REVIEW OF RESEARCH

ISSN: 2249-894X
IMPACT FACTOR : 3.8014(UIF)
VOLUME - 6 | ISSUE - 6 | MARCH - 2017

WORKING CAPITAL MANAGEMENT - A CONCEPTUAL ANALYSIS

Dr. Gopal Sahu
B.Com, M.Com, Ph.D,
University Department of Commerce and Business Administration, L.N. Mithila University, Darbhanga

ABSTRACT
Working Capital is defined varyingly keeping in view the objectives and purposes. To businessmen, working capital comprises current assets of business whereas to the accountant/creditors/investment analysts working capital is understood as the difference of current assets minus current liabilities. This is also called the Net Working Capital. There is operative aspect of working capital i.e. current assets (which is known as 'funds' also) employed in the business process form the gross working capital. Current assets comprise: cash, receivables, inventories, marketable securities held as short- term investment and other items near cash or equivalent to cash. This is also known as going-concern concept of working capital. This paper is a modest attempt to study the conceptual framework of working capital management.

KEYWORDS : *Current Assets, Current Liabilities, Working Capital.*

INTRODUCTION

On the basis of the above concepts of Gross' and "Net' working capital, it can be classified in two ways. In the first case the classification may be linked with 'Gross' Concept. Such working capital shall be those sums invested in various components of current assets, such as cash, receivables, short-term unexpired costs and inventories. Second classification is based on 'time" element which classifies working capital as "permanent" or "temporary'. Permanent working capital is that amount of funds required to produce goods and services necessary to satisfy demand at its lowest point. Such capital possesses the following characteristics viz, it is constantly changing from one asset form to another; and it remains permanently within the process of the business and can be returned back to its owners/suppliers when the business comes to an end. It has another special feature that it increases with the growth of business of the company. On the other hand, temporary working capital do change its form from cash to inventory to receivables and back to cash with the difference that it is not always gainfully employed. Seasonal business requires more temporary working capital.

Working capital comes into business operation when actual operation takes place. Generally, the requirement of quantum of working capital is determined by the level of production which depends upon the management attitude towards "risk' and the factors which Influence the amount of cash, inventories, receivables and other current assets required to support given volume of production. Risk is understood in the sense of the probability of bearing unfavourable results on account of not maintaining sufficient current assets to meet all the financial obligations as they mature and to support the proper level of sales.

A Finance Manager takes three broad decisions in respect of working capital management and they are -

- the level of current assets,
- the structure/composition of current assets and
- the financing of current asset.

While comparing the analysis of the financial statements and the cost per litre, it can be said that Dairy could only achieve economic viability by increasing the sale of milk with proper attention paid to increase its procurement and also minimizing its operational costs. Dairy with too require effective financial management. Despite the factors like procurement, processing and distribution responsible for the better functioning of a diary unit, its operational efficiency is mostly based on its financial management**.**

Nature and Types of Working Capital

Working capital is the life blood of any business, without which the fixed assets are inoperative. Working capital circulates in the business, and the current assets change from one form to the other. Cash is used for procurement of raw materials and stores items and for payment of operating expenses, then converted into work-in-progress, then to finished goods. When the finished goods are sold on credit terms receivables balances will be formed. When the receivables are collected, it is again converted into cash. The need for working capital arises because of time gap between production of goods and their actual realisation after sales. This time gap is called technically called as ‘operating cycle' or ‘working capital cycle'. The operating cycle of a company consists of time period between the procurement of inventory and the collection of cash from receivables. The operating cycle is the length of time between the company’s outlay on raw materials, wages and other expenses and inflow of cash from sale of goods. Operating cycle is an important concept in management of cash and management of working capital. The operating cycle reveals the time that elapses between outlay of cash and inflow of cash. Quicker the operating cycle less amount of investment in working capital is needed and it improves the profitability. The duration of the operating cycle depends on the nature of industry and the efficiency in working capital management.

Gross and Net Working Capital

Generally the working capital has its significance in two perspectives. These are gross working capital and net working capital is called ‘balance sheet approach’ of working capital. The term 'gross working capital' refers to the firm’s investment in current assets. According to this concept working capital refers to a firm’s investment in current assets. The amount of current liabilities is not deducted from the total of current assets. The concept of gross working capital is advocated for the following reasons:

- Profits of the firm are earned by making investment of its funds in fixed and current assets. This suggests the part of the earning relate to investment in current assets. Therefore, aggregate of current assets should be taken to mean the working capital.
- The management is more concerned with the total current assets as they constitute the total funds available for operating purposes than with the sources from which the funds come.
- An increase in the overall investment in the enterprise also brings an increase in the working capital.

