UNIT-V
WORKING CAPITAL DECISIONS

1. What is Working Capital? State factors affecting requirement of working capital.

Ans. The working capital, also known as net worth capital is the money that a company needs for managing its short term expenses. It is calculated as a difference between an organisation's current assets and its current liabilities.

Experts define working capital in both, narrow as well as broad sense. In the narrow sense, it is defined as "the difference between current assets and current liabilities".
According to Gerstenbergh, "working capital is the excess of current assets over current liabilities". However, Gerstenbergh prefers to call working capital as circulating capital.

In a broader sense, "working capital means current assets".
According to Western and Brigham, "working capital refers to a firm's investment in short term assets such as cash, short term securities, account receivable and inventories".

Factors affecting Working Capital Requirement:

The factors affecting working capital requirement are as follows:

(i)Nature of Business: The nature of business highly influences the requirement of working capital. Industrial and manufacturing enterprises, trading firms, big retail stores etc. need a large amount of working capital as they have to satisfy varied and continuous demands of consumers.

(ii)Business Cycle: When there is boom in the economy, sales will increase, which will lead to an increase in investment in stock.
Hence, additional working capital would be required. During recession period, sales would decline and the need of working capital would also decrease.

(iii)Production Cycle: Production cycle is the time span between the receipt of raw material and their conversion into finished goods. Some businesses have a longer production cycle while some have a shorter one. Duration and the length of production cycle, affects the amount of funds required for raw materials and expenses.

(iv)Seasonal Fluctuations: The requirement of working capital depends upon the seasonal fluctuations. It states that, if the demand for the product is seasonal, the working capital required in that season will be more.

For e.g. the demand for sweaters is more in winter. Sweater manufacturing companies need more working capital before winters to make the goods available in the market before the season starts.

(v)Credit Control: Volume and terms of credit sales, collection policy etc. are the important factors of credit control. Sound credit policy improves cash flow and hence the firms making cash sales require less working capital. Liberal credit policy increases the risk of bad debts and hence the firms selling on easy credit terms may require more working capital.

(vi)Size of Business: The size of business has a great impact on the requirement of working capital. Large scale firms require large amount of working capital and vice-versa.

(vii)Management Ability: The requirement of working capital will reduce if there is proper co-ordination between production and distribution of goods. Lack of co-ordination between different departments may result in heavy stocking of finished and semi-finished goods, which ultimately leads to an increase in the requirement of working capital.

(viii) Scale of Operations: For organizations which operate on a higher scale of operation, the quantum of inventory, debtors required is generally high. Such organizations, therefore, require large amount of working capital as compared to the organizations which operate on a lower scale.

2. Explain the different concepts of working capital.

Ans. Generally, there are two concepts of working capital i.e. gross concept and net concept.

(i) Gross Concept of Working Capital: According to gross concept, working capital refers to all the current assets and represents the amount of funds invested in current assets. Thus, gross working capital is the capital invested in current assets. Current assets are those assets which can be converted into cash within the short-time period.

Gross Working Capital = Total current assets.

In this way, gross working capital refers to the firm's investment in current assets. Gross working capital represents total of current assets which includes cash in hand, cash at bank, inventory, prepaid expenses, bills receivable etc.

(ii) Net Concept of Working Capital: According to the net concept, working capital is the excess of current assets over current liabilities. In other words, the difference between current assets and current liabilities is called net working capital.

Net Working Capital = Current Assets - Current liabilities.

In this way, net working capital is the difference of current assets and current liabilities.

3. Explain the different sources of short-term finance.

Ans. Short-term financing comes due within one year. The main sources of unsecured short-term financing are trade credit, bank loans, and commercial paper. Secured loans require a pledge of certain assets, such as accounts receivable or inventory, as security for the loan. Factoring, or selling accounts receivable outright at a discount, is another form of short-term financing. These are discussed below:

(i)Commercial bank: Commercial banks are the most important source of short term capital. A major portion of working capital loans are provided by commercial banks. It provides loans & advances through loans, cash credit, overdraft, purchasing & discounting of bills etc.

