WORKING CAPITAL MANAGEMENT

INTRODUCTION

- The role of a financial manager does not stop with arranging long term sources of finance for creation of fixed assets to enable the firm to carry out its intended business operations.
- The money is also required for **purchasing raw materials, converting them into finished goods and selling on credit to customers**.

WORKING CAPITAL

The capital required by a business to meet its **day-to-day expenses is known as the working capital.**

assets and the sources to finance them.

TYPES OF WORKING CAPITAL

GROSS WORKING CAPITAL

Gross working capital is the **total value of the company's current assets.** Current assets include cash, receivables, short-term investments, and especially market securities.

NET WORKING CAPITAL

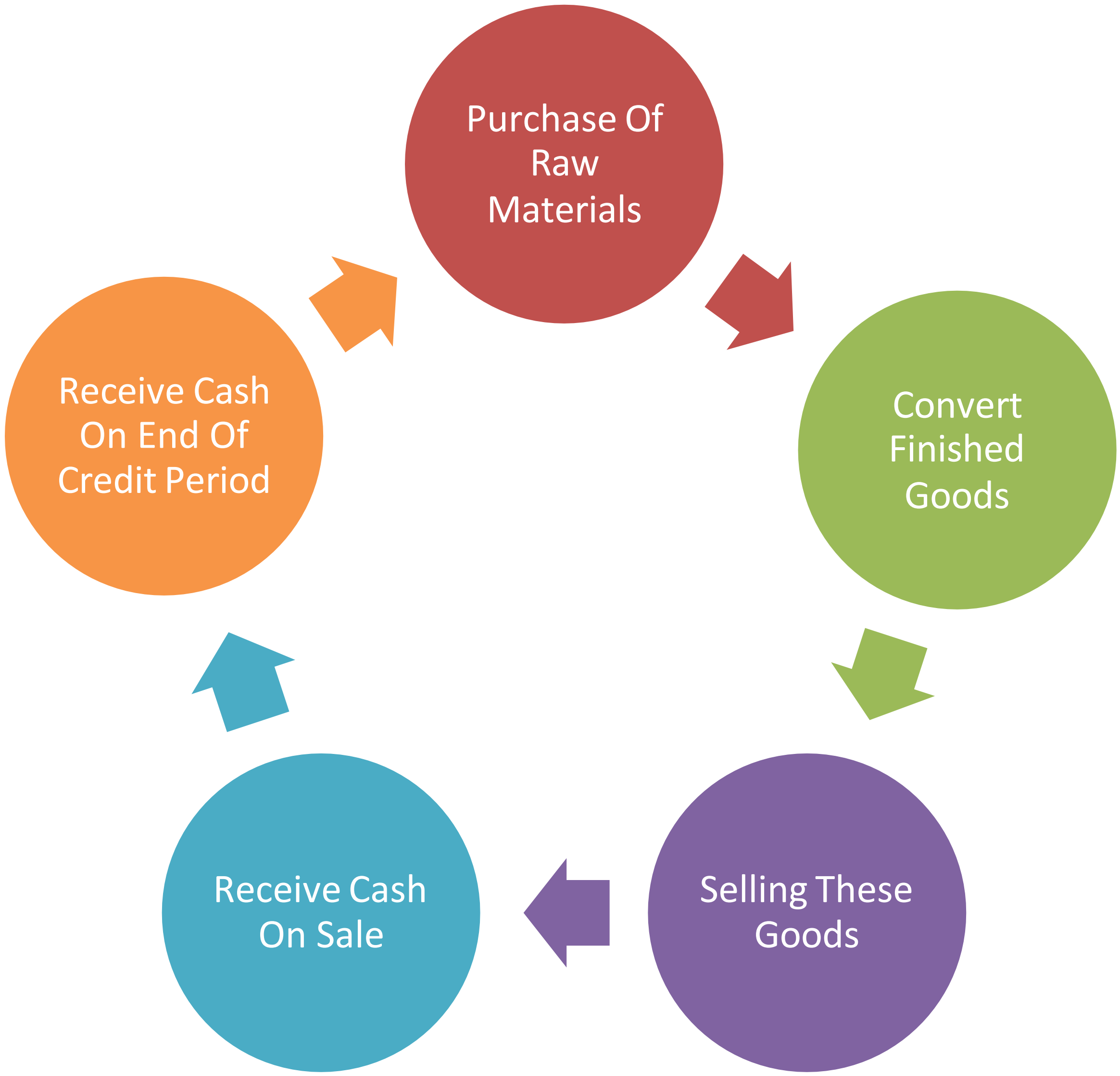
Net working capital is the **difference between the current assets and current liabilities of the company.** It can be negative or positive.

