

Fixed Capital & Working Capital

1 Mark Questions

1. How does inflation affect the working capital requirements of a company? State. (Delhi 2014)

Ans. With rising prices, larger amounts are required even to maintain a constant volume of production and sales. The working capital requirement of a business thus, become higher with higher rate of inflation.

2. State how growth prospects affect the working capital requirement of a company? (Delhi 2013)

Ans. If the growth potential of a concern is perceived to be higher, it will require large amount of working capital, so that it will be able to meet higher production and sales target whenever required.

3. Name any two essential ingredients of sound working capital management.(All India 2010)

Ans. (i) Inventory management (ii) Receivable management

4. Define fixed capital. (All India 2010; Delhi 2010, 2009, 2008)

Ans. The amount of capital investment in fixed assets is called fixed capital, e.g. plant and machinery, land and building, etc.

5. What is working capital? (Delhi 2010, 2009, 2008; All India 2008)

Ans. Working capital is that part of total capital which is required for holding current assets. It may also be defined as an excess of current assets over current liabilities.

6. Identify the decision taken in financial management which affects the liquidity as well as the profitability of business. (Hots; All India 2008)

Ans. Short-term investment decision or working capital decision affects the liquidity as well as the profitability of the business.

7. State why does the working capital needs for a service industry different from that of a manufacturing industry? (Hots; All India 2008)

Ans. Service industries require no inventory and manufacturing overheads, hence, require less working capital.

4/5 Mark Questions

8. Explain any four factors which affect the working capital requirements of a company. (All India 2013)

Ans. Working capital is that part of total capital which is required for holding current assets. It may also be defined as an excess of current assets over current liabilities. The four main factors affecting working capital requirements are as follows

(i) **Production cycle** It is the time span between the receipt of raw materials and their conversion into finished goods. Length of production cycle affects the working capital requirement. If the duration of production cycle is longer, the working capital requirements to meet day-to-day expenses would be higher and vice-versa.

(ii) **Business cycle** At times of boom period in the market, e.g. Diwali, Guru Parv, etc. The production as well as sales are likely to be higher. Whereas, the working capital requirement would be lower in times of depression in the market. •

(iii) **Nature of business** A trading business needs less amount of working capital because there is no processing of goods. On the other hand, the working capital requirement would be more in case of manufacturing business where raw materials are converted into finished goods.

(iv) **Scale of operations** A large scale organisation requires large amount of working capital as compared to a small scale organisation because the quantum of inventory, debtors and cash required is generally high.

9. Explain any four factors which affect the 'fixed capital' requirements of a company. (All India 2013)

Ans. The amount of capital investment in fixed assets is called fixed capital, e.g. plant and machinery, land and building, etc.

(i) **Nature of business** While deciding the fixed capital requirement of a business enterprise, its nature should be considered, e.g. trading concern needs lower investment in fixed assets as compared with a manufacturing organisation; since it does not require to purchase plant and machinery, etc.

(ii) **Scale of operations** A large organisation operating at a higher scale needs higher investment in fixed assets as compared to the small organisation.

(iii) **Choice of technique** A capital intensive organisation requires higher investment in plant and machinery. So, requirement of fixed capital would be higher. On the other hand, labour intensive organisation requires less investment in fixed assets.

(iv) **Technology upgradation** These days upgradation with the latest technologies is



essential and there is a need to replace the old technology with new. Thus, in this case, higher investment is required and vice-versa.

10. Neelabh is engaged in transport business and transports fruits and vegetables to different states. Stating the reason in support of your answer, identify the working capital requirements of Neelabh. Neelabh also wants to expand and diversify his transport business, explain any two factors that will affect his fixed capital requirements. (Hots; Delhi 2012)

or

Pranav is engaged in transport business. Identify the working capital requirements of Pranav stating the reason in support of your answer. Pranav wants to expand and diversify his transport business. Explain any two factors that will affect his fixed capital requirements. (All India 2012)

Ans. In the transportation business, lesser amount of working capital is required as Neelabh and Pranav are engaged in service industry. A firm engaged in service industry needs less working capital.

(i) Lower investment is required to carry out the day-to-day operations.

(ii) Lower investment require to maintain inventory, if any.

(iii) Cash transactions.

Factors affecting the fixed capital requirement are:

(i) **Growth prospects** Businessman wants to expand his business, in such a situation, company requires higher investment to meet the anticipated demand in future. Thus the requirement of fixed capital will be higher.

(ii) **Diversification** If the businessman diversify his business, this mean larger amount of fixed capital is required.

6 Mark Questions

11. Explain the following as factors affecting the requirements of working capital (All India 2014; Foreign 2014)

(i) Nature of business

(ii) Scale of operations

(iii) Seasonal factors

(iv) Production cycle

Ans. Factors affecting working capital requirements are:

(i) **Nature of business** A trading business needs less amount of working capital because there is no processing of goods. On the other hand, the working capital requirement would be more in case of manufacturing business where raw materials are converted into finished goods.

(ii) **Scale of operation** A large scale organisation requires large amount of working capital as compared to small scale organisation because the quantum of inventory, debtors and cash required is generally high.

(iii) **Seasonal factors** Business operations are affected by the seasonal changes. As during peak season higher are the level of activities and higher the requirements of working capital, on the other hand, during lean season requirements of working capital will be lower.

(iv) **Production cycle** It cycle is the time span between the receipt of raw materials and their conversion into finished goods. Length of production cycle affects the working capital requirement. If the duration of production cycle is longer, the working capital requirements to meet day to day expenses would be higher and vice-versa.