(ii)Trade Credit: Trade Credit refers to an arrangement whereby a manufacturer is granted credit from the supplier of raw materials, inputs, spare parts etc. The suppliers allow their customer to pay their outstanding balance within a credit period. Generally the duration of credit period is 3 to 6 month and thus it is a short term financing facility.

(iii)Instalment credit or hire purchase: This is another method by which the assets are purchased and the possession of goods is taken immediately but the payment is made in instalment over a pre-determined period of time.

(iv)Factoring: Factoring is a financial service under which factor i.e. financial institution rendered the following service:
(a) Discounting of bills of Exchange.
(b) Providing information regarding the credit worthiness of prospective clients.

(v)Commercial Papers: Commercial paper is a source of short term finance. The commercial paper was introduced in India for the first time in 1990. It is an unsecured promissory note issued by public or private sector companies with a fixed maturity period, which various from 3-12 month.

(vi)Advances: Some business houses get advances from their customers and agents against orders and this source is a short term source of finance for them. It is a cheap source of finance and in orders to minimum their investment in working capital.

4. What is Cash Management? State its objectives.

Ans. Cash Management refers to the collection, handling, control and investment of the organizational cash and cash equivalents, to ensure optimum utilization of the firm’s liquid resources. Money is the lifeline of the business, and therefore it is essential to maintain a sound cash flow position in the organization.

Objectives of Cash Management

Why do we need to manage cash flow in the organization? What is the use of cash management in the business? Following purposes of cash management will resolve the above queries:

(i)Fulfil Working Capital Requirement: The organization needs to maintain ample liquid cash to meet its routine expenses which possible only through effective cash management.

(ii)Planning Capital Expenditure: It helps in planning the capital expenditure and determining the ratio of debt and equity to acquire finance for this purpose.

(iii)Handling Unorganized Costs: There are times when the company encounters unexpected circumstances like the breakdown of machinery. These are unforeseen expenses to cope up with; cash surplus is a lifesaver in such conditions.

(iv) Initiates Investment: The other aim of cash management is to invest the idle funds in the right opportunity and the correct proportion.

(v)Better Utilization of Funds: It ensures the optimum utilization of the available funds by creating a proper balance between the cash in hand and investment.

(vi) Avoiding Insolvency: If the business does not plan for efficient cash management, the situation of insolvency may arise. It is either due to lack of liquid cash or not making a profit out of the money available.

5. Explain the motives of holding cash.

Ans. Cash is the most liquid asset, but it does not earn any substantial return for the business. But still everybody and every firm maintain some cash balance. Thus the basic question is why firms hold cash? Some of the reasons for holding cash are listed below.

(i)Transaction Motive: It requires a firm to hold cash to conduct in business in ordinary course. The firm needs cash primarily to make payments for purchases, wages, salaries, other operating expenses, taxes, dividends etc. The transaction motive mainly refers to holding cash to meet anticipated payments, whose timing is not perfectly matched without cash receipts.

(ii)Precautionary Motive: The precautionary motive is the need to hold cash to meet contingencies in the future. It provides a cushion or buffer withstand some unexpected emergencies. It stronger the ability of the firm to borrow at short notices then the need for precautionary balance will be less. The amount of cash set-aside for precautionary reasons will be invested in high liquid and low risk marketable securities.

(iii)Speculative Motive: It relates to the holding of cash for investing in profit making opportunities as and when they arise. The opportunity to make profit may arise when the security prices change. The firm will hold cash when it is expected that there will be a rise in price of commodities and securities. The firm will also purchase securities when it is expected that interest rates will rise and security prices will fall. Then the firm will be benefited by the subsequent rise in prices of securities.

