# IMPORTANCE OF WORKING CAPITAL MANAGEMENT

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**Abstract:** Financial Management is that managerial activity which is concerned with the planning and controlling of the firm's financial resources. A company's working capital essentially consists of current assets and current liabilities. Current assets refer to those assets that can be converted into cash within one year, like debtors, and stock and prepaid expenses- expenses that have already been paid for. Thus, working capital management refers to monitoring these two components or the short-term liquidity of your firm. Structuring an effective working capital management is a great way to enhance the income. Ratio analysis and management of individual components of working capital are two primary importance of working capital management. There are several techniques to delay payment of accounts payable namely (1) avoidance of early payments; (2) centralized disbursements; (3) floats; (4) accruals. This importance of working capital management will assist you in maintaining optimum inventory level. Also, you can build your strategies and techniques to clear aged inventories, improve working capital, generate cash and much more. Your steps towards significance of working capital management will definitely improve your brand loyalty as well as profitability for your organization.

**Key words: Working capital Management, Financial Management, Capital.**

## 1. INTRODUCTION

Financial Management is that managerial activity which is concerned with the planning and controlling of the firm's financial resources. Financial management focuses on finance manager performing various tasks as budgeting financial forecasting, cash management, credit administration, investment analysis, funds management etc.

Any firm, from time to time employs its short-term assets as well as short-term financing sources to carry out its day to day business. It is this management of such assets as well as liabilities which is described as working capital management.

## 2. WORKING CAPITAL MANAGEMENT MEANING

A company's working capital essentially consists of current assets and current liabilities. Current assets refer to those assets that can be converted into cash within one year, like debtors, and stock and prepaid expenses- expenses that have already been paid for. Current liabilities are the day-to-day debts incurred by a business in its operation. These could be credit purchases made from vendors (creditors) and outstanding expenses (expenses that are yet to be paid). Thus, working capital management refers to monitoring these two components or the short-term liquidity of your firm. Three fundamental parameters that help you manage working capital requirements better and indicate your liquidity standing of your firm are:

**1. Working Capital Ratio:**
A ratio between the current assets and current liabilities, it signifies the current ability of an organization to pay off its short-time financial obligations.

**2. Collection Period Ratio**
Also known as the debtors or accounts receivables turnover ratio, this ratio is indicative of a company's ability to convert its debts into cash. The lesser number of days it takes to realise its payments from its debtors, the better.

**3. Inventory Turnover Ratio**
Also known as the stock turnover ratio, this ratio monitors the time a company takes to converts its goods into cash. Lower the time taken, higher is the company's stock efficiency.

Strong working capital management aids a company in having a higher operational efficiency and hence, higher profitability. For this, Bajaj Finserv offers special working capital loan which will help your business meet its short-term liquidity smoothly.

## 3. IMPORTANCE OF WORKING CAPITAL

Structuring an effective working capital management is a great way to enhance the income. **Ratio analysis** and **management of individual components** of working capital are two primary importance of working capital management.

***1. Ratio Analysis***
Process of determining and analysing numerical relationships in accordance to financial statements like balance sheets, income statements and cash inflow statements is known as ratio analysis. The primary purpose of ratio analysis is to appraise the operating and financial performance of an economic activity and determine its efficiency, profitability, liquidity and solvency. It also helps in getting a brief idea about comparative valuation by comparing ratios of different companies in the same sector.

***2. Inventory Management***
Inventory management has huge importance of working capital management, it involves overseeing the purchase of new items and managing the existing ones. It aims to create such a purchase plan that will ensure effective delivery of materials. Two most used inventory management strategies are 'Just-in-Time Method' and 'Material Required Planning.' In former one the firm plans to receive items at the time of need rather than maintaining high inventory levels, and the latter one is based sales forecasts.

***3. Cash Management***

Cash management is process of collecting, managing and utilizing the cash inflow to optimize the short-term financial stability. The key component in accomplishing this task is solvency as an importance of working capital management. Successful cash management is useful when any unexpected demand for cash occurs unexpectedly.

**Figure – 1**

**Importance of the working capital**


**4. ADVANTAGES 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, shareholder 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 its 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 favourable 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.

