Summary

Chapter Five

Working Capital Management –an aggregate view

Learning Objectives :

1. Provide conceptual understanding of working capital and its various kinds.
2. Throw light on significance of working capital management.
3. Dilate upon principles of working capital management.
4. Discern the factors determining the size of working capital management working capital.
5. Provide acquaintance with various methods of determining working capital.
6. Provide an idea of zero working capital.
7. Provide conceptual understanding of funds flow statement & its utility in financial decision making.

A. Backdrop

Earlier we were involved with the study of long term investments which decide success of the enterprise. Now we focus on short term assets & liabilities which have to be managed on a day to day basis under working capital management.

The problem faced by the finance manager here is that of balancing conflict between the goals of liquidity & profitability.

B. Conceptual Understanding of Working Capital

Under going concern concept, working capital is a sum total of all current assets of the company. This gross working capital concept is required for company to correctly estimate & provide necessary fund for this capital which allows smooth & productive use of company's other funds.

Working capital is also understood in its net concept as excess of current assets over current liabilities. This net concept is of use to finance manager in managing sources from where funds for working capital are obtained and maintain healthy relationship between current assets & liabilities.

Both 'gross' and 'net' concepts of working capital are important, requiring study of both current assets & current liabilities for management of working capital.

C. Circular Flow Concept of Working Capital

Because of this nature of working capital, it was called 'Circulating Capital'. In a new firm this cycle, typically starts with conversion of cash into raw materials. These in turn moves into work in process to end into finished goods. Sale of these goods results in trade debtors, which when liquidated provide cash inflows. This cash is used to defray operating expenses, pay creditors / taxes, declare dividends etc. & rest put into circulation.

D. Redeeming Features of Working Capital

Current assets are of short duration, actual time varies from asset to asset. Cash can remain idle for not more than a week; debtors are realized in 30 to 60 days. Raw material, work in process, finished goods have life that is determined by their respective production cycle. Next thy change their form at regular interval as explained above. If there are no losses sum of cash at the end of the cycle is greater than that at the beginning, because of profit earned.

E. Significance of Working Capital management

Finance Manager has to maintain adequate working capital in the form of cash to meet day today expenses, cash in on business opportunities and meet emergencies; raw materials, wip for uninterrupted production; finished goods to meet changing market demands; debtors to provide desired credit to its customers.

However, all these assets need to be maintained at appropriate levels, as both surfeit and shortage is detrimental to financial health of the company.

F. Classification of Working Capital

For finance manager the classification of working capital into ‘gross’ comprising of current assets plus liabilities and ‘net’ representing balance of current assets minus current liabilities is important.

The classification of working capital into ‘gross’ and ‘net’ does not take into consideration the element of time. Using time as a basis, Working capital is classified as Permanent and Temporary working capital.

Every firm has to carry irreducible minimum of inventories, debtors to ensure continuous production and sales. This constitutes its permanent working capital.

Additionally extra capital is needed in busy seasons. Inventory needs to be built up in anticipation of heavy demand. Once higher sales take place inventory reduces but debtors increase for a couple of moths. This additional working capital is called temporary or variable working capital.

G. Cardinal Principles of working Capital Management

G.1. Principle of Optimization :

Select the level of working capital that optimizes firm's rate of return. This level is defined as that point at which the incremental cost associated with a decline in working capital is equal to incremental gain caused by it. To attain this Finance Manager considers all factors affecting risk and return and tries to balance both.

G.2. Principle of Worth whileness of investment in Working Capital :

Invest capital in each component of working capital as per equity position of the company. This ensures strength of its financial health.

G.3. Principle of Suitability :

Offset each asset in working capital with a financing instrument of the same maturity. Temporary / seasonal requirements of capital be financed by short term financing instruments & permanent by long term.

Conservative management prefers to depend on long term finance for covering fixed & permanent current assets to ensure adequate capital is always available to meet business needs. There are also aggressive finance managers who finance a part of permanent current assets from short term financing which is less costly.

H. Determinants of Working Capital Requirements.

Prudent principle of financial management dictates that as small amount as possible be kept in working capital without any undue risk of insolvency.

H.1. Factors influencing Level of working Capital

(a) Internal Factors :

1. Nature of Business- Nature of business and technology employed decide amounts of fixed and working capitals required by a company.

2. Size of Business – Firm’s size either in assets or sales, decides working capital needs. Small firms with a few sources of cash inflows need extra cushion of working capital to ward off against defaults in any source (customer delaying payments).

3. Firm’s Production Policy – Firms following uniform production policy need extra working capital in off season when inventories have to be stocked in anticipation of peak season ahead.

