BBA – II Year, III Semester
25BBBA33T: BUSINESS FINANCE

UNIT – 1: INTRODUCTION TO BUSINESS FINANCE

1. Meaning of Business Finance

Business Finance refers to the money required for starting, operating and expanding a business. It deals with the procurement, allocation and effective utilisation of funds.

Definition:

Business Finance is the process of planning, raising, managing and controlling the financial resources of a business organisation.

Example: A company requires money to purchase machinery, raw materials, buildings, pay salaries and meet other expenses.

2. Nature of Business Finance

The nature of business finance explains its basic characteristics.

1. Science and Art: Finance involves scientific principles and practical decision-making.
2. Continuous Process: Financial activities are required throughout the life of a business.
3. Future-Oriented: Financial decisions are based on future expectations.
4. Investment Decisions: It helps in selecting profitable investment opportunities.
5. Financing Decisions: It determines the sources from which funds are raised.
6. Risk and Return: It considers the relationship between risk and expected returns.
7. Optimum Utilisation: It ensures the effective utilisation of available funds.
8. Profitability: It aims to improve the profitability of the organisation.
9. Liquidity: It ensures sufficient cash to meet short-term obligations.
10. Decision-Making: It helps management make important financial decisions.

3. Scope of Business Finance

The scope of business finance includes the following areas:

1. Investment Decisions

Investment decisions involve selecting the best projects or assets in which funds should be invested.

Examples:

- Purchasing machinery.
- Establishing a new branch.
- Purchasing land and buildings.

2. Financing Decisions

These decisions determine how the business raises funds.

Sources include:

- Equity shares.
- Preference shares.
- Debentures.
- Bank loans.
- Retained earnings.

3. Dividend Decisions

Dividend decisions relate to the distribution of profits among shareholders and the retention of profits for future growth.

4. Working Capital Decisions

These decisions relate to the management of current assets and current liabilities.

Examples: Cash, inventory, debtors and creditors.

5. Financial Planning

Financial planning estimates the financial requirements of a business and determines how funds should be obtained and utilised.

4. Significance of Business Finance

Business finance is important for the following reasons:

1. Starting a Business: It provides the initial capital required to establish a business.
2. Business Expansion: It helps in opening new branches and increasing production.
3. Purchase of Assets: It provides funds to purchase machinery, equipment and buildings.
4. Day-to-Day Operations: It meets daily operating expenses.
5. Maintaining Liquidity: It helps meet short-term financial obligations.
6. Increasing Profitability: Proper financial management improves profits.
7. Risk Management: It helps businesses prepare for financial uncertainties.
8. Modernisation: It supports the adoption of new technology.
9. Business Survival: It ensures the continuous functioning of the organisation.
10. Wealth Maximisation: It aims to increase shareholders' wealth.

5. Financial Goals

Financial goals are the objectives that a business organisation wants to achieve through financial management.

Major financial goals

1. Profit Maximisation

Profit maximisation means increasing the profits of the business.

Advantages:

- Increases business income.
- Improves financial performance.
- Encourages cost reduction.
- Supports business growth.

Limitations:

- Ignores the time value of money.
- Ignores risk factors.
- Focuses mainly on short-term profits.

2. Wealth Maximisation

Wealth maximisation means increasing the market value of shareholders' investment.

Advantages:

- Considers risk and return.
- Considers the time value of money.
- Focuses on long-term growth.
- Protects shareholders' interests.

Difference between Profit Maximisation and Wealth Maximisation

Basis	**Profit Maximisation**	**Wealth Maximisation**
Meaning	Increasing profits	Increasing shareholders' wealth
Focus	Profit	Market value of shares
Time	May be short-term	Long-term
Risk	May ignore risk	Considers risk
Time value	Generally ignored	Considered
Objective	Profit growth	Shareholder value

6. Finance Function

The finance function refers to all activities relating to the acquisition, allocation and utilisation of funds in a business organisation.

Major finance functions

1. Estimating financial requirements.
2. Selecting appropriate sources of finance.

3. Investment of funds.
4. Managing working capital.
5. Dividend decisions.
6. Financial planning.
7. Financial control.
8. Maintaining financial records.
9. Managing financial risks.
10. Ensuring optimum utilisation of funds.

