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NEED OF THE STUDY OF WORKING CAPITAL MANAGEMENT

Need of the Study of Working Capital Management

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Abstract - There are two concepts of working capital 'gross' and 'net'. According to the gross concept, working capital is die total of current assets. In turn of the net concept, working capital is die excess of current assets over current liabilities. Unless otherwise indicated it is the latter concept, which has been followed for the purpose of this study. This is because it permits a long run view of working capital of the enterprise selected for study.

In earning a reasonable rate of return, the functional, complementary, proportional and technical role of working capital plays a great part. Besides, the presence of an adequate working capital also helps in maintaining an earning a good reputation in the business world. The analysis of working capital should concern itself with its circulation, liquidity level and the structural health. Preparing a fund flow statement or conducting various ratio tests can analyze the working capital position of a company. Of the two the latter is better and of greater importance since it deals with each and every aspects of the working capital analysis and is useful for both the internal as well as external management.

Working Capital consists of that portion of the assets of a business, which are used, in current operations. It includes receivables, inventories or raw materials, stores, work-in-progress and finished goods, merchandise, bill receivable and cash.

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INTRODUCTION

Working Capital is the life blood of every business concern. Business firm can not make progress without adequate working capital. Inadequate working capital means shortage of inputs, whereas excess of it leads to extra cost. So the quantum of working capital in every business firm should be neither more nor less than what is actually required. The management has to see that funds invested as working capital in their organization earn return at least as much as they would have earned return if it invested anywhere else. At the time of increasing capital costs and scare funds, the area of working capital management assumes added importance as it deeply influences a firm's liquidity and profitability. A notable feature of utilization of funds is that they are of recurring nature. Therefore, efficient working capital management requires a proper balance between generation and utilization of these funds without which either shortage of funds will cause obstruction in the smoother functioning of the organization or excess funds will prevent the firm from conducting its business efficiently. So the main objective of working capital management is to arrange the needed funds on the right time from the right source and for the right period, so that a trade off between liquidity and profitability may be achieved.

A firm may exist without making profits but cannot survive without liquidity. The function of working capital management organization is similar that of heart in a human body. Also it is an important function of financial management. The financial manager must determine the satisfactory level of working capital funds and also the optimum mix of current assets and current liabilities. He must ensure that the appropriate sources of funds are used to finance working capital and should also see that short term obligation of the business are met well in time.

These types of assets are normally temporary in nature. In accounting concept of working capital it is the difference between inflow and outflow of funds i.e. sources and uses of funds, i.e. net cash inflow. In other words, working capital is the excess of current assets over current liabilities.

Working capital management is concerned with problem that arises in attempting to manage the current liabilities and the interrelationship exists between them. Management of short term asset and short term financing is referring to working capital management and current asset management. The goal of working capital management is to manage a current asset in such a manner so that the satisfactory level should be maintained.

Working capital as represented by excess of current assets over current liabilities and identifying the relatively liquid portion of the total enterprise capital which constitutes a margin for meeting obligation within the ordinary operating cycle of the business.

"The sum of the current asset is the working capital." J.S Mill defines the gross concept. "Whenever working capital is mentioned it brings to mind current assets and current liabilities with general understanding that working capital is the difference between the two."

There are two concepts of working capital, Gross concept and Net Concept. Gross working capital refers to a firm's investment in current assets. Current assets are the assets, which can be converted into cash within an accounting year and includes cash, short term securities, debtor, bills receivables and inventories. In other way, it defines as "total of current assets i.e. circulating capital." This concept is also known as quantitative concept.

The net concept i.e. net working capital concept refers to the difference between current assets and current liabilities. Current liabilities are those claims of outsiders, which are expected to mature for payment within an accounting year and include creditors, bills payable, bank overdraft and outstanding expenses. This concept gives idea regarding sources of financing capital i.e. amount of current assets which would remain surplus if all current liabilities are paid. It can be positive or negative positive is net working capital and negative is deficit working capital.

TECHNIQUES FOR ANALYSIS OF WORKING CAPITAL

Proper management of working capital requires a careful inquiry into current assets and current liabilities and trends in the terms that are included in working capital i.e. components of current assets and liabilities.

Many reasons may make it essential to analyze the working capital position of a business enterprise. One reason for analyzing the working capital is to see what will be found when financial statements are examined. A second reason is to enable management to detect trends and take corrective steps when the analysis indicates need for them. A third person is to see what changes have been taken place in the company over a period of time so that this knowledge may be used in setting guidelines. There are four important techniques for analyzing the working capital position of an enterprise.

a) Ratio Analysis

b) Fund Flow Analysis

c) Cash Flow Analysis

d) Trend Analysis

(a) Ratio Analysis:

It is commonly used technique for analyzing working capital management. Management can use ratio analysis of working capital as a means of checking upon the efficiency with which working capital is being used in a concern. It can be used with profit to measure the pulse of the working capital. It can help us to diagnose the working capital position of the enterprise.

