ORIGINAL RESEARCH PAPER

Accountancy

COMPONENTS AND KINDS OF WORKING CAPITAL WITH IMPORTANCE OF ADEQUATE WORKING CAPITAL

KEY WORDS: Working Capital, Management, Components

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ABSTRACT

Working Capital refers to funds required to be invested in the business for a short period usually up to one year. It is also known as short-term capital or circulating capital. Working Capital may be regarded as the lifeblood of a business. Its effective provision can do much to ensure the success of a business. Its inefficient management can lead not only to loss of profit but also to the downfall of a business. A study of Working Capital is of major importance to internal and external analysis because of its close relationship with the current day-to-day operations of a business. Every business needs funds for two purpose. Long term funds are required to create production facilities through purchase of fixed assets, such as, plants, machineries, land, building etc.

- **WORKING CAPITAL :**

Any firm, from time to time, employs its short-term assets as well as short-term financing sources to carry out its day to day business. It is this management of such assets as well as liabilities which is described as Working Capital Management. Working Capital represents a company's ability to pay its current liabilities with its current assets. Working Capital is an important measure of financial health since creditors can measure a company's ability to pay off its debts within a year. Working Capital , also known as net working capital,is the difference between a company's current assets, such as cash, accounts receivable (debtors) and inventories (stock) of raw materials and finished goods, and its current liabilities, such as accounts payable (creditors).

- **HOW TO CALCULATE WORKING CAPITAL :**

Working Capital can be calculated by determining the current assets and the current liabilities of a company. Current assets include a company's liquid cash as well as other assets that can be converted to cash within one year or less. Some examples of current assets include money in checking accounts, inventories, supplies, equipment, and temporary investments. Current liabilities include all the expenses and debts that a company needs to pay within one year. Examples of current liabilities are account payable (creditors), dividends and income taxes owed.

- **CONCEPT OF WORKING CAPITAL:**

There are two concepts of Working Capital: Gross and Net.

The term gross working capital, also referred to as working capital, means the total current assets.

The term net working capital can be defined in two ways: (1) the most common definition of net working capital is difference between current assets and current liabilities and (2) alternate definition of net working capital is that portion of current assets which is financed with long-term funds.

The task of the financial manager in managing working capital efficiently is to ensure sufficient liquidity in the operations of the enterprise. The liquidity of a business firm is measured by its ability to satisfy short-term obligations as they become due. The three basic measures of a firm's overall liquidity are (1) Current Ratio, (2) Acid-test Ratio and (3) Net working capital.

Net Working Capital, as a measure of liquidity, is not very useful for comparing the performance of different firms, but it is quite useful for internal control. The Net Working Capital helps in comparing the liquidity of the same firm over time.

For purpose of Working Capital Management, therefore, Net Working Capital can be said to measure the liquidity of the firm. In other words, the goal of Working Capital Management is to manage the current asset and liabilities in such a way that an acceptable level of Net Working Capital is maintained.

- **WORKING CAPITAL VS. NET WORKING CAPITAL :**

Working Capital represents a company's overall liquidity and ability to meet short-term demands. However, net working capital is determined by removing the cash from the asset category and short-term debt from the liability side of the equation. Net working capital can be calculated as follows :

Net Working Capital = Current Assets (less cash) – Current Liabilities (less debt)
OR
Net Working Capital = Accounts Receivable + Inventory – Accounts Payable.

1. COMPONENTS OF WORKING CAPITAL :

The term working capital refers to the gross working capital and represents the amount of funds invested in current assets. Current assets are those assets which in the ordinary course of business can be converted into cash within a short period of normally one accounting year.

Example of current assets are :Cash and Bank Balance, Short term Loans and Advances, Bills Receivables, Sundry Debtors, Inventories (such as Raw materials, Work-in-progress, Finished goods) Prepaid Expenses, Accrued Incomes, Money receivable within 12 months In a narrow sense, the term working capital refers to the net working capital. Net working capital is the excess of current assets over current liabilities, or

Net Working Capital = Current Assets – Current Liabilities

Current liabilities are those liabilities which are intended to be paid in the ordinary course of business within a short period of normally one accounting year.

Examples of current liabilities are : Bills Payable, Sundry Creditors, Accounts Payable, Short-term Borrowings, Dividend Payable, Statutory Liabilities, Accrued or Outstanding Expenses, Bank Overdraft, Provident Fund Dues, Any other payment due within 12 months.

Nature of Working Capital :

The nature of working capital is described with the help of nature of operation cycle of the firm. The process of cash or operation cycle starts when a firm uses cash to purchase raw materials and pay for other manufacturing cost to produce goods. These goods are carried as inventory for some time till they are sold. When goods are sold either cash is received or accounts receivable, are credited. Account receivables are collected from debtors, this brings cash into firm. Thus, a cash cycle is complete, and a new process of a cash cycle starts over again. These processes are described as circulating nature of current assets. The speed of circulation of working capital or the turnover of current assets is an indicator of the degree of efficiency of the management. The faster the turnover, the higher the degree of efficiency.

