Working Capital Management

Working Capital Management is concerned with the problems that arises in attempting to manage the CA, the CL, and the interrelationship that exists between them.

The term 'CA' refers to those assets which in the ordinary course of business can be turned into cash within 1 year without disrupting the firm's operations and consists of cash, inventory, receivables and marketable securities.

The term 'CL' are those which are intended at their inception to be paid in the ordinary course of business, within a year out of CA or earnings of the firm and consists of accounts payables, BOD and outstanding expenses.

The basic goal of WC is to manage the firm's CA & CL so as to maintain satisfactory level of WC. It is necessary because if the firm is not able to maintain these level it is likely to become insolvent & may even forced into bankruptcy.
The WC management is thus concerned with maintaining a trade-off between profitability & risk associated with a firm's level of CA & CL.

Concept of working capital

The term working capital refers to the amount of capital which is readily available to a company.

- **That is, working capital is the difference between resources in cash or readily convertible into cash (Current Assets) and organisational commitments for which cash will soon be required (Current Liabilities).**
  Working capital typically means the firm's holding of current or short-term assets such as cash, receivables, inventory and marketable securities.
- **These items are also referred to as circulating capital.**
- **Corporate executives devote a considerable amount of attention to the management of working capital.**

Working Capital refers to that part of the firm's capital, which is required for financing short-term or current assets such a cash marketable securities, debtors and inventories. Funds thus, invested in current assets keep revolving fast and are constantly converted into cash and this cash flow out again in exchange for other current assets. Working Capital is also known as revolving or circulating capital or short-term capital.

Current Assets are resources which are in cash or will soon be converted into cash in "the ordinary course of business".

Current Liabilities are commitments which will soon require cash settlement in "the ordinary course of business".

Thus:
WORKING CAPITAL = CURRENT ASSETS - CURRENT LIABILITIES
In a company's balance sheet components of working capital are reported under the following headings:

Current Assets: Liquid Assets (cash and bank deposits), Inventory, Debtors and Receivables

<u>Current Liabilities</u>: Bank Overdraft, Creditors and Payables & Other Short Term Liabilities

TYPES OF WORKING CAPITAL

<u>Gross Working Capital -</u> Total Current assets
Where Current assets are the assets that can be converted into cash within an accounting year & include cash , debtors etc.
Referred as "Economics Concept" since assets are employed to derive a rate of return.
Total or gross working capital is that working capital which is used for all the current assets. Total value of current assets will equal to gross working capital. In simple words, it is total cash and cash equivalent on hand. But remember, we do not account of current liabilities in gross working capital.

<u>Net Working Capital =</u> CA – CL
Referred as 'point of view of an Accountant'.
It indicates liquidity position of a firm & suggests the extent to which working capital needs may be financed by permanent sources of funds. Net working capital is the excess of current assets over current liabilities.

Net Working Capital = Total Current Assets – Total Current Liabilities

This amount shows that if we deduct total current liabilities from total current assets, then balance amount can be used for repayment of long term debts at any time. It also measure of both a company's efficiency and its short-term financial health.

<u>Permanent Working Capital</u>
Permanent working capital is that amount of capital which must be in cash or current assets for continuing the activities of business. It also shows the minimum amount of all current assets that is required at all times to ensure a minimum level of uninterrupted business operations.

PWC or Fixed WC represents CA required on a continuous basis over the entire year. Depending upon changes in production & sales the need for WC over & above permanent WC will fluctuate.

A manufacturing enterprise has to carry minimum amount of inventories necessary to ensure uninterrupted production & sales. Likewise, some amount of funds remains tied-up in receivables when the firm sells goods on credit, while some amount of cash is to be held by the firm so as to exploit business opportunities, to meet operational requirements & to provide insurance against business fluctuations.

Thus, minimum amount of CA which the firm has to hold for all the time to carry on an operation at any time is termed as – "Permanent" or "Regular" WC. Further, PWC will tend to expand so long as the firm experiences growth in its operations.

<u>Temporary Working Capital</u>
Sometime, it may possible that we have to pay fixed liabilities, at that time we need working capital which is more than permanent working capital, then this excess amount

will be temporary working capital. In normal working of business, we don't need such capital.
Temporary or Variable or Fluctuating WC is the extra WC, needed to support the changing production & sales activities. Over & above the permanent WC, the firm may need additional WC, i.e., CA, temporarily to satisfy seasonal or cyclic demand. For eg., extra inventory must be held to support the peak-selling period, or extra cash may be needed to pay for additional supplies following expansion in business activity.

<u>OPERATING CYCLE</u>
The need for WC to run the day-to-day business activities cannot be overemphasized. In its endeavor to maximize the SHs wealth, a firm should earn sufficient return from its operations. Earning a steady amount of profit requires successful sales activity. The firm has to invest enough funds in CA for the success of sales activity. CA are needed because sales do not convert into cash spontaneously. There is always an operating cycle involved in the conversion of sales into cash.
OC is the time duration required to convert sales, after the conversion of resources into inventories, into cash. The OC of a firm begins with the acquisition of RM & ends with the collection of receivables. It may be divided into 4 stages:

1. **Raw Material & Stores Storage Stage.**
2. **Work-in-Process Stage.**
3. **Finished Goods Inventory Stage.**
4. **Debtors Collection Stage.**

These stages affects CFs, which most of the time, are neither synchronized (because cash outflows usually occurs before cash inflows) nor certain (because sales & collections which generates cash inflows are not forecasted accurately). The firm is therefore required to invest in CA for a smooth & uninterrupted functioning & to maintain liquidity to purchase RM & pay expenses.

- **Cash is held to meet any future exigencies.**
- **Stocks of RM & WIP are kept to ensure smooth production.**
- **Stocks of FGs to meet the demand of customers on continuous basis & sometimes sudden demand.**
- **Book debts i.e., account receivables are created because goods are sold for credit for marketing & competitive reasons.**

<u>Sources of Working Capital Finance</u>

- **Trade credit**
- **Working capital advance by commercial bank**
- **Factoring**
- **Instalment credit**
- **Accruals**
- **Income received in advance**
- **Advances received from customers**
- **Bank Overdraft**
- **Commercial paper**
- **Letter of Credit**
- **Trade Finance**
- **Invoice Discounting**
- **Accounts Receivable Financing**
- **Inventory Financing**