Lesson 10

Working Capital: Meaning, Determinants and Sources

Objectives of the lesson

After studying this lesson, students will be able to:

- Understand the concept and types of working capital,
- Describe need and determinants of working capital, and
- Develop understanding of traditional and alternative sources of working capital.

1.0 Introduction

Asset is defined as anything that generates future benefits. Traditionally assets have been categorized as fixed & current. Fixed assets result from application of long-term funds to procure machines, land, building and other factors of production that have a productive life. But the assets do not produce returns all by themselves until put to use. In other words, investment in fixed assets in non-productive till it turns operational. A new machine, if allowed to remain idle will produce negative returns by way of depreciation charge. Hence, it is imperative to make 'capital' 'working' in the business. The concept of working capital can be better understood as 'the capital that is working'.

Let us investigate it deeper. Current assets refer to those assets which in ordinary course of business can be or will be converted to cash within a year without undergoing diminution in value and without disrupting the operations of the firm. The major current assets are cash, accounts receivable, inventories and marketable securities. Current assets alone are non-productive without appropriate operating cycle. It is essentially the desired mix of fixed assets & current assets that produces the returns in any business.

2.0 Concept of Working capital

The part of capital involved in financing current assets is known as working capital. It is the fuel required for efficient operation of business. In finance, working capital is the excess of current assets over current liabilities. Symbolically,

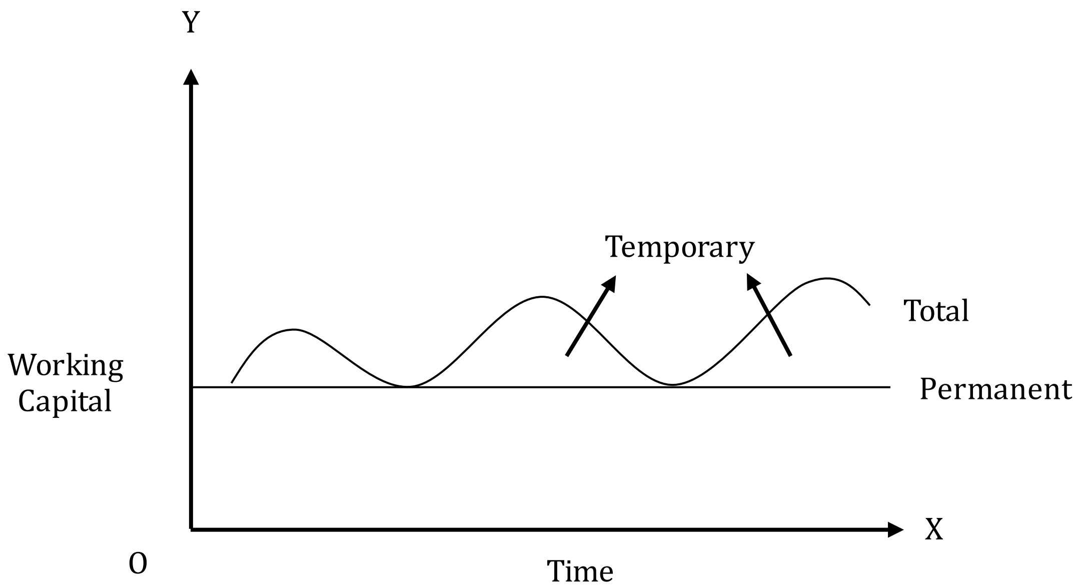
$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

The concept of working capital is discussed in several ways. On the basis of value, it is explained as (i) gross working capital, and (ii) net working capital; and on the basis of time, it is classified as (i) permanent working capital, and (ii) temporary working capital.

2.1 Gross and Net Working Capital: Gross working capital is sum of current assets. It means the amount invested in current assets is termed as gross working capital. Net working capital is excess of current assets over current liabilities. Symbolically, Net Working Capital = Current Assets – Current Liabilities.

2.2 Permanent and Temporary Working Capital: Permanent working capital refers to the base working capital or the minimum level of investment in net current assets. It is generally financed from long-term sources of finance.

Temporary working capital, also called as fluctuating working capital is maintained over and above permanent working capital and is arranged form short-term sources of finance.



3.0 Need of Working Capital

Working capital involves application of fund to the current assets in a business which provide base for routine operational needs. The objective of working capital is to ensure that:

- The operations of the business run smoothly and should not hamper for the want of adequate levels of current assets.
- An excess of current assets over current liabilities is maintained to ward off risks of insolvency.
- The cost of current liabilities justifies the benefits accruing to the business.
- A prudent mix of current assets exists to deliver optimal profitability.
- The short-term obligations are met when due.

4.0 Determinants of Working Capital

Following are some of the important factors that determine the levels of working capital requirements in a business firm.

- Nature and Size of Business: Working capital needs of a firm largely depend on the nature of the business. A manufacturing or construction company maintains larger amount of working capital while service sector firms, such as transport company or professional's firms maintain lesser amount of working capital. Size of business also has direct relation with working capital needs.

