Presentation on

WORKING CAPITAL MANAGEMENT - II

Part-II

For the students
of
Semester – VI
B.Com.(Hons. & General)

By

Dr. Asim Kumar Manna

FINANCING OF CURRENT ASSETS

Important aspect of working capital management is to decide the pattern of financing the current assets and one of the major problem in working capital management is the decision whether to finance the working capital with one source or the other, the firm has to decide about the sources of funds which can be availed to make investment in current assets.

Nature of current assets

Circulating in nature as they are converted into cash, cannot be used for other purposes as it is reinvested in current assets again for the continuity of business activities. However, a part of the current assets may be released temporarily due to seasonality of demand. This part which is so released and can temporarily be invested elsewhere is called **temporary or fluctuating current assets.** The other part which remains locked till the continuation of business is called permanent current assets and the money so invested can be withdrawn from the business only on its winding up. Thus, current assets = Permanent current assets + Temporary current assets.

Nature of current assets

It may be noted that both the permanent and temporary components are predictable yet they differ on at least one dimension i.e., the permanent component of working capital is similar to an investment in fixed assets because it has to be replenished over time and thus requires financing for the long term. Consequently, it can be argued that this component should be financed with long term sources – either debt or equity or a combination of the two, depending upon the financing mix the firm chooses to use for financing long term assets. A part of permanent working capital may be financed by current liability also depending upon the trade-off between risk of having current liabilities and the cost associated with long term financing. The temporary component of working capital should be financed with pre-arranged lines of short term credit and the current liabilities

Sources of funds

It has been noted earlier that the net working capital is the excess of total current assets over total current liabilities. Thus, a part of total current assets is funded by current liabilities and only the remaining portion of current assets, known as net working capital, is to be arranged for. Therefore, the financial manager has to arrange funds for making investment in net working capital only. Different long term and short term sources of funds are available to a firm and all these sources are different from one another with respect to their nature and characteristics. The working capital requirements of a firm can be financed by all or any combination of these sources

Sources of funds

Different sources of funds can be grouped as follows:

i) **Long Term Sources** which provide funds for a relatively longer period. Under the category the main sources are the share capital, retained earnings, debentures and long term borrowings.

ii) **Short Term Sources** which usually provide funds for a short period say up to one year or so. In this category, the main sources are bank credit, public deposit, commercial papers, factoring etc.

iii) **Transactionary Sources** which provide fund to a business through the normal business operations e.g., credit allowed by suppliers and outstanding labor and other expenses. To the extent the firm delays or postpones the payments, the funds are available to it and that too generally at no cost. These are also called spontaneous sources of finance.

Financing Current Asset: Factor

While formulating the most suited mixing, companies pay attention mainly on three factors, viz., Flexibility, risk and return. Besides these three factors, financial markets might also play an important role.

1. Flexibility:

It is comparatively easy to repay short-term loans than long-term ones when the need for funds decreases. Long-term funds, e.g., debenture or preference share capital cannot be redeemed before time. Therefore, when the need for finance is of seasonal/ fluctuating nature, short-term sources (for financing current assets) will be more advantageous than long-term ones from the standpoint of flexibility.

Financing Current Asset: Factor

2. Risk:

Short-term financing, no doubt, involves less cost, but at the same time more risky than long-term ones due to the following:

(i) Interest cost on short-term borrowings may fluctuate widely whereas interest on long-term borrowings is more stable.

(ii) Continued financing from short-term sources exposes the firm unable to repay its short-term debts which adversely impacts on the credit reputation of the firm. In future, the firm may be unable to raise any funds since the lenders will be reluctant to extend loans and consequently, its operating activities may be disrupted.

Therefore, it is better to use long-term funds than short-term funds for financing current assets. At least, the fixed/permanent current assets should be financed from long-term sources in order to avoid risk.

Financing Current Asset: Factor

Risk-return trade-off:

From the above, it is quite clear that short-term financing is less expensive than long-term financing but the former involves greater risk than the latter. So, the choice between long-term and short-term financing relates to trade-off between risk and return.

