

Working Capital Management— A Managerial Approach

[For M.B.A. and P.G.D.M. Courses]

ABHIJIT DUTTA

M.Com., PGDBM, Ph.D.
Dean and Professor of Finance
MIMTS

Bhubaneswar



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1

WORKING CAPITAL MANAGEMENT

Chapter

Chapter Contents

After reading this chapter, you will learn the following concepts:

- » Introduction to Working Capital Management
- » Components of Current Assets and Current Liabilities
- » Objectives of Working Capital Management
- » Static and Dynamic view of Working Capital
- » Factors Affecting Composition of Working Capital

INTRODUCTION TO WORKING CAPITAL MANAGEMENT

Assets and liabilities of a company can be classified on the basis of duration into:

(i) **Assets** : Fixed Assets and Current Assets

(ii) **Liabilities** : Long-term liabilities and short-term of current liabilities.

Assets are possessions owned by the firm which are capable of being expressed in monetary terms, whether tangible (like land, building, stock, etc.) or intangible (goodwill, patents, copyrights, etc). These are used by the company for generating future benefits. Fixed assets are those assets which are permanent in nature and are held for use in business activities and not for sale. Examples of fixed assets are land, building, machinery, long-term investment, etc. Current assets, on the other hand, are those liquid assets of the company which are either held in the form of cash or can be easily converted into cash within one accounting period, usually a year. Examples of current assets are cash, short-term investments, sundry debtors or accounts receivable, stock, loans and advances, etc.

Liabilities are economic obligations of the company to pay cash or provide goods or services to outsiders including shareholders. Liabilities may be long-term or current. Long-term liabilities are those which are repayable over a period greater than the accounting period like share capital, debentures, long-term loans etc. Current liabilities on the other hand have to be paid within the accounting period like sundry creditors or accounts payable, bills payable, outstanding expenses, short-term loans, etc.

The management of fixed assets and current assets differs in three important ways-

- In managing fixed assets, the time factor is very important. That is why discounting and compounding play a very important role in any capital budgeting decision. But because the time frame of current assets is only one accounting period, the time value of money is less significant in the management of current assets.
- The liquidity position of a firm is dependent on the investment in current assets, the more, the better, whereas the role of fixed assets as far as liquidity is concerned is negligible.
- Any short run, immediate need of the company whether that be need for cash or adjustments to fluctuations in sales can be made only through adjusting the levels of the various components of the current assets. This calls for efficient management of current assets which forms part of management of working capital.

COMPONENTS OF CURRENT ASSETS AND CURRENT LIABILITIES

Working capital management involves not only managing the different components of current assets, but also managing the current liabilities, or to be more precise, the financing aspect of current assets. It is, therefore appropriate to provide a brief description of current assets and current liabilities. To provide an insight into the practices followed in the Indian corporae sector we shall make the presentation in the context of XYZ Ltd. Taken from the company's balance sheet, the practices followed are presented in Table 1.1.

Table 1.1
XYZ Co. Ltd.
Composition of Current Assets and Current Liabilities
Current Assets, Loans and Advances

Rupees in lakh		
A. INVENTORIES		
1. Stores and Spare Parts		37.63
2. Loose Tools		13.37
3. Stock of machines, including own manufactured	1952.11 550.20	
4. Goods in Transit		2502.31
5. Raw Materials		411.91
6. Work-in-process		567.61
7. Value of incomplete job contracts carried forward		2133.03
		5665.86

Note: 1. Inventories are as valued and certified by the Management [See Note (a) for mode of valuation]

Rupees in lakh		
B. SUNDRY DEBTORS		
1. Debts outstanding for a period exceeding six months		
Unsecured-Good		1173.43
Unsecured-Doubtful		17.93
		1191.36
Less: Provision for doubtful debts		17.93
		1173.43
2. Other debts (Unsecured-Good)		4069.35
		5242.78

