SNS COLLEGE OF ENGINEERING

Kurumbapalayam (Po), Coimbatore – 641 107

An Autonomous Institution

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DEPARTMENT OF MANAGEMENT STUDIES

COURSE NAME : 19BA201 FINANCIAL MANAGEMENT

I YEAR / II SEMESTER

UNIT 5 - WORKING CAPITAL MANAGEMENT

Meaning of Working Capital

- Working capital means the firm's holding of current or short-term assets such as cash, receivables, inventory and marketable securities (circulating capital)
- Working Capital is also called as Net Working Capital (NWC)
- Working capital = Current assets – Current liabilities
- NWC can be positive or negative.
  - Positive NWC = CA > CL
  - Negative NWC = CA < CL

Current Assets

- Current assets are all the assets of a company that are expected to be sold or used as a result of standard business operations over the next year
- Current assets include cash, cash equivalents, accounts receivable, stock inventory, marketable securities, pre-paid liabilities, and other liquid assets
- Current assets are important to businesses because they can be used to fund day-to-day business operations and to pay for the ongoing operating expenses

Current Liabilities

- Current liabilities are a company's short-term financial obligations that are due within one year or within a normal operating cycle.
- Current liabilities are typically settled using current assets, which are assets that are used up within one year.
- Examples of current liabilities include accounts payable, short-term debt, dividends, and notes payable as well as income taxes owed.

Working Capital Management

- Working Capital Management is a business tool that helps companies effectively make use of current assets, helping companies to maintain sufficient cash flow to meet short term goals and obligations.

Gross working capital (GWC)

- GWC refers to the firm's total investment in current assets.

Permanent And Variable Working Capital

Permanent or fixed working capital

A minimum level of current assets, which is continuously required by a firm to carry on its business operations, is referred to as permanent or fixed working capital. (Ex: Coffee Shop - Place, Coffee Machine)

Fluctuating or variable working capital

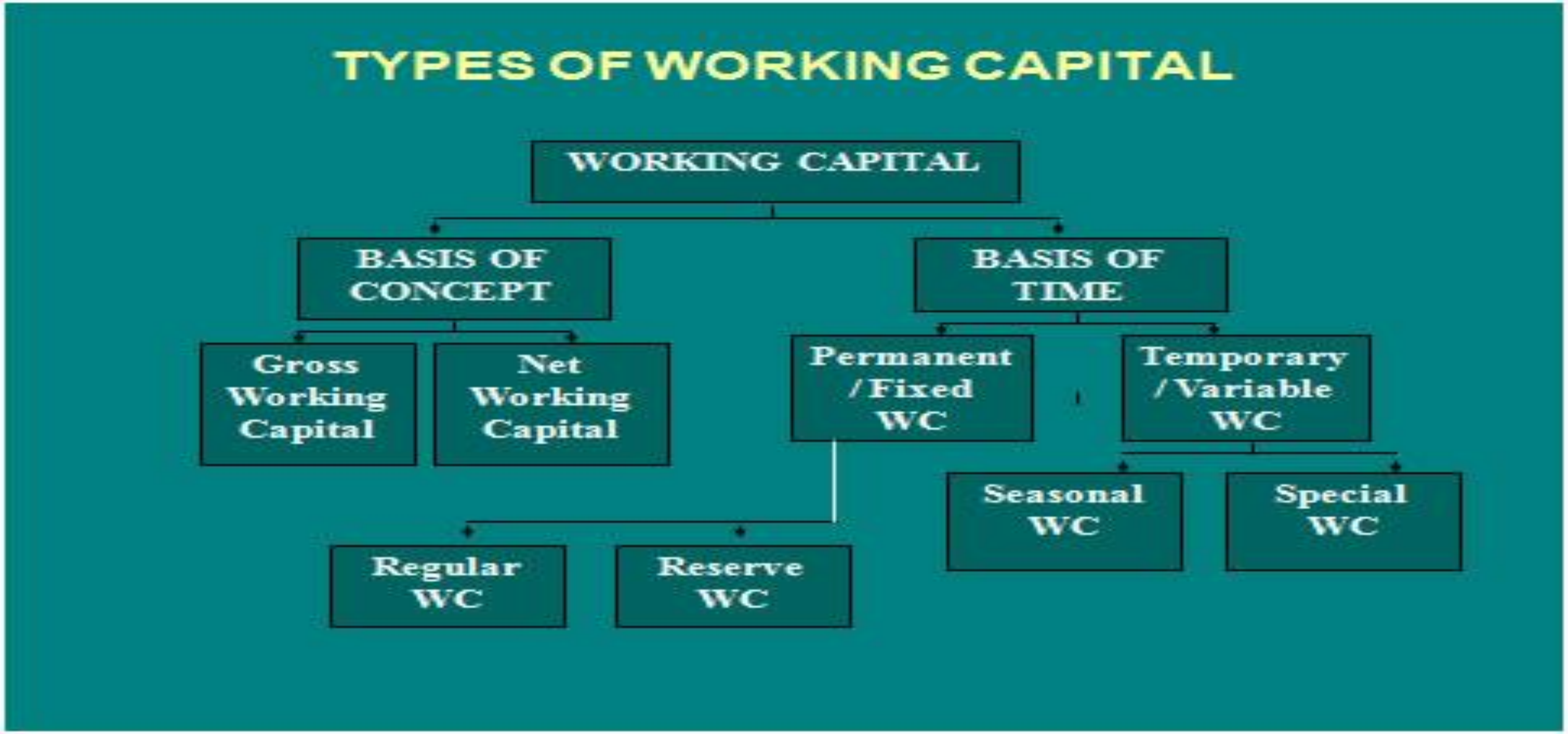
The extra working capital needed to support the changing production and sales activities of the firm is referred to as fluctuating or variable working capital. (Ex: Coffee Shop - Sugar, Coffee Powder based on Demand)

