

WORKING CAPITAL MANAGEMENT

Chapter One

Introduction to Working Capital Management

Unit Introduction

Working capital may be used as a measure of a business's performance and short-term financial stability. It expresses the difference between current liabilities and current assets for laypeople. It refers to the company's stock of short-term or current assets (like cash) (Knauer & Wöhrmann, 2013).

Net working capital and gross working capital are the two main categories of working capital. Total current assets, also known as circulating assets, make up GWC (gross working capital). With the liquidity-profitability conundrum firmly established in the financial framework of responsibilities that mature in a year, NWC (net working capital), or (current assets minus from current liabilities), gives a precise evaluation of the liquidity status of the company (Zariyawati et al., 2010).

As we've seen, assets and liabilities make up the working capital's two major parts. Firstly, the share of funds budgeted for and raised is represented as short-term or current obligations. These and other funds should be wisely raised as management should be focused on sound financial structure. The decision to invest in assets includes short-term or current assets, which the firm's executives must carefully examine. Furthermore, careful management of the appropriate asset and funds must be assured because there is a direct association between sales swings and invested assets in current assets (Ganesan, 2007).

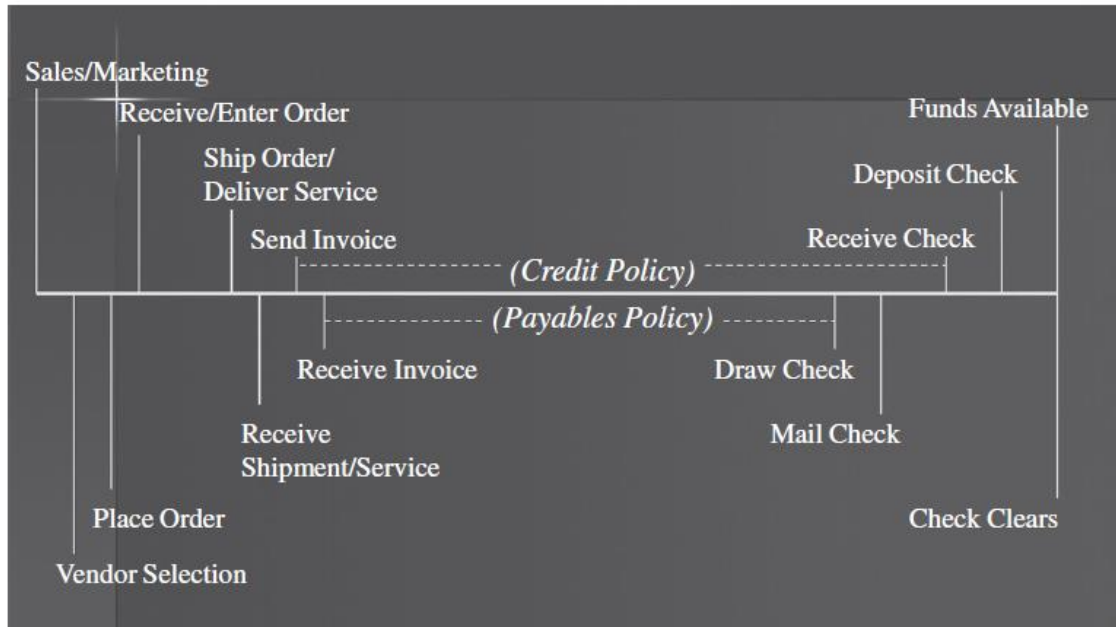


Figure 1.1. Working Capital Timeline (Source: Semantic Scholar, Creative Commons License)

Learning Objective

Upon completion of this unit, you will be capable to:

1. Understand the idea of working capital.
2. Discuss the importance of working capital.
3. Determine the variables influencing the need for working capital.
4. Discuss the levels of investment in working capital.
5. Explain the policy of working capital as a whole.