Rupees in lakh		
C. CASH AND BANK BALANCES		
1. Cash and Cheques on hand and at collection centers including remittances in transit Rs. 40.40 lakh	-	501.13
2. Balance with Scheduled Banks:		
In Current Account	9.09	
In Fixed Deposits (Receipts endorsed favoring customers as security)	1.49	
In Guarantee/L/C/Margin Account	23.73	34.31
3. Balances with Non-Scheduled Banks in* Current Account with:		
a. Bank of Ceylon	0.21	
b. In Investioni Bank (Czechoslovakia)	1.85	2.06
		537.50

* Includes Rs. 0.54 lakh with a Bank in liquidation

Rupees in lakh	
D. LOANS AND DAVANCES	
1. Bills Receivable-Guaranteed by Scheduled Banks	30.97
2. Loans including secured Rs. 4.48 lakh (Rs. 5.01 lakh)	28.83
3. Advances & loans to Subsidiary (See Note 9)	308.46
4. Advances recoverable in cash or in kind or for value to be received	
Considered Good	1229.94
Considered Doubtful	0.18
	1230.12
Less: Provision for doubtful advances	0.18
5. Balances with Excise, Customs and Port Trust	1229.94
6. Taxes paid in advance and deducted at source	23.83
(after adjusting provision for taxation Rs 114.87 lakh)	183.93
	1805.96
E. OTHER CURRENT ASSETS	313.48
Total of A+B+C+D+E	13,565.58

Current Liabilities and Provisions

Rupees in .kh	
A. CURRENT LIABILITIES	
1. Acceptances:	1435.15
2. Sundry Creditors (including premium on Redemption of Debentures Rs. 25.54)	3906.76
3. Advances and Deposits from customers	2688.35
4. Other Liabilities	437.40
5. Unclaimed Dividends	7.50
6. Application Money Refundable	5.21
7. Interest accrued but not due on loans	105.67
8. Hire purchase dues	42.23
9. Temporary bank Overdraft as per books of account	15.81
	8644.08
B. PROVISIONS	
1. Provision for Taxation (for wealth Tax)	0.16
2. Proposed Dividend	42.44
	42.60
C. SECURED LOANS	
From Banks for working capital	2959.40
D. UNSECURED LOANS	
1. Fixed Deposits	40.88
2. Short-term loans and advances	600.00
3. Other term loans and advances	363.00
	1003.88
TOTAL (A+B+C+D)	12649.96

Note: Valuation of Inventories

- (a) Stores and spare parts, loose tools, goods-in-transit, raw materials and work-in-process are valued at cost.
- (b) The finished goods including those manufactured by the company are valued at cost or estimated market value, whichever is lower.
- (c) Incomplete job contracts are valued at the direct cost incurred on such contracts.

Current Assets

1. When the Balance Sheet is presented in the form of a 'T', the right hand side will present the current assets, loans and advances of the company. The first item of current assets is inventories whose value is certified by management in accordance with the principle of conservatism which says that inventories are to be valued at cost or market price whichever is lower. Item (1) in inventories denotes the value of stores and spare parts which amounted to Rs. 37.63 lakh at the end of the accounting period. When spare parts for machinery used are not readily available, they are acquired at the time of purchase and held in stock. In the case of imported plant and machinery, the supplier also sells spare parts which may be laying in stock. Some of the stores and spares will be consumed during the year when the machinery is being operated. However, when a better machine comes into the market, existing machinery may have to be replaced for increased operational efficiency. At that time, spares of the old machine will fetch very little in the market. A thorough analysis of spares in terms of Vital, Essential and Desirable (VED) categories is warranted when they comprise a reasonably large chunk of current assets. The company started with an opening inventory of stores and spares of Rs.39.52 lakh. Stores to the extent of Rs.160.43 lakh were consumed during the year as revealed by the annual reports of the company.
2. Item (2) shows loose tools used by the company for the manufacture and repair of the various machines and equipment, which stood at Rs.13.37 lakh at the end of the year. The opening balance was Rs.14.89 lakh and purchases of loose tools amounted to Rs.43.49 lakh, indicating that loose tools worth Rs.45.01 lakh were consumed during the year. (consumption=opening stock plus purchases less closing stock.)
3. The company is in the business of manufacturing various items of machinery and machine tools like industrial equipment, pollution control equipment, air-conditioning and refrigeration systems, textile machinery, etc. As such, the machines manufactured by the company for the purposes of sale will be included under inventories and not under fixed assets. The set of machines used for making these machineries meant for sale will come under fixed assets as these will be used by the company year after year for the manufacture of its goods (machineries for sale). Item (3) indicates the closing stock for the finished goods of the company including goods (machinery) in transit. This amounts to Rs.2,502.31 lakh. The company had an opening stock of finished goods of Rs.1,728.02 lakh. These are also conservatively valued by the company at cost or market value whichever is lower.