Importances of Working Capital Management

- The goal of working capital management is to maximize operational efficiency.
- Efficient working capital management helps maintain smooth operations and can also help to improve the company's earnings and profitability.
- Management of working capital includes inventory management and management of accounts receivables and accounts payables.

- Working Capital Ratio=CA/CL it should between 1.2 to 2

Types of Working Capital



Regular Working Capital

- The minimum amount of working capital to be maintained in normal condition is called Regular Working Capital.

Reserve Working Capital

- It is otherwise called as Cushion Working Capital. It refers to the short term financial arrangement made by the business units to meet uncertain changes or to meet uncertainties. A firm is always working with the expectation of some risks which may be controllable or uncontrollable. The reserve working capital can be used in order to meet the uncontrollable risks and sustain in the business world.

Seasonal Working Capital

•Some products have seasonal demand. Seasonal demand arises due to festival. In this way, seasonal working capital means an amount of working capital maintained to meet the seasonal demand of the product.

Special Working Capital

•Special programmes may be conducted for business development. The programmes may be advertisement campaign, sales promotion activities, product development activities, marketing research activities, launching of new products, expansion of markets and the like. Therefore, special working capital means an amount of working capital maintained to meet the expenses of special programmes of the company.

Factors affecting Working Capital Requirements

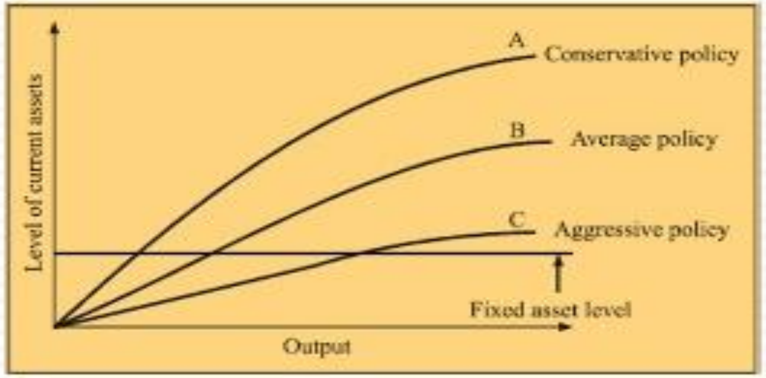
Nature of Industry or Business	Seasonality of Industry	Competition
Production Cycle Time	Credit and Dividend Policy	Growth and Expansion
Shortage of supply of Raw Material	Taxes	Price Level

