TOWARDS THE MANAGEMENT OF WORKING CAPITAL-- A CONCEPTUAL ANALYSIS

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ABSTRACT:

In recent years a special emphasis has been laid on an examination of the management performance in regard to financial management and a critical analysis of working capital management has been initiated in developing countries, particularly in India. In financial management, one of the important decisions which is very vital is working capital management and the firms have to always analyse its effect to final impact upon profitability and risk. At the time of increasing capital costs and scare funds, the area of working capital management assumes added importance as it deeply influences a firm's liquidity and profitability. A notable feature of utilization of funds is that they are of recurring in nature. Therefore, efficient working capital management requires a proper balance between generation and utilization of these funds without which either shortage of funds will cause obstruction in the smoother functioning of the organization or excess funds will prevent the firm from conducting its business efficiently. For the efficient use of working capital every firm and every student of business management must acquainted with the basis concepts of working capital, the firms may have optimum level of working capital used in an efficient way to ensure profits. For a student knowledge about the concepts of working capital is essential to improve his entrepreneurship as he is the future-manager or entrepreneur of a firm.

Keeping the importance of the working capital management, the present paper makes a modest attempt to introduce, explain and present the basic concepts of working capital management. This academic exercise is very useful for both owners/entrepreneurs of the firms and the students. This paper analyses the concepts like classification and determinants of working capital, working capital policy, method of estimating the volume of working capital and sources of working capital which facilitates a clear and an easy understanding of the working capital management.

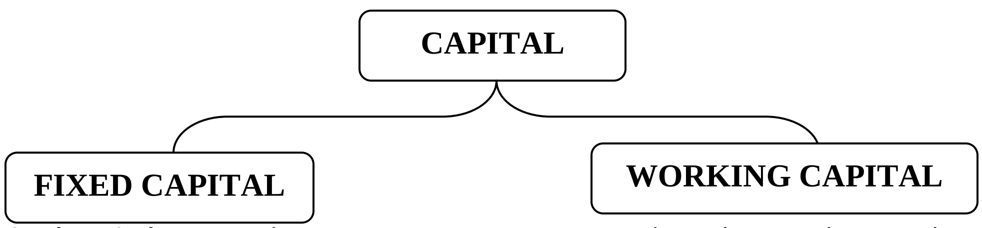
Key Words: Working Capital, Determinants of working capital, WCM policy, Methods of Estimation, Operating Cycle.

INTRODUCTION

In these days of global level competition among firms, companies and industries, profit maximisation through a strategy of improvement of productivity of all factors of production occupies a significant place for earning profits and to compete with competitors. Besides, every firm and company has to pay adequate attention towards its financial management in which working capital management has much importance. As too low or too much working capital suffers a firm or a company, an optimum level of working capital is the key to a smooth inflow of profits. The summary of the definitions given by the business experts reveals that working capital represents currents assets (cash, receivables and inventory etc.,) minus current liabilities (debt obligations due within one year). Keeping in view the significant of these components, it is important to maintain an appropriate level of working capital and its contribution to business survival. The managers of small business have to develop a working capital philosophy and they have to apply to operation of their business with a proper monitoring of the movements of working capital in their firms or companies.

Components of Capital:

Capital employed in a firm or company or an industry can be divided into the following two major categories.



- **Fixed Capital** is a mandatory one-time investment made at the introductory phase of a business establishment. Fixed capital includes land, building, machinery and other assets having a relatively permanent existence.
- **Working Capital** Similarly, the capital, which is needed for investing in current assets, is called working capital. The capital which is needed for the regular operation of business is called working capital. Working capital is also called circulating capital or revolving capital or short-term capital.

