***CHAPTER TWO***

***PRINCIPLES OF WORKING CAPITAL MANAGEMENT***

Every business needs funds for short-term purposes to finance current operations. Investment in short term assets like cash, inventories, debtors etc., is called ‘Short-term Funds’ or ‘Working Capital’. The ‘Working Capital’ can be categorized, as funds needed for carrying out day-to-day operations of the business smoothly.

Working capital management is the administration of the company’s current assets and the financing needed to support current assets. “Working capital management is an act of planning, organizing and controlling the components of working capital like cash, bank balance, inventory, receivables, payables, overdraft and short-term loans.”

Working capital management is the administration of current assets and current liabilities. Effective management of working management ensures that the organization is maximizing the benefits from net current assets by having an optimum level to meet working capital demands.

Working capital management is concerned with the problems that arise in attempting to manage the current assets, current liabilities and the interrelationship that exist between them.

The objective of working capital management is to manage the company’s current assets and liabilities in a way that a reasonable level of working capital is maintained. If a company is unable to keep up a suitable level of working capital; it is likely to turn out to be bankrupt and may even be forced into insolvency. The current assets must be adequate to cover up its current liabilities in order to make sure a rational margin of well-being. Each of the current assets must be managed effectively in order to keep up the liquidity of the company whilst not retaining too high level of any one of those.

* 1. **The Concept of Working Capital Management**

There are two major concepts of working capital – *net* working capital and *gross* working capital. When accountants use the term *working capital*, they are generally referring to **net** **working capital**, which is the difference between current assets and current liabilities. This is one measure of the extent to which the firm is protected from liquidity problems.

Financial analysts, on the other hand, mean current assets when they speak of working capital. Therefore, their focus is on **gross working capital**. Because it does make sense for the financial manager to be involved with providing the correct amount of current assets for the firm at all times, we will adopt the concept of gross working capital. As the discussion of **working capital management** unfolds, our concern will be to consider the administration of the firm’s current assets – namely, cash and marketable securities, receivables, and inventory – and the financing (especially current liabilities) needed to support current assets.

* 1. **Operating and cash conversion cycle**

**Working Capital Cycle (Operating, Trading, Cash Cycle)**

The working capital cycle measures the time between paying for goods supplied to you and the final receipt of cash to you from their sale. It is desirable to keep the cycle as short as possible as it increases the effectiveness of working capital. The diagram below shows how the cycle works:

**Trade receivables**

Customers owing money, as sales made on credit

**Trade payables**

Money owing to suppliers as stock purchased on credit

**Inventories**

Sold on credit

**Cash**

The table below shows how the activities of a business have an impact on the cash flow:

|  |  |
| --- | --- |
| Trade Process | Effects on Cash |
| Inventories are purchased on credit which creates trade payables. | Inventories bought on credit temporarily help with cash flow as there is no immediate to pay for these inventories. |
| The sales of inventories is made on credit which creates trade receivables. | This means that there is no cash inflow even though inventory has been sold. The cash for the sold inventory will be received later. |
| Trade payable need to be paid and the cash is collected from the trade receivables. | The cash has to be collected from the trade receivables and then paid to the trade payables otherwise there is a cash flow problem. |

The control of working capital is ensuring that the company has enough cash in its bank. This will save on bank interest and charges on overdrafts. The company also needs to ensure that the level of inventories and trade receivables is not too great, as this means funds are tied up in assets with no returns (known as the opportunity cost). The working capital cycle therefore should be kept to a minimum to ensure efficient and cost effective management.

The shorter the cycle, the better it is for the company as it means:

* Inventories are moving through the organization rapidly.
* Trade receivables are being collected rapidly.
* The organization is taking the minimum credit possible from suppliers.

The shorter the cycle, the lower the company's reliance on external supplies of finance like bank overdrafts which is costly.

Excessive working capital means too much money is invested in inventories and trade receivables. This represents:

* Lost interest or excessive interest paid and
* lost opportunities (the funds could be invested elsewhere and earn a high return).

The longer the working capital cycle, the more capital is required to finance it.

* 1. **Permanent and Variable Working Capital**

Having defined working capital as current assets, it can now be classified according to

***Components***, such as cash, marketable securities, receivables, and inventory ***Time***, as either permanent or temporary.

Though the *components* of working capital are self-explanatory, classification by *time* requires some explanation. A firm’s **permanent working capital** is the amount of current assets required to meet long-term minimum needs to ensure effective utilization of fixed assets and for maintaining the circulation of current assets. There is always a minimum level of current assets which is continuously required by the enterprise to carry out its normal business operations. You might call this “bare bones” working capital. **Temporary working capital**, on the other hand, is the investment in current assets that varies with seasonal requirements, to meet the seasonal demands and some special contingencies. The firm’s changing needs for working capital over time while highlighting both the temporary and permanent nature of those needs.

