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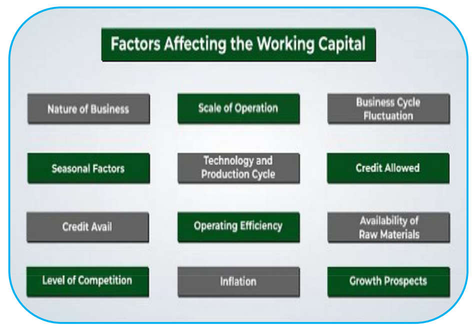
FACTORS DETERMINING THE WORKING CAPITAL REQUIREMENTS

Rakhi Kumari
Research Scholar,
University Department of Commerce and Business Administration,
L. N. Mithila University, Darbhanga.

ABSTRACT:

Working Capital is defined varyingly keeping in view the objectives and purposes. To businessmen, working capital comprises current assets of business whereas to the accountant/creditors/investment analysts working capital is understood as the difference of current assets minus current liabilities. This is also called the Net Working Capital. There is operative aspect of working capital i.e. current assets (which is known as 'funds' also) employed in the business process form the gross working capital. Current assets comprise: cash, receivables, inventories, marketable securities held as short- term investment and other items near cash or equivalent to cash. This is also known as going-concern concept of working capital. This paper mainly focuses on the factors determining the Working Capital Requirements.



KEY WORDS: *Cash, Receivables, Inventories, Working Capital Requirements.*

INTRODUCTION:

On the basis of the above concepts of Gross' and "Net' working capital, it can be classified in two ways. In the first case the classification may be linked with 'Gross' Concept. Such working capital shall be those sums invested in various components of current assets, such as cash, receivables, short-term unexpired costs and inventories. Second classification is based on 'time" element which classifies working capital as "permanent" or "temporary'. Permanent working capital Is that amount of funds required to produce goods and services necessary to satisfy demand at its lowest point. Such capital possesses the following characteristics viz, it is constantly changing from one asset form to another; and it remains permanently within the process of the business and can be returned back to its owners/suppliers when the business comes to an end. It has another special feature that it increases with the growth of business of the company. On the other hand, temporary working capital do change its form from cash to inventory to receivables and back to cash with the difference that it is not always gainfully employed. Seasonal business requires more temporary working capital.

Factors Determining the Working Capital Requirements

The company's need for working capital is determined by a number of variables. It should be emphasized that this depends on a variety of factors. Internal and external variables are the two main categories into which the determining elements can be divided. The factors that correspond to each category are shown below.

Internal Factors

A corporation will take into account the following elements when evaluating the amount of working capital needed for a specific time period. Each variable is thoroughly discussed. nature of the enterprise- The amount of working capital needed will vary depending on the kind of business the company does. Manufacturing and trading businesses will keep more inventory on hand, have a large number of trade debtors, and may need to use short-term financing and trade payables to pay them off. As a result, a lot of working capital is needed. Service businesses with cash transactions, such hotels or restaurants, will, on the other hand, have a modest proportion of debtors. As a result, a restaurant's working capital may be considerably lower than that of a manufacturing company, but it will nevertheless maintain food and beverage inventories to ensure smooth operations. Size of the company - Small businesses, particularly those who are just starting out, will not have enough money to finance their working capital, and creditors won't lend to persons they don't believe to be creditworthy. Small businesses will therefore typically have minimal levels of working capital. Large companies, on the other hand, will seek to maintain the growing momentum and will have big stocks and debts. They also have enormous turnover and profits. As a result, the large company typically needs a lot of working cash. Production strategy of the company - The working capital needs of the company may be influenced by the company's production strategy. There are often two extreme production policies: steady policy, where the need for working capital will be constant over the course of the term. The other is seasonal policy, when businesses expand production during periods of high sales, which causes a rise in the need for working capital. Firms' credit policies - Some businesses might only grant their consumers 15 days of credit, while others might extend it to 60 days. The company will need to use additional working capital to finance the debtors if the loan period is extended. A company's need for working capital is reduced when it has a credit policy that lasts for a shorter time period since more money will flow in and the company won't be as cash-starved. Firm growth and expansion - There will be a higher requirement to fund current assets and fixed assets when a company's directors decide to extend the business or when the business is developing naturally. The greatest need for working cash arises in these two scenarios. Stocks are purchased with the idea of selling them, and generous trade credit terms are offered. As a result, working capital will be more necessary in order to support the business over time.