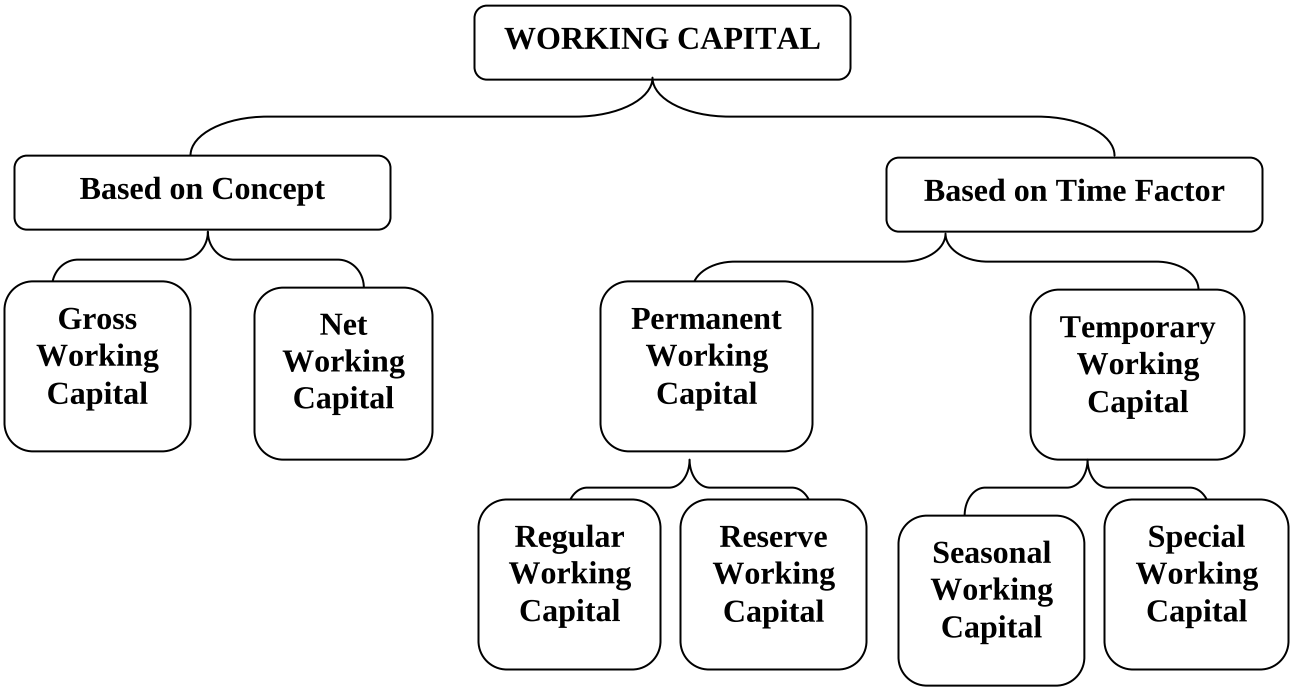
NEED AND IMPORTANCE OF WORKING CAPITAL:

Working capital is the life blood and nerve centre of business. Working capital is very essential to maintain smooth running of a business. No business can run successfully without an adequate amount of working capital. Working capital management occupies a key place due to the following reasons:

- **Strengthen the short term Solvency**: Working capital helps to operate the business smoothly without any financial problem for making the payment of short-term liabilities.
- **Enhance Goodwill**: for making prompt payments and helping to create and maintain goodwill.
- **Easy Obtaining Loan** : getting financial assistance from financial institutions.
- **Regular Supply Of Raw Material**: ensures regular supply of raw materials and continuous production.
- **Smooth Business Operation**:. All expenses and current liabilities are paid on time.
- **Ability to Face Crisis** : Adequate working capital enables a firm to face business crisis in emergencies such as depression.

CLASSIFICATION OF WORKING CAPITAL:

For better management of working capital, a firm or a company has to pay much attention to the following classification of working capital:



A brief discussion of the above classification is provided to have a better understanding of different concepts of working capital.

Gross Working Capital:

Gross Working Capital is the general concept which determines the working capital concept. Thus, the gross working capital is the capital invested in total current assets of the business concern. Gross Working Capital is simply called as the total current assets of the concern.

GWC = Current Assets only

Net Working Capital:

Net Working Capital is the specific concept, which considers both current assets and current liability of the concern. Net Working Capital is the excess of current assets over the current liability of the concern during a particular period. If the current assets exceed the current liabilities it is said to be positive working capital; it is reverse, it is said to be Negative working capital.

NWC = Current Assets – Current Liabilities

Permanent Working Capital:

GWC = Total Current Assets Only

It is the minimum working capital required for producing predetermined production. Permanent working capital is the minimum investment kept in the form of inventory of raw materials, work in progress, finished goods, stores & spare, and book debts to facilitate uninterrupted operation of a firm.

Though this investment is stable in the short run, it certainly varies in the long run depending upon the expansion programmes undertaken by a firm. It may increase or decrease over a period of time.

