

## **Factors affecting the requirement of working capital or determinants of working capital requirement of any business enterprise**

In this unit we are going to discuss that how a business firm is going to forecast the working capital requirement by keeping in view and analyzing the different situations and environment existing in the market .There are so many factors which need to be taken into consideration while deciding the size and the amount of the working capital in any business enterprise. These factors have been classified into two categories: One is external factors and other is internal factors. First of all I will discuss the internal factors which must be taken into consideration for forecasting working capital and which go to determine the working capital requirement of any business enterprise .Internal factors are as follows:

- (1) Nature of business enterprise
- (2) Size of business
- (3) Manufacturing cycle
- (4) Gestation period
- (5) Operating cycle
- (6) Firm's credit policy
- (7) Access to money market
- (8) Expansion and growth of business
- (9) Profit margin and dividend policy
- (10) Depreciation policy
- (11) Operating efficiency of the firm
- (12) Coordination activities of the firm

So far the external factors are concerned, these factors are:

- (1) Business cycle fluctuations
- (2) Technological development
- (3) seasonal fluctuations
- (4) Environmental factors
- (5) Taxation policy
- (6) Banking connection

### (1) Nature of business enterprise

This is the most important factor which goes to determine the requirement of working capital in any business concern. While deciding the amount of the working capital, a financial manager has to see the nature of the business enterprise first. The nature of the business Enterprises is either trading concern or the manufacturing concern, consumer goods industry or capital goods industry labour intensive industry or capital intensive industry, public utility concern or non public utility concern. By keeping in view this nature of the business enterprise, the amount of the working capital requirement is different. It means that in the trading and financial firm, the requirement of the working capital is comparatively very high in comparison to the fixed assets but in the case of the manufacturing concern the requirement of the fixed capital is more in comparison to working capital or sometimes we say that the requirement of the working capital and fixed capital both are very high in the case of manufacturing concern which is not so high in the case of trading and financial firm. In the same way, we find that in a public utility concern, the requirement of the working capital is comparatively very low but so far the requirement of fixed capital is concerned, it is very high in the case of the non public utility concern. The requirement of the working capital is comparatively very low. Thus, the nature of the business enterprise will go to determine the amount and the size or volume of the working capital of any business Enterprise to the greater extent.

(2) Size of the business : The second important factor which goes to determine the requirement of the working capital is the size of business enterprise. It is quite natural that in the case of the small scale business firm, the requirement of the working capital is comparatively very low but in the case of medium and large scale business firm, the requirement of the working capital is very high. Thus, it is very clear that the amount or size of the working capital is going to be different in the different size of the business enterprise.

(3) Firms Credit Policy: The level of the working capital is also determined by credit policy which relates sales and purchase. The Credit Policy influences the requirement of the working capital in different ways. This is also known as the terms and conditions of trade. Sometimes, we feel that the concern goes to purchase the raw material on credit and sell the product for cash in such situation, the requirement of the working capital is very low but if the case is just different where the business firm purchases the raw material for cash and sell the product on credit, the requirement of the working capital will be very high. Thus, the terms and conditions of the trade or purchase and sale of the raw material and finished product go to influence the requirement of the working capital to the greater extent. Hence, while deciding the amount of the working capital, the credit policy of the business firms should also be taken into consideration.

(4) Access to money market: Working capital requirement of a firm is also conditioned by the firm's access to different sources of money market. If the firm is in a position to get available credit from bank and trade credit facilities are available at favourable terms and conditions under this situation the firm needs less working capital but a firm without such facility needs to arrange greater amount of working capital. It means that the business firm which has an easy access with the bank and the money market, in such a situation the availability of the working capital is going to be made very easily but if the terms and conditions and the relationship with the bank and the money market is not good or if the terms and conditions of the money market

are not favourable, in such a situation the arrangement of the working capital from the money market will be a very difficult job and in such a situation the concern should arrange the greater amount of working capital in advance.

(4) Scope of growth and expansion of Business firm: There are certain businesses where there is a greater scope of growth and expansion and for which the arrangement of the working capital needs to be made immediately from the date of its inception but there are certain businesses for which immediate growth and expenses are not required and accordingly the requirement of the working capital is going to be very less. Thus, it is obvious that in the case of the expansion of a business firm, the requirement of the working capital is more for increasing sales and acquiring fixed assets. In the case of growth and expansion there will be an all-round increase in investment that is to say with the increase in fixed assets for increasing sales the requirement of working capital will be expanded not only for financing an increase in volume of raw materials but also to finance maintenance of inventory, stock and grant credit to customers.