The term 'net working capital' refers to the excess of current assets over current liabilities. It refers to the difference between current assets and current liabilities. The net working capital is a qualitative concept which indicates the liquidity position of a firm and the extent to which working capital needs may be financed by permanent source of funds. The concept looks into the angle of judicious mix of long-term and short-term funds for financing current assets. A portion of net working capital should be financed with permanent sources of funds. The gross and net working capital are ascertained as shown below:

		(Rs.)
Current assets:		
Raw material stock		xxx
Work-in-process stock		xxx
Finished goods stock	xxx	
Sundry debtors		xxx
Bills receivable		xxx
Short-term investments		xxx
Cash and bank balances		xxx
		......
Gross working capital		xxx
Less; Current liabilities:		
Creditors for materials	xxx	
Creditors for expenses	xxx	
Bills payable	xxx	
Tax liability	xxx	
Short-term loans	xxx	xxx
	....	.....
Net working capital		xxx

Importance of Working Capital

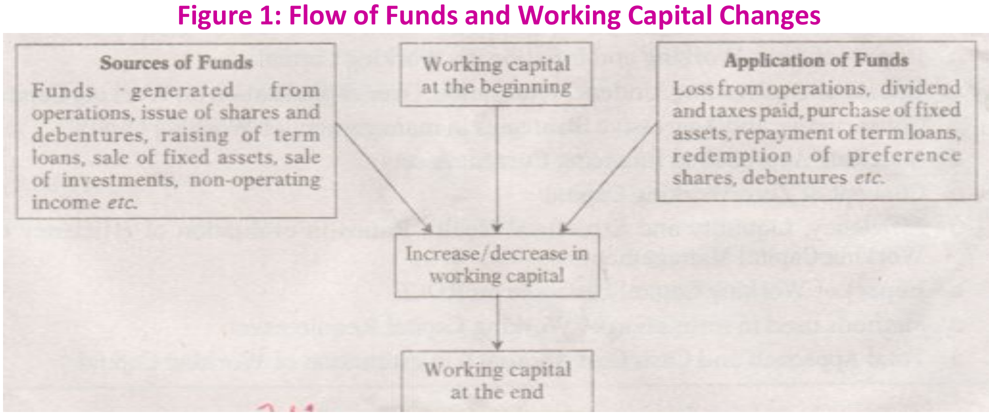
In the past, a lot of research has been conducted to investigate the relationship between working capital management and profitability of the firm in different environments. Shin and Soenen (1998) used a sample of 58,985 firms' years covering the period 1975-1994 in order to investigate the relationship between net-trade cycle, which was used as a measure of working capital management efficiency and corporate profitability. He observed a strong negative, relationship between the length of net-trade cycle and its profitability. Deloof (2003) made an investigation for the relationship between working capital management and corporate profitability. He used a sample of 1009 large Belgium non-financial firms for the period from 1992 to 1996. The results showed a negative relationship between gross operating income, a measure of corporate profitability, and cash conversion cycle, as well as day's account receivable and inventories. Lazaridis and Tryfonidis (2006) also investigated the relationship between working capital management and corporate profitability for the firms listed in the Athens Stock Exchange for a sample of 131 listed companies. Researchers used the company financials from 2001-2004 for the study. The results of the study of regression analysis showed that there was a statistically significant relationship between gross operating profit, a measure of profitability and the cash conversion cycle. He suggested that by optimizing the cash conversion cycle, the managers could create value for the shareholders.

Components of Working Capital

Working capital to a company is like the blood to human body. It is the most vital ingredient of a business. Working capital management if carried out effectively, efficiently and consistently, will ensure the health of an organization. A company invests its funds for long-term purposes and for short-term operations. That portion of a company's capital, invested in short-term or current assets to carry on its day to day operations smoothly, is called the 'working capital'. Working capital refers to a firm's investment in short-term assets viz., cash, short-term securities, amounts receivables and inventories of raw materials, work-in-process and finished goods. It refers to all aspects of current assets and current liabilities. The management of working capital is no less important than the management of long-term financial investment. Sufficient liquidity is necessary and must be achieved and maintained to provide that fund's to payoff obligation as they arise or mature. The adequacy of cash and other current assets together with their efficient handling virtually determine the survival of the company. The efficient working capital management is necessary to maintain a balance of liquidity and profitability. If the funds are tied-up in idle current assets represent poor and inefficient working capital management which affects the firm's liquidity as well as profitability.

Working capital is defined as 'the excess of current assets over current liabilities'. All elements of working capital are quick moving in nature and therefore, require constant monitoring for proper management. For proper management of working capital, it is required that a proper assessment of its requirement is made. Working capital is also known as circulating capital, fluctuating capital and revolving capital. The magnitude and composition keep on changing continuously in the course of business. If the working capital level is not properly maintained and managed, then it may result in unnecessary blockage of scarce resources of the company. Therefore, the Finance Managers should give utmost care in management of working capital.

