Research Paper Management

Liquidity Management - A Review of Relevant Literature

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ABSTRACT

Effective liquidity management is one of the requirements for the survival of an organization. Various components of working capital should be managed in such a way that the organization is able to maintain appropriate working capital. Adequate working capital enables an organization to meet its obligations in time. It avoids the organization for making payment of unnecessary interests to the creditors. The firm has to invest enough funds in current assets for generating adequate sales capacity; there should be proper quantity & quality of inventories for maintaining and improving sales capacity. Working capital can be assumed as a lifeline of every concern. Without adequate working capital, no progress is possible; inadequate working capital leads to shortage of raw-materials & underutilization of machinery & finally failure of business.

KEYWORDS Survival, Inventory and Working Capital.

Introduction:

It is the review of existing literature in the field of liquidity management. Nowadays huge numbers of researchers are centralizing on working capital management of business. Review of literature helps in capturing both conceptual and research based studies of liquidity management[1]. Here both India and abroad based research and conceptual studies are involved. Many studies relating to management of various elements of working capital have been analyzed. Number of studies is accessible on the topic; it is the summary of critical points of a particular topic consisting of essential findings as well as theoretical and methodological contributions. A qualified literature review is characterized by displaying proper arranged ideas. The following displays the studies and observations on liquidity management. Here both India and abroad based research and conceptual studies are examined.

Review of Relevant Literature:

Abramovitz and Modigliani (1957)[2]:

They highlighted the relationship between capacity utilization and inventory investment. Existing stock of inventories was expected to adjust to the desired levels. Thus the variable, existing stock of inventories, was essential to be negatively related with the desired stock. The result was that there is positive relation among the ratio of inventory to sales and inventory investment. High ratio of stocks to sales in the past suggests requirement of high levels of inventories in the past and promising high investment in inventories in the current period also.

R.S. Chadda (1964)[3]:

Study had been made on inventory management practices of Indian companies. The analysis suggested application of modern scientific inventory control techniques like operations research. These modern scientific techniques furnish opportunities for the companies, Companies can minimize their investment in inventory but there is continuous flow of production. He argued that industrially advanced countries, like, USA, were engaged in developing highly sophisticated mathematical models and techniques for modernizing and redefining the existing tools of inventory investment.

National Council of Applied Economic Research (NCAER 1966)[4]:

Conducted a study in 1966 regarding working capital management of three industries namely cement, fertilizer and sugar. This study mainly devoted to ratio analysis of composition, utilization and financing of working capital for the period of 1959 to 1963. The study reveals that inventory constituted a major portion of working capital i.e. 74.06 per cent in the sugar industry followed by cement industry (63.1%) and fertilizer industry (59.58%). It was observed that inventory had not managed properly. So far as the utilization of working capital was concerned, cement and fertilizer industry had better implementation of working capital. The sugar industry had huge accumulation of stocks so there was inefficient utilization of working capital heavily.

Welter (1970)[5]:

He stated that working capital originated because of the global delay in making payment for purchase of raw material and receiving amount for the sale of finished product. He recognized that working capital can be reduced through most fashionable information from computers and improved professional ability of management. Reduction in length of global delay can lead decreased working capital. Global delay can be minimized through favorable redistribution of this global delay among the different delay centers.

V. Appavadhanulu (1971)[6]:

Identified lack of attention being given to working capital, less amount is invested. He analyzed working capital management by examining the impact of method of production on working capital investment. Various production techniques require different amount of working capital, mainly because different techniques have specific length of production period, the rate of output flow per unit of time and time pattern of value addition.

Warren and Shelton (1971)[7]:

Applied financial simulation to assume future financial statements of a firm based on a set of simultaneous equations. Financial simulation approach makes it possible to make a link between uncertainty of future and interrelationships among current assets, current liabilities and other balance sheet ac-

counts.

Weston and Brigham (1972) [8]:
The second proposition which had been suggested by Walker was further extended. Debt was divided into long-term debt and short-term debt. Short-term debt is suggested to be used instead of long-term debt whenever their use would lower the average cost of capital to the firm. The study also advised a business to hold short-term marketable securities only after meeting short-term debt obligations. They further suggested that current assets holding to be strengthened to the point where marginal returns on increase in these assets would equal to the cost of capital required for financing such increases.

