Working Capital Management

Meaning of Working Capital Management

Working capital management is a business strategy designed to ensure that a company operates efficiently by monitoring and using its current assets and liabilities to the best effect. The primary purpose of working capital management is to enable the company to maintain sufficient cash flow to meet its short-term operating costs and short-term debt obligations.

A company's working capital is made up of its current assets minus its current liabilities.

Current assets include anything that can be easily converted into cash within 12 months. These are the company's highly liquid assets. Some current assets include cash, accounts receivable, inventory, and short-term investments.

Current liabilities are any obligations due within the following 12 months. These include operating expenses and long-term debt payments.

Nature of Working Capital

The nature of working capital is as discussed below:

- **i.** It is used for purchase of raw materials, payment of wages and expenses.
- **ii.** It changes form constantly to keep the wheels of business moving.
- **iii.** Working capital enhances liquidity, solvency, creditworthiness and reputation of the enterprise.
- **iv.** It generates the elements of cost namely: Materials, wages and expenses.
- **v.** It enables the enterprise to avail the cash discount facilities offered by its suppliers.
- **vi.** It helps improve the morale of business executives and their efficiency reaches at the highest climax.

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vii. It facilitates expansion programmes of the enterprise and helps in maintaining operational efficiency of fixed assets.

Importance of Working Capital

Working capital is a vital part of a business and can provide the following advantages to a business:

1. Higher return on capital

Firms with lower working capital will post a higher return on capital. Therefore, shareholders will benefit from a higher return for every dollar invested in the business.

2. Improved credit profile and solvency

The ability to meet short-term obligations is a pre-requisite to long-term solvency. And it is often a good indication of counterparty's credit risk. Adequate working capital management will allow a business to pay on time its short-term obligations. This could include payment for a purchase of raw materials, payment of salaries, and other operating expenses.

3. Higher profitability

According to research conducted by Tauringana and Adjapong Afrifa, the management of account payables and receivables is an important driver of small businesses' profitability.

4. Higher liquidity

A large amount of cash can be tied up in working capital, so a company managing it efficiently could benefit from additional liquidity and be less dependent on external financing. This is especially important for smaller businesses as they typically have limited access to external funding sources. Also, small businesses often pay their bills in cash from earnings so efficient working capital management will allow a business to better allocate its resources and improve their cash management.

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5. Increased business value

Firms with more efficient working capital management will generate more free cash flows which will result in higher business valuation and enterprise value.

6. Favorable financing conditions

A firm with a good relationship with its trade partners and paying its suppliers on time will benefit from favorable financing terms such as discount payments from its suppliers and banking partners.

7. Uninterrupted production

A firm paying its suppliers on time will also benefit from a regular flow of raw materials, ensuring that the production remains uninterrupted and clients receive their goods on time.

8. Ability to face shocks and peak demand

Efficient working capital management will help a firm to survive through a crisis or ramp up production in case of an unexpectedly large order.

9. Competitive advantage

Firms with an efficient supply chain will often be able to sell their products at a discount versus similar firms with inefficient sourcing.

Classification of Working Capital

(a) Gross Working Capital: Gross working capital refers to the amount of funds invested in various components of current assets. It consists of raw materials, work in progress, debtors, finished goods, etc.

(b) Net Working Capital: The excess of current assets over current liabilities is known as Net working capital. The principal objective here is to learn the composition and magnitude of current assets required to meet current liabilities.

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(c) Positive Working Capital: This refers to the surplus of current assets over current liabilities.

(d) Negative Working Capital: Negative working capital refers to the excess of current liabilities over current assets.

(e) Permanent Working Capital: The minimum amount of working capital which even required during the dullest season of the year is known as Permanent working capital.

(f) Temporary or Variable Working Capital: It represents the additional current assets required at different times during the operating year to meet additional inventory, extra cash, etc.

It can be said that Permanent working capital represents minimum amount of the current assets required throughout the year for normal production whereas Temporary working capital is the additional capital required at different time of the year to finance the fluctuations in production due to seasonal change. A firm having constant annual production will also have constant Permanent working capital and only Variable working capital changes due to change in production caused by seasonal changes.

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