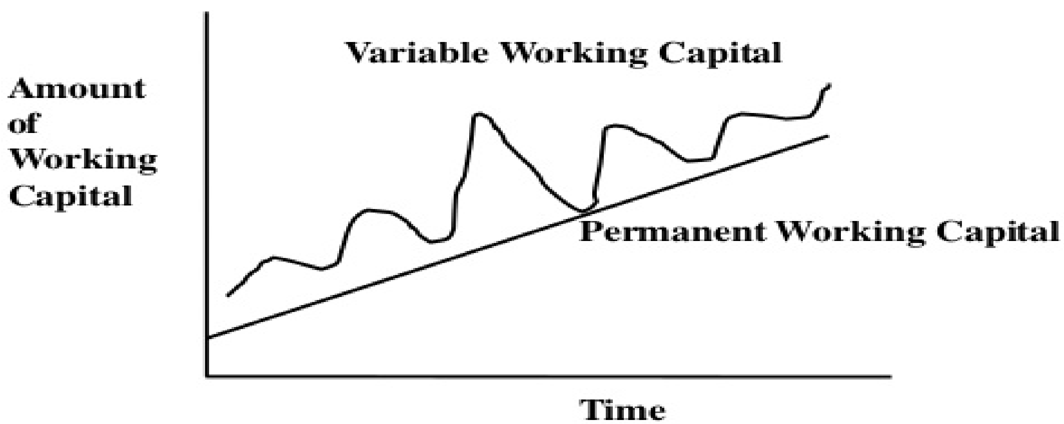
1) **Regular Working Capital**: It is the minimum amount of liquid capital required to keep up the circulation of the capital from cash to inventories to receivables and back again to cash.
2) **Reserve margin or Cushion Working Capital**: It is extra capital required to meet unforeseen contingencies that may arise in future. These contingencies may crop up on account of rise in prices, business depression, strikes, lock-outs, fires and unexpected competition. It is needed over and above the regular working capital requirements.

Temporary Working Capital:

It is also known as variable working capital. It is the amount of capital which is required to meet the Seasonal demands and some special purposes. It can be further classified into

1) **Seasonal Working Capital**: The capital required to meet the seasonal needs of the business concern is called as Seasonal Working Capital.
2) **Special Working Capital**: The capital required to meet the special exigencies such as launching of extensive marketing campaigns for conducting research, etc.

GRAPHICAL PRESENTATION OF PERMANENT AND TEMPORARY WORKING CAPITAL



DETERMINANTS OF WORKING CAPITAL:

Requirements of working capital depend upon various factors such as nature of business, size of business, the flow of business activities. However, small organization relatively needs lesser working capital than the big business organization. Following are the factors which affect the working capital of a firm:

- **Size of Business:** Working capital requirement of a firm is directly influenced by the size of its business operation.
- **Nature of Business:** Working capital requirement depends upon the nature of business carried by the firm. Normally, manufacturing industries and trading organizations need more working capital than in the service business organizations.
- **Storage Time OR Processing Period:** Time needed for keeping the stock in store is called storage period. The amount of working capital is influenced by the storage period. If storage period is high, a firm should keep more quantity of goods in store and hence requires more working capital. Similarly, if the processing time is more, then more stock of goods must be held in store as work-in-progress.

- **Credit Period**: Credit period allowed to customers is also one of the major factors which influence the requirement of working capital. Longer credit period requires more investment in debtors and hence more working capital is needed. But, the firm which allows less credit period to customers' needs less working capital.
- **Seasonal Requirement:** In certain business, raw material is not available throughout the year. Such business organizations have to buy raw material in bulk during the season to ensure an uninterrupted flow and process them during the entire year.
- **Potential Growth Or Expansion of Business:** If the business is to be extended in future, more working capital is required.
- **Changes in Price Level**: As the price of raw materials increases, the amount of working capital needs of a firm or company increases.
- **Dividend Policy**: The dividend policy of the firm is an important determinant of working capital. If a firm retains more profit and distributes lower amount of dividend, it needs less working capital and vice versa
- **Access to Money Market:** If a firm has good access to capital market, it can raise loan from banks and financial institutions.
- **Working Capital Cycle:** When the working capital cycle of a firm is long, it requires larger amount of working capital and if working capital cycle is short, it needs less working capital.
- **Operating Efficiency**: The operating efficiency of a firm also affects the firm's need of working capital. The operating efficiency of the firm depends upon the optimum utilization of assets, which in turn results in to higher amounts of funds to meet the needs of working capital.

WORKING CAPITAL MANAGEMENT POLICY:

Working Capital Management formulates policies to manage and handle efficiently; for that purpose, the management established three policies based on the relationship between Sales and Working Capital.

