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The Management of Working Capital

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THE MANAGEMENT OF WORKING CAPITAL

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INTRODUCTION

Generally, working capital typically means the firm's current or short-term assets such as cash, receivables, inventory and marketable securities. These items are also referred to as circulating* capital.

Working capital management is concerned with the problems that arise in attempting to manage the current assets, the current liabilities and the interrelations that exist between them. As we know, current assets refer to those assets which in the ordinary course of business can be, or will be, converted into cash within one year without undergoing a diminution in value and without disrupting the operations of the firm. For instance, cash, marketable securities, accounts receivable and inventory. By the way, current liabilities are those liabilities that are intended, at their inception, to be paid in the ordinary course of business, within a year, out of the current assets or the earnings of the concern. For example, it is possible to be mentioned accounts payable, bills payable, bank overdraft and outstanding expenses.

OBJECTIVE OF WORKING CAPITAL MANAGEMENT

As already mentioned above, basically, the main purpose of working capital management is to manage the firm's current assets and liabilities in such a way that a satisfactory level of working capital is maintained. From this point of view, it can be clearly seen that the interaction between current assets and current liabilities is, therefore the main theme of the theory of the working capital management.

CONCEPTS OF WORKING CAPITAL

According to the real process of working capital, we can say working capital is the capital you require for the working for example, functioning of your business in the short run. There are two possible interpretations of working capital concept:

- ✓ Gross working capital- refers to the firm's investment in the current assets and includes cash, short term securities, debtors, bills receivables and inventories.

It is necessary to concentrate on the fact that the investment in the current assets should be neither excessive nor inadequate.

- ✓ Net working capital- generally refers to the difference between the current assets and the current liabilities.

* *Circulation capital means assets of a company that are changed in the ordinary course of business from one form to another, as for example, from cash to inventories to receivable, receivable to cash.*

Current liabilities are those claims of outsiders, which are expected to mature for the payment within an accounting year include creditors, bills payable, bank overdraft and outstanding expenses.

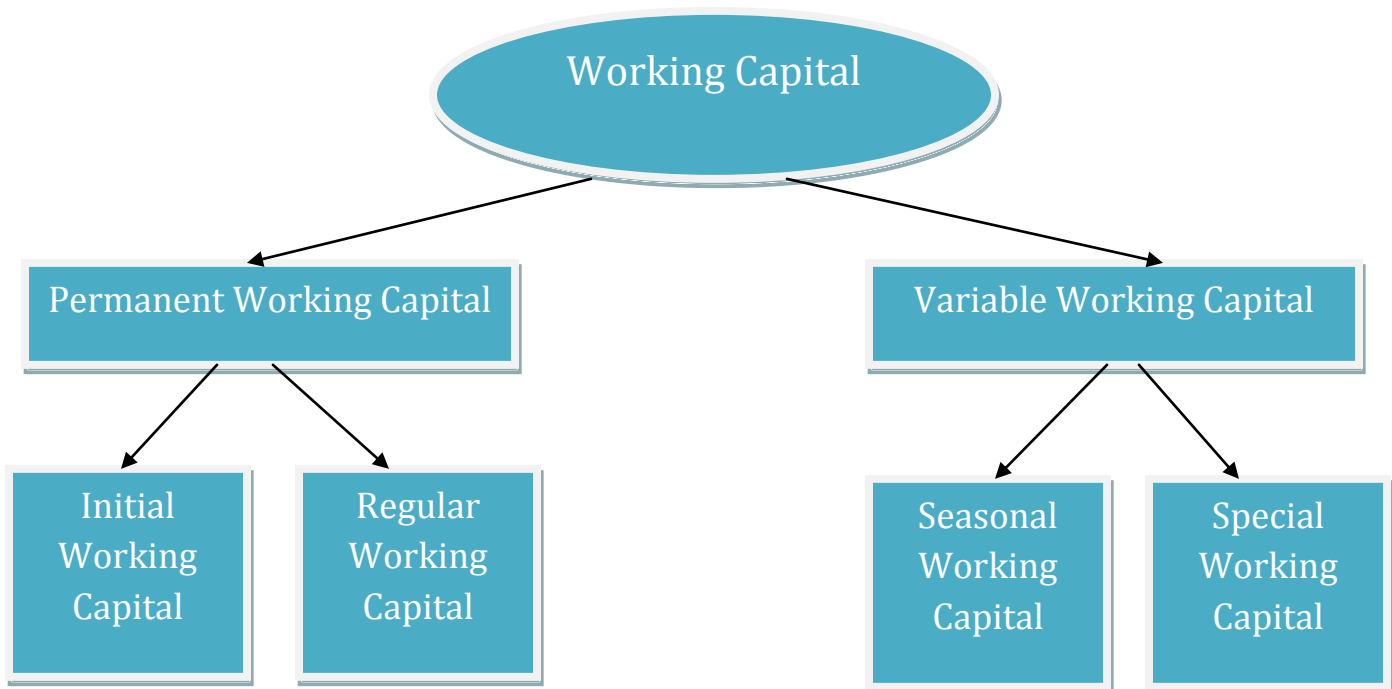
When current assets exceed current liabilities it is called positive working capital and when current liabilities exceed current assets it is called negative working capital.

