Quadrant II - Notes

Paper Code: COG140

Module Name: Determinants of working capital

Factors Determining Working Capital Requirement

1. **Nature or Character of Business**
   The working capital requirements of a firm basically depend upon the nature of the business. Public entity 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 requires less investment in fixed assets but have to invest large amounts in currents assets like inventories, receivables and cash, as such they need large amount of working capital.
2. **Size of Business/Scale of Business**
   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 operation. Greater the size of a 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 disadvantage 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 he production policy. The production could be kept either steady by accumulating inventories during slack period 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 the length of manufacturing process. Longer the process period of manufacturing, larger is the amount of working capital required.
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 then during the entire year. A huge amount is, thus, blocked in the form of material inventories during such season, 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 start with the purchase of raw materials and ends with the realisation of cash from the sale of finish products . this cycle involves purchase of raw materials and stores, its conversion into stock of finish goods through working in progress with progressive increment of labour and service costs, conversion of finish stock into sales, debtors and receivables and ultimately realisation of cash and this cycle continues again from cash to purchase raw materials and so on

7. **Rate of stock turnover**

   There is a high degree of inverse correlation ship between the quantum of working capital and the velocity or the speed with which sales are affected. A firm having high rate of stock turnover will need lower amount of working capital as compare to a firm having lower rate of turnover. For example in case of precious stone dealer the turnover is very slow. They have to maintain large variety of stocks and the movement of stock is very slow ,thus the working capital requirements of a such a dealer shall be higher than that of a provision store

8. **Credit policy**

   The credit policy of a concern in its dealing with debtors and creditors influence considerably the requirement of working capital. A concern that purchase its requirements on credits and sells its product and service on cash basis requires lesser amount of working capital. On the other hand a concern buying its requirement for cash and allowing credits to its customer, shall need larger amount of working capital as very huge amount of funds are bound to be tied up in debtors and bills receivables

9. **Business cycles**

   Business cycle refers to alternate expansion and contraction in general business activity in a period of boom that is 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. on the contrary in the times of depression that is when there is down swing of the cycle, the business contract, the sales decline, difficulties are face in collection from debtors and firms may have large of working lying idle.

10. **Rate of growth of business**

    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 retain profits to provide for more working capital but in fast growing concerns, we shall require large 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. The dividend policy of concern also influences the requirements of its working capital. A firm that maintains a steady higher rate of cash dividend irrespective of its generation of profits need more working capital than the firms that retains larger parts of its profits and doesn’t pay so high rate of cash dividend.

12. Price level changes

Changes in the price level also affects the working capital requirements generally, the rising prices will require the firm to maintain larger amount of working capital as more fund will be required the same current assets. The effects of rising prices may be different for different firms. Some firms may be affected much while some other may not be affected at all by the rise in the prices

13. Other factors

Certain other factors such as operating efficiency, management ability, irregularity of supply, import policy, assets structure, important of labour, banking facilities, etc., also influence the requirements of working capital.