WORKING CAPITAL MANAGEMENT

Working Capital Management (WCM) is the process of **managing a company's short-term assets and liabilitie**s to ensure efficient operations and financial health.

assets and the sources to finance them.

WORKING CAPITAL CYCLE



The normal operations of a business enterprise consist of some or all of the actions like, purchase of raw materials, processing/conversion of raw materials into finished goods, selling these goods on cash/ credit basis, receive cash on sale or end of credit period and again purchase raw materials. **This is called working capital cycle**.

The length of this cycle depends on

- The **stocks of raw materials required** to be held.
- The **work in process**, which in turn depends on the process involved in manufacturing/processing to convert the raw materials into finished goods.
- The **credit period** required to be provided to the purchasers.

The **longer the working capital cycle**, the more is working capital requirement, i.e., the need for maintaining the current assets. The correct assessment of this cycle is the most important part of working capital management.

CURRENT ASSETS/WORKING CAPITAL OF A FIRM

The amount and type of current assets and working capital, which a firm has to hold for smoothly conducting its business, **depends on various factors.**

NATURE OF BUSINESS

- **Public utility undertakings** such as electricity, water supply and railways require very **little working capital finance** because they sell their services on cash terms. They supply services not products, and very **little funds are tied up in inventories and receivables**.
- **Trading and financial firms require less investment in fixed assets** but need large sums as working capital and fixed investments.

SIZE OF THE BUSINESS

Greater the size of the business, greater is the requirement of working capital.

PRODUCTION POLICY : If a company produces at a constant rate regardless of seasonal demand fluctuations, it will overproduce during off-peak seasons.

SEASONAL VARIATION : Generally, during the busy season, a unit will require larger working capital than in slack season.

OPERATING/WORKING CAPITAL CYCLE : It is the duration of the operating cycle that determines the requirements of working capital. **Longer the cycle larger is the requirement of working capital.**

In general, the current assets required to be held by a firm, can be classifies as under

- Cash & cash equivalents
- Inventory
- Receivables

- Other current assets

SOURCES OF FINANCE FOR CURRENT ASSETS

The following are the main sources of finance for acquiring current assets.

FIRM'S OWN WORKING CAPITAL FUNDS

- This represents the amount to be brought in by the **firm through its own long-term source**s.
- Bankers in India expect this portion to be a m**inimum of 25% of the total current assets**. This portion is known as the Net Working Capital (NWC).

ACCRUALS : An accrual represents the liability of the firm which has already accrued but the payment for it will be made after some time.

TRADE CREDIT : Trade credit is the **negotiated delay in payment to the suppliers of goods and services.** In other words, it is the credit provided to the firm by its suppliers. Trade credit is often a substantial source of short-term finance for a firm.

A firm has to consider two main aspects in availing the trade credit.

- How much credit can be provided by the suppliers

- How much credit should be availed of by the firm

The amount of credit which the suppliers are willing to provide depends on the following factors:

- Industry practice
- Payment record of the firm and its reputation
- Liquidity position of the firm
- Firm's profitability over last few years

The decision of the firm regarding the amount of credit to be availed of from the suppliers depends mainly on.

Cost of credit

There is a hidden cost in trade credit. The rates **quoted by the supplier takes into account the credit period provided by him**. For immediate payments the supplier may be willing to offer a discount.

Liquidity position of the firm

A firm will be negotiating for a higher credit period if its liquidity position is not comfortable. On the other hand, if it has idle cash at satisfactory level, it may prefer to negotiate a reduced credit period in exchange for a discount.

PUBLIC DEPOSITS

- A firm can raise funds through **public deposits to finance its requirement of current assets.** The interest Tale of these deposits is not regulated by RBI, now.
- The interest rate will depend on **firm's financial stability, reputation and the prevailing market conditions.** The Companies Act 2013 provides detailed requirements to be followed by the companies for raising public deposits.

INTER-CORPORATE DEPOSITS

- Short term deposits of **up to six months**, accepted by a company from **another company**, are called inter-corporate deposits.

- In Inter-corporate deposits, **call deposit** is a type of deposit can be withdrawn by the lender by **giving a notice of one day**. Apart from this, there are 3 month and 6-month inter-corporate deposits.

RIGHTS DEBENTURES FOR WORKING CAPITAL

Rights" debentures can be issued by **public limited companies to their shareholders.** Though the object is to augment the **long-term resources of the company,** the same can be used for the company's working capital requirements also.

COMMERCIAL PAPER

- Commercial Paper (CP) is an **unsecured money market instrument** issued in the form of a promissory note.
- CP, as a privately placed instrument, **was introduced in India in 1990** with a view to **enable highly rated corporate borrowers** to diversify their sources of short-term borrowings and to provide an additional instrument to investors.