External Variables

These are the outside variables over which managers have no control. These elements are mostly influenced by the environment in which a business operates. Economic and business seasonal cycle: The majority of businesses encounter swings in demand for their goods and services, sometimes as a result of seasonality. These operational inconsistencies have an impact on the working capital requirements. When the economy is booming, demand for the items will typically rise, leading to higher sales. As a result, the firm's investment in inventories, debtors, and short-term obligations will also rise. Additional investments could be made in useful fixed assets in this scenario. If there is a cash balance, the businesses will often use retained earnings or long-term debt to pay for these fixed asset investments. While a slowing of the economy will result in decreased sales, the company will attempt to cut their short-term borrowings as the amount of stocks and debtors will be little.

Changes in technology: If a company manufactures items, better technology might speed up the production process and shorten the cash operating cycle because finished goods could be sold sooner. However, a large capital outlay will be needed for the technological investment's first investment.

Taxation policy: A nation's tax laws will govern the amount of tax that must be paid. If the business environment is conducive to investment, there may be lower tax rates, which won't affect the company's capacity to pay taxes. This is not typically the case. Some taxation systems demand upfront tax payments, such as quarterly of a company's financial period. As a result, if the money is invested in debtors, the company might need to borrow some of the money needed to pay taxes. Working capital management is impacted by taxes.

In conclusion, the financial manager of the company needs to be aware of the internal and external variables that may affect the company's requirement for working capital. He or she should plan solutions to deal with these issues in order to manage working capital.

Sources of Working Capital

Sources of working capital can be divided into two types;

- Long Term Sources (Permanent Sources)
- Short Term Sources

Long Term Sources: The sources of fixed working capital are long-term and may be both internal and external. The retained earnings and depreciation are the more explicit internal sources. Undistributed profit is referred to as retained earnings, and it depends a lot on things like the tax rate and dividend schedule. Typically, this source is utilized for growth, but depending on how much is available, it may also be used as working capital. Depreciation is a component of production costs that is later recouped in cash. Depreciation has a better likelihood of being used as working capital for a comparatively longer period of time. For a longer period of time, retained earnings and depreciation funds can prove to be the finest sources of working capital. Normally, these are not accessible in the early stages of an organization.

The share capital, debentures, and long-term loans from financial institutions are specifically mentioned as external sources. One method to increase the equity base might be to issue shares. The likelihood that debentures will be issued successfully appears to be very slim. A number of investors may be drawn to the issue of bonds or debentures on the Indian capital market. Working capital can also be obtained through loans from commercial banks and financial institutions. A significant portion of the working capital may be secured externally in the form of loans from banks and other financial organizations. These loans could be either unsecured or secured. The commercial banks may offer overdraft credit to the units. Secured loans are those that are guaranteed by the pledging of particular securities, typically inventory.

Since the management is freed from the worry of having to repay the money on a set maturity date in the case of shares, they are more likely to prove advantageous than debentures.

Quick-Term Sources: Additionally, these sources could be internal or external. It is possible to refer to tax and dividend provisions as internal sources. Taxes that have been postponed in payment may be a source of flexible working capital. Taxes are not paid on a daily basis; instead, reserves show the accrued liability.

Internal short-term funds are produced in order to meet the demands of business operations in the form of unpaid wages, salaries, the owner's share of the company's profits, tax obligations, etc. Such short-term liability always has a lag between when it is incurred and when it is sold. The short-term sources give funding throughout this time. Also known as spontaneous sources of short-term credit, internal short-term finances are

Open account trade credit and short-term borrowing are two categories of external short-term funding sources. Trade credit is only available for a brief time until it is ultimately entirely liquidated at any given moment during the year. With the exception of seasonal businesses, this is not true for all industries. One of the main sources of funding for inventory is trade credit, which is continuously renewed with the arrival of new goods. This form of credit has different lengths and amounts depending on the company. The conditions of trade credit are set up such that, wherever feasible, it is not used for other purposes; nonetheless, if a company does not take advantage of the offered discount, it is considerably more expensive than alternative options.

Bank credit, public deposits, and money obtained from various other sources, including the sale of commercial papers and the issuance of short-term promissory notes, are all examples of short-term borrowings. Bank provides short-term financing for the business unit.

Working capital can take on many different forms, including (a) managing cash credit and (b) discounting bills. Public deposits are often allowed for a set length of time, after which they must be repaid in full if they are not renewed. Due to the numerous limitations set by the government, they cannot be obtained indefinitely. The majority of short-term loans, however, are made to banks, primarily through cash credit arrangements. A company should make the most of unforeseen financial streams.

Components of Working Capital

The main three components of working capital are as under:

- Cash
- Receivable
- Inventory

Cash

Since cash is what keeps a business operating, it is essential to working capital. The common purchasing power exchange medium is cash. It contains the firm's holdings of coins, money, chaques, and bank account balance. Near monetary goods are occasionally also included. Cash is a very liquid commodity that is crucial to the continual operation of the organization. Raw material purchases and payment of obligations to the business both demand cash. In other words, money is the fundamental input required to keep a business operating continuously. The availability of cash has a major impact on a company's ability to pay. As a result, money in a company might be compared to the blood that provides an organism life and vigor. Similar to how money gives a corporate concern life, vitality, profitability, and solvency.