TYPES OF WORKING CAPITAL MANAGEMENT

Commonly, there are two types of working capital are needed in the business:

1. Permanent Working Capital
2. Variable Working Capital

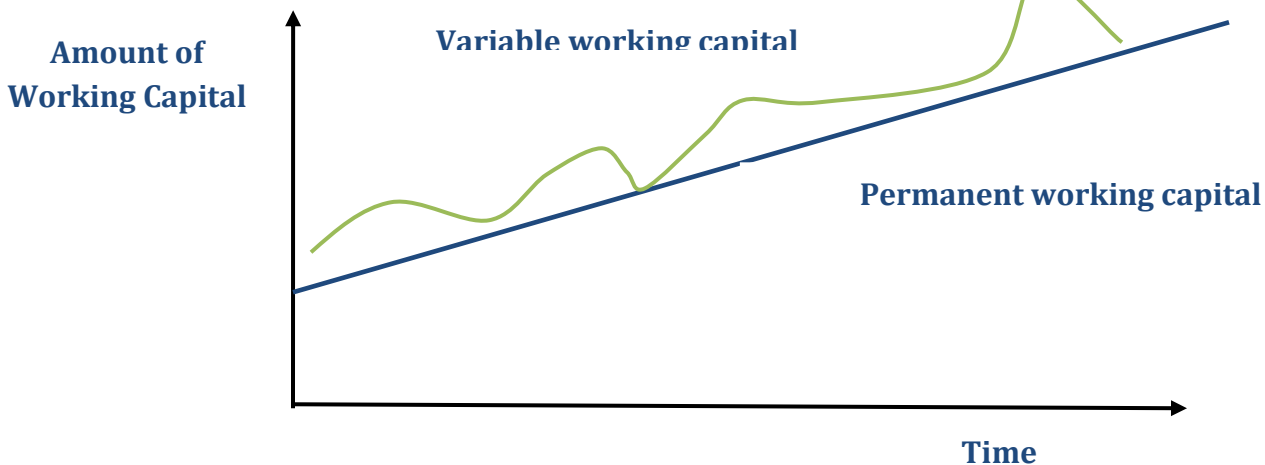
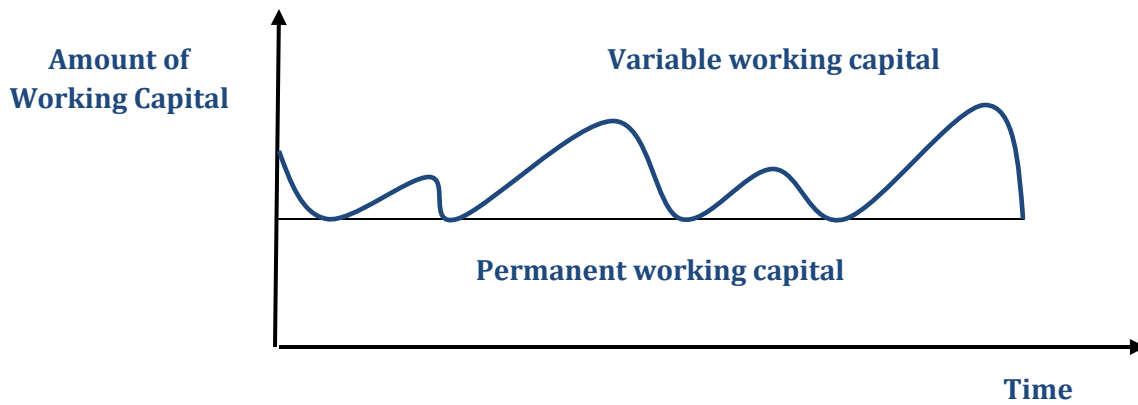
These two types of working capital can also be classified as under:



Permanent working capital: This is the minimum level of current assets, which is continuously required by the firm to carry on its business operations. It is permanent in the same way as the firm's fixed assets are. Depending upon the changes in the production and sales, the need for working capital, over and above the permanent working capital, will fluctuate.

