VIDYA BHAWAN BALIKA VIDYA PITH

शक्ति उत्थान आश्रम लखीसराय बिहार

Class 12 commerce   Sub. BST. Date 14.9.2020

Teacher name – Ajay Kumar Sharma

BUSINESS FINANCE

FACTORS AFFECTING THE WORKING CAPITAL REQUIREMENTS

1. Nature of Business: The basic nature of a business influences the amount of working capital required. A trading organisation usually needs a lower amount of working capital compared to a manufacturing organisation. This is because there is, usually no processing, therefore, there is no distinction between raw materials and finished goods. Sales can be effected immediately upon the receipt of materials, sometimes even before that. In a manufacturing business, however, raw material needs to be converted into finished goods before any sales become possible. Other factors remaining the same, trading business requires less working capital. Similarly, service industries which usually do not have to maintain inventory require less working capital.

2. Scale of Operations: For organisations which operate on a higher scale of operation, the quantum of inventory, debtors required is generally high. Such organisations, therefore, require large amount of working capital as compared to the organisations which operate on a lower scale.

3. Business Cycle: Different phases of business cycles affect the requirement of working capital by a firm. In case of a boom, the sales as well as production are likely to be higher and therefore, higher amount of working capital is required. As against this the requirement for working capital will be lower during period of depression as the sales as well as production will be low.

4. Seasonal Factors: Most business have some seasonality in their operations. In peak season, because of higher level of activity, higher amount of working capital is required. As against this, the level of activity as well as the requirement for working capital will be lower during the lean season.

5. Production Cycle: Production cycle is the time span between the receipt of raw material and their conversion into finished goods. Some businesses have a longer production cycle while some have a shorter one. Duration and the length of production cycle, affects the amount of

funds required for raw materials and expenses. Consequently, working capital requirement is higher in firms with longer processing cycle and lower in firms with shorter processing cycle.

6. Credit Allowed: Different firms allow different credit terms to their customers. These depend upon the level of competition that a firm faces as well as the credit worthiness of their clientele. A liberal credit policy results in higher amount of debtors, increasing the requirement of working capital.

7. Credit Availed: Just as a firm allows credit to its customers it also may get credit from its suppliers. To the extent, it avails the credit on its purchases, the working capital requirement is reduced.

8. Operating Efficiency: Firms manage their operations with varied degrees of efficiency. For example, a firm managing its raw materials efficiently may be able to manage with a smaller balance. This is reflected in a higher inventory turnover ratio. Similarly, a better debtors turnover ratio may be achieved reducing the amount tied up in receivable. Better sales effort may reduce the average time for which finished goods inventory is held. Such efficiencies may reduce the level of raw materials, finished goods and debtors resulting in lower requirement of working capital.

9. Availability of Raw Material: If the raw materials and other required materials are available freely and continuously, lower stock levels may suffice. If, however, raw materials do not have a record of un-interrupted availability, higher stock levels may be required. In addition, the time lag between the placement of order and actual receipt of the materials (also called lead time) is also relevant. Higher the lead time, higher the quantity of material to be stored and higher is the amount of working capital requirement.

10. Growth Prospects: If the growth potential of a concern is perceived to be higher, it will require higher amount of working capital so that is able to meet higher production and sales target whenever required.

11. Level of Competition: Higher level of competitiveness may necessitate higher stocks of finished goods to meet urgent orders from customers. This increases the working capital requirement. Competition may also force the firm to extend liberal credit terms discussed earlier.

12. Inflation: With rising prices, higher amounts are required even to maintain a constant volume of production and sales. The working capital requirement of a business thus, become higher with higher rate of inflation. It must, however, be noted that an inflation rate of 5%, does not mean that every component of working capital will change by the same percentage. The actual requirement shall depend upon the rates of price change of different components (e.g.,

raw material, finished goods, labour cost,) Finished goods as well as their proportion in the total requirement.