Unit V

WORKING CAPITAL

The current assets are the assets such as Cash and other resources that are expected to be converted into cash or to be consumed through normal business operations within one year of the balance sheet date or if a company's operating cycle is longer than one year, it will be converted into cash or be consumed within the operating cycle. Example cash, cash equivalents, accounts receivable, stock inventory, marketable securities, pre-paid liabilities, and other liquid assets.

The Current Liability is an obligation that is due within one year or within the operating cycle of a business if the operating cycle is longer than one year. The current liabilities are settled with the help of current assets. Examples of current liabilities include accounts payable, short-term debt, dividends, and notes payable as well as income taxes owed.

Working capital is the difference between the current assets and current liabilities of a company. Working capital is a measure of a company's liquidity, operational efficiency and its short-term financial health. If a company has positive working capital, then it should have the potential to invest and grow. If a company's current assets do not exceed its current liabilities, then it may have trouble paying back creditors, or even go bankrupt. However higher working capital is also not always considered positive for the business as it may indicate that huge inventories are in stock or the business isn't investing its excess cash properly.

Classification of Working Capital:

Working capital can be categorized on the

- Basis of Concept
- Basis of periodicity

On the basis of concept the working capital may be further classified as:

- Gross working capital refers to the firm's total investment in current assets.
- Net working capital is the difference between the current assets and current liabilities. Current Assets – Current Liabilities

On the basis of Periodicity the working capital may be classified as

- Permanent/ fixed working capital Permanent working capital is that minimum amount of investment in raw materials, work-in-process inventory, finished goods, stores and spares, accounts receivable and cash balance which a firm is required to have in order to carry on a desirable level of business activity. It is permanently locked up in the current assets to carry out the business smoothly. This investment in current assets is of the permanent nature and will increase as the size of business expands. It keeps on changing its form from one current asset to another. As long as the firm is a going concern, working capital cannot be substantially reduced.
  The permanent working capital may be further divided into

Regular working capital is the minimum amount of liquid capital needed to keep up the circulation of capital and sufficient minimum bank balance to discount all the bills, maintain adequate supply of raw materials etc.

Reserve Margin or Cushion Working Capital:

It is the excess over the needs or regular working capital that should be kept in reserve for contingencies that may arise at any time. These contingencies include rising prices, strikes, special operations such as experiments with new products etc.

- Temporary/variable working capital. It is the working capital requirement that changes with the change in the volume of production or the business.
  The variable working capital may be further understood as
  Seasonal working capital which is required to meet the seasonal needs of the industry for seasonal production and special working capital which is raised to meet the special needs like the capital required for R&D, experimentation etc.

  The two major components of Working Capital are Current Assets and Current Liabilities. One of the major aspects of an effective working capital management is to have regular analysis of the company's currents assets and liabilities. This helps to take into account unforeseen events such as changes in the market conditions and competitor activities. Furthermore, steps taken to increase sales income and collecting accounts receivable also improves a company's working capital.

Importance of working capital:

1. **Continuation of Business Operations**: Working capital is needed to purchase raw materials, to pay the workers and staff and also to pay the recurring expenses like electricity and rent, etc.
2. **Dividend Payment**: Working capital is needed to pay a dividend to the shareholders. The payment of dividend takes place on a yearly or half-yearly basis.
3. **Increases Creditworthiness**: A company that pays its creditors well on time has a positive reputation in the credit market which gives the companies goodwill. The dealers are also willing to give money to the such a company. Hence, working capital increases company's creditworthiness.
4. **Boosts Efficiency and Productivity**: The company that faces no working capital problems provides better working conditions and welfare facilities to its workers like spending money for training and development. All such steps boost the efficiency and productivity of the company.
5. **Competition**: Working capital helps the company to withstand competition. It can be used to advertise and to do sales promotion. The company can also afford to give longer credit terms to the customers.
6. **Seasonal Fluctuations**: Though the working capital is required throughout the year, the sales may be seasonal in nature. If the sales are down, the money inflow

is less. Therefore, liquid cash is required, to pay wages to workers and to meet other expenses. So, it helps the company to withstand seasonal fluctuations.

