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Working Capital Position of Company

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Abstract – A successful sales programme is necessary for earning profits by any business enterprise. However, sales do not convert in to cash instantly; there is invariably a time lac between the sale of goods and the receipt of cash. There is therefore, need for working capital in the form of current assets to deals with the problem arising out of the lack of immediate realization of cash against goods sold. Therefore, sufficient working capital is necessary to sustain sales activity.

Working capital represents the short-term strength of the firm. It is the excess of current assets over the current liabilities. The term current assets refers to assets which in the normal course of business get converted into cash without diminution in value over a short period, usually not exceeding one year or length of operating cycle whichever is more. Current liabilities are those liabilities which at the inception are required to be paid is short period, normally a year.

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INTRODUCTION

If a company's current assets do not exceed its current liabilities, then it may run into trouble paying back creditors in the short term. The worst-case scenario is bankruptcy. A declining working capital ratio over a longer time period could also be a red flag that warrants further analysis. For example, it could be that the company's sales volumes are decreasing and, as a result, its accounts receivables number continues to get smaller and smaller.
Working capital also gives investors an idea of the company's underlying operational efficiency. Money that is tied up in inventory or money that customers still owe to the company cannot be used to pay off any of the company's obligations. So, if a company is not operating in the most efficient manner (slow collection), it will show up as an increase in the working capital. This can be seen by comparing the working capital from one period to another; slow collection may signal an underlying problem in the company's operations.

LIQUIDITY

Liquidity is a prerequisite for the very survival of a firm. Liquidity is important for a firm to meet the short-term obligations when they become due for payment can hardly be overstressed. So the liquidity ratios measure the ability of a firm to meet its short-term obligation and reflect the short-term financial strength/solvency of the firm. The ratios which indicate the liquidity of the firm are

1. Net working capital

2. Current ratios

3. Acid test ratio

4. Turnover ratio

DETERMINANTS OF WORKING CAPITAL

A firm should plan its operations in such a way that it should have neither too much nor too little working capital. The total working capital requirement is determined by a wide variety of factors. These factors, however, affect different enterprise differently. They also vary from time to time. In general, the following factors are involved in a proper assessment of the quantum of working capital required.

GENERAL NATURE OF BUSINESS

The working capital requirement of an enterprise are basically related to the conduct of business. Enterprise fall into some broad categories depending on the nature of their business. For instance, public utilities have certain features. Which have a bearing on their working capital needs? The two relevant features are: (i) the cash nature of business, that is cash sale, and (ii) Sale of services rather than commodities.

PRODUCTION CYCLE

Another factor which has a bearing on the quantum of working capital is the production cycle. The term ‘production or manufacturing cycle’ refers to the time involved in the manufacture of goods. It covers the time span between the procurement of raw material and the completion of the manufacturing process leading to the production of finished goods. Funds have to be necessarily tied up during the process of manufacture, necessitating entranced working capital. In other words, there is some time gap before raw materials become finished goods. To sustain such activities the need for working capital is obvious. The longer the time-span (i.e. the production cycle), the larger will be the tied-up funds and, therefore, the larger is the working capital needed.

BUSINESS CYCLE

The working capital requirement are also determined by the nature of the business cycle. Business fluctuations lead to cyclical and seasonal changes which, in turn, cause a shift in the working capital position, particularly for temporary working capital requirement. The variations in business conditions may be in two directions: (i) upward phase when boom conditions prevail, and (ii) downswing phase when economic activity is marked by a decline. During the upspring of business activity, the need for working capital is likely to grow to cover the lag between increased sales and receipt of cash as well as to finance purchases of additional material to cater to the expansion of the level of activity. Additional funds may be required to invest in plant and machinery to meet the increased demand. The downswing phase of the business cycle has exactly an opposite effect on the level of working capital requirement. The decline in the economy is associated with a fall in the volume of sales which, in turn, leads to a fall in the level of inventories and took debts.