In the case of credit sales, cash is transformed into raw materials, which are then transformed into works-in-progress, works-in-progress, finished items, and debtors, who are then transformed into cash. If a corporation doesn't have enough liquidity, it could wind up paying a price that results in the company being liquidated. However, having too much cash might be expensive because it doesn't provide any income. Therefore, effective cash management is required to prevent both situations of excessive and insufficient liquidity.

Motives for Holding Cash

Despite the fact that cash does not generate significant profits for the business, a firm still keeps cash on hand. Three justifications have been put forth for why people keep cash on hand. The following are these motivations: Transactions that are both cautious and speculative. By putting less focus on people, we may utilize these three categories to describe the reasons why businesses hoard cash.

1. Transaction Motive: This refers to keeping cash on hand to cover both daily expenses and payments for things like purchases. dividends, taxes, and wages that come up naturally in business.

2. Speculative Motive: To profit from fleeting possibilities, such as a sharp drop in the cost of raw materials, and to speculate on changes in interest rates, etc.

3. Precautionary Motive: A business must keep cash on hand for uses that are unforeseen and irrational. For instance, flooding, strikes, paying bills before they are due, a spike in the price of raw materials, an unanticipated slowdown in the collection of receivables, etc.

Receivables or Debtors

The second crucial element of the overall working capital is debtors and receivables. Businesses have the option of selling their products or services for cash or on credit. When products or services are sold for cash, payment is made right away, but when they are sold on credit, a debtor situation occurs. The only kind of receivable is a debtor. Risk and bad debts were engaged with debtors and receivables.

Debtors or receivables are asset accounts that represent the sums owing to the company as a result of sales of products or services made in the normal course of business, according to Hampton.

As a result, debtors and receivables are assets that represent claims made by the company against its clients. These are listed under headings like bills receivable, notes receivable, various debtors, trade debtors, book debt, account receivables, etc. on the asset side of the balance sheet.

These debtors are the outcome of giving customers access to credit facilities. Credit sales are occasionally utilized to entice clients and boost sales volume. Some clients want credit because they are unable to pay in full at the time of purchase. Therefore, the purpose of such a facility is to give the customers a reasonable amount of time to pay for the things they have purchased. These traits describe receivables and debtors.

1. **It entails risk:** Credit sales carry the risk of losing money, and since customers must pay for the items or services they purchase on credit in the future, there is also the chance that inflation will lower the real worth of their money.
2. **Based on current economic worth:** This statement is supported by current economic value. The economic worth of the items is transferred instantly at the time of sale, but the seller anticipates receiving an equivalent benefit in the future.
3. **It suggests the future:** It suggests the future. The buyer will be responsible for paying the value of the products or services at a later time.

The primary goals of keeping Debtors are;

- To increase the sales
- To increase in profit and
- To make capable for facing competition.

Debtors and receivables are not the company's cost-free asset. It comes with a variety of prices. The cost of receivables rises when they are managed poorly, but expenses fall when they are managed effectively. Receivables are related with the following costs:

1. Opportunity cost: Due to the time lag between the sale of goods to customers and the customers' payment, the company's financial resources are stuck in receivables. if such a sum is not put against the accounts receivable. It might have been used in other ways to generate cash. Opportunity cost refers to the income lost as a result of investing in receivables.
2. Administrative expenses: In order to keep track of credit customers, a business must pay a variety of expenses. These expenses include the wages paid to the staff members responsible for keeping track of credit sales and payments, as well as the cost of finding out a potential customer's creditworthiness.
3. Collection expenses: These expenses come from consumers who owe money on a credit basis. If a customer doesn't pay on time, we must write a letter of reminder, send telegrams or fax messages, occasionally dispatch a person, and occasionally we must incur legal fees if the debtor disputes their obligation to pay.
4. Defaulting costs: Credit is typically issued following a careful examination of the clients' financial situation and credit worthiness. Even so, there are situations when clients are unable to pay and the company may not be able to collect the past-due amounts from them. Since the amounts owed will not be recovered in the future, these obligations are considered bad debts and must be written off as such. Even though the company has adequate insurance against bad debts, the cost will rise if credit sales increase proportionately to cash sales.

Inventory

Inventory makes up the third part of working capital. The factory is like a very large kitchen that needs hundreds or thousands of different ingredients to produce various goods. The stock of raw materials, commodities in progress, finished goods, and other consumable stores are some examples of such items. The majority of a corporate organization's present assets are made up of inventory. A delicate topic in working capital management is stock cost.

