Question 1

Discuss the three strategies of working capital management along with diagrametic representation.

Answer:

There are mainly three types of working capital management strategies to choose the mix of long-term or short-term funds for financing the working capital requirements of a firm.

The three strategies are:

(i) Conservative strategy

(ii) Hedging strategy

(iii) Aggressive strategy

Conservative Strategy:

In this type of strategy along with the fixed assets, permanent current assets and part of temporary current assets are financed by long-term financing. Short-term financing is used to finance the remaining part of temporary current assets.

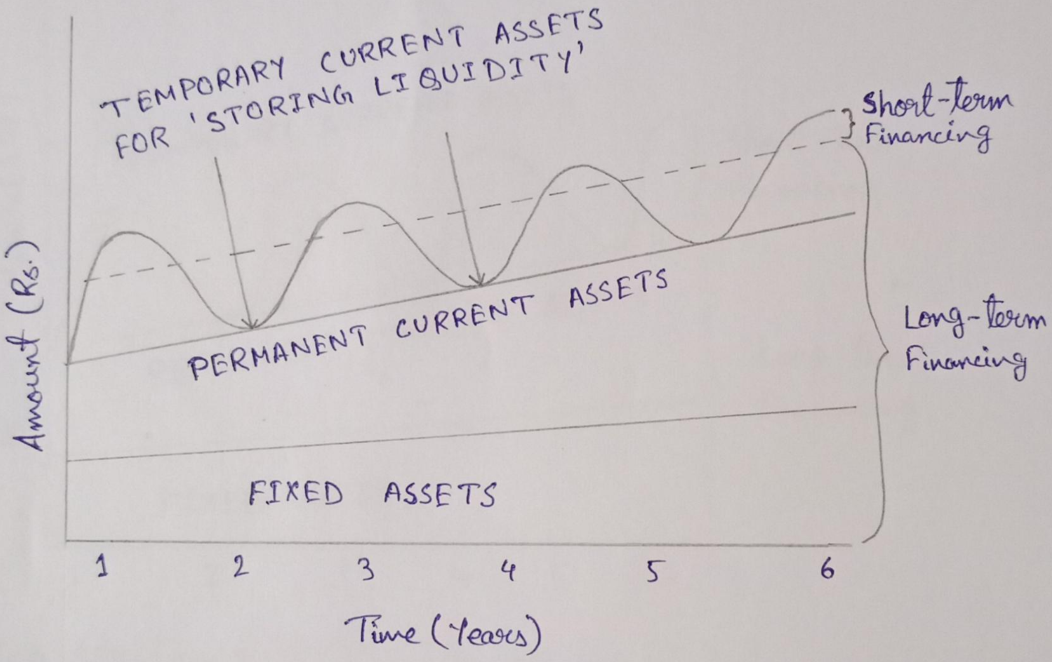
The risk profitability trade-off in this type of strategy is low risk and low profitability.

Here funds are applied as follows:

Long-term financing >> Fixed Assets + Permanent Current Assets + Part of Temporary Current Assets

Short-term financing >> Remaining part of Temporary Current Assets

This is depicted in the diagram below:



Hedging Strategy:

In this type of strategy each of the assets are financed with a debt instrument of almost the same maturity. It means if an asset is maturing after 30 days the payment of the debt which financed the assets should also have its due date of payment after 30 days.

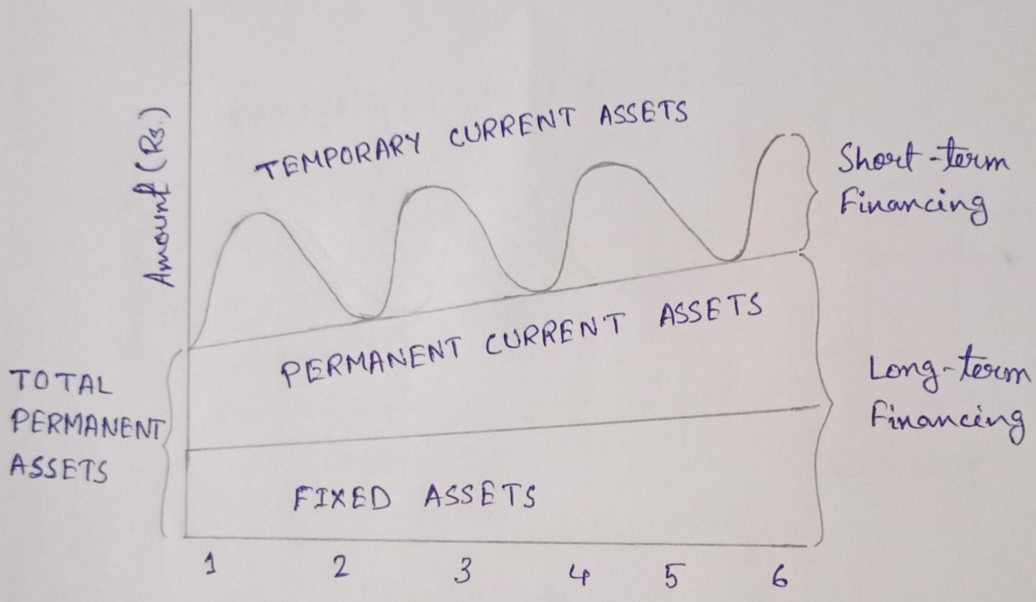
Here funds are applied as follows:

Long-term financing >> Fixed Assets + Permanent Current Assets

Short-term financing >> Temporary Current Assets

The risk profitability trade-off in this type of strategy is moderate risk and moderate profitability.

