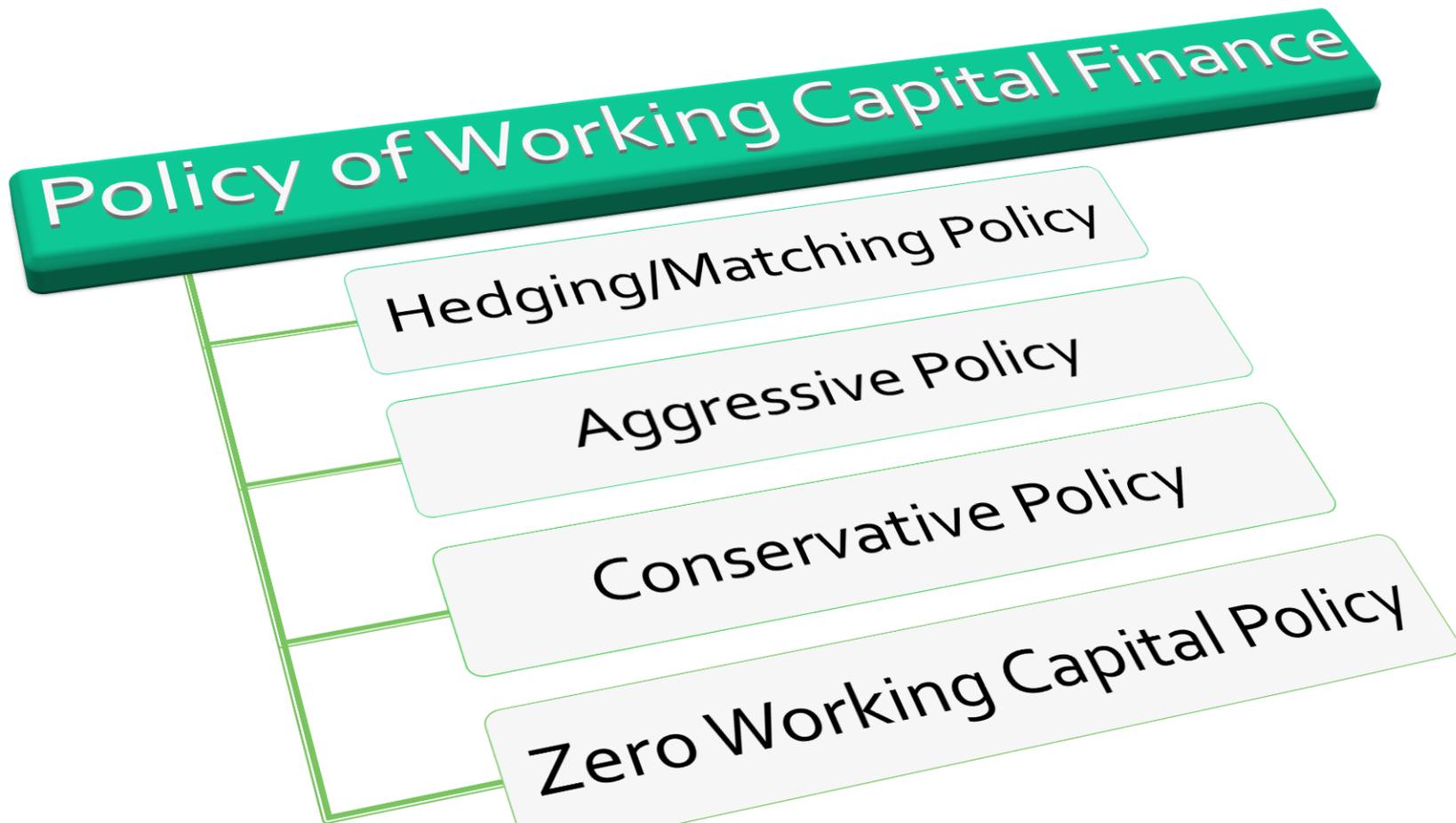


LECTURE 3

Working Capital Management

Approaches to Working Capital Finance



Hedging Policy

- Hedging Policy is also known as Matching Approach.
- For example if Company is planning to buy a machinery having an effective life of 10 years then a loan of 10 years has to be taken. It indicates a matching approach. It means the loan EMI is to be paid from the earnings of that machinery
- Similarly if an inventory purchased can be sold in 60 days , then in that case short-term loan is to be arranged only for 60 days.

- Hedging approach suggests that the variable or seasonal working capital should be financed from short-term loans where as permanent working capital needs are to be met from long term sources.
- As short-term loans imply lesser interest cost hence short-term fund needs should be financed by short-term loans only.

Conservative Policy

- In this approach excess cash balance is maintained to meet unexpected demands, if any, that arises due to higher levels of business activity.
- Maintaining higher cash balance does not always imply higher level of business activity. On the other hand excess cash maintained loses the interest that would have been earned if kept in bank.
- Here long –term borrowing is resorted by the firm to meet short-term fund needs.