12. Explain the following as factors affecting the requirements of working capital (Delhi 2014)

(i) **Business cycle**

(ii) **Operating efficiency**

(iii) **Availability of raw material**

(iv) **Level of competition**

Ans. Working capital is the capital invested in current assets which facilitates day-to-day operations of the business. The amount of working capital required depends on various factors; Factors affecting working capital requirement are:

(i) **Business cycle** Different phases of business cycles affect the requirement of working capital by a firm. In case of a boom, the sales as well as production are likely to be larger and, therefore, larger amount of working capital is required. As against this, the requirement for working capital will be lower during the period of depression as the sales as well as production will be small.

(ii) **Operating efficiency** Firms manage their operations with varied degrees of efficiency. For example, a firm managing its raw materials efficiently may be able to manage with a smaller balance. This is reflected in a higher inventory turnover ratio. Similarly, a better debtors turnover ratio may be achieved reducing the amount tied up in receivables. Better sales effort may reduce the average time for which finished goods inventory is held. Such efficiencies may reduce the level of raw materials, finished goods and debtors resulting in lower requirement of working capital.

(iii) **Availability of raw material** If raw material required is freely available, lower stock levels may be sufficient and vice-versa lead time, i.e. time lag between placing the order and actual receipt of material is also a major determinant. A larger lead time will require larger amount of raw material to be stored, thus larger amount of working capital is required.

(iv) **Level of competition** Higher level of competitiveness may necessitate larger stocks of finished goods to meet urgent orders from customers. This increases the working



capital requirement.

13. Explain how the following factors affect the working capital requirements of Business

- (i) Inflation**
- (ii) Business cycle**
- (iii) Level of competition**
- (iv) Nature of business**

Ans. Factors affecting working capital requirement are:

(i) **Inflation** Inflation leads to increase in prices of raw materials, thus more working capital is required.

(ii) **Business cycle** Different phases of business cycles affect the requirement of working capital by a firm. In case of a boom, the sales as well as production are likely to be larger and, therefore, larger amount of working capital is required. As against this, the requirement for working capital will be lower during the period of depression as the sales as well as production will be small.

(iii) **Level of competition** Higher level of competitiveness may necessitate larger stocks of finished goods to meet urgent orders from customers. This increases the working capital requirement.

(iv) **Nature of business** A trading business needs less amount of working capital because there is no processing of goods. On the other hand, the working capital requirement would be more in case of manufacturing business where raw materials are converted into finished goods.

14. Explain the following as factors affecting the requirements of fixed capital.

- (i) Scale of operations**
- (ii) Choice of technique**
- (iii) Technology upgradation**
- (iv) Financing alternatives**

or

Explain any four factors affecting fixed capital requirement of a company. (Compartment 2014)

Ans. The capital invested in fixed assets like land and buildings, plant and machinery, furnitures and fixtures etc, is known as fixed capital. How much is to be invested in fixed capital. How much is to be invested in fixed assets is determined by many factors. Factors affecting fixed capital requirement are:

(i) **Scale of operations** A larger organisation operating at a higher scale needs higher investment in fixed assets as compared with the small organisation.

(ii) **Choice of technique** Some organisations are capital intensive whereas others are labour intensive. A capital intensive organisation requires higher investment in plant and machinery as it relies less on manual labour. The requirement of fixed capital for such organisations would be higher. Labour intensive organisations on the other hand require less investment in fixed assets.

(iii) **Technology upgradation** In certain industries, assets become obsolete sooner. Consequently, their replacements become due faster. Higher investment in fixed assets may, therefore, be required in such cases, e.g. computers become obsolete faster and are replaced much sooner than say, furniture. Thus, such organisations which use assets are prone to obsolescence require higher fixed capital to purchase such assets.

(iv) **Financing alternatives** Availability of leasing facilities reduce the fund requirement to be invested in fixed capital as the firm has to only pay lease rentals against outright purchase of the asset.

15. Explain the following as factors affecting the requirements of fixed capital

(i) **Nature of business**

(ii) **Growth prospects**

(iii) **Diversification**

(iv) **Level of collaboration (Delhi 2014)**

Ans. (i) Nature of business The type of business has a bearing upon the fixed capital requirements, e.g. a trading concern needs lower investment in fixed assets compared with a manufacturing organisation, since it does not require to purchase plant and machinery, etc.

(ii) **Growth prospects** Higher growth of an organisation generally requires higher investment in fixed assets. Even when such growth is expected, a company may choose to create higher capacity in order to meet the anticipated higher demand quicker. This entails larger investment in fixed assets and consequently larger fixed capital.

(iii) **Diversification** If a firm diversify its operations, its fixed capital requirements increases.

(iv) **Level of collaboration** Usually organisations show each other's facilities as it is feasible and reduces the level of investment in fixed assets, e.g. PNB bank may use ATM of Andhra Bank.

16. You are the financial manager of a newly established company. The directors have asked you to determine the amount of working capital requirement for the company. Explain any four factors that you will consider while determining the working capital requirement of the company.

(HOTS; Delhi 2011,2009,2008,2008 C; All India 2009)

or

Explain any four factors which determine the working capital requirement of an organisation. (Delhi 2011)

Ans. Factors determining the working capital requirement

(i) **Nature of business** A trading business needs less amount of working capital because there is no processing of goods. On the other hand, the working capital requirement would be more in case of manufacturing business where raw materials are converted into finished goods.

(ii) **Scale of operation** A large scale organisation requires large amount of working capital as compared to small scale organisation because the quantum of inventory, debtors and cash required is generally high.

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Working capital is the capital invested in current assets which facilitates day-to-day operations of

the business. The amount of working capital required depends on various factors;

Factors affecting working capital requirement are:

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Ans. Factors determining the fixed capital requirement (Any four)

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