TOPICS
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Sources of Working Capital.

MEANING OF WORKING CAPITAL

What is Working Capital?

> *Working capital refers to the liquid funds available to a company for its daily operations. It is the difference between the company's* ***current assets*** *and* ***current liabilities*** *and can either be in the form of cash or bank deposits.*

Working capital has crucial importance because it helps a company meet its short-term financial obligations, such as rent, payroll, and utilities, thereby maintaining smooth business operations.

Positive working capital exists when a company's current assets exceed its current liabilities. It signifies that it has sufficient finances to meet its short-term obligations. If a company's current liabilities are exceeding its current assets, it has a negative working capital, indicating financial trouble.

Formula for Working Capital

To calculate the working capital or liquid funds of a business, one can use the below-mentioned formula:

Working Capital = Current Assets (Net of Depreciation) − Current Liabilities

Components of Working Capital

Working Capital components can be bifurcated into two major categories: Current Assets and Current Liabilities. Several elements come under each of these categories.

Current Assets

The components included under Current Assets are:

- **Cash and cash equivalents:** This refers to the money a company has on hand or in a bank account. It is easily accessible and comes into use to meet short-term financial obligations.
- **Accounts receivable:** This is the money that consumers owe a firm for products or services that have been supplied but have yet to be paid for. It is a short-term asset that represents money that the company expects to receive in the near future.
- **Inventory:** This refers to the goods a company has on hand and wants to sell to its customers. It can include raw materials, work-in-progress, and finished goods. Inventory is categorized as a current asset since it is expected to be turned into cash within a year.
- **Short-term investments:** The company has made these investments in securities or other **financial instruments**, which they can easily convert into cash within one year or less. Certificates of deposit, treasury, and **money market** funds are all examples of short-term investments.
- **Prepaid expenses:** These are expenses that a company has paid for in advance, for example, **insurance premiums**, rent, or subscriptions. They are considered current assets because the company will benefit from them within one year or less.

Current Liabilities

The components included under Current Liabilities are:

- **Accounts payable:** The amount of money owed by a corporation to its suppliers for products or services supplied but not yet paid for. It is a short-term obligation that indicates the money the company must pay in the near future.
- **Short-term loans:** These are loans that a company has taken out and is required to repay within one year or less. Lines of credit, trade credit, and commercial paper are all examples of short-term loans.
- **Accrued expenditures:** These are expenses incurred but not yet paid for by a corporation, such as salaries, taxes, and interest. They are classified as a liability since the corporation is legally obligated to pay them in the near future.
- **Current portion of long-term debt:** It is the portion of a company's long-term debt (e.g., a mortgage or bond) that is due in a year or less. It is a current liability since it represents the money that the company is obligated to pay in the near future.
- **Unearned revenue:** This is payment received in advance for goods or services the company has yet to deliver. It is a liability because the company has a legal obligation to deliver the goods or services in the near future.

Importance of Working Capital

Below is the importance of working capital:

1. Liquidity Management

Working capital guarantees that a business has adequate cash on hand to meet its short-term financial responsibilities, e.g., paying suppliers, employees, rent, and other costs., The financial team of an enterprise would plan for their funds by analyzing the expenses payable or to be incurred in the near future.

2. Cash Flow Management

Efficient management of working capital can help companies manage their cash flows better, which is critical to their survival and growth. Inappropriately planned day-to-day expenses may result in enterprise liquidity issues.

3. Decision-Making

Managing working capital enables businesses to make informed decisions pertaining to investments, sales, production, and pricing. The finance team can handle the funds efficiently by analyzing the requirement of funds for daily operations.

4. Business Growth

Having enough working capital helps a business in its growth and expansion. Working capital can facilitate a business to invest in novel projects, extend its operations, and capitalize on emerging growth opportunities. Contrarily, a lack of working capital in a business can hinder growth efforts and limit its ability to compete in the market.

5. Value Addition

Proper management of working capital helps the business pay its outstanding debts on time, creating **goodwill** and adding value in the market.

6. Short-Term Profit

A business can invest extra working capital to create short-term profits rather than keeping a heavy amount of funds as working capital, which may not be necessary.

7. Builds Creditworthiness and Work Culture

Timely payment of salaries and other day-to-day expenses creates a good working environment, which motivates employees to work harder and strengthens the company's culture. Furthermore, adequate working capital planning ensures timely payments to creditors, which improves the business's creditworthiness and makes it easier to obtain funds when required.