(iv)Compensating Motive: Business of today is predominantly depend on the commercial bank for financial support for some of services; the bank charges a commission or service charges but for some others it insist that a pre-determined minimum balance be kept with the bank, which should not be withdrawn in the ordinary course of business, for instance, if a bank guarantee is issued by the bank, guarantee charges based on the period and amount are debited by the bank. In addition it may ask for relation of some minimum balance too. Such balance is known as Compensating balance.

(v)Expansion Motive: It refers to the motive of accumulating cash to meet the requirements of expansion envisaged by the business. Holding of cash for such purposes been described as business expansion motive.

6. Explain the Facets of Cash Management

Ans. In order to resolve the uncertainty about cash flow prediction and lack of synchronization between cash receipts and payments, the firm should develop appropriate strategies for cash management. The firm should evolve strategies regarding the following four facets of cash management:

(i)Cash planning: Cash outflows and inflows must be planned. Estimates about cash outflows and inflows for the planning period must be made to project cash deficit or surplus. Cash budget must be prepared for this reason.

(ii)Managing cash flows: Cash flows must be managed in such a manner that this accelerates cash inflows and delays cash outflows as much as possible.

(iii)Optimum cash level: The firm must decide regarding the optimum cash balance, that it should keep. This decision needs a trade of among the cost of excess cash and the cost of cash deficiency.

(iv) Investing surplus cash and financing deficit: Surplus cash must be invested in short-term instruments in order to receive profits along with continue liquidity. As the same, the firm must also plan in advance about the sources for finance short term cash deficit.

The cash management system design is affected by the firm's products organization structure, the competition, market and the culture wherein it operates. Cash management is not a standalone function although it needs close coordination, precise and timely inputs from different departments of the organization.

7. What is Receivable Management? State its objectives.

Ans. Receivable Management means the collection of the due payments of sales from the customers in a timely manner. The customers owe money to the company in exchange for the goods or services sold to them (customers) by the company on credit terms. Simply, the collection of that due money is termed as Receivable Management.

(i) To optimize the amount of sales.
(ii) To minimize cost of credit.
(iii) To optimize investment in receivables.
(iv) To increase credit sales.

8. Explain the factors to be considers for size of receivables.

Ans. Receivables size of the business concern depends upon various factors. Some of the important factors are as follows:

(i)Sales Level: Sales level is one of the important factors which determine the size of receivable of the firm. If the firm wants to increase the sales level, they have to liberalise their credit policy and terms and conditions. When the firms maintain more sales, there will be a possibility of large size of receivable.

(ii)Credit Policy: Credit policy is the determination of credit standards and analysis. It may vary from firm to firm or even some time product to product in the same industry.
Liberal credit policy leads to increase the sales volume and also increases the size of receivable.
Stringent credit policy reduces the size of the receivable.

(iii)Credit terms: Credit terms specify the repayment terms required of credit receivables, depend upon the credit terms, size of the receivables may increase or decrease. Hence credit term is one of the factors which affect the size of receivable.

(iv)Credit period: It is the time for which trade credit is extended to customer in the case of credit sales. Normally it is expressed in terms of Net days.

(v)Cash Discount: Cash Discount is the incentive to the customers to make early payment of the due date. A special discount will be provided to the customer for his payment before the due date.

(vi)Management of Receivable: It is also of the factors which affects the size of receivable in the firm. When the management involves systematic approaches to the receivable, the firm can reduce the size of receivable.
At last words, Receivable management plays important role in any organization to operate properly because it is current assets of the business concern.

9. What is Inventory management? State its objectives.

Ans. Inventory management is an approach for keeping track of the flow of inventory. It can be defined as a systematic control over purchasing, storing and consumption of material, so as to maintain regular and timely supply of materials at the same time availing the right quantity of material of right quality at the right time and place at the minimum cost.

Objective of Inventory Management:

(i)To make available all type of materials and stores of right quality without any intervention.

(ii)To make purchase of materials of required quality according to the standard fixed for finished product.

(iii) To make purchases of materials at reasonable low cost or at maximum economy.