7. Duties and Responsibilities of a Finance Manager

A Finance Manager is a person responsible for planning, organising and controlling the financial activities of an organisation.

Important duties

1. Financial Planning: Preparing financial plans and budgets.
2. Raising Funds: Selecting suitable sources of finance.
3. Investment Decisions: Identifying profitable investment opportunities.
4. Working Capital Management: Managing cash, inventory and receivables.
5. Dividend Decisions: Recommending dividend payments.
6. Financial Control: Controlling unnecessary expenditure.
7. Risk Management: Identifying and managing financial risks.
8. Financial Reporting: Preparing financial statements.
9. Cost Control: Reducing operating costs.
10. Coordination: Coordinating financial activities with other departments.

Qualities of a Good Finance Manager

- Analytical skills.
- Decision-making ability.
- Leadership qualities.
- Financial knowledge.
- Communication skills.
- Honesty and integrity.
- Problem-solving ability.

UNIT – 2: CAPITAL BUDGETING

1. Meaning of Capital Budgeting

Capital Budgeting is the process of evaluating and selecting long-term investment projects that require large amounts of money.

Definition:

Capital Budgeting is the process of planning and evaluating investments in long-term assets to determine their profitability and financial feasibility.

Examples:

- Purchasing new machinery.
- Constructing a factory.
- Establishing a new branch.
- Introducing a new product.
- Expanding production capacity.

2. Features of Capital Budgeting

1. Long-Term Investment: Decisions involve investments for many years.
2. Large Amount of Funds: Requires substantial capital investment.
3. Long-Term Benefits: Benefits are received over several years.
4. Risk and Uncertainty: Future cash flows are uncertain.
5. Irreversible Decisions: Many investments cannot easily be reversed.
6. Strategic Decisions: These decisions influence the future growth of the business.

7. Time Value of Money: Money received today is more valuable than the same amount received in the future.

3. Importance of Capital Budgeting

1. Helps in selecting profitable projects.
2. Ensures proper utilisation of capital.
3. Reduces investment risks.
4. Supports business expansion.
5. Improves long-term profitability.
6. Helps in financial planning.
7. Avoids unnecessary investment.
8. Increases shareholders' wealth.
9. Helps in replacing outdated machinery.
10. Supports strategic decision-making.

4. Techniques of Capital Budgeting

The major techniques are:

1. Payback Period Method.
2. Accounting Rate of Return Method.
3. Net Present Value Method.
4. Profitability Index Method.
5. Internal Rate of Return Method.

5. Payback Period Method (PBP)

Meaning:

Payback Period refers to the time required to recover the original investment from the cash inflows generated by a project.

Formula:

Payback Period=Initial Investment/Annual Cash Inflow

Advantages

- Simple to understand.
- Easy to calculate.
- Focuses on recovery of investment.
- Useful for businesses facing liquidity problems.

Disadvantages

- Ignores the time value of money.
- Ignores cash flows after the payback period.
- Does not directly measure profitability.
- May favour short-term projects.

6. Accounting Rate of Return (ARR)

Meaning:

Accounting Rate of Return measures the average annual accounting profit earned from an investment as a percentage of average investment.

Formula:

ARR=Average Annual Profit/Average Investment×100

Advantages

- Easy to calculate.
- Uses accounting information.
- Considers profits throughout the project.
- Easy to understand.

Disadvantages

- Ignores the time value of money.
- Uses accounting profits instead of cash flows.

- Different methods of calculating depreciation may affect ARR.

7. Net Present Value (NPV)

Meaning:

Net Present Value is the difference between the present value of cash inflows and the initial investment.

Formula:

NPV=PV of Cash Inflows−Initial Investment

Decision Rules

- Positive NPV: Accept the project.
- Negative NPV: Reject the project.
- Zero NPV: The project earns exactly the required rate of return.

Advantages

1. Considers the time value of money.
2. Considers all cash flows.
3. Helps in wealth maximisation.
4. Provides a clear financial decision.

Disadvantages

1. Requires the selection of a discount rate.
2. Calculations are comparatively complex.
3. Difficult to estimate future cash flows accurately.

8. Profitability Index (PI)

Meaning:

Profitability Index measures the present value of future cash inflows per rupee of initial investment.

Formula:

PI=PV of Cash Inflows/Initial Investment

Decision Rules

- PI greater than 1: Accept.
- PI less than 1: Reject.
- PI equal to 1: Indifferent.