4. Firm’s Credit Policy – Firms following liberal credit policy need extra working capital

while those with aggressive credit collection minimize debtors & need lesser working capital.

5. Access to Money Markets – Firm with readily available credit from banks and other sources can do with lesser working capital as it can raise required cash at a short notice.

6. Growth or Expansion of Business – Growing and expanding firms require additional working capital on a continuous basis to support increases in fixed and current assets. There is no specific relationship between growth in business and requirement of additional capital.

7. Profit Margin & Dividend Policy – Larger profit margins allow companies to plough back more earnings and reduce need for funding of working capital.

8. Depreciation Policy – Higher depreciation reduces profits and firm has to pay lesser taxes thereby reducing needs for working capital. If dividends are linked to net profits, then lesser dividends are declared & that further reduces cash outflows and hence working capital.

9. Operating Efficiency of the Firm - Higher efficiency permits optimum utilization of resources at minimum cost. This increases profit margins & needs foe working capital.

10. Co-ordination of Activities in Firm – Greater interface between production and distribution results in lesser pressure on working capital.

(b) External Factors :

1. Business Fluctuations: When there is economic boom, sales & production increase claiming

additional working capital. When depression creeps in sales & production decline, requiring lesser capital. But funds are blocked in inventories and to meet operating expenses additional capital may be required.

2. Technological Development: When there is change in method of production due to introduction of new technology, production cycle is shortened or raw materials are used more economically. This reduces inventories and, therefore, working capital.

3. Transport & Communication Developments: When there is complex inefficient system, distribution cycle is long necessitating higher working capital than when firm operates under sophisticated transport / communication systems.

4. Import Policy: Restrictive policy compels firms to hold larger than necessary inventories increasing need for working capital. Import Licenses lengthens procurement cycles.

5. Taxation Policy: Regressive policy takes away a major portion of earnings of a company, leaving lesser funds for working capital. Hence tax concessions are offered to new units by the Government so that they can operate with lesser borrowings in initial years.

H.2. Estimating Cash Requirements:

For Transactions - **With the help of well developed cash budget, cash inflows and outflows are assessed and accordingly, excess of cash payments over receipts determined to arrive at cash requirements correctly. Where management succeeds in synchronizing cash outflows with inflows need for cash is minimized. Terms of Purchase or Sale; Collection Period of Receivables; Credit Position**

of the Firm; Production Policy of the Firm; Nature of Demand for Firm's Products ; Sale and Asset Relationship; Amount of Current Liabilities & their Maturity Periods etc. must be reviewed.

For Precautionary Motive - While cash required for transactions is determined systematically, that required to meet unexpected events is very difficult. Customer defaults, strikes, fires, are some of the occurrences that call for large cash reserves. Management's willingness to take risks; and its capacity to raise funds at a short notice are important factors that are to be considered.

For Speculative Motive - Cash is also required by management of some companies that wants to exploit opportunities of profit making through fluctuations in prices of materials or securities.

H.3. Estimating Receivables Requirements-

The size of the receivables and time taken to collect them decide funds required to carry receivables. Higher turnover of receivables reduces collection period which in turn reduces amount of funds required for receivables. Firm's credit policy and efficiency of its collection process determine receivables turnover.

H.4. Estimating Inventory Requirements-

Inventories assume prominent component of firm's assets and must be maintained at optimum levels. Quantities are determined by production cycle, regularity of demand, time available to meet customer orders etc. Larger inventories block capital and can lead to obsolescence of materials. Lesser inventories lead to interruptions in production, delayed deliveries that can lose customers.

Nature of Business Activity; Inventory Turnover; Method of Inventory Valuation; Management Ability to Predict Disruption; Nature of Arrangements with Supplier of Goods are factors that decide inventory.

Quantum of anticipated Production; Scope of Business Activity; Need to pile raw materials; Management Policy are factors that decide raw materials.

Period of Production Cycle; Operational Efficiency of a Firm; Processes of Production decide work in process.

Inventory Turnover; Need to Store Finished Goods; Sale of Goods on Contract, Change in Economic Conditions like boom or depression; Durability & Style of Product; Attitude of Management all decide needs to maintain inventory of finished goods.

I. Methods of Estimating Working Capital Requirements.

I.1 Percentage of Sales Method-

Using past experience, relationship is established between sales and working capital employed. This percentage is used to determine working capital needed for projected sales.

I.2 Regression Analysis Method –

In this statistical method working capital is determined by establishing the average relationship between sales and various components of working capital.

I.3 Operating Cycle Approach –

According to this approach, size of working capital is determined by multiplying duration of the operating cycle (raw materials, work in process, finished goods, receivables) by cost of operations.

Next, Chapter Six, 'Equity Stock financing'