George (1972)[9]:
It was the study on cross section analysis of balance sheet data of 52 public limited companies for the period of 1967-70. Accelerator, internal and external finance variables were considered in the formulation of equations for raw materials including goods-in-process inventories. However, equations for finished goods inventories conceive only output variable. Deliberation was given on accelerator and external finance variables.

Chakraborty (1973)[10]:
Approaching working capital as a segment of capital employed rather than a mere cover for creditors. He emphasized that working capital is the required fund to pay all the day-to-day operating expenses while running a business. He concluded that return on capital employed is an overall measurement of efficiency for running a business. Return on capital can be affected negatively by excess amount of working capital. In the same way very little working capital invested may reduce the earning capacity of the fixed capital employed over the succeeding periods.

B.S. Sharma (1974)[11]:
The paper considered problems of financial planning in public undertakings in three stages of operation, i.e. gestation, operation and expansion. The study covered purposive sample of units initiated by the Central Government and which are administered by Fertilizer Corporation of India ,Hindustan Steel Limited, Bokaro Steel Limited, Heavy Electricals Limited, Bhopal, Bharat Heavy Electricals Limited, New Delhi, Heavy Engineering Corporation Limited and Mining and Allied, Machinery Corporation Limited. He also focused on the art of working capital management in these enterprises. The result shows that requirement of working capital grows continuously.

DK Desai & V Ramachandran (1974)[12]:
This paper estimates required working capital for the purposes of procurement and distribution of food grains. Estimates of the marketed surplus are needed to identify financial requirements of food grains. Assumption of a certain percentage of the total food grains production as the marketed surplus was avoided; a different technique was used to estimate the marketed surplus. By considering the prices and stocks of food grains required at the beginning of the month and the marketed surplus of food grains the working capital requirements were estimated for different years. Working capital estimates for food grains shows that the available bank credit met only 38% of the maximum working capital required in 1972-1973. Food grain distribution has to rely on non-banking sources, not getting help from banking sources. It increases cost of financing working capital and finally raises the price of food grains.

Mishra (1975)[13]:
It is the study of six major public sector enterprises. He concluded that (i) inventory constitutes the most important component of working capital of public enterprises (ii) efficiency of working capital funds employed in receivables is terribly low in the selected enterprises and (iii) In all units both the current assets and the quick ratios are greater than their standards. Enterprises need proper control on receivables.

SK Bhattacharya & M Raghavacahari (1977)[14]:
The study consisted of 72 large Indian companies. Many financial analysts have confidence on traditional financial ratios for finding out effectiveness of working capital management. They correlated corporate performance with the ideal ratios. The present study examined the validity of such practices and to identify a method for classification of those companies which manage their working capital more effectively than others.

Discriminant Analysis shows that the important ingredients of effective working capital management are (a) profit after tax as a percentage of sales (b) sales as number of times of total assets and (c) Quick assets as a percentage of current liabilities and (d) receivables as number of days' sales. They recommended that these variables should be considered while planning and information systems of companies for effectiveness of working capital management.

Lambrix and Singhvi (1979)[15]:
Adopted working capital cycle approach in working capital management, also suggested that investment in working capital can be optimized and cash flows can be improved by reducing the time frame of physical flow starting from the receipt of raw material to the shipment of finished goods, i.e. inventory management, and by improving the terms and conditions on which firm sells goods as well as receipt of cash.

Lal (1981)[16]:
He studied Modi Steels Limited as a case study, his study focused on inventory management. He originated a model which involve price variable in inventory management; earlier price variable in inventory was not considered in that company. The analysis recommended solid policies, which would look after internal and external factors, ultimately it would help in bringing in efficient working capital management.

Mark L Defond (1994)[17]:
Examined a sample of 94 firms. The paper discovers abnormal accruals that reported debt convenant restrictions to influence accounting choices in the preceding and the year of violation. Time-series and cross–sectional models were used in estimating normal accruals. In the year prior to violation, both models indicate that abnormal total & working capital accruals are significantly positive.

I M Pandey (1997)[18]:
Studied private sector manufacturing companies of Sri Lanka. The survey provided an empirical evidence of working capital management policy and practices. Information were gathered through questionnaires and interviews from chief financial officers of manufacturing companies listed on Colombo Stock Exchange. The main result of the study is that most companies in Sri Lanka are adopting informal working capital policy. Managing director plays a unique part in formulating formal and informal policy. Company size has an influence on the overall working capital policy (formal or informal) and approach (conservative, moderate or aggressive) & review period. The study concluded that company profitability has an influence on the methods of working capital planning and control.

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