Unit IV: WORKING CAPITAL MANAGEMENT: CONCEPT, IMPORTANCE AND OBJECTS

CONTENT

INTRODUCTION

It has been often observed that the shortage of working capital leads to the failure of a business. The proper management of working capital may bring about the success of a business firm. The management of working capital includes the management of current assets and current liabilities. A number of companies for the past few years have been finding it difficult to solve the increasing problems of adopting seriously the management of working capital.

A firm may exist without making profits but cannot survive without liquidity. The function of working capital management in an organization is similar that of the heart in a human body. Also it is an important function of financial management. The financial manager must determine the satisfactory level of working capital funds and also the optimum mix of current assets and current liabilities. He must ensure that the appropriate sources of funds are used to finance working capital and should also see that short term obligation of the business are met well in time.

DEFINITION OF WORKING CAPITAL

"Working Capital is the excess of C.A. over current liabilities."

CONCEPT OF WORKING CAPITAL MANAGEMENT

There are two concepts of working capital viz .quantitative and qualitative. Some people also define the two concepts as gross concept and net concept.

According to **quantitative** concept, the amount of working capital refers to 'total of current assets'. Current assets are considered to be gross working capital in this concept.

The **qualitative** concept gives an idea regarding source of financing capital. According to qualitative concept the amount of working capital refers to "excess of current assets over current liabilities." L.J. Guthmann defined working capital as "the portion of a firm's current assets which are financed from long–term funds." The excess of current assets over current liabilities is termed as 'Net working capital'. In this concept "Net working capital" represents the amount of current assets which would remain if all current liabilities were paid.

Both the concepts of working capital have their own points of importance. "If the objectives is to measure the size and extent to which current assets are being used, 'Gross concept' is useful; whereas in evaluating the liquidity position of an undertaking 'Net concept' becomes pertinent and preferable. It is necessary to understand the meaning of current assets and current liabilities for learning the meaning of working capital, which is explained below.

Current assets – It is rightly observed that "Current assets have a short life span. These type of assets are engaged in current operation of a business and normally used for short– term operations of the firm during an accounting period i.e. within twelve months. The two important characteristics of such assets are, (i) short life span, and (ii) swift transformation into other form of assets. Cash balance may be held idle for a week or two; account receivable may have a life span of 30 to 60 days, and inventories may be held for 30 to 100 days.

Current liabilities – The firm creates a Current Liability towards creditors (sellers) from whom it has purchased raw materials on credit. This liability is also known as accounts payable and shown in the balance sheet till the payment has been made to the creditors. The claims or obligations which are normally expected to mature for payment within an accounting cycle (1 year) are known as current liabilities. These can be defined as "those liabilities where liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current assets, or the creation of other current liabilities."

TYPES OF WORKING CAPITAL

According to the needs of business, the working capital may be classified into following two basis:

1) On the basis of periodicity

2) On the basis of concept

On the basis of periodicity:

The requirements of working capital are continuous. More working capital is required in a particular season or the peck period of business activity. On the basis of periodicity working capital can be divided under two categories as under:

1. Permanent working capital
2. Variable working capital

(a) **Permanent working capital:** This type of working capital is known as Fixed Working Capital. Permanent working capital means the part of working capital which is permanently locked up in the current assets to carry out the business smoothly. The minimum amount of current assets which is required to conduct the business smoothly during the year is called permanent working capital.

For example, investments required to maintain the minimum stock of raw materials or to cash balance. The amount of permanent working capital depends upon the size and growth of company. Fixed working capital can further be divided into two categories as under:

1. **Regular Working capital:**

   Minimum amount of working capital required to keep the primary circulation. Some amount of cash is necessary for the payment of wages, salaries etc.

2. **Reserve Margin Working capital:**

   Additional working capital may also be required for contingencies that may arise any time. The reserve working capital is the excess of capital over the needs of the regular working capital is kept aside as reserve for contingencies, such as strike, business depression etc.

(b) Variable or Temporary Working Capital:

The term variable working capital refers that the level of working capital is temporary and fluctuating. Variable working capital may change from one assets to another and changes with the increase or decrease in the volume of business.

The variable working capital may also be subdivided into following two sub-groups.

