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# UNIT-5 MANAGEMENT OF WORKING CAPITAL

## FACTORS AFFECTING WORKING CAPITAL

## OR

## DETERMINANTS OF WORKING CAPITAL

A firm should have neither too much nor too little working capital. The working capital requirement is determined by a large number of factors. A wide variety of considerations may affect the quantum of working capital required and these considerations may vary from time to time. The working capital needed at one point of time may not be good enough for some other some situation. The determination of working capital requirement is continuous process and must be undertaken on a regular basis in the light of the changing situations. Following are some of the factors which are relevant in determining the working capital needs of the firm:

1. **NATURE OF BUSINESS:** The working capital requirement is closely related to the nature of business of the firm. For example, public utilities such as railways, transport, water electricity etc. have a very limited need for

working capital because they have to invest fairly large amounts in fixed assets. Their working capital need is minimal because they get immediate payment for their services and do not have to maintain big inventories. On the other hand, the trading and financial enterprises which have to invest less amount of fixed assets (like retailers) and a large amount in working capital. This is so because the nature of their business is such that they have to maintain a sufficient amount of cash, inventories and debtors.

2. **SIZE OF BUSINESS:** Larger the size of the business enterprises, greater would be the need for the working capital. The size of a business may be measured in terms of scale of its business operations.

3. **GROWTH AND EXPANSION:** As business enterprises grows, it is logical to expect that a larger amount of working capital will be required. Growing industries require more working capital those that are static.

4. **PRODUCTION CYCLE:** Production cycle means the time-span between the purchase of raw materials and its conversion into finished goods. The longer the production cycle, the larger will be the need for working capital because the funds will be tied up for a longer period in work in process. If the production cycle is small, the need for working capital will also be small.

5. **BUSINESS FLUCTUATIONS:** Business fluctuations may be in the direction of boom and depressions. During boom period the firm will have to operate at full capacity to meet the increase demand which in turn, leads to increase in the level of inventories and book debts. Hence, the need of working capital in the conditions of boom is bound to increase. The depression phase of business fluctuations has exactly an opposite effect on the level of working capital requirement.

6. **SEASONAL OPERATIONS:** If a firm is operating in goods and services having seasonal fluctuations in demand, then the working capital requirement will

also fluctuate with every change. For example, in a cold drink factory, the demand will certainly will be higher during summer season and therefore, more working capital is required to maintain higher production, in the form of larger inventories and bigger receivables. On the other hand, if the operations are smooth and even throughout the year then the working capital requirement will be constant and will not be affected by the seasonal factors.

7. **CREDIT POLICY:** The credit policy means the totality of terms and conditions on which goods are sold and purchased. A firm has to interact with two types of credit policies at a time. One, the credit policy of the supplier of raw materials, goods etc, and two, the credit policy relating to credit which it extends to its customers. If a firm adopts liberal credit policy in respect of sales, the amount tied up in debtors will also be higher. Obviously, higher book debt means more working capital. On the other hand, if the firm follows, tight credit policy, the magnitude of working capital will decrease.

8. **AVAILABILITY OF CREDIT FROM BANKS:** If a firm can get easy bank credit facility in case of need, it will operate with less working capital. On the other hand, if such facility is not available, it will have to keep large amount of working capital.

9. **DIVIDEND POLICY:** Dividend policy is a significant element in determining the level of working capital in an enterprise. The payment of dividend reduces the cash and, thereby, affects the working capital to that extent. On the contrary, if the company does not pay dividend but retains the profits, more would be the contribution of profits towards working capital pool.

10. **PRICE LEVEL CHANGES:** Changes in price level also affects the working capital requirements. If the price level is rising, more funds will be required to maintain the existing level of production.

## ADVANTAGES OF ADEQUATE WORKING CAPITAL

(1) **Availability of Raw Materials Regularly:** Adequacy of working capital makes it possible for a firm to pay the suppliers of raw materials on time. As a result it will continue to receive regular supplies of raw materials and thus there will be no disruption in production process.

(2) **Full Utilisation of Fixed Assets:** Adequacy of working capital makes it possible for a firm to utilise its fixed assets fully and continuously. For example, if there is inadequate stock of raw material, the machines will not be utilised in full and their productivity will be reduced.