- Conservative Working Capital Policy.
- Moderate Working Capital Policy.
- Aggressive Working Capital Policy

Conservative Approach:

Conservative Working Capital Policy refers to minimize risk by maintaining a higher level of Working Capital. This type of Working Capital Policy is suitable to meet the seasonal fluctuation of the manufacturing operation

Moderate Working Capital Policy:

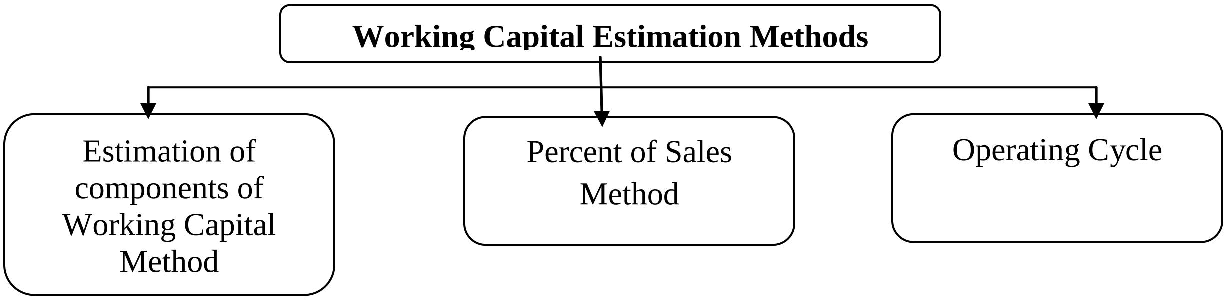
Moderate Working Capital Policy refers to the moderate level of Working Capital maintenance according to moderate level of sales. It means one percent of change in Working Capital that is Working Capital is equal to sales.

Aggressive Working Capital Policy:

Aggressive Working Capital Policy is one of the high risky and profitability policies which maintain low level of Aggressive Working Capital against the high level of sales, in the business concern during a particular period.

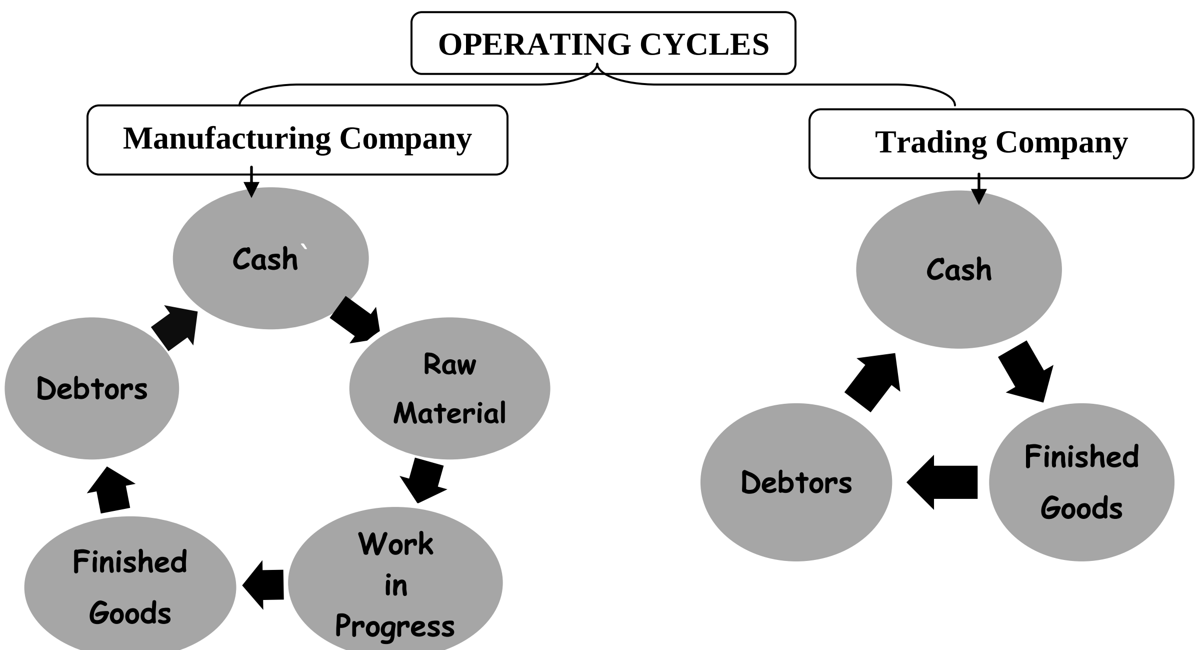
METHODS OF WORKING CAPITAL ESTIMATION:

The amount of working capital required for a firm or a company can be estimated by the following methods.



