



## CHAPTER

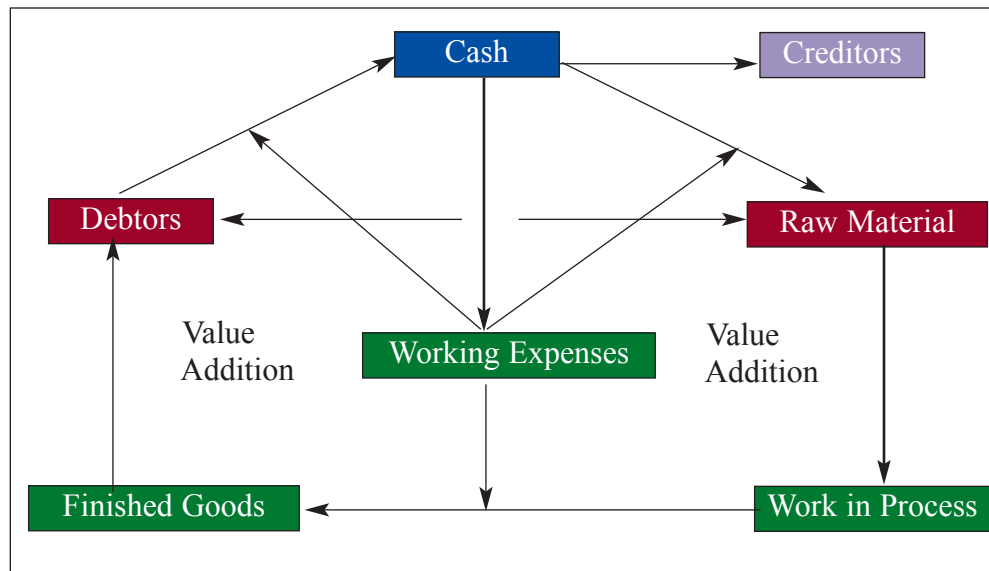
## *Working Capital Management*

**I**n the chapters on ‘Planning an SSI Unit’ and ‘Business Plan’, a discussion was made on the fixed capital and the working capital. Every business needs investment to procure fixed assets, which remain in use for a longer period. Money invested in these assets is called ‘Long term Funds’ or ‘Fixed Capital’. Business also needs funds for short-term purposes to finance current operations. Investment in short term assets like cash, inventories, debtors etc., is called ‘Short-term Funds’ or ‘Working Capital’. The ‘Working Capital’ can be categorised, as funds needed for carrying out day-to-day operations of the business smoothly. The management of the working capital is equally important as the management of long-term financial investment.

Every running business needs working capital. Even a business which is fully equipped with all types of fixed assets required is bound to collapse without (i) adequate supply of raw materials for processing; (ii) cash to pay for wages, power and other costs; (iii) creating a stock of finished goods to feed the market demand regularly; and, (iv) the ability to grant credit to its customers. All these require working capital. Working capital is thus like the lifeblood of a business. The business will not be able to carry on day-to-day activities without the availability of adequate working capital. The diagram shown on the next page clarifies it:

Working capital cycle involves conversions and rotation of various constituents/components of the working capital. Initially ‘cash’ is converted into raw materials.

Subsequently, with the usage of fixed assets resulting in value additions, the raw materials get converted into work in process and then into finished goods. When sold on credit, the finished goods assume the form of debtors who give the business cash on due date. Thus ‘cash’ assumes its original form again at the end of one such working capital cycle but in the course it passes through various other forms of current assets too. This is how various components of current assets keep on changing their forms due to value addition. As a result,



they rotate and business operations continue. Thus, the working capital cycle involves rotation of various constituents of the working capital.

While managing the working capital, two characteristics of current assets should be kept in mind viz. (i) short life span, and (ii) swift transformation into other form of current asset. Each constituent of current asset has comparatively very short life span. Investment remains in a particular form of current asset for a short period. The life span of current assets depends upon the time required in the activities of procurement; production, sales and collection and degree of synchronisation among them. A very short life span of current assets results into swift transformation into other form of current assets for a running business. These characteristics have certain implications:

- i. Decision regarding management of the working capital has to be taken frequently and on a repeat basis.
- ii. The various components of the working capital are closely related and mismanagement of any one component adversely affects the other components too.
- iii. The difference between the present value and the book value of profit is not significant.

The working capital has the following components, which are in several forms of current assets:

- ☞ Stock of Cash
- ☞ Stock of Raw Material

- ☐ Stock of Finished Goods
- ☐ Value of Debtors
- ☐ Miscellaneous current assets like short term investment loans & advances

The working capital needs of a business are influenced by numerous factors. The important ones are discussed in brief as given below:

#### **i. Nature of Enterprise**

The nature and the working capital requirements of an enterprise are interlinked. While a manufacturing industry has a long cycle of operation of the working capital, the same would be short in an enterprise involved in providing services. The amount required also varies as per the nature; an enterprise involved in production would require more working capital than a service sector enterprise.