8. Good Reputation

Maintaining a good reputation in the market due to timely payments and fulfilling commitments helps the business easily obtain contracts and generate more business. A business with a good reputation can act as a guarantor for other enterprises, which can help it secure more contracts and generate more profits.

ESTIMATION OF WORKING CAPITAL

1. OPERATING CYCLE METHOD

Working Capital Management Example

Oliver Corporation is a company in the electronics business. They have the following details for the current year. Based on these details, calculate the net working capital of Oliver Industries, and what does this mean for the company's short-term financial health?

Current Assets

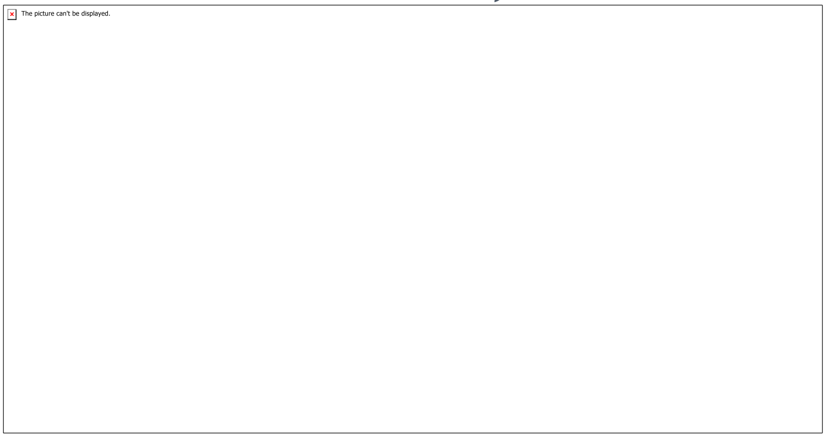
- Cash and cash equivalents: $35,000
- Accounts receivable: $25,000
- Inventory: $40,000
- Prepaid expenses: $5,000
- Total current assets: $105,000

Current Liabilities

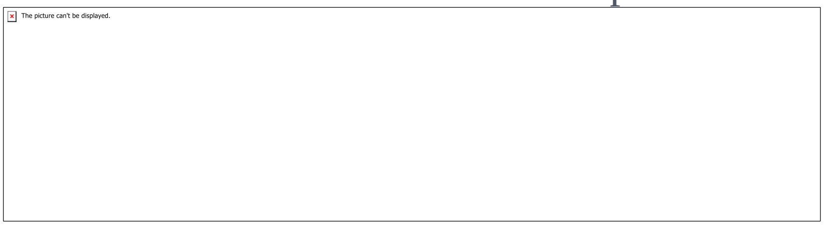
- Accounts payable: $20,000
- Accrued expenses: $10,000
- Short-term debt: $15,000
- Total current liabilities: $45,000

Solution:
Step 1: Calculate Current Assets
The current assets of Oliver Corporation are:

To calculate the total current assets, we add up these individual assets:
Total current assets = $35,000 + $25,000 + $40,000 + $5,000
Total current assets = $105,000

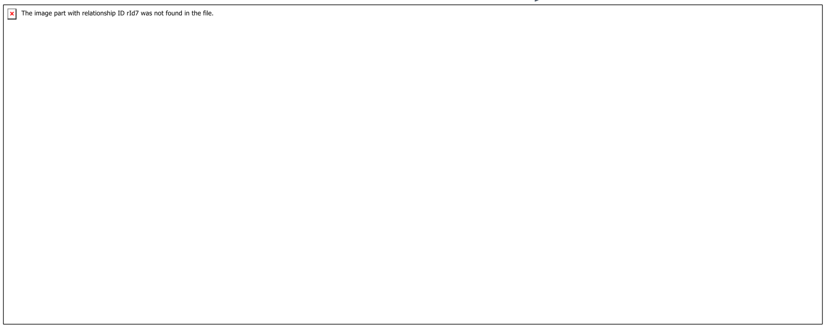


Step 2: Calculate Current Liabilities
The current liabilities of Oliver Corporation are:



