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WORKING CAPITAL MANAGEMENT: AFINANCIAL METRIC REPRESENTING OPERATING LIQUIDITY AVAILABLE TO BUSINESS

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ABSTRACT

Working capital, also known as net working capital or NWC, is a financial metric which represents operating liquidity available to a business. Along with fixed assets such as plant and equipment, working capital is considered a part of operating capital. It is calculated as current assets minus current liabilities. If current assets are less than current liabilities, an entity has a working capital deficiency, also called a working capital deficit.

Working Capital = Current Assets − Current Liabilities

A company can be endowed with assets and profitability but short of liquidity if its assets cannot readily be converted into cash. Positive working capital is required to ensure that a firm is able to continue its operations and that it has sufficient funds to satisfy both maturing short-term debt and upcoming operational expenses. The management of working capital involves managing inventories, accounts receivable and payable and cash.

KEYWORDS: Working Capital, Financial Metric Representing Operating Liquidity.

INTRODUCTION

Working capital requirements of a concern depends on a number of factors, each of which should be considered carefully for determining the proper amount of working capital. It may be however be added that these factors affect differently to the different units and these keeps varying from time to time. In general, the determinants of working capital which re common to all organizations can be summarized as under:

NATURE OF BUSINESS

Need for working capital is highly depends on what type of business, the firm in. there are trading firms, which needs to invest a lot in stocks, ills receivables, liquid cash etc. public utilities like railways, electricity, etc., need much less inventories and cash. Manufacturing concerns stands in between these two extends. Working capital requirement for manufacturing concerns depends on various factor like the products, technologies, marketing policies.

PRODUCTION POLICIES

Production policies of the organizations effects working capital requirements very highly. Seasonal industries, which produces only in specific season requires more working capital.

Some industries which produces round the year but sale mainly done in some special seasons are also need to keep more working capital.

SIZE OF BUSINESS

Size of business is another factor to determines the need for working capital

LENGTH OF OPERATING CYCLE

Operating cycle of the firm also influence the working capital. Longer the orating cycle, the higher will be the working capital requirement of the organization.

CREDIT POLICY

Companies; follows liberal credit policy needs to keep more working capital with them. Efficiency of debt collecting machinery is also relevant in this matter. Credit availability form suppliers also effects the company's working capital requirements. A company doesn't enjoy a liberal credit from its suppliers will have to keep more working capital

BUSINESS FLUCTUATION

Cyclical changes in the economy also influence the level of working capital. During boom period, the tendency of management is to pile up inventories of raw materials and finished goods to avail the advantage of rising prove. This creates demand for more capital. Similarly during depression when the prices and demand for manufactured goods. Constantly reduce the industrial and trading activities show a downward termed. Hence the demand for working capital is low.

CURRENT ASSET POLICIES

The quantum of working capital of a company is significantly determined by its current assets policies. A company with conservative assets policy may operate with relatively high level of working capital than its sales volume. A company pursuing an aggressive amount assets policy operates with a relatively lower level of working capital.

FLUCTUATIONS OF SUPPLY AND SEASONAL VARIATIONS

Some companies need to keep large amount of working capital due to their irregular sales and intermittent supply. Similarly companies using bulky materials also maintain large reserves' of raw material inventories. This increases the need of working capital. Some companies manufacture and sell goods only during certain seasons. Working capital requirements of such industries will be higher during certain season of such industries period.

OTHER FACTORS

Effective co-ordination between production and distribution can reduce the need for working capital. Transportation and communication means. If developed helps to reduce the working capital requirement.

OPERATING CYCLE

The operating cycle of the company consists of time period between procurement of the inventory and the collection of the cash from the receivables. The operating cycle is the length of time between the company's outlay on raw materials, wages, and other expenses and inflow of cash from sale of goods. Operating cycle is an important concept in the management of cash and management of working capital. The operating cycles reveals the time that elapses between outlay of cash and inflow of cash.

