WORKING CAPITAL MANAGEMENT

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Concepts of working capital

- Gross working capital
- Net working capital

CONCEPTS

Working capital is also called revolving, circulating or short term capital. Every business require the funds for its establishment which is called fixed capital and require funds to carry out its day to day operations like purchase of raw material, payment of wages etc. which is called working capital. Thus, working capital is the capital required to finance the short term or current assets such as cash,

IN BROAD SENSE:

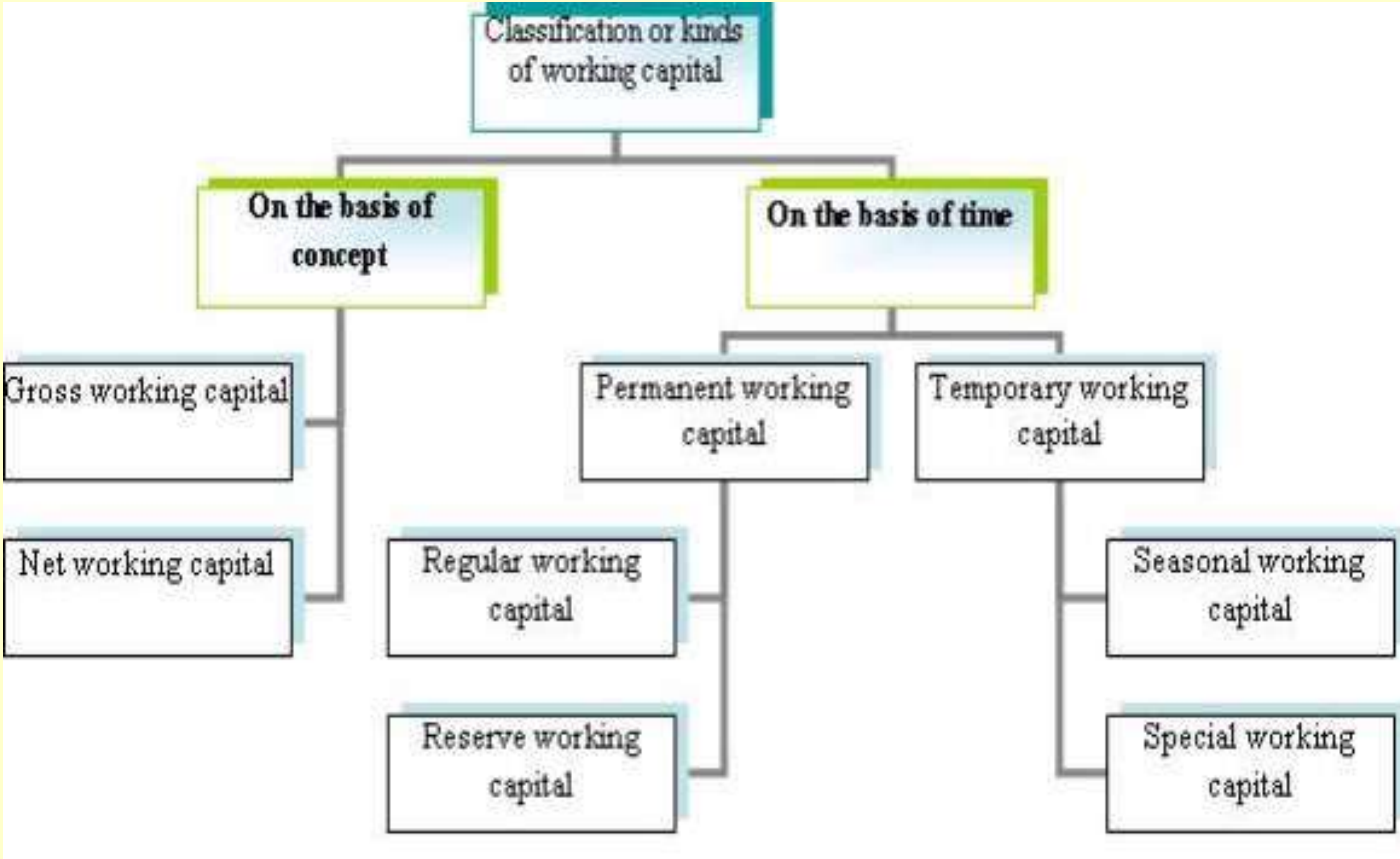
working capital refers to *gross working capital*. It is also defined as financial concept or going concern concept. It means the capital invested in the current assets of the firm. Current assets mean the assets which can be converted into cash easily or within one accounting period. It helps in determining the return on investment in working capital and providing correct amount of working capital at right time.