Advantages

- Considers the time value of money.
- Useful when capital is limited.
- Helps compare investment projects.

Disadvantages

- Requires discount rate calculation.
- May not always give the same ranking as NPV for mutually exclusive projects.

9. Internal Rate of Return (IRR)

Meaning:

Internal Rate of Return is the discount rate at which the Net Present Value of a project becomes zero.

Where:

- L = Lower discount rate.
- H = Higher discount rate.
- NPVLNPV_LNPVL = Positive NPV at lower rate.
- NPVHNPV_HNPVH = Negative NPV at higher rate.

Decision Rule

- IRR greater than required rate of return: Accept.
- IRR less than required rate of return: Reject.
- IRR equal to required rate: Indifferent.

Advantages

- Considers the time value of money.
- Considers all project cash flows.
- Expressed as a percentage.
- Useful for investment comparison.

Disadvantages

- Calculation is complex.
- Multiple IRRs may arise in certain cash-flow patterns.
- May give misleading rankings for mutually exclusive projects.

UNIT – 3: CAPITALIZATION AND SOURCES OF FINANCE

1. Meaning of Capitalization

Capitalization refers to the total amount of long-term funds invested in a business organisation.

It includes:

- Equity share capital.
- Preference share capital.
- Debentures.
- Long-term loans.
- Retained earnings.

Definition:

Capitalization is the process of determining the total financial requirements of a business and arranging the long-term funds required for its operations.

2. Theories of Capitalization

There are two important theories of capitalization.

A. Cost Theory of Capitalization

According to this theory, capitalization is based on the total cost of establishing and operating a business.

It includes:

1. Cost of land and buildings.
2. Cost of machinery.
3. Preliminary expenses.
4. Working capital.
5. Other establishment expenses.

B. Earnings Theory of Capitalization

According to this theory, the capitalization of a company is determined based on its expected annual earnings and the normal rate of return.

3. Overcapitalization

Meaning:

Overcapitalization occurs when the capital employed in a business is more than what is justified by its earning capacity.

In simple words, a company is overcapitalized when it earns a lower rate of return compared with the normal expected rate of return.

Causes of Overcapitalization

1. Excessive issue of shares and debentures.
2. Purchase of assets at high prices.
3. Underutilisation of business resources.
4. Excessive borrowing.
5. Poor financial management.
6. Decline in demand for products.
7. High operating expenses.

8. Incorrect estimation of future earnings.
9. Excessive investment in fixed assets.
10. Economic recession.

Effects of Overcapitalization

Effects on the Company

1. Reduction in profitability.
2. Lower dividend payments.
3. Difficulty in raising additional finance.
4. Decrease in the market value of shares.
5. Loss of investor confidence.

Effects on Shareholders

1. Lower dividend income.
2. Reduction in share value.
3. Loss of investment confidence.

Effects on Employees

1. Salary and bonus difficulties.
2. Reduced employment opportunities.
3. Possibility of retrenchment.

Remedies for Overcapitalization

1. Reduction of share capital.
2. Redemption of debentures.
3. Reduction in operating expenses.
4. Efficient utilisation of assets.
5. Improvement in management efficiency.
6. Sale of unnecessary assets.
7. Increasing production and sales.
8. Debt restructuring.

4. Undercapitalization

Meaning:

Undercapitalization occurs when the capital available in a business is less than what is required for its operations or when the business earns an unusually high rate of return compared with its capital.

In simple words, the company earns high profits with relatively small capital.

Causes of Undercapitalization

1. Underestimation of financial requirements.
2. Efficient management.
3. High business profitability.
4. Conservative dividend policy.
5. Low initial investment.
6. Increase in demand for products.
7. Technological improvements.
8. High productivity.
9. Unexpected increase in earnings.
10. Low operating costs.

Effects of Undercapitalization

1. High profits and high returns.
2. Increase in market value of shares.
3. Possibility of unhealthy competition.
4. Employee dissatisfaction due to low wages relative to profits.
5. Government attention due to excessive profits.

6. Pressure to increase dividend payments.
7. Difficulty in maintaining business expansion without additional capital.

Remedies for Undercapitalization

1. Issue additional shares.
2. Issue bonus shares.
3. Increase the face value of shares, where legally permissible.
4. Expand business operations.
5. Invest in modern technology.
6. Improve employee compensation.
7. Maintain an appropriate capital structure.

