Working Capital Management

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Working Capital Management

Working capital management is a business strategy to ensure that operating activities of business are smooth and efficient. Working capital management involves a relationship between current assets and current liabilities enabling the company to maintain adequate working capital in order to meet the current obligations of business.

Two Concepts of Working Capital:
Gross Working Capital = Total Current Assets
Net Working Capital =Current Assets – Current Liabilities

Current Assets and Current Liabilities

Current assets mean those short term assets which in the normal course of business are converted into cash within a year. Examples of current assets are:

1. Inventories of raw material, work-in-progress and finished goods
2. Debtors, bill receivable
3. Short term investment or marketable securities
4. Pre-paid expenses
5. Short term advances
6. Accrued incomes
7. Cash in hand and bank balances

Current liabilities are those short term liabilities which in the normal course of business are payable within a year. Examples of current liabilities are:

1. Creditors, bill payables
2. Outstanding expenses
3. Short term loans
4. Bank overdrafts
5. Provision for tax
6. Proposed dividends etc.

Different Sources of Working Capital

A business firm uses two types of sources to finance its working capital requirements:

A. Long Term Sources
B. Short Term Sources

Long Term Sources of Working Capital Financing:

Every business is required to maintain a minimum balance of cash and other current assets at all times irrespective of business level of operations. The part of working capital which is continuously maintained by any business at all times to carry on its business is called the permanent working capital. This type of working is advised to be financed partly through long term sources as given under:

1. Issue of equity and preference share capital
2. Retained earnings
3. Issue of debentures and long term bonds
4. Long term loans from financial institutions

Short Term Sources of Working Capital Financing:

Generally, it is the short term working capital which used to finance the short term payment obligations. This working capital is termed as temporary working capital needed to support seasonal fluctuations in the operations. The examples of short term sources are given as under:

1. Bank credit, overdraft etc.
2. Public deposits
3. Trade credits
4. Sales revenues
5. Outstanding expenses
6. Provision for depreciation, taxes etc
7. Advances from customers
8. Employees' security money etc.

Importance of Working Capital Management

1. Efficient and smooth business operations
2. Optimizing profits in current assets investment
3. Helpful in continuous production and supply
4. Improved liquidity and solvency of business
5. Enhancement in business credibility
6. Efficient use of fixed assets
7. Meeting of contingencies
8. Timely payment of interest and dividend
9. Better cash flow management
10. Consistent with wealth maximization objective

Consequences of Inadequate and Surplus of Working Capital

Working capital management seeks to find the optimum level to ensure liquidity and maximize profitability. The working capital of an organization is the result of deducting its current liabilities. If managers do not keep an organization's working capital within certain levels, it can have serious consequences to the organization's financial health.

The Inadequacy of working capital results in the following:

1. Interrupted production and supply
2. Low employees morale
3. Low efficiency and profitability
4. Low market reputation
5. Defaults in payment of interest and other dues
6. Lack of synchronization in cash flows

Consequences of Excess Working Capital

On the other hand surplus working capital is also not good for the organization. Excess working capital in a business organization results in the following consequences:

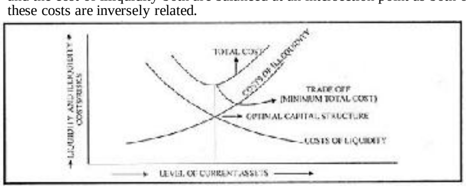
1. Wastage and quality deterioration of inventory
2. Increased cost of funds invested in working capital
3. Unnecessary expenses leading to inefficiency and losses
4. Misuse of resources
5. Increased bad debts and defaults
6. Increased imbalance in cash flows
7. Continuous fall in efficiency and profitability

Concept of Optimum Level of Working Capital

Optimum level of working capital is that level of working capital where the business organization is capable to pay all its short term dues.

In addition to this, the company should carry an additional working capital in order to meet its emergency situation of business such as delay in supply of raw material, sudden excess demand of production and supply, payment of advance to suppliers, employees etc.

Optimum level of working capital is the situation wherein the cost of liquidity and the cost of illiquidity both are balanced at an intersection point as both of these costs are inversely related.



Important Principles of WC Management

Principles of working capital management are the general guidelines which if are carefully followed would lead to effective and efficient management of working capital in a given organization. These principles are:

1. Principle of Equity Position of Current Assets
2. Principle of Cost of Capital
3. Principle of Maturity of Payment
4. Principle of Risk Variation

Principles of WC Management (Cont..)

Principle of equity position: As per this principle all the current assets in the organization should measured optimally so that each part of current asset can contribute to the net worth of the firm. The position of current assets can be well judged by the two ratios: a) current assets to total asset and; b) current asset to total sales.

Principle of Cost of Capital and Risk: Different sources of working capital finance have different cost of capital. There is an inverse relationship between the risk and cost of capital, which means more the risk less will be the cost and vice versa. So there should be balance between the two, cost and risk. For example loan is less costly and more risky whereas reserve is more costly and less risky.

Principle of Maturity of Payment: This principle states that funds for working capital should be raised from different sources keeping in mind their maturity aspect so that the firm can repay them on the time of their maturity of payment.

Principle of risk variation: there is direct relationship between risk and return. More liquidity facilitates transaction and reduces the risk of failure of operation but high funds means more cost of capital and less return and vice versa.

Factors affecting Working Capital Requirement

1. Length of operating and manufacturing cycle
2. Nature of business
3. Scale of operation
4. Business cycle fluctuation
5. Seasonal factors
6. Production techniques
7. Sales and credit policy
8. Credit availability
9. Operating efficiency
10. Easy availability of raw material
11. Level of competition
12. Level of inflation
13. Growth prospects of business

Concluding Remarks

1. Working capital management establishes a relationship between current assets and current liabilities.
2. The objective of working capital management is to ensure smooth functioning of business operation and timely meeting short term obligations.
3. In order to fulfill working capital management objectives, finance manager is required to ensure the availability of optimum working in business.
4. Optimum working capital is that position which is none of shortage or excess of working capital.
5. Only at optimum working capital business ensures efficient and profit working capital management.
6. The four principles of working capital management are helpful in fulfilling the objectives.
7. there are a number of consideration that influence working requirement in an organization.