Variable working capital: This is the working capital which, keeps on changing with the change in the production and sales activities. It is the extra working capital, over the above the permanent working capital, that is needed to support the changing production and sales activities. This type of working capital is also called as fluctuating or variable working capital.

The difference between the permanent and variable working capital may be represented in the following two diagrams:



Difference between permanent and variable working capital

THE POLICY OF WORKING CAPITAL MANAGEMENT

An important aspect of working capital policy is to maintain and provide sufficient liquidity to the firm. The decision on how much working capital be maintained involves a trade-off,

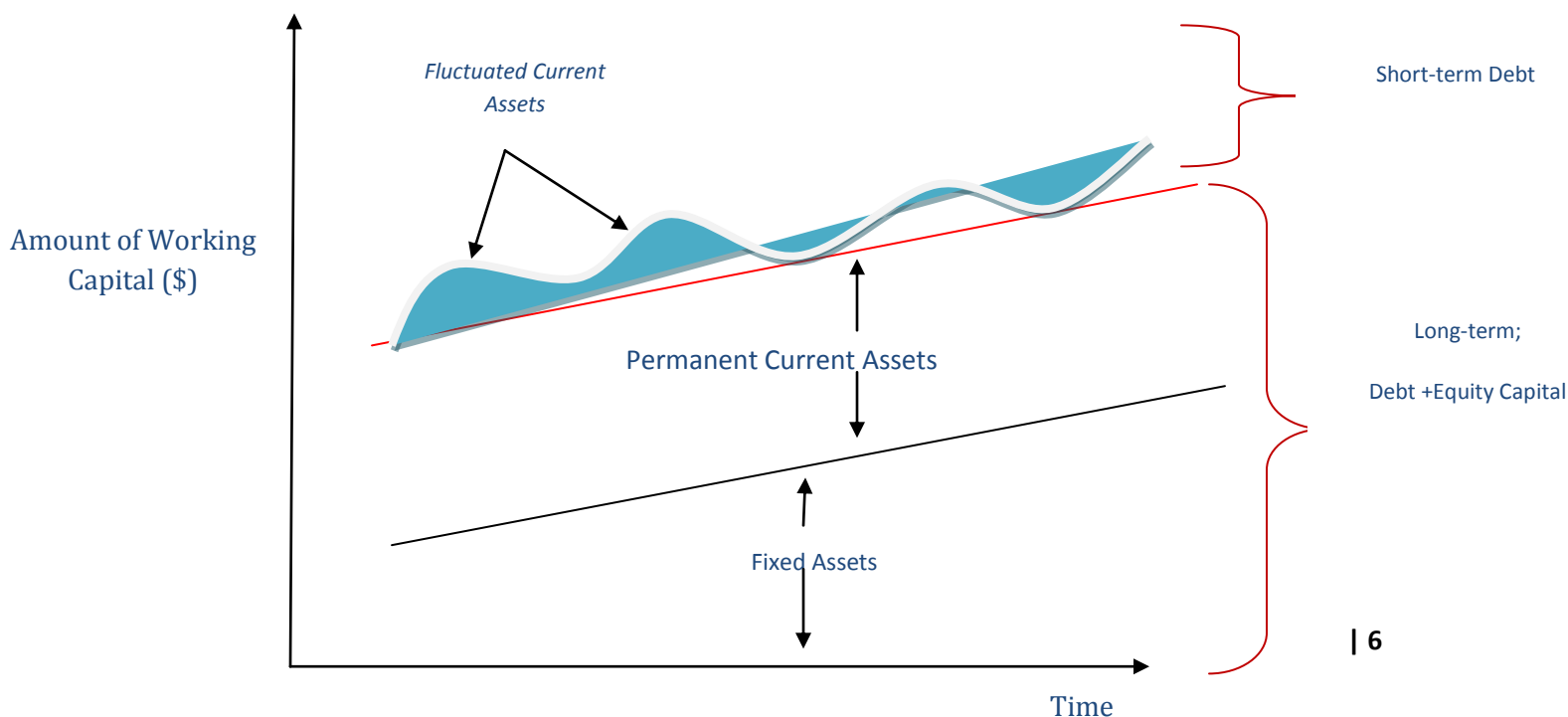
for instance, having a large net working capital may reduce the liquidity-risk faced by the firm, but it can have a negative effect on the cash flows. That's why the net effect on the value of the firm should be used to determine the optimal amount of working capital.

