UNIT 12 WORKING CAPITAL MANAGEMENT

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12.1 INTRODUCTION

Working capital management is the process of managing a company's short-term assets and liabilities to ensure its smooth operations and financial health. It involves managing the cash, inventory, accounts receivable, and accounts payable of a business to maintain an optimal level of working capital.

Effective working capital management is essential for a company's success as it ensures that there is enough cash available to cover day-to-day expenses and operations, meet short-term obligations, and fund growth initiatives. Poor working capital management can lead to cash flow problems, missed payments to suppliers and creditors, and even bankruptcy.

The key elements of working capital management include managing the cash conversion cycle, optimizing inventory levels, managing accounts receivable and accounts payable, and financing working capital needs. It requires a careful balance between liquidity and profitability, as excessive working capital can tie up valuable resources, while insufficient working capital can lead to missed opportunities and operational difficulties.

Thus, effective working capital management is critical for the financial stability and success of any business. By maintaining an appropriate level of working capital, a company can ensure that it can meet its short-term obligations while investing in growth and maximizing profitability.

12.2 OBJECTIVES

After reading this unit you will be able to understand:

- Working Capital and Components of Working Capital.
- Factors Affecting Working Capital Requirements
- Working Capital: Liquidity vs. Profitability Trade Off.

12.3 WORKING CAPITAL

Working capital refers to the difference between a company's current assets and its current liabilities. It represents the amount of cash or liquid assets that a company has available to meet its short-term obligations and fund its day-to-day operations.

Working capital is a crucial financial metric as it indicates a company's ability to operate efficiently and meet its short-term financial obligations. It is also an important measure of a company's liquidity, which is its ability to convert assets into cash to meet its financial obligations as they come due.

A company's working capital is important to consider when assessing its financial health, as insufficient working capital can result in a company's inability to pay its bills, purchase inventory, or pay employees. On the other hand, excessive working capital can indicate inefficient use of resources and may suggest that a company is not maximizing its profitability.

Working capital is calculated by subtracting a company's current liabilities from its current assets. If the resulting figure is positive, the company has positive working capital, which means it has more assets than liabilities to meet its short-term obligations. Conversely, if the resulting figure is negative, the company has negative working capital, which means it has more short-term liabilities than assets to meet those obligations.

Concept of Gross and Net Working Capital

Working capital is the amount of money required by a company to run its day-to-day operations. It is the excess of current assets over current liabilities of a company. There are two types of working capital: gross working capital and net working capital.

1. Gross Working Capital:

Gross working capital refers to the total amount of current assets that a company possesses. It includes cash, bank balance, inventories, debtors, and other short-term assets. The gross working capital represents the company's ability to meet its short-term obligations.

Gross working capital can be further classified into two categories:

a) Permanent or fixed working capital: This refers to the minimum amount of current assets that a company requires to carry out its day-to-day operations. It is also known as core working capital, and it is needed to maintain the company's operating cycle.

b) Temporary or variable working capital: This refers to the additional working capital required by a company to meet its seasonal or special demands. It is also known as fluctuating working capital.

2. Net Working Capital:

Net working capital is the difference between current assets and current liabilities. It represents the liquidity position of a company and its ability to meet its short-term obligations.

Net working capital can be further classified into two categories:

a) Positive net working capital: This refers to a situation where current assets are higher than current liabilities. It indicates that the company has sufficient liquidity to meet its short-term obligations.

b) Negative net working capital: This refers to a situation where current liabilities are higher than current assets. It indicates that the company may face difficulty in meeting its short-term obligations.

Types of Working Capital

1. **Permanent working capital or fixed working capital** refers to the minimum amount of current assets required by a company to carry out its daily operations smoothly over a long period of time. It is also referred to as the core working capital. The amount of permanent working capital varies from industry to industry and depends on factors such as the scale of operations, nature of business, production cycle, etc.