(5) Profit margin and dividend policy: Magnitude of working capital in a firm depends upon its profit margin and dividend policy. As a matter of fact a high net profit margin reduces the working capital requirements of the firm because it contributes towards the working capital pool. Similarly, distribution of a high proportion of profits in the form of cash dividends results in a drain on cash resources and that reduces a company's working capital to that extent. Where the management follows a conservative dividend policy and retains a larger portion of the net profit the company's working capital position is strengthened. Thus, the profit margin and the dividend policy as followed by the business firms affect the requirement of the working capital to a greater extent.

(6) Depreciation policy: The depreciation policy also influences the level of the working capital by affecting tax liability and retained earnings of the enterprise. Depreciation is a tax-deductible expense item. This will affect the firm's tax liability and retained earnings. operating

(9) Efficiency of the firm: The operating efficiency of management is also an important determinant of the level of the Working Capital Management and it can contribute to a sound working capital position through operating efficiency. Efficiency of operation accelerates the base of the cash cycle and improves the working capital turnover.

(7) Coordination activities of the firm: Absence of coordination in production and distribution policies in a company results in a high demand for working capital where production and distribution activities are coordinated pressure on working capital will be minimized.

(8) operating cycle: The working capital requirement is also going to be affected with the operating cycle as maintained by the business form if the operating cycle is long the requirement of the working capital will be more. But if the operating cycle is less the requirement of the working capital will also be less. Operating cycle denotes the period between which the finished product is kept in the Godown and the cash is realised from the customer after Sale.

(9) Gestation period : The working capital is also going to be affected with gestation period of the business enterprise. Gestation period as you know the period on which the business and the plant is installed and the production actually starts. If Gestation period is long naturally

requirement of the working capital will be more but if the Gestation period is very short the requirement of the working capital will be comparatively very low.

In addition to these internal factors, there are certain external factors also which affect the requirement of the working capital in any business firm. These external factors are;

(i) Business cycle fluctuations : This is one of the important factor which determines the need of the working capital in any business firm. Business cycle goes to move from Boom to depression and from depression to Boom, from high demand to low demand and from low demand to high demand. Type of fluctuation in the demand of the goods and services will go to affect the business cycle to the greater extent and accordingly the requirement of the working capital will be more or less. In the case of the Boom the requirement of the working capital will be more but in the case of the depression the requirement of the working capital will be comparatively low.

(ii) Technological Development: Changes in technology may lead to an improvements in processing raw materials, minimising wastage, greater productivity and more speed of production. All these improvements mainly enabled the firm to reduce investment in inventory. Thus, change in Technology affect the requirement of working capital. If the firm decides to go for automation, if the firm adopts labour intensive process policy, the requirement for working capital will be larger.

(iii) Seasonal fluctuations: There are certain products which are produced throughout the year but the demand is existing in a particular season. Similarly, there are the certain products which are produced in a particular season but the demand of that product goes to continue throughout the year. If the product is as such which is produced in a particular season, in such a situation the store of the raw material for that products is going to be made possible in a particular season and for which the business firm has to arrange the greater amount of the working capital. Similarly, if the demand of the product goes to exist in a particular season which is known as the busy season like winter season, summer season, rainy season in such a season the demand of that product is going to be very high and accordingly the production will be very high, hence the requirement of the labour and the payment for the same will be very high. In such a situation, the working capital will be needed more. Thus it is found that in a busy season the requirement of the working capital will be more but in the off season the requirement of the working capital will be comparatively very low.

(iv) Environment related factors: Political stability brings stability in the money market and other trade activities of the country. Risky ventures are possible with enhanced need of working capital Finance, Similarly availability of local infrastructure facilities, Road Transport etc. are the demand of the today's market which also influence the business and working capital requirement to the greater extent. Thus we find that infrastructural facilities and other environmental factors are also one of the important determinants of the working capital requirement of any business enterprise.

(v) Taxation policy: Taxes must be paid out of the profits. Tax liability is unavoidable and adequate provision should be made for it in working capital planning. If the tax liability increases it will impose an additional strain on the working capital. The financial manager must do tax planning in order to avail the benefits of all sorts of tax concessions and incentives. Thus, we

find that taxation policy of the government affects the requirement of the working capital to the greater extent. If the tax taxation policy of the government is very strict in such a situation the amount of the net savings and the profit will go to reduce and requirement of the working capital will be more but if the tax rate is low, in such a situation, savings will be more than the requirement of the working capital will also be less.

Thus, we find that there are a number of external and internal factors which go to affect the requirement of the working capital of any business firm and these factors are basically known as the determinants of the working capital requirement in any business firm. The financial manager has to see all the external and internal factors in deciding the size and the volume of the working capital for any business firm during the particular period of time.