Various Inventory Types

The following types of inventories;

1. Raw material: In a manufacturing company, raw materials are consumable items that have not yet been committed to production. They could include essential raw materials, supplies, and spare parts. Like iron ore in the steel sector or groundnuts or oil seeds in the oil industry.

2. Work-in-process: Materials utilized in the production process but not yet transformed into the finished goods are included in work-in-process inventories.

3. Finished goods: Products that have been fully manufactured and are ready for sale are included in finished goods inventories. It's necessary for efficient marketing operations. As a result, inventories connect the production and consumption of products.

A firm's amount of the three different types of inventories relies on the nature of its operation. A manufacturing company will have far higher levels of all three types of stocks than a retail or wholesale company, which will have much higher levels of finished goods and inventories but no raw materials or work-in-progress inventories. Large heavy engineering firms develop items with lengthy manufacturing cycles, therefore they maintain enormous inventories. Contrarily, a company that sells consumer goods won't have big inventories due to its quick turnover and short production cycle.

Companies also retain a fourth category of supplies in their inventory. Supplies include things like oil, fuel, light bulbs, and cleaning supplies for offices and factories (soap, brooms, etc.). These materials are not used right away in the manufacturing process. Typically, these items make up a modest portion of the entire inventory and don't require a big financial commitment. Consequently, it may not be possible for them to maintain a sophisticated inventory control system.

Keeping Inventories Necessary

Only when the businesses have inventories does the issue of managing them arise. The corporation must spend money on transportation and storage since maintaining various sorts of inventories ties up the company's cash. Despite this, all businesses maintain sufficient stockpiles. Holding inventory serves a variety of objectives, some of which are listed below.

1) To guarantee production: Without a sufficient supply of raw materials, production would be hindered. A business cannot simply obtain raw materials anytime they are required. Between placing an order and getting the products, there is a delay. Due to strikes, transportation problems, disruptions, and material shortages, it can occasionally be challenging to get raw materials. Therefore, a company needs to keep a sufficient amount of raw materials on hand to ensure a steady supply to the facility and ongoing output.

2) Getting a quantity discount: A business can benefit from trade discounts by placing large orders with suppliers. If a company orders twice or three times as much as it typically needs, suppliers typically provide a significantly lower price. The cost of storing stocks and the discount that is anticipated to be obtained must be kept in a correct ratio.

3) Lower order costs: Typing, checking, and mailing forms adds to the cost of each order. Goods must be acknowledged, examined, and counted when they arrive. Before sending the invoice to the accounting department to be paid to the supplier, it must be compared to the products. If the company places a few larger orders rather than many little ones, the expenses that vary with each orders can be decreased.

4) Full capacity utilization: The company must also keep enough supply of raw materials to utilise its unused production capacity. Owing to the fact that some cost components are intended for production capacity, if the production capacity is not being used to its maximum potential due to a lack of raw materials, the cost of production will increase. Partial capacity utilization does not lead to a reduction in these expenses. Therefore, maintaining an appropriate inventory is necessary to safeguard the company against such losses.

5) To maintain the flow of sales: While timely delivery is crucial for customer satisfaction, it is not always possible to create items as soon as an order is received. Maintaining a sufficient stock of finished items is crucial for on-time delivery in order to satisfy consumers with the prompt delivery of their purchased goods. The necessity of continuing production and sales is often referred to as a transaction motive.

6) Precautionary motive: Holding inventories is necessary to protect against the possibility of unforeseen changes in supply and demand dynamics as well as other factors. The chance cannot be taken advantage of even though the demand for finished items and their pricing are increasing. in order to take advantage of such a chance. It is necessary to keep a specific quantity of finished goods on hand.

7) Speculative motive: A speculative motive is the intention to profit from favorable price movements. It seeks to profit from changes in price. The stock level changes in accordance with the fluctuating price scenario. If raw material prices are predicted to grow in the near future, a bigger quantity of stock may be kept on hand.

Current obligations

It is an additional crucial element of operating capital;

(1) Present-day business debtors: These debts can be paid off in whole within a year or less in cash. This liability acts as a short-term source of funding up until the payment is due.

(2) Current provision: These are obligations that arise in the regular course of business, such as taxes, dividends, interest, etc., and are due for payment soon.

(3) Short-term loans

CONCLUSION

Working Capital refers to a firm's investment in short- term assets. It refers to all aspects of current assets and current liabilities. Efficient working capital needed to balance liquidity and profitability and to maintain sufficient liquid assets to provide funds to pay off obligations as when they arise, without loss goodwill and affecting the day to day operation of business, Working capital management studies the ways to optimise investment in current assets, to improve return on capital employed. The basic principle of working capital management is that, the permanent currents to be financed from long-term sources and temporary fluctuations in current assets to be financed by raising short-term funds.

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