MBA(HA) 2nd Semester

Financial Management MHA-206

Current Assets Management Unit-4

MEANING OF WORKING CAPITAL

Capital of the concern may be divided into two major headings.

Fixed capital means that capital, which is used for long-term investment of the business concern. For example, purchase of permanent assets. Normally it consists of non-recurring in nature.
Working Capital is another part of the capital which is needed for meeting day to day requirement of the business concern. For example, payment to creditors, salary paid to workers, purchase of raw materials etc., normally it consists of recurring in nature. It can be easily converted into cash. Hence, it is also known as short-term capital.

Definitions

J.S.Mill, "The sum of the current asset is the working capital of a business".
Bonneville, "Any acquisition of funds which increases the current assets, increase working capital also for they are one and the same".
Weston and Brigham, "Working Capital refers to a firm's investment in short-term assets, cash, short-term securities, accounts receivables and inventories".

Concepts of Working Capital:

There are two concepts of working capital namely gross working capital and net working capital.

(i) **Gross Working Capital:** It is also called simply 'working capital'. It refers to the total of all the current assets of the firm. Current assets are the assets which are meant to be converted into cash within a year or an operating cycle. Stock of raw materials, stock of semi-finished goods, stock of finished goods, trade debtors, bills receivable, prepaid expenses, cash at bank and cash in hand are examples of current assets.

(ii) **Net Working Capital:** For financing current assets, long-term funds as well as short term funds are used. Short-term funds are provided by current liabilities i.e. claims of outsiders which are expected to mature for payment within a year. Trade creditors, bills payable and outstanding expenses are examples of current liabilities. Net working capital refers to the excess of current assets over current liabilities.

Suppose the total current assets and total current liabilities of a firm amount to Rs 80,000 and Rs 40,000 respectively. Then, gross working capital of the firm is Rs 80,000 while net working capital of the firm is Rs 40,000 and this sum of Rs 40,000 will be financed by long-term funds. Thus, net working capital is that part of the working capital which is financed by long-term funds.

Generally, current assets far exceed current liabilities. It is considered ideal those current assets are twice as much as current liabilities. Even in unfavourable situations, current assets are likely to be more than current liabilities.

In a very rare case, current liabilities may be more than current assets. It means that there is a negative net working capital. It is a very serious situation indicating that short- term funds are being used to meet a part of the long-term capital requirements.

TYPES OF WORKING CAPITAL

Working Capital may be classified into three important types on the basis of time.

Permanent Working Capital

It is also known as Fixed Working Capital. It is the capital; the business concern must maintain certain amount of capital at minimum level at all times. The level of Permanent Capital depends upon the nature of the business. Permanent or Fixed Working Capital will not change irrespective of time or volume of sales.

Temporary Working Capital

It is also known as variable working capital. It is the amount of capital which is required to meet the Seasonal demands and some special purposes. It can be further classified into Seasonal Working Capital and Special Working Capital. The capital required to meet the seasonal needs of the business concern is called as Seasonal Working Capital. The capital required to meet the special exigencies such as launching of extensive marketing campaigns for conducting research, etc.

Semi Variable Working Capital

Certain amount of Working Capital is in the field level up to a certain stage and after that it will increase depending upon the change of sales or time.

NEEDS OF WORKING CAPITAL

Working Capital is needed for the following purposes.

1Purchase of raw materials and spares
2. Payment of wages and salary
3. Day-to-day expenses
4. Provide credit obligations

Importance of working capital

Working capital is a vital part of a business and can provide the following advantages to a business:

1.Higher return on capital: Firms with lower working capital will post a higher return on capital. Therefore, shareholders will benefit from a higher return for every dollar invested in the business.

2.Improved credit profile and solvency: The ability to meet short-term obligations is a pre-requisite to long-term solvency. And it is often a good indication of counterparty's credit risk. Adequate working capital management will allow a business to pay on time its short-term obligations. This could include payment for a purchase of raw materials, payment of salaries, and other operating expenses.

3.Higher profitability: According to research conducted by Tauringana and Adjapong Afrifa, the management of account payables and receivables is an important driver of small businesses' profitability.

4.Higher liquidity: A large amount of cash can be tied up in working capital, so a company managing it efficiently could benefit from additional liquidity and be less dependent on external financing. This is especially important for smaller businesses as they typically have limited access to external funding sources.

Also, small businesses often pay their bills in cash from earnings so efficient working capital management will allow a business to better allocate its resources and improve their cash management.