4. Item (5) denotes raw materials. The company started with an opening balance of raw materials of Rs.359.14 lakh. The company purchased raw materials worth Rs.1,835.23 lakh during the year, making Rs.2,194.37 lakh available for consumption. Actual consumption was to the tune of Rs.1,782.46 lakh, leaving a closing balance of Rs.411.91 lakh.
5. Work-in process, also called stock-in process indicates partially finished goods which have been valued at the end of the year at Rs.567.61 lakh. Since it takes some time for the raw materials and components that enter the production process to become finished goods, at any point of time, there will always be some partly finished goods besides goods that are finished and ready for sale shown in item (3). Item (6) shows the value of such work-in process which have been valued at cost.
6. The company undertakes job works on contract basis like project engineering. Job contracts which are incomplete at the end of the accounting period, and which are to be carried forward to the next accounting period. Such items will also be shown under inventories. This is shown in item (7) and such incomplete jobs have been valued at Rs.2,133.03 lakh.
7. Item (B) represents sundry debtors or accounts receivable and is more liquid than inventories as it arises consequent upon the sale of finished goods on a credit basis. In accordance with the provisions of Company Law, debtors are to be categorized into 2 groups - one group outstanding for a period exceeding 6 months and the other below 6 months. For the company, debtors outstanding for a period exceeding 6 months amount to Rs.1,191.36 lakh, of which Rs.17.93 lakh are considered doubtful for which a provision has to be made, and this leaves the net amount at Rs.1,173.43 lakh. The second group amounts to Rs.4,069.35 lakh, making total sundry debtors Rs.5,242.78 lakh.
8. Item (C) indicates the most liquid form of all current assets, viz., cash and bank balances. While these assets provide immediate liquidity, they do not generate any returns unless they are invested in some other form. Consequently only a reasonably small percentage is held in this form, the influencing or determining factors being the degree of synchronization of cash inflows and outflows, the degree of uncertainty surrounding them and the ability of the firm to raise liquid cash at short notice. For the company the amount of cash and bank balance is only 3.96% of total current assets whereas inventory accounts for 41.8% of total current assets.
9. Item (D) consists of loans and advances which include bills receivables, advances and loans and advances which include bills receivables, advances and loans to subsidiaries of the company, balances with Excise,

Customs and Port Trust, advance payments of tax, etc., after deducting provision for taxation and providing for doubtful advances. The net amount under this head for the company amounts to Rs.1,805.96 lakh. Item (E) represents other current assets like interest accrued on investments, prepaid expenses etc., which amount to Rs.313.48 lakh.

Current Liabilities

These are shown on the left hand side of a 'T' shaped Balance Sheet and are grouped under 4 heads. As per the provisions of the Companies Act, Items (C) and (D) of Table 1 will not be shown as part of current liabilities but will shown separately along with other long-term secured and unsecured loans. However, as the liabilities have been utilized for financing the current assets of the company, they have been included here to give a complete picture.