Figure 1: Flow of Funds and Working Capital Changes



Current assets are those assets which are convertible into cash within a period of one year and are those which are required to meet the day to day operations of the business. The working capital management to be more precise the management of current assets. The current assets are cash or near cash resources. These include:

I. Cash and bank balances
II. Temporary investments
III. Short-term advances
IV. Prepaid expenses
V. Receivables
VI. Inventory of raw materials, stores and spares

VII. Inventory of work- in- progress
VIII. Inventory of finished goods

Current Liabilities are those claims of outsiders which are expected to mature for payment within an accounting year. These include:

I. Creditors for goods purchased
II. Outstanding expenses
III. Short-term borrowings
IV. Advances received against sales
V. Taxes and dividends payable
VI. Other liabilities maturing within a year

Strategies in Working Capital Management

So far the banks were the sole source of funds for working capital needs of business sector. At present more finance options are available to a Finance Manager to see the operations of his firm go smoothly. Depending on the risk exposure of business, the following strategies are evolved to manage the working capital.

Conservative Approach

A conservative strategy suggests not to take any risk in working capital management and to carry high levels of current assets in relation to sales. Surplus current assets enable the firm to absorb sudden variations in sales, production plans, and procurement time without disrupting production plans. It requires to maintain a high level of working capital and it should be financed by long-term funds like share capital or long-term debt. Availability of sufficient working capital will enable the smooth operational activities of the firm and there would be no stoppages of production for want of raw materials, consumables. Sufficient stocks of finished goods are maintained to meet the market fluctuations. The higher liquidity levels reduce the risk of insolvency. But lower risk translates into lower return. Large investments in current assets lead to higher interest and carrying costs and encouragement for inefficiency. But conservative policy will enable the firm to absorb day to day business risks.

Financing Strategy

Long-term funds = Fixed assets + Total permanent current assets + Part of temporary current assets
Short-term funds = Part of temporary current assets

Aggressive Approach

Under this approach cut-rent assets are maintained just to meet the current liabilities without keeping any cushion for the variations in working capital needs. The core working capital is financed by long-term sources of capital, and seasonal variations are met through short- term borrowings. Adoption of this strategy will minimise the investment in net working capital and ultimately it lowers the cost of financing working capital. The main drawbacks of this strategy are that it necessitates frequent financing and also increases risk as the firm is vulnerable to sudden shocks.

Financing Strategy

Long-term funds = Fixed assets + Pan of permanent current assets
Short-term funds = Part of permanent current assets + Total temporary current assets

Matching Approach

Under matching approach to functioning Working Capital requirements of a firm, each asset in the balance sheet assets side would be offset with a financing instrument of the same approximate maturity. The basic objective of this method of financing is that the permanent component of current assets and the fixed assets would be met with long-term funds and short-term or seasonal variations in current assets would be finance with short-term debt.

Financing Strategy

Long -term funds= Fixed Assets+ Total Permanent Current Assets

Short-term funds= Total temporary current assets for management of working capital, ratios are calculated and benchmarked.

CONCLUSION

Working Capital refers to a firm's investment in short- term assets. It refers to all aspects of current assets and current liabilities. Efficient working capital needed to balance liquidity and profitability and to maintain sufficient liquid assets to provide funds to pay off obligations as when they arise, without loss goodwill and affecting the day to day operation of business, Working capital management studies the ways to optimise investment in current assets, to improve return on capital employed. The basic principle of working capital management is that, the permanent currents to be financed from long-term sources and temporary fluctuations in current assets to be financed by raising short-term funds.

REFERENCES:

1. *Madan Mohan, C (1989), Dairy Management in India (A Study in Andhra Pradesh), Mittal Publication, Delhi, pp.258-261*
2. *Kishore, Ravi M (2000), Financial Management, Taxmann Allied Services Pvt Ltd., New Delhi, p.115*
3. *Ibid, pp. 121-122*
4. *Lazaridis, Ioannis and Tryfondis, Dimitrios (2006), One Relationship Between Working Capital Management and Profitability of Listed Companies in Athens Stock Exchange, University of Macedonia, Department of Accounting and Finance, North Egnatia Street, Thosalonik:, Greece*
5. *Zaryawati, M. A, Annuar, MN and Abdul Rahim, A S (2009), Working Capital Management and Corporate Performance: Case of Malaysia, Journal of Modern Accounting and Auditing, Vol.5, No. ii, Serial No. 54*
6. *Nasr, Mohammad and Rehman, Abdul (2007), Working Capital Management and Profitability- Case of Pakistani Firms, International Review of Business Research Papers, Vol.13, No.1, March, pp.279-300*
7. *Eljelly, Abdul M A (2004), Liquidity- Profitability Trade off: An Empirical Investigation in An Emerging Market , International Journal of Commerce and Management, Vol. 14, No.2, February, p.48*
8. *Singh, D P (2012), working capital management and profitability in the It and Telecom Industry in India, Indian Journal of Finance, Vol.6, No.3, March, pp.55-59*
9. *Reports of the Tondon Committee, 1974 and the Chore Committee, 1979 on Maximum Permissible Bank Finance-www.rbi.org.in*