- Production Cycle/ Conversion Period: Working capital needs depend on length of the production cycle. If length of production cycle in a firm is small, it will need to maintain lesser amount of working capital. If it is not, they have to maintain large amount of working capital.
- Credit Policy: Credit policy of both, sales and purchase affect the working capital requirements If business concerns follow rigid credit policy and prefer to sell goods for cash, they maintain lesser amount of working capital and vice-versa. Similarly, if firms pay dues to creditors on time, they will have to maintain sufficient or more working capital.
- Business Cycle/ Market Fluctuations: Business fluctuations, which results into cyclical and seasonal variations in the market conditions affect the working capital requirements. In the booming conditions, the working capital needs are high and in depression, the requirement of working capital low.
- Inventory Level: Major part of working capital requirements depends on level of inventory as it is the basic components of the production process. If raw material is not readily available, it will lead to production stoppage.
- Production policy: It is also one of the important factors which affect the working capital requirement of the business concern. If a firm maintains continues production policy, its need of regular working capital will be more and vice-versa.
- Growth and Expansion: During the growth and expansion phase of a business concern, working capital requirements are higher, because it needs some additional working capital and incurs extra expenses at the initial stages.
- Availability of Raw Material and their Prices: If it is expected that raw material will not be available in future or if price of raw material is expected to increase in future, firm will create additional inventory, which may result into increase in working capital.
- Volume of Operating Profits and Earning capacity: If the business concern has high earning capacity, it can generate more working capital through high cash from operation. Earning capacity is also one of the factors which determines the working capital requirements in the business.
- Operating Efficiency: Effective & efficient utilization of available resources by the management helps with the reduced requirement of working capital. Elimination of waste, optimal utilization of existing resources allows the management to realize every bit of investment by way of faster cash realization cycle & improved turnover.
- Technology Level: High level of technology helps organizations in reducing dependence on labour force, thus reducing labour cost and low requirements of working capital.

- Depreciation Policy: Depreciation is a non-cash charge against the profits. It lowers tax liability. High depreciation rates lower the profits and the tax liability and increased cash profits.
- Tax Liability: Taxes have often paid in advance on quarterly rests. If tax liability on business firm is high, it will increase short-term liability and working capital needs.
- Dividend Policy: Profit retention results into increased availability of working capital, Payment of dividend reduces cash resources affecting the working capital adversely. Bonus shares help the company to preserve cash without reducing the working capital.
- Short-term Financing Options: If firm has easy availability of short-term funds from alternative sources, it will not be required to maintain more working capital.

5.0 Sources of Working Capital

The sources of working capital can be (i) long-term (for permanent working capital: already discussed in Chapter 7), and (ii) short-term. The sources of short term working capital are as follows.

5.1 Bank Credit: Bank credit is the primary source of institutional finance. The amount approved by bank for the company working capital is called credit limit. Banks offer working capital finance in the two forms; fund-based and non-fund-based facility. Fund-based facilities make funds available to the customer for application, whereas non-fund-based facilities do not require cash outlays by the banks, at least in the initial stage. Fund based facilities include cash credit, overdraft, demand loans, working capital term loans, export finance, and bill purchase/ discounting. The non-fund-based facilities consist of letter of credit, and bank guarantees.

a) Cash Credit (CC): Under cash credit a borrower is sanctioned a line of credit and is allowed to make withdrawals up to the sanctioned levels. The interest is charged on the usage and not on the sanctioned limits. Current assets in the form stocks and receivables form the primary security. This is cost effective as interest on CC is payable on the amounts outstanding and not on the sanctioned limits.

b) Overdraft (OD): Under this arrangement the borrower is allowed to withdraw the amount up to a certain limit from his current account over and above his actual credit balance. Within the stipulated limits any number of withdrawals is permitted by the bank.

c) Bills Discounting: These represent advances against bills of exchange drawn by the customers on their clients. Bills accompanied by documents to title of goods are called documentary bills and without such documents are called clean bills. Documents under bills are either deliverable against acceptance or against payment.

d) Demand Loans: Banks grant major portion of working capital in the form of demand loan. These loans are granted for a fixed term, and the minimum period of such demand loans keeps on changing from time to time.

e) Term Loans: These advances are sanctioned by banks for a fixed period either in lump sum or in installments. These are repayable as per schedule of repayment and not on demand. These are generally granted to meet capital expenditures against the security of immovable property, plant & machinery etc. Term loans are granted in different forms. These are (i) Hypothecation (where underlying asset securing the bank's exposure is movable in nature, and borrower has right to use the asset); (ii) Pledge (where borrower forgoes the possession of the asset); (iii) Mortgage (it involves transfer of legal interest of an immovable property to secure the payment of a debt, however, borrower has right to use the asset); (iv) Lien (It is the right of a creditor to retain in his possession the goods and securities owned by the debtor until the debt has been discharged, but has no right to sell the goods and securities so retained); (v) Charge (where an immovable asset is made the security for payment of money, however, as against mortgage the interest in the property is not transferred); (vi) Assignment (it involves transfer of a right of an actionable claim, existing or future; the assignee enjoys absolute right over the debts assigned and other creditor of assignor cannot get priority over the assignee).

f) Export Credit: Export credit is the assistance granted by the banks under the various directives and policies issued by the Reserve Bank of India, FEDAI, EXIM policy etc. It is classified into pre-shipment and post-shipment credit. Pre-shipment credit is extended prior to the shipment of goods and the assistance extended subsequent to shipment is termed as post-shipment credit.

g) Letter of Credit (LC): It is a written instrument issued by a bank on the request of a buyer in favor of the seller undertaking to honor the documents or drafts drawn by the seller in accordance with the terms and conditions specified; within a specified time. Under this arrangement the purchaser of goods on credit arranges for a LC from his banker whereby the bank undertakes the responsibility to make payment to the supplier in case the purchaser fails to honor the obligation on due date.

