CLASS NOTE

B.COM: SEM--6

Subject: FINANCIAL MANAGEMENT

CHAPTER: WORKING CAPITAL - II

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LECTURE NO. 02

SUB: FINANCIAL MANAGEMENT

CHAPTER: WORKING CAPITAL - II

TOPIC; Policies relating Current Assets – Conservative, Aggressive and Balanced ; Various sources of finance to meet working capital requirements; Financing current assets: Strategies of financing (Matching, Conservative, and Aggressive policies) ; Management of components of working capital (debtors management only–credit period -simple type)

**Sub Topic – 2: Various sources of finance to meet working capital requirements**

ANSWER

Sources of Working Capital

Sources of working capital can short term and long term Short term sources are tax provisions, dividend provisions, bank overdraft, cash credit, trade deposits, public deposits, bills discounting, short-term loans, inter-corporate loans, and commercial paper. Long-term sources are retained profits, provision for depreciation, share capital, long-term loans, and debentures.

 Sources of Short-Term and Long-Term Financing for Working Capital

A constant flow of working capital is an intrinsic component of a successful business. This is especially true considering the outflow that is a part and parcel of every cycle: salaries and wages need to be paid; raw materials need to be purchased and equipment need to be serviced; funds are needed for marketing, advertising, and other general overhead costs; reserves are required till the customers make their payment. Working capital is truly the lifeline for any company. The question arises as to how does a business acquire funds for working capital. There are two types of financing: short term and long term.

Short Term Financing

Banks can be an invaluable source of short term working capital finance.

1. Overdraft Agreement:

By entering into an overdraft agreement with the bank, the bank will allow the business to borrow up to a certain limit without the need for further discussion. The bank might ask for security in the form of collateral and they might charge daily interest at a variable rate on the outstanding debt. However, if the business is confident of making the repayments quickly, then an overdraft agreement is a valuable source of financing, and one that many companies resort to.

2. Accounts Receivable Financing:

Many banks and non-banking financial institutions provide invoice discounting facilities. The company takes the commercial bills to the bank which makes the payment minus a small fee. Then, on the due date the bank collects the money from the customer. This is another popular method of financing especially among small traders. Businesses that offer large terms of credit can carry on their operations without having to wait for the customers to settle their bills.

3. Customer Advances:

There are many companies that insist on the customer making an advance payment before selling them goods or providing a service. This is especially true while dealing with large orders that take a long time to fulfill. This method also ensures that the company has some funds to channelize into its operations for fulfilling those orders.

4. Selling Goods on Installment:

Many companies, especially those that sell television sets, fans, radios, refrigerators, vehicles and so on, allow customers to make their payments in installments. Since many of these items have become modern day essentials, their customers might not come from well-to-do backgrounds or the cost of the product might be too prohibitive for immediate payment. In such a case, instead of waiting for a large payment at the end, they allow the customers to make regular monthly payments. This ensures that there is a constant flow of funds coming into the business that does not choke up the accounts receivable numbers.

Long-Term Financing

Relying purely on short-term funds to meet working capital needs is not always prudent, especially for industries where the manufacture of the product itself takes a long time: automobiles, aircraft, refrigerators, and computers. Such companies need their working capital to last for a long time, and hence they have to think about long term financing.

1. Long-Term Loan from a Bank:

Many companies opt for a full-fledged long term loan from a bank that allows them to meet all their working capital needs for two, three or more years.

2. Retain Profits:

Rather than making dividend payments to shareholders or investing in new ventures, many businesses retain a portion of their profits so that they may use it for working capital. This way they do not have to take loans, pay interest, incur losses on discounted bills, and they can be self-sufficient in their financing.

3. Issue Equities and Debentures:

In extreme cases when the business is really short of funds, or when the company is investing in a large-scale venture, they might decide to issue debentures or bonds to the general public or in some cases even equity stock. Of course, this will be done only by conglomerates and only in cases when there is a need for a huge quantum of funds.

Companies cannot rely only on limited sources for their working capital needs. They need to tap multiple avenues. They also need to constantly evaluate what their needs are, through analysis of financial statements and financial ratios, and choose their working capital channels judiciously. This is an ongoing process, and different routes are appropriate at different points in time. The trick is to choose the right alternative as per the situation.

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