#### **ii. Manufacturing/Production Policy**

Each enterprise in the manufacturing sector has its own production policy, some follow the policy of uniform production even if the demand varies from time to time, and others may follow the principle of 'demand-based production' in which production is based on the demand during that particular phase of time. Accordingly, the working capital requirements vary for both of them.

#### **iii. Operations**

The requirement of working capital fluctuates for seasonal business. The working capital needs of such businesses may increase considerably during the busy season and decrease during the slack season. Ice creams and cold drinks have a great demand during summers, while in winters the sales are negligible.

#### **iv. Market Condition**

If there is high competition in the chosen product category, then one shall need to offer sops like credit, immediate delivery of goods etc. for which the working capital requirement will be high. Otherwise, if there is no competition or less competition in the market then the working capital requirements will be low.

#### **v. Availability of Raw Material**

If raw material is readily available then one need not maintain a large stock of the same, thereby reducing the working capital investment in raw material stock. On the other hand, if raw material is not readily available then a large

inventory/stock needs to be maintained, thereby calling for substantial investment in the same.

#### vi. **Growth and Expansion**

Growth and expansion in the volume of business results in enhancement of the working capital requirement. As business grows and expands, it needs a larger amount of working capital. Normally, the need for increased working capital funds precedes growth in business activities.

#### vii. **Price Level Changes**

Generally, rising price level requires a higher investment in the working capital. With increasing prices, the same level of current assets needs enhanced investment.

#### viii. **Manufacturing Cycle**

The manufacturing cycle starts with the purchase of raw material and is completed with the production of finished goods. If the manufacturing cycle involves a longer period, the need for working capital would be more.

At times, business needs to estimate the requirement of working capital in advance for proper control and management. The factors discussed above influence the quantum of working capital in the business. The assessment of working capital requirement is made keeping these factors in view. Each constituent of working capital retains its form for a certain period and that holding period is determined by the factors discussed above. So for correct assessment of the working capital requirement, the duration at various stages of the working capital cycle is estimated. Thereafter, proper value is assigned to the respective current assets, depending on its level of completion. The basis for assigning value to each component is given below:

Component of Working Capital		Basis of Valuation
i.	Stock of raw material	Purchase cost of raw materials
ii.	Stock of work in process	At cost or market value, whichever is lower
iii.	Stock of finished goods	Cost of production
iv.	Debtors	Cost of sales or sales value
v.	Cash	Working expenses

Each constituent of the working capital is valued on the basis of valuation enumerated above for the holding period estimated. The total of all such valuation becomes the total estimated working capital requirement.

The assessment of the working capital should be accurate even in the case of small and micro enterprises where business operation is not very large. We know that working capital has a very close relationship with day-to-day operations of a business. Negligence in proper assessment of the working capital, therefore, can affect the day-to-day operations severely. It may lead to cash crisis and ultimately to liquidation. An inaccurate assessment of the working capital may cause either under-assessment or over-assessment of the working capital and both of them are dangerous.

## CONSEQUENCES OF UNDER ASSESSMENT OF WORKING CAPITAL

- Growth may be stunted. It may become difficult for the enterprise to undertake profitable projects due to non-availability of working capital.
- Implementation of operating plans may become difficult and consequently the profit goals may not be achieved.
- Cash crisis may emerge due to paucity of working funds.
- Optimum capacity utilisation of fixed assets may not be achieved due to non-availability of the working capital.
- The business may fail to honour its commitment in time, thereby adversely affecting its credibility. This situation may lead to business closure.
- The business may be compelled to buy raw materials on credit and sell finished goods on cash. In the process it may end up with increasing cost of purchases and reducing selling prices by offering discounts. Both these situations would affect profitability adversely.
- Non-availability of stocks due to non-availability of funds may result in production stoppage.
- While underassessment of working capital has disastrous implications on business, overassessment of working capital also has its own dangers.

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## CONSEQUENCES OF OVER ASSESSMENT OF WORKING CAPITAL

- Excess of working capital may result in unnecessary accumulation of inventories.
- It may lead to offer too liberal credit terms to buyers and very poor recovery system and cash management.
- It may make management complacent leading to its inefficiency.
- Over-investment in working capital makes capital less productive and may reduce return on investment.

Working capital is very essential for success of a business and, therefore, needs efficient management and control. Each of the components of the working capital needs proper management to optimise profit.