The following are some characteristics of permanent working capital:

a. It is required to meet the day-to-day operational requirements of the business.

b. The amount of permanent working capital is fixed and does not vary with changes in the level of production.

c. It is financed through long-term sources of finance such as equity, long-term loans, debentures, etc.

d. It is used to finance fixed assets such as plant and machinery, land, building, etc.

e. The level of permanent working capital is determined by the minimum level of current assets required to support the fixed assets.

Examples of items that form part of permanent working capital include cash, bank balance, inventories of raw materials, work-in-progress, finished goods, and minimum level of accounts receivable.

Proper management of permanent working capital is essential for the smooth functioning of a business, as a shortage of permanent working capital can lead to disruptions in the production process and affect the overall profitability of the business. On the other hand, excess permanent working capital can lead to an increase in the cost of capital and reduced profitability.

2. Variable or fluctuating working capital refers to the part of the working capital that keeps changing from time to time, depending on the production and sales activities of a company. It is also known as temporary working capital as it is required to meet the day-to-day or short-term requirements of the business.

Some of the examples of variable working capital are:

a. Inventory: The amount of inventory required by a company keeps fluctuating depending on the level of demand for its products. During the peak season, the inventory level increases to meet the higher demand, while it decreases during the off-season.

b. Accounts Receivable: The amount of accounts receivable also keeps changing depending on the level of credit sales made by the company. During the high sales period, the amount of accounts receivable increases, while it decreases during the low sales period.

c. Cash: The cash balance of a company also fluctuates depending on the level of sales and purchases. During the high sales period, the cash balance increases, while it decreases during the low sales period.

d. Short-term Liabilities: The amount of short-term liabilities such as accounts payable and short-term loans also keeps fluctuating depending on the level of purchases and borrowings made by the company. During the high purchase period, the short-term liabilities increase, while it decreases during the low purchase period.

Managing the variable working capital effectively is important for the smooth functioning of the business. The company needs to ensure that it has sufficient funds to meet the short-term obligations such as payment of salaries, rent, taxes, and other expenses. At the same time, it needs to avoid excessive investment in working capital,

which may lead to an increase in the cost of capital and reduce the profitability of the business.

12.4 COMPONENTS OF WORKING CAPITAL

The various components of Working Capital are as follows:

1. **Current assets** are resources that are expected to be converted into cash within a year or an operating cycle, whichever is longer. The different components of current assets are:

   a) Inventories - Inventories include raw materials, work in progress, finished goods, stores, spares, fuel, etc. The value of inventories is determined by the accounting method used (FIFO, LIFO, weighted average, etc.) and their cost is considered in the calculation of the cost of goods sold.

      i. Stock of Raw Materials: This includes all the materials purchased by the company that are yet to be processed or converted into finished goods.

      ii. Stock of Work in Progress: This refers to all the goods that are in the process of being manufactured but are not yet complete.

      iii. Stock of Finished Goods: This includes all the completed goods that are ready to be sold.

      iv. Stock of stores, spares and fuel, etc.: This category includes all the items that are necessary for the smooth functioning of the production process, such as tools, equipment, fuel, and maintenance supplies.

   b) Sundry Debtors - Sundry debtors are customers who owe money to the company. They can be classified into two categories: (a) debts outstanding for a period exceeding six months and (b) other debts.

      i. Debts outstanding for a period exceeding six months: These are debts that have been outstanding for more than six months and have not been paid by the customers.

      ii. Other Debts: This includes all other debts owed by the customers, such as invoices that have not yet been paid.

   c) Bills Receivables - Bills receivables are bills of exchange that the company has accepted from its customers. They represent a claim for payment of goods or services that have been supplied by the company.

   d) Cash and Bank - This includes cash and cash equivalents held by the company such as bank deposits, short-term investments, and cash on hand.

i. With Scheduled Banks: This refers to the company's cash and bank balances held with scheduled banks.

    1. In current account: These are funds held in a bank account that can be accessed on demand and used for day-to-day expenses.