IN NARROW SENSE:

working capital refers to *net working capital*. It is also defined as accounting concept. It means excess of current assets over current liabilities. It helps in finding out firm's capability to meet short term liabilities as well as indicates the financial soundness of the enterprise.

Net working capital = current assets – current liabilities

Net working capital can be +ve or –ve. When current assets are more than the current liabilities than working capital is +ve and when current assets are less than the current liabilities than working capital is –ve.



Classification or kinds of working capital
On the basis of concept
On the basis of time
Gross working capital
Net working capital
Permanent working capital
Temporary working capital
Regular working capital
Reserve working capital
Seasonal working capital
Special working capital

TYPES OF WORKING CAPITAL
ON THE BASIS OF TIME

1) Permanent working capital: it is also called fixed working capital. It means to carry on the day to day expenses the firm is required to maintain the minimum amount of working capital. For example the firm is required to maintain the minimum level of raw material, finished goods or cash balance etc.

a) Regular working capital- it means the minimum amount which the firm has to keep with itself to carry on the day to day operation.

b) Reserve working capital- it means the excess amount over the regular working capital for uncertain circumstances like strike, lock out, depression etc.

2) Temporary working capital: it is also called variable working capital, which is required to meet the seasonal demands as well as for special purposes.

a) Seasonal working capital- it is required to meet the seasonal needs of the enterprise.

b) Special working capital- it is required for some special purposes of

1. Percentage of Sales Method:

This method of estimating working capital requirements is based on the assumption that the level of working capital for any firm is directly related to its sales value. If past experience indicates a stable relationship between the amount of sales and working capital, then this basis may be used to determine the requirements of working capital for future period.

2. Regression Analysis Method

(Average Relationship between Sales and Working Capital):

This method of forecasting working capital requirements is based upon the statistical technique of estimating or predicting the unknown value of a dependent variable from the known value of an independent variable. It is the measure of the average relationship between two or more

The relationships between sales and working capital are represented by the equation:

$$\boxed{y = a + bx}$$

Where, y = Working capital (dependent variable)

a = Intercept of the least square

b = Slope of the regression line

x = Sales (independent variable)

For determining the values 'a' and 'b' two normal equations are used which can be solved simultaneously :

$$\boxed{\begin{aligned} \sum y &= na + b\sum x \\ \sum xy &= a\sum x + b\sum x^2 \end{aligned}}$$

3. Cash Forecasting Method:

This method of estimating working capital requirements involves forecasting of cash receipts and disbursements during a future period of time. Cash forecast will include all possible sources from which cash will be received and the channels in which payments are to be made so that a consolidated cash position is determined.

4.Operating Cycle Method:

- This method of estimating working capital requirements is based upon the operating cycle concept of working capital. The cycle starts with the purchase of raw material and other resources and ends with the realization of cash from the sale of finished goods.

The requirements of working capital be estimated as follows:

$$\text{Working Capital Required} = \text{Cost of goods sold} \times \frac{\text{Operating cycle (days)}}{\text{365 or 360 days}} + \text{Desired cash balance}$$

Illustration 8. Details of X Ltd. for the year 2007-08, are given as under :

Cost of goods sold	₹ 48,00,000
Operating cycle	60 days
Minimum desired level of cash balance	₹ 75,000

You are required to calculate the expected working capital requirement by assuming 360 days in a year.

Solution :

Expected Working Capital requirement

$$= \text{Cost of goods sold} \times \frac{\text{Operating cycle (days)}}{\text{365 or 360 days}} + \text{Desired cash balance}$$

$$= 48{,}00{,}000 \times \frac{60}{360} + 75{,}000$$

$$= ₹\ 8{,}75{,}000$$

ALL THE BEST