5. Difference Between Overcapitalization and Undercapitalization

Basis	**Overcapitalization**	**Undercapitalization**
Meaning	Excessive capital	Comparatively insufficient capital
Earnings	Low rate of return	High rate of return
Profitability	Low relative to capital	High relative to capital
Share value	Generally decreases	Generally increases
Dividend	Low dividend	Relatively high dividend
Financial position	Weak earning capacity	Strong earning capacity
Remedies	Reduce capital	Increase capital

6. Sources of Finance

Sources of finance refer to the different methods through which a business organisation obtains funds to meet its financial requirements.

They are classified as follows:

A. On the Basis of Period

1. Short-Term Sources of Finance

Funds required for a period of up to one year.

Examples:

- Trade credit.
- Bank overdraft.
- Cash credit.
- Commercial papers.
- Short-term bank loans.
- Bills discounting.

2. Medium-Term Sources of Finance

Funds required generally for one to five years.

Examples:

- Medium-term bank loans.
- Lease financing.
- Hire purchase.
- Financial institution loans.

3. Long-Term Sources of Finance

Funds required for more than five years or for long-term investment.

Examples:

- Equity shares.
- Preference shares.
- Debentures.
- Long-term bank loans.
- Retained earnings.

B. On the Basis of Ownership

1. Owned Capital

Owned capital refers to funds contributed by the owners of the business.

Examples:

- Equity shares.
- Preference shares.
- Retained earnings.

Features:

- Provides permanent or long-term financial support.
- Does not generally require compulsory repayment like loans.
- Equity shareholders participate in ownership.
- Dividend payments are not fixed obligations.

2. Borrowed Capital

Borrowed capital refers to funds obtained from outside parties that must be repaid according to agreed terms.

Examples:

- Bank loans.
- Debentures.
- Financial institution loans.
- Public deposits.

Features:

- Carries interest obligations.
- Has a repayment period.
- Lenders do not normally receive ownership rights.
- Interest is generally a fixed financial obligation.

7. Important Sources of Finance

1. Equity Shares

Equity shares represent ownership capital in a company.

Features:

- Equity shareholders are owners of the company.
- They generally have voting rights.
- Dividends are not fixed.
- They bear the business risk.
- They receive the residual claim on profits and assets.

Advantages

- Permanent source of capital.
- No compulsory dividend.
- Improves borrowing capacity.
- No fixed repayment obligation.

Disadvantages

- Dilution of ownership.
- Higher expected return for investors.
- Issue of shares may involve costs.
- Profits are shared among more shareholders.

2. Preference Shares

Preference shares are shares that carry preferential rights regarding dividend payment and repayment of capital.

Features:

- Preferential dividend rights.
- Priority in repayment of capital over equity shareholders.

- Usually carry a fixed dividend rate.
- Voting rights are generally limited.

Advantages

- No dilution of ordinary voting control in most cases.
- Fixed dividend rate.
- Useful for raising long-term funds.

Disadvantages

- Dividend expectations create a financial burden.
- Cost may be high.
- Preference dividend is not tax-deductible.

3. Debentures

Debentures are written instruments acknowledging a company's debt.

Features:

- Carry a fixed rate of interest.
- Debenture holders are creditors.
- Interest is payable according to the terms.
- Usually have a specified repayment period.
- Debenture holders do not generally have voting rights.

Advantages

- No dilution of ownership.
- Interest is generally tax-deductible.
- Suitable for long-term finance.

Disadvantages

- Fixed interest obligation.
- Repayment obligation.
- Excessive borrowing increases financial risk.

4. Bank Loans

A bank loan is money borrowed from a bank for a specific period at an agreed interest rate.

Types:

- Short-term loans.
- Medium-term loans.
- Long-term loans.

Advantages:

- Quick access to finance, subject to approval.
- Flexible loan options.
- Interest costs are generally tax-deductible.

Disadvantages:

- Interest payment is compulsory.
- Security may be required.
- Repayment creates financial pressure.

5. Trade Credit

Trade credit is a short-term source of finance provided by suppliers when goods or services are purchased on credit.

Example: A business purchases raw materials worth ₹50,000 and pays the supplier after 30 days.