Generally three types of working capital policy are accepted, (!) Moderate working capital policy; (!!) Conservative working capital policy; (!!!) The Aggressive working capital policy. Actually, these policies describe the relationship between the sales level and the level of current assets.

In other words, determine an appropriate financial-mix, it can be used mostly three approaches:

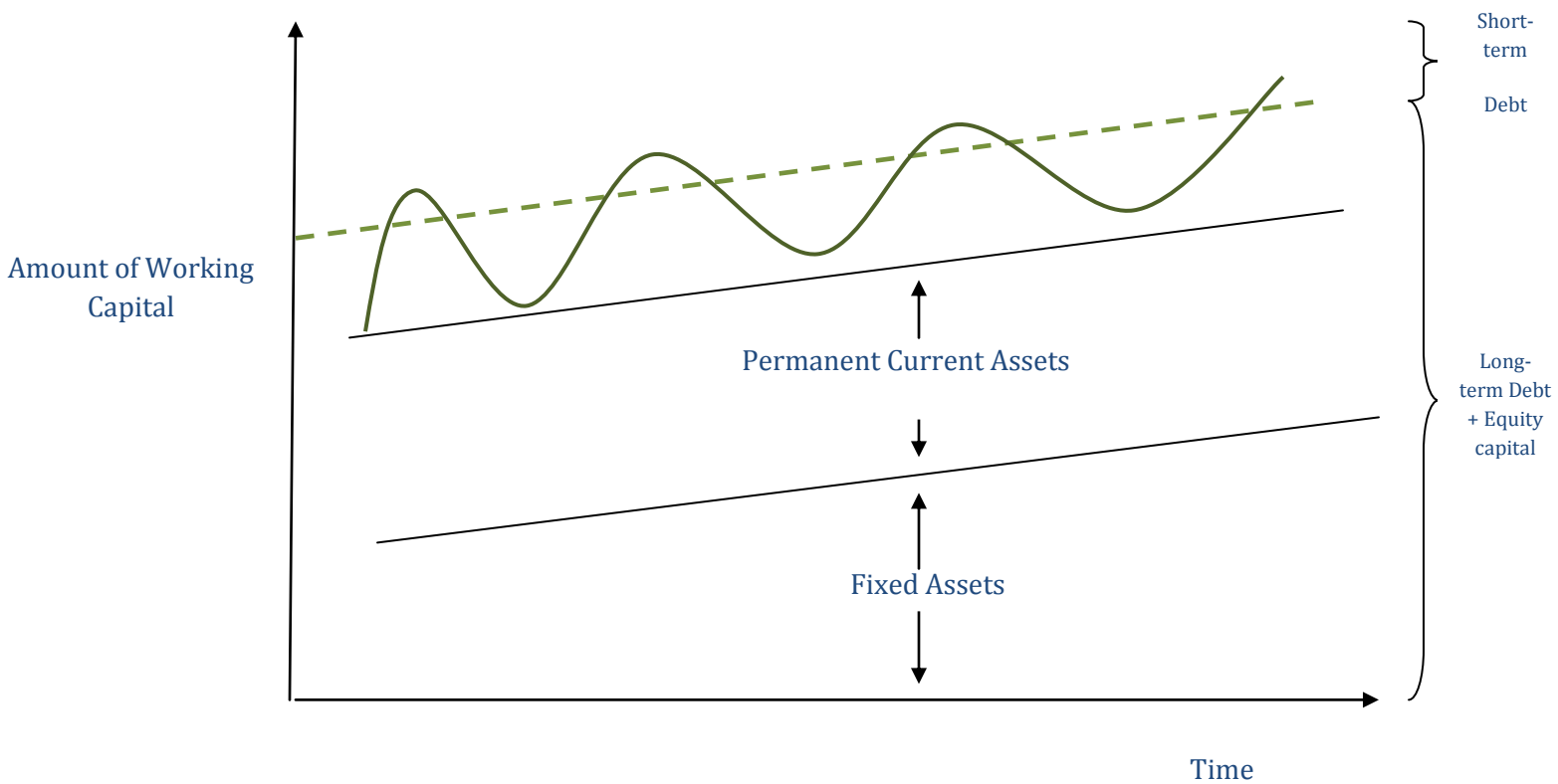
1. Hedging approach, also it is called the matching approach;
2. Conservative approach;
3. An aggressive approach.

