

Determinates of Working Capital

WORKING CAPITAL



In addition to the working parameters peculiar to a company that determine the quantum of required working capital, the following factors are also equally important:

1. Nature of Business

A company's working capital requirements are directly related to the types of business operations. Generally speaking, trading and financial firms require relatively large amounts of working capital, public utilities comparatively small amounts, whereas manufacturing concerns stand between these two extremes, their needs depending upon the character of industry of which they are a part.

2. Size of Business Unit

It is an important factor for determining the proportion of working capital. The general principle in this connection is that the bigger size of the unit, the more will be the amount of working capital required. But it is quite likely that the bigger sized business unit, i.e. a consumers' goods industry may require a large amount of fixed capital than working capital.

3. Growth and Expansion of Business

As a company expands, it is logical to expect that larger amount of working capital will be required though It Is difficult to draw up firm rules for the relationship between the growth in the volume of a company's business and the growth of its working capital.

4. Production Policies

Depending upon the kind of items manufactured, a company is able to offset the effect off-seasonal fluctuations upon working capital by adjusting its production schedules. The choice rests between varying output in order to adjust inventories to seasonal requirements and maintaining a steady rate of production and permitting stocks of inventories to build up during off-season periods. It will thus be obvious that a level production plan would involve a higher investment in working capital.

5. Manufacturing Process

If the manufacturing process in an industry entails a longer period because of its complex character, more working capital is required to finance that process. The longer it takes to make an approach and the greater its cost, the larger the Inventory tied up In Its manufacture and, therefore, higher the amount of working capital.

6. Turnover of Circulating Capital

The speed with which the circulating capital completes its round I.e., conversion of cash into inventory of raw material Into Inventory of finished goods. Inventory of finished goods into book debts or accounts receivables and book debt into cash account, plays an important and decisive role in judging the adequacy of working capital.

7. Credit Policy

A business unit, making purchase on credit basis and selling its finished products on cash basis, will require lower amount of working capital than a concern having no credit facilities and which may further be forced to grant credit to its customers.

8. Seasonal Variations

A number of industries manufactures and sell goods only during seasons. For example, the sugar industry produces practically all the sugar between December and April and the woolen textile industry makes its sales generally during winter.

9. Requirements of Cash

The need to have cash in hand to meet various requirements e.g., payment of salaries, rents, rates etc., has an effect on the working capital. The more the cash requirements the higher will be working capital needs of the company and vice versa.

10. Business Cycle Fluctuations

In addition, to the long-term secular trend, the recurring movements of the business cycle influence working capital changes. In periods of the boom and depression, more working capital is needed than during the other stages of cyclical fluctuations. For arriving at a satisfactory working capital position in time of prosperity the firm should conserve current capital by avoiding wasteful expenditure. When inflationary pressure has been created during a period of emergency like a war, unnecessary hoarding should be avoided because such periods of rising prices are temporary. During a period of recession, production is disturbed due to scarcity of materials. The current assets should be converted into cash without creating new financial obligations by borrowing at a high rate of interest.

11. Terms of Purchase and Sales

A business unit, making purchases on credit basis and selling its finished products on cash basis, will require lower amount of working capital, on the contrary, a concern having no credit facilities and at the same time forced to grant credit to its customers may find itself in a tight position.

12. Dividend Policy

A desire to maintain an established dividend policy may affect the volume of working capital, or changes in working capital may bring about an adjustment of dividend policy. In either event, the relationship between dividend policy and working capital is well established and very few companies ever declare a dividend without giving due consideration to its effects on cash and their needs for cash.

13. Other Determinants

In addition to the above mentioned considerations there are also a number of other factors which affect the requirements of working capital. Some of them are given below:

- a) Degree of co-ordination between production and distribution policies.
- b) Specialization in the field of distribution.
- c) Import policy of the Government.
- d) Developments of means of transportation and communications.
- e) The hazards and contingencies inherent in the type of business.