Advantages:

- Easy availability for eligible customers.
- No immediate cash payment.
- Helps maintain working capital.

Disadvantages:

- Limited credit period.
- Late payment may attract charges.
- Loss of cash discounts.

6. Commercial Papers

Commercial Paper is an unsecured, short-term money market instrument issued by eligible companies to raise funds.

Features:

- Unsecured instrument.
- Short-term maturity.
- Generally issued at a discount and redeemed at face value.
- Used by financially sound eligible companies.

Advantages:

- Helps meet short-term financial requirements.
- May be cheaper than some bank borrowings.
- Flexible funding instrument.

Disadvantages:

- Not suitable for financially weak companies.
- Repayment must be arranged at maturity.
- Market conditions affect availability.

7. Bank Credit

Bank credit refers to financial assistance provided by banks to businesses in the form of loans, cash credit, overdrafts and other credit facilities.

Types:

1. Cash credit.
2. Bank overdraft.
3. Term loans.
4. Bill discounting.

8. Retained Earnings

Retained earnings refer to the portion of net profit kept in the business instead of distributing it as dividends.

Advantages:

- No interest payment.
- No dilution of ownership.
- Strengthens financial position.
- Supports expansion.

Disadvantages:

- May reduce dividend payments.
- Limited by the availability of profits.
- May lead to inefficient investment of surplus funds.

UNIT – 4: CAPITAL STRUCTURE

1. Meaning of Capital Structure

Capital Structure refers to the proportion of different sources of long-term finance used by a company.

It includes:

- Equity share capital.
- Preference share capital.
- Debentures.
- Long-term loans.
- Retained earnings.

Definition:

Capital Structure is the combination of debt and equity used by a company to finance its assets and business operations.

2. Features of Capital Structure

1. It represents the composition of long-term funds.
2. It includes debt and equity.
3. It influences financial risk.
4. It affects the cost of capital.
5. It influences shareholders' returns.
6. It is related to the financial stability of a company.
7. It helps in long-term financial planning.

3. Factors Influencing Capital Structure

1. Cost of Capital

The company should select sources of finance that minimise the overall cost of capital.

2. Risk

A company should maintain a suitable balance between debt and equity to control financial risk.

3. Control

Equity shares generally carry voting rights. Companies may prefer debt when they want to avoid dilution of ownership control.

4. Flexibility

Capital structure should allow the company to raise additional funds whenever required.

5. Size of the Company

Large companies generally have better access to different sources of finance.

6. Nature of Business

Stable businesses can generally support more debt than businesses with highly uncertain earnings.

7. Trading on Equity

A company may use borrowed funds to increase the returns available to equity shareholders, provided the return on investment exceeds the cost of debt.

8. Tax Benefits

Interest on eligible borrowings is generally tax-deductible, subject to applicable tax laws.

9. Market Conditions

The availability and cost of debt and equity depend on capital market conditions.

10. Profitability

Companies with stable profitability may be in a better position to use borrowed capital.

11. Cash Flow Position

A company should have sufficient cash flows to pay interest and repay debt.

12. Government Policies

Government regulations and financial policies influence financing decisions.

4. Types of Leverages

Leverage refers to the use of fixed costs or borrowed funds to increase the potential returns to shareholders.

There are three major types.

A. Operating Leverage

Operating leverage arises due to the existence of fixed operating costs in a business.

Formula:

B. Financial Leverage

Financial leverage arises due to the use of fixed-cost funds such as debt and preference share capital.

C. Combined Leverage

Combined leverage measures the combined effect of operating and financial leverage on earnings per share.

Difference Between Three Types of Leverage

Basis	Operating Leverage	Financial Leverage	Combined Leverage
Meaning	Fixed operating costs	Fixed financial costs	Both operating and financial costs
Focus	EBIT	EPS/EBT relationship	EPS and sales relationship
Risk	Business risk	Financial risk	Total risk
Formula	Contribution/EBIT	EBIT/EBT	DOL × DFL

5. Theories of Capital Structure

Capital structure theories explain the relationship between debt, equity, cost of capital and the value of a company.

1. Net Income (NI) Approach

According to the Net Income Approach, a company can increase its total value and reduce its overall cost of capital by increasing the proportion of debt in its capital structure, assuming the costs of debt and equity remain constant.