    2. In deposit account: This includes all the funds that the company has deposited in various bank accounts for a specific period.

ii. With Non-Scheduled Banks: This includes all the cash and bank balances held with non-scheduled banks.

iii. Cash and Cheque at collection centers: This category includes all the cash and cheques that have been deposited at the company's collection centers.

iv. With others: This refers to any other cash and bank balances held by the company.

e) Marketable Securities - Marketable securities are financial instruments that can be easily bought and sold in the market, such as stocks, bonds, and commercial paper.

f) Loans and Advances - Loans and advances include amounts given by the company to third parties that are expected to be repaid in the future. These can be secured or unsecured and may include deposits, advances recoverable in cash or kind for value to be received, balances with customs and excise authorities, taxes paid in advance, and other advances.

i. Bills receivables granted by scheduled banks: This refers to short-term loans or advances granted to the company by scheduled banks.

ii. Secured loans: These are loans that are secured by some collateral or asset of the company.

iii. Unsecured loans:

    1. Advances recoverable in cash or kind for value to be received: This includes all the advances made to suppliers or vendors for the purchase of goods or services that have not yet been received.

    2. Deposits: This includes all the deposits made by the company for various purposes, such as security deposits for rentals or utility services.

3. Balances with customs and Excise Authorities: This refers to any balances held by the company with customs and excise authorities for various duties and taxes.

iv. Taxes paid in advances and deducted at source: This includes any taxes paid in advance by the company or deducted at source, such as TDS (Tax Deducted at Source) or advance tax.

g) Prepaid Expenses - Prepaid expenses are expenses that have been paid in advance, such as insurance premiums, rent, and taxes. They are considered assets as they provide future benefits to the company.

2. **Current liabilities** refer to the financial obligations of a company that are due for payment within one year or less. They are usually short-term debts or payables that a company must settle within its operating cycle or the period of 12 months.

a) Acceptances: This refers to the bills of exchange that have been accepted by the company and are awaiting payment at a future date. Acceptances are usually issued by a company to its creditors as a guarantee of payment.

b) Sundry Creditors: These are the amounts owed by the company to its suppliers for the goods or services purchased on credit. Sundry creditors usually represent short-term liabilities that need to be paid within a year.

c) Advances and deposits from customers: These are the amounts received from customers in advance for goods or services yet to be delivered. Advances and deposits from customers are recorded as current liabilities because they are expected to be settled within a year.

d) Unclaimed dividend warrants: These are the dividends declared by the company but not yet claimed by the shareholders. Such dividends are recorded as current liabilities until they are claimed by the shareholders.

e) Unclaimed denture interest warrants: These are the interest payments declared by the company but not yet claimed by the debenture holders. Such interest payments are recorded as current liabilities until they are claimed by the debenture holders.

f) Application money refundable: This refers to the amounts received by the company as application money from investors for shares or debentures. If the company fails to issue shares or debentures to the investors, the application money is refunded. Application money refundable is recorded as a current liability until it is refunded.

g) Interest accrued but not due on loans: This refers to the interest payments that have accrued on loans but are not yet due for payment. Interest accrued but not

due on loans is recorded as a current liability until it becomes due for payment.

h) Hire purchase dues: These are the amounts due to the hire-purchase companies for the hire-purchase of assets such as vehicles and machinery. Hire purchase dues are recorded as current liabilities because they are expected to be settled within a year.

i) Short term loans and advances: These are the loans and advances received by the company that are expected to be repaid within a year. Short-term loans and advances include bank loans, loans from financial institutions, and advances from customers.

j) Cash credit from banks: This refers to the amount of credit provided by banks to the company for short-term working capital requirements. Cash credit from banks is recorded as a current liability because it is expected to be settled within a year.

k) Other short-term payables: These include all other short-term payables that the company owes to its suppliers, contractors, employees, etc.

