P: ISSN NO.: 2394-0344 RNI No.UPBIL/2016/67980 VOL-3* ISSUE-4* (Supplementary Issue) July- 2018
E: ISSN NO.: 2455-0817 *Remarking An Analisation*

The Management of Working Capital; Some Told and Untold Facts

Goutam Chatterjee
Principal,
Krishna Chandra College,
Hetampur, Birbhum (W.B)

Abstract

This paper has endeavoured to show the various forms of Working Capital. It has also tried to explore the possible strategies of Working Capital Management. This paper has focused on the working capital management technique.

Working capital management requires financial managers to decide what quantities of cash, other liquid assets, accounts receivable and inventories of the firm will be held at the proper point of time. In addition, Financial Managers must decide how their current assets are to be financed. Financing choices include the mixture of current as well as long –term liabilities.

This paper consists of five parts; i) Introduction ii) Few concepts and definitions. iii) need for working capital iv) Problems related to working capital v) how to manage the need for working capital vii) conclusion & suggestion.

Keywords: Gross Working Capital, Net Working Capital, Overemphasized, Box Thinking, Operating Cycle.

Introduction

Capital required for a business can be classified under two main categories viz.

1. Fixed capital
2. Working capital

Every business needs funds for two purposes-for its establishment and to carry out its day to day operations. Long term funds are required to create production facilities through purchase of fixed assets such as plant, machinery, land, building, furniture etc. Investment in those assets represents that part of firm's capital which is blocked on a permanent or fixed basis term purposes for the purchase of raw materials, payment of wage and other day to day expenses etc. These funds are known as Working Capital. In simple words, working capital refers to that part of the firm's capital which is required for financing term or current aspects such as cash, marketable securities, debtors inventories. Funds, thus, invested in currents assets keep revolving fast and are being constantly converted into cash and this cash flows out again in exchange for other current assets. Hence, it is also known as revolving or circulating capital or short term capital.

Circulating capital means current assets of a company that are changed in the ordinary course of business from one form to another, for example, from cash to inventories, inventories to receivables, receivables to cash etc.

Working capital is the life blood and nerve centre of business. Just as circulation of blood is essential in the human body to maintain life, so also working capital is very essential to maintain the smooth running of business. No business can run successfully without an adequate amount of working capital.

Statement of problem

Financing of Working Capital

The working capital requirements of concern can be classified as -

1. Fixed working capital requirements
2. Variable working capital requirements.

Fixed working capital should be financed in a manner that the enterprise may have its uninterrupted use for a sufficiently long period whereas variable working capital requirements of a concern may be met from the short term sources of capital.

The Finance Manager is to analyze decisions such as: How should the firm manage its cash? To whom should the firm grant credit? How much inventory should the firm keep? What should be the composition of the firm's current debt?

Objectives of this paper

The main objectives of this paper are as follows:-

1. To examine and explain the concept of working capital, and related terms.
2. To review the Problems related to working capital.
3. To review the importance of working capital.
4. To venture some suggestions on the management of working capital

Few Concepts and Definitions

Concept of Working Capital

There are two concepts of working capital:

1. Gross working capital
2. Net working capital

In the broad sense, the term working capital refers to the gross working capital and represents the amount of funds invested in current assets. Thus the gross working capital is the capital invested in total current assets of the enterprise. Current assets are those assets which are in the ordinary course of normally one accounting year. Examples of Current Assets are:

1. Cash in hand and bank balances
2. Bills receivable
3. Sundry debtors (Less Provisions for bad debts)
4. Short term loans and advances
5. Inventories of Stocks such as,
   a. Raw Materials
   b. Work-in-progress
   c. Stores and spares
   d. Finished goods
6. Temporary investments of surplus funds
7. Prepaid expenses
8. Accrued Incomes

In narrow sense, the term working capital refers to the net working Capital which is the excess of current liabilities, or say:

Net Working capital= Capital Assets- Current Liabilities.