Main assumptions:

- Cost of debt remains constant.
- Cost of equity remains constant.
- Debt is cheaper than equity.
- No corporate taxes in the original model.

Conclusion: Higher debt can increase the value of the firm under the assumptions of this theory.

2. Net Operating Income (NOI) Approach

According to the Net Operating Income Approach, capital structure does not affect the total value of the firm.

Main assumptions:

- Overall cost of capital remains constant.
- Cost of debt remains constant.
- Cost of equity increases with financial leverage.
- The market capitalises the total operating income at a constant rate.

Conclusion: The capital structure is irrelevant to the total value of the firm.

3. Traditional Approach

According to the Traditional Approach, a company can achieve an optimum capital structure by using a reasonable combination of debt and equity.

Main points:

- Debt is generally cheaper than equity.
- Initially, increasing debt reduces the overall cost of capital.
- Excessive debt increases financial risk.
- After a certain point, the overall cost of capital may increase.

Conclusion: There is an optimum level of debt and equity at which the cost of capital is minimised and the value of the firm is maximised.

4. Modigliani and Miller (MM) Approach

Modigliani and Miller developed a theory explaining whether capital structure affects the value of a company.

A. MM Approach Without Taxes

According to the original MM theory, capital structure does not affect the total value of a firm under perfect market assumptions.

Assumptions:

- Perfect capital markets.

- No taxes.
- No transaction costs.
- Investors have rational expectations.
- Companies have similar business risk within a given class.

Conclusion: The value of the firm is independent of its capital structure.

B. MM Approach With Taxes

When corporate taxes are considered, debt financing provides a tax advantage because interest is generally tax-deductible.

Conclusion: Debt can increase the value of the firm through the interest tax shield, although excessive borrowing creates financial distress costs in practice.

Summary of Capital Structure Theories

Theory	Main Idea
Net Income	More debt can increase firm value
Net Operating Income	Capital structure does not affect firm value
Traditional	Optimum mix of debt and equity exists
MM without tax	Capital structure is irrelevant
MM with tax	Debt provides a tax advantage

UNIT – 5: WORKING CAPITAL MANAGEMENT

1. Meaning of Working Capital

Working Capital refers to the funds required by a business organisation for its day-to-day operations.

It is used to purchase raw materials, pay salaries, maintain inventory, meet electricity expenses and pay other operating expenses.

Definition:

Working Capital is the capital required for financing the short-term assets and day-to-day activities of a business organisation.

2. Concepts of Working Capital

There are two important concepts of working capital.

A. Gross Working Capital

Gross Working Capital refers to the total investment made in current assets.

Examples:

- Cash.
- Bank balance.
- Inventory.
- Debtors.
- Bills receivable.
- Short-term investments.

B. Net Working Capital

Net Working Capital refers to the difference between current assets and current liabilities.

Where:

- CA = Current Assets.
- CL = Current Liabilities.

3. Features of Working Capital

1. Short-Term Nature: Working capital is mainly required for short-term business operations.
2. Liquidity: It represents funds available to meet current obligations.
3. Continuous Requirement: It is required throughout the business cycle.
4. Regular Investment: Funds are continuously invested in current assets.

5. Fluctuating Nature: Working capital requirements change according to business activity.
6. Important for Daily Operations: It helps in the smooth functioning of business activities.
7. Profitability: Proper working capital management improves business profitability.
8. Risk Management: It helps avoid liquidity problems.

4. Components of Working Capital

Working capital consists of current assets and current liabilities.

A. Current Assets

Current assets are assets that are expected to be converted into cash, sold or consumed during the normal operating cycle or within the applicable accounting period.

Examples:

1. Cash: Money available with the business.
2. Bank Balance: Money deposited in bank accounts.
3. Inventory: Raw materials, work-in-progress and finished goods.
4. Debtors: Amounts receivable from customers.
5. Bills Receivable: Written promises to receive money.
6. Short-Term Investments: Investments that can be converted into cash in the short term.

B. Current Liabilities

Current liabilities are obligations that are expected to be settled during the normal operating cycle or within the applicable accounting period.

Examples:

1. Creditors: Amounts payable to suppliers.
2. Bills Payable: Written promises to pay money.
3. Bank Overdraft: Short-term borrowing from banks.
4. Outstanding Expenses: Expenses incurred but not yet paid.
5. Short-Term Loans: Loans repayable within a short period.