l) Bank overdraft: This refers to the amount of money that a company has withdrawn from its bank account beyond the amount of money available in the account. Bank overdraft is recorded as a current liability because it is expected to be settled within a year.

m) Provisions: Provisions are amounts set aside by the company for specific purposes such as taxation, proposed dividends on preference and equity shares, employee benefits, warranty provisions, and so on. Provisions are recorded as current liabilities if they are expected to be settled within a year.

    i. Provision for Taxation: This refers to the amount set aside by the company to pay for its taxes.

    ii. Proposed dividends on preference and equity shares: This refers to the dividends declared by the company but not yet paid to the shareholders. Proposed dividends on preference and equity shares are recorded as current liabilities until they are paid to the shareholders.

n) Bills payable: This refers to the amount of money that the company owes to its creditors for the goods or services purchased on credit.

o) Income received in advance: This refers to the income received by the company in advance for the goods or services yet to be delivered.

12.5 NEED AND SIGNIFICANCE OF WORKING CAPITAL MANAGEMENT (WCM)

Working capital management is the process of managing a company's short-term assets and liabilities to ensure its daily operations run smoothly. The need and significance of working capital management can be explained as follows:

a) Meeting day-to-day expenses: Working capital management helps a company meet its day-to-day operating expenses, such as payment of salaries, purchase of raw materials, payment of utility bills, etc. Without adequate working capital, a company may not be able to operate smoothly.

b) Efficient utilization of resources: Effective working capital management ensures that a company's resources are utilized efficiently. It helps a company minimize idle resources, avoid overstocking of inventory, and reduce unnecessary debt.

c) Smooth production process: Adequate working capital helps a company maintain a smooth production process. It ensures that raw materials and other inputs are available when required, and there are no interruptions due to shortage of funds.

d) Cash flow management: Working capital management helps a company manage its cash flow effectively. It helps a company maintain a balance between inflows and outflows of cash, and avoid situations where there is excess cash or cash shortage.

e) Creditworthiness: A company's ability to manage its working capital efficiently is an indicator of its creditworthiness. Banks and other financial institutions consider a company's working capital position when deciding whether to lend money to the company.

f) Maximizing profitability: Effective working capital management can help a company maximize its profitability. By minimizing idle resources, reducing debt, and optimizing inventory levels, a company can increase its profits.

Thus, working capital management is critical for a company's short-term and long-term success. It helps a company maintain a healthy cash flow, avoid unnecessary debt, maximize profitability, and remain competitive in the market.

12.6 FACTORS AFFECTING WORKING CAPITAL REQUIREMENTS

Factors affecting working capital requirements can be broadly classified into two categories: internal and external.

1) Internal factors include:

a) Nature of the business: The nature of the business plays an important role in determining the working capital requirements. For example, a manufacturing

company that produces goods in large quantities requires a higher amount of working capital compared to a service-oriented business that does not hold inventory.

b) Size of the business: The size of the business also affects the working capital requirements. A large business with multiple units and a diverse range of products may require more working capital than a small business.

c) Production cycle: The length of the production cycle determines the level of working capital required. For example, if a company's production cycle is long, it may need more working capital to cover the expenses during the production process.

d) Sales cycle: The sales cycle of a business is the time between the sale of a product and the receipt of payment from the customer. If the sales cycle is long, the business may require more working capital to finance its operations.

e) Inventory management: The way a company manages its inventory affects its working capital requirements. For example, if a company maintains a large inventory, it may require more working capital to finance the purchase of inventory.

2) External factors include:

a) Economic conditions: The general economic conditions in the market affect the working capital requirements. During a recession, businesses may require more working capital to manage their cash flow.

b) Competition: The level of competition in the market affects the working capital requirements. If the competition is high, businesses may need to invest more in marketing and advertising, which increases the working capital requirements.

c) Interest rates: The interest rates charged by financial institutions affect the cost of borrowing, which in turn affects the working capital requirements.

d) Government regulations: The regulations imposed by the government also affect the working capital requirements. For example, if the government imposes stricter regulations on businesses, they may need more working capital to comply with these regulations.