Financing Current Asset: Factor

3. Cost of Financing:

Short-term sources are less expensive than long-term since short-term sources involve greater degree of risk from the standpoint of risk preferences. As such, the lenders will prefer short-term financing. From the co's view point, short-term sources are comparatively risky as the money to be repaid within a short period of time. Another notable point is that, in case of long-term sources the co. has to pay interest for the whole period even for the seasons when funds are temporarily not required.

The following illustration will make the principle clear.

Illustration:

(a) Total investments:

In Fixed Assets	Rs.	1,20,000	
In Current Assets	Rs.	80,000	
			2,00,000

(b) Earning (EBIT) is 12%.

(c) Debt-ratio is 60%.

(d) Rs. 80,000 being 40% assets is financed by the equity shareholders, i.e., long-term sources.

(e) Cost of short-term debt and long-term debt is 7% and 8% respectively.

(f) Assume Income-tax @ 50%.

As a result of the financing policy, ascertain the return on equity shares.

Solution:

Table 8.1 Showing the effect of long-term and short-term financing

	Financing Plans		
	Conservative	Moderate	Aggressive
	Rs.	Rs.	Rs.
Current Assets	80,000	80,000	80,000
Fixed Assets	1,20,000	1,20,000	1,20,000
Total Assets	2,00,000	2,00,000	2,00,000
Short-term debt (7%)	—	40,000	80,000
Long-term debt (8%)	80,000	40,000	—
EBIT (@ 12½ on Rs. 2,00,000)	25,000	25,000	25,000
Less : Interest	6,400	6,000	5,600
Taxable Income	18,600	19,000	19,400
Less : Tax @ 50%	9,300	9,500	9,700
Earning on equity share	9,300	9,500	9,700
Rate of return on equity share	11.62%	11.88%	12.'2%

$$\left(\frac{9,300}{80,000} \times 100\right)$$

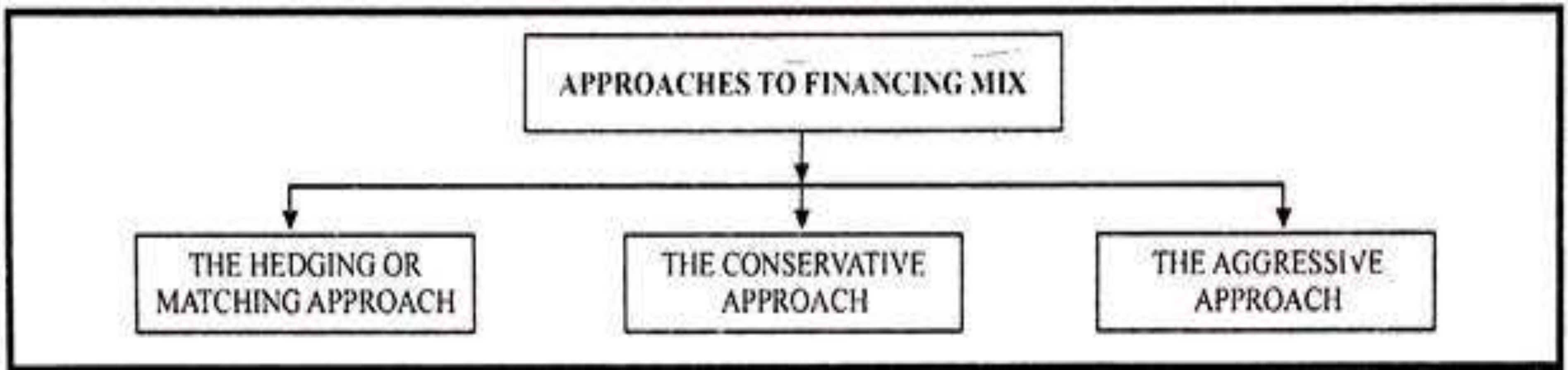
It is evident from the above table that the return on equity shares differs under different policies. It is the highest in the case of aggressive policy and lowest in the case of conservative policy. Since the ratio of short-term debt to total assets is higher in the case of aggressive policy, the risk is also great and in the opposite case, there is no risk.