DETERMINANTS OF WORKING CAPITAL

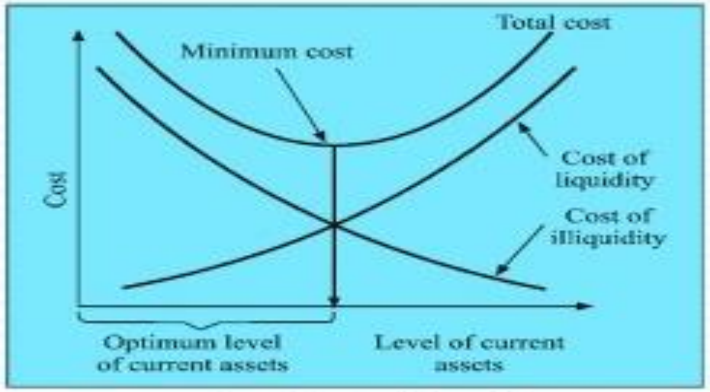
- ***Size Of Business***
- ***Nature Of Business***
- ***Storage Period***
- ***Credit Period***
- ***Seasonal Requirement***
- ***Potential Growth Or Expansion Of Business***
- ***Changes In Price Level***
- ***Dividend Policy***
- ***Working Capital Cycle***
- ***Operating Efficiency***
- ***OTHER FACTORS***

Issues in Working Capital Management

- Current Assets to Fixed Assets Ratio
- Liquidity *vs. Profitability:* Risk–Return Trade-off
- The Cost Trade-off



Alternative current asset policies



Cost Trade-off

Working Capital Estimation

Working Capital Estimation...

- Factors to be considered:
  - Total costs incurred on materials, wages and overheads.
  - The length of time for which raw materials remain in store before they are issued to production.
  - The length of the production cycle or WIP, i.e., the time taken for conversion of Raw Material into Finished Goods.
  - The length of the Sales Cycle during which Finished Goods are kept waiting for sales.
  - The average period of credit allowed to customers.
  - The amount of cash required to pay day-to-day expenses of the business.
  - The amount of advance payments if any.
  - The average period of credit to be allowed by suppliers.
  - Time – lag in the payment of wages and other overheads.