5. Increased business value: Firms with more efficient working capital management will generate more free cash flows which will result in higher business valuation and enterprise value.
6. Favorable financing conditions: A firm with a good relationship with its trade partners and paying its suppliers on time will benefit from favorable financing terms such as discount payments from its suppliers and banking partners.
7. Uninterrupted production: A firm paying its suppliers on time will also benefit from a regular flow of raw materials, ensuring that the production remains uninterrupted and clients receive their goods on time.
8. Ability to face shocks and peak demand: Efficient working capital management will help a firm to survive through a crisis or ramp up production in case of an unexpectedly large order.
Competitive advantage: Firms with an efficient supply chain will often be able to sell their products at a discount versus similar firms with inefficient sourcing.

Factors Determining Working Capital Requirement

The following are the major factors which are determining the Working Capital requirements.
Basic Nature of Business: Working Capital of the business concerns largely depend upon the nature of the business. If the business concerns follow rigid credit policy and sell goods only for cash, they can maintain lesser amount of Working Capital. A transport company maintains lesser amount of Working Capital while a construction company maintains larger amount of Working Capital.
Business Cycle Fluctuations: Business fluctuations lead to cyclical and seasonal changes in the business condition and it will affect the requirements of the Working Capital. In the booming conditions, the Working Capital requirement is larger and in the depression condition, requirement of Working Capital will reduce. Better business results lead to increase the Working Capital requirements.
Seasonal Operations: If a firm is operating in goods and services having seasonal fluctuations in demand, then the working capital requirement will also fluctuate with every change. In a knitwear factory, the demand will certainly be higher during winter season and therefore, more working capital is required to maintain higher production, in the form of large inventories and biggaer recaeivables.

Market Competitiveness: In a view of the competitive conditions prevailing in the market, the firm may have to offer liberal credit terms to the customers resulting in higher debtors. Even larger inventories may be maintained to serve an order as and when received; therwise the customer may go to some other supplier. Thus the working capital tends to be high as a result of greater investment in inventories and receivable.

Credit Policy: Credit policy of sales and purchase also affect the Working Capital requirements of the business concern. If the company maintains liberal credit policy to collect the payments from its customers, they have to maintain more Working Capital. If the company pays the dues on the last date it will create the cash maintenance in hand and bank.

Supply Condition: The time taken by a supplier of raw materials, goods etc., after placing an order, also determines the working capital requirement

Computation of working capital

How to calculate the Working Capital needs of the business concern? It may also depend upon various factors but some of the common methods are used to estimate the Working Capital.
1. Estimation of components of working capital method : Working capital consists of various current assets and current liabilities. Hence, we have to estimate how much current assets as

inventories required and how much cash required to meet the short term obligations. Finance Manager first estimates the assets and required Working Capital for a particular period.

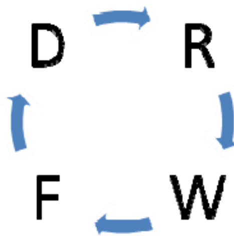
2.Percent of sales method: Based on the past experience between Sales and Working Capital requirements, a ratio can be determined for estimating the Working Capital requirement in future. It is the simple and tradition method to estimate the Working Capital requirements Under this method, first we have to find out the sales to Working Capital ratio and based on that we have to estimate Working Capital requirements. This method also expresses the relationship between the Sales and Working Capital.

3.Operating cycle: Working Capital requirements depend upon the operating cycle of the business. The operating cycle begins with the acquisition of raw material and ends with the collection of receivables.

Operating cycle consists of the following important stages:

1. Raw Material and Storage Stage, (R)
2. Work in Process Stage, (W)
3. Finished Goods Stage, (F)
4. Debtors Collection Stage, (D)
5. Creditors Payment Period Stage. (C)

O = R + W + F + D–C



Working Capital Cycle

Each component of the operating cycle can be calculated by the following formula:

R = Average Stock of Raw Material / Average Raw Material Consumption Per Day

W= Average Work in Process Inventory/Average Cost of Production Per Day

F = Average Finished Stock Inventory/Average Cost of Goods Sold Per Day

D = Average Book Debts/Average Credit Sales Per Day

C = Average Trade Creditors ./Average Credit Purchase Per Day

WORKING CAPITAL MANAGEMENT POLICY

Working Capital Management formulates policies to manage and handle efficiently; for that purpose, the management established three policies based on the relationship between Sales and Working Capital.

