Working capital should be maintained by the finance

Business, Industries

WorkingCapital is the basic requirement of the Businesses, as they require a regularamount of cash to make routine payments, to cover unexpected costs and purchasebasic materials used in the production of goods.

It is one of the mostimportant components of the corporate finance. Recently Haq et al. (2011) noted that the firm's profitability is directlyaffected by working capital management. There are two major concepts of workingcapital. One of the working capital concept is Gross working capital and isindicates the total current assets of the business. If current assets aremanaged efficiently be the business it gives more growth and can increase thevalue of the business in the market. The other concept of working capital isthe net working capital which indicates the difference between the currentassets and the current liabilities. One of the fundamental decisions which a financemanagers make is the management of working capital.

Workingcapital is the common measure of liquidity efficiency and overall health of thefirm. As it includes cash, inventory, account receivable, accounts payable, aportion of debt due within one year and other short term accounts, a company'sworking capital reflects company's activities. Working Capital Management dealswith the management of short term financing and investment decisions of a firmand a very important component of the corporate finance decisions. Thereare two possibilities of working capital, it may be positive or negative aswell, Positive working capital indicates that the business is in a position topay off its short term liabilities almost immediately and negative workingcapital indicates that a business is unable to do so. This is why it should be managed verycarefully. An optimal level of working capital should be maintained by thefinance managers otherwise it may affect the profitability or the liquidity ofthe firm. Objective of working capital management is to manage the currentassets and liabilities in such a way that satisfactory level of working capitalis maintained. Workingcapital management (WCM) involves a risk return trade off: means not to take anadditional risk until and unless it is well accomplished with assure additionalreturns.

The existence of a firm depends largely on its ability to efficientlyand effectively management of working capital. Working capital management isthe heart of every firm's day to day operations and also improve thecorporate's profitability. Working capital is considered as the life blood ofthe businesses. The interaction between the current assets and currentliabilities is, therefore the main theme of the theory of the working capitalmanagement.

Working capital efficiency primarilymeasured by the cash conversion cycle. Cash conversion cycle basically showshow long an industry or firm takes to convert its cash outflows into cashinflows. It consists of three parts, inventory turnover, payable deferralperiod, receivable collection period. Working capital should be at optimallevel, if a management team doesnot keep an organization's working capital within certain levels, it can havecrushing consequences to the organization's financial health. Working capitalmanagement affects either profitability or the liquidity of the firm, asworking capital management is directly affects the profitability as well as theliquidity of the firm.

Therefore, working capital management should be managedefficiently and effectively, as (BPPlearning media, 2010) stated that the efficient working capital means tomanage various components of working capital in such a way that an adequateamount of working capital is maintained for the smooth running of the firmoperations and the fulfillment of the profitability objective. Thereare many factors which can influence the decision of financial managers aboutthe firm’s current assets and current liabilities, those factors may beinternal or external. Generally, there are two basic approaches from whereworking capital management is derived: one of them is known as aggressivepolicy, which indicates low levels of current assets, mainly low cash balances, a very limited credit grants to its customers and very low level of inventoriesstock and large amounts of investments in non-current assets, for the purposeof generating more profits. Though, this approach pretends a higher level ofrisk with regard to the probability of adequate funds for day to day operationsand also to pay for current liabilities (Van-Horne and Wachowicz, (Van-Horne, 2008)2008).

The second approach for working capital management in known asconservative and is also a flexible approach, this approach suggests to havelarge investments in current assets, particularly more cash balances, higherinventory levels and customer loans, and low amount of investments in thenon-current assets, which may create more value for the firm (Nazir and Afza, (Nazir, “ Impact of aggressive working capital management policy on firms' profitability",, (2009)) 2009). Most empirical studies relating toworking capital management and profitability support the fact that efficientmanagement of working capital enhance a firm's profitability. Undoubtedly, profitability of the firm andthe working capital management have some relationship with each other.

Muchresearch on the relationship of working capital management and the firmprofitability is available but the selected sector i. e. Cement sector, is notmuch considered, about the impact of working capital management. So, muchliterature is not available in this sector in Pakistani context. Workingcapital is very important component of business accomplishments of any firm. Hence, for the Cement as well, working capital management is of great importance. Therefore, the aim of this study is to find out " Does efficient working capitalmanagement have any impact on the profitability of firms of Cement sector ofPakistan?"