1. **Seasonal Variable Working capital:**

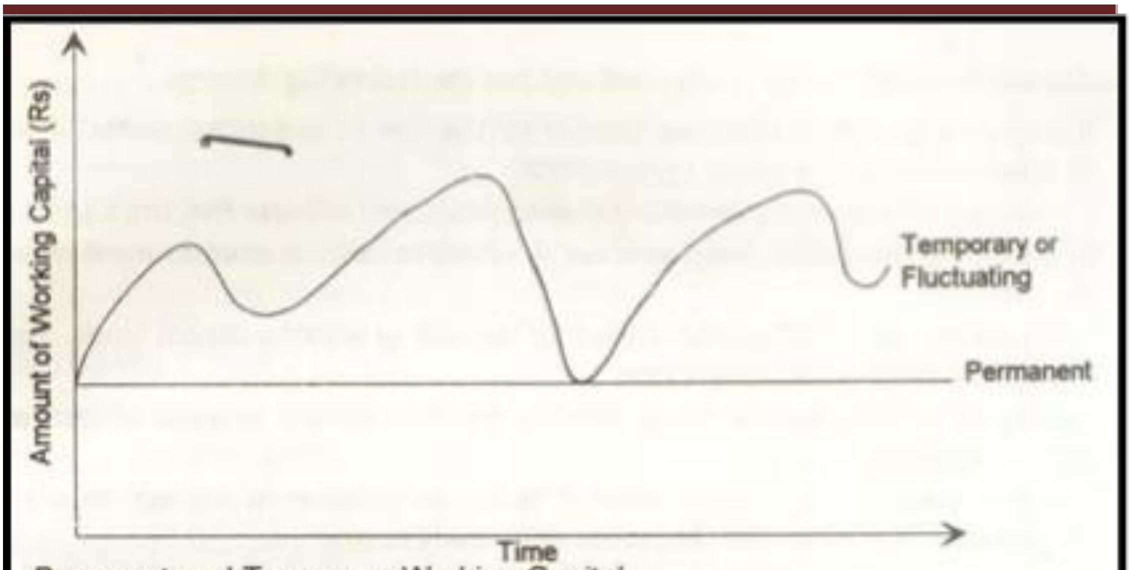
   Seasonal working capital is the additional amount which is required during the active business seasons of the year. Raw materials like raw-cotton or jute or sugarcane are purchased in particular season. The industry has to borrow funds for short period. It is particularly suited to a business of a seasonal nature. In short, seasonal working capital is required to meet the seasonal liquidity of the business.

2. **Special variable working capital:**

   Additional working capital may also be needed to provide additional current assets to meet the unexpected events or special operations such as extensive marketing campaigns or carrying of special job etc.

Difference Between Permanent and Variable Working Capital:

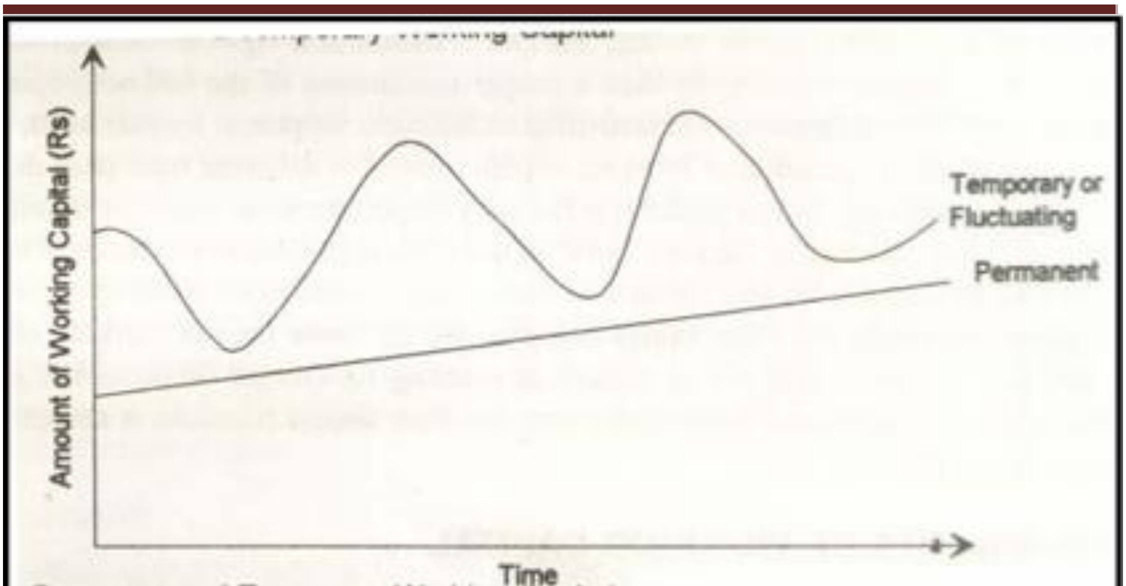
The distinction between permanent or fixed working capital and variable working capital or temporary working capital is of great importance in operating cycle and raising the funds. However, there is always a minimum level of current assets which is continuously required by the firm to carry on its business operations. This minimum level of current assets is referred to as permanent or fixed working capital and is permanent in the same way as the firm’s fixed asset.