Strategies of Working Capital Financing

MEANING OF FINANCING STRATEGIES

A financing strategy establishes the fundamental steps of how an organization can achieve its financing targets, be it short term or long term. It involves a strategic plan as to how the organization can finance its overall operations. An ideal financing strategy must serve as a guideline for the employees of an organization in conducting the day to day finances

There are three strategies or approaches or methods of working capital financing –
Maturity Matching (Hedging), Conservative and Aggressive.



1. Hedging or Matching Financing Strategy

This strategy finances permanent current assets and fixed assets with long-term sources and temporary current assets with short-term sources.

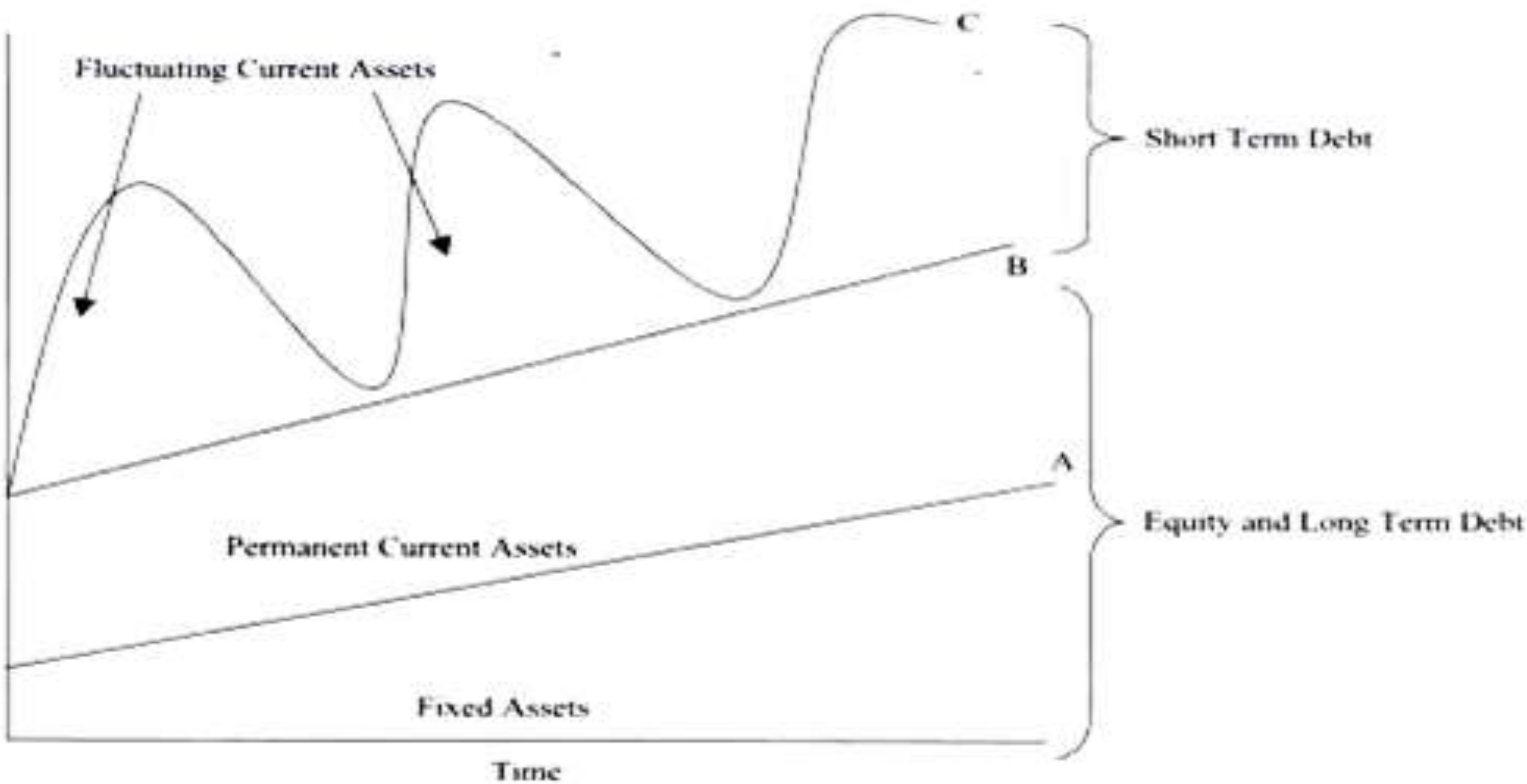


FIGURE 8.1 Hedging/Matching Policy

2. Conservative Financing Strategy

In this strategy, only a portion of temporary current assets are financed with short-term sources. Long-term financing is used to fund the other portion of temporary current assets along with the permanent current assets and fixed assets.