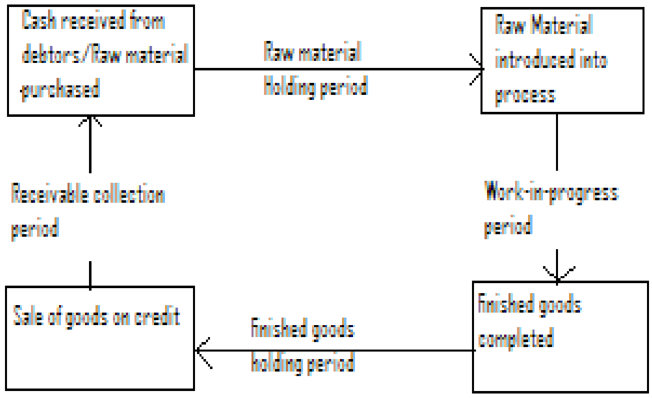


Diagram: OPERATING CYCLE

SOURCES OF WORKING CAPITAL

The company can choose to finance its current assets by

A. Long term sources
B. Short term sources

A. Long term sources of permanent working capital

It includes 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 follow:

A1. 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. Issue of preference shares is also a source of creating working capital

A2. RETAINED EARNINGS

Retain earning accumulated profits are a permanent sources of regular working capital. It is regular and cheapest. It creates not charge on future profits of the enterprises.

A3. 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.

A4. LONG TERM DEBT

Company can raise fund from accepting public deposits, debts from Financial Institution 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.

B. SHORT TERM SOURCES OF TEMPORARY WORKING CAPITAL

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

B1. COMMERCIAL BANK

A commercial bank constitutes a significant source 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.

B2. PUBLIC DEPOSITS

Most of the companies in recent years depend on these sources to meet their short term working capital requirements ranging fro six month to three years.

B3. 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

B4. 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.

SOURCES OF ADDITIONAL WORKING CAPITAL

Sources of additional working capital include the following

- Existing cash reserves
- Profits (when you secure it as cash)
- Payables (credit from suppliers)
- New equity or loans from shareholder
- Bank overdrafts line of credit
- Long term loans

If you have insufficient working capital and try to increase sales, you can easily over stretch the financial resources of the business, this is called overtrading.

POLICIES FOR FINANCING CURRENT ASSETS

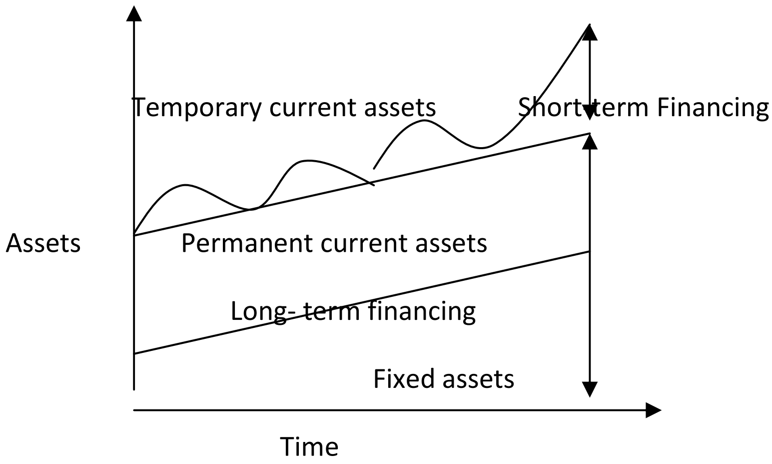
- Long term financing: The sources of long term financing include Ordinary shares, Preference shares, and debentures, long term borrowings from financial institutions and reserves and surplus (retained earnings)
- Short term borrowing: Short term financing include working capital, funds from banks, public deposits, commercial paper and factoring of receivables etc.
- Spontaneous financing: Spontaneous financing refers to the automatic sources of short term funds arising in the normal course of a business. Trade creditors and outstanding expenses are the example of it.