1. Conservative working capital policy: Conservative Working Capital Policy refers to minimize risk by maintaining a higher level of Working Capital. This type of Working Capital Policy is suitable to meet the seasonal fluctuation of the manufacturing operation.

2. Moderate working capital policy: Moderate Working Capital Policy refers to the moderate level of Working Capital maintainance according to moderate level of sales. It means one percent of change in Working Capital, that is Working Capital is equal to sales.

3. Aggressive working capital policy: Aggressive Working Capital Policy is one of the high risky and profitability policies which maintains low level of Aggressive Working Capital against the high level of sales, in the business concern during a particular period

SOURCES OF WORKING CAPITAL

Working Capital requirement can be normalized from short-term and long-term sources. Each source will have both merits and limitations up to certain extract. Uses of Working Capital may be differing from stage to stage.

The above sources are also classified into internal sources and external sources of working capital.
1. Internal sources such as:
• Retained Earnings
• Reserve and Surplus
• Depreciation Funds etc.
2. External sources such as:
• Debentures and Public Deposits
• Loans from Banks and Financial Institutions
• Advances and Credit
• Financial arrangements like Factoring, etc.

Management of Cash

Cash is the money which a business concern can disburse immediately without any restriction. The term cash includes coins, currency, cheques held by the business concern and balance in its bank accounts. Management of cash consists of cash inflow and outflows, cash flow within the concern and cash balance held by the concern etc.
The term cash not only includes coins, currency notes, cheques, bank draft, demand deposits with banks but also the near cash assets like marketable securities and Narrow Sense Broader Sense time deposits with bank Cash in Hand i.e. because they can readily currency notes & Cash & its converted into cash. equipment i.e. cash coins at Bank, short term investment.

Although cash is only 1-3% of total current assets but its management is very important.

Motives for Holding Cash

1. **Transaction motive**
It is a motive for holding cash or near cash to meet routine cash requirements to finance transaction in the normal course of business. Cash is needed to make purchases of raw materials, pay expenses, taxes, dividends etc.
2. **Precautionary motive**
It is the motive for holding cash or near cash as a cushion to meet unexpected contingencies. Cash is needed to meet the unexpected situation like, floods strikes etc.
3. **Speculative motive**
It is the motive for holding cash to quickly take advantage of opportunities typically outside the normal course of business. Certain amount of cash is needed to meet an opportunity to purchase raw materials at a reduced price or make purchase at favorable prices.
4. **Compensating motive**
It is a motive for holding cash to compensate banks for providing certain services or loans. Banks provide variety of services to the business concern, such as clearance of cheque, transfer of funds etc.

Objectives of Cash Management

- To maintain optimum cash balance
- Tokeep the optimum cash balance requirements at minimum level by prompt collection & late disbursement etc.

Cash Management Techniques

Managing cash flow constitutes two important parts:

(A) Speedy Cash Collections

Business concern must concentrate in the field of Speedy Cash Collections from customers. For that, the concern prepares systematic plan and refined techniques. These techniques aim at, the customer who should be encouraged to pay as quickly as possible and the payment from customer without delay. Speedy Cash Collection business concern applies some of the important techniques as follows:
(i)Prompt Payment by Customers
Business concern should encourage the customer to pay promptly with the help of offering discounts, special offer etc. It helps to reduce the delaying payment of customers and the firm can avoid delays from the customers. The firms may use some of the techniques for prompt payments like billing devices, self address cover with stamp etc.

(ii)Early Conversion of Payments into Cash
Business concern should take careful action regarding the quick conversion of the payment into cash. For this purpose, the firms may use some of the techniques like postal float, processing float, bank float and deposit float.
(iii)Concentration Banking
It is a collection procedure in which payments are made to regionally dispersed collection centers, and deposited in local banks for quick clearing. It is a system of decentralized billing and multiple collection points.
(iv)Lock Box System
It is a collection procedure in which payers send their payment or cheques to a nearby post box that is cleared by the firm's bank. Several times that the bank deposit the cheque in the firms account. Under the lock box system, business concerns hire a post office lock box at important collection centers where the customers remit payments. The local banks are authorized to open the box and pick up the remittances received from the customers. As a result, there is some extra savings in mailing time compared to concentration bank.