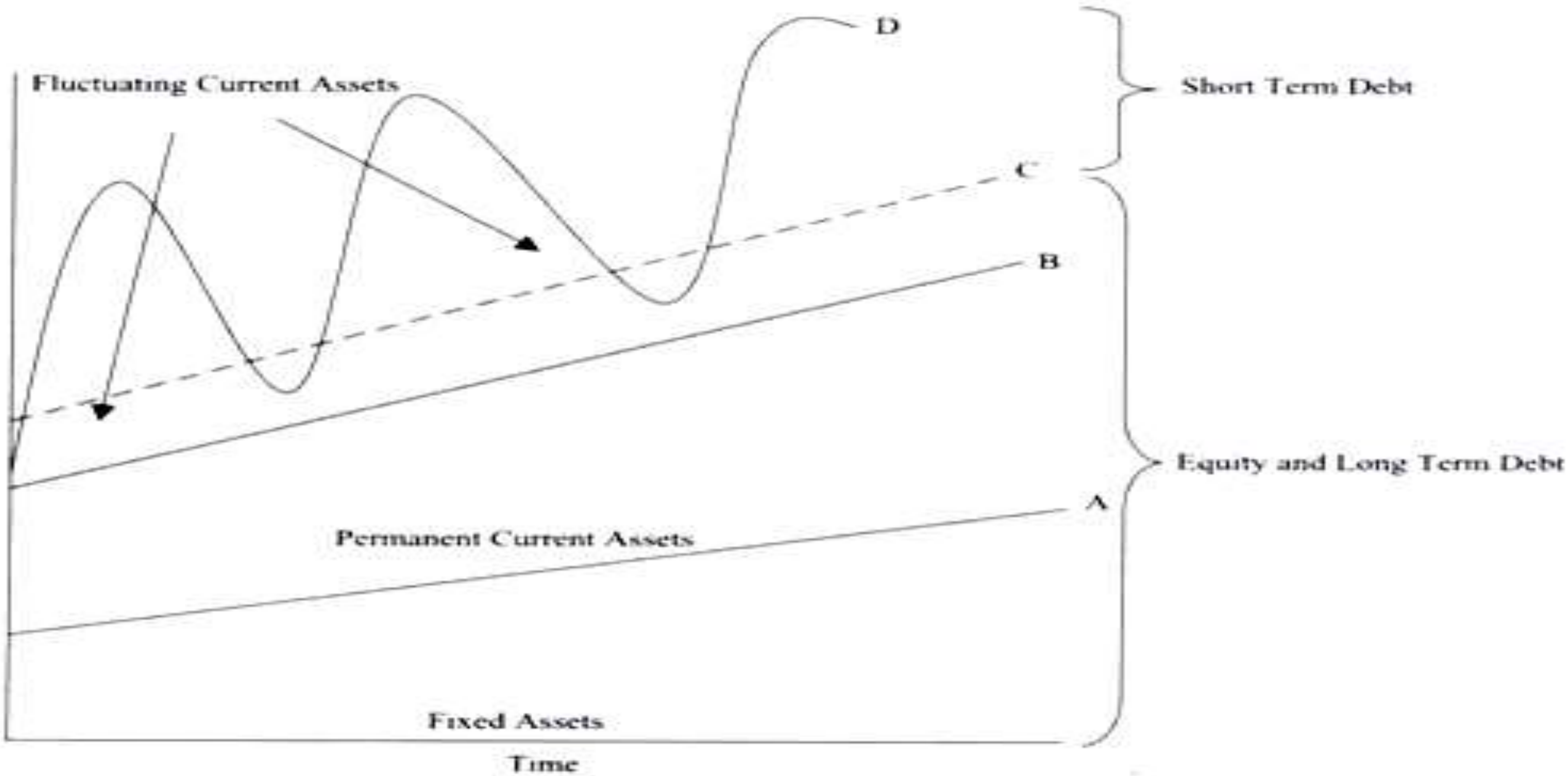


FIGURE 8.2 Conservative Policy

3. Aggressive Financing Strategy

Using an aggressive financing strategy, a company will finance a portion of permanent current assets and all temporary current assets with short-term sources. Long-term financing is used to fund the other portion of permanent current assets and fixed assets.

