

SOS POLITICAL SCIENCE AND PUBLIC ADMINISTRATION

MBA FA 403

SUBJECT NAME: WORKING CAPITAL MANAGEMENT

UNIT-V

TOPIC NAME: OPTIMUM WORKING CAPITAL POLICY

CURRENT ASSETS:

Balances in the main statement of an entity which represent liquid cash and balance in savings and current account at the date of the statement, accounts receivables which are amounts owing by customers, marketable securities which are instruments like treasury bill and commercial paper, inventory which are the items available for sale, prepaid expenses which are amounts paid in advance such as insurance and deposits on rent and electricity and all other assets that could be converted to cash easily. These items are called current if they are expected to change in value over the next twelve months.

CURRENT LIABILITIES:

A company's debts or obligations that are due in near future usually within one year, and includes short term debts that must be paid within a year, accounts payable which is what you owe your suppliers of goods and service, accrued liabilities such as telephone bills, electricity, rent and accounting fees that you did not pay by the end of the period but must be paid promptly and other short-term debts.

WORKING CAPITAL:

This is the value that the business has to work with to generate its sales and pay its bills in the short run. The working capital measures both company's efficiency and its short term financial health. The value of the working capital calculated as:

CURRENT ASSETS- CURRENT LIABILITIES.

EFFECTIVE WORKING CAPITAL MANAGEMENT:

The individual owner of a business is accountable to determine and ensure the requirements of working capital in such a way that the amount of working capital

available is neither too large nor too small for its requirement. Large amount of working capital would mean that the business has ideal funds. On the other hand if there is inadequate working capital, then the business might run into risk of insolvency, and continued scarceness of adequate working capital can seriously challenge the financial viability and sustainability of the business.

OPTIMUM WORKING CAPITAL:

There is no standard rule for an Optimum Working Capital. The working capital requirements vary from industry to industry. Traditionally, Current Ratio (Current Assets: Current Liabilities) of 1.5 to 3 is considered to be comfortable liquidity position. However, it should be remembered that optimum working capital can be determine only with the reference to a particular circumstances.

WORKING CAPITAL POLICY:

The working capital policy of a company refers to the level of investment in current assets for attaining their targeted sales. Commonly, these policies are also named as aggressive, conservative and hedging policy.

Working capital policy involves decisions about a company's current assets and current liabilities what they consist of, how they are used, and how their mix affects the risk versus return characteristics of the company. Both the terms working capital and net working capital normally denote the difference between the company's current assets and current liabilities. The two terms are often used interchangeably.

Working capital policies, through their effect on the firm's expected future returns and the risk associated with these returns, ultimately have an impact on shareholder wealth. Effective working capital policies are crucial to a firm's long-run growth and survival. If, for example, a company lacks the working capital needed to expand production and sales, it may lose revenues and profits. Working capital is used by firms to maintain liquidity, that is, the ability to meet their cash obligations

as they come due. Otherwise, it may incur the costs associated with a deteriorating credit rating, a potential forced liquidation of assets, and possible bankruptcy.

Working capital management is a continuing process that involves a number of day-to-day operations and decisions that determine the following:

- The firm's level of current assets
- The proportions of short-term and long-term debt the firm will use to finance its assets
- The level of investment in each type of current asset
- The specific sources and mix of short-term credit (current liabilities) the firm should employ

Working capital differs from fixed capital in terms of the time required to recover the investment in a given asset. In the case of fixed capital or long-term assets (such as land, buildings, and equipment), a company usually needs several years or more to recover the initial investment. In contrast, working capital is turned over, or circulated, at a relatively rapid rate. Investments in inventories and accounts receivable are usually recovered during a firm's normal operating cycle, when inventories are sold and receivables are collected.

IMPORTANCE OF WORKING CAPITAL:

It has already been noted that a firm must have working capital to operate and survive. In many industries, working capital (current assets) constitutes a relatively large percentage of total assets. In the manufacturing sector, for example, current assets comprise about 40 percent of the total assets of all U.S. manufacturing corporations. Among the wholesaling and retailing sectors, the percentages are even higher in the 50 to 60 percent range. Shows the distribution of aggregate assets for several large companies. For the five companies shown, current assets as a percentage of total assets range from about 25 percent to over 50 percent.