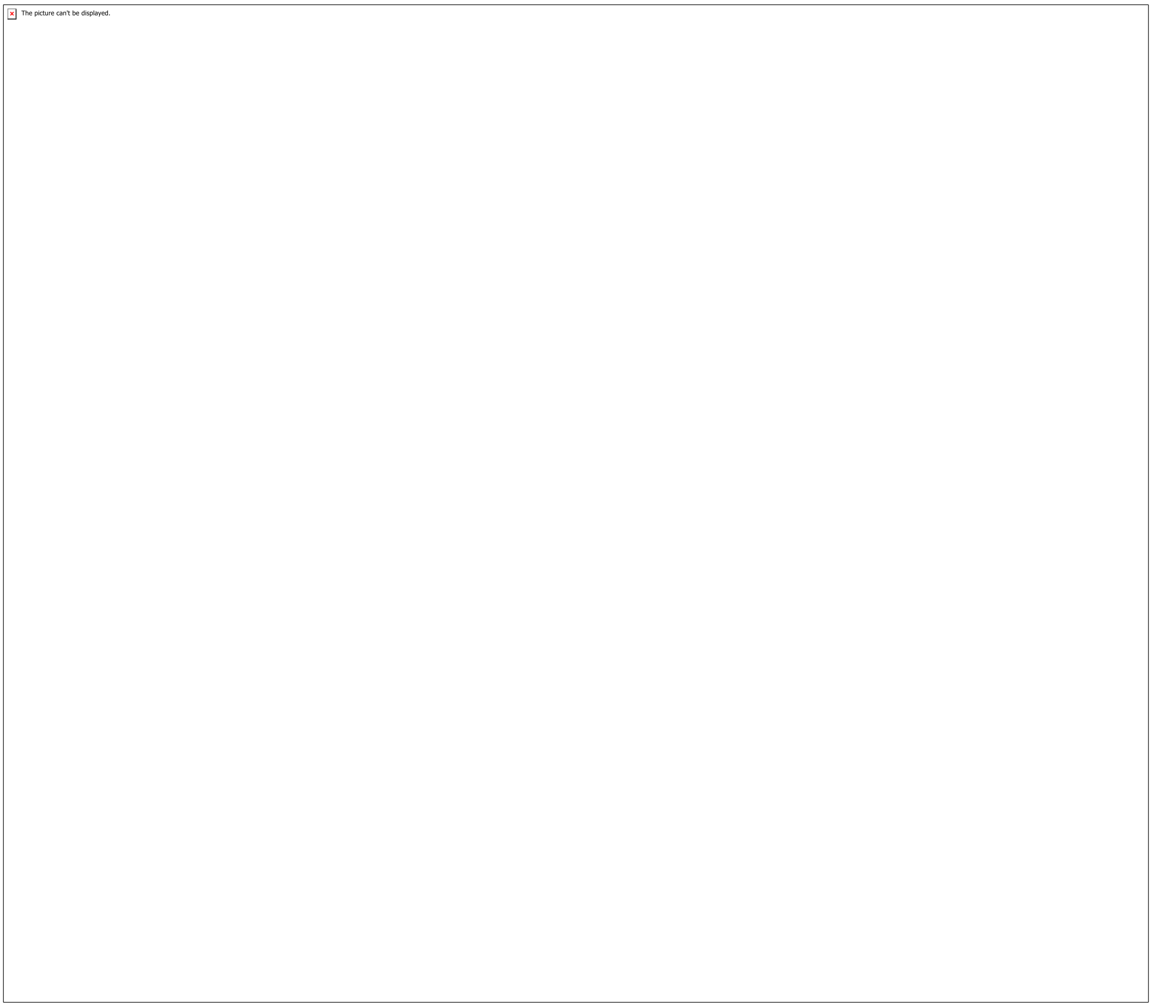
To calculate the total current liabilities, we add up these individual liabilities:
Total current liabilities = $20,000 + $10,000 + $15,00

Total current liabilities = $45,000



Step 3: Calculate Net Working Capital

In order to calculate the net working capital, we must subtract the total current liabilities from the total current assets:



Net working capital = Total current assets – Total current liabilities
= $105,000 − $45,000
= $60,000

Step 4: Result Analysis
The net working capital of Oliver Corporation is $60,000. This means the company has enough **short-term assets** to cover its short-term liabilities, which is a positive sign for its financial health. This also means that Oliver Corporation can easily pay off its current obligations and still have enough current assets to operate its business effectively.

Conclusion

Working capital has significant importance in achieving organizational goals and enhancing the profitability of a business. It is essential to calculate the working capital regularly, whether it is on a monthly, quarterly, or yearly basis. However, it is usually preferred to calculate the working capital requirement and availability every quarter to make informed decisions accordingly. Further, spare funds should be invested in a manner that maximizes returns. By effectively managing working capital, a business can improve its liquidity, cash flow, decision-making, growth prospects, reputation,

FACTORS AFFECTING WORKING CAPITAL

Determinants of Working Capital Requirement

Working capital is the lifeblood of a business, ensuring smooth operations and financial stability. Its requirement can vary based on multiple factors that can either increase or decrease the need for funds in daily operations. Let's delve into the factors determining working capital:

To Avail Unsecured business loans

Size of Business

Larger businesses usually require more working capital due to their expansive operations, diverse product lines, and vast customer base. Such entities might need significant funds on hand to manage their extensive transactions.