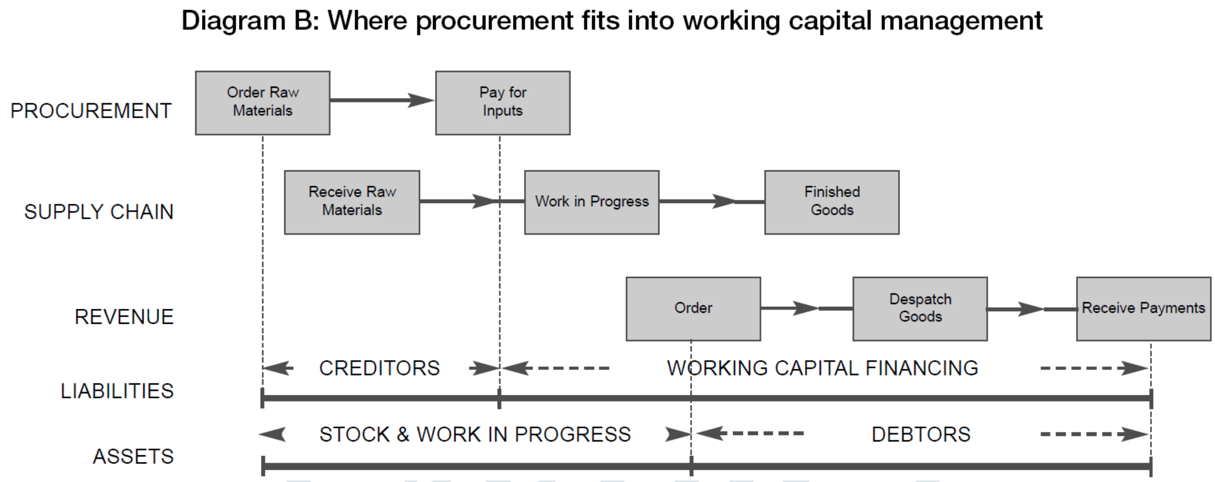
**5. ABILITY TO FACE SHOCKS AND PEAK DEMAND**

Efficient working capital management will help a firm to survive through a crisis or ramp up production in case of an unexpectedly large order. Cash Planning: **-** Cash inflows and cash outflows should be planned to project cash surplus or deficit for each period of the planning period. Cash budget should prepare for this purpose.

**Managing the cash flows: -** The flow of cash should be properly managed. The cash inflows should be accelerated while, as far as possible decelerating the cash outflows. Optimum cash level: **-** The firm should decide about the appropriate level of cash balances. The cost of excess cash and danger of cash deficiency should be matched to determine the optimum level of cash balances.

**Investing surplus cash: -** The surplus cash balance should be properly invested to earn profits. The firm should decide about the division of such cash balance between bank deposits, marketable securities and inter corporate lending. The ideal Cash Management system will depend on the firm's products, organization structure, competition, culture and options available. The task is complex and decision taken can affect important areas of the firm.

**Figure – 2**




## 6. MOTIVES FOR HOLDING CASH

There are four primary motives for maintaining cash balances:

1. Transaction motive
2. Precautionary motive
3. Speculative motive
4. Compensating motive

**1. Transaction motive: -** The transaction motive refers to the holding of cash to meet anticipated obligations whose timing is not perfectly synchronized with cash receipts. If the receipts of cash and its disbursements could exactly coincide in the normal course of operations, a firm would not need cash for transaction purposes. Although a major part of transaction balances are held in cash, a part may also be in such marketable securities whose maturity conforms to the timing of the anticipated payments