Thus, understanding the factors affecting working capital requirements is essential for businesses to manage their finances effectively and ensure they have the necessary funds to operate smoothly.

12.7 INTRODUCTION ESTIMATION OF WORKING CAPITAL

The estimation of working capital is crucial for the efficient management of a company's operations. There are various methods to estimate working capital requirements, including the operating cycle approach, the percent of sales approach, and the estimation of components of working capital method as follows:

1) **The operating cycle approach** is a method of estimating working capital needs that focuses on the time it takes to convert cash into inventory, inventory into sales, and sales back into cash. The operating cycle is the time period between the acquisition of inventory and the receipt of cash from the sale of the inventory. The longer the operating cycle, the greater the need for working capital.

   The formula for estimating working capital using the operating cycle approach is as follows:

   Operating cycle = Inventory conversion period + Accounts receivable collection period

   Working capital = Operating cycle * Average daily sales

   Where:

   Inventory conversion period: the time it takes to convert inventory into sales

   Accounts receivable collection period: the time it takes to collect payments from customers

   Average daily sales: the average daily sales of the company

   Example:

   Let's assume that ABC Company has an inventory conversion period of 30 days and an accounts receivable collection period of 45 days. The company's average daily sales are Rs.10,000.

   Operating cycle = 30 + 45 = 75 days

   Working capital = 75 * Rs.10,000 = Rs.750,000

   Therefore, ABC Company would need Rs.750,000 of working capital to fund its operating cycle based on the operating cycle approach.

   It's important to note that this approach does not take into account any seasonal fluctuations in sales or inventory. Additionally, it assumes that the accounts payable period is the same as the inventory conversion period. Thus, this approach should be used in conjunction with other methods of estimating working capital needs.

2) **The Percent of Sales Approach** is a method of estimating working capital requirements based on the percentage of a company's sales revenue. This method assumes that as sales increase or decrease, the level of working capital required will also increase or decrease proportionally.

   The steps involved in the Percent of Sales Approach are as follows:

   a) Determine the historical relationship between sales and working capital: To estimate future working capital requirements, a company needs to analyze its past financial statements and determine the average percentage of working capital to sales.

b) Forecast future sales: The company needs to forecast its future sales revenue for the upcoming period based on market trends, industry forecasts, and other relevant factors.

c) Calculate the estimated working capital requirements: Using the historical relationship between sales and working capital, the company can estimate its future working capital requirements by applying the average percentage of working capital to the forecasted sales revenue.

The formula for estimating working capital requirements using the Percent of Sales Approach is as follows:

Working Capital = Percentage of Working Capital x Sales Revenue

For example, if a company has historical data showing that it requires 10% of working capital for every Rs.1 million of sales revenue, and it forecasts sales revenue of Rs.5 million for the upcoming period, the estimated working capital requirement would be:

Working Capital = 10% x Rs.5,000,000 = Rs.500,000

However, it's important to note that this method is only an estimate and should be used in conjunction with other methods to get a more accurate picture of a company's working capital needs. Additionally, changes in a company's operations, market conditions, or industry trends can significantly impact working capital requirements, making it important to regularly review and update these estimates.

3) **The estimation of components of working capital method** involves estimating the various components of working capital separately and then adding them up to arrive at the total working capital requirement. This method involves analyzing the various components of current assets and current liabilities, estimating the amount required for each component, and then adding them up to arrive at the total working capital requirement.

The components of working capital that are estimated using this method include inventory, accounts receivable, cash, accounts payable, and accruals. The estimation of each component is done by taking into account the past trends, current business requirements, and future expectations.