Net working capital may be positive or negative. When the current assets exceed the current liabilities, the working capital is positive and negative working capital results when the current liabilities are more than the current assets. Current liabilities are those liabilities which are intended to be paid in the ordinary course of business within a short period of normally one accounting year out of current assets or the income of the business. Example of current liabilities are:

1. Bill Payable
2. Sundry Creditors or Account Payable
3. Bank Overdraft
4. Dividend payable
5. Accrued or outstanding Expenses.
6. Provision for taxation.
7. Short term loans, advances and deposits.

The gross working capital concept is a financial or going concern concept whereas net working capital concept is an accounting concept of working capital.

Need for Working Capital

The need for working capital arises due to the time gap between production and realization of cash from sales. There is an operating cycle involved in the sales and realization of cash. There are time gaps in purchases of raw materials and production; production and sales and realization of cash. Thus, working capital is needed for the following purpose:-

1. For the purpose of raw materials, components and spares.
2. To incur day to day expenses and overhead costs a such as fuel, power and office expenses, etc.
3. To pay wages and salaries.
4. To meet the selling costs such as packing advertising.
5. To provide credit facilities to the customers.
6. To maintain the inventories of raw material, work-in-progress, stores and spares and finished stock.

The working capital requirements of concern depend upon a large number of factors such as nature and size of business, The character of their operations, the length of production cycles, the rate of stock turnover and the state of economic situation.

These two concepts of working capital are not exclusive; rather both have their own merits. The gross concept is sometimes preferred to the net concept of working capital for the following reasons:

1. It enables the enterprise to provide correct amount of working capital at the right time.
2. Every management is more interested in the total current asset with which it has to operate than in the sources from where it is made available.
3. The gross concept takes into consideration the fact that every increase in the funds of the enterprise would increase its working capital.
4. The gross concept of working capital is more useful in determining the rate of return on investments in working capital.

The net working capital concept, however, is also important for the following reasons:

1. It is qualitative concept which indicates the firm's ability to meet its operating expenses and short term liabilities.
2. It indicates the margin of protection available to the short term creditors i.e. the expenses of current assets over current liabilities.
3. It is an indicator of financial soundness of an enterprise.
4. It suggests the need for financing a-part of the working capital requirements out of permanent source of funds.

To conclude, it may be said that both gross and net concept of working capital are important aspects of working capital management. In other words, working capital management plays a prominent role in the success of business enterprises. The net concept of working capital may be suitable only for proprietary form of organization, such as sole trader or partnership firms. But the gross concept is very suitable to the company form of organization where there is a co-ordination between ownership, management and control.

Problems Related To Working Capital

There are many reasons why a business gets working capital problems. As a business owner, it is critical to determine why the situation exists, and how to correct the problem immediately. Here is a short list of some of the usual causes of this issue.

1. Information on inventory unavailable.
2. No much sale, therefore not much cash
3. Past dues increase the .receivables.
4. Customers are paying short, due to quality issues.
5. Staff has been added to process orders and/or invoices
6. For Over purchasing
7. Due to Inventory turnover problems
8. Interest incurred or late payment penalties from vendors

How to Manage Need For Working Capital

10 Ways to manage working capital

1. A balance between inflow and outflow of funds needed.
2. Significant matching between inflow and outflow of cash necessary.
3. Maintain a good relationship with your banker; never hide information that could compromise the trust you have established
4. Whenever possible, reach agreements with suppliers to stagger major cash outlays
5. Obtain a reasonable line of credit based on the net value of the business
6. Pay particular attention to your inventory levels; despite the fact that a balanced inventory is often difficult to identify, avoid excess stock, which ties up cash flow
7. Collect amounts due from customers as quickly as possible, and do not hesitate to offer discounts for fast payment terms
8. Do not hesitate to ask for deposits from certain customers, or for certain types of contracts
9. Finance long-term assets with term financing equal to the life of the assets
10. Longer payment terms established with the permission of suppliers.

Conclusion & Suggestion

The management of the working capital is concerned with the management of assets such as cash, marketable securities, accounts receivable, investor prepaid expenses, and the current assets, also, liabilities such as accounts payable, wages payable, and accruals. The finance manager is to analyze decisions such as: How should the firm manage its cash? To whom should the firm grant credit? How much inventory should the firm keep? What should be the composition of the firm's current debt? While recognizing the current financial policies and procedures followed by the corporate sector, the text focuses on the best method (the state of the art) that finances to offer. In the sense, the text is prescriptive; it recommends the most advantageous ways of addressing the problems in the management of working capital.