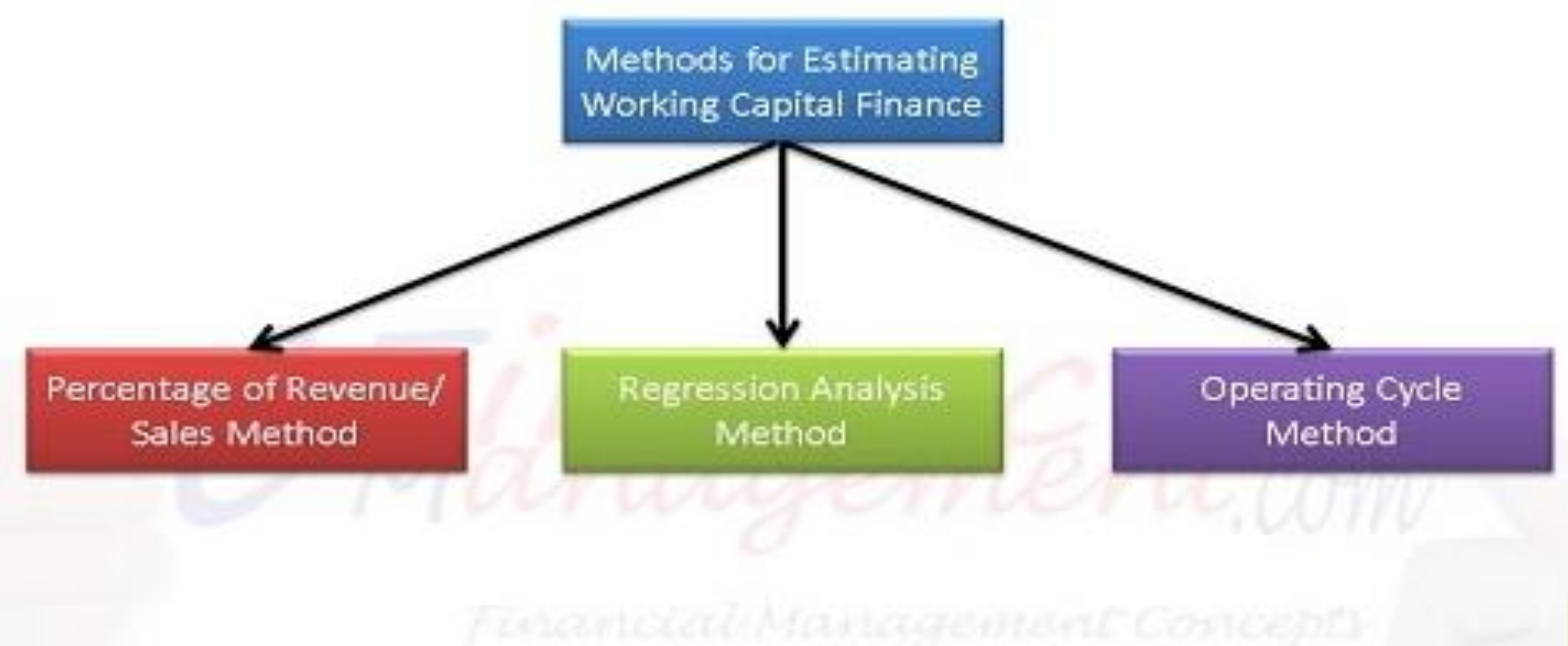
Working Capital Estimation

Particulars	Amount (Rs.)
Current Assets	
(i) Cash	----
(ii) Receivables (For…..Months' Operating Cost)	----
(iii) Stocks (For……Months' COGS)	----
(iv)Advance Payments if any	----
Less : Current Liabilities	
(i) Creditors (For….. Months' Purchases)	----
(ii) Lag in payment of expenses	-----
WORKING CAPITAL (CA – CL)	XXX
Add : Provision / Margin for Contingencies	-----
NET WORKING CAPITAL REQUIRED	XXX

Working Capital Estimation

STATEMENT OF WORKING CAPITAL REQUIRED	Amount (Rs.)
Current Assets	
(i) Stock of R M(for ....months' consumption)	-----
(ii)Work-in-progress (for... months' production)	
(a) Raw Materials	-----
(b) Direct Labour	-----
(c) Overheads	-----
(iii) Stock of Finished Goods (for ...months' COGS)	
(a) Raw Materials	-----
(b) Direct Labour	-----
(c) Overheads	-----
(iv) Sundry Debtors (for ...months' operating Cost)	
(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	-----
Less : Current Liabilities	
(i) Creditors (For..... Months' Purchases)	-----
(ii) Lag in payment of expenses	-----
(iii) Any other	-----
WORKING CAPITAL (CA – CL)	xxx
Add : Provision / Margin for Contingencies	-----
NET WORKING CAPITAL REQUIRED	XXX

Method for Estimating Working Capital



Percentage Sales Method

- The percent of sales method is a financial forecasting model in which all of a business's accounts financial line items like costs of goods sold, inventory, and cash are calculated as a percentage of sales.
- Those percentages are then applied to future sales estimates to project each line item's future value.

Current Sales (1 + Growth Rate/100)

=

Forecasted Sales

HubSpot

	Yr. 1	% of Sales	Forecast 10% Increase
Sales	$100,000	100%	$ 110,000
COGS	$ 75,000	75%	$ 82,500

COGS Forecast calculation = 75% x 110% x $ 100,000 = $ 82,500

Regression Analysis Method

- The Regression analysis, a statistical tool, is used to estimate the working capital and its components
- It establishes an equation relationship between revenue and working capital. It can also be called trend analysis
- Working Capital = Intercept + Slope * Revenue (or) y = a + bx
- where y represents the working capital, x represents sales, a & b are intercept and slope

The relationship between sales and working capital can be represented by :

