

Subject: Financial Management  
Topic: working capital Management  
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The term 'working capital management' primarily refers to the efforts of the management towards effective management of current assets and current liabilities. Working capital is nothing but the difference between the current assets and current liabilities. In other words, an efficient working capital management means ensuring sufficient liquidity in the business to be able to satisfy short-term expenses and debts.

Concept of Working Capital:

1. Balance Sheet Concept
2. Operating Cycle Concept

**Balance Sheet Concept**

It is represented by the excess of current assets over current liabilities and is the amount normally available to finance current operations.

Under Balance Sheet Concept working capital may be described as

- (a). Gross Concept [Total Current asset]
- (b). Net Concept [Total Current asset- Total current liabilities]

**Operating cycle concept**

A company's operating cycle typically consists of three primary activities; purchasing resources, producing the product, and distributing (selling) the product. These activities create funds flows and cash disbursements usually take place before cash receipts.



**Factors Affecting Working Capital Requirements**

The working capital requirement of a concern depends upon a large numbers of factors. These are:

1. Nature or Character of Business: The working capital requirement of a firm basically depends upon the nature of this business. Public utility undertakings like electricity water supply and railways need very limited working capital because they offer cash sales only and supply services, not products and as such

no funds are tied up in inventories and receivables. Generally speaking it may be said that public utility undertakings require small amount of working capital, trading and financial firms require relatively very large amount, whereas manufacturing undertakings require sizable working capital between these two type of business.

2. Scale of Operations: The working capital requirement of a concern is directly influenced by the size of its business which may be measured in terms of scale of operations
3. Length of Production Cycle: In manufacturing business the requirement of working capital increases in direct proportion of length of manufacturing process. Longer the process period of manufacture, larger is the amount of working capital required.
4. Seasonal Variation: In certain industries raw material is not available through out the year. They have to buy raw materials in bulk during the season to ensure an uninterrupted flow and process them during the entire year.
5. Stock Turnover: There is a high degree of inverse co-relationship between the quantum of working capital; and the velocity or speed with which the sales are affected. A firm having a high rate of stock turnover will need less amount of working capital.
6. Credit Policy: The credit policy of a concern in its dealing with debtors and creditors influence considerably the requirement of working capital. A concern that purchases its requirement on credit and sell its products/services on cash require lesser amount of working capital and vice versa.
7. Business Cycle: Business cycle refers to alternate expansion and contraction in general business activity. In a period of boom i.e., when the business is prosperous, there is a need of larger amount of working capital due to increase in sales, rise in prices.
8. Rate of Growth of Business: The working capital requirement of a concern increase with the growth and expansion of its business activities.

(a) Preparation of a Statement Showing Working Capital Requirement Forecast

**Illustration 5**

From the following particulars, prepare a statement showing working capital need to finance a level of activity of 12,000 units of output per annum :

Analysis of selling price per unit :	Rs.
Raw Materials	5
Labour	3
Overhead	2
	10
Profit	2
Selling price	12

**Additional Information :**

- (i) Raw Materials are to remain in store on an average 1 month.
- (ii) Materials are in process, on an average, 2 months.
- (iii) Finished Goods are in stock, on an average, 3 months.
- (iv) Credit allowed to Debtors is 4 months.
- (v) Credit allowed by suppliers is 2 months.

It may be assumed that production and overheads accrue evenly throughout the year.

**Solution :**

Sales for the year 12,000 × Rs. 12 = Rs. 1,44,000.

Sales per month Rs.  $\frac{1,44,000}{12}$  = Rs. 12,000.

Amounts to be blocked in Materials, Labour and Overheads per month are :

Materials Rs. 12,000 ×  $\frac{5}{12}$  = Rs. 5,000

Labour Rs. 12,000 ×  $\frac{3}{12}$  = Rs. 3,000

Overheads Rs. 12,000 ×  $\frac{2}{12}$  = Rs. 2,000

*Alternatively,*

Annual Production 12,000 units

Monthly Production 12,000 ÷ 12 = 1,000 units

Average cost of production per month :

Raw Material 1,000 × Rs. 5 = Rs. 5,000

Labour 1,000 × Rs. 3 = Rs. 3,000

Overheads 1,000 × Rs. 2 = Rs. 2,000.

**METHOD 1**

**Net Block Period for Each Element of Cost**

	(Period in months)		
	Materials	Labour	Overheads
Raw Materials in Store	1	—	—
Processing Period	2	—	2
Finished Goods in Store	3	2	3
Credit to Debtors	4	3	4
	4	4	4
	10	9	9
Less : Credit from Suppliers	2	—	—
Net Block Period	8	9	9

**Working Capital Requirement Forecast :**

Raw Materials	:	Rs. 5,000 × 8 =	Rs. 40,000
Labour	:	Rs. 3,000 × 9 =	Rs. 27,000
Overheads	:	Rs. 2,000 × 9 =	Rs. 18,000
Total requirements			<u>Rs. 85,000</u>

From the above, it is quite clear that the total working capital requirements would be Rs. 85,000 in order to sustain the production programme of 12,000 unit p.a. But this method fails to reveal the estimated values of current assets and current liabilities, the two components of working capital.