## Inventory Management

Inventory includes all types of stocks. For effective working capital management, inventory needs to be managed effectively. The level of inventory should be such that the total cost of ordering and holding inventory is the least. Simultaneously, stock out costs should also be minimised. Business, therefore, should fix the minimum safety stock level, re-order level and ordering quantity so that the inventory cost is reduced and its management becomes efficient.

## Receivables' Management

Given a choice, every business would prefer selling its produce on cash basis. However, due to factors like trade policies, prevailing marketing conditions, etc., businesses are compelled to sell their goods on credit. In certain circumstances, a business may deliberately extend credit as a strategy of increasing sales. Extending credit means creating a current asset in the form of 'Debtors' or 'Accounts Receivable'. Investment in this type of current assets needs proper and effective management as it gives rise to costs such as:

- i. Cost of carrying receivable (payment of interest etc.)
- ii. Cost of bad debt losses

Thus the objective of any management policy pertaining to accounts receivables would be to ensure that the benefits arising due to the receivables are

more than the cost incurred for receivables and the gap between benefit and cost increases resulting in increased profits. An effective control of receivables helps a great deal in properly managing it. Each business should, therefore, try to find out average credit extended to its client using the below given formula:

Average credit	=	Total amount of receivables
Extended (in days)		Average credit sales per day

Each business should project expected sales and expected investment in receivables based on various factors, which influence the working capital requirement. From this it would be possible to find out the average credit days using the above given formula. A business should continuously try to monitor the credit days and see that the average credit offered to clients is not crossing the budgeted period. Otherwise, the requirement of investment in the working capital would increase and, as a result, activities may get squeezed. This may lead to cash crisis.

## Cash Management

Cash is the most liquid current asset. It is of vital importance to the daily operations of business. While the proportion of assets held in the form of cash is very small, its efficient management is crucial to the solvency of the business. Therefore, planning cash and controlling its use are very important tasks. Cash budgeting is a useful device for this purpose.

## Cash Budget

Cash budget basically incorporates estimates of future inflows and outflows of cash over a projected short period of time which may usually be a year, a half or a quarter year. Effective cash management is facilitated if the cash budget is further broken down into month, week or even on daily basis.

There are two components of cash budget (i) cash inflows and (ii) cash outflows. The main sources for these flows are given hereunder:

- |              |  |
|--------------|--|
| Cash Inflows | (a) Cash sales                               |
|              | (b) Cash received from debtors               |
|              | (c) Cash received from loans, deposits, etc. |

- (d) Cash receipt of other revenue income
- (e) Cash received from sale of investments or assets.

**Cash Outflows**

- (a) Cash purchases
- (b) Cash payment to creditors
- (c) Cash payment for other revenue expenditure
- (d) Cash payment for assets creation
- (e) Cash payment for withdrawals, taxes
- (f) Repayment of loans, etc.

A suggestive format for 'Cash Budget' is given below:

**Cash Budget of M/s...**

Particulars	Months		
	January	February	March
Estimated cash inflows ----- -----			
I. Total cash inflows			
Estimated cash outflows ----- -----			
II. Total cash outflows			
III. Opening cash balance			
IV. Add/Deduct surplus/Deficit during the month (I–II)			
V. Closing cash balance (III–IV)			
VI. Minimum level of cash balance			
VII. Estimated excesses or shortfall of cash (V–VI)			

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## Financing Working Capital

Now let us understand the means to finance the working capital. Working capital or current assets are those assets, which unlike fixed assets change their forms rapidly. Due to this nature, they need to be financed through short-term funds. Short-term funds are also called current liabilities. The following are the major sources of raising short-term funds:

### i. Supplier's Credit

At times, business gets raw material on credit from the suppliers. The cost of raw material is paid after some time, i.e. upon completion of the credit period. Thus, without having an outflow of cash the business is in a position to use raw material and continue the activities. The credit given by the suppliers of raw materials is for a short period and is considered current liabilities. These funds should be used for creating current assets like stock of raw material, work in process, finished goods, etc.

### ii. Bank Loan for Working Capital

This is a major source for raising short-term funds. Banks extend loans to businesses to help them create necessary current assets so as to achieve the required business level. The loans are available for creating the following current assets:

- Stock of Raw Materials
- Stock of Work in Process
- Stock of Finished Goods
- Debtors

Banks give short-term loans against these assets, keeping some security margin. The advances given by banks against current assets are short-term in nature and banks have the right to ask for immediate repayment if they consider doing so. Thus bank loans for creation of current assets are also current liabilities.

### iii. Promoter's Fund

It is advisable to finance a portion of current assets from the promoter's funds. They are long-term funds and, therefore do not require immediate repayment. These funds increase the liquidity of the business.