Working Capital Management

Dr.C.Boopathi
HEAD – DEPARTMENT OF B.COM (PA)
SREE SARASWATHI THYAGARAJA COLLEGE
POLLACHI

Abstract: **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 are 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.**

INTRODUCTION

The study of working capital management occupies an important place in financial management. It has never received so much attention as in recent years. Working capital management is an integral part of overall financial management. The sphere of working capital throws a welcome challenge and opportunity to a financial manager. "Working capital management has been looked upon as the driving seat of financial manager."

The management of working capital is synonymous with the management of short term financial liquidity. The importance of short term liquidity can best be gauged by examining the repercussions which stem from a lack of ability to meet short term obligations.

A lack of liquidity implies a lack of freedom of choice as well as constraints on managements freedom of movement. If lack of liquidity continues to be a problem, it may ultimately lead to insolvency and bankruptcy. Thus, working capital management is linked with the continuous existence of an enterprise. Regardless of excellent products, effective marketing, efficient production, and wise fixed assets management.

Many management has lost the control of its firm because liquidity crisis resulted in takeover by creditors, forced merger or bankruptcy. An excellent long run outlook for a business becomes immaterial if control is lost in the short run. Working capital policies affect marketing, personnel, production and what happens in the business related to working capital decisions. Working capital management as an area is concerned with carrying out working capital functions. In any enterprise, the working capital function must exist in some form or other.

CONCEPT AND TYPES OF WORKING CAPITAL

An enterprise needs not only fixed capital but also working capital. The working capital is the capital needed to conduct the day to day operations of a business. Working capital is, therefore, a broader term and there are chances of misunderstanding it.

Broadly speaking, it is taken either as the total assets or as the excess of current assets over current liabilities. "Working capital, according to the time honoured definition", say Professor Hanry G. Guthmann and Herbert E. Dougall, "is the excess of current assets over current liabilities." Accountants Handbook completely endorses this view, while to Professor C.W. Gerstenberg, "any comprehensive discussion on the working capital includes the excess of current assets over current liabilities."

Working capital is defined in the Annual Survey of Industries to include "stock of materials, stores, fuels, semi finished goods and by-products, cash in hand and bank and the algebric sum of sundry creditors as represented by (a) Outstanding factor payment e.g. rent, wages, interest and dividend;b) Purchases of goods and services;

(c) Short term loans and advances and sundry debtors comprising amounts due to factory on account of sales of goods and services and advances towards purchase and tax payment." This supports the view of Professor Guthmann and Dougall. An overwhelming support to this view has been advanced by some renowned financial analysts. For example, Dr. Colin Park and Professor John W. Gladson say. "Most commonly, working capital is defined as the excess of current assets of a business over current items owned to employees and others.

In fact, there are two concept of working capital, viz., gross and net. Gross working capital refers to the sum of current assets represented by inventories, cash, receivables and marketable securities. Net working capital means „working capital as the excess of current assets over current liabilities. Gross working capital and total current assets are thus synonymous. The need for the net concept of working capital arises due to the fact that the gross concept fails to consider current liabilities.

While differentiating current assets from non-current assets or current liabilities from non-current liabilities, generally a period of one year is used as a line of the demarcation which is somewhat arbitrary. It suggests that the investment in any asset or liability with a life of less than a year falls into the

realm of working capital management. Park and Gladsons attack on the problem of working capital management began with their attempt to define what were current assets and current liabilities. They stated that the prevailing one year temporal standard applying for classifying assets or liabilities as „current was not universally valid. What was current or non- current depends on the nature of the core business activity. Thus, for a fruit processing business, two to three months would be the correct „currentness. Current assets have a short life span. For a lumbering or winemaking business, however a period longer than one year should be the currentness standard. Thus, currentness varies with the nature of business. In addition to all these, the fixed assets of one company may be the current assets of another, e.g. electric company, but part of the fixed assets of a refrigerating and cold storage company. However, the current assets are used to indicate cash, inventories and other assets which are expected to be realised, sold or consumed during the operating cycle of a business generally in a year.

WORKING CAPITAL OBJECTIVES

With regard to management of working capital, there are two major implications. Firstly, the decisions that affect the level of working capital are frequent and repetitive. Such decisions should be consistent with the objectives and goals of a firm, and a framework of unambiguous rules should be created for implementation of those decisions by the lower operating levels. Secondly, efficient management of one component of working capital cannot be undertaken without simultaneous consideration of other components because of a close interaction among them. The characteristic feature of the three basic activities of a manufacturing firm, viz., production, sales and collection, is that they are non-instantaneous,

unsynchronized and determine the life span of the components of working capital. The element of uncertainty, when added to this situation, creates a more intense need for effective working capital management.

There are two important objectives of working capital:

- Profitability
- Liquidity

Financial management cannot afford to stick to only one of these objectives. There should be a proper balance between the two so that one objective does not suffer at the expense of the other.

