i. Current asset  
Current liabilities
  - ii. Current asset  
Total asset
  - iii. Current asset- inventory  
Liabilities
  - iv. Cash +marketable securities  
Current asset
- B. To have understanding of percentage of fund in current account
- C. Recording time spent in managing current account

## WORKING CAPITAL CYCLE



**Working capital cycle:-** The determination of WC helps in forecast, control & management of WC. The duration of WC may vary depending upon the nature of business. The duration of operating cycle (WC cycle) for the purpose of estimating WC is equal to the sum of duration of each of above events less the credit period allowed by the supplier

For ex.- A co. holds raw material on an average for 60 days, it gets credit firm supplier for 15 days, production process needs 15 days, finished products are held 30 days & 30 days is the total WC cycle. So,  $60+15+30+30-15=120$  days.

## VARIOUS COMPONENTS OF OPERATING CYCLE

It may be calculated as follows:

$$\text{A) Raw material shortage period} = \frac{\text{Average stock of raw material}}{\text{Average cost of raw material consumed per day}}$$

$$\text{B) WIP holding period} = \frac{\text{Average WIP inventory}}{\text{Average cost of production per day}}$$

$$\text{C) Finished goods storage period} = \frac{\text{Estimated production (in units)} * \text{direct lab permit}}{12 \text{ months} / 360 \text{ days}}$$

$$\text{OR} \quad \frac{\text{Average stock of finished goods}}{\text{Average cost of goods sold per day}}$$

$$\text{D) Debtors collection period} = \frac{\text{Average goods debtors}}{\text{Average credit sale per day}}$$

$$\text{E) Credit period available to suppliers} = \frac{\text{Average rate credit}}{\text{Average credit purchase per day}}$$

$$\text{Operating Cycle} = R+W+F+D-C$$

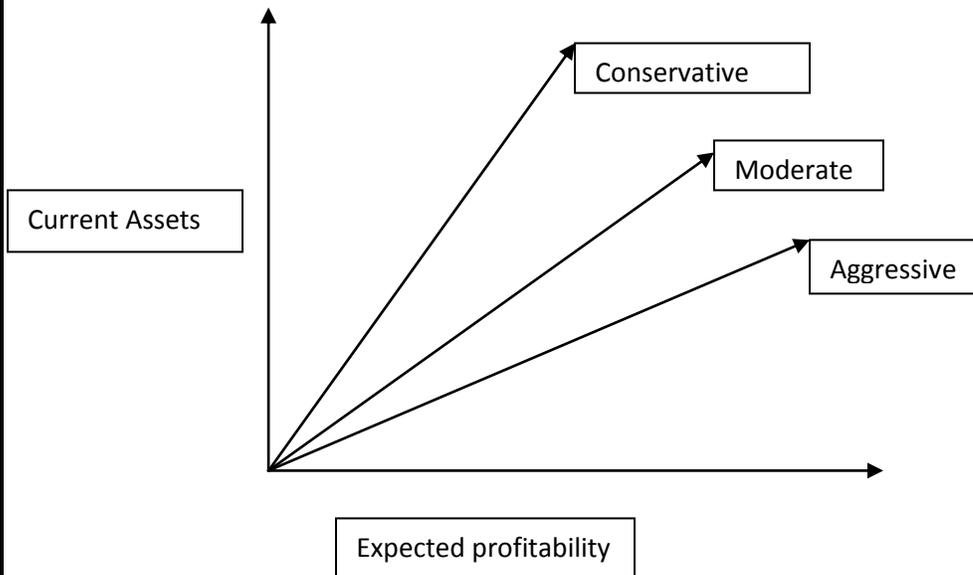
## WORKING CAPITAL POLICY / APPROACHES

It can be explained by two approaches:

- Conservative approach
- Aggressive approach

**Conservative approach:** A firm financing its common permanent assets & also with long term financing & less risky so far as insolvency is concerned. However funds may be invested in such investment which fetches small returns to build up liquidity.

**Aggressive approach:** The firm uses only short term financing. In this approach, the firm finances a part of the permanent assets with short term financing. This approach refers to more risky but may at returns to the assets.



## **FINANCING OF WORKING CAPITAL**

Financing of working capital can be done in two ways:

- Long term sources
- Short term sources

### **A. Long term sources**

1. Share capital
  - a. Equity share capital
  - b. Preference share capital
2. Debentures
  - a. Convertible debentures
  - b. Non-convertible debentures
  - c. Redeemable debentures
  - d. Non-Redeemable debentures

3. Bonds
4. Loans from banks & financial institutions
5. Retained earnings
6. Venture capital fund for innovative projects

**B. Short term sources**

1. Bank credit
2. Transaction credit
3. Advances from customers
4. Bank advances
5. Loans
6. Overdraft
7. Bills purchase and discounted
8. Advance against documents of title of goods
9. Term loans by bank
10. Commercial paper
11. Bank deposits

## **REGULATION OF BANK FINANCE**

**Traditionally bank credit:**

- Source of meeting of working capital needs of business firms.
- In other words, they have been extending credit to industry & trade on the basis of security.
- RBI has appointed various committees to ensure equitable distribution of bank resources to various sectors of economy. The committees suggest ways & means to make the bank credit & effective instrument of industrialization.

**1. DAHEZA COMMITTEE**

In September 1969, Daheza committee of RBI pointed out in his report that in the financing practice of the banks. There was no relationship between the optimum requirement & bank loan.

The committee also pointed out that banks do not give proper attention to financing patterns. So clients move towards double & multiple financing.

The Daheza committee suggested:

- ✓ The heart hole which represents the minimum level of raw material, finished goods & stores which any industrial concerned is required to hold for maintaining certain level of production.
- ✓ The strictly short term components which should be the fluctuating path of the accounting, the path should represents the short term inventory, taxes, dividend, bonus payments.

Conclusion of Daheza committee:

- Orientation towards project & need based lending.

## **2. TONDON COMMITTEE**

In July 1974, RBI constituted a study group under the chairpersonship of Mr. P.L Tondon. The study group was asked to give its recommendations on the following matter:

- ✓ What constitutes the working capital requirement of industry and what is end use of credit?
- ✓ How is the quantum of bank advanced to be decided?
- ✓ Can norms be involved of current assets & for debt equity ratio to ensure minimum dependents on bank finance?
- ✓ Can the current manner & stage of lending be imposed?
- ✓ Can an adequate planning assessment & implementation system be involved to ensure a discipline flow of credit to meet genuine production needs & its proper supervision?

The final recommendations for committee were:

- A. Banks finance essentially for meeting working capital needs.
- B. To fill up the working capital gap.
- C. Norms: The borrowing requirement of industrial unit depends on the length of working capital cycle.
- D. Three different methods for calculating the borrowing limit to finance working capital requirements are:

- First step is to use required fund deposit your money in term deposit, never purchase excessive inventory.
- The borrower will have to provide a minimum 25% of total current assets from the term fund.
- To decide the limit as per current assets & current liabilities.

E. Style of credit

F. Information system for banks