Depending on the mix of short term and long term financing, the approach followed by a company may be referred to as:

A. Matching approach
B. Conservative approach
C. Aggressive approach

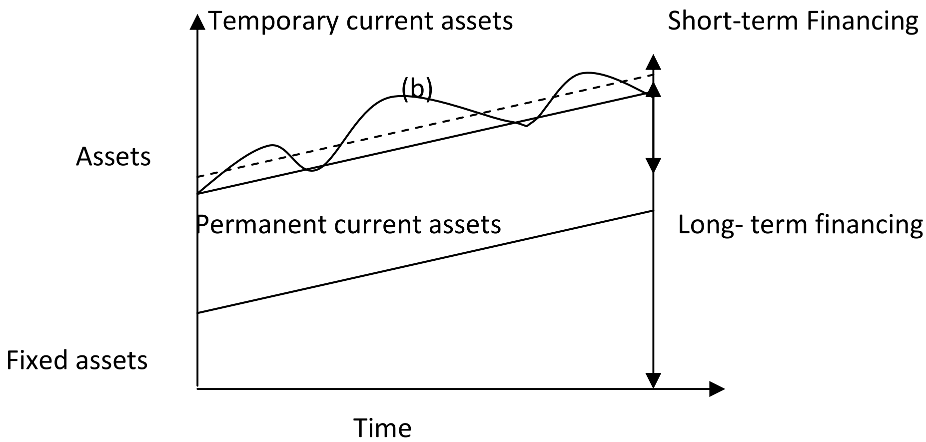
A. MATCHING APPROACH

The firm can adopt a financial plan which matches the expected life of assets with the expected life of the source of funds raised to finance assets. When the firms follow the matching approach (known as hedging approach), long term financing will be used to finance the fixed assets and permanent current assets and short term financing to finance temporary or variable current assets.



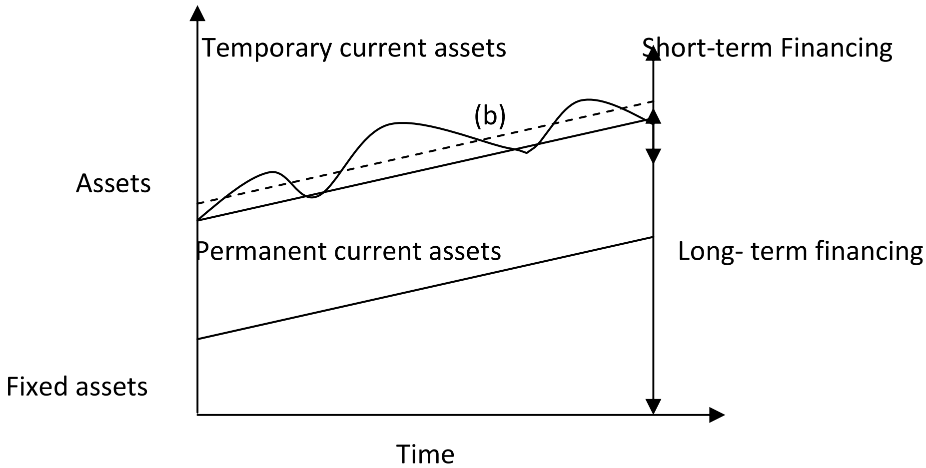
B. CONSERVATIVE APPROACH

The financing policy of the firm is said to be conservative when it depends more on long term funds for financing needs. Under a conservative plan, the firm finances its permanent assets and also a part of temporary current assets with long term financing.



C. AGGRESSIVE APPROACH

A firm may be aggressive in financing its assets. An aggressive policy is said to be followed by the firm when its uses more short term financing than warranted by the matching plan. Under an aggressive policy, the firm finances a part of its permanent current assets with short term financing.



WORKING CAPITAL FINANCING

TANDON COMMITTEE: NORMS AND RECOMMENDATIONS

In 1974, a study group under the chairmanship of Mr. P. L. Tandon was constituted for framing guidelines for commercial banks for follow-up & supervision of bank credit for ensuring proper end-use of funds. The group submitted its report in August 1975, which came to be popularly known as Tandon Committee's Report. Its main recommendations related to norms for inventory and receivables, the approach to lending, style of credit, follow ups & information system.

