Unit 10 Working Capital Management

QN1 What is working capital? What are the factors affecting level of it in a business firm?

Working capital is the different between a company's current assets and current liabilities and also referred to net working capital. There are two concepts of working capital:

Gross working capital: The gross concept of working capital refers to total current assets. Gross working capital and total current assets are synonymous. Current assets are the assets which can be converted into cash within an accounting year (or operating cycle) and include cash, short-term securities, debtors, bills receivables and inventories. Gross working capital is also known as total working capital.

Net working capital: The net working capital refers to current assets less current liabilities. Current liabilities are those claims of outsiders which are expected to mature for payment with in an accounting year and include creditors, bills payable, bank overdraft and outstanding expenses.

Factors affecting working capital:

Nature of Business: A company's working capital requirements are directly related to the kind of business it conducts. For example services business runs with small working capital, partly because it's cash nature or their business. On contrary, trading concerns have to invest proportionately high amounts in current assets.

Cash conversion cycle: The longer of CCC the higher the requirement of working capital and vice-versa.

Availability of credit: A firm with steadily available credit from bank can get with less working capital.

Competitive conditions: when competition is keen, there is more pressure to stock varied lines of inventory to satisfy customer's demand s and to grant more generous credit term.

Dividend policy: Change in working capital may bring about an adjustment of dividend policy.

Business cycle: When there is an upward swing in economy i.e. boom economy, this will increase the sales and investment on working capital rises and vice versa.

Change in technology: If the firm purchases new equipment that processes raw material faster than previously, the permanent need for inventory may be changed.

Seasonal operations: If a firm is operation in goods and services having seasonal fluctuations in demand, then the working capital will also fluctuate with every change.

Supply conditions: If goods are received as soon as or in a short period after placing an order, then the purchaser will not like to maintain a high level of inventory of that goods.

Credit policy: The liberal credit period and follow up procedures will increase the investment in debtor and increases the working capital.

QN2 What do you mean by working capital cash flow cycle or cash conversion cycle? How do you measure it? How can it be shortened?

The time duration required to complete one cycle of business is called working capital cash flow cycle or cash conversion cycle. The length of time between the payments of cash for inputs: material, labour, direct expenses etc and receipt of cash from cash sales or collection of credit sales is called CCC.

CCC = (ICP+RCP)-PDP = Operating Cycle-PDP

Inventory conversion cycle (ICP) is the length of time between purchase of raw materials and the conversion of it to finished goods. ICP=Average Inventory×360/Cost of goods sold.

Receivable conversion period (RCP) is the length of time between sale of finished goods and conversion of receivable into cash. The length of RCP is depends on credit policy of firm. RCP = Average receivable × 360/ Credit sales.

Operating Cycle= ICP+RCP

Payable deferred period (PDP) is the average length of time between the purchase of raw materials and labour and the payment of cash for them. PDP = Average payable ×360/Cost of goods sold.

The cash conversion cycle can be shortened by reducing inventory conversion period i.e. processing and selling goods more quickly, reducing receivable collection period by speeding up collections, or by lengthening the payables deferred period i.e. slowing down the credit payment.

QN3 What are the types of working capital? Explain the various working capital or current assets investment and financing policies?

For deciding the sources of financing for working capital it can be classified into two groups.

1. **Permanent working capital**: The amount of working capital required for the business to maintain a minimum level of current assets for the whole period is called permanent working capital or fixed working capital. It is comprises of minimum cash balance, minimum level of inventory etc. It is desirable to finance the permanent working capital by using long-term sources like long-term

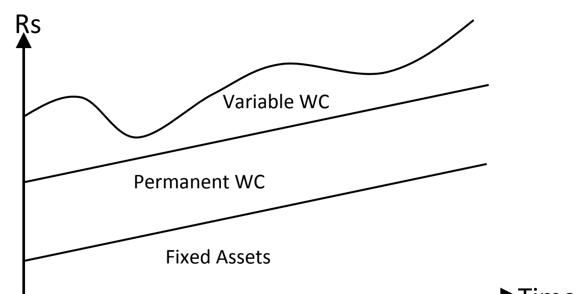

Fig: Types of WC

debt or equity. Requirement of permanent working capital may increase due to inflation or growth in sales.

2. **Variable/temporary working capital**: This additional portion of working capital which is required during peak business season is known as variable or temporary or seasonal working capital. This portion of working capital can be withdrawn from the business after end of such season. Therefore sources like trade credit, commercial paper, arrangement of other short term loan from the bank.

Current assets investment policies:

Working capital policies refers to the policies regarding target levels for each category of current assets and how current assets will be financed?

A relaxed current assets investment policy or conservative policy: Conservative policy carries a high level of current assets (cash, marketable securities, receivables, and inventories) to support the given level of sales mostly around 60% of total sales.

A restricted current assets investment policy or aggressive policy: Aggressive policy carries a low level of current assets for the given level of sales, mostly around 40% of total sales.

Moderate current asset investment policy or moderate policy: Moderate policy carries a moderate level (average level) of current assets to sales, mostly around 50% of sales.

Current assets financing policies:

Depending on the risk exposure of the business, the following current asset financing policies are evolved to manage the working capital.

Hedging or Matching Approach: A firm attempts to much the maturity structure of its assets and liabilities exactly. Thus, when the firm follows matching approach long term financing will be used to finance fixed assets and permanent current assets and short term financing to finance variable current assets. Inventory expected to be sold in 30 days could be financed with a 30-day bank loan; a machine expected to last for 5 years could be financed by 5-year loan.

Financing strategy:
Long term funds = Fixed assets +Total permanent current assets.
Short term funds = Total temporary current assets.

Aggressive Approach: Under an aggressive financing police, the firm finances a part of its permanent current assets with short term financing. Some extremely aggressive firms may even finance a part of their fixed assets with short term financing. Relatively more use of short term financing makes the firm more risky.

Financing strategy:

Long term funds = Fixed assets +Total current assets.
Short term funds = Total current assets.

Conservative Policy: The financing policy of the firm is said to be conservative when it depends more on long term funds. Thus, the firm finances its total permanent assets and a part of variable current assets with long term financing. The conservative policy relies heavily on long term financing and therefore, is less risky.

Financing strategy:
Long term funds = Fixed assets +Total permanent CA + Part of temporary current assets
Short term funds = Part of temporary current assets