Presentation on

WORKING CAPITAL MANAGEMENT - II

Part-I

For the students

of

Semester – VI

B.Com.(Hons. & General)

By

Dr. Asim Kumar Manna

Along with fixed assets, working capital is considered a part of operating capital.

While investing in fixed assets=> long–term decision, investment in working capital=> short-term decision as far as the fluctuating (variable) part is concerned.

A company having sufficient assets and also earning sufficient profit may be short of liquidity if its assets cannot readily be converted into cash for the payment of immediate demands. Positive working capital is required to ensure the continuity of its regular operations. It must have sufficient funds to satisfy both maturing short-term debts and regular operational expenses. Working capital management calls for short-term reversible decisions. These decisions are, therefore, not taken in the same line as decisions relating to fixed assets; rather it is based on liquidity and/or profitability.

Liquidity refers to the firm's continuous ability to meet its short-term maturing obligations. Since cash is used to meet a firm's obligations, emphasis is given on holding large investment in current assets which include cash and near-cash items like receivables, short-term investment, etc. Thus, holding relatively large investment in current assets will ensure safety in paying the short-term claims (i.e., of the creditors and others).

Liquidity is measured by using current ratio and liquidity ratio. It can also be measured by using working capital ratio which is **Working Capital/Current Liabilities**.

The higher the ratio, the better is the position. Thus, the ratio suggests that liquidity may be improved by increasing the amount of working capital.

Profitability is the profit earning capacity of a product, process, plant or the firm, as the case may be. ROI(capital employed) may be used as the measure of profitability of a firm which is

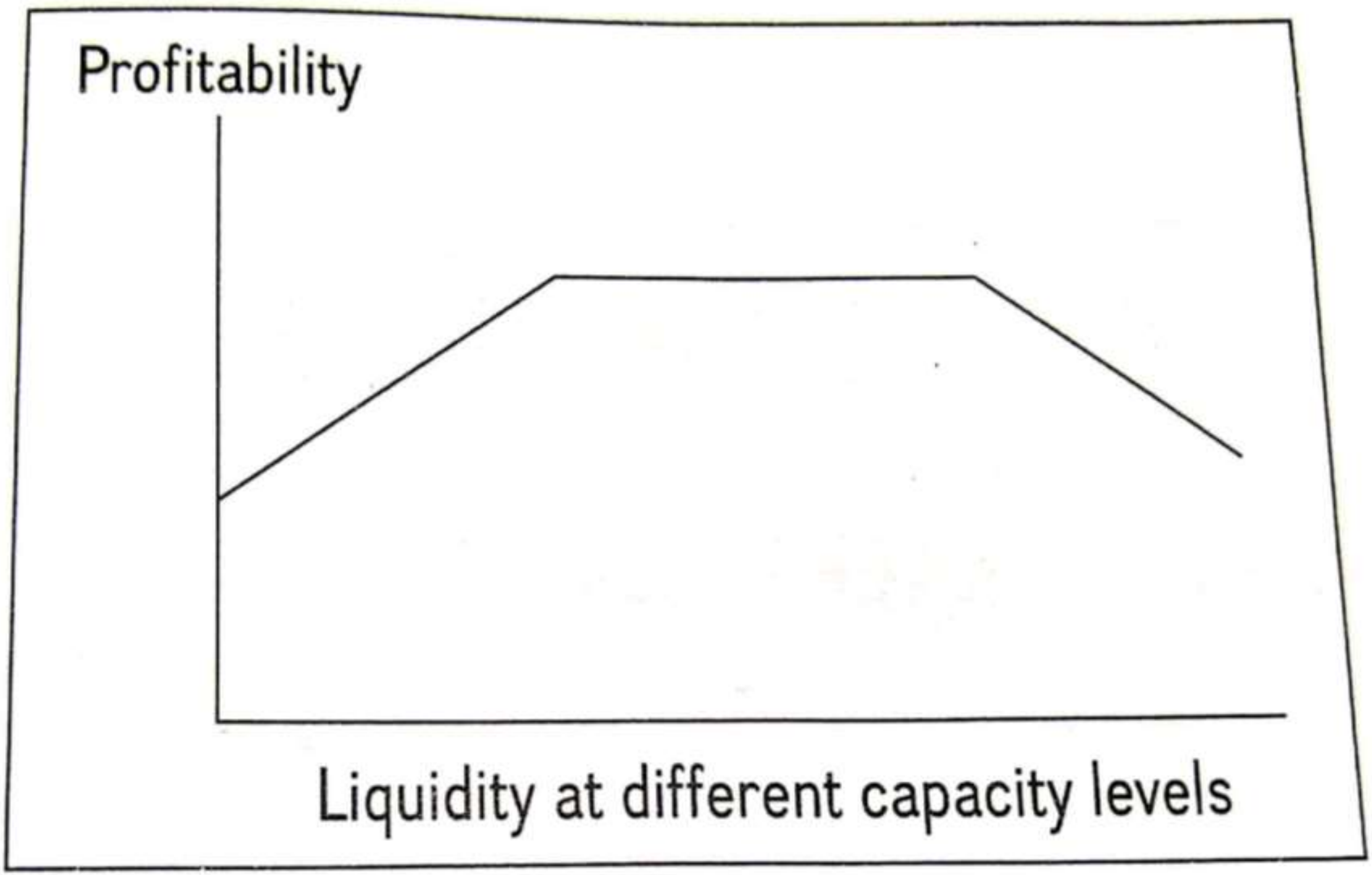
Profit / Capital Employed = Profit / (Fixed Assets + Working Capital)