Eligibility for Issue of CP

- Any other body corporate with a minimum net worth of 100 crore or higher
- Co-operative societies/unions and limited liability partnerships with a minimum net worth of 100 crore or

higher.

- Any other entity specifically permitted by the Reserve Bank

FACTORING

- Factoring is a type of finance in which a **business would sell its accounts receivable (invoices**) to a third party to meet its short-term liquidity needs.

- Under the transaction the f**actor would pay the amount due on the accounts receivable minus its commission or fee**s. The financier is called 'Factor' and can be a financial institution.
- RBI had earlier stipulated that the **pre-payment amount offered** by banks for the receivables acquired under factoring should not exceed **80% of the invoice value.**

The purchase of book debts/receivables can be with recourse or without recourse to the client.

With Recourse

In recourse factoring, the **factor does not take on the risk of bad debts**. They will be able to reclaim their money from you even if the customer does not pay.

Without Recourse

In without recourse, the **client is not liable to pay to the factor in case of failure of the buyer to pay.**

FORFAITING

- This is similar to factoring but is used only **in case of exports and where the sale is supported by bills of exchange/promissory notes**. The financier discounts the bills and collects the amount of the bill from the buyer on due dates.
- Forfaiting is **always without recourse to the client. Therefore, the exporter does not carry the risk of default by the buyer** Importers

WORKING CAPITAL ADVANCE BY COMMERCIAL BANKS/

FINANCIAL INSTITUTIONS

Working Capital Advance, provided by Commercial Banks, may be in the form of **fund based or non-fund-based facilities.**

Fund Based Facilities

Fund based facilities can be in the form of **cash credit, overdraft, loan or discounting of bills.**

Non-Fund Based Facilities

Non-fund-based facilities include **letters of credit, bank guarantees, and co-acceptance of bills.**

WORKING CAPITAL ASSESSMENT BY BANKS

- Deciding on the **Level of Turnover of the firm** is the first and very important step in any method of assessment of working capital limits.
- In case of existing enterprises, the **past performance is used as a guide to make an assessment of this.**

- In case of **new enterprises**, this is based on the production capacity, proposed market share, availability of raw materials, industry norm, etc.

Based on the projected turnover, banks adopt various methods for assessing the working capital needs of a firm. These are discussed below:

HOLDING NORMS BASED METHOD

Calculation of Bank Finance

- Logically, the need for working capital finance from the **bank is equal to the gap between total working Capital** and the availability of funds from all the sources, as mentioned above (excluding bank finance).
- Banks can prescribe the amount to be brought in by the enterprise through its own long-term sources i.e., the NWC and remaining amount of working capital is financed by bank.

There are several methods for calculating bank finance

First Method of Lending

Under this, the enterprise was required to bring in **NWC of at least 25 per cent of the working capital gap** (total current assets minus total current liabilities excluding bank finance).

Second Method of Lending

Under this, the enterprise was required to bring in NWC of at least 25 per cent of the total current assets.

Third Method of Lending

Under this, the enterprise was required to bring in, as NWC, **100 per cent of those current assets which are considered "core assets' and at least 25 per cent of the remaining current assets.**

CASE STUDY ON HOLDING NORMS-BASED METHOD

Current Assets	Amount	Current Liabilities (excluding bank finance)	Amount
Inventory	200,000	Accounts Payable	80,000
Accounts Receivable	100,000	Other Current Liabilities	20,000
Other Current Assets	50,000	Total Current Liabilities (excluding bank finance)	100,000
Total Current Assets	350,000		

CASH BUDGET METHOD OF ASSESSMENT

- The genesis of an enterprise's requirement for the working capital funds, from the bank, lies in the fact that during a particular day, its opening cash balance and cash inflows are not sufficient to meet its normal cash outflows.

- Under this method the **cash deficit will be the level of total working capital finance to be provided to the borrower by the Bank**. The cash deficit will be ascertained from the Projected Cash Budget Statement submitted by the borrower.

TURNOVER METHOD OF ASSESSMENT

Under this method of working capital assessment, it is assumed that the **enterprise needs 25% of its annual turnover** as gross working capital, out of which 20% will be provided by the bank and 5**% will be brought in as margin by the enterprise**. For loans and advances to Micro and Small Enterprises (MSES), RBI guidelines are as under: 'Banks are advised to grant working capital credit limits to Micro and Small Enterprises (MSEs) computed on the basis of minimum 20% of their estimated annual turnover whose credit

limit in individual cases is up to 5 crores'.