Key Terms

1. Working Capital
2. Current Liabilities
3. Current Assets
4. Cost of Sale
5. Balance Sheet Concept
6. Operating Cycle Concept

7. Ratio Analysis

1.1. Concept of Working Capital

Working capital is commonly defined as a company's holdings of temporary or present assets like receivables, cash, inventory, and marketable securities. Working capital is a company's total capital used to fund existing or short-term assets such as debtors, cash, inventories, and marketable securities (Fess, 1966). Working capital can be defined as the portion of a company's total capital that has been utilized. To put it another way, working capital is the sum of money that a company needs to be able to pay for the expenses associated with operating the firm (Aminu & Zainudin, 2015).

Working capital is defined as the finances (for example, capital) accessible and utilized for an enterprise's daily operations (for example, working). It generally refers to the portion of an organization's assets that have been utilized in the business's ongoing operations or are tied to those operations (Harris, 2005). It is the amount of money that is spent for an accounting cycle to achieve a current income that is compatible with the primary reason a firm exists (Pass & Pike, 1984).

The money utilized to produce things and generate sales is known as working capital. The return on investment is more likely to be higher when less working capital is utilized to generate sales (Bhattacharya, 2021). The financial and commercial facets of inventory, purchasing, credit, marketing, royalties, and investment strategy are all covered under working capital administration (Walker, 1964). The working capital required to produce and market titles will likely be smaller the larger the profit margin (Hawawini et al., 1986). The investment return is predicted to be higher the faster we produce and sell the books. In light of this, we have been employing.

The working capital notion can be interpreted in two different ways:

- i. Balance Sheet Conception
- ii. Operating Cycle Conception

It should go without stating that the method used to define management will significantly impact it. As a result, the two ideas are briefly treated independently (Nuhiu & Dermaku, 2017).

Did you know?

The more proactive (and hazardous) the company's working capital program, the greater the proportion of funds collected from short-term funds, and vice versa.

1.1.1. Balance Sheet Concept

Based on the balance sheet concept, working capital can be interpreted in two different ways. The discrepancy between current liabilities and current assets represents the amount readily accessible to fund ongoing activities (Stern, 1997). However, working capital can also be used interchangeably with gross or cumulative current assets. In this situation, the difference between current and current liabilities has been referred to as overall current assets or working capital (Dichev, 2008). Economists such as Baket, Malott, Mead, and Field endorse the latter view of working capital. They believe that since current assets contribute to profit, they must be viewed as working capital. The management seems to be more concerned with overall current assets since they represent the whole amount of money available for operational needs. However, economists such as Salvers and Lincoln support the first point of view (Dobija, 1998). They contend that:

1. In the long term, what matters is the excess of current assets over current liabilities;
2. Such conception aids investors and creditors in assessing the firm's financial soundness;
3. Because this amount isn't refundable, it may always be depended on to cover unforeseen expenses;
and
4. This definition aids in determining the correct financial position of firms with certain characteristics.

While advocating for a vertical balance sheet, the Institute of Chartered Accountants of India also supported the previous understanding of working capital when it defined net current assets as the difference between current liabilities and current assets (Levit, 1973).

It's not quite clear what working capital is when it's defined traditionally as the difference between current liabilities and current assets. Working capital is locked up and utilized to fund present activities as a part of long-term finance. Therefore, the percentage of long-term capital resources diverted to short-term operations increases as the quantity of working capital so generated increases. Due to the tight working capital scenario, the logic of the aforementioned definition might suggest a cash diversion; nevertheless, if the usual approach were used, working capital would undoubtedly stay the same (Rushbrook & Wells, 1987). Furthermore, working capital will remain constant if creditors and inventory are converted into cash when cash sources are scarce or increasingly coming from long-term funding resources in the absenteeism of adequate revenues, a

relatively high level of working capital, as per this definition can give rise to a false feeling of security (DeFond, 2002). Cash is once more factored into the calculation of working capital according to the usual procedure. However, the exclusion of cash from these computations might have been more reasonable given that one evaluates cash requirements to current assets minus current liabilities (Alvarez et al., 2004). According to standard working capital calculations, this converts current assets into cash during the financial term, which may then be utilized to pay for current liabilities and other operating costs. The paradox is that until they have been turned into cash, such current assets, which are used to provide cash, must be sustained by long-term funds themselves (Davis, 2016).