**METHOD 2**

**Working Capital Requirement Forecast**

*Current Assets :*

		Rs.	Rs.
1. Stock of Raw Materials (1 month)			
Raw Materials	Rs. 5,000 × 1 =	5,000	5,000
2. Work-in-Progress (2 months)			
Raw Materials	Rs. 5,000 × 2 =	10,000	
Labour	Rs. 3,000 × 2 =	6,000	
Overheads	Rs. 2,000 × 2 =	<u>4,000</u>	20,000
3. Stock of Finished Goods (3 months)			
Raw Materials	Rs. 5,000 × 3 =	15,000	
Labour	Rs. 3,000 × 3 =	9,000	
Overheads	Rs. 2,000 × 3 =	<u>6,000</u>	30,000
4. Debtors (4 months)			
Raw Materials	Rs. 5,000 × 4 =	20,000	
Labour	Rs. 3,000 × 4 =	12,000	
Overheads	Rs. 2,000 × 4 =	<u>8,000</u>	40,000
Profit Credit to Debtors		8,000	
( $\frac{1}{5}$ th of cost or $\frac{1}{6}$ th of sales)		<u>          </u>	<u>48,000</u>
			<u>1,03,000</u>
<i>Less :</i>			
<i>Current Liabilities :</i>			
1. Creditors (2 months)			
Raw Materials	Rs. 5,000 × 2 =	10,000	10,000
Requirement of Working Capital			<u><u>93,000</u></u>

This method, however, suggests the estimated values of current assets and current liabilities. But the difference in the requirement of working capital between the two methods is due to the profit element in Debtors, i.e., in Method 1, profit element is excluded, whereas, in Method 2, profit element is included.

**METHOD 3**

Or, Alternative Approach (in a Columnar Form)

**Working Capital Requirement Forecast**

Particulars	Period in Months	Total	Raw Materials	Work-in-Progress	Finished Goods	Debtors	Creditors
		Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
1. <i>Materials :</i>							
In stores	1		5,000				
In process	2			10,000			
In Finished goods	3				15,000		
With Debtors	4					20,000	
	<u>10</u>						
Less : Credit from Creditors	2						10,000
	<u>8</u>	40,000					
2. <i>Wages :</i>							
In process	2			6,000			
In Finished goods	3				9,000		
With Debtors	4					12,000	
	<u>9</u>	27,000					
3. <i>Overheads :</i>							
In process	2			4,000			
In Finished goods	3				6,000		
With Debtors	4					8,000	
	<u>9</u>	18,000					
4. <i>Profit :</i>							
Credit to Debtors	4	8,000				8,000	
Total	<u>4</u>	<u>8,000</u>				<u>8,000</u>	
		<u>93,000</u>	<u>5,000</u>	<u>20,000</u>	<u>30,000</u>	<u>48,000</u>	<u>10,000</u>

∴ Total Working Capital requirement Rs. 93,000.

**Financing of Working Capital Needs**

Once, estimation of working capital required is completed, then the next step is financing of working capital. Statement of working capital gives clear picture about the components, (raw materials, work-in-process, finished goods and receivables) and required investment in these components of working capital. Generally investment in these components varies a great deal during the course of the year. Financing of current assets is the responsibility of finance manager who may require spending lot of time for raising finance.

Working capital should be financed by suitable and optimal mix of short-term source of funds and long-term source of funds.

1. Loans
2. Overdrafts
3. Cash credits
4. Purchase or discounting of bills
5. Letter of Credit
6. Bank Guarantee
7. Commercial Papers
8. Trade Credit
9. Accrued Expenses

## Difference between Permanent and Temporary Working Capital:

Permanent working capital refers to a level of current assets which is to be maintained and vital for the firm to carry its business regardless of the operation levels. While Temporary working capital refers to the working capital which is over and above the permanent working capital. It is required to meet seasonal needs and temporary requirements.

Permanent working capital is also known as fixed or hardcore working capital. Temporary working capital is also known as fluctuating or variable or seasonal working capital.

Permanent capital does not depend upon any factors while temporary working capital depends upon several factors as it is keep on fluctuating from period to period.

Permanent working capital is stable while temporary working capital is fluctuating i.e., sometimes increasing and sometimes decreasing.

There are more such differences between these working capitals. We have the best team of experts who are experienced in writing for years. We also clear explanation to this by using diagrams and figures like the levels of working capital in case of a stable firm and in case of a growing firm.

# Temporary Working Capital

**The amount of current assets that varies with seasonal requirements.**