PRODUCTION POLICY

The quantum of working capital is also determined by production policy. In the case of certain lines of business the demand for products is seasonal, that is they are purchased during certain months of the year. What kind of production policy should be followed in such cases? These are two options open to such enterprise: either they confine their production only to periods when goods are purchased or they follow a steady production policy throughout the year and produce goods at a level to meet the peak demand. In the former case, there are serious production problems. During the slack season, the firm have to maintain their working force and physical facilities without adequate production and sale.

CREDIT POLICY

The credit policy relating to sales and purchases also affects the working capital. The credit policy influences the requirement of working capital in two ways: (i) through credit terms granted by the firm to its customers/buyers of goods, (ii) credit terms available to the firm from its creditors.

GROWTH AND EXPANSION

As a company grows, it is logical to expect that a larger amount of working capital is required. It is, of course, difficult to determine precisely the relationship between the growth in the volume of business of a company and the increase in its working capital. The composition of working capital in a growing company also shifts with economic circumstances and corporate practice.

VAGARIES IN THE AVAILABILITY OF RAW MATERIAL

The availability or otherwise of certain raw material on a continuous basis without interruption on a continuous basis without interruption would sometimes affect the requirement of working capital. There may be some materials which cannot be procured easily either because of their sources are few or they are irregular. To sustain smooth production, therefore, the firm might be compelled to purchase and stock them far in excess of genuine production needs. This will result in an excessive inventory of such material. The procurement of some essential raw materials is difficult because of their sporadic supply. This happens very often with raw materials which are in very short supply and are controlled to ensure equitable distribution. The buyer has in such cases very limited options as to the quantum and timing of procurement. It may so happen that a bulk consignment may be available but the firm may be short of funds, while when surplus funds are available the commodities may be in short supply. This element of uncertainty would lead to a relatively high level of working capital.

PROFIT LEVEL

The level of profits earned differ from enterprise to enterprise. In general, the nature of the product, hold on the market, quality of management and monopoly power would by and large determine the profit earned by a firm. A prior, it can be generalized that a firm dealing in a high quality product, having a good marketing arrangement and enjoying monopoly power in the market, is likely to earn high profits and vice-versa. Higher profit margin would improve the prospects of generating more internal funds thereby contributing to the working capital pool. The cash profit is a source of working capital to the extent that it has been earned in cash.

LEVEL OF TAXES

The first appropriation out of profits is payment or provision for tax. The amount of taxes to be paid is determined by the prevailing tax regulations. The management has no discretion in this respect. Very often, taxes have to be paid in advance on the basis of the profit of the preceding year. Tax liability is, in a sense, short term liability is, in a sense, short term liability payable in cash. An adequate provision for tax payment is, therefore an important aspect of working capital planning.

DIVIDEND POLICY

Another appropriation of profits which has a bearing on working capital is dividend payment. The payment of dividend consumes cash resource and thereby, affects working capitals to that extent. Conversely, if the firm does not pay dividend but retaines the profit, working capital increases.

DEPRECIATION POLICY

Depreciation policy also exerts an influence on the quantum of working capital. Depreciation charges do not involve any cash outflows. The effect of depreciation policy on working capital is therefore, indirect.

PRICE LEVEL CHANGES

Changes in the price level also affects the requirements of working capital Rising prices necessitate the use of more funds of maintaining an existing level of activity. For the same level of current assets, higher cash outlays are required. The effect of rising prices is that a higher amount of working capital is needed.

OPERATING EFFICIENCY

The operating efficiency of the management is also an-important determinant of the level of working capital. The management can contribute to a sound working capital position through operating efficiency. Although the management cannot control the rise in prices, it can ensure the efficient utilization of resources, by eliminating waste, improving coordination, and a fuller utilization of existing resources and so on. Efficiency of operations accelerates the pace of cash cycle and improves the working capital turnover.

CONCLUSION

Every stakeholder has interest in the liquidity position of a company. Supplier of goods will check the liquidity of the company before selling goods on credit. Employees are also have interest in the liquidity to know whether the company can meet its employees' related obligations: salary, pension, provident fund etc. Shareholders are interested in understanding the liquidity due to its huge impact on the profitability. Shareholders may not like high liquidity as profitability and liquidity are inversely related. However, shareholders are also aware that non-liquidity will deprive the company from getting incentives from the suppliers, creditors, and bankers.

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