The higher the ratio, the better is the position. But increase in WC leads to increase in denominator and thereby reduces the ratio. This implies that increase in liquidity will reduce profitability.

Profitability suggests holding of lesser liquid assets, whereas liquidity suggests holding of more liquid assets. There is a negative relationship between liquidity and profitability.

To maintain output and sales at the optimum level there should be a minimum level of investment in liquid assets. Increase in the liquid assets beyond an optimum level will lead to decline in profitability. Therefore, up to certain level, liquidity will increase profitability. Beyond that, profitability may remain constant with increase in liquidity up to a certain level, and thereafter, increase in further liquidity will lead to decline in profitability.

Following figure represents the relation between liquidity and profitability



IMPORTANT DECISIONS IN WORKING CAPITAL MANAGEMENT – LEVEL OF CURRENT ASSET AND THEIR MEANS OF FINANCING

Working capital management has two main decisions at two consecutive stages. They are as follows:

1. The level of Current Assets – How much to invest in Current Assets to achieve the Targeted Revenue?
2. Means of Financing Current Assets – How should the above Current Asset Investment be financed i.e. the mix of long and short term finance?

DIFFERENCE BETWEEN WORKING CAPITAL POLICIES AND WORKING CAPITAL FINANCING STRATEGIES

Commonly, policies of working capital and strategies (approaches) of working capital financing are interchangeably used and which is not correct. There is a thin line of difference between the two.

Working capital management policy deals with the first decision and working capital management strategies or approaches deal with the second decision.

The working capital policy of a company refers to the level of investment in current assets for attaining their targeted sales. It can be of three types viz. restricted, relaxed, and moderate. whereas the working capital strategies are aggressive, conservative and hedging (Maturity Matching).

TYPES OF WORKING CAPITAL POLICIES

Based on the attitude of the finance manager towards risk, profitability and liquidity, the working capital policies can be divided into following three types.

RESTRICTED POLICY

In restricted policy, the estimation of current assets for achieving targeted revenue is done very aggressively without considering for any contingencies and provisions for any unforeseen event. After deciding, these policies are forcefully implemented in the organization without tolerating any deviations.

Adopting this policy would result in an advantage of the lower working capital requirement due to the lower level of current assets. This saves the interest cost to the company and which in turn produces higher profitability i.e. higher return on investment (ROI). On the other hand, there is the disadvantage in the form of high risk due to very aggressive policy. That is why; it is also called as **aggressive working capital policy**.

RELAXED POLICY

Relaxed policy is just the opposite of restricted policy. In this policy, the estimation of current assets for achieving the targeted revenue is prepared after careful consideration of uncertain events such as seasonal fluctuations, a sudden change in the level of activities or sales etc. After the reasonable estimates also, a cushion to avoid any unforeseen circumstances is left to avoid the maximum possible risk.

The companies having relaxed working capital policies assume an advantage of almost no risk or low risk. This policy guarantees the entrepreneur of the smooth functioning of the operating cycle. We know that earnings are more important than higher earnings. On the other hand, there is a disadvantage of lower return on investment because higher investment in the current assets attracts higher interest cost which in turn reduces profitability. Because of its conservative nature, this policy is also called as **conservative working capital policy**.