5. Types of Working Capital

Working capital can be classified into two major types.

A. Permanent Working Capital

Permanent Working Capital refers to the minimum amount of working capital required by a business to carry on its normal operations continuously.

Features:

- Required throughout the year.
- Essential for business survival.
- Relatively stable in the long run.
- Supports regular business activities.

Example: A company needs a minimum of ₹2,00,000 to maintain inventory and cash for its normal operations.

B. Temporary Working Capital

Temporary Working Capital refers to the additional working capital required to meet seasonal or special business requirements.

Features:

- Required for a limited period.
- Changes according to business activity.
- Depends on seasonal demand.
- Generally fluctuates throughout the year.

Example: A textile business requires additional working capital during festival seasons to meet increased customer demand.

Difference Between Permanent and Temporary Working Capital

Basis	Permanent	Temporary
Meaning	Minimum working capital	Additional working capital
Period	Required continuously	Required temporarily
Nature	Stable	Fluctuating
Requirement	Normal operations	Seasonal demand
Example	Regular inventory	Festival inventory

6. Importance of Working Capital

Working capital is important for the successful operation of a business.

1. Smooth Business Operations

It helps businesses carry out daily activities without interruptions.

2. Purchase of Raw Materials

It provides funds to purchase raw materials required for production.

3. Payment of Salaries

It helps organisations pay salaries and wages to employees on time.

4. Maintaining Liquidity

It ensures sufficient funds to meet short-term obligations.

5. Maintaining Creditworthiness

Timely payment of creditors improves the reputation of the business.

6. Increasing Profitability

Proper management of working capital reduces unnecessary expenses.

7. Business Expansion

It helps businesses increase production and sales.

8. Meeting Emergencies

It provides financial support during unexpected situations.

9. Maintaining Inventory

It ensures the availability of sufficient raw materials and finished goods.

10. Improving Business Efficiency

It improves the overall efficiency of business operations.

7. Factors Affecting Working Capital Requirements

The following factors influence the working capital requirements of a business.

1. Nature of Business

Manufacturing businesses generally require more working capital than some service businesses.

2. Size of Business

Large businesses generally require more working capital than small businesses.

3. Production Cycle

Businesses with longer production cycles require more working capital.

4. Business Cycle

During economic prosperity, working capital requirements may increase because of higher demand.

5. Seasonal Fluctuations

Seasonal businesses require additional working capital during peak seasons.

6. Credit Policy

Companies offering more credit to customers generally require more working capital.

7. Availability of Raw Materials

Businesses that need to maintain large inventories of raw materials require more working capital.

8. Operating Efficiency

Efficient management of inventory and receivables reduces working capital requirements.

9. Growth and Expansion
Expanding businesses require additional working capital.
10. Price Level Changes
Inflation and increases in the prices of raw materials increase working capital requirements.
11. Production Policy
Continuous production may require different working capital levels compared with seasonal production.
12. Business Risk
Businesses facing greater uncertainty may need additional working capital reserves.

8. Working Capital Management

Working Capital Management refers to the process of managing current assets and current liabilities to maintain sufficient liquidity and profitability.

Objectives of Working Capital Management

1. Maintaining adequate liquidity.
2. Ensuring uninterrupted business operations.
3. Improving profitability.
4. Reducing financial risk.
5. Maintaining optimum inventory levels.
6. Collecting receivables on time.
7. Making timely payments to creditors.
8. Ensuring efficient utilisation of current assets.

Important Areas of Working Capital Management

1. Cash Management
Cash management involves maintaining an appropriate cash balance to meet daily business expenses.
2. Inventory Management
Inventory management involves maintaining optimum levels of raw materials, work-in-progress and finished goods.
3. Receivables Management
Receivables management involves collecting payments from customers on time.
4. Payables Management
Payables management involves managing payments to suppliers and creditors effectively.

9. Difference Between Working Capital and Fixed Capital

Basis	**Working Capital**	**Fixed Capital**
Meaning	Funds for daily operations	Funds for long-term assets
Period	Short-term	Long-term
Investment	Current assets	Fixed assets
Liquidity	Generally high	Generally low
Examples	Cash, stock, debtors	Land, buildings, machinery
Purpose	Day-to-day operations	Long-term business activities