1. Item (A) represents current liabilities, the major chunk of which is contributed by sundry creditors or accounts payable, followed by advances and deposits from customers which have to be returned. Refund of application money on non-allotment, interest accrued but not due, hire purchase dues, unclaimed dividends, temporary bank over draft (OD) and other outstanding expenses also come under this head, creating a total of Rs. 8,664.08.08 lakh.
2. Item (B) includes provisions which like current liabilities also call for short-term payments by the company, but the exact figure of which is not known beforehand. The company has provided Rs. 0.16 lakh for taxes and Rs. 42.44 lakh for dividend, totaling to Rs. 42.60 lakh.
3. As per the requirements of Company Law, the arrangements made with banks for working capital towards the financing part of the current assets by providing security in the form of hypothecation of stocks or pledge on sundry debtors are shown separately under the head secured loans along with term loans from financial institutions secured by mortgaging fixed assets or bank guarantees. But since bank loans for working capital are strictly of short-term nature and used for financing the current assets of the company, these should also be shown along with current liabilities and provisions. Item (C) shows that the company has availed itself Rs. 2,959.40 lakh as secured loan for working capital from commercial banks.
4. Strictly speaking, fixed deposits repayable within one year should also form part of current liabilities. However, since fixed deposits are mainly raised to meet the financial requirement of current assets, it may not be a bad idea to consider the total amount of fixed assets as part of current liabilities. However in Table 1.1, Item (D) Fixed Deposits and other short-term loans includes only those repayable within one year by the company. They amount to Rs. 1,003.88 lakh.

OBJECTIVES OF WORKING CAPITAL MANAGEMENT

Liquidity or Profitability: Which is more important

The basic objective of working capital is to provide adequate support for the smooth functioning of the normal business operations of a company. The question then arises as to the determination of the quantum of investment in working capital that can be regarded as 'adequate'. Once we recognize the fact that a company has to operate in an environment permeated with uncertainty/risk, the term 'adequate working capital' becomes somewhat subjective depending upon the attitude of the management towards uncertainty/risk. Therefore the quantum of investment in current assets has to be made in a manner that it not only meets the needs of the forecasted sales but also provides a built-in cushion in the form of safety stocks to meet unforeseen contingencies arising out of factors such as delays in arrival of raw materials, sudden spurts in sales demand etc. Consequently, the investment in current assets for a given level of forecasted sales will be higher if the management follows a conservative attitude than when it follows an aggressive attitude. Thus a company following a conservative approach is subjected to a lower degree of risk than the one following an aggressive approach. Further, in the former situation the high amount of investment in current assets imparts greater liquidity to the company than under the latter situation wherein the quantum of investment in current assets is less. This aspect considers exclusively the liquidity dimension of working capital. There is another dimension to the issue, viz., the 'profitability' and it is discussed below.

Once we recognize the fact that the total amount of financial resources at the disposal of a company is limited and these resources can be put to alternative uses, the larger the amount of investment in current assets, the smaller will be the amount available for investment in other profitable avenues at hand with the company. A conservative attitude in respect of investment in current assets leaves less amount for other investments than an aggressive approach does. Further, since current assets will be more for a given level of sales forecast under the conservative approach, the turnover of current assets (calculated as the ratio of net sales to current assets) will be less than what they would be under the aggressive approach. This being so, even if we assume the same level of sales revenue, operating profit before interest and tax and net (operating) fixed assets, the company following a conservative policy will have a low percentage of operating profitability compared to its counterpart following an aggressive approach as can be seen from the numerical illustration 1.1.

Illustration 1.1

S.No.	Particulars	Conservative Policy	Aggressive Policy
1.	Net Sales	Rs.50 lakh	Rs.50 lakh
2.	Operating profit Before Interest and tax	Rs. 5 lakh	Rs. 5 lakh
3.	Net (Operating) Fixed Assets	Rs. 10 lakh	Rs. 10 lakh
4.	Current Assets	Rs. 8 lakh	Rs. 5 lakh
5.	Total Operating Assets [= (3) + (4)]	Rs. 18 lakh	Rs. 15 lakh
6.	Net Operating Profit Margin $\left[= \frac{(2)}{(1)} \right]$	$\frac{5}{50} = 10\%$	$\frac{5}{50} = 10\%$
7.	Turnover of Net Operating Fixed Assets $\left[= \frac{(1)}{(3)} \right]$	$\frac{50}{10} = 5$ times	$\frac{50}{10} = 5$ times
8.	Turnover of Current Assets $\left[= \frac{1}{4} \right]$	$\frac{50}{8} = 6.25$ times	$\frac{50}{5} = 10$ times
9.	Turnover of Total Operating Assets $\left[= \frac{(1)}{(5)} \right]$	$\frac{50}{18} = 2.78$ times	$\frac{50}{15} = 3.33$ times
10.	Rate of Return on Total Operating Assets [=(6) × (9), (2) × 100 (5)]	27.8%	33.3%
11.	Ratio of Current Assets to Net Operating Fixed Assets $= \left[\frac{(4)}{(3)} \right]$	$\frac{8}{10} = 0.8 = 80\%$	$\frac{5}{10} = 0.5 = 50\%$