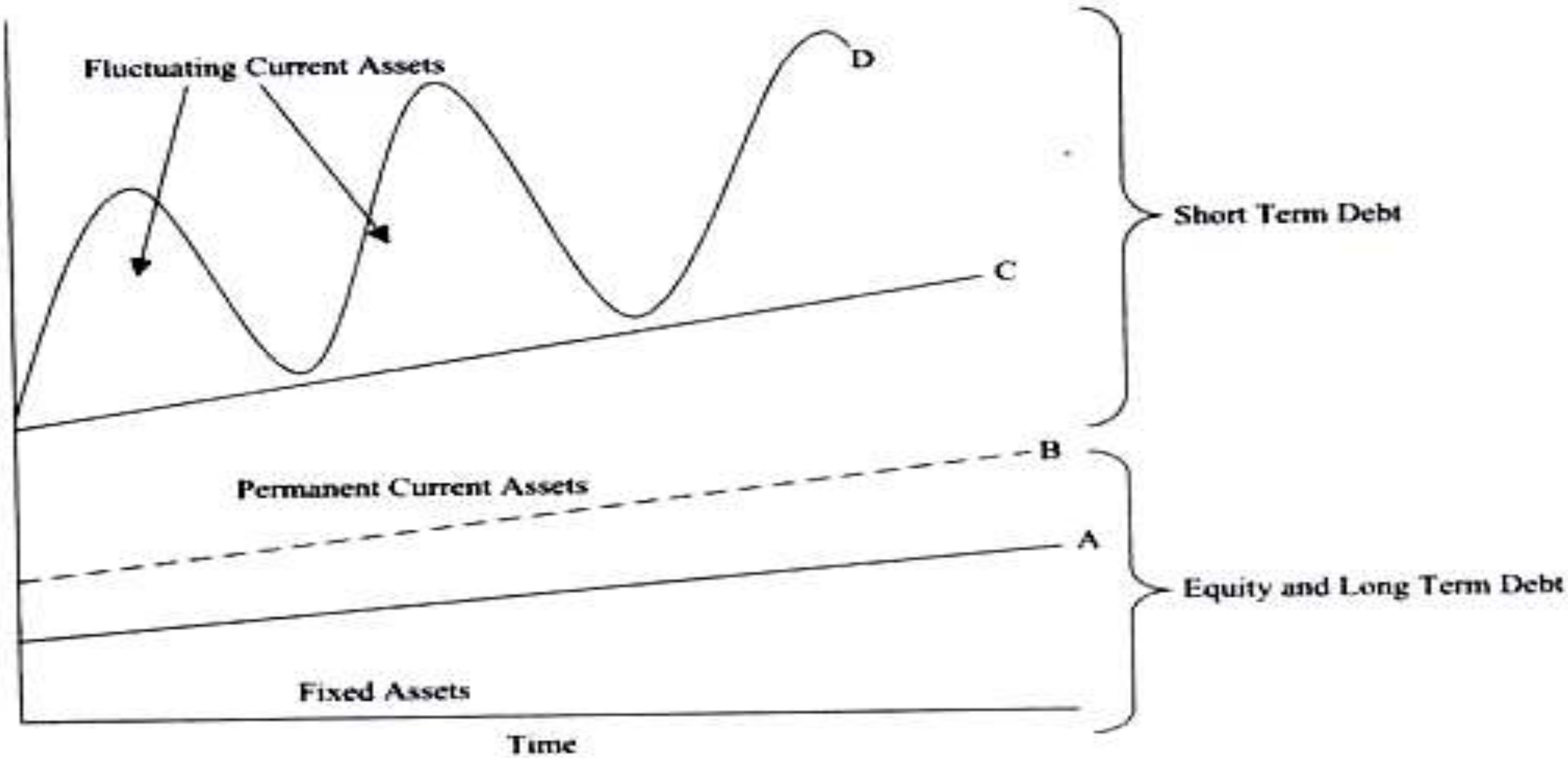


FIGURE 8.3 Aggressive Policy

Approaches in tabular form

Approaches / Types of assets	Matching	Conservative	Aggressive
FA	From long-term sources	From long-term sources	From long-term sources
Permanent WC	From long-term sources	From long-term sources	A part from long-term sources and balance part from short-term sources
Temporary WC	From short-term sources	A part from long-term sources and balance part from short-term sources	From short-term sources
Impact of the approaches on Firm's			
Liquidity	Balanced	High	Low
Profitability	Moderate	Low	High
Risk	Balanced	Low	High

Explain the working capital position of Ankita Co. under different working capital policies from the following figures:

Particulars	Working Capital Policy		
	Conservative (₹)	Balanced (₹)	Aggresive (₹)
Fixed Assets	1,60,000	1,60,000	1,60,000
Current Assets	1,60,000	1,40,000	1,20,000
Total Assets	3,20,000	3,00,000	2,80,000
Share Capital	1,60,000	1,40,000	1,20,000
12% Debentures	1,20,000	1,00,000	80,000
8% Short term loan	40,000	60,000	80,000
	3,20,000	3,00,000	2,80,000

Sales ₹7,20,000; Operating Profit – 15% on sales; Assume tax rate @ 40%.

Solution:

Analysis of Working Capital Position

Particulars	**Working Capital Policy**		
	Conservative (₹)	**Balanced (₹)**	**Aggresive (₹)**
Current Assets (C.A.)	1,60,000	1,40,000	1,20,000
Less : Current liabilities (C.L.) (8% Short term loan)	40,000	60,000	80,000
Net Working Capital	1,20,000	80,000	40,000
Current Assets financed by :			
Short term sources	40,000	60,000	80,000