Nature of the Business

A manufacturing enterprise might have different working capital needs than a service-based business. The former often requires funds for inventory, while the latter might need more for payroll.

Scale of Operations

Companies operating globally typically have more intricate financial needs, warranting higher working capital. Diverse markets, varied currencies, and differing regulations come into play.

Sales Growth

Rapid sales growth, while positive, can strain resources. As sales volume increases, more working capital is needed to support production, delivery, and potentially longer receivables cycles.

Credit Policy

A lenient credit policy might attract more customers, but it can tie up funds in receivables. The longer the credit terms, the higher the working capital needed to bridge the gap until payment is received.

Business Cycles

During boom periods, businesses may need more working capital to cater to increased demand. Conversely, during downturns, they might have excess capital due to reduced sales.

Government Regulations

Stringent regulations can lead to increased working capital needs. For instance, specific industries might be required to maintain certain inventory levels, pushing up working capital requirements.

Creditworthiness

A company with a good credit history can easily obtain short-term credit, reducing the need for high working capital. Conversely, firms with poorer credit might need to maintain higher reserves.

SOURCES OF WORKING CAPITAL:

A company has various sources of working capital. Depending upon its condition and requirements, a company may use any of these sources of working capital. These sources may be spontaneous, short-term, or long-term.

Spontaneous Sources: The sources of capital created during normal business activity are called spontaneous sources of working capital. The amount and credit terms vary from industry to industry and depend on the business relationship between the buyer and seller. The main characteristic of spontaneous sources is 'zero-effort' and 'negligible cost' compared to traditional financing methods. The primary sources of spontaneous working capital are trade credit and outstanding expenses.

Short-term Sources: The sources of capital available to a business for less than one year are called short-term sources of working capital.

Long-term Sources: The sources of capital available to a business for a longer period, usually more than one year, are called long-term sources of working capital.

SHORT-TERM SOURCES OF WORKING CAPITAL

Short-term sources of capital may further be divided into two categories – Internal Sources and External Sources.

The short-term internal sources of working capital include provisions for tax and dividends. These are essentially current liabilities that cannot be delayed beyond a point. All companies make separate provisions for making these payments. These funds are available with the company until these payments are made. Hence, these are called the internal sources of working capital. However, this value is relatively small and thus not that significant.

On the other hand, the short-term external sources of working capital include capital from external agencies like

banks, NBFCs, or other financial entities. Some of the primary sources of short-term external sources of working capital are listed below:

Loans from Commercial Banks: Businesses, mostly MSMEs, can get loans from commercial banks with or without offering collateral security. There is no legal formality involved except creating a mortgage on the assets. Repayment can be made in parts or lump sum at the time of loan maturity. At times, banks may offer these loans on the personal guarantee of the directors of a country. They get these loans at concessional rates; hence it is a cheaper source of financing for them. However, the flip side is that getting this loan is a time-consuming process.

Public Deposits: Many companies find it easy and convenient to raise funds for meeting their short-term requirements from public deposits. In this process, the companies invite their employees, shareholders, and the general public to deposit their savings with the company. As per the Companies Act 1956, companies can advertise their requirements and raise money from the general public against issuing shares or debentures. The companies offer higher interest rates than bank deposits to attract the general public. The biggest of this source of financing is that it is simple and cheaper. However, its drawback is that it may not be available during the depression and financial **stringency.**

Trade Credit: Companies generally source raw materials and other items from suppliers on credit. The amount payable to these suppliers is also treated as a source of working capital. Usually, the suppliers grant their buyers a credit period of 3 to 6 months. Thus, they provide, in a way, short-term finance to the purchasing company. The availability of trade credit depends on various factors like the buyer’s reputation, financial position, business volume, and degree of competition, among others. However, when a business avails trade credit, it stands to lose the benefit of cash discount, which it would earn if they make the payment within 7 to 10 days of making the purchase. This loss of cash discount is treated as an implicit cost of trade credit.

Bill Discounting: Just as business buys goods on credit, they offer credit to their buyers. The credit period may vary from 30 days to 90 days and sometimes extends, even up to 180 days. During this period, the company funds get blocked, which is not good. Instead of waiting that long, sellers prefer to discount these bills with a bank or NBFC. The financial entity charges some amount as commission, called a 'discount', and makes the balance payment to the sellers. This discount compensates them for the time gap between disbursing and collecting the money on the maturity of the bill. This 'discount' charged by the bank is treated as the cost of raising funds through this method. Businesses widely use this method for raising short-term capital.