From the illustration 1.1, it can be easily seen from item (10), that the alternative of following a conservative approach to investment in current assets results in a low profitability of 27.8 percent compared to the profitability of 33.3

percent obtained under the alternative-an aggressive approach. The reason for this can be directly traced to the low turnover of current assets leading to a lower turnover of total operating assets under the conservative approach compared to that under the aggressive approach. From item (11) it can be seen that current assets comprise 80 percent of net operating fixed assets-resulting in higher proportion of current assets and hence greater liquidity compared to the corresponding figure of 50 percent indicating low liquidity under the aggressive approach. From the above discussion it is apparent that management of current assets inevitably leads to a trade-off between 'profitability' and 'liquidity'. An aggressive approach results in greater profitability but lower liquidity. This can be resolved to a certain extent by the management by following a moderate policy which is neither highly conservative. Under this approach some liquidity and some profitability have to be sacrificed so that the resultant figures of liquidity and profitability are reasonably satisfactory to the company. For example, in the numerical illustration given earlier, if the management decides to follow a moderate approach which leads to an investment of Rs.6.5 lakh in current assets, then the rate of return of total operating assets will become 30.30 percent ($=5/16.5$) which is higher than the rate of return of 27.8 percent under the conservative approach but lower than the figure of 33.3 percent under the aggressive approach. Further, the degree of liquidity as indicated by the ratio of current assets to net operating fixed assets will now be 65 percent which is lower than the figure of 80 percent under the conservative approach but higher than the figure of 50 percent under the aggressive approach. Thus, a proper balancing between liquidity and profitability can be reached by commandeering alternatives along with their consequences on liquidity and profitability. Among the alternatives the one which matches the attitude of the management toward risk can be selected.

CHOOSING THE PATTERN OF FINANCING

The objective of working capital management covers not only the management of current assets in tune with the attitude of management toward risk and arriving at a satisfactory level of current assets that balances the liquidity and profitability criteria but also the management of financing the chosen level of current assets, once again taking into consideration the attitude of management towards risk.

From the description of current assets and current liabilities discussed above, it can be observed that in the normal course of business a company will usually have access to non-interest bearing short-term liabilities such as sundry creditors, accrued expenses and other current liabilities as also provisions toward financing current assets. These are called spontaneous liabilities as they arise more or less automatically in the context of current assets. The difference between the amounts

of current assets and spontaneous liabilities needs to be financed by a combination of bank borrowings in the form of cash credit/overdraft arrangement and long-term sources of finance such as debentures and equity capital. Fixed deposits obtained from the public for periods ranging from one to three years can also be used for the same purpose. Here also an aggressive financing policy will tend to have a financing mix tilted in favor of bank borrowings and public deposits compared to a conservative policy tilted more towards long-term sources like equity and to some extent debentures.

Except in rare instances, the general tendency in the case of manufacturing and trading companies is that during certain periods in a year the need for current assets will be much higher than in other periods in the year. As the financing charges in the case of bank borrowings are geared to and move in tandem with the credit needs occasioned by the higher investment in current assets, the total interest charge is likely to be low. However, debt-servicing cost will be high as bank borrowings have to be repaid (rather re-negotiated for the coming year). Consequently, the risk of 'technical insolvency' (a situation where a company is not in a position to honor its current liabilities including short-term bank borrowings which can arise even in the case of profitable companies) is likely to be high. On the other hand, a conservative policy having a high proportion of equity capital and to some extent debentures will have comparatively low debt-servicing resulting in a lower degree of the risk of technical insolvency. However, the cost of financing will be high as the cost of equity capital is the highest and it does not provide tax benefit which the interest on borrowed capital provides to the company and debenture interest (even after reckoning with tax benefit) has to be paid throughout the year irrespective of the fluctuating credit needs of a company towards financing its current assets. Even in the case of choosing the mix of instruments for financing current assets the risk of technical insolvency tends to be high while the cost of financing tends to be low under an aggressive policy compared to a conservative policy under which the risk of technical insolvency will be low while the cost of financing tends to be high. Once again, the management's attitude toward risk will go a long way in determining the financing-mix considered appropriate to the company.