(iv) To avoid wastages and losses during storage and usage.

(v) To avoid the situation of under stocking i.e., to provide continuous supply of required material so that the activities of production may not be held up.

(vi)To avoid the over stocking i.e. to maintain optimum investment in inventory.

(vii) To maintain proper and up to date records of inventory.

(viii)To provide required information to the management, so as to help the management in taking inventory decision.

10. Name and explain the different techniques of Inventory Management.

Ans. The different techniques of Inventory Management are**:**

(i)Determination of Stock Levels: Carrying of too much and too little of inventories is detrimental to the firm. If the inventory level is too little, the firm will face frequent stock-outs involving heavy ordering cost and if the inventory level is too high it will be unnecessary tie-up of capital. Therefore, an efficient inventory management requires that a firm should maintain an optimum level of inventory where inventory costs are the minimum and at the same time there is no stock-out which may result in loss of sale or stoppage of production.

(ii)Economic ordering quantity (EOQ): It is the quantity of inventory which can be reasonably ordered at a time and purchased economically. It is also known as standard order quantity, optimum quantity or economy lot size. The EOQ is fixed in such a manner to minimize the cost of ordering and carrying the stock i.e. ordering cost and inventory carrying cost.

$$\textbf{EOQ}=\sqrt{\frac{2CO}{I}}$$

Where, C =Annual consumption.
O= ordering cost per order.
I = Carrying cost per unit per year.

(iii)ABC Analysis: ABC Analysis is also known as a system of inventory control. Under this method (Always Better Control) efficient control of store is required to give more care on costlier item. As such on the basis of the value of different Materials item are grouped into 3 category –
(a) High price materials (A)
(b) Medium Price Materials (B)
(c) Low price Materials (C)

(iv) VED Analysis: VED Analysis (Vital, Essential & Desirable) is used primarily for control of spare parts. The spare parts can be divided into 3 categories- Vital, Essential, or Desirable keeping in view the Criticality to production.
The spares, the stock out of which is even for a short time will stop production for quite some time and where the cost of stock out is very high are known as vital spares.
The spares, the absence of which cannot be tolerated for a more than a few hours on a day and the cost of lost production is high and which are essential for the production to continue are known as essential spares .
The desirable spare are those spares which are needed but the absence for even a week or so will not lead to stoppage of production.

(v) Just in time Inventory system: Just in time purchasing mean purchase when required only. Purchase immediately before use. The main objective of JIT purchase is to minimise the carrying cost, storage cost, material handling cost, obsolescence etc.

(vi)Perpetual Inventory system: Perpetual Inventory system is a system of recording store balances after receipt and issue, to facilitate regular checking and to avoid closing down for stock taking. The basic objective of P.I. system is to provide a continuous quantity cum value records of receive, issue and balance of each item of store followed continuous stock taking.

11. What is Payable Management? State its importance/objectives.

Ans. When a company purchases goods on credit which needs to be paid back in a short period of time, it is known as Accounts Payable. Account payable management refers to the practices, procedures, and policies used by a company with respect to managing trade credit purchases.

Importance of Payable Management

Accounts payable and its management are vital for the smooth functioning process of any business entity. It is important for any business because:

(i)It primarily takes charge of paying the entity's bills on a timely basis. This is important so that strong credit and long-term relationship with the vendors can be maintained.

(ii)Only when invoices are paid on time, vendors will ensure an uninterrupted flow of supplies and services; which in turn will help in the systematic flow of business.

(iii)A good accounts payable process ensures there are no overdue charges, penalty or late fees to be paid for the dues.

(iv)The organized accounts payable process ensures all that the invoices due are tracked and paid properly. This will help avoid missing payments and making a payment twice.

(v)It also enables business entities to manage better cash flows (i.e. making payments only when due, using the credit facility provided by the vendor, etc.)

(vi)Frauds and thefts can be avoided to a greater extent by following a stringent accounts payable process.