

# WORKING CAPITAL

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# What is working capital?

- Working Capital is that capital which is involved in the current assets of the business. Basically it is the capital which is required to meet the day to day expenses of the business.
- Working capital is a measure of a company's liquidity, efficiency, and overall health which includes cash, inventory, accounts receivable, accounts payable, the portion of debt due to within one year, and other short term accounts etc.

- Working capital is the difference between the current assets and the current liabilities. It is the amount invested by the promoters on the current assets of the organization.

**Working capital = current assets – current liabilities**

# TYPES OF WORKING CAPITAL

- Balance sheet view/ on the basis of concept
- operating cycle view/ on the basis of need



- On the basis of Balance sheet view, types of working capital are described as:

1. Gross working capital (GWC)
2. Net working capital (NWC)

# GROSS WORKING CAPITAL

- Gross working capital refers to the firm's investment in current assets. Current assets are the assets which can be converted into cash within an accounting year and include cash, short term securities, debtors(accounts receivable), bills receivable and stock.
- .Gross working capital =Total current assets

# NET WORKING CAPITAL

Net working capital refers to the difference between current assets and current liabilities. Current liabilities are those claims of outsiders which are expected to mature for payment within an accounting year and include creditors, bills payable, and outstanding expenses.

- Net working capital can be positive or negative. A positive net working capital will arise when current assets exceed current liabilities.
- A negative net working capital occurs when current liabilities are in excess of current assets.
- Net working capital = Current assets - Current Liabilities



- On the basis of operating cycle types of working capital are described as:

1. Permanent/fixed working capital
2. Temporary / variable working capital



# PERMANENT WORKING CAPITAL

- Permanent working capital is the minimum investment required in working capital irrespective of any fluctuation in business activity. Also known as fixed working capital, it is that level of net working capital below which it has never gone on any day in the financial year.
- The sum up of the funds required to finance the minimum level of current assets of the business is known as the permanent working capital. This capital is required every time to put the business into working condition.

# TYPES OF PERMANENT WORKING CAPITAL

## Regular working capital

It is the permanent working capital which is required in the normal course of business for the working capital to flow smoothly.

## Reserve working capital

It is the working capital which needs to be maintained over and above regular working capital for contingencies which may arise due to unexpected situations.

# TEMPORARY WORKING CAPITAL

- Temporary working capital (TWC) is the temporary fluctuation of net working capital over and above the Permanent working capital. It is the additional working capital requirement arising out of seasonal demand of the product. it is the difference between net working capital and the permanent working capital.

# TYPES OF TEMPORARY WORKING CAPITAL

SEASONAL WORKING CAPITAL	Special working capital
<p>It is that fluctuation of net working capital which is caused due to the effect of season. It refers to liquid capital needed during the particular season. During the season, the business enterprises have to push up purchase of raw materials and employ more people to convert them into finished goods and thus require large amount of working capital.</p>	<p>It is that part of the variable capital which is needed for financing special operations such as the organization of special campaigns for increasing sales through advertisement or other sale promotion activities for conducting research experiments or execution of special orders of government that will have to be financed by additional working capital.</p>

# Need of working capital

- For the purchase of raw material.
- To pay wages and salaries.
- To incur day to day expenses and overhead cost such as fuel, power and office expense etc.
- To meet selling cost as packing, advertising etc.
- To provide credit facilities to the customers.
- To maintain the inventories of raw material, work-in-progress, store and spare and finished stock.

# Determinants of working capital

## **NATURE OF BUSINESS**

Working capital requirements of a firm are basically influenced by the nature of business. Trading and financial firms have a very small investment in fixed assets, but require a large sum of money to be invested in working capital. Public utilities may have limited need for working capital and have to invest abundantly in fixed assets. Their working capital requirements are nominal because they may have only cash sales and supply services, not products.

## **2)Storage time or processing period**

Time needed for keeping the stock in store is called storage period. The amount of working capital is influenced by the storage period. If storage period is high, a firm should keep more quantity of goods in store and hence requires more working capital. Similarly, if the processing time is more, then more stock of goods must be held in store as work in progress.

## **3)Credit period**

Longer credit period requires more investment in debtors and hence more working capital is needed. But, the firm which allows less credit period to customers needs less working capital.

#### **4) Operating efficiency**

The operating efficiency of the firm relates to the optimum utilization of all its resources at minimum costs. The efficiency in controlling operating costs and utilizing fixed and current assets leads to operating efficiency. The use of working capital is improved and pace of cash conversion cycle is accelerated with operating efficiency.