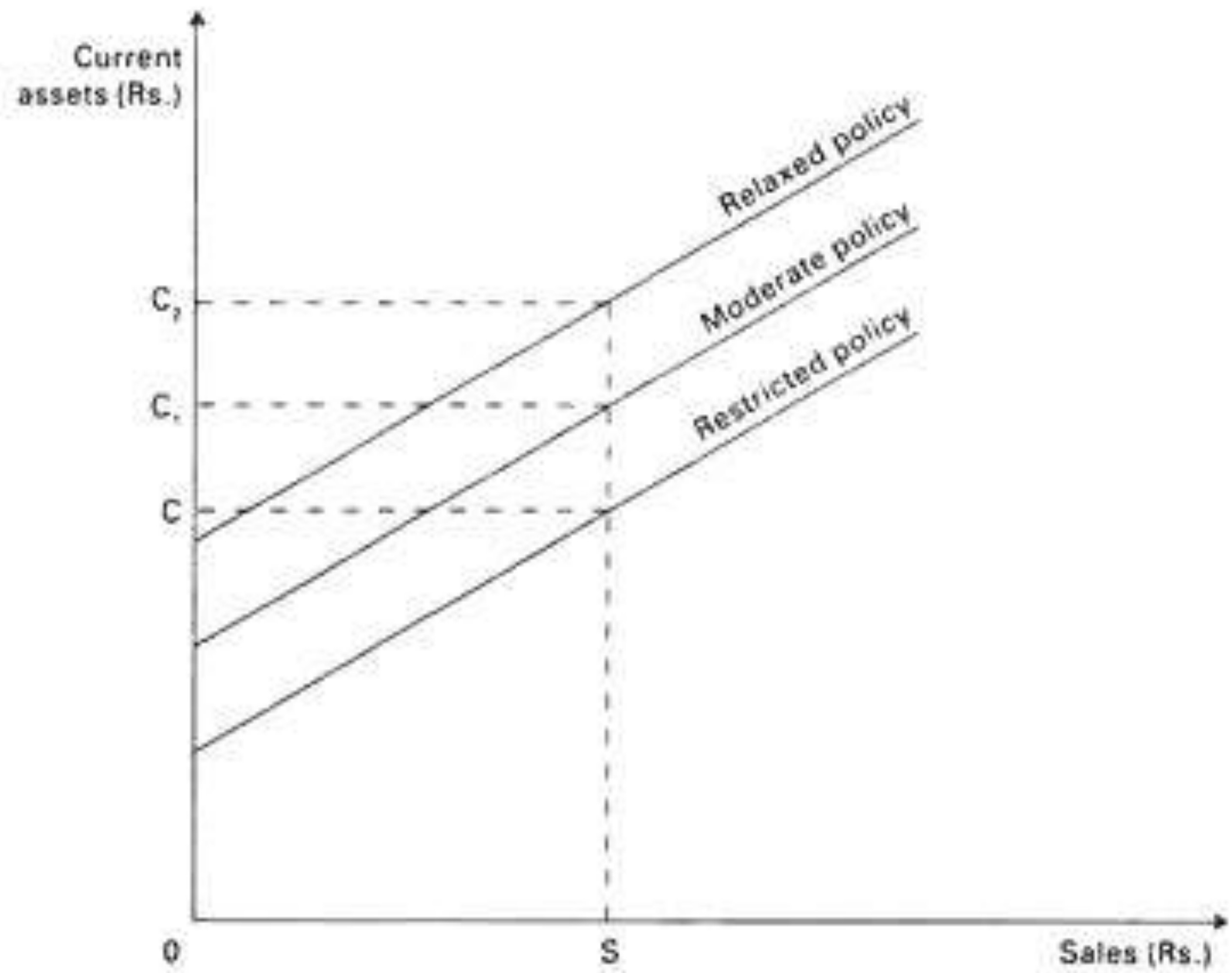
MODERATE POLICY

Moderate policy is a balance between the two policies i.e. restricted and relaxed. It assumes characteristics of the both the policies. To strike a balance, moderate policy assumes risk which is lower than restricted and higher than conservative. In profitability front also, it lies between the two.

The biggest benefit of this policy is that it has reasonable assurance of smooth operation of working operating capital cycle with moderate profitability.

The relationship of sales and corresponding levels of investment in current assets is shown in the following figure.

FIGURE 33.8 LEVEL OF CURRENT ASSETS IN DIFFERENT POLICIES



Under ‘restricted policy’, the company intend to yield high return and accepting higher risk and the management is ready to counter any financial difficulties arising out of restricted policy.

