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Research Paper Management

Working Capital Management-"Indicators of Short Term Financial Health

* Bhavesh P Chadamiya ** Mital R Menapara

*, ** Assistant Professor, Om Vindhyavasini College for IT & MGT. Saurashtra University, Rajkot, Morbi

ABSTRACT

Management of working capital is a delicate area in the field of financial management, working capital management is concerned with short term financial decision shortage of funds for working capital has caused many business to fail and in many cases, has retarded their growth, lock of efficient and effective utilization of working capital leads to earn low rate of return on capital employed or even compels to sustain losses, the need for working capital management has thus become greater in recent years, the requirement of working capital is depending upon the nature of business, production policy, market conditions, seasonality of operations, conditions of reply etc, working capital to a company like the blood to human body, it is the most vital ingredient of a business, working capital management is if carried out effectively and consistently, will ensure the health of an organization.

The efficient working capital management is necessary to maintain a balance of liquidity and profitability.

Keywords : Working Capital Management, Profitability and Risk, Financial Performance, Decision Criteria

1.1 INTRODUCTION

Working capital is defined as the exceeds of current assets over current liabilities, Decisions relating to **working capital** and short term financing are referred to as working capital management. 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 also known as net working capital or NWC is a financial metric which represents operating liquidity available to a business.

current assets are those assets which will be converted into cash within the current accounting period or within the next year a result of the ordinary operations of the business, they are cash or near cash resources, these include,

- Cash and bank balances
- Receivables
- Inventory
  - Raw material, stores and spares
  - Work in progress
  - Finished good
- Prepaid expenses

1.2 Need to DETERMINE working capital

The individual components method of estimation of working capital involves the following steps.

STEP 1:- IDENTIFY the various items of current assets and current liabilities

STEP 2:-

- Estimate the HOLDING PERIOD of each items stock, row m/t, w-i-p and finished goods.
- Estimate two COLLECTION **PERIOD** of sundry debtors.
- Estimate the desire cash balance for meeting the requirement of day to day operations.
- Estimate the payment DEFFARAL PERIOD OF CREDITORS for raw materials.
- Estimate the LEG IN PAYMENT of wages and Exp.

STEP 3:-

- Determine the raw material, labor and overhead cost per unit.
- Determine the operating level.
- Determine the percentage of conversion cost incurred on work in progress.
- Ascertain the value of each item of current assets and current liabilities taking into account the information in step (2) and (3).

1.3 WORKING CAPITAL DEFICIT

If current assets are less than current liabilities, an entity has a working capital deficiency, also called a working capital deficit that means company is not having enough cash to meet its day to day liability. A company can be endowed with assets and profitability but short of liquidity if its assets cannot readily be converted into cash. There is a chance of insolvency as the concern:

- Can not pay its short term liabilities in time.
- The fixed assets may not be optimally used.
- Firm's growth may stagnate.
- Interruptions in production schedule may occur ultimately resulting in lowering of the profit of the firm.
- The firm may not be able to take benefit of an opportunity.
- Will loss its reputation and shall not be able to get good credit facilities.
- Can not pay day to day expenses of its operations.
- It creates inefficiencies, increase costs and reduces the profits of the business.
- It creates loss of goodwill, difficulties to business operations.

1.4 EXCESSIVE WORKING CAPITAL

The excessive working capital, when the investment in working capital is more than the required level and it may result in:

- Unnecessary accumulation of inventories resulting in waste, theft, damage etc.
- Delays in collection of receivables resulting in more liberal credit terms to customers than warranted by the market conditions.
- Adverse influence on the performance of the management.

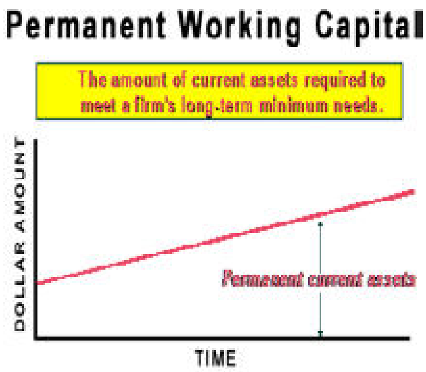
1.5 POSITIVE WORKING CAPITAL

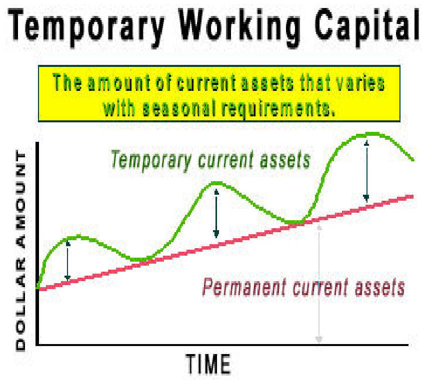
Adequate working capital or positive working capital is required to ensure that a firm is able to continue its operations and that it has sufficient funds to satisfy both maturing short-term debt and upcoming operational expenses. The management of working capital involves managing inventories, accounts receivable and payable and cash. Positive working capital means that the company is able to pay off its short-term liabilities. Negative working capital means that a company currently is unable to meet its short-term liabilities with its current assets (cash, accounts receivable and inventory).

1.6 TYPES of Working Capital

Permanent working capital: There is always a minimum level of working capital which is continuously required by a firm in order to maintain its activities. Every firm must have a minimum of cash, stock and other current assets in order to meet its business requirements irrespective of the level of operations.

Temporary Working Capital: over and above the permanent working capital, the firm may also require additional working capital in order to meet the requirement arising out of fluctuation in sales volume.