The formula for estimating the components of working capital is as follows:

Working Capital = Inventory + Accounts Receivable + Cash - Accounts Payable - Accruals

where,

Inventory = Raw materials + Work in progress + Finished goods + Stores and spares + Fuel, etc. Accounts Receivable = Total credit sales × (credit period ÷ 365) Cash = Minimum cash balance required + Operating cash expenses for one month Accounts

Payable = Total credit purchases × (credit period ÷ 365) Accruals = Wages and salaries + Taxes + Utilities + Rent + Other expenses

Let's take an example to understand the estimation of working capital using the components of working capital method:

ABC Ltd. is a manufacturing company. The following information is available:

Credit sales for the year: Rs.1,000,000

Credit period allowed to customers: 60 days

Credit purchases for the year: Rs.600,000

Credit period allowed by suppliers: 30 days

Operating cash expenses for one month: Rs.50,000

Minimum cash balance required: Rs.20,000

Raw materials inventory: Rs.80,000

Work in progress inventory: Rs.50,000

Finished goods inventory: Rs.120,000

Stores and spares inventory: Rs.30,000

Fuel inventory: Rs.10,000

Wages and salaries: Rs.100,000

Taxes: Rs.30,000

Utilities: Rs.20,000

Rent: Rs.40,000

Other expenses: Rs.15,000

Using the components of working capital method, we can estimate the working capital requirement as follows:

Inventory = Rs.80,000 + Rs.50,000 + Rs.120,000 + Rs.30,000 + Rs.10,000 = Rs.290,000 Accounts Receivable = Rs.1,000,000 × (60 ÷ 365) = Rs.164,384 Cash = Rs.20,000 + Rs.50,000 = Rs.70,000 Accounts Payable = Rs.600,000 × (30 ÷ 365) = Rs.49,315 Accruals = Rs.100,000 + Rs.30,000 + Rs.20,000 + Rs.40,000 + Rs.15,000 = Rs.205,000

Working Capital = Rs.290,000 + Rs.164,384 + Rs.70,000 - Rs.49,315 - Rs.205,000 = Rs.270,069

Therefore, the estimated working capital requirement for ABC Ltd. using the components of working capital method is Rs.270,069.

Check Your Progress-A

Fill in the blanks.

1. ……………is a method of estimating working capital needs that focuses on the time it takes to convert cash into inventory, inventory into sales, and sales back into cash.
2. …………………. refers to the amount of money that a company has withdrawn from its bank account beyond the amount of money available in the account.

12.8 WORKING CAPITAL: LIQUIDITY VS. PROFITABILITY TRADE OFF

The liquidity versus profitability trade-off refers to the dilemma faced by companies in balancing their need for liquidity and their desire for profitability. Liquidity is the ability of a company to meet its short-term obligations as they come due, while profitability is the ability to generate earnings and returns for its investors.

On one hand, companies need to maintain sufficient liquidity to pay their bills, cover unexpected expenses, and take advantage of growth opportunities. This requires holding a certain level of working capital, such as cash, inventory, and receivables. On the other hand, too much working capital can be detrimental to profitability, as it represents idle resources that earn no return for the company. For example, holding excessive inventory ties up funds that could be invested elsewhere, while extending too much credit to customers can increase the risk of bad debts.

To strike a balance between liquidity and profitability, companies need to carefully manage their working capital. This involves analyzing their cash conversion cycle, which measures the time it takes to convert cash into inventory, inventory into sales, and sales into cash. By reducing the time it takes to turn inventory and receivables into cash, companies can improve their liquidity and reduce the need for excess working capital.

At the same time, companies should also look for ways to optimize their working capital and improve profitability. For example, they can negotiate better terms with suppliers to reduce inventory costs, or implement more efficient inventory management practices to reduce carrying costs. They can also offer discounts to customers who pay early or implement more effective credit control measures to reduce bad debts.

Thus, the liquidity versus profitability trade-off requires a careful balancing act. Companies need to maintain sufficient working capital to ensure they can meet their short-term

obligations, but they also need to optimize their use of working capital to improve profitability and generate returns for their investors.