Current assets are not only short-lived but also change their form and one type of assets can easily be converted into another, say, cash is converted into raw materials, raw materials into work-in-progress, work-in-progress into finished products, finished products into debtors, in case of credit sales or into cash. That is way they are also defined as circulating assets.

The goal of working capital management is to manage the firm's current assets and current liabilities in such a way that a satisfactory level of working capital is maintained. That is so because if the firm cannot maintain a satisfactory level of working, it is likely to become insolvent and may even be forced into bankruptcy. The current assets should be large enough to cover its current liabilities in order to ensure a reasonable margin of safety. Each of the current assets must be managed efficiently in order to maintain the liquidity of the firm while not keeping too high a level of any one of them. Each of the short-term sources of financing must be continuously managed to ensure that they are obtained and used in the best possible way. The interaction between current assest and current liabilities is, therefore, the main theme of the theory of working capital management.

2. KINDS OF WORKING CAPITAL :

The changes in current assets, in short and long terms, have led to the classification of working capital into two components:

(1) Permanent or Fixed Working Capital :

Permanent Working Capital is the minimum investment required in working capital irrespective of any fluctuation in business activity. Also known as fixed working capital, it is that level of net working capital below which it has never gone on any day in the financial year. The component represents the value of the current assets required on a continuing basis over the entire year, and for several years. Permanent working capital is the minimum amount of current assets which is needed to conduct a business even during the dullest season of the year. This minimum level of current assets is called Permanent or Fixed Working Capital as this part of capital is permanently blocked in current assets. This amount varies from year to year, depending upon the growth of a company and the stage of the business cycle in which it operates. It is the amount of funds required to produce the goods and services which are necessary to satisfy demand at a particular point. It represents the current assets which are required on a continuing basis over the entire year. It is maintained as the medium to carry on operations at any time. Permanent Working Capital has the following characteristics :

(1) It is classified on the basis of the tome factor
(2) It constantly change from one asset to another and continues to remain in the business process
(3) Its size increases with the growth of business operations.

The permanent working capital can further be classified as regular working capital and reserve working capital. Regular working capital is the minimum amount of working capital required to ensure circulation of current assets from cash to inventories, from inventories to receivables and from receivables to cash and so on. Reserve working capital is the excess amount over the requirement for regular working capital which may be provided for contingencies that may arise at unstated periods such as strikes, rise in prices, depression etc.

(2) Temporary or Variable Working Capital :

This components represents a certain amount of fluctuations in current assets during a short period. These fluctuations are increases or decreases and are generally cyclical in nature. Additional current assets are required at different time during the operating year. Variable working capital is the amount of additional current asset required for short period. The capital required to meet the seasonal needs of a firm is called seasonal working capital. For example, additional inventory will be required for meeting the demand during the peak selling periods, and receivables increase during the period of high sales. When the peak period is over variable working capital starts decreasing or very little during the normal period. It is temporarily invested in current assets and possesses the following characteristics :

(1) It is not always gainfully employed, though it may change from one asset to another, as permanent working capital does.
(2) It is particularly suited to business of a seasonal or cyclical nature.

3. IMPORTANCE OF ADEQUATE WORKING CAPITAL:

A business firm must maintain an adequate level of working capital in order to run its business smoothly. It is worthy to not that both excessive and inadequate working capital position are harmful. However, out of the two, inadequacy of working capital is more dangerous for a firm. Excessive working capital results in idle funds on which no profit is earned. Similarly insufficiency of working capital results in interruption of production. This will lead to inefficiencies, increase in costs and reduction in profits.

Working Capital is just like the heart of business. If it becomes weak, the business can hardly prosper and survive. No business can run successfully without an adequate amount of working capital. The following are a few advantages of adequate working capital in the business:

(1) **Cash Discount:** Adequate working capital enables a firm to avail cash discount facilities offered to it by the suppliers. The amount of cash discount reduces the cost of purchase.
(2) **Goodwill :** Adequate working capital enables a firm to make prompt payment. Making prompt payment is a base to create and maintain goodwill.
(3) **Ability to face crisis :** The provision of adequate working capital facilities to meet situation of crises and emergencies. It enables a business to withstand periods of depression smoothly.
(4) **Credit-wittiness :** it enables a firm to operate its business more efficiently because there is no delay in getting loans from banks and others on easy and favourable terms.
(5) **Regular supply of raw materials :** It permits the carrying of inventories at a level that would enable a business to sever satisfactorily the needs of its customers. That is it ensures regular supply of raw materials and continues production.