Long term sources	1,20,000	80,000	40,000
	1,60,000	1,40,000	1,20,000
Current ratio (CA/CL) (times)	4	2.33	1.5
Sales	7,20,000	7,20,000	7,20,000

Analysis of Working Capital Position

Particulars	Working Capital Policy		
	Conservative (₹)	Balanced (₹)	Aggresive (₹)
Operating Profit (EBIT) (15% on sales)	1,08,000	1,08,000	1,08,000
Less: Interest:			
– Interest on Debentures (12%)	14,400	12,000	9,600
– Interest on short term loans (8%)	3,200	4,800	6,400
	90,400	91,200	92,000
Less: Tax @ 40%	36,160	36,480	36,800
EAT	54,240	54,720	55,200
Return on Investment (ROI) $\left[\frac{\text{EAT}}{\text{Total Assets}} \times 100\right]$	16.95%	18.24%	19.71%

Analysis:

We can observe from the above analysis that current ratio is 4 times if conservative policy is followed, it has dropped to 1.5 in management of working capital under aggressive policy. However, the return on investment has increased from 16.95% to 19.71%, if aggressive approach is adopted. Higher risk is attached with the higher return, under aggressive policy.

In conservative approach majority of current assets are financed from long-term sources of finance. When it comes to financing current assets under aggressive approach, majority of current assets are financed from short-term sources.

The moderate policy stands in between two extremes of conservative and aggressive financing approaches. Majority of the corporate follow the moderate policy of working capital financing, which enables to avoid higher risk and to earn moderate profit margin on additional investments in current assets.


Thank
you