Estimation OF working capital:

There are three methods of estimating the working capital requirements.

1.**Percentage of Sales Method:** the working capital requirement is expressed as a percentage of expected sales for a particular period. This approach is based on the assumption that higher the sales level, the greater would be the need for working capital.

There are three steps involved in the estimation of working capital.

a) To estimate total current assets as a % of estimated net sales.

b) To estimate current liabilities as a % of estimated net sales, and

c) The difference between the two above, is the net working capital as a % of net sales.

2. **Regression analysis Method**: This is a statistical estimation tool that establish trend relationship and for working capital estimation.

This method expresses the relationship between revenue & working capital in the form of an equation

Working Capital = Intercept + Slope * Revenue.

Slope is the rate of change of working capital with a unit change in revenue.
Intercept is the point where regression line and working capital axis meets.

3. **Operating cycle Method**: Time which is needed to convert raw material into finished goods, finished goods into sales and account receivable into cash is called operating cycle.

Under operating cycle method, time needed for different types of current assets and time lag needed for payment of purchase and expenses are considered to compute requirement of working capital.

Operating cycle = Raw material holding period + Work in progress conversion period + Finished goods conversion period + Debtors conversion period – Creditors conversion period

Where, inventory of

$$\text{Raw Material} = \frac{(\text{Annual output X material cost per unit X inventory holding period})}{\text{Total Periods}}$$

$$\text{Work in progress} = \frac{(\text{Annual output X manufacturing cost per unit X inventory holding period})}{\text{Total Periods}}$$

Finished goods = (Annual output X total cost per unit X inventory holding period)

Total Periods

Account receivables = (Annual credit sales X total cost per unit X credit period allowed)

Total Periods

Account payables = (Annual output X raw material cost per unit X credit period)

Total Periods

Prepaid expenses = (Annual expenses X Advance period)

Total Periods

Outstanding wages = (Annual output X labour cost per unit X Time lag)

Total Periods

Outstanding expenses = (Annual expenses X Time lag)

Total Periods

Outstanding Overheads = (Annual output X overhead per unit X Time lag)

Total Periods

Management of current assets:

The management of current assets and current liabilities and the inter relationship that exist between them may be termed as working capital management. It is also known as current assets management. It is concerned with the problems that arise in attempting to manage the current assets, the current liabilities, and the inter relationship that exist between them. It involves the administration of short- term assets like cash, marketable securities, accounts receivables and inventories. Technically it is an integral part of the financial management, and it attempts to manage and control the current assets and the current liabilities in order to maximise the profitability and ensure proper liquidity in the business. Liquidity and Profitability are two important and major aspects of business life. No firm can survive if it has no liquidity. A firm may even exist without making profits but cannot survive without liquidity.An operating cycle begins when the firm invests cash in the raw materials used to produce its goods or services and ends with the collection of cash for the sale of those same goods or services. For example, if a company manufactures and sells candy products, its operating cycle begins when it purchases the raw materials for the products (e.g., sugar) and ends when it cycle of most businesses is less than one year, we tend to think of current assets as those assets that can be converted into cash in one year. Current assets consist of cash, marketable securities, accounts receivable, and inventories.Cash comprises both currency and assets that are immediately transformable into cash. Marketable securities are securities that can be readily sold when cash is needed. Every company needs to have a certain amount of cash to fulfil immediate needs, and any cash in excess of immediate needs is usually invested temporarily in marketable securities. Investments in marketable securities are simply viewed as a short-term place to store funds.Accounts receivable are amounts due from customers who have purchased the firm’s goods or services but haven’t yet paid for them. To encourage sales, many firms allow their customers to “buy now and pay later,” perhaps at the end of the month or within 30 days of the sale.