WORKING CAPITAL

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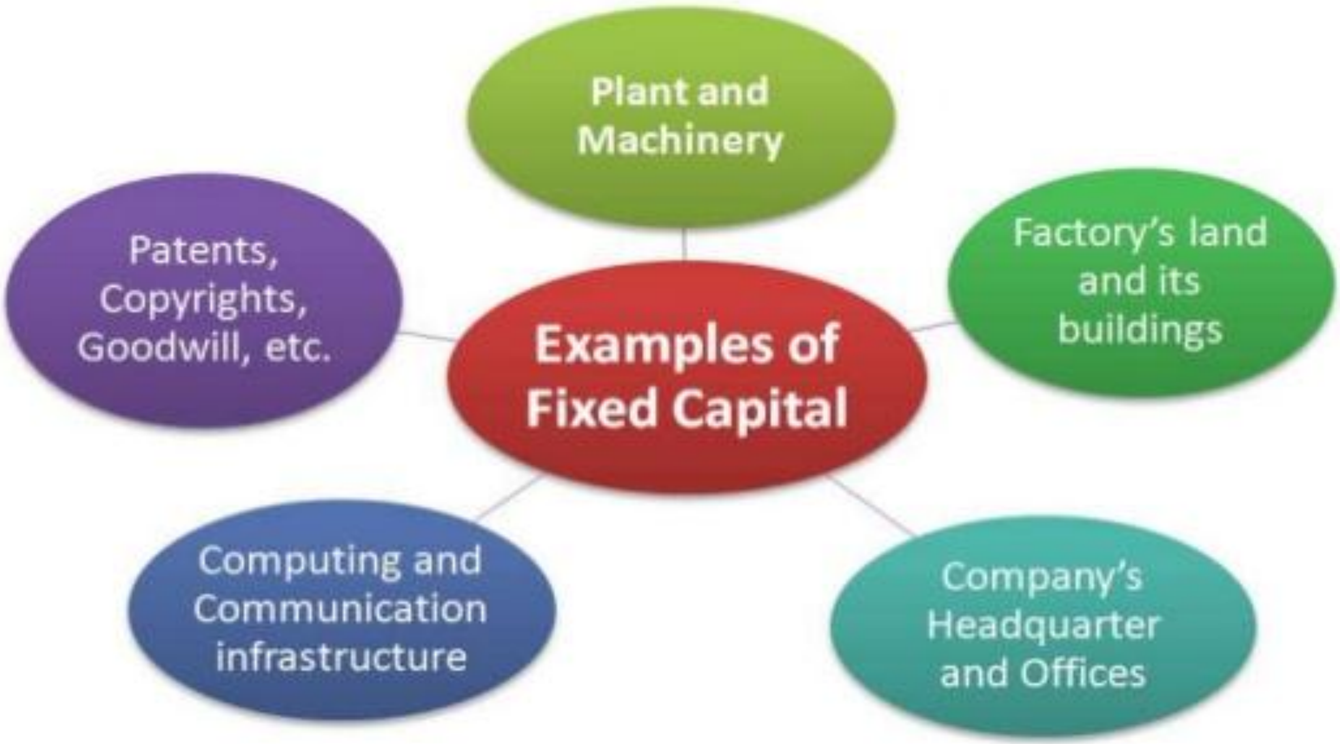
Types of Capital

Two types of Capital are needed in the business enterprise –

- Fixed Capital
- Working Capital

Fixed Capital



WORKING CAPITAL

- Capital is also needed for short-term purposes, i.e. meeting day to day operations.
- Capital invested for this purpose is known as
  - Current Capital OR Working Capital

TWO CONCEPTS OF WORKING CAPITAL

- Gross Working Capital Concept- Quantitative Aspect,
- Net Working Capital Concept- Qualitative Aspect.

Gross Working Capital concept

Gross Working Capital is also known as‘Current Capital.

Valid reasons for Gross Working Capital

- Current Assets, Whatever may be the sources of acquisition, are used in activities relating to day-to-day operations and their forms keep on changing. Therefore, they should be considered as Working Capital.

Net Working Capital concept

According to this concept Current Assets minus Current Liabilities is known as Working Capital.

W.C. = C.A.- C.L.

Positive W.C.= C.A.> C.L. (company position is sound)

AND

Negative W.C. = C.A.< C.L. (it indicates financial crisis)

Thus, the concept lays emphasis on qualitative aspect which indicates the liquidity position of the concern.

Valid Reasons for net Working Capital

- The material thing in the long run is the surplus of current assets over current liabilities.

Components of Working Capital

Working Capital as per Net Concept has two components-

1. Current Assets and,
2. Current Liabilities.

CURRENT ASSETS

Assets which can easily be converted into cash in the normal course of the business are known as current assets. These assets may include:-

1. Cash in hand or at Bank,
2. Debtors and Bills Receivable,
3. Stock or inventory of– raw materials, stores, and spares,

   -- Works in Progress,

   -- Finished Goods.
4. Advance payments towards expenses, purchases and other short term advances.
5. Temporary investment of surplus funds.
6. Accrued incomes.

One common characteristics of all the above items of current assets is that each component is swiftly transformed into other assets forms.

Current Liabilities

A part of the need for the funds to finance the current assets may be met from supply of goods on credit and deferment, on account of custom, usage of arrangement of payment of expenses.

CURRENT LIABILITIES INCLUDES -

Typical items of Current Liabilities are –

1. Trade creditors i.e. goods purchased on credit and Bills Payable.
2. Outstanding and Accrued expenses.
3. Short term borrowings.
4. Taxes and Dividend payable.
5. Advances received from parties against goods to be sold to them or as short term deposits.
6. Bank overdraft.
7. Outstanding liabilities currently payable.

KINDS OF WORKING CAPITAL

1. CORE, PERMANENT OR FIXED WORKING CAPITAL.

2. FLUCTUATING OR VARIABLE WORKING CAPITAL.

FIXED OR PERMANENT WORKING CAPITAL

- This is irreducible minimum amount necessary for maintaining the circulation of the current assets.
- This is permanently locked up in the business and therefore, it is referred to fixed or Permanent Working Capital.

Variable Working Capital

- Variable working capital refers to that portion of total working capital which is needed over and above fixed working capital.
- Such need for Variable Working Capital arise on account of:-

  - Seasonal changes,

  - Abnormal and Unanticipated conditions,

  - To face tough conditions in the market,

  - To meet contingencies like strikes and lockouts,

  - Special Advertising Campaigns or other Promotional activities,

Are financed by variable working capital

Current Assets to Fixed Assets Ratio

- The financial manager should determine the optimum level of current assets so that the wealth of shareholders is maximized.

- A firm needs fixed and current assets to support a particular level of output.

Current Assets to Fixed Assets Ratio

- A higher CA/FA ratio indicates a **conservative current assets policy.** It implies **greater liquidity and lower risk;**

- A lower CA/FA ratio means an **aggressive current assets policy,** it indicates **higher risk and poor liquidity**.