(B) Slowing Disbursement

An effective cash management is not only in the part of speedy collection of its cash and receivables but also it should concentrate to slowing their disbursement of cash to the customers or suppliers. Slowing disbursement of cash is not the meaning of delaying the payment or avoiding the payment. Slowing disbursement of cash is possible with the help of the following methods:
(i) **Avoiding the early payment of cash**
The firm should pay its payable only on the last day of the payment. If the firm avoids early payment of cash, the firm can retain the cash with it and that can be used for other purpose.
(ii)**Centralised disbursement system**
Decentralized collection system will provide the speedy cash collections. Hence centralized disbursement of cash system takes time for collection from our accounts as well as we can pay on the date.

Cash Management Models

Cash management models analyse methods which provide certain framework as to how the cash management is conducted in the firm. Cash management models are the development of the theoretical concepts into analytical approaches with the mathematical applications. There are three cash management models which are very popular in the field of finance.

1. Baumol model

The basic objective of the Baumol model is to determine the minimum cost amount of cash conversion and the lost opportunity cost. It is a model that provides for cost efficient transactional balances and assumes that the demand for cash can be predicated with certainty and determines the optimal conversion size.
Total conversion cost per period can be calculated with the help of the following formula:
$t = \frac{Tb}{C}$
where,
T = Total transaction cash needs for the period
b = Cost per conversion
C = Value of marketable securities
Opportunity cost can be calculated with the help of the following formula;
$i = \frac{C}{2}$ C/2
where,
i = interest rate earned
C/2 = Average cash balance
Optimal cash conversion can be calculated with the help of the following formula;
$C = \frac{\sqrt{2bT}}{i}$
where,

C = Optimal conversion amount
b = Cost of conversion into cash per lot or transaction
T = Projected cash requirement
i = interest rate earned

2. Miller-Orr model

This model was suggested by Miller Orr. This model is to determine the optimum cash balance level which minimises the cost of management of cash. Miller-Orr Model can be calculated with the help of the following formula;

$$C = \frac{bE(N)}{t} + iE(M)$$

where,
C = Total cost of cash management
b = fixed cost per conversion
E(M) = expected average daily cash balance
E (N) = expected number of conversion
t = Number of days in the period
i = lost opportunity cost

***3.* Orgler's model**

Orgler model provides for integration of cash management with production and other aspects of the business concern. Multiple linear programming is used to determine the optimal cash management.
Orgler's model is formulated, based on the set of objectives of the firm and specifing the set of constrains of the firm.

Receivables Management

It is an asset owed to the firm by the buyer out of the credit sales with the terms and conditions of repayment on an agreed time period.

Meaning of the receivables management*:* The receivables out of the credit sales crunch the availability of the resources to meet the day today requirements. The acute competition requires the firm to sustain among the other competitors through more volume of credit sales and in the intention of retaining the existing customers. This requires the firm to sell more through credit sales only in order to encourage the buyers to grab the opportunities unlike the other competitors they offer in the market.

Objectives of Accounts Receivables

1. Achieving the growth in the volume of sales
2. Increasing the volume of profits
3. Meeting the acute competition

Cost of Maintaining the Accounts Receivables

4. **Capital cost:** Due to in sufficient amount of working capital with reference to more volume of credit sales which drastically affects the existence of the working capital of the firm. The firm may be required to borrow which may lead to pay certain amount of interest on the borrowings. The interest which is paid by the firm due to the borrowings in order to meet the shortage of working capital is known as capital cost of receivables.
5. Administrative cost*:* Cost of maintaining the receivables.

Collection cost: Whatever the cost incurred for the collection of the receivables are known as collection cost.

Defaulting cost*:* This may arise due to defaulters and the cost is in other words as cost of bad debts and so on.

Factors Affecting the Accounts Receivables

Level of sales: The volume of sales is the best indicator of accounts receivables. It differs from one firm to another.

Credit policies: The credit policies are another major force of determinant in deciding the size of the accounts receivable. There are two types of credit policies viz lenient and stringent credit policies.

Lenient credit policy: Enhances the volume of the accounts receivable due to liberal terms of the trade which normally encourage the buyers to buy more and more.

Stringent credit policy: It curtails the motive buying the goods on credit due stiff terms of the trade put forth by the supplier unlike the earlier.

Terms of trade: The terms of the trade are normally bifurcated into two categories viz credit period and cash discount

Credit period: Higher the credit period will lead to more volume of receivables, on the other side that will lead to greater volume of debts from the side of buyers.

Cash discount: If the discount on sales is more, that will enhance the volume of sales on the other hand that will affect the income of the enterprise.

Management of Accounts Payable/Financing the Resources

It is more important at par with the management of receivable, in order to avail the short term resources for the smooth conduct of the firm.