IMPORTANCE OF WORKING CAPITAL MANAGEMENT

One can probably attribute a large number of business failures in recent years to the inability of financial managers to plan properly and control current assets and current liabilities of their respective firms. Shortage of funds for working capital as well as uncontrolled over-expansion of working capital have caused many businesses to fail and in less severe cases, has stunted their growth. Specially, in small firms, working capital management may be the factor that decides success or failure; in larger firms, efficient working capital management can significantly affect the firms risk, return and share price.

Working capital in an enterprise is like blood in life. An enterprise cannot be run without appropriate working capital. Not only working capital is enough, but also there should be proper management of working capital, because it is very important for the success of an enterprise and for maximizing the value.

Cash and financial budgets, are the major tools for management of working capital.

The inefficient working capital management will lead to loss of profits in the short run but it will ultimately lead to the downfall of the enterprise in the long run. A deeper understanding of the importance of working capital can lead not only to material savings in the economical use of capital but can also assert in furthering the ultimate aim of business. An excessive investment in working capital will lower the rate of return while inadequate investment will hamper the solvency position and growth, thereby affecting the smooth operation of business. However, stock of the importance of working capital for a business enterprise can be taken only when certain criteria of business efficiency are evolved and the role of working capital vis-à-vis fixed capital is adjudged in relation to them. A reasonable rate of return on investment and a good reputation in the business world can be suggested as the two meaningful criteria for viewing the efficiency of a business enterprise. In earning a reasonable rate of return the functional, complementary, proportional and technical roles of working capital play a great part.

WORKING CAPITAL MANAGEMENT: RISK-RETURN IMPLICATIONS

Almost all financial decisions involve some sort of risk return trade off. But this is more so in the working capital decisions. To take an example, the lower the cash balances held on hand, the higher would be the expected return. But at the same time the enterprise will have to assume the greater risk of running out of cash. The higher return is due to the less money tied up in non-income earning assets and the higher risk is due to the possibility of shortage of cash in the event of urgency. Thus, a low liquidity is associated with high rates of return. However, it does not mean that low liquidity is in the best interest of shareholders. No doubt, profitability has to do with the overall goal of shareholder"s wealth maximization but liquidity has to do with ensuring that the enterprise is able to satisfy all of its current financial obligations. The liquidity foal is, therefore, closely connected with management of working capital, that is, decisions concerning short term assets and liabilities, while the profitability goal reflects both short term and long term decisions-making. Generally, an enterprise cannot have zero investment in working capital. Even if this is possible the enterprise generally makes investment in working capital because it pays them to do so. The investment in working capital provides a desirable flexibility so far as seasonal requirement for funds is concerned, thereby avoiding the shortage of capital or capital lying idle in the business. It does not mean that larger the working capital, the better it is. Regarding the size of working capital to be held in the business, there is likely to be some position or range of positions that is best. The investment in fixed assets is held constant, then the benefits resulting from an additional increase in working capital will be subjected to diminishing returns. If the objective of working capital management is to maintain high liquidity in the business it means a reduced return to shareholders and a lower risk of becoming technically insolvent. Similarly, if the objective is to maintain low liquidity, it means an increased return but a high risk of becoming technically insolvent. All working capital policies ranging from low to high liquidity policies are not equally favourable. The extremely high and low liquidity policies are not at all favourable as the required rate of return or cost of capital is higher than the expected rate of return. Hence, only those liquidity policies are favourable where the expected rate of return is higher than the required rate of return or cost of capital.

REGULATION OF BANK CREDIT FOR WORKING CAPITAL

To bring a measure of discipline among industrial borrowers and redirect credit to other sources, the Reserve Bank of India has been issuing guidelines and directives from the banking sectors on the basis of recommendations given by the Tandon committee and the Chore committee.

TANDON COMMITTEE RECOMMENDATIONS

The Reserve Bank of India set up in 1974 a study group to frame guide lines for follow up of bank credit under the chairmanship of P.L.Tandon.

The study group reviewed the system of working capital financing and identified its major shortcoming as follows:

1. The cash credit system of lending wherein the borrower can draw freely within limits sanctioned by the banker hinders sound credit planning on the part of the banker and induces financial indiscipline in the borrower.
2. The security-oriented approach to lending favoured borrowers with strong financial resources and also led to diversion of funds, borrowed against the security of current assets, for financing fixed assets.
3. Relatively easy access to working capital finance led to large inventory levels with industry.
4. Working capital finance provided by banks, theoretically supposed to be short term in nature, tended to be, in practice, a long-term source of finance.

For the regulating bank credit, the study group made comprehensive recommendations which have been made by and large accepted by the Reserve Bank of India. These recommendations relate to:-

(A) Norms for inventories and receivables:

It is suggested for major industries. These norms have been based, inter alia, on company finance studies made by the Reserve Bank of India, process period in different industries, discussions with industry experts and feedback received on the interim report.

1. For raw materials (including stores and other materials used in process of manufacture):- maximum stock should not be more than by 2-3/4 times consumption of raw material in the industry in a month.
2. For stock in process (work-in-process):- should not be more than by half of the cost of production of a month.
3. For finished goods:- it should not be

more than by the two times of cost of goods sold of a month.