The relaxed policy allows the company to have sufficient cushion for uncertainties, contingencies, seasonal fluctuations, changes in activity levels, changes in sales etc. The level of investment in current assets is high, which results in lesser return, but the risk level is also reduced.

In moderate policy, the expected profitability and risk levels fall between relaxed policy and restricted policy. The higher the level of investment in current assets represents the liberal working capital policy, in which the risk level is less and also the marginal return is also lesser.

Policies relating the levels of current assets at a glance

Policies / Description	Conservative	Moderate	Aggressive
Amount of Current Assets	Higher	Balance	Lower
Ratio of CA to Sales	Higher	Balance	Lower
Ratio of CA to FA	Higher	Balance	Lower
Impact of the policies on Firm's			
Liquidity	High	Moderate	Low
Profitability	Low	Moderate	High

Examples

A firm has projected the following for its operation in a year:

Sales ₹60,00,000; EBIT ₹7,50,000 and Fixed assets ₹20,00,000.

Due to uncertainty, the firm is not in a position to ascertain the exact amount of working capital and as a result, it is considering the following three levels of current assets holding

(a) ₹30,00,000; (b) ₹25,00,000 and (c) ₹20,00,000.

Comment on these three options.

Solution

Particulars	Case (a)	Case (b)	Case (c)
Fixed assets (₹) – A	20,00,000	20,00,000	20,00,000
Current assets (₹) – B	30,00,000	25,00,000	20,00,000
Total Investment (₹) – C = A + B	50,00,000	45,00,000	40,00,000
Sales (₹) – D	60,00,000	60,00,000	60,00,000
EBIT (₹) – E	7,50,000	7,50,000	7,50,000
Current assets to Sales – B × 100/D	50%	41.67%	33.33%
Return on investment (RoI) – E × 100/C	15%	16.67%	18.75%

Liquidity represented by Current assets to Sales is the highest (50%) in case (a) and lowest (33.33%) in case (c); and in between lies case (b) where the ratio is 41.67%.

RoI, on the other hand, is maximum (18.75%) in case of case (c) and the least (15%) in case (a); for case (b) it is in between (16.67%) the case (c) and case (a).

Here, case (a) is a conservative policy, case (b) is a moderate policy and case (c) is an aggressive policy.

Example 2

A company is considering its investment in working capital for next year. Estimated fixed assets are ₹8,00,000 and current liabilities ₹5,50,000. Its sales and EBIT depends on investment in current assets (more particularly in stock and receivables). Following policies are under consideration:

Policy	Conservative	Moderate	Aggressive
Current assets (₹)	11,50,000	9,50,000	6,50,000
Sales (₹)	30,00,000	28,00,000	25,00,000
EBIT (₹)	3,00,000	2,75,000	2,50,000

Calculate the following and give your observations:

a) Net working capital
b) Measure of profitability (both on turnover and on capital invested)
c) Measure of liquidity (both based on turnover and relative assets)

Solution

Policy	Conservative	Moderate	Aggressive
Fixed assets (₹) ....(A)	8,00,000	8,00,000	8,00,000
Current assets (₹) ....(B)	11,50,000	9,50,000	6,50,000
Current liabilities (₹) ....(C)	5,50,000	5,50,000	5,50,000
Capital Employed (₹) ...... (D = A + B – C)	14,00,000	12,00,000	9,00,000
Sales (₹) ....(E)	30,00,000	28,00,000	25,00,000
EBIT (₹) .... (F)	3,00,000	2,85,000	2,75,000
Answers:			
(a) Net working capital [B – C] (G) (in ₹)	6,00,000	4,00,000	1,00,000
(b) Measure of profitability:			
On turnover [F × 100/E] (H)	10%	10.17%	11%
On capital invested [F × 100/D] (I)	21.42%	23.75%	30.56%
(c) Measure of liquidity:			
Based on turnover [B/E] (J)	0.38	0.34	0.26
Based on relative asset [B/A] (K)	1.44	1.19	0.81
Comments:			
Liquidity in terms of working capital [see G]	*Highest*	*Moderate*	*Lowest*
Liquidity in terms of turnover and relative assets [see J & K]	*Highest*	*Moderate*	*Lowest*
Profitability both in terms of turnover and capital [see H & I]	*Lowest*	*Moderate*	*Highest*
Risk (from liquidity aspect) [see J & K]	*Low*	*Balanced*	*High*
Return (from profitability aspect) [see H & I]	*High*	*Balanced*	*Low*
Remarks: increase in liquidity, reduces risk as well as return and vice versa.			


Thank you