The aforementioned seems to support at least three points. Firstly, other than as a gauge of the firm's current capability to pay its creditors, the balance sheet concept of working capital may not be all that useful. Secondly, when businesses mention a lack of working capital, they can mean a lack of cash resources. Thirdly, as typically defined in fund flow analysis, growth in working capital signifies the utilization or usage of funds (Goldsmith, 2009).

<p>Current Assets Cash & Bank Accounts Trade Receivables Inventories Other Current Assets</p>	<p>Current Liabilities Suppliers Employees ST Financial Debt Taxes</p>
<p>Noncurrent Assets Goodwill PP&E Other LT Assets</p>	<p>Noncurrent Liabilities LT Financial Debt Other LT Liab.</p>
	<p>Shareholders' Equity</p>

Figure 1.2. The Balance Sheet (Source: Fundsnet Services, Creative Commons License)

1.1.2. Operating Cycle Concept

The three main actions of a company's operational cycle are procuring resources, manufacturing, and distributing (selling) the product. Since cash disbursements typically occur before cash receipts, these actions result in fund flows that seem to be out of synchronization (Chakraborty, 1973).

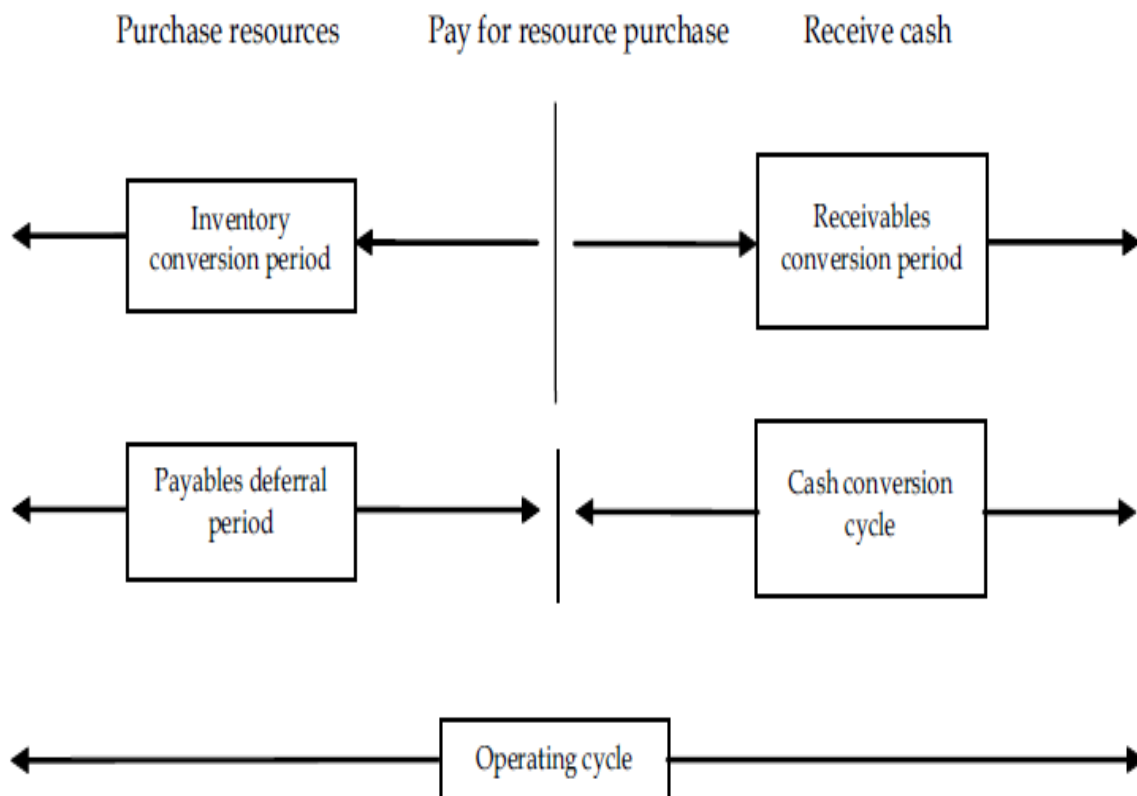


Figure 1.3. Operating Cycle of Typical Company (Source: Aleksandar Damnjanovic, Creative Commons License)

The typical company's operational cycle is depicted in Figure 1.1. The conversion periods for inventories and receivables are equal to the operating cycle:

Operating cycle = the period of inventory conversion + the period of receivables conversion

The time needed to sell and produce the item is known as the inventory conversion period (Pettersson, 2019).