5.2 Trade Credit: Trade Credit refers to the credit extended by the suppliers of goods and services in the normal course of business. This facilitates the processing and sale of the product before paying for the purchases. No formal agreement exists between the transacting parties and the transactions are carried on an open account basis. The credit so received is recorded as creditors/ accounts payable in the books of accounts. The availability of trade credit depends on the firm's past record of payments and the size of transactions. However, it carries an implicit cost in terms of cash discount foregone that is available to the purchaser in case the payment is made immediately.

5.3 Accrued Expenses: The accrued or outstanding expenses is a built-in and an automatic source of finance as most of the services like wage, salaries, taxes etc. are paid at the end of the period. This is an interest free source of finance as it does not involve implicit or explicit cost.

5.4 Funds from Operation: Funds generated from operation increase working capital by an equivalent amount. The two main components of funds generated from operations are profit and depreciation.

5.5 Advance from Customers: Firms with monopolistic tendencies and high product image may accept order of their customers by taking advance amount in part or full. This constitutes a very prominent source of working capital finance.

5.6 Intercorporate Loans and Deposits: Sometimes, firms having surplus funds invest for short period with other organizations. The rate of interest on such investments is higher than bank and depends on financial soundness of borrower firm.

5.7 Commercial Papers (CP): Commercial paper is a short-term usance promissory note issued by a company, negotiable by endorsement and delivery, issued at such a discount on face value as may be determined by the issuing company. Each commercial paper will bear a certificate from the bank verifying the signatures of the executants. The companies, which are financially sound and has a good track record can access to commercial papers. These can be issued under certain conditions: (i) Corporate with high net worth can issue commercial papers; (ii) It must be financially sound with good track record of profits; (iii) CPs are issued for a period 7 days to 1 year; (iv) These must have high credit rating given by reputed credit rating agency, such as, CRISIL, CARE, ICRA, CARE, Duff & Phelps, Standard & Poor, Moody's etc.; (v) CPs are issued for minimum of Rs. 5 lakh or multiple thereof, subject to a maximum of Rs. 25 Lakh.

5.8 Public Deposits: Deposit fro public are one of the important sources of working capital finance particularly for well-established big companies with huge capital base. These are issued for a period ranging from 6 Months to 3 Year. The maximum amount of public deposit cannot exceed 25% of company's net worth.

5.9 Factoring Services: Factoring is an agreement in which the book debts arising out of sales are sold by the firm to a financial intermediary known as a factor. Factoring agent is entitled to receive the proceeds arising out of the receivables; he may even be required to bear the losses arising out of any book debts turning bad in case of a full-service factoring (without recourse facility). A factor purchases the trade debts at a price by the way of advances against the debts assigned. in case the debts are factored with recourse, the client will have to refund the finance granted against the debt in case of non-realization of such book debt. As a part of this service the factor also maintains a record of all outstanding payments and reports are shared periodically with the client. Factoring offers certain advantages which makes it quite attractive to many firms. These are (i) Firm can convert accounts receivables into cash without bothering about repayment; (ii) Factoring ensures a definite pattern of cash inflows; (ii) Continuous factoring almost eliminates the need for the credit department; (iii) Seller firm may continue to finance its receivables on a more or less automatic basis; (iv) Unlike an unsecured loan, compensating balances are not required in this case; (v) It relieves the borrowing firm of substantial credit and collection costs and to a degree from a considerable part of cash management.

Summary

Every company is required to maintain a minimum level of working capital at any point of time. This level can be termed as the permanent working capital. Above this level, the working capital varies as per the level of activity of the company; higher the level of activity, more the working capital required. Since the permanent working capital is locked-up permanently it needs to be financed from long term sources of finances such as internal accruals, equity shares, preference shares, debentures and to an extent term loans. The fluctuating or variable component of working capital can be financed through short term sources such as trade credit, bank credit, commercial papers, public deposits, factoring services, and other sources such as. accrued expenses, funds from operation, advance from customers, and intercorporate loans and deposits.

Self check Questions

1. Define working capital'. Discuss the factors effecting working capital needs.
2. What do you mean by working capital? Discuss various sources of working capital in a business firm.
3. “Inadequate working capital is disastrous whereas redundant working capital is a criminal waste.” Discuss this statement.
4. Write short notes on: (a) Modes of bank finance, (b) Commercial papers, and (c) Factoring services
5. Write a detailed note on need and importance of working capital.