The tendency of the management to follow an aggressive mix of financial instruments towards financing current assets is severely handicapped by the restrictions imposed by the commercial banks in permitting cash credit/overdraft limits.

From the above discussion it emerges that working capital management encompasses the management of current assets and the means of financing them. The objective of working capital management is to balance the 'liquidity' and 'profitability' criteria while taking into consideration the attitude of management toward risk and the constraints imposed by the banking sector while providing short-term credit in the form of cash credit/bank overdraft.

STATIC VIEW OF WORKING CAPITAL AND ITS SHORTCOMINGS

Traditionally the term working capital is defined in two ways, viz., gross working capital and net working capital. Gross working capital is equal to the total of all current assets (including 'loans and advances') of a company. Net working capital is defined as the difference between gross working capital and current liabilities (including 'provisions'). Sometimes net working capital is also referred to as 'net current assets.' Since both gross working capital and net working capital are obtained from the data contained in the balance sheet, working capital viewed in either sense denotes the position of current assets (or net current assets) as at the end of a company's accounting year. An important characteristic of current assets is conventionally considered to be their convertibility into cash within a single accounting year unlike fixed assets which provide the 'production capacity' for the manufacture of finished goods for sale. Current liabilities arise in the context of and hence are derived from current assets. Conventionally current liabilities are of short-term nature and come up for payment within a single accounting year. Consequently, a lot of emphasis is traditionally placed on the current assets (which are valued on a conservative basis in accordance with the 'conservatism principle' of accounting) vis-à-vis current liabilities. As a rule of thumb, the value of 2:1 for the ratio of current assets to current liabilities (popularly known as current ratio) is considered to be satisfactory by the short-term creditors, the underlying logic being that a company can face the unlikely situation of meeting all of its current liabilities by liquidating its current assets even at half of their recorded value without any financial embarrassment.

Limitations

The definition of working capital given above considers the purpose of current assets is to provide adequate cover for current liabilities. This definition suffers from many limitations as stated below.

First, the amount of working capital, viewed in either sense, is obtained from the data contained in the balance sheet which merely indicates the financial position of a company as on a specific date and, is therefore, 'static' in nature. Consequently 'working capital' as defined traditionally provides a snapshot picture of current assets and current liabilities as on the balance sheet date. It fails to reflect the true dynamic nature of working capital which can be captured by combining the data contained in both the balance sheet and profit and loss account of a company. The dynamic approach to working capital is far more useful from the point of view of managerial decision-making than the static approach.

Secondly, the balance sheet of a company is prepared and presented in the annual report in accordance with the schedule VI requirements of the Indian Companies Act. As a result, the amount of net working capital obtained by subtracting current liabilities from assets presented in the balance sheet fails to reflect the true amount of net working capital. This is so, for the following reasons:

Bank borrowings in the form of cash credit/overdraft accounts obtained for financing current assets, which are basically short-term borrowings, are not shown as part of current liabilities but separately under the head-secured loans. Similarly, unsecured loans of short-term duration such as public deposits are also shown separately under the head-unsecured loans. To obtain a true picture of the position of net working capital the above mentioned items have to be regarded as part of current liabilities. This problem is taken care of by the Bombay Stock Exchange official directory as their classification of current liabilities includes all borrowings other than long-term borrowings.

Current assets, as presented in the balance sheet do not include marketable securities such as treasury bills whose main motive is to improve the liquidity position of the company and are held for short periods. These are considered under the generic head 'investments' which include both trade investments and others.