Permnent and Temporary Working Capital

Depending on the change in production and sales, the need of working capital, over and above the permanent working capital, will fluctuate.

It is shown in below figure that permanent working capital is stable over time, while temporary working capital is fluctuating-sometimes increasing and sometimes decreasing. However, the permanent working capital line need not be horizontal if the firm's requirement for permanent capital is increasing or decreasing over period. For a growing firm, the difference between permanent and temporary working capital can be depicted the figure as under.



Permnent and Temporary Working Capital

2) On the basis of concept:

on the basis of concept working capital is divided into two categories as under:

(A) Gross Working Capital:

Gross working capital refers to total investment in current assets. The current assets employed in business give the idea about the utilization of working capital and idea about the economic position of the company. Gross working capital concepts is popular and acceptable concept in the field of finance.

(B) Net Working Capital:

Net working capital means current assets minus current liabilities. The difference between current assets and current liabilities is called the net working capital. If the net working capital is positive, business is able to meet its current liabilities. Net working capital concept provides the measurement for determining the creditworthiness of company.

FACTORS DETERMINING WORKING CAPITAL

The following factor determine the amount of working capital

1. **Nature of Companies:**

   The composition of an asset is a function of the size of a business and the companies to which it belongs. Small companies have smaller proportions of cash, receivables and inventory than large corporation. This difference becomes more marked in large corporations. A public utility, for example, mostly employs fixed assets in its operations, while a merchandising department depends generally on inventory and receivable. Needs for working capital are thus determined by the nature of an enterprise.

2. **Demand of Creditors:**

   Creditors are interested in the security of loans. They want their obligations to be sufficiently covered. They want the amount of security in assets which are greater than the liability.

3. **Cash Requirements:**

   Cash is one of the current assets which are essential for the successful operations of the production cycle. A minimum level of cash is always required to keep the operations going. Adequate cash is also required to maintain good credit relation.

4. **Nature and Size of Business:**

   The working capital requirements of a firm are basically influenced by the nature of its business. Trading and financial firms have a very less investment in fixed assets, but require a large sum of money to be invested in working capital. Retail stores, for example, must carry large stocks of a variety of goods to satisfy the varied and continues demand of their customers. Some manufacturing business, such as tobacco manufacturing and construction firms also have to invest substantially in working capital and a nominal amount in the fixed assets.

5. **Time:**

The level of working capital depends upon the time required to manufacturing goods. If the time is longer, the size of working capital is great. Moreover, the amount of working capital depends upon inventory turnover and the unit cost of the goods that are sold. The greater this cost, the bigger is the amount of working capital.

6. **Volume of Sales:**

This is the most important factor affecting the size and components of working capital. A firm maintains current assets because they are needed to support the operational activities which result in sales. They volume of sales and the size of the working capital are directly related to each other. As the volume of sales increase, there is an increase in the investment of working capital-in the cost of operations, in inventories and receivables.

7. **Terms of Purchases and Sales:**

If the credit terms of purchases are more favourable and those of sales liberal, less cash will be invested in inventory. With more favourable credit terms, working capital requirements can be reduced. A firm gets more time for payment to creditors or suppliers. A firm which enjoys greater credit with banks needs less working capital.

8. **Business Cycle:**

Business expands during periods of prosperity and declines during the period of depression. Consequently, more working capital required during periods of prosperity and less during the periods of depression.

9. **Production Cycle:**

The time taken to convert raw materials into finished products is referred to as the production cycle or operating cycle. The longer the production cycle, the greater is the requirements of the working capital. An utmost care should be taken to shorten the period of the production cycle in order to minimize working capital requirements.

10. **Liquidity and Profitability:**

If a firm desires to take a greater risk for bigger gains or losses, it reduces the size of its working capital in relation to its sales. If it is interested in improving its liquidity, it increase the level of its working capital. However, this policy is likely to result in a reduction of the sales volume, and therefore, of profitability. A firm, therefore, should choose between liquidity and profitability and decide about its working capital requirements accordingly.

