The significance of working capital management

Working capital management is significant in financial management due to the fact that it plays a vital role in keeping the wheel of the business running. Every business requires capital, without which it cannot be promoted. Investment decision is concerned with investment in current asset and fixed asset. There are two assets required to be financed by fixed capital and working capital. In other words, the required capital can be divided into two categories, such as fixed capital and working capital. Fixed capital required for establishment of a business, where as working capital required to utilize fixed asset. Fixed asset cannot be utilized without current asset. It is just like blood in the human body, without which there is no body.

Working capital plays a key role in a business enterprise just as the role of heart of heart in human body. It acts as grease to run the wheels of fixed asset. Its effective provision can ensure the success of a business while its inefficient management can lead not only to loss but also unlimited downfall of what otherwise might be considered as a promising concern. In other words, efficiency of a concern depends largely on its ability to manage its working capital. Working capital management is there for one of the important facet of a firm's over all financial management.

Meaning

Working capital refers to short term fund to meat operating expenses. To quote great Indian financial analyst and scholar Mr. Ramamoorthy, " it refers to the funds, which a company must possess to finance its day to day operations". It is concerned with the management of the firm's current asset and current liabilities. It relates to with the problems that arise in attempting to manage current assets, current liabilities and their inter relationship that exist between them. If a firm cannot maintain a satisfactory level of working capital, it is likely to become insolvent and may even be forced into bankruptcy.

Concepts of working capital

The concept of working capital has been a matter of great controversy, among the financial wizards and they view it differently. There is no universally accepted definition of working capital. Broadly there are to concepts of working capital commonly found in the existing literature of finance such as:

Gross Working Capital

Net Working Capital

Gross Working Capital concept

According to this concept, the total current assets are termed as the gross working capital or circulating capital. Total current asset include; cash, marketable securities, account receivables, inventory, prepaid expenses, advanced payment of tax. This concept also called as quantitative or broad approach. To quote Weston and Brigham, " Gross Working Capital refers to firm's investment in short term assets such as, cash, short term securities, account receivables and inventories ". The concept helps in making optimum investment in current assets and in their financing.

According to Walker, “ use of this concept is helpful in providing for the current amount of working capital at the right time so that the firm is able to realize the greatest return on investment”.

Significance

Gross working capital concept focuses attention on the two aspect of current asset management. They are:

1). Optimum investment in current assets:

Investment in current asset must be just adequate to the needs of the firm. On the other hand excessive investment in current asset should be avoided.

2). Financing of current asset:

Need for working capital arise due to the increasing level of business activity. Therefore, there is a need to provide it quickly. If there is surplus fund arise that should be invested in short term securities.

Net Working Capital Concept

As per this concept the excess of current asst over current liabilities represents net working capital. Similar view is expressed by Guthmann, Gerstenberg, Goel Etc.

Net Working Capital represents the amount of current asset which remain after all the current liabilities were paid. It may be either positive or negative. It will be positive if current asset exceed current liabilities and vice versa.

To quote Roy Chowdry, “ Net Working Capital indicates the liquidity of the liquidity of business whilst gross working capital denotes the quantum of working capital with which business has to operate.

Significance

Net Working Capital Concept focuses on two aspects. They are:

1). Maintaining liquidity position:

Excess current assets help in meeting its financial obligation within the operating cycle of the firm. Negative and excess working capitals both are bad to the firm.

2). To decide upon the extent of long term capital in financing current asset:

Net working capital means the portion of current asst that should be financed by long term funds. This concept helps to decide the extent of long term fund required in finance current assets.

Kinds of working capital

The categorization of working capital can be made either based on its concept or the need to maintain current asset either permanently and or temporarily. As per conceptual view it may be classified in to gross and net work in capital. Gestenberg has conveniently classified the working capital in to regular or permanent working capital and temporary or variable working capital.

Gross working capital or quantitative

Net working capital or qualitative

Temporary or variable working capital

Permanent or regular working capital

Types of working capital

Concept base

Time base

Permanent working capital

This is the minimum investment kept in the form of inventory of raw materials, work in process, finished goods, stores and spares and book debt to facilitate uninterrupted operation in a firm. Though this investment is stable in short run, it certainly varies in long run depending upon the expansion programs undertaken by the firm. It may increase or decrease over a period of time.

Temporary working capital

Any additional working capital apart from permanent working capital required to support the changing production and sales activities is referred to as temporary working capital. A firm required to maintain an additional amount current asset temporarily over and above permanent working capital.

Temporary

Permanent

Components of working capital

1). Current Asset

Current are those assets that in the ordinary course of business can be or will be turned into cash within an accounting period. It includes cash, marketable securities, inventories, sundry debtors, banks and prepaid expenses.

2). Current Liabilities

Current liabilities are those liabilities intent to be paid in the ordinary course of business within a reasonable period. It consist of sundry creditors, loans and advances, bank over draft, short term borrowing, taxes and proposed dividend.

Aspects of Working Capital Management

Management of working capital involves the following four aspects:

1). Determining the total fund requires to meet the current operations of the firm.

2). To decide the structure of current assets.

3). To evolve suitable policies, procedures and reporting system for controlling the individual components of current assets.

4). To determine the various sources of working capital.

Objectives of Working Capital Management

1). To ensure optimum investment in current assets.

2). To strike a balance between the twin objectives of liquidity and profitability in the use of funds.

3). To ensure adequate flow of funds for current operations.

4). To speed up the flow of funds or to minimize the stagnation of funds.

Operating cycle

The operating cycle involves the following procedure:

a). conversion of cash in to raw materials

b). conversion of raw materials in to work in progress

c). conversion of work in progress in to finished goods

d). conversion of finished goods in to sales

e). conversion of debtors in to cash

Finished goods

Work in process

Raw materials

cash

Sales

Debtor

Factors influencing working capital

Nature of business

Size of business

Production cycle process

Production policy

Credit policy or terms of purchase and sales

Business cycle

Growth and expansion

Scarce availability of raw materials

Profit level

Level of taxes

Dividend policy

Depreciation policy

Price level changes

Operating efficiency

Availability of credit

Need to maintain balanced working capital

For maximization profit or minimization of working capital cost or to maintain balance between liquidity and profitability, there is a need to maintain a balance in working capital. It should not be excessive or inadequate. Excessive working capital means idle funds that can earn no profit but involve cost, and inadequate working capital disturbs production and profitability.

Danger of excessive working capital

It results in unnecessary accumulation of inventories.

It is indication of defective trade policies and slack in collection period.

It makes management complacent which degenerates in to managerial inefficiency.

Accumulation inventories tend to make speculative profits grow.

Danger of inadequate working capital

It stagnate growth.

It becomes difficult to implement operating plans and achieve the firm's target.

Operating inefficiencies creep in.

It leads to inefficient utilization of fixed assets.

Firm loses its reputation.