FACULTY OF COMMERCE AND MANAGEMENT

COURSE: MBA III SEM..

SUBJECT: WORKING CAPITAL MANAGEMENT

SUBJECT CODE: MBAFM01

LECTURE: 4

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LECTURE-4

FACTORS DETERMINING THE WORKING CAPITAL REQUIREMENTS

The Working capital requirements of a concern depend upon a large number of factors such as nature and size of business, the character of their operations, the length of production cycles, the rate of stock turnover and the state of economic situation. It is not possible to rank them because all such factors are of different importance and the influence of individual factors changes for a firm over time. However the following are important factors generally influencing the working capital requirements.

1. **Nature or Character of Business**: The Working capital requirements of a firm basically depend upon the nature of its business. Public utility undertakings like Electricity. Water supply and Railways need very limited working capital because they offer cash sales only and supply services, not products, and as such no funds are tied up in inventories and receivables. On the other hand trading and financial firms require less investment in fixed assets but have to invest large amount in current assets like inventories, receivables and cash; as such they need large amount of working capital. The manufacturing undertakings also require sizable working capital along with fixed investments. Generally speaking it may be said that public utility undertaking require small amount of working capital, trading and financial firms require relatively very large amount, whereas manufacturing undertakings require sizable working capital between these two extremes.
2. **Size Business/Scale of Operations:** The working capital requirements of a concern are directly influenced by the size of its business which may be measured in terms of scale of operations. Greater the size of business unit, generally larger will be the requirements of working capital. However, in some cases even a smaller concern may need more working capital due to high overhead charges, inefficient use of available resources and other economic disadvantages of small size.

3. **Production Policy:** In certain industries the demand is subject to wide fluctuations due to seasonal variations. The requirements of working

capital in such cases depend upon the production policy. The production could be kept either steady by accumulating inventories during slack periods with a view to meet high demand during the peak season or the production could be curtailed during the slack season and increased during the peak season. If the policy is to keep production steady by accumulating inventories it will require higher working capital.

4. **Manufacturing Process/Length of Production Cycle:** In manufacturing business, the requirements of working capital increase in direct proportion to length of manufacturing process. Longer the process period of manufacture, larger is the amount of working capital required. The longer the manufacturing time, the raw material and other supplies have to be carried for a longer period in the process with progressive increment of labor and service costs before the finished product is finally obtained. Therefore, if there are alternative processes of production, the process with the shortest production period should be chosen.

5. **Seasonal Variations:** In certain industries raw material is not available throughout the year. They have to buy raw materials in bulk during the season to ensure an uninterrupted flow and process them during which gives rise to more working capital requirements. Generally, during the busy season, a firm requires larger working capital than in the slack season.

6. **Working Capital Cycle:** In a manufacturing concern, the working capital cycle starts with the purchase of raw material and ends with the realization of cash from the sale of finished products. This cycle involves purchase of raw materials and stores, its conversion into stocks of finished goods through work-in-progress with progressive increment of labor and service costs, conversion of finished stock into sales, debtors and receivables and ultimately realization of cash and

this cycle continues again from cash to purchase of raw material and so on.

7. **Rate of Stock Turnover:** There is a high degree of inverse co-relationship between the quantum of working capital and the velocity or speed with which the sales are affected. A firm having a high rate of stock turnover will need lower amount of working capital as compared to a firm having a low rate of turnover.
8. **Credit Policy:** The credit policy of a concern in its dealing with debtors and creditors influence considerably the requirements of working capital. A concern that purchases its requirements on credit and sells its products/services on cash requires lesser amount of working capital. On the other hand a concern buying its requirements for cash and allowing credit to its customers, shall need larger amount of working capital as very huge amount of funds are bound to be tied up in debtors or bills receivables.

9. **Business Cycles:** Business cycle refers to alternate expansion and contraction in general business activity. In a period of boom i.e., when the business is prosperous, there is a need for larger amount of working capital due to increase in sales, rise in prices, optimistic expansion of business, etc.

10. **Rate of Growth of Business:** The working capital requirements of a concern increase with the growth and expansion of its business activities. Although, it is difficult to determine the relationship between the growth in the volume of business and the growth in the working capital of a business, yet it may be concluded that for normal rate of expansion in the volume of business, we may have retained profits to provide for more working capital but in fast growing concerns, we shall require larger amount of working capital.

11. **Earning Capacity and Dividend Policy:** Some firms have more earning capacity than others due to quality of their products, monopoly conditions, etc. Such firms with high earning capacity may generate cash profits from operations and contribute to their working capital. The dividend policy of a concern also influences the requirements of its working capital. A firm that maintains a steady high rate of cash dividend irrespective of its generation of profits needs more working capital than the firm that retains larger part of its profits and does not pay so high rate of cash dividend.

12. **Price Level Changes:** Changes in the price level also affect the working capital requirements. Generally, the rising prices will require the firm to maintain larger amount of working capital as more funds will be required to maintain the same current assets. The affect of rising prices may be different for different firms. Some firms may be affected much while some others may not be affected at all by the rise in prices.

13. **Other Factors:** Certain other factors such as operating efficiency, management ability, irregularities of supply, import policy, asset structure, importance of labor, banking facilities, etc., also influence the requirements of working capital.