



Working Capital Management / Policy

Course Instructor: Punita Rajpurohit
Financial Management
University Elective

Topics

- +Overview
- +Current assets and current liabilities
- +Working capital
- +Factors affecting working capital requirements
- +Operating cycle and cash cycle
- +Cash requirement for working capital

Overview

- + Long term financial management – capital budgeting, capital structure, dividend
- + Short term financial management – working capital
- + Key difference: timing of cash
- + Long term: extended period of time
- + Short term: within a year or within operating cycle of firm
- + Working capital – decisions related to current assets and current liabilities

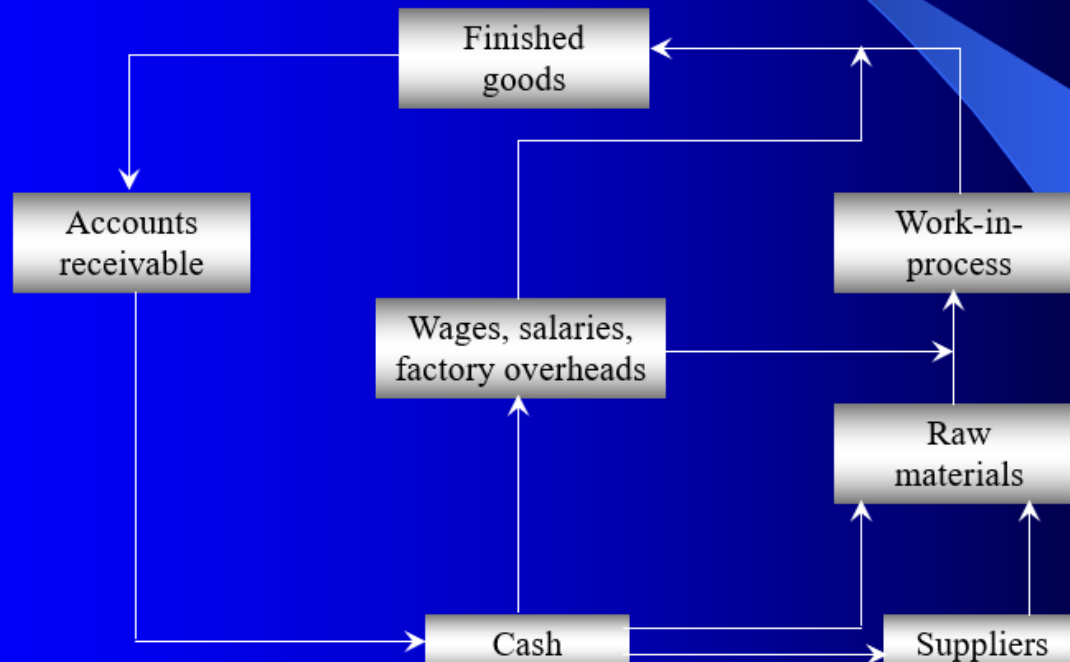
Current Assets

- +Inventories (raw materials, work in process and finished goods)
- +Trade debtors (receivables)
- +Loans and advances (given)
- +Cash and bank balances
- +Prepaid expenses

Characteristics of Current Assets

- **Short life span**
- **Swift transformation into other asset forms**

Current Assets Cycle



Current Liabilities

- +Sundry creditors (payables)
- +Trade advances
- +Short term borrowings (commercial banks and others)
- +Provisions

Working Capital

- + Gross working capital = total current assets
- + Net working capital = current assets – current liabilities

Working Capital

- +Permanent working capital refers to **the level of current assets that have** to be maintained and are important for the firm to run its business regardless of the level of operations.
- +Temporary working capital refers to the working capital which is over & above the permanent working capital

Factors Affecting Working Capital Requirements

- + Nature of business
- + Seasonality of operations
- + Production policy
- + Market conditions
- + Conditions of supply

Working Capital Policy

Two important issues in working capital policy are:

- What should be the level of investment in current assets?
- What mix of long-term and short-term financing should the firm employ to support current assets?

