Working Capital

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Description of Module

Items	Description of Module
Subject Name	Law
Paper Name	Corporate Finance
Module Name /Title	Working capital
Module No.	III

Working Capital

Objective: After reading this module, the learners will have a clear picture of :

This refers to that minimum amount of investment in all Current assets which is required at all times to carry out minimum level of business activities. it represents the current assets required on a continuing basis over the entire year

Learning Outcomes:

The term "working capital" is often referred to "circulating capital" starting from cash, changing to raw materials, converting into work-in-progress and finished products, sale of finished products and ending with realization of cash from debtors.

Introduction:

Working Capital: The term working capital is commonly used for the capital required for day-to-day working in a business concern, such as for purchasing raw material, for meeting day-to-day expenditure on salaries, wages, rents rates, advertising *etc.*

Definition: According to Weston & Brigham - "Working capital refers to a firm's investment in short term assets, such as cash amounts receivables, inventories *etc.* But as per accounting terminology, it is difference between the inflow and outflow of funds.

Circulating Capital : The term "working capital" is often referred to "circulating capital" starting from cash, changing to raw materials, converting into work-in-progress and finished products, sale of finished products and ending with realization of cash from debtors.

Kinds of Working Capital:

Permanent Working Capital: This refers to that minimum amount of investment in all

Current assets which is required at all times to carry out minimum level of business activities. it represents the current assets required on a continuing basis over the entire year. For example: maintain minimum stock of raw material, finished products salaries and wages throughout the year. It also grows with the size of the business. In other words, greater the size of the business, greater is the amount of such working capital and *vice versa*

Temporary Working Capital: The amount of such working capital keeps on fluctuating
From time to time on the basis of business activities. For example, extra inventory has to be maintained to support sales during peak sales period

DETERMINANTS OF WORKING CAPITAL:
The factors influencing the working capital decisions of a firm may be classified as two groups,
Such as internal factors and external factors.

The internal factors includes: Nature of business Size of business, firm's product policy, credit policy, dividend policy, and access to money, and capital markets, growth and expansion of business *etc.*

The external factors include business:
Fluctuations, changes in the technology, infrastructural facilities, import policy and the taxation
Policy *etc.* These factors are discussed in brief in the following lines.

I. Internal Factors

1. Nature and size of the business

The working capital requirements of a firm are basically influenced by the nature and size of the business. Size may be measured in terms of the scale of operations. A firm with larger scale of operations will need more working capital than a small firm.
Similarly, the nature of the business - influence the working capital decisions. Trading and financial firms have less investment in fixed assets. But require a large sum of money to be invested in working capital. Retail stores, business units require larger amount of working capital.

2. Firm's production policy

The firm's production policy (manufacturing cycle) is an important factor to decide the working
Capital requirement of a firm. The production cycle starts with the purchase and use of raw
Material and completes with the production of finished goods. On the other hand production

Policy is uniform production policy or seasonal production policy etc., also influences the Working capital decisions. Larger the manufacturing cycle and uniform production policy – Larger will be the requirement of working capital. The working capital requirement will be Higher with varying production schedules in accordance with the changing demand.

3. Firm's credit policy

The credit policy of a firm influences credit policy of working capital. A firm following liberal

Credit policy to all customers requires funds. On the other hand, the firm adopting strict credit

Policy and grant credit facilities to few potential customers will require less amount of working

Capital.

4. Availability of credit

The working capital requirements of a firm are also affected by credit terms granted by its suppliers – *i.e.* creditors. A firm will need less working capital if liberal credit terms are available

to it. Similarly, the availability of credit from banks also influences the working capital needs of the firm. A firm, which can get bank credit easily on favorable conditions, will be operated with less working capital than a firm without such a facility.

5. Growth and expansion of business

Working capital requirement of a business firm tend to increase in correspondence with growth

In sales volume and fixed assets. A growing firm may need funds to invest in fixed assets in Order to sustain its growing production and sales. This will, in turn, increase investment in Current assets to support increased scale of operations. Thus, a growing firm needs additional Funds continuously.

6. Profit margin and dividend policy

Distribution of high proportion of profits in the form of cash dividends results in a drain on cash resources and thus reduces company's working capital to that extent. The working capital position of the firm is strengthened if the management follows conservative dividend policy and *vice versa*.

7. Operating efficiency of the firm

Operating efficiency means the optimum utilisation of a firm's resources at minimum cost. If a firm successfully controls operating cost, it will be able to improve net profit margin which, will, in turn, release greater funds for working capital purposes.

8. Coordinating activities in firm

The working capital requirements of a firm is depend upon the co-ordination between

Production and distribution activities. The greater and effective the co-ordinations, the pressure
on the working capital will be minimized.

II. External Factors

1. Business fluctuations

Most firms experience fluctuations in demand for their products and services. This business Variations affect the working capital requirements. When there is an upward swing in the Economy, sales will increase, correspondingly,

2. Changes in the technology

The technological changes and developments in the area of production can have immediate effects on the need for working capital. If the firm wish to install a new machine in the place of old system, the new system can utilise less expensive raw materials, the inventory needs may be reduced there by working capital needs.

3. Import policy

Import policy of the Government may also effect the levels of working capital of a firm since they have to arrange funds for importing goods at specified times.

4. Infrastructural facilities

The firms may require additional funds to maintain the levels of inventory and other current assets, when there is good infrastructural facilities in the company like, transportation and Communications.

5. Taxation policy

The tax policies of the Government will influence the working capital decisions. If the Government follow regressive taxation policy, *i.e.* imposing heavy tax burdens on business firms, they are left with very little profits for distribution and retention purpose. Consequently the firm has to borrow additional funds to meet their increased working capital needs. When there is a liberalised tax policy, the pressure on working capital requirement is minimised. Thus the working capital requirements of a firm is influenced by the internal and external

factors.