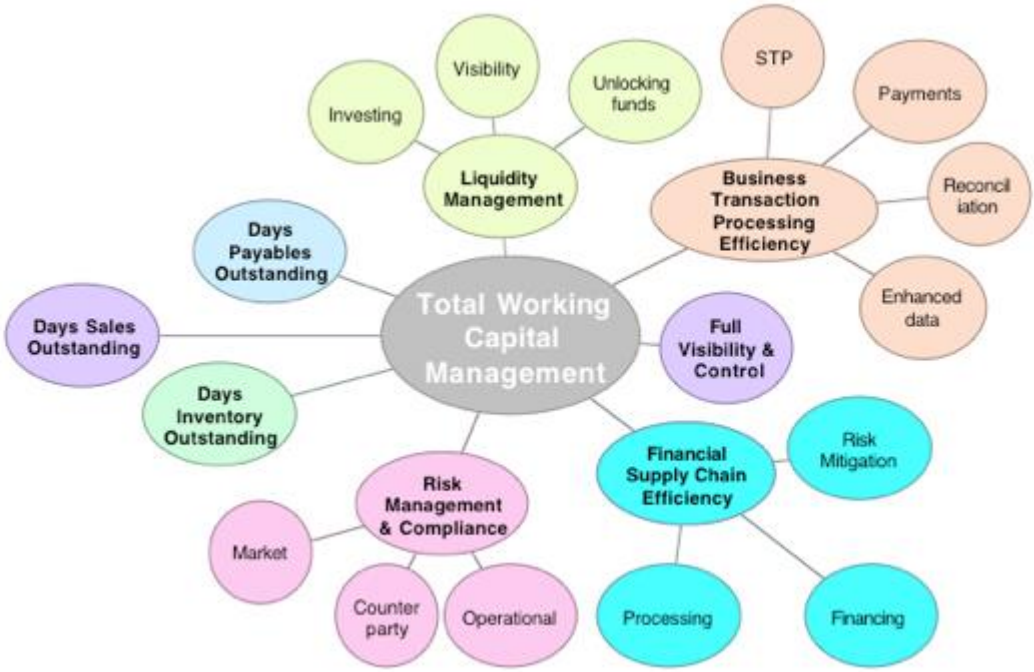
**2. Precautionary motive: -** Precautionary motive of holding cash implies the need to hold cash to meet unpredictable obligations and the cash balance held in reserve for such random and unforeseen fluctuations in cash flows are called as precautionary balances. Thus, precautionary cash balance serves to provide a cushion to meet unexpected contingencies. The unexpected cash needs at short notice may be the result of various reasons as: unexpected slowdown in collection of accounts receivable, cancellations of some purchase orders, sharp increase in cost of raw materials etc. The more unpredictable the cash flows, the larger the need for such balances. Another factor which has a bearing on the level of precautionary balances is the availability of short term 26 credit. Precautionary cash balances are usually held in the form of marketable securities so that they earn a return.

**3. Speculative motive: -** It refers to the desire of a firm to take advantage of opportunities which present themselves at unexpected movements and which are typically outside the normal course of business. The speculative motive represents a positive and aggressive approach. Firms aim to exploit profitable opportunities and keep cash in reserve to do so. The speculative motive helps to take advantage of: In opportunity to purchase raw materials at a reduced price on payment of immediate cash; a chance to speculate on interest rate movements by buying securities when interest rates are expected to decline; delay purchases of raw materials on the anticipation of decline in prices; etc.

**4. Compensation motive: -** Yet another motive to hold cash balances is to compensate banks for providing certain services and loans. Banks provide a variety of services to business firms, such as clearances of cheques, supply of credit information, transfer of funds, etc. While for some of the services banks charge a commission of fee for others, they seek indirect compensation. Usually clients are required to maintain a minimum balance of cash at the bank. Since this balance cannot be utilized by the firms for transaction purposes, the bank themselves can use the amount for services rendered. To be compensated for their services indirectly in this form, they require the clients to always keep a bank balance sufficient to earn a return equal to the cost of services. Such balances are compensating balances. Compensating balances are also required by some loan agreements between a bank and its customer.

**Figure – 3**

**Total working capital management**




**Meeting the payments schedule: -** A basic objective of the cash management is to meet the payment schedule, i.e. to have sufficient cash to meet the cash disbursement needs of the firm. The importance of sufficient cash to meet the payment schedule can hardly be over emphasized. The advantages of adequate cash are:

1. It prevents insolvency or bankruptcy arising out of the inability of the firm to meet its obligations;
2. The relationship with the bank is not strained;
3. It helps in fostering good relations with trade creditors and suppliers of raw materials, as prompt payment may also help their cash management;
4. It leads to a strong credit rating which enables the firm to purchase goods on favourable terms and to maintain its line of credit with banks and other sources of credit;
5. To take advantage of favourable business opportunities that may be available periodically;
6. Finally, the firm can meet unanticipated cash expenditure with a minimum of strain during emergencies, such as strikes, fires or a new marketing campaign by competitors.

**Minimizing funds committed to cash balances**

The second objective of cash management is to minimize cash balances. In minimizing cash balances two conflicting aspects have to be reconciled. A high level of cash balance will, ensure prompt payment together with all the advantages, but it also implies that large funds will remain idle ultimately results less to the expected. A low level of cash balances, on the other hand, may mean failure to meet the payment schedule that aim of cash management should be to have an optimal amount of cash balances. Cash management techniques and process the following are the basic cash management techniques and process which are helpful in better