Points mentioned above tend to distort the calculation of net working capital from the simple balance sheet heads stated as current assets and current liabilities. For XYZ company, net working capital as per the Static definition will amount to Rs.4,878.90 lakh i.e., current assets, loans and advances of Rs.13,565.58 lakh from which current liabilities and provisions of Rs.8,686.68 lakh have been deducted. But if we include bank loan for working capital of Rs.2,959.40 lakh and unsecured loans repayable within one year of Rs. 1,003.88 lakh, we find that net working capital amounts to only Rs.915.62 lakh. This seems to be more realistic amount and denotes the magnitude of long-term funds used for financing the balance amount of current assets not financed from short-term funds.

A negative net working capital indicates the siphoning off of short-term funds for the financing of long-term or fixed assets which then continued for long can lead to problems of liquidity for an organization. This is because, the investment in fixed assets will not create liquidity in the short run and the company may face problems in meeting its short-term financial obligations. It is worth noting that the calculation of net working capital made above is more in line with what bankers follow, as it will be useful in taking managerial decisions in respect of working capital which encompasses not only the management of current assets but also the management of the 'financing' aspect of current assets.

DYNAMIC VIEW OF WORKING CAPITAL

In the light of shortcomings of the traditional view of working capital there is a need for evolving a more expressive definition that highlights the importance of working capital to a company. Working capital can be viewed as the amount of capital required for the smooth and uninterrupted functioning of the normal business operations of a company ranging from the procurement of raw materials, converting the same into finished products for sale and realizing cash along with profit from the accounts receivables that arise from the sale of finished goods on credit.

From the above definition, the need for working capital by a typical manufacturing and selling company becomes self-evident. In order to meet the production plans of a company some quantity of raw materials has to be maintained in the form of inventory as there will usually be a time lag from the moment an order is placed for raw materials with suppliers till the same is received by the company. Absence of adequate raw materials inventory may result in stoppage of production for want of raw materials.

The quantum of raw material inventory to be maintained by a company depends, inter alia, on the availability of raw materials in the domestic market, the need for importing raw materials in case they are not indigenously available, the existence or otherwise of curbs by the government on imported raw materials, the lead time (the time gap between placing an order and receiving the supply of raw materials) for the procurement of raw materials, availability of bulk purchase discounts offered by suppliers and inflationary pressure on the price of raw materials. Once the raw materials are put into the production process, the company has to incur manufacturing expenses like wages and salaries, fuel and other manufacturing overheads. The nature of process technology adopted by the company is an important factor in determining the time taken for converting raw materials into finished goods. Consequently, the company may have some amount of finished goods and the balance in the form of partly-finished goods denoted by the term work-in process. Thus, work-in-process inventory which a company carries becomes an inevitable accompanying feature of the production process.

The quantum of finished goods inventory a company carries is basically determined by the degree of accuracy in forecasting sales demand, the ability to meet sudden and unforeseen spurts in the demand for finished goods of the company, seasonality of the demand considered in conjunction with the production policy and the amenability of the product to become perishable in a relatively short period of time (as in the case of cigarettes and certain types of pharmaceutical). The amount of finished goods inventory held by a company should normally provide its sales executives reasonable elbow-room for negotiating and clinching deals with new customers. Unless a company enjoys

special advantage over its competitors, it may have to honor the product followed by the sentiment to which it belongs in the sale of finished goods. By and large in a competitive market, the finished goods are sold on a credit basis. When a company gives a credit period to its customers from the date of consummation of sale, the amount of sales value will become accounts receivable or sundry debtors which get converted into cash only after the expiry of credit period.

Further, a company usually maintains at all times some amount of liquid cash either on hand or at bank towards meeting cash payments arising out of transactions as also for providing adequate cushion towards meeting unanticipated demand for cash such as, for example, availing cash discount on purchases suddenly introduced by suppliers, before the generation of cash takes place in the normal course of business. One more point needs to be considered at this stage. Just as the company extends credit to its customers, in many instances it can receive credit from its suppliers of materials. Consequently, the drain on cash resources of the company can be delayed till the expiry of credit period, until such time the amount will become 'Accounts payable' of the company and as such provides a spontaneous source of credit. From this discussion it is evident how important a role working capital plays in supporting the normal business operations of a typical manufacturing and trading company.