ExxonMobil, with its relatively high percentage of fixed assets, has a relatively low percentage of current assets.

LEVELS OF WORKING CAPITAL INVESTMENT - FINANCIAL MANAGEMENT:

Overall working capital policy considers both a firm's level of working capital investment and its financing. In practice, the firm has to determine the joint impact of these two decisions upon its profitability and risk. However, to permit a better understanding of working capital policy, the working capital investment decision is discussed in this section, and the working capital financing decision is discussed in the following section. The two decisions are then considered together. The size and nature of a firm's investment in current assets is a function of a number of different factors, including the following:

- The type of products manufactured
- The length of the operating cycle
- The sales level (because higher sales require more investment in inventories and receivables)
- Inventory policies (for example, the amount of safety stocks maintained; that is, inventories needed to meet higher than expected demand or unanticipated delays in obtaining new inventories)
- Credit policies
- How efficiently the firm manages current assets (Obviously, the more effectively management economizes on the amount of cash, marketable securities, inventories, and receivables employed, the smaller the working capital requirements.)

For the purposes of discussion and analysis, these factors are held constant for the remainder of this chapter. Instead of focusing on these factors, this section examines the risk–return trade-offs associated with alternative levels of working capital investment.

PROFITABILITY VERSUS RISK TRADE-OFF FOR ALTERNATIVE LEVELS OF WORKING CAPITAL INVESTMENT:

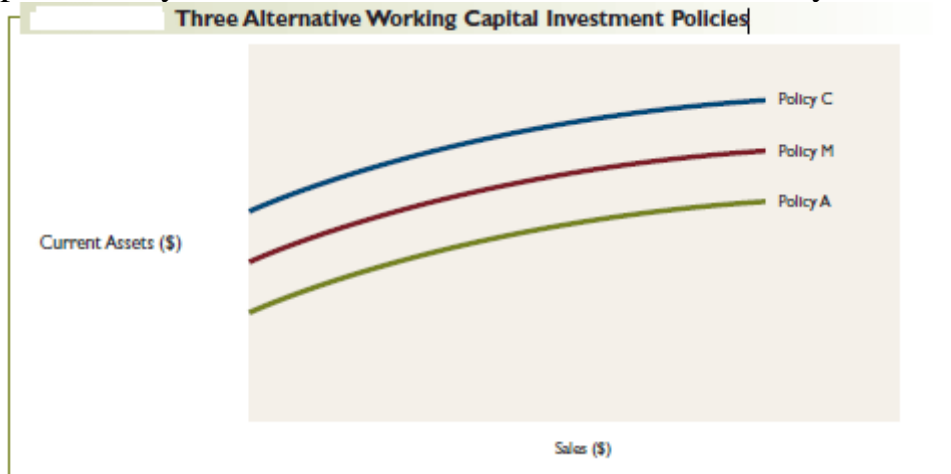
Before deciding on an appropriate level of working capital investment, a firm's management has to evaluate the trade-off between expected profitability and the risk that it may be unable to meet its financial obligations. Profitability is measured by the rate of (operating) return on total assets; that is, EBIT/total assets. As mentioned earlier in this chapter, the risk that a firm will encounter financial difficulties is related to the firm's net working capital position.

Illustrates three alternative working capital policies. Each curve in the figure demonstrates the relationship between the firm's investment in current assets and sales for that particular policy.

Policy C represents a conservative approach to working capital management. Under this policy, the company holds a relatively large proportion of its total assets in the form of current assets. Because the rate of return on current assets is normally assumed to be less than the rate of return on fixed assets, this policy results in a lower expected profitability as measured by the rate of return on the company's total assets. Assuming that current liabilities remain constant, this type of policy also increases the company's net working capital position, resulting in a lower risk that the firm will encounter financial difficulties.

In contrast to Policy C, Policy A represents an aggressive approach. Under this policy, the company holds a relatively small proportion of its total assets in the form of lower-yielding current assets and thus has relatively less net working capital. As a result, this policy yields a higher expected profitability and a higher risk that the company will encounter financial difficulties.

