

BUSINESS FINANCE

Q. Explain the significance of managing working capital. Suggest 5 ways to improve the working capital.

Ans. Working capital, sometimes referred to as the lifeblood of the business is also known as the circulating capital. It is the amount of money needed to finance the day-to-day expenses such as wages electricity and gas charges. It is the difference between the current assets and current liabilities i.e. the amount of money left after paying off the short – term debts. Current assets includes stock, debtors and cash at bank and in hand while current liabilities include trade creditors accrued expenses and bank overdrafts.

Managing working capital is essential for the efficient working of the business. Usually the working capital available should be twice as much as short – term debts so that they can easily be paid off in case of an urgency. Too little working capital causes liquidity problems as creditors start to ask for payments. In case of non – payment relations may worsen the relations with suppliers. Who may stop provision of raw materials causing disruption in production. Also if too long credit periods are demanded then this would give poor name to the business and other suppliers would avoid transactions with the business in future. Also if interest charges aren't paid on time then tenders may not tend in future because of adverse track – record. In case other expenses such as gas bills of electricity charges are not paid then they may be cut off due to which production may suffer which may cause production not to meet deadlines and non – delivery of orders to customers.

However, excess working capital would also cause problem. This means that assets i.e. stock and cash are lying idle in the business which leads to opportunity costs. Idle cash could be invested in other projects to get revenue in the form of returns from shares (if shares of other businesses are bought). Also too high stocks may result in high storage costs, greater chance of theft, stock becoming obsolete or ruining. Thus stock control may be required. Additionally, very high working capital may also be a to too long credit periods given to debtors which increases chances of bad debts. But suitable time should be given to debtors in line with that of competitors in order to avoid losing customers.

In order to improve the working capital, transaction of the nature that increase current assets without increasing current liabilities or which decrease current liabilities without reduce current assets, have to be undertaken. One way to increase working capital is by the sales of existing fixed assets makes cash available to the business. The fixed assets should be one lying useless which is no longer required by the business. Or it may be a sale and leaseback. In this fixed asset sold for immediate cash while lease payments are small. However, the problem is that the fixed asset may be needed if there is a sudden increase in demand. Also in sale and leaseback, the overall payments are greater than the original cost.

Second way to improve working capital is by bank loans of the long – term nature to generate cash. A fixed rate of interest has to be paid so if beforehand negotiations are undertaken then agreed rate is low. Bank loans interest has to be paid before tax so the tax charges are lower. Also they are eventually repaid, so after repayment no further interest would have to be paid. However, bank loans increase gearing of business. The third way to improve working capital is by the

issue of ordinary shares. This is a source of permanent capital and dividends do not have to be paid every year. Improves gearing of the business too. However it leads to a diluting of ownership and ownership may change hands.

Fourthly, benefiting from discounts offered by the trade creditors also increases working capital. This is because on quickly paying creditor, the discounts may result in the payment of 90% of the purchases while the 10% is part of discount received. This becomes a source of earning and thus cash paid is less than liability settled. The benefit is improvement in track record of payment to suppliers whose relationship improves. Finally working capital is also improved by the factoring of debts or selling off debts to the specialist companies which gives quick cash for quickly improving the liquidity of the business.

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BUSINESS PLAN

It is a detailed document which gives evidence about a new or existing business that aims to convince external lenders and investors to extend finance to the business.

The main sections of the business plan are as follows

1. **Introduction**
It contains the nature of the business, its main aims and objectives, the amount of finance required and the proposed specific use of that finance.
2. **A Business Description**
It contains the evidence of past performance (if there is any), legal and capital structure, brief history and background and the business experience of the main employees.
3. **Market Research & Marketing Plan:**
It contains the evidence about the market research undertaken by the business to support the potential success of the product or service. A sales forecast as well as the main marketing strategies proposed for the launch or growth of the company's product should also be submitted.
4. **Operations Plan:**
It contains brief details about the production process used by the business. E.g. whether job or batch production is employed as well as the costs involved in production and machinery use.
5. **Financial Plan & Information:**
It contains the projected profit and loss account, projected balance sheet, cashflow forecast for at least one year (though minimum preferred is for 3 years). It should also have break-even details.

FINANCIAL INSTITUTION

Local Institutions

1. Leasing Companies
2. Commercial Banks
3. Merchant Banks

4. Debt – factoring companies
5. Stock Exchange
6. Central Bank

International Institutions

1. World Bank
2. IMF – International Monetary Fund
3. Asian Development Bank
4. United Nations

Mega Lecture