This technique is most commonly used because it practically deals with each and every aspect of working capital analysis. In this technique for each aspect of analysis, certain ratios are computed and then results are drawn based on trends shown by then against those fixed as guideposts. Various ratios are used in analyzing the various aspects of the working capital position of an enterprise. Ratio analysis is not only a technique to find out or point out the relationship between two figures but also points out the devices to measure the fundamental strengths or weakness of a concern.

Most important ratio of working capital management used in analyzing the various aspects of the working capital position of an enterprise

(i) Turnover of working capital (Net Sales divided by net working capital)

(ii) Current Ratio (Current assets divided by current liabilities)

Quick Ratio (Quick ratio divided by Quick liabilities)

Current debt to tangible net worth (Current liabilities divided by tangible net worth)

(b) Fund Flow Analysis:

Fund flow analysis shows how funds have been procured for a business and how they have been employed. This technique helps to analyze changes in working capital components between two dates. The comparison of current assets and current liabilities as shown in the balance sheet at beginning and at the end of a specific period, shows changes in such types of current assets as well as the sources from which working capital has been obtained. It shows how funds have been procured for a business and how they have been employed. It is a useful tool for internal management in its control of working capital.

"The statement of sources and applications of funds gives a clear answer to the questions of what has become of the net profit in such a situations. And also what has become of the funds obtained from all other sources."

However, with the help of this technique we cannot know whether the working capital is being used most efficiently. It does not throw light on the significance of movements in the working capital structure.

One objective of efficient working capital management is to minimize the amount of cash in hand. Minimizing the funds required means knowing when funds will be available and when funds will be needed. The funds flow can be managed so that the inflows and outflows nearly match. It is not sufficient that the final accounts shows a profit and the balance sheet points a rosy picture of financial health of an enterprises. All will look meaningless unless the funds inflows and outflows are so regulated that at all times there is enough cash available to meet obligation as and when they mature.

(c) Cash Flow Analysis:

It is an important component of working capital because it is a form of liquid capital. It is very necessary for day-to-day operation. It is the important current asset, which affects business activities. Cash flow analysis is an important tool for cash flow planning. Cash is the focal point of working capital flows.

A statement showing the variation in cash has to be prepared and is known as cash flow statement. It highlights the causes, which changes the cash position between two balance sheet dates. It depicts a penetrating review of cash movement and an operating cycle. It shows the flow of cash for a period. Hence, an analysis dealing with inflow and outflow of cash referred to as cash flow analysis. It shows the movement of cash in and out of the business by listing the source of cash receipts and the uses of cash. Sound working capital management requires maintenance of an adequate amount of cash. Controlling the investment in working capital begins with cash management.

(d) Trend Analysis:

Working capital trend analysis in an important technique of working capital management. Trend percentage constitutes an important tool of interpretative analysis of financial position of a company. It indicates die changes, which have been taking, place from time to time in individual items of current assets, current liabilities and net working based on some standard year and its effect on working capital position. It enables us to evaluate the upward and downward trend of current asset and current liabilities.

These are usually measured from review of comparative balance sheets of a concern at the end of two accounting years and results are drawn based on trend shown by them. Trend analysis involves the calculation of percentage relationship that each statement item bears to the same items in the base year. Trend percentage discloses change in the financial and operating data between specific periods and makes it possible for the analyst to form an opinion as to whether favorable or unfavorable tendencies are reflected by data.

IMPORTANCE OF WORKING CAPITAL MANAGEMENT

The aim of working capital management is to manage a firm's current assets e.g. debtors, receivables, cash in hand, cash at bank, stock etc. and firm's current liabilities viz. creditors, bills payable etc. in best possible manner. If it does not maintain it in good manner, it is likely to become insolvent and may also become bankrupt. The current assets should be large enough to cover current liabilities in order to ensure a reasonable margin of safety. Each of the current assets must be managed efficiently in order to maintain the liquidity of a concern while not keeping too high level of any one of them so that the cost increases. Each of short term sources of finance must be continuously manageable to ensure that they are obtained and used in the best possible way.