#### **5) Changes in price level**

Change in price level also effects the working capital requirements. Generally, the rise in price will require the firm to maintain large amount of working capital as more funds will be required to maintain the sale level of current assets.



## **6) Dividend policy**

The dividend policy of the firm is an important determinant of working capital. The need for working capital can be met with the retained earning. If a firm retains more profit and distributes lower amount of dividend, it needs less working capital.

## **7) Access to money market**

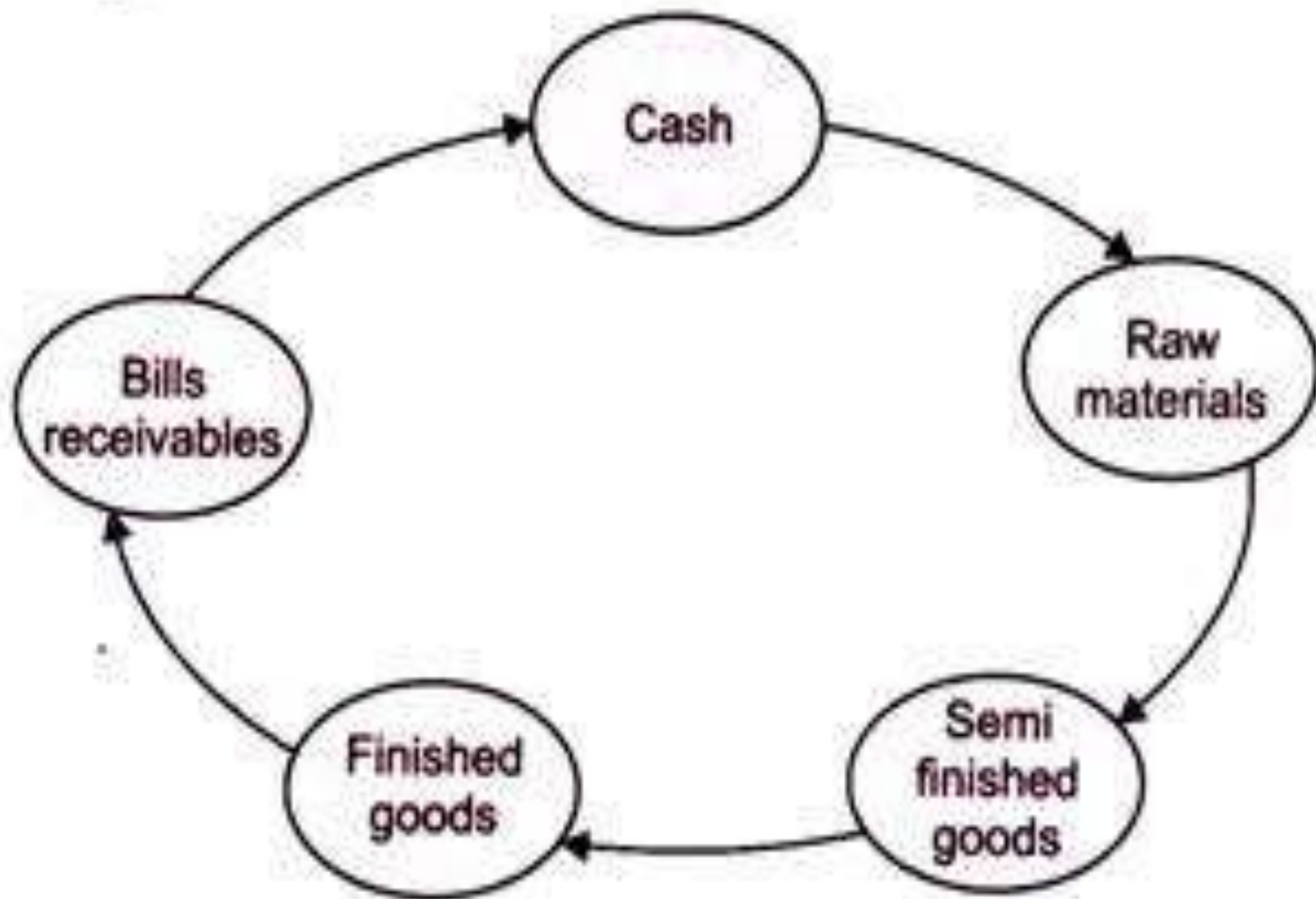
If a firm has good access to capital market, it can raise loan from bank and financial institutions. It results in minimization of need of working capital.