12.9 CASE STUDY: WORKING CAPITAL MANAGEMENT AT A MANUFACTURING COMPANY

Background: A medium-sized manufacturing company was experiencing cash flow problems due to an inefficient working capital management system. The company's management team decided to conduct a review of the company's working capital policies to improve cash flow and profitability.

Problem: The Company was facing several issues related to its working capital management, including excessive inventory levels, slow collections of receivables, and long payment terms with suppliers. These issues were putting a strain on the company's cash flow and affecting its ability to meet financial obligations.

Solution: The Company’s management team implemented several measures to improve working capital management. These included:

Inventory Optimization: The Company reduced its inventory levels by implementing a just-in-time (JIT) inventory system. This helped to reduce carrying costs and freed up cash that was tied up in inventory.

Receivables Management: The Company implemented a more rigorous credit management policy to ensure timely payment from customers. This involved a more structured approach to credit checks, setting clear payment terms and implementing a system to track and follow up on overdue payments.

Supplier Management: The Company negotiated more favourable payment terms with its suppliers, which helped to reduce the amount of cash tied up in payables. The company also streamlined its procurement process to reduce lead times and improve efficiency.

Results: The Company’s working capital management initiatives resulted in several positive outcomes. These included:

Improved Cash Flow: By optimizing inventory levels, managing receivables more effectively and reducing payment terms with suppliers, the company was able to improve cash flow and reduce its reliance on external funding.

Improved Profitability: The Company’s efforts to improve working capital management had a positive impact on profitability. The reduction in carrying costs and the freeing up of cash allowed the company to invest in growth opportunities and generate higher returns.

Improved Creditworthiness: The Company’s improved cash flow and profitability also had a positive impact on its creditworthiness. This allowed the company to negotiate more favourable financing terms and improve its access to capital.

Questions:

a) What were the challenges faced by the manufacturing company related to working capital management?

b) What measures did the company take to optimize its working capital management?

c) What were the positive outcomes of the company's working capital management initiatives?

Check Your Progress- B

Write True or False.

3. Bills payable refers to the amount of money that the company owes to its creditors for the goods or services purchased on credit.
4. Current assets are resources that are expected to be converted into cash within a year or an operating cycle, whichever is longer.
5. Permanent working capital or fixed working capital refers to the minimum amount of current assets required by a company to carry out its daily operations smoothly over a long period of time.

12.10 SUMMARY

Working capital management is the process of managing a company's short-term assets and liabilities to ensure that it has enough liquidity to meet its obligations and run its operations efficiently. The goal of working capital management is to strike a balance between liquidity and profitability, as having too much or too little working capital can both have negative consequences for a company.

The components of working capital include current assets such as inventory, accounts receivable, and cash, and current liabilities such as accounts payable and short-term debt. Managing these components effectively requires monitoring and forecasting cash flows, optimizing inventory levels, and managing credit and collections policies.

There are various methods for estimating working capital requirements, including the operating cycle approach, the percent of sales approach, and the estimation of components of working capital method.

Effective working capital management can lead to improved cash flow, increased profitability, and reduced financial risks. However, it requires careful planning, analysis, and decision-making, as well as effective communication and collaboration across different departments and stakeholders within a company.

12.11 GLOSSARY

- ***Working Capital:*** Working capital is the amount of money a business has available for its day-to-day operations. It is the difference between a company's current assets and current liabilities. In simpler terms, it is the amount of funds required to meet the short-term expenses of a business.

12.12 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress –A

1. The operating cycle approach
2. Bank overdraft

Check Your Progress –B

3. True.
4. True.
5. True.

12.13 REFERENCES

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12.15 TERMINAL QUESTIONS

1. Define Working Capital and the Components of Working Capital?
2. Explain the Factors Affecting Working Capital Requirements.
3. Elucidate the Working Capital: Liquidity vs. Profitability Trade Off.