Finally, Policy M represents a moderate approach. With this policy, expected profitability and risk levels fall between those of Policy C and Policy A.



These three approaches may be illustrated with the following example. Suppose Burlington Resources has forecasted sales next year to be \$100 million and EBIT to be \$10 million. The company has fixed assets of \$30 million and current liabilities totaling \$20 million. Burlington Resources is considering three alternative working capital investment policies:

- An aggressive policy consisting of \$35 million in current assets
- A moderate policy consisting of \$40 million in current assets
- A conservative policy consisting of \$45 million in current assets

Assume that sales and EBIT remain constant under each policy contains the results of the three proposed policies. The aggressive policy would yield the highest expected rate of return on total assets, 15.38 percent, whereas the conservative policy would yield the lowest rate of return, 13.33 percent. The aggressive policy would also result in a lower net working capital position (\$15 million) than would the conservative policy (\$25 million). Using net working capital as a measure of risk, the aggressive policy is the riskiest and the conservative policy is the least risky. The current ratio is another measure of a firm's ability to meet financial

obligations as they come due. The aggressive policy would yield the lowest current ratio, and the conservative policy would yield the highest current ratio.

OPTIMAL LEVEL OF WORKING CAPITAL INVESTMENT:

The optimal level of working capital investment is the level expected to maximize shareholder wealth. It is a function of several factors, including the variability of sales and cash flows and the degree of operating and financial leverage employed by the firm. Therefore, no single working capital investment policy is necessarily optimal for all firms.

THREE ALTERNATIVE WORKING CAPITAL INVESTMENT POLICIES:

In practice, however, this assumption may not be completely realistic because a firm's sales are usually a function of its inventory and credit policies. Higher levels of finished goods inventories and a more liberal credit extension policy both of which increase a firm's investment in current assets may also lead to higher sales. This effect can be incorporated into the analysis by modifying the sales and EBIT projections under the various alternative working capital policies. Although changing these projections would affect the numerical values contained in, it does not affect the general conclusions concerning the profitability versus risk trade-offs.

OBJECTIVES OF WORKING CAPITAL MANAGEMENT:

- The primary objective of working capital management is to ensure a smooth operating cycle of the business. Secondary objectives are to optimize the level of working capital and minimize the cost of such funds.
- The superior objective of financial management is wealth maximization and that can be gained by profit maximization accompanied by sustainable growth and development. For sustainable growth and development, the objectives of all the stakeholders including customers, suppliers, employees, etc should be aligned to the growth of the organization.

Some objectives are given below:

1. Smooth working capital operating cycle:

This implies that the operating cycle i.e. the cycle starting from the acquisition of raw material to its conversion to cash should be smooth. It is not easy; it is as good as circulating 5 balls with two hands without dropping a single one. If the following 6 points can be managed, this operating cycle can be managed well.

1. It means raw material should be present on the requirement and it should not be a cause to stoppages of production.
2. All other requirements of production should be in place before time.
3. The finished goods should be sold as early as possible once they are produced and inventoried.
4. The accounts receivable should be collected on time.
5. Accounts payable should be paid when due without any delay.
6. Cash should be available as and when required along with some cushion.

2. Lowest working capital:

Working capital here refers to the current assets less current liabilities (net working capital). It should be optimized because higher working capital means higher interest cost and lower working capital means a risk of disturbance of the operating cycle.

3. Minimize rate of interest or cost of capital:

The cost of capital utilized in working capital should be minimized so as to achieve higher profitability. If the investment in working capital involves bank finance, interest rates should be negotiated with the bank.

The cost can be minimized by utilizing long-term funds but in a proper mix. While deciding the mix of working capital, the fundamental principle of financial management should be kept in mind that fixed assets and permanent assets should be financed by long term sources of finance of approximately same maturity and short-term or temporary assets should be financed by short-term sources of finance.

4. Optimal return on current asset investment :

The return on the investment made in current assets should be more than the weighted average cost of capital so as to ensure wealth maximization of the owners. In other words, the rate of return earned due to investment in current assets

should be more than the rate of interest or cost of capital used for financing the current assets.

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