FACTORS AFFECTING THE COMPOSITION OF WORKING CAPITAL

We have discussed the need for working capital along with its constituent elements in the case of a typical manufacturing and selling organization. But it is not necessary that every company should have all the constituent elements considered earlier. For example, a purely trading company which purchases finished products on credit basis and sells the same for cash will only have finished goods inventory and cash as current assets and accounts payable as current liabilities. Since there is no manufacturing involved, the investment in fixed assets will be minimal, say around 5 percent of the investment in current assets. Consequently working capital management assumes greater significance in such organizations. Now, we shall try to identify some of the significant factors affecting the composition of working capital or current assets.

Nature of Business

As mentioned above purely trading organizations will have basically finished goods inventory, accounts receivable (in some cases) and cash as current assets and accounts payable as current liabilities. Similarly travel agency firms will have predominantly accounts receivable and some amount of cash as current assets unlike manufacturing and trading companies. The investment in net (operating) fixed assets will at most be around 5 percent of investment in current

assets. On the other hand, capital goods manufacturing and trading companies will have a high proportion of current assets in the form of inventory of raw materials components and work-in-process. The ratio of net (operating) fixed assets to current assets will be around cent percent or more.

Nature of Raw Material Used

The nature of major raw material used in the manufacture of finished goods will greatly influence the quantum of raw material inventory. For example, if the raw material is an agricultural product whose availability is pronouncedly seasonal in character the proportion of raw material inventory to total current assets will be quite high. For example, tobacco is the major raw material for cigarette industry whose availability is seasonal in nature and also the tobacco procured requires a reasonably long 'curing' period. Consequently, the percentage of raw material inventory to total current assets will be quite high compared to other items.

Similarly, companies using imported raw materials with long lead time tend to have a high proportion of raw material inventory. In the case of capital goods manufacturing company the demand for whose product is growing over time the tendency will be to have high inventory of raw materials and components.

Process Technology Used

In case the raw material has to go through several stages during the process of production, the work-in-process inventory is likely to be much higher than any other item of current assets.

Nature of Finished Goods

The nature of finished goods greatly influences the amount of finished goods inventory. For example, if the finished goods have what is called a short span of 'shelf-life' as in the case of cigarettes the finished goods inventory will constitute a very low percentage of total current assets.

In the case of construction companies, which undertake work on a turnkey basis, as soon as the construction is completed the customer will take possession of it. Consequently the finished goods inventory will be virtually insignificant and the work-in-process inventory (rather work-in-process) will be considerable high.

In the case of companies the demand for whose finished goods is seasonal in character, as in the case of fans, the inventory of finished goods will constitute a high percentage of total current assets. This is mainly because from the point of view of fixed costs to be incurred by the company it would be more economical

to maintain optimum level production throughout the year than stepping up production operations during busy season.

In the case of reputed companies, manufacturing consumer goods that enjoy growing demand over the years, the finished goods inventory need not be high as sales demand can be forecast with a reasonable degree of accuracy. However, in such companies the raw material inventory tends to be high in view of the large variety of products to be manufactured.

Degree of Competition in the Market

When the degree of competition in the market for finished goods in an industry is high, then companies belonging to the industry may have to resort to an increased credit period to its customers, partially lowering credit standards and similar other practices to push their products. These practices are likely to result in a high proportion of accounts receivable.

QUICK REVIEW OF THE CHAPTER

In this chapter we observed the type nature and components of working capital. We also read about the static and dynamic concepts of working capital in this chapter. It is noted that working capital decision helps the business in creating its profitability. The appropriate working capital strategy helps the firm in increasing its profitability. Further it has been observed that a fine adjustment in the component of working capital will enable the business to earn a greater deal of profit.

Review Questions

1. What is working capital and how does it affect the business?
2. What do you mean by static and dynamic concepts of working capital?
3. What are the various factors which affect the working capital?
4. Which component influence the working capital decision the most in business and why?
5. What is the role of a finance manager in deciding the fate of working capital of a business?
6. What is more important for a business - liquidity or profitability? What role does the liquidity play in working capital management?