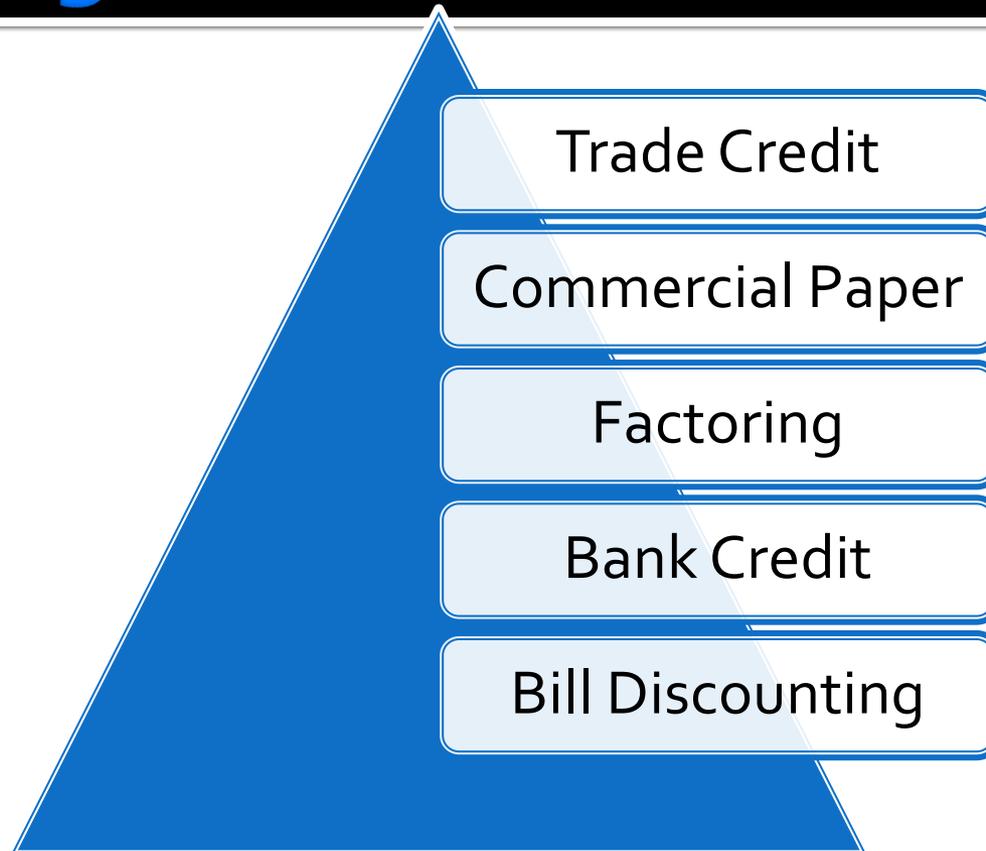
Aggressive Policy

- Under this approach all the requirement of short-term assets are financed by short –term loans.
- In addition a part of the permanent current assets are also financed by short-term loans.

Zero Working Capital Policy

- This approach implies that Current Assets should be equal to Current Liabilities hence $CA-CL=Zero$
- This approach could mean that current ratio will be 1 and quick ratio as a result will be less than 1.

Methods of Working Capital Financing



Trade Credit

- It refers to the Credit period extended by the supplier of goods in the normal course of business.
- It is an informal arrangement and depends on the credit worthiness and confidence of the Supplier.
- Credit Terms refers to the conditions of due date and cash discount.
- It could either be on open account basis where the supplier sends goods and the payment will be made in future as per the terms of the sales invoice or it could be in the form of bills payable whereby the buyer signs the bill payable on a specified future date.

Advantages and Disadvantages of Trade Credit

Advantages

- Easy Availability
- Flexibility
- Informality

Disadvantages

- Higher Charges by the Supplier

Bank Credit for Working Capital

It could take either of the following terms:

- Overdraft
- Cash Credit
- Purchase or Discounting of Bills
- Letter of Credit
- Working Capital Loan

Next to trade Credit Bank Credit is the next important source of working capital finance

- Overdraft is a facility provided by Commercial Banks to Business Houses whereby the Business House draws more money than the account holder has in the account.
- The firm pays interest on the excess amount drawn by the firm

- Letter of Credit is generally issued by a Bank in the home country to another bank in the foreign country which acts as a guarantee .
- So if the purchaser of raw materials fails to pay to the seller then the Bank accepting the guarantee will pay to the bank account of the person in other country

Bill Discounting

- In Bill discounting a bank takes the bills on which goods are sold and pays the party the amount due after deducting charges of commission
- On due date the Bank Collects the amount due from the debtors by presenting the bills.

Commercial Paper

- Commercial Paper is an important source of money market instrument and is a form of unsecured promissory note issued by the firms to raise short-term funds.
- Commercial papers can be issued for a minimum period of 15 days and maximum for a period of one year. And renewal is not permissible

Advantages

1. It is a cheaper source of finance as compared to bank credit

Disadvantages

- It is available only to financially sound and highly rated Companies
- It can not be redeemed until maturity.

Factoring

- In Factoring a Financial Institution acting as a Factor purchases the Business Firm's Accounts Receivable (which arises from credit sales) and makes payment to the Business Firm against these Accounts receivables before their maturity against receipt of Service Charges.

Advantages

- It acts as an additional source of finance.
- And it improves the Cash Flow.

Disadvantages

- Due to higher amount of cost of finance profitability decreases.

Advantages of Adequate Working Capital

- Business can avail the cash discount from the supplier by making the timely payment.
- Easy availability of loans from Commercial Banks.
- Exploitation of Good opportunity relating to purchase of raw materials
- Meeting unforeseen contingency
- Increase in Production efficiency

Disadvantages of inadequate Working Capital

- Implementation of proper production plan becomes difficult.
- Bargaining capacity decreases in credit purchases.
- Business may be forced to borrow at a higher interest rate.
- Business may be forced to sell at a lower selling price by giving higher discount to get funds.