FACULTY OF COMMERCE AND MANAGEMENT

COURSE: B.COM V SEM..

SUBJECT: FUNDAMENTAL OF FINANCIAL MANAGEMENT

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LECTURE: 33

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LECTURE-33

"Working capital is the life-blood and controlling nerve centre of a business". No business can be successfully run without an adequate amount of working capital. To avoid the shortage of working capital at once, an estimate of working capital requirements should be made in advance so that arrangements can be made to procure adequate working capital.

Methods of Estimating Working Capital Requirements

The following method are usually followed in forecasting working capital requirements of a firm

1. Percentage of Sales Method
2. Regression Analysis Method
3. Cash Forecasting Method
4. Operating Cycle Method
5. Projected Balance Sheet Method

1. Percentage of Sales Method: This method of estimating working capital requirements is based in the assumption that the level of working capital for any firm is directly related to it sales value. If past experience indicates a stable relationship between the amount of sales and working capital, then this basis may be used to determine the requirements of working capital for future period. Thus, if sales for the year 2007 amounted to Rs.30,00,000 and working capital required was Rs.60,00,000; the requirement of working capital for the year 2008 on an estimated sales liabilities can also be estimated on the basis of the past experience as a percentage of sales. This method is simple to understand and easy to operate but it cannot be applied in all cases because the direct relationship between sales and working capital may not be established.

2. Regression Analysis Method (Average Relationship between Sales and Working Capital): This method of forecasting working capital requirements is based upon the statistical technique of estimating or predicting the unknown value of a dependent variable from the known value of an independent variable. It is the measure of the average relationship between two or more variables, i.e., sales and working capital, in terms of the original units of the data.

The relationships between sales and working capital is represented by the equation:

$$Y = a + bx$$

Where, y = Working Capital (dependent variable)

a = Intercept of the least square , b = Slope of the regression line

x = Sales (independent variable)