



Working Capital Management and Profitability of Commercial Banks in India

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ABSTRACT

This paper aims to assess the effect of working capital management (WCM) on the performance. The main objective of this study is to examine whether empirical results on the relationship between working capital management practices and profitability of non financial firms are applicable to financial firms like Banks in India. More specifically, we investigate whether the working capital management of selected Indian Commercial banks is associated with more profitability. The study used panel data methodology within the framework of the random effects technique for the presentation and analysis of findings. The findings of our study found to be significantly consistent with the view of the traditional working capital theory. The results suggest that working capital management and performance are positively correlated. The findings showed that there is significant positive relationship between banks' performance and bank size; there is a significant negative relationship between profitability and cash conversion cycle and leverage; there is a significant negative relationship between liquidity and creditors' payment period and leverage; and there is a significant positive relationship between liquidity and debtors' collection period, cash conversion cycle and credit risk. Surprisingly, however listed banks appear to perform poorly as compared to unlisted banks. The revelation in this paper is to inform bank directors and policy makers on the direction of managing bank working capital.

KEYWORDS

Working Capital Management, Profitability, Bank Performance, Cash Holding, Liquidity Introduction

INTRODUCTION

Banking service contributes to economic growth by producing the financial means to facilitate production in other industries (Rajan & Zingales, 1998; Levine, 1998). However, the banking firms sometimes find it difficult to finance its operation. This financing problem also affects the management of working capital of the individual banks which intend affect their level of profitability (Goddard et al., 2004), liquidity management. Efficient working capital management is known to have many favourable effects: it speeds payment of short-term commitments on firms (Peel et. al, 2000); it facilitates owner financing; it reduces working capital as a cause of failure among small businesses (Berryman, 1983); it ensures a sound liquidity for assurance of long-term economic growth and attainment of profit generating process (Wignaraja and O'Neil, 1999); and it ensures acceptable relationship between the components of firms working capital for efficient mix which guarantee capital adequacy, (Osisioma, 1997). Furthermore, given the low level of development of our capital market, banks offer an appropriate alternative for providing funding to financial and non-financial firms. In spite of its importance and attractiveness, not all banks have had it easy operating in the country. While some banks have had to liquidate other existing banks have been experiencing slow growth rate in their profitability level (BoG, 2010). Generally, investment in working capital could be grouped into permanent and variable. The portion of working capital kept to sustain the level of sales which is not affected by seasonality while variable working capital is the additional working capital required during periods of fluctuations in sales. It is expected the permanent working capital would be financed by long term capital while variable working capital is financed by short term capital. Companies meet their working capital needs through the aggressive policy, conservative policy and the moderate policy. A company using the aggressive policy funds its current liabilities with minimal current assets. In other words current liabilities far exceed its current assets. On the contrary, a company going by the conservative policy keeps more current assets as against current liabilities. The aim is to reduce their liquidity risk by having enough current assets to meet current liabilities. But moderate work-

ing capital policy is meant to adequately match current assets against current liabilities. The level of working capital requirement is influenced by the industry in which the firm operates. Banks throughout the world have mandatory liquidity position to maintain in addition to ensuring that they have enough liquid funds to meet customer withdrawals. Working capital management is related to short-term financial planning of cash level or liquidity, which tends to underscore smooth running and operational performance of firms. It is against this background that this paper aims to examine the relationship of working capital management on profitability of banks in India.

REVIEW OF LITERATURE

The choice of working capital policy affects the profitability of firms. This working capital structure leads to high liquidity risk and expected profitability. On the other hand, conservative working capital policy has greater current assets to current liability. This is to ensure moderate liquidity risk through lower financing cost which also leads to moderate profitability (Czyzewski and Hicks, 1992 and Afza and Nazir, 2007). Some studies done included: the working capital management and corporate performance (Raheman et al. 2007; Padachi, 2006; Deloof, 2003), Cash Conversion Cycle and Profitability, (Uyar, 2009), determinant factors of working capital management (Nazir and Afza, 2007). All these studies tend to postulate an optimal way efficient working capital policies could lead to profit maximization and which in turn, leads to increase firm wealth (Lazaridis I, Tryfonidis D, 2006; Besley S, Meyer R, 1987).

FACTORS AFFECTING BANK PROFITABILITY

Even though profitability does not necessarily mean liquidity, profitability ensures firm survival, growth and less debatably firm liquidity levels. Among the key factors that influence bank profitability are capital structure, size, growth, market discipline, risk and reputation.

RESEARCH METHODOLOGY

The study used both descriptive and econometric model to analyse the effect of working capital on profitability of selected banks

in India. The descriptive statistics made use of mean, median and maximum and minimum. These are used to describe the general behaviour of the data. The analysis is based on a panel data from the selected banks' financial statements obtainable from the Indian Stock Exchange. The study then estimated the determinant of profitability by using the Ordinary Least Squares (OLS). Panel data methodology was used for the analysis. Apart from the fact that panel methodology allows researchers to undertake cross-sectional observations over several time periods, it can also control for individual heterogeneity due to hidden factors, which, if neglected in time-series or cross-section estimations leads to biased results (Baltagi, 1995). The basic model is written as follows:

$$Y_{it} = \alpha + \beta X_{it} + \epsilon_{it}$$

Where the subscript

i denotes the cross-sectional dimension and

t represents the time-series dimension.

