

# SIGNIFICANCE OF WORKING CAPITAL

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# IMPORTANCE OF ADEQUATE WORKING CAPITAL

Working capital is the life blood and nerve centre of a business . Just as circulation of blood is essential in the human body for maintain life, working capital to maintain the smooth running of a business. The main advantages of maintaining adequate amount of working capital are as follows:



- **Solvency of the business:**

Adequate amount of working capital helps in maintaining solvency of the business by providing uninterrupted flow of production.

- **Good will:**

Sufficient working capital enables a business concern to make prompt payments and hence helps in creating and maintaining goodwill.



- **Regular supply of Raw material:**

Sufficient working capital ensures regular supply of raw materials and continuous production.

- **Regular payment of salaries, wages & other day commitments:**

A company which has ample working capital can make regular payment of salaries, wages and other day-to-day commitments which raises the morale of its employees., increase their efficiency, reduces wastage and cost and enhances production and profits.



- **Quick & regular return on Investment:**  
Every investor wants a quick and regular return on his investments. Sufficiency of working capital enables a concern to pay quick and regular dividends to investors as there may not much pressure to plough back profits. This gain confidence of its investors and creates a favorable market to raise additional funds.
- **Cash discount:**  
Adequate amount of working capital also enables a concern to avail cash discount on the purchases and hence it reduces costs.



- **Easy loans:**

A concern having adequate amount of working capital, having solvency and good credit standing can arrange loans from banks and others on easy and favorable term.

- **Ability to face crisis:**

Sufficient working capital enables a concern to face business crisis in emergencies such as depression because during such periods, generally, there is much pressure on working capital.



- **Exploitation of favorable market conditions:**

Only concern with adequate working capital can exploit favorable conditions such as purchasing its requirements in bulk when the prices are lower and by holding its inventories for higher prices.



# EXCESS OR INADEQUATE WORKING CAPITAL

## **Disadvantage of redundant or excessive working capital**

- ❖ When there is a redundant working capital, it may lead to unnecessary purchasing and accumulation of inventories causing more chances of theft, waste and losses.
- ❖ Excessive working capital means idle funds which earn no profits for the business and hence the business cannot earn a proper rate on its investments.
- ❖ Excessive working capital implies excessive debtors and defective credit policies which may cause higher incidence of bad debts.



- ❖ When there is excessive working capital, relations with banks and other financial institution may not be maintained.
- ❖ Due to low rate of return on investments, the value of share may also fall.
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- ❖ The redundant working capital gives rise to speculative transactions.
- ❖ It may results into overall inefficiency in the organization.



## **Disadvantage or danger of inadequate working capital**

- ❖ A concern which has inadequate working capital cannot pay its short term liabilities in time. Thus, it will lose its reputation and shall not be able to get good credit facilities.
- ❖ It cannot buy its requirements in bulk and cannot avail of discounts, etc.
- ❖ It become difficult for the firm to exploit favorable market conditions and undertake profitable projects due to lack of working capital.



- ❖ The firm cannot pay day-to-day expenses of its operations and it creates inefficiencies, increases costs and reduces the profits of the business.
- ❖ It becomes impossible to utilize the fixed assets due to non-availabilities of liquid funds.
- ❖ The rate of return on investments also falls with the shortage of working capital.



# THE NEED OR OBJECTS OF WORKING CAPITAL

- For the purchase of raw materials, components and spares.
- To pay wages and salaries.
- To incur day-to-day expenses and overhead costs such as fuel, power and office expenses, etc.
- To meet the selling costs as packing, advertising, etc.
- To provide credit facilities to the customers.
- To maintain their inventories of raw material, work-in-progress, stores and spares and finished goods.