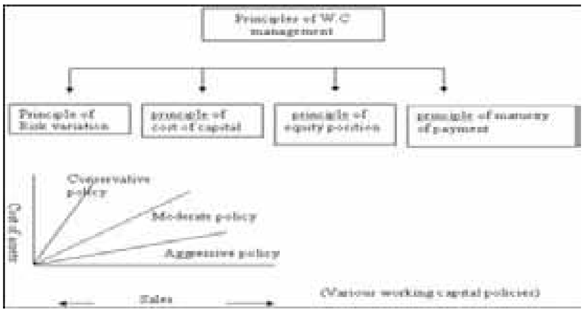


1.7 DECISION criteria

By definition, working capital management entails short term decisions - generally, relating to the next one year periods - which are "reversible". These decisions are therefore not taken on the same basis as Capital Investment Decisions rather they will be based on cash flows and / or profitability.

The most useful measure of profitability is Return on capital (ROC). The result is shown as a percentage, determined by dividing relevant income for the 12 months by capital employed; Return on equity (ROE) shows this result for the firm's shareholders. Firm value is enhanced when, and if, the return on capital, which results from working capital management, exceeds the cost of capital, which results from capital investment decisions as above. ROC measures are therefore useful as a management tool, in that they link short-term policy with long-term decision making.

POLICIES AND TECHNIQUES FOR DECISION MAKING



Management will use a combination of policies and techniques for the management of working capital. These policies aim at managing the current assets (generally cash and cash equivalents, inventories and debtors) and the short term financing, such that cash flows and returns are acceptable.

- Cash management
- Inventory management
- Debtors management
- Short term financing

1.8 PROFITABILITY and Risk

Underlying sound working capital management lie two fundamental decision issues for the firm. They are the determination of:

1. The optimal level of investment in current assets.
2. The appropriate mix of short-term and long-term financing used to support this investment in current assets.

In turn, these decisions are influenced by the trade-off that must be made between profitability and risk. Lowering the level of investment in current assets, while still being able to support sales, would lead to an increase in the formal rate of return on the total assets. To the extent that the explicit costs of short-term financing are less than those of intermediate and the long-term financing, the greater the proportional of short-term debt to total debt, the higher is the profitability of the firm.

Poor working capital management can lead to:

1. over-capitalization

2. overtrading

Required capital raising and working capital management capabilities
(A Model of Bank of America)

1.9 EFFICIENCY in managing working capital

- Establish safety of public funds
- Drive efficiencies and service improvements with electronic receipts
- Manage disbursements effectively with electronic payments
- Help deter payment fraud and protect data
- Access the global securities markets
- Satisfy staff financial needs with payroll solutions
- Manage registry funds and bankruptcy cases with comprehensive solutions for courts

1.10 WHY WCM- INDICATORS of Short Term Financial Health

European companies of all sizes and branches of industry have been surveyed with regard to their current working capital management practice. This survey has established that on average 74 percent of all companies consider that working capital management is either important or very important. The different company sizes have to be taken into consideration. If a scale of 1 (not very important) to 5 (very important) is used, the companies answered the question concerning the significance of working capital management for their company as follows: With a rating of 4.2, working capital management is perceived to be most important by companies with total assets of between 0.5 and 1 billion. These are followed by companies with total assets of between 1 and 5 billion (3.9) and very large companies with total assets of more than 5 billion (3.8). The subject is of least relevance for small companies. Companies with assets of between 0.5 and 1 billion accordingly attach the highest level of significance to working capital management. There may be two different reasons for this result: On the one hand, it can be assumed that the size of the company is related to the complexity of processes and thus the potential for reducing the amount of working capital. On the other hand, in recent years, the possibilities of external financing have tended to be more difficult, particularly for smaller companies. As a result of high entry costs, large companies have better opportunities than midsize companies for obtaining funds directly on the capital market, e.g. by way of syndicated loans, private placements or securitizations of receivables. This is possibly the reason why companies of this size are starting to focus on internal financing opportunities, e.g. working capital management.

An analysis of the results of the survey on the basis of branches of industry demonstrates that there is a considerable distinction between wholesale/ retail, energy and communications industries with regard to the responses of the other participants. 92 percent of the wholesale/retail sector perceives working capital management to be either important or very important. The importance of working capital management, thus, can be expressed in terms of the following points:

- The level of current assets changes constantly and regularly depending upon the level of actual and forecasted sales. This requires that the decisions to bring levels of current assets to the desired levels of current assets should be made at the earliest opportunity and as frequently as required. In a typical manufacturing firm, current assets exceed one half of total assets.

- The changing levels of current assets may also require review of the financing pattern. How much working capital needs to be financed by different sources of financing must be periodically reviewed. Excessive levels can result in substandard return on investment.

- Inefficient working capital management may result in loss of sales and consequently decline in profits of the firm.

- Inefficient working capital management may also lead to insolvency of the firm if it is not in a position to meet its liabilities and commitments.

- Current liabilities are the principal source of external financing for small firms.

- Requires continuous, day to day managerial supervision.

- WCM affects the co.'s risk, return and share price.

1.11 CONCLUSION

The efficient working capital management is important from the point of view of both the liquidity and the profitability. Poor and inefficient working capital management means that funds are unnecessarily tied up in idle assets. This reduces the liquidity as well as the ability to invest funds in productive assets, so affecting profitability. A financial manager should look into the framing of a suitable working capital policy for the firm as it is the indicators or we can say the measurement of the company's financial health.