Permanent working capital is similar to the firm’s fixed assets in two important respects. First, the dollar investment is long term, despite the seeming contradiction that the assets being financed are called “current.” Second, for a growing firm, the level of permanent working capital needed will increase over time in the same way that a firm’s fixed assets will need to increase over time. However, permanent working capital is different from fixed assets in one very important respect – it is constantly changing.

* 1. **Determinants of working capital management**

Both unnecessary and insufficient investments in working capital components are dangerous for a company. Therefore, the finance executive has to scrutinize all the factors which decide the working capital necessities within the hypothetical and realistic points of view. The hypothetical considerations from time to time control the tactic of assessment; whilst the company is forced to follow the restrictions forced by the borrowers. The finance executive, therefore, ought to think all the factors that have a bearing on the working capital as well as on the cash, receivables and inventory. There are no laid down regulations or formulae to decide the working capital necessity of a company. A huge number of factors, every one having a diverse significance, affect the working capital requirement of a company. Also, the magnitude of factors varies for a company over time. Therefore, a study of applicable factors ought to be made in turn to settle on total investment in working capital. It is not probable to grade determinants of working capital since all such factors are of various degrees of significance and the power of individual factor may vary for a company over time. The following are vital factors normally affecting the working capital necessities of a company:

* Environment of Business
* Sales and Demand Conditions
* Technology and production policy
* Credit Policy
* Availability of Credit
* Working effectiveness
* Changes in price level
  1. **Financing Current Assets**

Within a business, funds are required to finance both non-current and current assets. The level of current assets fluctuates, although there tends to be an underlying level required for current assets.

There are ***three types of working capital financing Strategies/ policies*** alternatively used by firms. Those are:

* Maturity Matching or Moderate strategy.
* Aggressive strategy
* Conservative strategy

**Hedging (Maturity Matching) Financing Strategy**

If the firm adopts a **hedging (maturity matching) approach** to financing, each asset would be offset with a financing instrument of the same approximate maturity. Short-term or seasonal variations in current assets would be financed with short-term debt; the permanent component of current assets and all fixed assets would be financed with long-term debt or with equity. If total funds requirements behave in the manner shown, only the short-term fluctuations would be financed with short-term debt. The rationale for this is that if long-term debt is used to finance short-term needs, the firm will be paying interest for the use of funds during times when these funds are not needed.

A hedging (maturity matching) approach to financing suggests that apart from current installments on long-term debt, a firm would show no current borrowings at the seasonal troughs for asset needs. As the firm moved into a period of seasonal asset needs, it would borrow on a short-term basis, paying off the borrowings with the cash released as the recently financed temporary assets were eventually reduced.

***Short-term financing***

***Current Assets***

***Long-term financing***

***Fixed Assets***

Although an exact matching of the firm’s schedule of future net cash flows and the debt payment schedule is appropriate under conditions of certainty, it is usually not appropriate when uncertainty exists. Net cash flows will deviate from expected flows in keeping with the firm’s business risk. As a result, the schedule of maturities of the debt is very significant in assessing the risk-profitability trade-off. The question is: What margin of safety should be built into the maturity schedule to allow for adverse fluctuations in cash flows? This depends on management’s attitude to the trade-off between risk and profitability.

**Conservative Financing Strategy**

Differences in risk between short- and long-term financing must be balanced against differences in interest costs. The longer the maturity schedule of a firm’s debt, the more costly the financing is likely to be. In addition to the generally higher costs of long-term borrowings, the firm may well end up paying interest on debt over periods of time when the funds are not needed. Thus there are cost inducements to finance funds requirements on a short-term basis. Consequently, we have a trade-off between risk and profitability. We have seen that, in general, short-term debt has greater risk than long-term debt but also less cost. The margin of safety provided by the firm can be thought of as the lag between the firm’s expected net cash flow and the contractual payments on its debt. This margin of safety will depend on the risk preferences of management. In turn, management’s decision on the maturity composition of the firm’s debt will determine the portion of current assets financed by current liabilities and the portion financed on a long-term basis.

Thus, in conservative financing policy, the entire non-current asset, permanent current asset and some of the temporary current assets are financed by long-term finance.

***Short-term financing***

***Current Assets***

***Long-term financing***

***Fixed Assets***

**Aggressive Financing Strategy**

In aggressive financing strategy, there is a *negative* margin of safety. The firm has financed part of its permanent current assets with short-term debt. As a result, it must refinance this debt at maturity, and this involves an element of risk. The greater the portion of the permanent asset needs financed with short-term debt, the more aggressive the financing is said to be.

Thus, in aggressive financing strategy, all the non-current assets and part of permanent current assets are financed by long-term finance. Remaining permanent current assets and all temporary fluctuating current assets are financed by short-term finance.

***Short-term financing***

***Current Assets***

***Long-term financing***

***Fixed Assets***