Proper management of working capital is very important for the success of a concern. **"**It aims at protecting the purchasing power of assets and maximizing the return on investment.**"** The manner of management of current assets to a very large extent determines die success of a concern. Constant management is required to maintain appropriate levels in the various working capital accounts. Cash and financial budget aid to establishing proper proportion, sales expansion, dividend declaration, plant expansion, new product lines increased salaries and wages, rising price level etc. add strain on working capital maintenance.

"There are many aspects of working capital management which make it an important function of the financial manager.**"** It has been found that the largest portion of financial manager's time is utilized in the management of working capital. It is particularly very important for small firms to manage their current assets and current liabilities very carefully.

"Failure of business is undoubtedly due to poor management and absence of management skill. Shortage of working capital, so often advanced as the main cause of failure of an industrial concern, is nothing but the clearest evidence of mismanagement of it which is so common.**"**

The management of working capital also helps the management in evaluating various existing or proposed financial constraints and financial offerings. All these factors clearly indicate the importance of working capital of an enterprise. It has been emphasized that a firm should maintain a sound working capital position and that there should be optimum investment in working capital. Thus, there is a great need to manage working capital adequately. Small firms may not have much investment in fixed assets, but they have to invest in current assets such as cash, debtors and inventories. Further, the role of current liabilities in financing current assets is far more significant in case of small firms, as unlike large firms, they face difficulties in raising long-term finances.

There is great relationship between sales and working capital needs. As sales grow, a firm needs to invest more in inventories and book debts. These needs become very frequent and fast when sales grow continuously. Continuous growth in sales may also require additional investment in fixed assets but they do not indicate the same urgency as displayed by current assets.

It may, thus be concluded that all precautions should be taken for effective and efficient management of working capital. Failure of business is undoubtedly due to poor management and absence of management skill.

In earning a reasonable rate of return, the functional complimentary, proportional and technical roles of working capital play a great part. Investment in working capital are relatively temporary in nature since the invested values are capable of being recovered within a short period of time depending upon the manufacturing cycle, as well as the collection cycles. In other words, it is the working capital, which after its transmutation into saleable products, actually generate revenue for business. Moreover, a low profit ratio can be geared to a high one by quickening the pace of working capital which besides providing the well spring for newer cycles will also increase die total realizable profit of a business enterprise.

Adequate working capital provides the business a cushion against the adverse effects of a shrinkage in the value of current assets, insures to a great extent the maintenance of a company's credit standing and provides the meeting emergencies. A fully equipped individual enterprise without adequate supply of materials to process or without cash to pay for workers' wages and other current expenses or a store without merchandize to sell is virtually useless. Consequently, the working capital position of any enterprise may readily become the controlling factor in determining the scope and character of its operation.

It plays technical role in maximization of the rate of return. An industrial concern can maximize its rate of return on the capital invested provided it keeps pace with the scientific and technological developments taking place in the field in which a concern operates. It is merely common abuse that as soon as some technological and scientific development takes place, an industrial concern in order to accelerate its profitability should immediately introduce the same in its productive processes.

Management of working capital is also important for the success of a business. It has been emphasized that a business should maintain a sound working capital position and that there should not be an excessive level of investment in working capital. It has also been found that the largest portion of financial managers time is utilized in the management of working capital like arranging term financing, negotiating favourable credit terms, controlling the movement of cash etc. On one hand, it maintains proper liquidity, while on other hand, it helps in increasing the profitability of the concern. If there is no liquidity, there cannot be good profitability. Profitability depends upon maximum utilization of all the components comprising working capital. If there is no proper planning of liquidity, a time may come when business may tend to drift towards liquidation. The amount of working capital funds reflects the solvency of business. The adequacy or inadequacy of working capital of a business is to be judged from the nature of business, its operating cycle, the working capital turnover etc.

The working capital plays the same role in the business as the role of heart in the human body. Working capital funds are generated and circulated in the business just tike blood in the heart. This is because the working capital is known as the circulating capital.

Working capital has also a technical role to play in the maximization of the rate of return on capital invested provided it keeps pace with scientific and technological development taking place in the field to which it pertains.

The funds generated from the issue of shares, borrowings and from operations are used to pay creditors for material etc. The material are processed, wages and overhead expenses are paid, this makes available stock of finished goods by sale of which either debtor are created or cash is receivable, thus generating profit A portion of profit is utilized for payment of tax, interest dividends. This working capital cycles continues throughout the life of business.

There should be a proper planning of liquidity. If there is no proper planning of liquidity a time may come when a business may tend to drift towards liquidation. The quantum of working capital funds reflects the solvency of the business but there is no single barometer to judge the efficiency of running a business. The adequacy or inadequacy of working capital in a business is to be judged from the nature of business, its operating cycle, the working capital turnover, the size of business and other factors.

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