Y_{it}, represents the dependent variable in the model, which is bank cash position.

X_{it} contains the set of explanatory variables in the estimation model.

α is the constant and β represents the coefficients.

Finally, the above general least square model is converted into specified variables as follows;

$$PROF_{i,t} = \alpha_0 + \beta_1 CPP_{i,t} + \beta_2 DCP_{i,t} + \beta_3 TDA_{i,t} + \beta_4 SIZE_{i,t} + \beta_5 GRO_{i,t} + \beta_6 LIST_{i,t} + \beta_7 LLR_{i,t} + \beta_8 ERR_{i,t} + \beta_9 AGE_{i,t} + \epsilon_{it}$$

$$PROF_{i,t} = \alpha_0 + \beta_1 CCC_{i,t} + \beta_3 TDA_{i,t} + \beta_4 SIZE_{i,t} + \beta_5 GRO_{i,t} + \beta_6 LIST_{i,t} + \beta_7 LLR_{i,t} + \beta_8 ERR_{i,t} + \beta_9 AGE_{i,t} + \epsilon_{it}$$

Income Statement

PARTICULARS	Mar-15	Mar-14	Mar-13	Mar-12	Mar-11
INCOME					
Interest Earned	49091.1	44178.2	40075.6	33542.7	25974.1

**Position Statement
Amount in lakhs**

Sources of Funds	Mar-15	Mar-14	Mar-13	Mar-12	Mar-11
Share Warrants & Outstanding	7.44	6.57	4.48	2.39	0.29
Share Capital	1159.66	1155.04	1153.64	1152.77	1151.82
Total Reserve	79262.26	72051.71	65547.84	59250.09	53938.82
Deposits	361562.73	331913.66	292613.63	255499.96	225602.11
Borrowings	172417.35	154759.05	145341.49	140164.91	109554.28
Shareholders Fund	80429.36	72213.33	66705.96	60405.24	55090.94
Other Liabilities & Provision	31719.86	34755.55	32133.6	32998.69	15986.35
Total Liabilities	646129.3	594641.6	536794.7	489068.8	406233.7
Application of Funds					
Cash & Bank Balance with Reserve Bank of India	25652.91	21821.83	19052.73	20461.29	20906.97
Balances at Bank & Money at Call and Short Notices	16651.71	19707.77	22364.79	15768.02	13183.11
Investment	186580.03	177021.82	171393.6	159560.04	134685.96
Advances	387522.07	338702.65	290294.44	253727.66	216365.9

Other Income	12176.1	10427.9	8345.7	7502.76	6647.89
Total Income	61267.3	54606	48421.3	41045.4	32621.9
EXPENDITURE					
Interest Expanded	30051.5	27702.6	26209.2	22808.5	16957.2
Operating Expenses	16651.7	19707.8	22364.8	15768	13183.1
PBDIT	19719.9	16594.6	13199.2	10386.5	9047.54
Provision & Contengies	3899.99	2626.41	1802.54	1583.05	2286.84
Profit Before Tax	15819.9	13968.2	11396.7	8803.43	6760.71
Taxes	4644.57	4157.69	3071.22	2338.17	1609.33
Total Expenditure	50091.9	44795.6	40095.8	34580.2	27470.6
PROFIT & LOSS					
Profit After Tax	11175.4	9810.48	8325.47	6465.26	5151.38
Profit Bought Forward	11318.6	9902.29	7054.23	5018.18	3464.38
Total Profit & Loss	11175.4	9810.48	8325.47	6465.26	5151.38
Appropriations	24493.9	19712.8	15379.7	11483.4	8615.76

Sources: Money Control.com

Gross Block	10404.42	9950.61	9643.58	9424.39	9107.49
Less : Accumulated Depreciation	5678.9	5272.47	4996.53	4809.7	4363.21
Net Block	4725.52	4678.14	4647.05	4614.69	4744.28
Other Assets	24997.05	32709.39	29087.07	34937.1	16347.47
Total Assets	646129.3	594641.6	536794.7	489068.8	406233.7
Contingent Liabilities	851977.61	781430.45	789989.31	915465.11	923121.61
Bills for Collection	16212.97	13534.91	12394.53	7525.06	8530.03
Total Profit & Loss	11175.36	9810.48	8325.47	6465.26	5151.38
Appropriations	24493.94	19712.76	15379.71	11483.44	8615.76

Source: Money control.com

From the exact sum of figures for analysis mentioned above, it can be well said about the comparison made keeping the base figures of Last approximate five year. Firstly, for Income Statement is concerned, there is drastic change of increment from Mar 2011 – March 2015 for the sum of totality of Income as well Expenditure, with the inclusion of Profits which has been supposed to be made before Taxes and also including Provisions & Contengies. Secondly, to talk about the Position Statement, it can be well said that , there is a tremendous increase on Application as well the Sources of Funds, resulting in better financial performance in comparison with Mar 2011 – Mar 2015.

Objectives of the Study

This research is focusing on working capital management and its impact on profitability for Indian listed commercial banks. To analyze the above problem statement, this study has two objectives;

To identify the relationship between the Working Capital Management and profitability of the CSE listed commercial banks.

To find out the effects of different components of working capital management on profitability.

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