**Cash management**

Speedy cash collection: In managing cash efficiently the cash inflow process can be accelerated through systematic planning and refined techniques. These are two broad approaches to do this which are narrated as under: Prompt payment by customer: One way to ensure prompt payment by customer is prompt billing with clearly defined credit policy. Another and more important technique to encourage prompt payment the by customer is the practice of offering trade discount/cash discount. Early conversion of payment into cash: Once the customer has made the payment by writing its cheques in favor of the firm, the collection can be expedited by prompt encashment of the cheque. It will be recalled that there is a lack between the time and cheque is prepared and mailed by the customer and the time funds are included in the cash reservoir of the firm. Concentration Banking: In this system of decentralized collection of accounts receivable, large firms which have a large no. of branches at different places, select some of these which are strategically located as collection centres for receiving payment for customers. Instead of all the payments being collected at the head office 28 of the firm, the cheques for a certain geographical area are collected at a specified local collection centre. Under this arrangement the customers are required to send their payments at local collection centre covering the area in which they live and these are deposited in the local account of concerned collection, after meeting local expenses, if any. Funds beyond a predetermined minimum are transferred daily to a central or disbursing or concentration bank or account. A concentration banking is one with which the firm has a major account usually a disbursement account. Hence this arrangement is referred to as concentration banking.

**Lock-Box System**

The concentration banking arrangement is instrumental in reducing the time involved in mailing and collection. But with this system of collection of accounts receivable, processing for purposes of internal accounting is involved i.e. sometime in elapses before a cheque is deposited by the local collection centre in its account. The lock-box system takes care of this kind of problem, apart from effecting economy in mailing and clearance times. Under this arrangement, firms hire a post office box at important collection centres. The customers are required to remit payments to lock-box. The local banks of the firm, at respective places, are authorized to open the box and pick up the remittance received from the customers. Usually the authorized banks pick up the cheques several time a day and deposit them in the firm's account. After crediting the account of the firm the banks send a deposit 4epo slip along with the list of payments and other enclosures, if any, to the firm by way of proof and record of the collection. Slowing disbursements: A basic strategy of cash management is to delay payments as long as possible without impairing the credit rating/standing of the firm. In fact, slow disbursement represents a source of funds requiring no interest payments.

There are several techniques to delay payment of accounts payable namely
(1) Avoidance of early payments;
(2) Centralized disbursements;
(3) Floats;
(4) Accruals.

**Avoidance of early payments**: One way to delay payments is to avoid early payments. According to the terms of credit, a firm is required to make a payment within a stipulated period. It entitles a firm to cash discounts. If however payments are delayed beyond the due date, the credit standing may be adversely affected so that the firms would find it difficult to secure trade credit later. But if the firm pays its accounts payable before the due date it has no special advantage. Thus a firm would be well advised not to make payments early i.e. before the due date. Centralized disbursements:

**Centralized disbursements:** Another method to slow down disbursements is to have centralized disbursements. All the payments should be made by the head office from a centralized disbursement account. Such an arrangement would enable a firm to delay payments and conserve cash for several reasons. Firstly it involves increase in the transit time. The remittances from the head office to the customers in distant places would involve more mailing time than a decentralized payment by a local branch. The second reason for reduction in operating cash requirement is that since the firm has a centralized bank account, a relatively smaller total cash balance will be needed. In the case of a decentralized arrangement, a minimum cash balance will have to be maintained at each branch which will add to a large operating cash balance. Finally, schedules can be tightly controlled and disbursements made exactly on the right day.

**Float: -** A very important technique of slow disbursements is float. The term float refers to amount of money tied up in the cheques that have been written, but have yet to be collected and enchased. Alternatively, float represents the difference between the bank balance and book balance of cash of a firm. The difference between the balance as shown in the firm's record and the actual bank balance is due to transit and processing delays. There is time lag between the issue of a cheque by the firm and its presentation to its bank by the customer's bank for payment. The implication is that although a cheque has been issued cash would be required later when the cheque resented for encashment. Therefore, a firm can send remittance although it does not have cash in its bank at the time of issuance of cheque. Meanwhile, funds can be arranged to make payments when the cheque is presented for collection after a few days. Float used in this sense is called cheque kitting.

**Accruals: -** Finally, a potential tool for stretching accounts payable is accruals which are defined as current liabilities that represent a service or goods received by a firm but not yet paid for instance, payroll, i.e. remuneration to employees, who render services in advance and receive payment later. In a way they extend credit to the firm for a period at the end of which they are paid, say, a week or month. The longer the period after which payment is made, the greater the amount of free financing and the smaller the amount of cash balances required. Thus, less frequent payrolls, i.e. monthly as compared to weekly, are important sources of accruals. They can be manipulated to slow down disbursements.

## 7. CONCLUSION

This importance of working capital management will assist you in maintaining optimum inventory level. Also, you can build your strategies and techniques to clear aged inventories, improve working capital, generate cash and much more. Your steps towards significance of working capital management will definitely improve your brand loyalty as well as profitability for your organization.

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