This is how it is explained:

$$\text{Inventory conversion period} = \frac{\text{Average inventory}}{\text{Cost of sales}/365}$$

The amount of time the business can put off paying for its various resource acquisitions is known as the payables deferral period (for instance, wages, materials, and taxes). The payables deferral period is calculated using the following equation:

$$\text{Payables deferral period} = \frac{\text{Accounts payable} + \text{Salaries, benefits, and Payroll taxes payable}}{(\text{Cost of sales} + \text{Selling general and administrative expense})/365}$$

Lastly, the cash conversion cycle denotes the time that passes between collecting cash payments for the firm's various resource expenditures and collecting cash receipts from product sales (Choubey, 2021). The formula is as follows:

$$\text{The cycle of cash conversion} = \text{Operating cycle} - \text{Payable deferral period}$$

Petty cash and cash in a bank are the most liquid assets. In the case of a manufacturing company, the operational cycle or cash conversion cycle is the length of time required to perform the following series of events:

1. Money is converted into essential materials.
2. The transformation of basic materials into active labor.
3. Converting unfinished work into finished goods
4. Using sales to turn finished goods into clients and receivable accounts
5. Cash conversion from receivables and clients

The cash conversion cycle demonstrates when new working capital financing should be received from sources other than the firm's operations (Milutinović et al., 2015). Without a comparable rise in the payables deferral period, the operational cycle lengthens the cash conversion cycle and increases the company's demand for working capital finance (Winborne, 1964).

The following events make up a trading company's working cycle:

1. Invest cash in inventories
2. Accounts receivable from inventories
3. Converting accounts receivable into cash (Romano et al., 2021).

1.2. Importance of Working Capital

A business's working capital serves as its heart and brain. Working capital is essential to the successful operation of a business, much as blood circulation is essential to human survival. No business can be successful unless it has enough working capital (Tauringana & Afrifa, 2013). The following are the key advantages of having adequate operating capital:

1. *Solvency of the business*: By guaranteeing an uninterrupted output flow, enough working capital helps ensure the company's solvency.

2. *Goodwill:* A company with enough working capital can make prompt payments, which helps build and sustain goodwill.
3. *Easy Loans:* Companies with sufficient high solvency, working capital, and good credit may secure loans from banks and other financiers on simple and advantageous conditions.
4. *Cash discounts:* A company with sufficient operating capital can also take advantage of cash discounts on purchases, which lowers costs.
5. *Consistent raw material supply:* Adequate working capital ensures a consistent supply of raw materials and manufacture.
6. *Consistent payment of salaries, wages, and other daily responsibilities:* A business with sufficient working capital may wage, pay salaries, and other day-to-day obligations on time, which boosts employee morale, promote productivity, lowers costs, and increases profits and production (Padachi, 2006).
7. *Exploiting favorable market conditions:* Only businesses with sufficient working capital can take advantage of favourable market situations, such as buying in bulk when prices are lower and holding onto inventory for high prices.
8. *Capacity to handle a crisis:* Since working capital is typically under a lot of strain at such times, appropriate work capital helps a concern handle the business crisis in circumstances like depression (Baños et al., 2010).
9. *Regular and quick return on investments:* An investor's need for a quick and consistent return on his assets is universal. When a company has enough working capital, there can't be much pressure to reinvest profits, allowing it to pay dividends to investors quickly and regularly (Eda & Mehmet, 2009). This increases the trust of its investors and generates a favorable market for future fundraising.
10. *Strong morale:* A business with enough working capital benefits from a climate of confidence, security, and high morale, as well as overall performance (Raheman & Nasr, 2007).