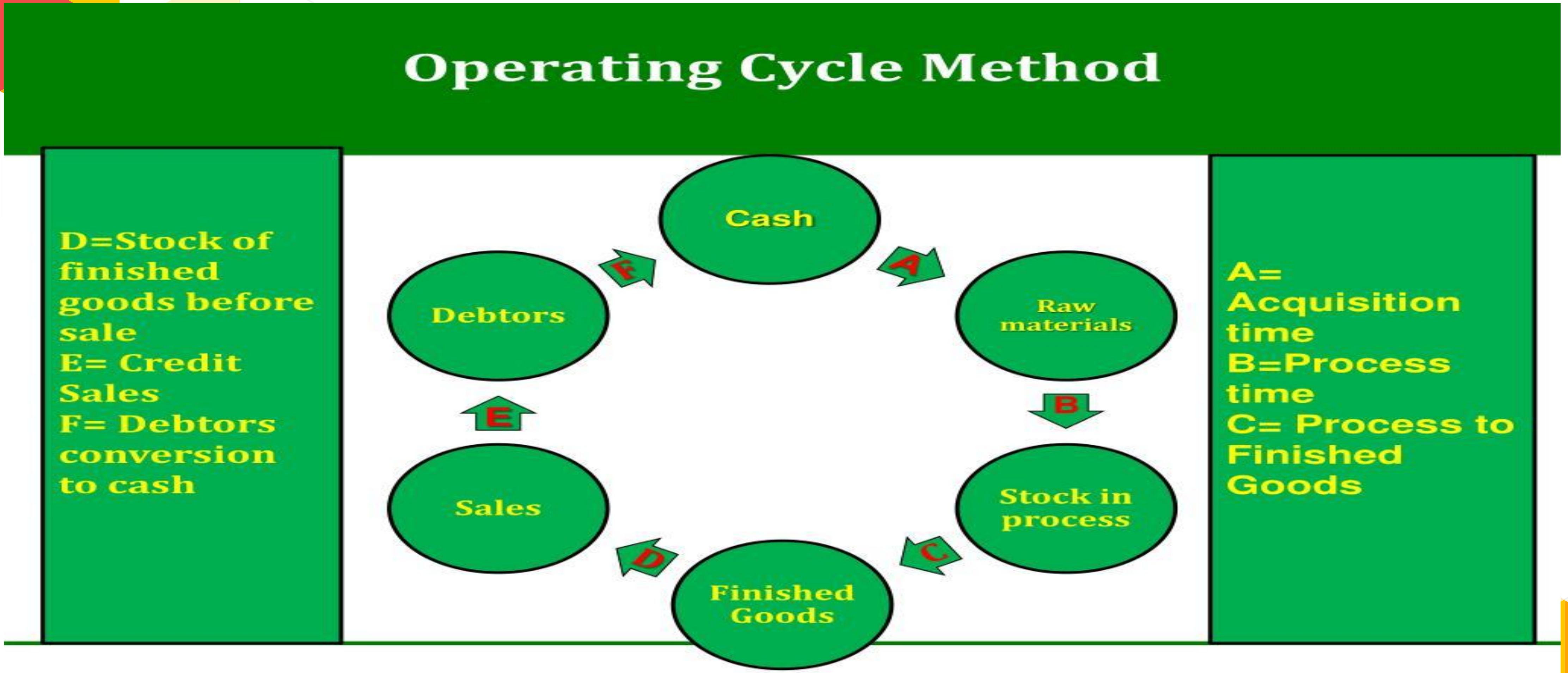
$y = a + bx$

Year	*Sales (x)*	*Working Capital (y)*	*xy*	*x^2*
2003-04	60	12	720	3,600
2004-05	80	15	1,200	6,400
2005-06	120	20	2,400	14,400
2006-07	130	21	2,730	16,900
2007-08	160	23	3,680	25,600
n = 5	$\Sigma x = 550$	$\Sigma y = 91$	$\Sigma xy = 10,730$	$\Sigma x^2 = 66,900$

$\Sigma y = na + b\,\Sigma x$

$\Sigma xy = a\,\Sigma x + b\,\Sigma x^2$

Operating Cycle Method



Operating Cycle Method

a. Procurement of Raw Material

b. Conversion / Process time

c. Average Finished Goods Holding Period

d. Average Collection Period

e. Average Supplier's Credit Period

f. Operating Cycle (a + b + c + d - e)

g. No. of Operating Cycles in a year

(365 days / f)

Bank Credit

- The term bank credit refers to the amount of credit available to a business or individual from a banking institution in the form of loans.

- Bank credit is the total amount of money a person or business can borrow from a bank or other financial institution.

FORMS OF CREDIT TERM LOANS

- Longer term finance to acquire fixed assets generally 2 to 10 years
- Repayment is made in installments and interest is charged on entire balance.

FORMS OF CREDIT (FINANCE) CASH CREDIT

- Banks lend money against the security of commodities and debt overdrawing from a Bank account.
- Interest is charged only on RUNNING BALANCE and not on Entire Amt

OVERDRAFTS

- The word overdraft means the act of overdrawing from a Bank account.
- In other words, the account holder withdraws more money from a Bank Account than has been deposited in it.
- Interest is charged only on RUNNING BALANCE and not on Entire Amt.