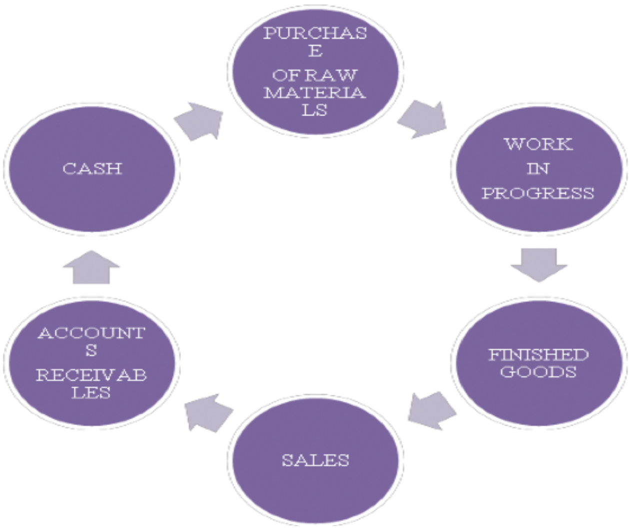
11. **Seasonal Fluctuations:**

Seasonal fluctuations in sales affect the level of variable working capital. Often, the demand for products may be of a seasonal nature. Yet inventories have got to be purchased during certain seasons only. The size of the working capital in one period may, therefore, be bigger than that in another.

OPERATING CYCLE

The duration of time required to complete the sequence of events right from purchase of raw material / goods for cash to the realization of sales in cash is called the operating cycle, working capital cycle or cash cycle.

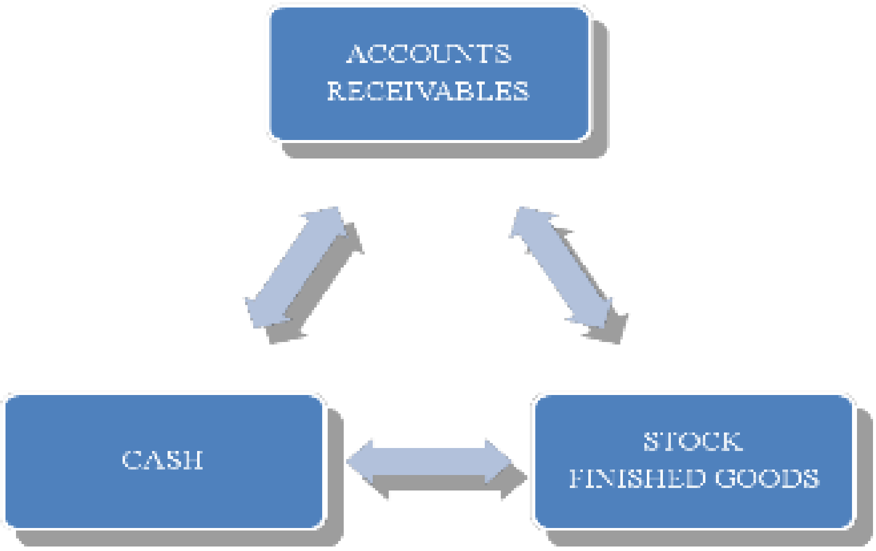
Operating Cycle of Manufacturing Cycle:



The above operating cycle in figure relates to a manufacturing firm where cash is needs to purchase raw materials and convert raw materials into work-in-process is converted into finished goods. Finished goods will be sold for cash or credit and ultimately debtors will be realized.