(3) **Cash Discount:** A firm having the adequate working capital can avail the cash discount by purchasing the goods for cash or by making the payment before the due date.

(4) **Increase in Credit Rating:** Paying its short-term obligations in time leads to a strong credit rating which enables the firm to purchase goods on credit on favourable terms and to maintain its line of credit with banks etc. its facilitates the taking of loan in case of need.

(5) **Facilitates Distribution of Dividends:** Occasionally, inspite of sufficient profits, management faces difficulty in paying a proper rate of dividend to the shareholders because of paucity of cash. Adequacy of working capital facilitates the payment of dividend.

(6) **Facility in Obtaining Bank Loans:** Banks do not hesitate to advance even the unsecured loan to a firm which has the sufficient working capital.

This is because the excess of current assets over current liabilities itself is a good security.

(7) **Increase in Efficiency of Management:** Adequacy of working capital has a favourable psychological effect on the managers. This is because no obstacle arises in the day-to-day business operations. Creditors, wages and all other expenses are paid on time and hence it keeps morale of managers high.

(8) **Meeting Unseen Contigencies:** Adequacy of working capital enables a company to meet the unseen contingencies successfully.

## EXCESSIVE AND INADEQUATE WORKING CAPITAL

A business enterprise should maintain adequate working capital according to the needs of its business operations. The amount of working capital should neither be excessive nor inadequate. If the working capital is in excess of its requirements it means idle funds adding to the cost of capital but which earn no profits for the firm. On the contrary, if the working capital is short of its requirements, it will result in interruptions and reduction of sales and, in turn, will affect the profitability of the business adversely.

- **DISADVANTAGES OF EXCESSIVE WORKING CAPITAL**

**(i)Excessive Inventory:** Excessive working capital results in unnecessary accumulation of large inventory. It increases the chances of misuse, theft, waste etc.

**(ii)Excessive Debtors:** Excessive working capital will result in liberal credit policy which, in turn, will result in higher amount tied up in debtors and higher incidence of bad debts

**(iii)Adverse Effect on Profitability:** Excessive working capital means idle funds in the business which adds to the cost of capital but earns no profit to the firm. Hence it has bad effect on the profitability of the firm.

**(iv)Inefficiency of Management:** Management becomes careless due to excessive resources at their command.

- **DISADVANTAGES OF INADEQUATE WORKING CAPITAL**

**(i)Difficulty in Availability of Raw-Materials:** Inadequacy of working capital results in non-payment of creditors on time. As a result the credit purchase of goods on favourable terms becomes increasingly difficult. Also, the firm cannot avail the cash discount.

**(ii)Full Utilisation of Fixed Assets not Possible:** Due to the frequent interruptions in the supply of raw materials and paucity of stock, the firm cannot make full utilisation of its machines etc.

**(iii)Difficulty in the Management of Machinery:** Due to the inadequacy of working capital, machines are not cared and maintained properly which results in the closure of production on many occasions.

**(iv)Decrease in Credit Rating:** Because of inadequacy of working capital, firm is unable to pay its short-term obligations on time. It decays the firm’s relations with its bankers and it becomes difficult for the firm to borrow in case of need.

**(v) Non utilisation of Favourable Opportunities:** for example, a firm cannot purchase sufficient quantity of raw materials in case of sudden decrease in the prices. Similarly, if the receives a big order, it cannot execute it due to shortage of working capital.

**(vi)Decrease in Sales:** Due to shortage of working capital, the firm cannot keep sufficient stock of finished goods. It results in the decrease in sales. Also, the firm will be forced to restrict its credit sales. This will further reduce the sales.

**(vii) Difficulty in Distribution of Dividends:** Because of paucity of cash resources, firm will not be able to pay the dividends to its shareholders.

**(viii) Decrease in the Efficiency of Management:** It will become increasingly difficult for the management to pay its creditors on time and pay its day to day expenses. It will also be difficult to pay the wages regularly which will have an adverse effect on the morale of managers.

An enlightened management should, therefore, maintain an adequate amount of working capital on a continuous basis.