Sources of Short-term Finance

- There are a number of sources of short-term finance which are listedbelow:

1. Trade credit
2. Bank credit

– Loans and advances

– Cash credit

– Overdraft

– Discounting of bills

3. Customers' advances
4. Installment credit
5. Loans from co-operatives

1. Trade Credit

- Trade credit refers to credit granted to manufactures and traders by the suppliers of raw material, finished goods, components, etc. Usually business enterprises buy supplies on a 30 to 90 days credit. This means that the goods are delivered but payments are not made until the expiry of period of credit. This type of credit does not make the funds available in cash but it facilitates purchases without making immediate payment. This is quite a popular source of finance.

2. **Bank Credit**

- Commercial banks grant short-term finance to business firms which are known as bank credit. When bank credit is granted, the borrower gets aright to draw the amount of credit at one time or in installments as and when needed. Bank credit may be granted by way of loans, cash credit, overdraft and discounted bills.

Bank Credit

(i) Loans

When a certain amount is advanced by a bank repayable after specified period, it is known as bank loan. Such advance is credited to a separate loan account and the borrower has to pay interest on the whole amount of loan irrespective of the amount of loan actually drawn. Usually loans are granted against security of assets.

(ii) Cash Credit

It is an arrangement whereby banks allow the borrower to withdraw money up to a specified limit. This limit is known as cash credit limit. Initially this limit is granted for one year. This limit can be extended after review for another year. However, if the borrower still desires to continue the limit, it must be renewed after three years. Rate of interest varies depending upon the amount of limit. Banks ask for collateral security for the grant of cash credit. In this arrangement, the borrower can draw, repay and again draw the amount within the sanctioned limit. Interest is charged only on the amount actually withdrawn and not on the amount of entire limit.

Bank Credit

(iii) Overdraft

When a bank allows its depositors or account holders to withdraw money in excess of the balance in his account up to a specified limit, it is known as overdraft facility. This limit is granted purely on the basis of credit-worthiness of the borrower. Banks generally give the limit up to Rs.20,000. In this system, the borrower has to show a positive balance in his account on the last Friday of every month. Interest is charged only on the overdrawn money. Rate of interest in case of overdraft is less than the rate charged under cash credit.

(iv) Discounting of Bill

Banks also advance money by discounting bills of exchange, promissory notes and hundies. When these documents are presented before the bank for discounting, banks credit the amount tocustomer's account after deducting discount. The amount of discounts equal to the amount of interest for the period of bill.