- **Estimation of components of working capital method:** Working capital consists of various current assets and current liabilities. Hence, we have to estimate how much current assets as inventories required and how much cash required meeting the short term obligations. Finance Manager first estimates the assets and required Working Capital for a particular period.
- **Percent of sales method:** Based on the past experience between Sales and Working Capital requirements, a ratio can be determined for estimating the Working Capital requirement in future. Under this method, the sales to Working Capital ratio is to be calculated and based on the ratios, Working Capital requirements are to be estimated. This method expresses the relationship between the Sales and Working Capital.
- **Operating Cycle/Cash Cycle/Operating Cycle :** Working Capital requirements depend upon the operating cycle of the business. The operating cycle is the time duration for conversion of cash into cash equivalents like Raw Materials, Work-In-Progress, finished Goods, Debtors and Cash.

TYPES OF OPERATING CYCLES:



Operating Cycle =
Raw Materials + Work in Progress + Finished Goods + Debtors – Creditors

SOURCES OF WORKING CAPITAL:

Sources of working capital can be spontaneous, short term and long term. Spontaneous working capital includes mainly trade credit such as the sundry creditor, bills payable, and notes payable. 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. The spontaneous, short term and long term sources of working capital are detailed in table-1.

Table. 1. Different Sources of Working Capital

Spontaneous Sources	Short Term Sources		Long Term Sources	
	Internal	External	Internal	External
Trade Credit	Tax Provisions	Bank Overdraft	Retained Profits	Share Capital
Sundry Creditors	Dividend Provisions	Trade Deposits	Depreciation Provision	Long Term Loans
Bills Payable		Public Deposits		Debentures
Notes Payable	_____	Bills Discounting	_____	_____
Accrued Expenses	_____	Short Term Loans	_____	_____

Spontaneous Sources of Working Capital Finance:

The word 'spontaneous' itself explains that this source of working capital is readily or easily available to the business in the normal course of business affairs. The quantum and terms of this credit depend on the industry norms and relationship between buyer and seller. These sources include trade credit allowed by the sundry creditors, credit from employees, and other trade-related credits. The biggest benefit of spontaneous sources as working capital is its effortless raising and insignificant cost compared to traditional ways of financing.

Short Term Sources of Working Capital Finance:

Short term sources can be further divided into internal and external sources of working capital finance. The short-term internal sources include tax provisions, dividend provisions etc. Short-term external sources include short-term working capital financing from banks such as bank overdrafts, cash credits, trade deposits, bills discounting, short-term loans, inter-corporate loans, commercial paper, etc. Tax and dividend provisions are current liabilities and cannot be delayed. The fund that would have been used in paying these provisions act as working capital till the point these are not paid.

Long Term Sources of Working Capital Financing:

Long term sources can also be divided into internal and external sources. Long term internal sources of finance are retained profits and provision for depreciation whereas external sources are Share Capital, long-term loan, and debentures.

Working capital can be classified into temporary working capital and permanent working capital. It is advisable to use long term sources for permanent and short-term sources for temporary working capital requirements. This will optimize the working capital cost and enforce good working capital management practices.

Conclusion:

Working capital means the funds which are required to meet the daily transactions of the business and it is very significant facet of financial management. Every business concern should have adequate working capital to run its operations smoothly. It should have neither excess working capital nor inadequate working capital because both of these have adverse effects on firm's profitability and liquidity positions. Every business concerns should maintain adequate working capital. The basic objective of working capital is to manage the firm's current assets and current liabilities in such a way that that a satisfactory level of working capital is maintained. Working capital policies have a great effect on a firm's liquidity and profitability. Therefore, the working capital should be managed in such a way that ensures higher profitability and proper liquidity to the business concern. The significance of working capital management is to ensure that the organization maintains a 'good fit' with the changing environment and it has to strive to build the capability to cope with challenges. Efficient working capital management requires a proper balance between generation and utilization of these funds keeping in view the main objective of working capital management i.e. arrangement of needed funds on the right time from the right source and for the right period, so that a trade-off between liquidity and profitability must be achieved.

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