The need for working capital to run the day-to-day business activities cannot be overemphasized. We will hardly find as business firm which does not require any amount of working capital. Indeed, firms differ in their requirements of the working capital

We know that firms aim at maximizing the wealth of shareholders. In its endeavor to maximize shareholders' wealth, the firm should earn sufficient return from its operations. Earning as steady amount of profit requires successful sales activity. Current assets are needed because sales do not convert into cash instantaneously. There is always an operating cycle involved in the conversion of sales into cash.

The duration of time required to complete the following sequence of events, in case of a manufacturing firm, is called the operating cycle:

1. Conversion of cash into raw materials.
2. Conversion of raw materials into work in process.
3. Conversion of work in process into finished goods.
4. Conversion of finished goods into debtors and billreceivables though sale.
5. Conversion of debtors and bills receivables into cash.

The increasing shifts in price levels make the functions of financial manager difficult. He should anticipate the effect of price level changes on working capital requirements of the firm. Generally, rising price levels will require a firm to maintain higher amount of working capital. The same levels of current assets will need increased investment when prices are increasing. However, the companies which can immediately revise their product prices with rising price levels will not face a sever working capital problem. Further, the effects of increasing general price level will be felt differently by the firms as individual prices may move differently. It is possible that some companies may not be affected by the rising prices while others may be badly hit by it. Thus, the effects of rising prices will be different for different companies. Some will face not working capital problem, while the working capital problems of others may be aggravated.

Under the depressed market conditions and with no revenue growth, the only way we can reduce our losses significantly and return to profitability is by reducing costs. We were forced to look beyond the 1 to 2 per cent kind of cost reduction. What we need is out of the box thinking.

Cost erosion champion and put in charge of the entire initiative. Four specific areas are identified.
Direct material costs (Generally which constitute roughly 65 percent of all costs)

Variable conversion costs (power, fuel, water, tools, etc);

Fixed costs (about, marketing, corporate expenses, plant operation, research and development);

Financial fresh structuring (working capital, debt restructuring, balance sheet etc.)

Three-tiered teams – members, leaders and champions – are to be set up at the plant level to implement, drive and monitor the exercise across the organization. Their task is to begin with spreading the cost-reduction message, emphasizing its importance to bringing the company black to good health. The company's union must be co-opted to communicate the programme and the house journal must do the same.

The company's quality improvement project and its cost-reduction exercise have run concurrently, and each has helped the other. For one, its people understand that cutting costs did not mean cutting corners. An illustration of this is what happened when Tata Engineering made major changes in some of its technologies. "We were using copper-brass radiators when a new technology allowed us to use aluminum radiators, which give much better performance, so the quality of the vehicle improved, and since aluminum is much cheaper than cooper and brass, the costs went down."

By this type of technique any company can afford to breathe easy.

References

Books

1. *Basu. A (2001) "Principles and Applications of Accounting" Tee Dee Publications. Kolkata.*
2. *Biswas.B.K. (1999), Modern Management, 1st Edition, Oriental Book Company Ltd, Calcutta. India.*
3. *Banerjee.B (1990), Financial Policy and Management Accounting, 3rd Edition, The world press private LTD, Calcutta, India.*
4. *Dutta J (2010) "Hisabsashtra". New Central Book Agency, Kolkata.*

Websites

5. *www.bdc.ca, Start or buy a business› Start your business*
6. *Retrieved (Viewed on)Dec29, 2015,*
7. *https://knowledge.b2bcfo.com/working-capital-problems*
8. *Working Capital Problems – Reasons For The Problems, Accessed on 1-11-17.*
9. *Website of The Institute of Chartered Accountants of India, Viewed on August 2017 (http://www.icai.org/post.html?post_id=622 &c_id=36)*
10. *http://www.studyfinance.com/lessons/workcap/- Working Capital Management, Accessed on 21-1-18*