It was a landmark in the history of bank lending in India. With acceptance of major recommendations by Reserve Bank of India, a new era of lending began in India.

TANDON COMMITTEE'S RECOMMENDATIONS

Breaking away from traditional methods of security oriented lending; the committee enjoyed upon the banks to move towards need based lending. The committee pointed out that the best security of bank loan is a well-functioning business enterprise, not the collateral.

Major recommendations of the committee were as follows:

1. Assessment of need based credit of the borrower on a rational basis on the basis of their business plans.
2. Bank credit would only be supplementary to the borrower's resources and not replace them, i.e. banks would not finance one hundred percent of borrower's working capital requirement.
3. Bank should ensure proper end use of bank credit by keeping a closer watch on the borrower's business, and impose financial discipline on them.
4. Working capital finance would be available to the borrowers on the basis of industry wise norms (prescribe first by the Tandon Committee and then by Reserve Bank of India) for holding different current assets, viz.

- Raw materials including stores and others items used in manufacturing process.
- Stock in Process.
- Finished goods.
- Accounts receivables.

5. Credit would be made available to the borrowers in different components like cash credit; bills purchased and discounted working capital, term loan, etc., depending upon nature of holding of various current assets.
6. In order to facilitate a close watch under operation of borrowers, bank would require them to submit at regular intervals, data

regarding their business and financial operations, for both the past and the future periods.

THE NORMS

Tandon committee had initially suggested norms for holding various current assets for fifteen different industries. Many of these norms were revised and the least extended to cover almost all major industries of the country.

EXPRESSION OF NORMS

The norms for holding different current assets were expressed as follows:

- Raw materials as so many months' consumption. They include stores and other items used in the process of manufacture.
- Stock-in-process, as so many months' cost of production.
- Finished goods and accounts receivable as so many months' cost of sales and sales respectively. These figures represent only the average levels. Individual items of finished goods and receivables could be for different periods which could exceed the indicated norms so long as the overall average level of finished goods and receivables does not exceed the amounts as determined in terms of the norm.
- Stock of spares was not included in the norms. In financial terms, these were considered to be a small part of total operating expenditure. Banks were expected to assess the requirement of spares on case-by-case basis. However, they should keep a watchful eye if spares exceed 5% of total inventories.

Suggested norms for inventory and receivables as suggested by the Tandon Committee are given in Annexure (I).

The norms were based on average level of holding of a particular current asset, not on the individual items of a group. For example, if receivables holding norms of an industry was two months and an unit had satisfied this norm, calculated by dividing annual sales with average receivables, then the unit would not be asked to delete some of the accounts receivable, which were being held for more than two months.

The Tandon committee while laying down the norms for holding various current assets made it very clear that it was against any rigidity and straight jacketing. On one hand, the committee said that norms were to be regarded as the outer limits for holding different current assets, but these were not to be considered to be entitlements to hold current assets upto this level. If a borrower had managed with less in the past, he should continue to do so. On the other hand, the committee held that allowance must be made for some flexibility under circumstances justifying a need for re-examination. The committee itself visualized that there might be deviations of norms in the following circumstances.

- Bunched receipt of raw materials including imports.
- Interruption of production due to power cuts, strikes or other unavoidable circumstances.
- Transport delays or bottlenecks.
- Accumulation of finished goods due to non-availability of shipping space for exports or other disruption in sales.
- Building up of stocks of finished goods, such as machinery, due to failure on the part of the purchaser for whom these were specifically designed and manufactured.
- Need to cover full or substantial requirement of raw materials for specific export contract of short duration.

While allowing the above exceptions, the committee observed that the deviations should be for known and specific circumstances and situation, and allowed only for a limited period to tide over the temporary difficulty of a borrowing unit. Returns to norms would be automatic when conditions return to normal.

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