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MANAGEMENT OF WORKING CAPITAL: AN OVERVIEW

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ABSTRACT

The management of working capital is no less important than the management of long-term financial investment. The uses of funds of a concern can be divided into two parts namely long-term funds and short-term funds. The long – term investment may be termed as 'fixed investment.' A major part of the long-term funds is invested in the fixed assets. These fixed assets are retained in the business to earn profits during the life of the fixed assets. To run the business operations short–term assets are also required. In this paper, Management of Working Capital is discussed critically.

KEYWORDS: *Working Capital, Long-Term Financial Investment, Short-Term Funds, Fixed Investment.*

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Introduction

There are two concepts of working capital *viz.* quantitative and qualitative. Some people also define the two concepts as gross concept and net concept. According to quantitative concept defined by Smith, "the amount of working capital refers to 'total of current assets' i.e. 'circulating capital'." Current assets are considered to be gross working capital in this concept. Similarly, Guthman observed that, "The qualitative concept gives an idea regarding source of financing capital. According to qualitative concept the amount of working capital refers to "excess of current assets over current liabilities." Also R.D. Kennedy and McMullen defined working capital as, "the portion of a firm's current assets which are financed from long–term funds." The excess of current assets over current liabilities is termed as 'Net working capital'. In this concept "Net working capital" shows the amount of current assets which would remain if all current liabilities were paid. Both the concepts of working capital have their own points of importance. If the objectives is to measure the size and extent to which current assets are being used, 'Gross concept' is useful; whereas in evaluating the liquidity position of an undertaking 'Net concept' becomes pertinent and preferable. According to Rajiv Srivastava and Anil Mishra, "Working capital is the investment made by firms in their current assets."

Circulation of Working Capital

At one given time both the current assets and current liabilities exist in the business. The current assets and current liabilities are flowing round in a business like an electric current. However, "The working capital plays the same role in the business as the role of heart in human body. Working capital funds are generated and these funds are circulated in the business. As and when this circulation stops, the business becomes lifeless. It is because of this reason that he working capital is known as the circulating capital as it circulates in the business just like blood in the human body."

Essential Features of Working Capital

The essential features of working capital distinguishing it from the fixed capital are as under:

- **Liquidity:** Working capital is more liquid than fixed capital. If need arises, working capital can be converted into cash within a short period and without much loss. A company in need of cash can get it through the conversion of its working capital by insisting on quick recovery of its bills receivable and by expediting sales of its product.

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- **Short term Needs:** Working capital is used to acquire current assets which get converted into cash in a short period. In this respect it differs from fixed capital which represents funds locked in long term assets. The duration of the working capital depends on the length of production process, the time that elapses in the sale and the waiting period of the cash receipt.
- **An Element of Fluctuation:** Though the requirement of working capital is felt permanently, its requirement fluctuates more widely than that of fixed capital. The requirement of working capital varies directly with the level of production. It varies with the variation of the purchase and sale policy; price level and the level of demand also.
- **Circular Movement:** Working capital is constantly converted into cash which again turns into working capital. This process of conversion goes on continuously. The cash is used to purchase current assets and when the goods are produced and sold out; those current assets are transformed into cash. Thus it moves in a circular away. That is why working capital is also described as circulating capital.
- **Less Risky:** Funds invested in fixed assets get locked up for a long period of time and cannot be recovered easily. There is also a danger of fixed assets like machinery getting obsolete due to technological innovations. Hence investment in fixed capital is comparatively more risky. As against this, investment in current assets is less risky as it is a short term investment. Working capital involves more of physical risk only, and that too is limited. Working capital involves financial or economic risk to a much less extent because the variations of product prices are less severe generally.
- **Special Accounting System not needed:** Since fixed capital is invested in long term assets, it becomes necessary to adopt various systems of estimating depreciation. On the other hand working capital is invested in short term assets which last for one year only. Hence it is not necessary to adopt special accounting system for them.
- **An Element of Permanency:** Though working capital is a short term capital, it is required always and forever. As stated before, working capital is necessary to continue the productive activity of the enterprise. Hence so long as production continues, the enterprise will constantly remain in need of working capital.

Significance of Working Capital

For smooth running an enterprise, adequate amount of working capital is very essential. Efficiency in this area can help, to utilize fixed assets gainfully, to assure the firm's long- term success and to achieve the overall goal of maximization of the shareholders, fund. Shortage or bad management of cash may result in loss of cash discount and loss of reputation due to non-payment of obligation on due dates. Insufficient inventories may be the main cause of production held up and it may compel the enterprises to purchase raw materials at unfavourable rates. Like-wise facility of credit sale is also very essential for sales promotions. It is rightly observed that "many a times business failure takes place due to lack of working capital."16 Adequate working capital provides a cushion for bad days, as a concern can pass its period of depression without much difficulty.

Significance of working capital management stems from two reasons, *viz.,*

- A substantial portion of total investment is invested in current assets, and
- Level of current assets and current liabilities will change quickly with the variation in sales.

Though fixed assets investment and long-term borrowing will also response to the changes in sales, but its response will be weak.

