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WORKING CAPITAL MANAGEMENT-AN OVERVIEW

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Abstract

The project revealed that the working capital has a direct impact on cash flow in a business. Since cash flow is the name of the game for all business owners, a good understanding of working capital is imperative to make any business enterprise successful. Companies must seek granular detail to identify the underlying drivers of working capital. By understanding the role and drivers of working capital management and taking steps to reach the "right" levels of working capital, companies can minimize risk, effectively prepare for uncertainty and improve overall performance. Successfully improving working capital management requires a different approach. The better a company manages its working capital, the less the company needs to borrow.

Keywords: Companies, Working capital.

1. INTRODUCTION

Every business needs funds for two purposes for its establishment and to carry out its day- to-day operations. Long terms funds are required to create production facilities through purchase of fixed assets such as plant &machinery, land, building, furniture, etc. Investments in these assets represent that part of firm's capital which is blocked on permanent or fixed basis and is called fixed capital. Funds are also needed for short-term purposes for the purchase of raw material, payment of wages and other day – to- day expenses etc.

The task of financial manager in managing working capital efficiently is to ensure sufficient liquidity in the operations of the enterprise.

2. IMPORTANCE OF THE TOPIC IN CORPORATE WORLD

Working capital management plays an important role in day to day operations of the business; hence the performance of the company mainly depends on it. The management of working capital involves managing inventories, accounts receivable and payable, and cash. The project aims to study the working capital management that is undertaken by the concern, to determine the Operating Cycle and Cash Cycle. This study also includes the analysis of the projected working capital requirements of the company and provides certain suggestions to improve the performance of the company.

3. CONCEPT OF WORKING CAPITAL

There are two concepts of working capital:

- Gross working capital
- Net working capital

The gross working capital is the capital invested in the total current assets of the enterprises (current assets are those assets which can convert in to cash within a short period normally one accounting year).

The net working capital is the excess of total current assets over total current liabilities.

4. CLASSIFICATION OF WORKING CAPITAL

Working capital may be classified in two ways:

1. On the basis of concept. – This can further classified as –
   - Gross working capital and
   - Net working capital.
2. On the basis of time - This can further classified as –
   - Permanent or fixed working capital.
   - Temporary or variable working capital

Permanent working capital refers to the hard core working capital which is that minimum level of investments in the current assets that is carried by the business at all times to carry out minimum level of its activities.

Temporary working capital refers to that part of the total working capital which is required over and above permanent working capital.

5. LITERATURE REVIEW

- **Bhunia** and **Das** in the year 2012 examined the relationship between the working capital management (WCM) and profitability of Indian private sector small-medium companies. Working capital management indicators and profitability indicators over the period from 2003 to 2010 were moulded as a linear regression analysis. The study revealed a small relationship between WCM including working capital cycle and profitability. Also, the multiple regression test confirmed a lower degree of association between WCM and profitability.

- **Nwankwo** and **Osho** in the year 2010 examined efficient working capital management as a pre-requisite to corporate survival and growth. Using the desk research method, they found out that the risk of changes in demand or technology leaves surplus stock unsalable and the risk of inability to settle financial obligations as at when due, and excess liquid capital tied up unproductively.

- **Falope** and **Ajilore** in the year 2009 provided empirical evidence about the effects of working capital management on profitability performance for a panel comprising fifty Nigerian quoted non-financial firms for the period 1996-2005. The study used panel data econometrics in a pooled regression. The study found a significant negative relationship between net operating profitability and the average payment period, and cash conversion cycle. They also found no significant variations in the effects of working capital management between large and small firms.

- **Ganesan** in the year 2007 analyzed working capital management efficiency of firms from telecommunications equipment industry. The relationship between working capital management efficiency and profitability was examined using correlation and regression analysis. Using a sample of 443 annual financial statements of 349 telecommunication equipment companies covering the period 2001-2007, the study revealed that "days working capital" is negatively related to profitability, however it does not significantly impact on the profitability of the firms.

- **Afza** and **Nazir** in the year 2007 investigated the relationship between aggressive and conservative approach to working capital management and profitability as well as risk for 208 Pakistani firms listed on Karachi Stock Exchange for the period of 1998-2005 using the Ordinary Least Square (OLS) regression analysis. The empirical result showed a negative influence of the working capital policies on the profitability of the firms.

6. CONCEPT OVERVIEW

Working capital management involves the relationship between a firm's short-term assets and its short-term liabilities. The goal of working capital management is to ensure that a firm is able to continue its operations and that it has sufficient ability to satisfy both maturing short-term debt and upcoming operational expenses. The management of working capital involves managing inventories, accounts receivable and payable, and cash.