Bank Overdraft: Some banks offer their esteemed customers and current account holders a facility to withdraw a certain amount of money over and above the funds held by them in their current account with the bank. The bank charges interest on the amount overdrawn and the period it is withdrawn. The overdraft facility is also granted against securities. The bank sets this limit and is subject to revision anytime, depending upon the customer's creditworthiness.

Advances from Customers: One effortless way to raise funds to meet the short-term requirement is to ask customers for some payment in advance. This advance confirms the order and gives much-needed cash to the business. No interest is payable to the customer for this advance. Even if any business pays interest, it is very nominal. Hence, this is one of the cheapest sources of raising funds to meet companies' short-term working capital requirements. However, this is possible only when the customers do not choose the terms of the sellers.

LONG-TERM SOURCES OF WORKING CAPITAL

When the companies require funds for more than one year, it makes sense to go for long-term sources, as they are generally cheaper than short-term sources.

Like short-term sources, long-term sources may also be classified as internal and external sources. Retained profits and accumulated depreciation are internal sources wholly earned and owned by the company itself. These funds are available to a company without any direct cost.

The external sources of long-term sources of working capital are listed below:

Share Capital: The Company may raise funds by offering the prospective shareholders a stake in their business. These shares may be held by the general public, banks, financial institutions, or even other companies. The response depends on several factors, including the company's reputation, perceived profit potential, and general economic condition. In return, the company offers dividends to their shareholders, which along with the floating cost, is treated as the cost of sourcing. However, the company is not legally bound to pay this dividend. Also, no rule prescribes how much dividend is to be given. All this makes this a very cheap source of working capital. But, in reality, most companies do not use this for meeting their working capital needs.

Long-term Loans: Also called Working Capital Loans, these long-term loans may be temporary or long-term. The long-term here is generally 84 months (7 years) or more. This loan is not taken for buying long-term assets or investments and is used to provide working capital to meet a company's short-term operational needs. Experts advise using long-term sources for permanent needs and short-term sources for temporary working capital needs.

Debentures: Like shares, debentures also include generating money from the general public, financial institutions, and other companies. However, unlike shares, in the case of debentures, the company has to declare the interest they will pay to their lenders openly. The company is legally bound to pay the agreed interest. So, here, if the funds are unused or even if the company runs into losses, they have to pay the lenders.

ADVANTAGES AND DISADVANTAGES

Short-term working capital finance is taken from banks and other NBFCs generally has a higher interest rate than spontaneous and long-term sources. But they offer the businesses great time flexibility, due to which finance managers prefer this. They can take the funds as and when required and pay it whenever the cash position is better. This does not create a long-term liability for them. In the case of long-term sources, the business has to hold funds and even pay for them even when funds are not in use. This makes short-term loans cheaper.

SOURCES OF WORKING CAPITAL FOR SMALL BUSINESS

When it comes to a small business, there are several sources of working capital. One option is a working capital loan based on your age in business, creditworthiness, and other industry factors. Some of the main options are:

Vendor and trade sources: The credit period offered by sellers is the most common source of short-term working capital for MSMEs. However, even this may be a challenge for start-ups. This is because the suppliers may ask for an advance or at the most cash-on-delivery (COD). Once you establish some relationships with them, you can negotiate a credit period of 15 to 30 days, which gives you some time to convert your inventory into finished goods and ultimately into cash.

If you are looking for funds to purchase equipment, try and search vendors who offer financing or leasing as an option. While the interest rates may be high, it will significantly reduce the amount to be paid upfront. One more option is to offer your customers an ‘early bird discount’ if they pay before the usual credit period. Though you may have to give away a 2% discount, it would be much lesser than the cost of borrowing against a line of credit.

Working capital loans from traditional lenders: Banks and NBFCs offer the most affordable working capital loans if your business is eligible for them. For an SME, it’s crucial to develop a healthy business relationship with the loan officer at your bank. Your loan officer can advise you on what’s available and may help you with approval. Even if it’s a small amount, it makes sense to avail it. Timely repayment of this amount will help you open doors for bigger loans in the future. The overdraft facility is yet another tool to improve the working capital situation. Like traditional loans and lines of credit, overdraft agreements are negotiated in advance. Once signed, they enable you “borrow” money from the bank, as and when required, without any delay or kind of penalty. The bank charges interest on the amount withdrawn until it is paid back.