This is depicted in the diagram below:



Aggressive Strategy:

In this type of strategy long-term financing are used for financing fixed assets and a small portion of permanent current assets. Short-term financing is used to finance temporary current assets and major portion of permanent current assets.

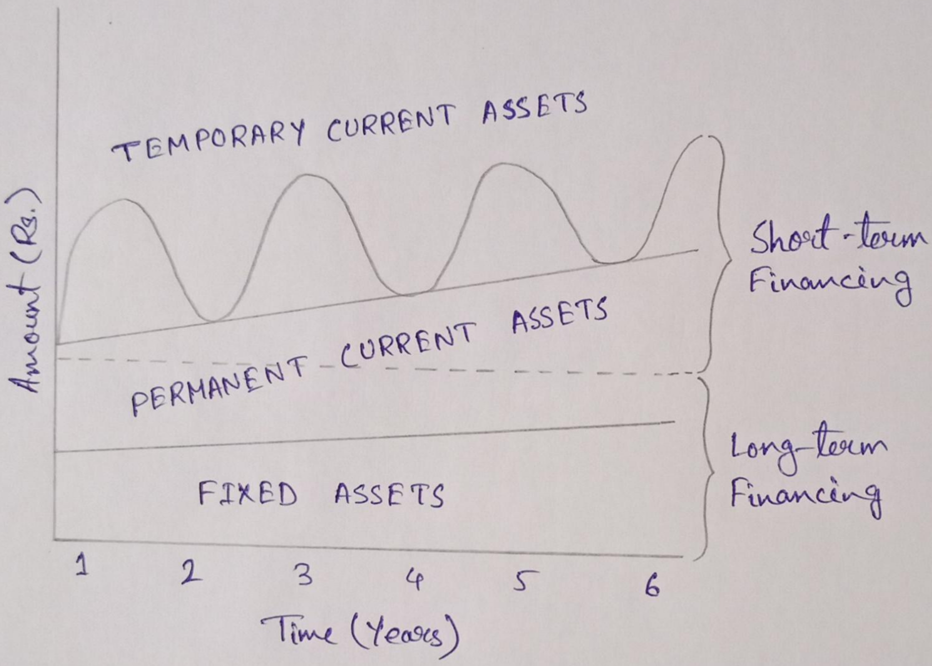
The risk profitability trade-off in this type of strategy is high risk and high profitability.

Here funds are applied as follows:

Long-term financing >> Fixed Assets + Part of Permanent Current Assets

Short-term financing >> Remaining part of Permanent Current Assets + Temporary Current Assets

This is depicted in the diagram below:



Question 2

Discuss the five factors influencing working capital requirements.

Answer:

The working capital needs of a firm are influenced by different factors. The important ones are:

(i) Nature of business
(ii) Seasonality of operations
(iii) Production policy
(iv) Market conditions and
(v) Conditions of supply

Nature of Business

The working capital requirement of a firm is related to the nature of its business.

For e.g., a service firm (electricity undertaking / transport corporation) which has a short operating cycle and which sells predominantly on cash basis has a modest working capital requirement.

However, a manufacturing concern (machine tools unit) which has a long operating cycle and which sells largely on credit has a substantial working capital requirement.

Seasonality of Operations

Firms which have marked seasonality in their operations usually have highly fluctuating working capital requirements.

For example, in case of a company selling ceiling fans the sale of ceiling fans reaches peak during summer months and drops sharply during the winter period. The working capital requirement of such a company increases during summer months and decreases considerably during winter months.

Production Policy

Companies which have pronounced seasonal fluctuations in their sales (like the company producing ceiling fans stated above) pursues a production policy in order to reduce the sharp variations in the working capital requirements.

For e.g., a company producing ceiling fans may maintain a steady production throughout the year rather than intensify the producing during the peak season. Such a policy will help to dampen the flactuations in working capital requirements.

Market Conditions

The degree of competition in the market place has an important bearing on working capital needs of a company.

For e.g., when competition is more, a large inventory of finished goods is required to promptly serve customers who may not be ready to wait as other manufacturers may be ready to meet their needs.

Hence, working capital needs are high because of greater investments in finished goods inventory and accounts receivable.

If competition is weak a company can manage with a small inventory of finished goods as customers can be served with some delay.

In addition, in such a situation the company can insist on cash payments and avoid lock up of funds in accounts receivable.

Conditions of supply

The inventory of raw materials, spares and stores depends on the conditions of supply.

If the supply is prompt and adequate a company can manage with a small inventory.

However, if the supply is unpredictable and scant then the company in order to ensure continuity of production will have to acquire stocks as and when available as well as maintain large inventory.

A similar policy will be followed for companies where the raw materials are available seasonally and production is carried out throughout the year.