Working Capital is the money used to make goods and attract sales. The less working capital used to attract sales, the higher is likely to be the return on investment. Working capital management is about the commercial and financial aspects of inventory, credit, purchasing, marketing, and royalty and investment policy. The higher the profit margin, the lower is likely to be the level of working capital tied up in creating and selling titles. The faster that we create and sell the books the higher is likely to be the return on investment.

Thus:

WORKING CAPITAL = CURRENT ASSETS – CURRENT LIABILITIES

7. COMPONENTS OF WORKING CAPITAL

In a department's Statement of Financial Position, these components of working capital are reported under the following headings:

Current Assets

- Liquid Assets (cash and bank deposits)
- Inventory
- Debtors and Receivables

Current Liabilities

- Bank Overdraft
- Creditors and Payables
- Other Short Term Liabilities

8. APPROACHES TO WORKING CAPITAL MANAGEMENT

Working capital management takes place on two levels:

1. Ratio analysis can be used to monitor overall trends in working capital and to identify areas requiring closer management.

2. The individual components of working capital can be effectively managed by using various techniques and strategies.

1) <u>RATIO ANALYSIS:</u>

Key working capital Ratios:

a) <u>Stock Turnover Ratio</u>

Formula: Average Stock * 365 / Cost of goods sold

Result = x days

b) <u>Receivables Ratio (in days)</u>

Formula: Debtors * 365/ Sales

Result = x days

c) <u>Payables Ratio (in days)</u>

Formula: Creditors * 365/Cost of Sales (or Purchases)

Result = x days

d) <u>Current Ratio</u>

Formula: Total Current Assets/ Total Current Liabilities

Result = x times

e) <u>Quick Ratio</u>

Formula: (Total Current Assets – Inventory – Prepaid Expenses)/(Total Current Liabilities – Bank overdraft – Cash Credit)

Result = x times

f) Working Capital Ratio

Formula: (Inventory + Receivables – Payables)/Sales

Result = As % Sales

2) <u>SPECIFIC STRATEGIES</u>

a) <u>Inventory Management</u>

Inventories are lists of stocks-raw materials, work in progress or finished goods-waiting to be consumed in production or to be sold. A department also needs a system of internal controls to efficiently manage stocks and to ensure that stock records provide reliable information.

The total balance of inventory is the sum of the value of each individual stock line. Stock records are needed to provide an account of activity within each stock line; as evidence to support the balances used in financial reports.

Inventory management is an important aspect of working capital management because inventories themselves do not earn any revenue. Holding either too little or too much inventory incurs costs.

The best ordering strategy requires balancing the various cost factors to ensure the department incurs minimum inventory costs.

b) Debtor Management

Debtors (Accounts Receivable) are customers who have not yet made payment for goods or services which the department has provided. Cash flow can be significantly enhanced if the amounts owing to a business are collected faster. Every business needs to know... who owes them money...how much is owed.. how long it is owing.... for what it is owed.

The objective of debtor management is to minimize the time-lapse between completion of sales and receipt of payment.

Debtor management includes both pre-sale and debt collection strategies. Slow payment has a crippling effect on business; in particular on small businesses who can least afford it. If you don’t manage debtors, they will begin to manage your business as you will gradually lose control due to reduced cash flow and, of course, you could experience an increased incidence of bad debt.

The costs of having debtors are:

- Opportunity costs (cash is not available for other purposes);
- Bad debts.

c) Creditor Management

Creditors (Accounts Payable) are suppliers whose invoices for goods or services have been processed but who have not yet been paid. Creditors are a vital part of effective cash management and should be managed carefully to enhance the cash position.

Organizations often regard the amount owing to creditors as a source of free credit. However, creditor administration systems are expensive and time-consuming to run. The over-riding concern in this area should be to minimize costs with simple procedures.

While it is unnecessary to pay accounts before they fall due, it is usually not worthwhile to delay all payments until the latest possible date., Regular weekly or fortnightly payment of all due accounts is the simplest technique for creditor management.

d) Cash Management

Good cash management can have a major impact on overall working capital management. Cash Management identifies the cash balance which allows for the business to meet day to day expenses, but reduces cash holding costs.

The key elements of cash management are:

- Cash forecasting;
- Balance management;
- Administration;
- Internal control.

e) Other components

Working capital, defined as the difference between current assets and current liabilities, may also include the following factors:

- Prepayments to creditors;
- Current portions of long-term liabilities;
- Revenue received before it has been earned;
- Provisions.

9. CONCLUSIONS

The project revealed that the working capital has a direct impact on cash flow in a business. Since cash flow is the name of the game for all business owners, a good understanding of working capital is imperative to make any business enterprise successful. Companies must seek granular detail to identify the underlying drivers of working capital. By understanding the role and drivers of working capital management and taking steps to reach the "right" levels of working capital, companies can minimize risk, effectively prepare for uncertainty and improve overall performance. Successfully improving working capital management requires a different approach. The better a company manages its working capital, the less the company needs to borrow.

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