3. Customers' Advances

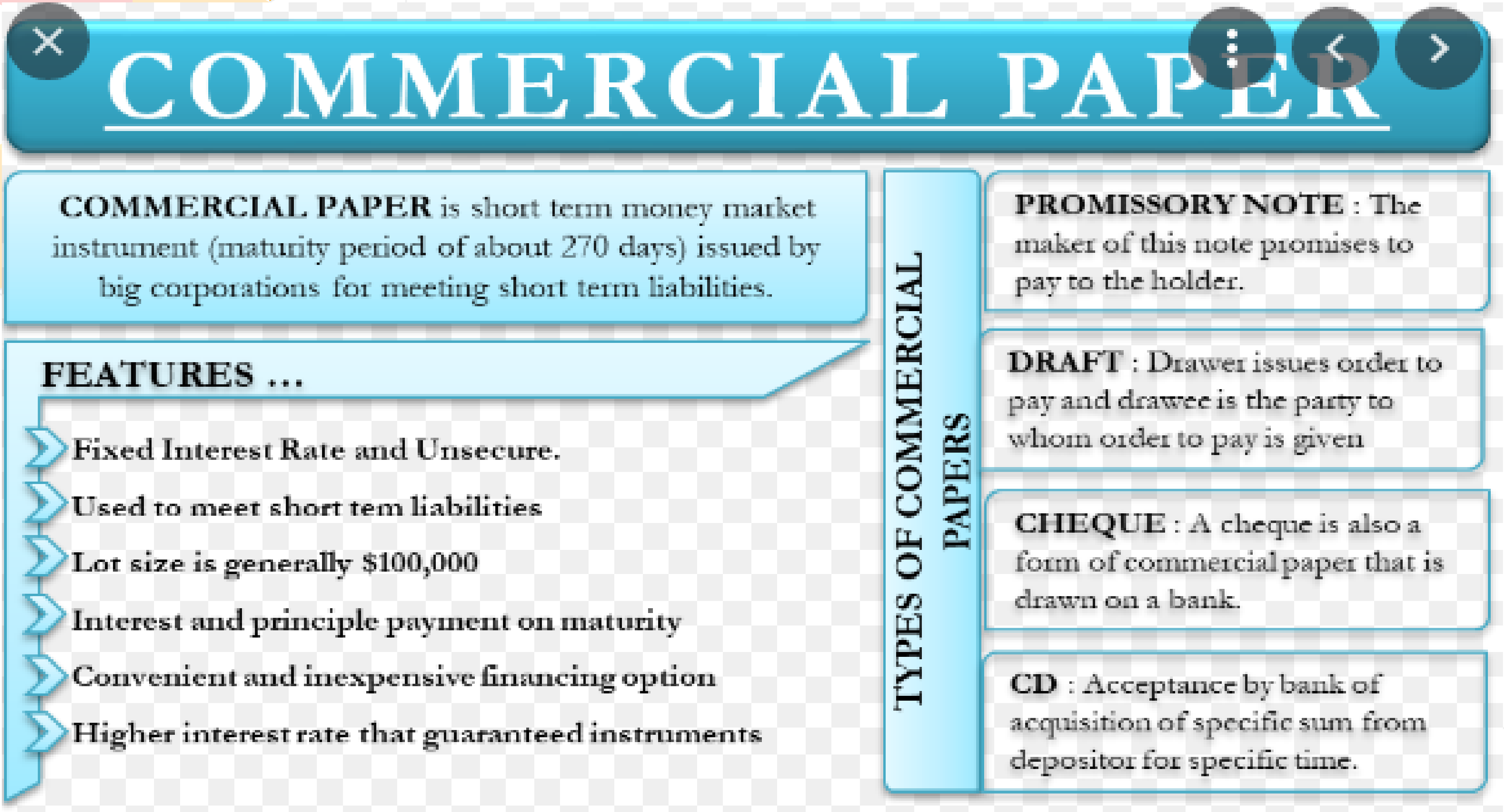
Sometimes businessmen insist on their customers to make some advance payment is generally asked when the value of order is quite large or things ordered are very costly. Customers' advance represents a part of the payment towards price on the product (s) which will be delivered at a later date. Customers generally agree to make advances when such goods are not easily available in the market or there is an urgent need of goods. A firm can meet its short-term requirements with the help of customers' advances.

4. Instalment credit

Installment credit is now-a-days a popular source of finance for consumer goods like television, refrigerators as well as for industrial goods. You might be aware of this system. Only a small amount of money is paid at the time of delivery of such articles. The balance is paid in a number of installments. The supplier charges interest for extending credit. The amount of interest is included while deciding on the amount of installment. Another comparable system is the hire purchase system under which the purchaser becomes owner of the goods after the payment of last installment. Sometimes commercial banks also grant installment credit if they have suitable arrangements with the suppliers.

5. Loans from Co-operative Banks

Co-operative banks are a good source to procure short-term finance. Such banks have been established at local, district and state levels. District Cooperative Banks are the federation of primary credit societies. The State Cooperative Bank finances and controls the District Cooperative Banks in the state. They are also governed by Reserve Bank of India regulations. These banks grant loans for personal as well as business purposes. Memberships the primary condition for securing loan. The functions of these banks are largely comparable to the functions of commercial banks.


COMMERCIAL PAPER
COMMERCIAL PAPER is short term money market instrument (maturity period of about 270 days) issued by big corporations for meeting short term liabilities.
FEATURES …
Fixed Interest Rate and Unsecure.
Used to meet short tem liabilities
Lot size is generally $100,000
Interest and principle payment on maturity
Convenient and inexpensive financing option
Higher interest rate that guaranteed instruments
TYPES OF COMMERCIAL PAPERS
PROMISSORY NOTE : The maker of this note promises to pay to the holder.
DRAFT : Drawer issues order to pay and drawee is the party to whom order to pay is given
CHEQUE : A cheque is also a form of commercial paper that is drawn on a bank.
CD : Acceptance by bank of acquisition of specific sum from depositor for specific time.

THANK YOU