Level of Current Assets

	<u>Flexible</u> <u>(Conservative)</u> <u>Policy</u>	<u>Restrictive</u> <u>(Aggressive)</u> <u>Policy</u>
Liquidity	High	Low
Inventories	Large	Small
Debtors	High	Low

A flexible policy results in fewer production stoppages, ensures quicker deliveries to customers, and stimulates sales .. but
HIGHER INVESTMENT IN CURRENT ASSETS (carrying cost)

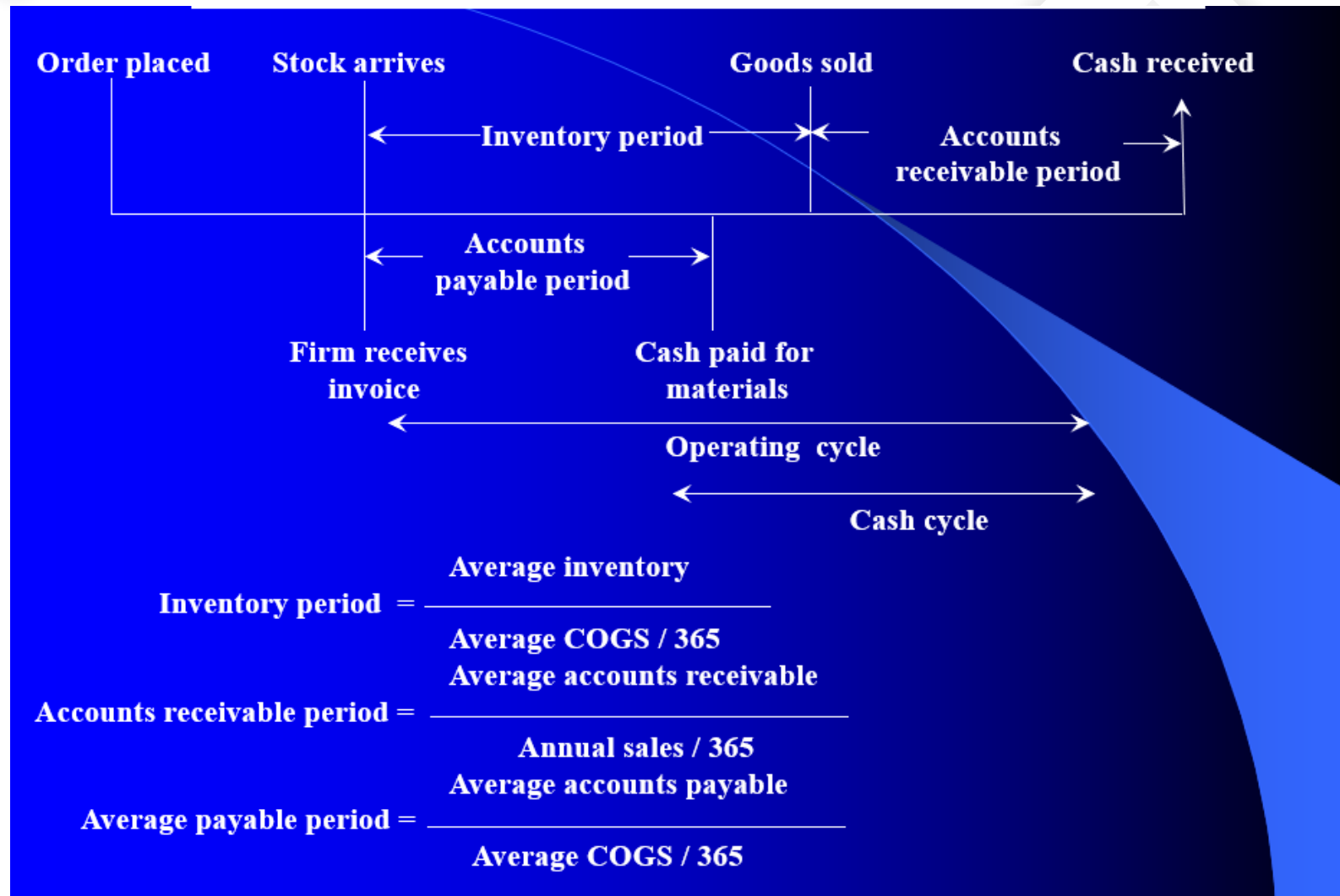
A restrictive policy leads to more production stoppages, delayed deliveries to customers, and lost sales ... but
LOWER INVESTMENT IN CURRENT ASSETS (shortage cost)

Optimal level of current assets involves a trade off between carrying costs and shortage costs

Current Assets Financing Policy

- +According to the matching principle, fixed assets and permanent current assets should be supported by long-term sources of finance whereas fluctuating current assets must be supported by short-term sources of finance.

Operating Cycle and Cash Cycle



Operating Cycle and Cash Cycle

- + Operating Cycle = inventory period + accounts receivable period
- + Cash cycle = Operating cycle – accounts payable period

Cash Requirement for Working Capital

- + How much cash do you need to meet the working capital need of your firm?
- + Step 1 : Estimate the cash cost of various current assets required by the firm.
- + Cash cost of current assets = value of current asset – profit element if any – non cash charges like depreciation
- + Step 2 : Deduct the spontaneous current liabilities from the cash cost of current assets
- + Spontaneous current liabilities = trade credit, accruals of wages/expenses