The Main Sources of Working Capital

The company can choose to finance its current assets by following two:

õ **Long-term Sources**

Long term sources of permanent working capital include equity and preference shares, retained earnings, debentures and other long term debts from public deposits and financial institution. The long term working capital needs should meet through long term means of financing. Financing through long term means provides stability, reduces risk or payment, and increases liquidity of the business concern. Various types of long term sources of working capital are summarized as follows:

- **Issue of Shares:** It is the primary and most important sources of regular or permanent working capital. Issuing equity shares as it does not create and burden on the income of the concern. Nor the concern is obliged to refund capital should preferably raise permanent working capital.
- **Retained Earnings:** Retain earning accumulated profits are permanent sources of regular working capital. It is regular and cheapest. It creates not charge on future profits of the enterprises.
- **Long Term Debt:** Company can raise fund from accepting public deposits, debts from financial institutution like banks, corporations etc. the cost is higher than the other financial tools. Other sources sale of idle fixed assets, securities received from employees and customers are examples of other sources of finance.
- **Issue of Debentures:** It creates a fixed charge on future earnings of the company. Company is obliged to pay interest. Management should make wise choice in procuring funds by issue of debentures.

õ **Short- term Sources**

Temporary working capital is required to meet the day to day business expenditures. The variable working capital would finance from short term sources of funds. And only the period needed. It has the benefits of, low cost and establishes closer relationships with banker. Some sources of temporary working capital are given below:

- **Public Deposits:** Most of the companies in recent years depend on these sources to meet their short term working capital requirements ranging for six month to three years.
- **Commercial Bank:** A commercial bank constitutes significant sources for short term or temporary working capital. This will be in the form of short term loans, cash credit, and overdraft and though discounting the bills of exchanges.
- **Reserves and other Funds:** Various funds of the company like depreciation fund. Provision for tax and other provisions kept with the company can be used as temporary working capital. The company should meet its working capital needs through both long term and short term funds. It will be appropriate to meet at least 2/3 of the permanent working capital equipments form long term sources, whereas the variables working capital should be financed from short term sources. The working capital financing mix should be designed in such a way that the overall cost of working capital is the lowest, and the funds are available on time and for the period they are really required.
- **Various Credits:** Trade credit, business credit papers and customer credit are other sources of short term working capital. Credit from suppliers, advances from customers, bills of exchanges, promissory notes, etc helps to raise temporary working capital

The Structure of Working Capital

The study of structure of working capital is another name for the study of working capital cycle. In other words, it can be said that the study of structure of working capital is the study of the elements of current assets *viz.* inventory, receivable, cash and bank balances and other liquid resources like short-term or temporary investments. “Current liabilities usually comprise bank borrowings, trade credits, assessed tax and unpaid dividends or any other such things.” The following points mention relating to various elements of working capital deserves:

- **Cash and Interest-bearing Liquid Assets:** Cash is one of the most important tools of day-to-day operation, because it is a form of liquid capital which is available for assignment to any use. Cash is often the primary factor which decides the course of business destiny. “The decision to expand a business may be determined by the availability of cash and the borrowing of funds will frequently be dictated by cash position.”
- **Raw Material Inventories:** Uncertainties about the future demand for finished goods, together with the cost of adjusting production to change in demand will cause a financial manager to desire some level of raw material inventory. In the absence of such inventory, the company could respond to increased demand for finished goods only by incurring explicit clerical and other transactions costs of ordinary raw material for processing into finished goods to meet that demand.

- **Work-in-process Inventory:** This inventory is built up due to production cycle. Production cycle is the time-span between introduction of raw material into production and emergence of finished product at the completion of production cycle. Till the production cycle is completed, the stock of work in-process has to be maintained.
- **Finished Goods Inventory:** Inventory is major item of current assets. The management of inventories *i.e.* raw material, goods-in-process and finished goods is an important factor in the short-run liquidity positions and long-term profitability of the company.
- **Finished Goods Inventory:** Finished goods are required for reasons similar to those causing the company to hold raw materials inventories. Customer's demand for finished goods is uncertain and variable. If a company carries no finished goods inventory, unanticipated increases in customer demand would require sudden increases in the rate of production to meet the demand. Such rapid increase in the rate of production may be very expensive to accomplish. Rather than loss of sales, because the additional finished goods are not immediately available or sustain high costs of rapid additional production, it may be cheaper to hold a finished goods inventory. "The flexibility afforded by such an inventory allows a company to meet unanticipated customer demands at relatively lower costs than if such an inventory is not held."

Cash-in-hand, however, is a non-earning asset. This leads to the question as to what is the optimum level of this idle resource. This optimum depends on various factors such as the manufacturing cycle, the sale and collection cycle, age of the bills and on the maturing of debt. It also depends upon the liquidity of other current assets and the matter of expansion. While, a liberal maintenance of cash provides a sense of security, a lack of sufficiency of cash hampers day-to-day operations.

On the basis of the above analysis it can be concluded that the management of working capital is life line of every industry. It is very essential to take care in this regard.

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