Financial Accounting and Management

Unit 4

"Working Capital is the excess of Current Assets over Current Liabilities."

Working Capital

Working Capital refers to firm's investment in short-term assets, viz. cash, short-term securities, accounts receivable (debtors) and inventories of raw materials, work-in process and finished goods. It can also be regarded as that portion of the firm's total capital, which is employed in short-term operations. It refers to all aspects of current assets and current liabilities. In simple words, we can say that working capital is the investment needed for carrying out day-to-day operations of the business smoothly. The management of working capital is no less important than the management of long-term financial investment.

Current assets: It is rightly observed that "Current assets have a short life span. These types 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."

Significance of Working Capital

The main compensation of maintaining ample amount of working capital is as under:

1. **Solvency of the Company:** Sufficient working capital helps in maintaining solvency of the company by providing continuous flow of manufacture.
2. **For Goodwill of business:** Sufficient working capital enables a business concern to make punctual payments and hence helps in creating and maintaining goodwill.
3. **Easy availability of loans:** A business having sufficient working capital, high solvency and good credit standing can assemble loans from banks and other on easy and positive terms.
4. **To avail cash discounts:** Enough working capital also enables a concern to avail cash discounts on the purchases and hence it reduces costs.
5. **Normal supply of raw materials:** Enough working capital ensures usual supply of raw materials and regular production.
6. **Usual payment for day-to-day commitments:** A company which has plenty working capital can make usual payment of salaries, wages and other day-to-day commitments

which raises the confidence of its employees, increases their competence, reduces wastages and costs and enhances manufacture and profits.

7. **Utilization of favourable market situation:** Only concern with sufficient working capital can exploit positive market conditions such as purchasing its necessities in bulk when the prices are lesser and by holding its inventories for upper prices.
8. **Capability to face crisis:** Sufficient working capital enables a concern to face company crisis in emergency periods such as gloominess because during such periods, usually, there is much pressure on working capital.
9. **Rapid and regular return on investments:** Every sponsor wants a quick and regular return on his investments. Adequacy of working capital enables an organization to pay quick and usual dividends to its investors as there may not be much force to plough back profits. This gains the assurance of its investors and creates a positive market to raise additional funds in the prospect.
10. **High confidence:** Sufficiency of working capital creates surroundings of safety, confidence, and high self-esteem and creates overall competence in a business.

Factors Affecting Working Capital Requirements

The following factors significantly influence the working capital requirements:

1. **Nature of Business:** The working capital necessity of a firm fundamentally depends upon the nature of the business. Public usefulness activities like electricity water supply and railways require very restricted working capital because they offer cash sales only and provide services, not products and as such no funds are coupled up in inventories and receivables. Usually speaking it may be said that public utility activities require small amount of working capital, trading and financial firms necessitate comparatively very large amount, whereas manufacturing activities require considerable working capital between these two limits.
2. **Scale of Operations:** The working capital necessity of a concern is directly influenced by the size of its company which may be calculated in terms of scale of operations.
3. **Production strategy:** In certain organizations the require is subject to wide fluctuations due to seasonal variations. The necessities of working capital in such cases depend upon the production strategy.
4. **Manufacturing procedure:** In manufacturing company the necessity of working capital increases in direct proportion of length of manufacturing procedure. Longer the procedure period of produce, larger is the amount of working capital required.
5. **Seasonal disparity:** In certain companies' raw material is not obtainable throughout the year. They have to buy raw materials in bulk in the season to make sure and continuous flow and process them during the entire year.
6. **Rate of stock proceeds:** There is a high degree of inverse co-relationship between the quantum of working capital; and the rapidity or speed with which the sales are affected. A firm having a high rate of stock turnover will need lesser amount of working capital as compared to a company, having a low rate of proceeds.
7. **Credit strategy:** The credit strategy of a company in its dealing with debtors and creditors influence significantly the necessity of working capital. A company that purchases its necessity on credit and sell its products/services on cash require smaller amount of working capital.

8. **Business rotation:** Business cycle refers to alternate development and contraction in common business actions. In a period of bang i.e., when the business is prosperous, there is a need of bigger amount of working capital due to amplify in sales, rise in prices, optimistic expansion of business contracts sales decline, difficulties are faced in collection from debtors and organisations may have a large amount of working capital lying inactive.
9. **Rate of expansion of company:** The working capital requirement of a concern increase with the growth and expansion of its business activities. Though it is difficulties to decide the relationship between the expansion in the volume of a company and the increase in the working capital of a business, yet it may be accomplished that of normal rate of expansion in the volume of business, we may have retained profits to provide for additional working capital but in fast growth in concern, we shall require bigger amount of working capital.
10. **Price stage change:** Changes in the price stage also result on the working capital necessity. Generally, the increasing prices will require the firm to maintain bigger amount of working capital as more funds will be essential to maintain the same current assets.

Liquidity Vs. Profitability

All decisions of the financial manager are assumed to be geared to maximization of shareholders wealth, and working capital decisions are no exception. Accordingly, risk-return trade-off characterizes each of the working capital decision. There are two types of risks inherent in working capital management, namely, liquidity risk and opportunity loss risk. Liquidity risk is the non-availability of cash to pay a liability that falls due. It may happen only on certain days. Even so, it can cause not only a loss of reputation but also make the work condition unfavourable for getting the best terms on transaction with the trade creditors. The other risk involved in working capital management is the risk of opportunity loss i.e. risk of having too little inventory to maintain production and sales, or the risk of not granting adequate credit for realizing the achievable level of sales. In other words, it is the risk of not being able to produce more or sell more or both, and, therefore, not being able to earn the potential profit, because there were not enough funds to support higher inventory and book debts. Thus, it would not be out of place to mention that it is only theoretical that the current assets could all take zero values. Indeed, it is neither practicable nor advisable. In practice, all current assets take positive values because firms seek to reduce working capital risks. However, if more funds are deployed in current assets, the higher would be the cost of funds employed, and therefore, lesser the profit.

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 experience 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 borrow at high rates of interest. This will also adversely affect the creditworthiness 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.**

Approaches to Managing Working Capital

Two approaches are generally followed for the management of working capital: (i) the conventional approach, and (ii) the operating cycle approach.

The Conventional Approach

This approach implies managing the individual components of working capital (i.e. inventory, receivables, payables, etc) efficiently and economically so that there are neither idle funds nor paucity of funds. Techniques have been evolved for the management of each of these components. In India, more emphasis is given to the management of debtors because they

generally constitute the largest share of the investment in working capital. On the other hand, inventory control has not yet been practised on a wide scale perhaps due to scarcity of goods (or commodities) and ever rising prices.

The Operating Cycle Approach

This approach views working capital as a function of the volume of operating expenses. Under this approach the working capital is determined by the duration of the operating cycle and the operating expenses needed for completing the cycle. The duration of the operating cycle is the number of days involved in the various stages, commencing with acquisition of raw materials to the realisation of proceeds from debtors. The credit period allowed by creditors will have to be set off in the process. The optimum level of working capital will be the requirement of operating expenses for an operating cycle, calculated on the basis of operating expenses required for a year.

In India, most of the organisations use to follow the conventional approach earlier, but now the practice is shifting in favour of the operating cycle approach. The banks usually apply this approach while granting credit facilities to their clients.