4. For receivable:- it should not be more than by 1-1\4 times of a month sales.

The norms suggested may not be viewed as rigid or inflexible. Under certain circumstances like bunched receipt of raw materials, this may be permitted.

(B) Quantum of permissible bank finance:

Three methods have been suggested for determining the maximum permissible amount of bank finance:-

1. 75 percent of excess of current assets over non-bank current liabilities.
2. 75 percent of current assets as reduced by non-bank current liabilities.
3. 75 percent of excess of current assets over core current assets as reduced by non-bank current liabilities.

In method 3 the core current assets means a part of current assets which should be permanent component of working capital.

The study group suggested that borrowings in excess of what is permissible under the first method should be converted into a working capital term loan repaid over a period of time. The borrowers should gradually move to the third method.

(C) Style of lending:

The study group suggested that overall credit limit may be bifurcated into a loan component, which would represent the minimum level of borrowing throughout the year and a demand cash credit, which would take care of the fluctuating requirements, both to be reviewed annually.

The demand cash credit should be charged a slightly higher interest rate than the loan component. This approach will give the borrower an incentive for good planning.

(D) Information and reporting system:

The study group suggested comprehensive information and reporting system which seeks to:

1. Induce the borrower to plan his credit need carefully and maintain a greater discipline in its use.
2. Promote free flow of information between the borrower and the banker so that latter can monitor the credit situation better.
3. Ensure that credit is used for intended purposes.

The study group suggested submitting quarterly information regarding profit or loss, current assets and current liabilities.

CHORE COMMITTE

The Reserve Bank of India constituted in April, 1979 a six member working group under the chairmanship of K.B.Chore to review the system of cash credit and credit management policy by banks. The committee report as considered by the R.B.I. is as follows:-

1. The net surplus cash generation of established industrial unit should be utilized partly at least for reducing borrowing for working capital purpose. In assessing maximum permissible bank finance, bank should adopt the second method of lending, recommended by the Tandon study group, according to which the borrowers contribution from owned funds and term finance to meet the working capital requirements should be equal to at least 25 percent of the total current assets. In cases where the borrowers may not be in a position to comply with this requirement immediately, the excess borrowing should be segregated and treated as working capital loan, repayable in half yearly installment (maximum five year) and rate of interest should not be less than the rate sanctioned for cash credit limit.
2. The existing system of lending (cash credit, loan and bill) should continue but wherever possible the use of cash credit should be supplemented by loans and bills. However, there should be scrutiny of the operation of the cash credit accounts at least once in a year.
3. Bifurcation of cash credit in demand loan for corporation and fluctuation cash credit component and to maintain a differential interest rate between these two components is withdrawn.
4. Banks should appraise and fix separate limits for the “normal non- peak level” and for the “peak level” credit requirements for all borrowers in excess of Rs. Ten lakhs indicating the relevant periods.
5. Drawal of funds to be regulated through quarterly statements within the sanctioned limit, borrower should intimate his need of funds in advance.
6. Borrowers should be discouraged from frequent seeking adhoc or temporary limits in excess of sanctioned limits to meet unforeseen contingencies. Additional interest of one percent should normally be
7. Advances against the book-debts

should be converted to bills wherever possible and at least 50 percent of the cash credit limit utilized for financing purchase of raw material inventory should also be changed to this bill system.

TECHNIQUES OF WORKING CAPITAL ANALYSIS

Working capital balance is measured from the financial data of corporate balance sheet. Usually, the working capital balance of a going concern has a positive value but often uses of working capital exceed the sources of working capital in certain periods. A study of cause of changes that takes place in the balances from time to time is necessary. The following techniques are generally used in the analysis of working capital.

1. Working capital trend analysis
2. Working capital ratios
3. Operating cycle approach
4. Fund flow analysis
5. Other techniques

CONCLUSION

From this study, it has been found the working capital management is to decide the pattern of financing of the current assets, which is one of the biggest problems of working capital management. The interesting emphasis upon cash for availing of discount facility shows the keenness of the businessmen to avoid the high cost of discount credit facility.

REFERENCES

- Aggrawal N.K. Management of working capital, Sterling publishers(P) Ltd., New-Delhi, 1983.
- Aggrawal N.P. Analysis of financial statement, National publishing house, New-Delhi, 1981.
- Backman T.N. Credit and Collection management & Theory, Mc.Graw Hills, New York, 1962.
- Bhalla P.N. Cash management in S.T.D., Lok-udyog Vol. VI No.8. (Nov.1972)
- Chadda R.S. Inventory Management in India, Allied publishers, Bombay, 1971.
- Chawla S.K. Working capital management – A practical approach
- Greig, Cuthbert Commercial credit and accounts collection, The furniture records, London.
- Leslie R. Harward Working capital – its management and control, McDonald and evans Ltd, London.
- Marting John Control of working capital.
- Mishra R.K. Working capital management, Somaiya publication (P) Ltd, Bombay.
- Norman E. Managing company cash.
- Pradhan R.S. Management of working capital.Rajan N. Material management in public enterprises.