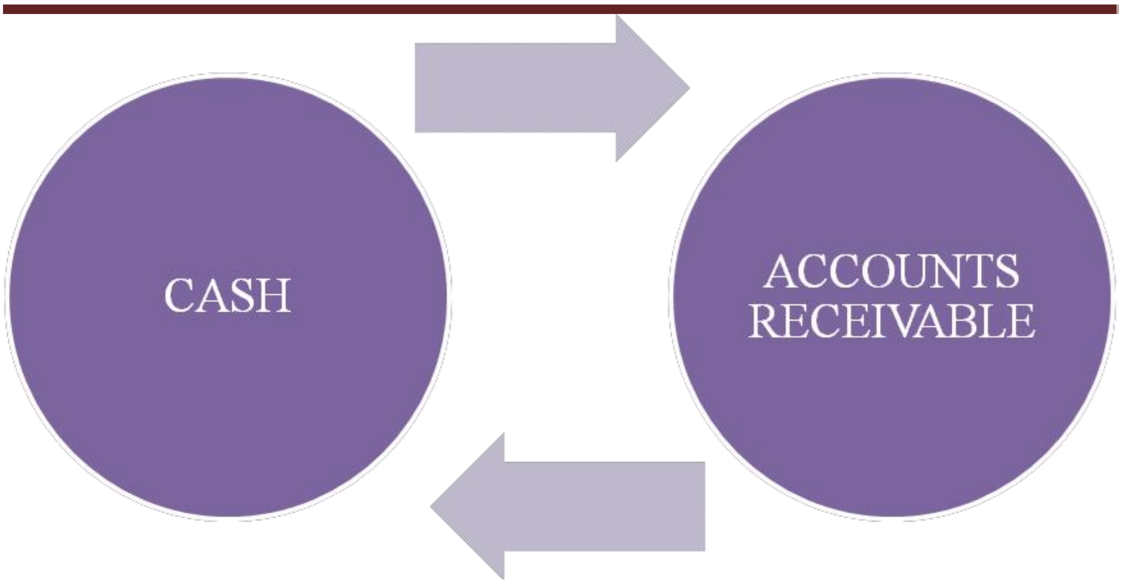
Operating Cycle of Non-Manufacturing Firm

The non-manufacturing firms, such as whole sellers and retailers, will not have the manufacturing phase; they will have rather direct conversion of cash into finished stock, into accounts receivables and then into cash. The operating cycle of a non-manufacturing firm is shown as under.



Operating Cycle of Service and Financial Firms

In addition to this, some service and financial concerns may not have any inventory at all. Such firm have the shorter operating cycle.



LIQUIDITY VERSUS PROFITABILITY: RISK-RETURN TANGLE

The firm would make just enough investment in current assets, if it were possible to estimate working capital needs exactly. Under perfect certainty, the current assets holdings would be at the minimum level. A ledger investment in current assets under certainty would mean a low rate or return investment for the firm, as excess investment in current assets will not earn enough return. A smaller investment in current assets, on the other hand, would mean interrupted production and sales, because of frequent stock-outs and inability to creditor in time to restrictive credit policy.

As it is not possible to estimate working needs accurately, the firm must decide about the levels of current assets to be carried. The current assets holdings of the firm will depend upon its working capital policy. It may follow a **conservative** or an **aggressive** policy. These polices have different risk-return implications.

A **conservative policy** means **lower return and risk**, while an **aggressive policy** produces **higher return and risk**.

The two important aims of the working capital management are: profitability and solvency.

Solvency, used in the technical sense, refers to the firm's continuous ability to meet maturing obligations. Lenders and creditors expected prompt settlement of their claims as and when due. To ensure solvency, the firm maintains a relatively large investment in current assets holdings. If the firm maintains a relatively large investment in current assets, it will have no difficulty in paying the claims of the creditors when they become due and will be able to fill all sales orders and ensure smooth production. Thus, a liquid firm has less risk of insolvency; that is, it will hardly experiences a cash shortage or stock-outs.

However, there is a cost associated with maintaining a sound liquidity position.

A considerable amount of the firm's funds will be tied up in current assets. **And to the extent this investment is idle, the firm's profitability will suffer.**

To have high **profitability**, the firm may sacrifice solvency and maintain a relatively low level of current assets. When the firm does so, its profitability will improve as less funds are tied up in idle current assets, but its solvency would be threatened and would be exposed to greater risk of cash shortage and stock-outs.

Therefore, the firm should balance the profitability solvency tangle by minimizing the total cost of liquidity and cost of illiquidity.

The Cost Trade-off:

A different way of looking into the risk-return trade of is in terms of the cost of maintaining a particular level of current assets. There are two different kinds of costs involved.

First there is the **cost of liquidity**. **If the firm carries too much liquidity, the firm's rate of return will be low.** Funds tied up in idle cash and excess inventory earn nothing, and receivables levels that are too large also reduce the firm's profitability. **Thus, the cost of liquidity increases with the level of current assets.**

There is the cost of liquidity, which is the cost of having too little invested in current assets. If the firm carries too little cash, it may not be able to pay bills promptly at they mature. This may force the firm to borrows at high rates of interest. This will also adversely affect the credit-worthiness of the firm and it will face difficulties in obtaining funds in future. This all may force the firm into insolvency.

If the firm's inventory level too low, sales may be lost and customers may shift to competitors. Also, low level of book debts may be due to tight credit policy, which would impair sales further. Thus, **the low level of current assets involves cost which increases as this level falls.**