## **8) Working capital cycle**

When the working capital cycle of a firm is long, it will require larger amount of working capital. But, if working capital cycle is short, it will need less working capital.

# Operating cycle

Working capital is also called a circulating capital or revolving capital. That is the money/capital which circulates in various forms of current assets in a continued manner. For example, at a point of time, funds may be tied up in raw materials, then later converted into semi-finished products, then into finished/ final products and when these finished products are sold, it is converted either into account receivables or cash.



**Figure 25.1:** Working Capital Operating Cycle

# GROSS OPERATING CYCLE

- The firm's gross operating cycle (GOC) can be determined as:
- **Gross operating Cycle=RMCP+WIPCP+FGCP+RCP**
- RMCP= Raw Material conversion Period
- WIPCP= work- in –progress conversion period
- FGCP=finished goods conversion period
- RCP= Receivable conversion period

# INVENTORY CONVERSION PERIOD

- The inventory conversion period (ICP) is the sum of raw material conversion period (RMCP), Work in process conversion period (WIPCP) and finished goods conversion period (FGCP):

$$ICP = RMCP + WIPCP + FGCP$$

# RAW MATERIAL CONVERSION PERIOD (RMCP)

- The RMCP is the average time period taken to convert material in to work in process. RMCP depends on raw material consumption per day and raw material inventory.
- The raw material conversion period is obtained when raw material inventory is divided by raw material consumption per day.

$$RMCP = RMI \div \frac{RMC}{360}$$

# WORK IN PROCESS CONVERSION PERIOD (WIPCP)

Work in process period is the average time taken to complete the semi finished work or work in process

$$WIPCP = WIP I \div \frac{COP}{360}$$

## FINISHED GOODS CONVERSION PERIOD(FGCP)

- It is the average time taken to sell the finished goods.

$$FGCP = FCI \div \frac{CGS}{360}$$



# DEBTORS CONVERSION PERIOD

- DCP is the average time taken to convert debtors into cash. It represents the average collection period.

$$DCP = \frac{\text{debtors}}{\text{credit sales}/360}$$

## CREDITORS DEFERRAL PERIOD (CDP)

- CDP is the average time taken by the firm in paying its suppliers(creditors)

$$CDP = \frac{\text{Creditors}}{\text{credit purchase}/360}$$

# PROFORMA - WORKING CAPITAL ESTIMATES

## 1. TRADING CONCERN

### STATEMENT OF WORKING CAPITAL REQUIREMENTS

	Amount (Rs.)
<i>Current Assets</i>	
(i) Cash	----
(ii) Receivables ( For.....Month's Sales)----	----
(iii) Stocks ( For.....Month's Sales)-----	----
(iv)Advance Payments if any	----
<i>Less : Current Liabilities</i>	
(i) Creditors (For..... Month's Purchases)-	----
(ii) Lag in payment of expenses	-----
<b>WORKING CAPITAL ( CA – CL )</b>	<b>xxx</b>
<i>Add : Provision / Margin for Contingencies</i>	-----
<b>NET WORKING CAPITAL REQUIRED</b>	<b>xxx</b>

# 1. MANUFACTURING CONCERN

## STATEMENT OF WORKING CAPITAL REQUIREMENTS

	Amount (Rs.)
<b>Current Assets</b>	
(i) Stock of R M( for ....month's consumption)	----
(ii)Work-in-progress (for...months)	
(a) Raw Materials	----
(b) Direct Labour	----
(c) Overheads	----
(iii) Stock of Finished Goods ( for ...month's sales)	
(a) Raw Materials	----
(b) Direct Labour	----
(c) Overheads	----
(iv) Sundry Debtors ( for ...month's sales)	
(a) Raw Materials	----
(b) Direct Labour	----
(c) Overheads	----
(v) Payments in Advance (if any)	----
(iv) Balance of Cash for daily expenses	----
(vii)Any other item	----
<b>Less : Current Liabilities</b>	
(i) Creditors (For..... Month's Purchases)	----
(ii) Lag in payment of expenses	----
(iii) Any other	----
<b>WORKING CAPITAL ( CA – CL )xxxx</b>	
<b>Add : Provision / Margin for Contingencies</b>	----
<b>NET WORKING CAPITAL REQUIRED</b>	<b>XXX</b>