In accordance with the approach of **Hedging or Marching**, the maturity of the sources of the funds should march the nature of the assets to be financed. This kind of approach suggests that long-term funds should be used to finance the fixed portion of current assets requirements in a manner similar to the financial of fixed assets.



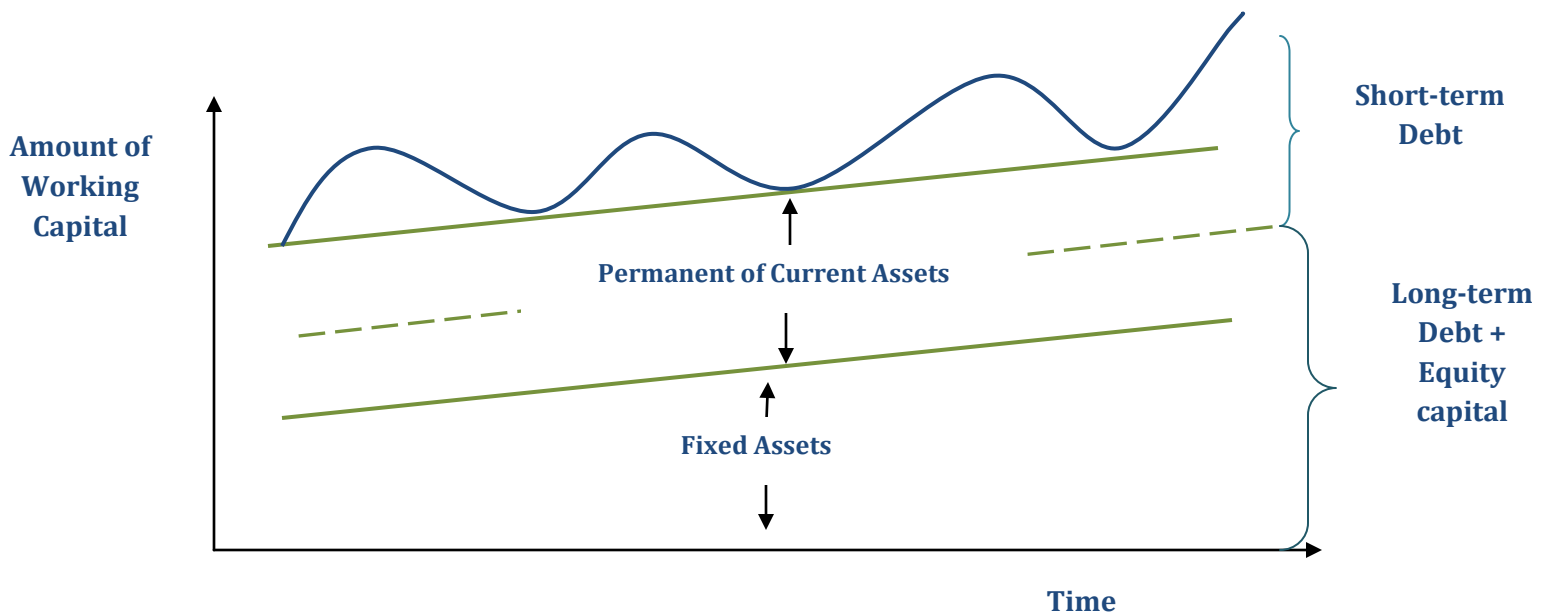
Hedging or Marching Approach

Conservative approach suggests that the estimated requirements of total funds should be met from long-term sources; the use of short-term funds should be restricted to only emergency situations or when there is an unexpected outflow of funds.



Conservative approach

Furthermore, the other most important working capital policy is called an aggressive policy if the firm decides to finance a part of the permanent working capital by the short term sources. The aggressive policy seeks to minimize excess liquidity while meeting the short



Aggressive approach

term requirements. The firm may accept even greater risk of insolvency in order to save cost of long term financing and thus in order to earn greater return.

CONCLUSION

To sum up, I want to note that working capital occupies a peculiar position in the Capital structure of a firm. It is the life-blood of all types of enterprises, manufacturing and trading both. If the business has enough working capital, it can maintain its operating efficiency. Not only that, but adequate working capital provides psychological satisfaction and relief to the management. Only those enterprises, which have adequate working capital, can survive in times of depression. It has been observed that number of business enterprises have failed due to inefficient management of working capital. From this point of view, the management of working capital becomes a tedious exercise for a financial manager of a firm. The most important point of that, working capital management is not only for big companies it is also quite important for small firms.

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