WORKING CAPITAL – A CONCEPTUAL FRAME WORK

Dr. N. Praveen Kumar Reddy
Professor, Department of Management
Dilla University, Dilla, Ethiopia

Abstract
In the competitive and international business world of today, finance is the most important and primary input of any economic activity. Any amount of money needed for economic activity can be divided into two categories: working capital, which is needed to maintain the fixed assets in operational condition, and fixed capital, which is needed to purchase various fixed assets. Any business that raises money can be divided into two primary categories: working capital (i) and fixed capital (ii). Funds are necessary for every firm to operate on a daily basis and to cover startup costs. To establish production and trading facilities, long-term financing is needed for the acquisition of fixed assets such buildings, furnishings, machinery, land, and plants. Fixed capital is the amount invested in these fixed company assets. Current assets can also be purchased with funds. Working capital is the money required for paying salaries, buying inventory, and other ongoing costs.

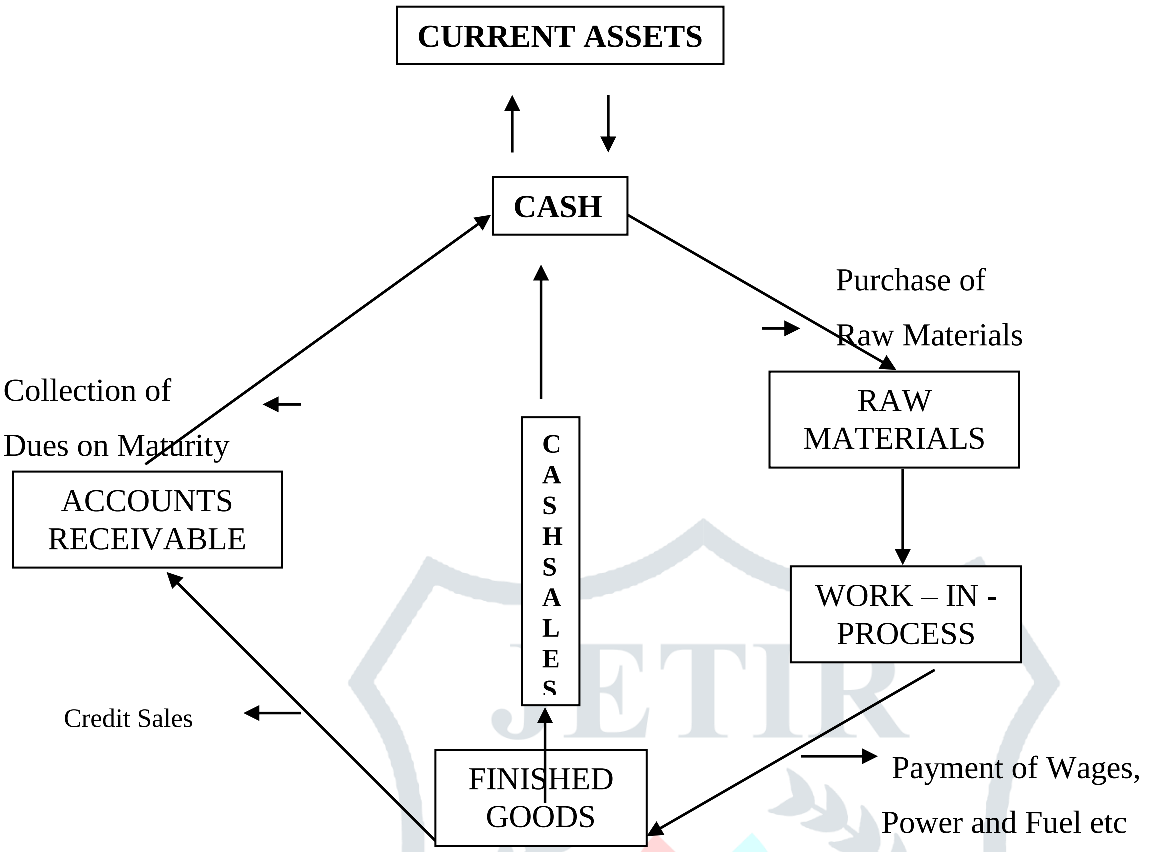
Key Words: Capital, Current Assets, Fixed Capital, Net Working Capital.

One may argue that working capital is the vitality and brains of every company. Just as blood circulation is vital to a physical body's survival, so too is it to a commercial entity. Regardless of size or position, it is an essential component for any commercial enterprise to operate smoothly in order to accomplish its objectives. No company unit can succeed without enough operating capital and using it wisely. Working capital resources should be managed effectively to ensure both liquidity and profitability, both of which have an impact on an organization's ability to grow.

Capital is the sum of money that a business's owners provide in order to launch and run it. It also includes of the business's total earnings over time. In addition to cash, there is additional capital available in the form of loans from commercial banks, financial institutions, and other lending organizations. The business's raised funds can be divided into two primary categories: (i) Fixed Capital and (ii) Working Capital. All businesses need money to operate on a daily basis and to cover their establishment costs. For manufacturing and trading facilities, long-term financing is needed for the acquisition of fixed assets including equipment, machinery, land, buildings, furnishings, etc.

Fixed capital is the amount invested in these fixed business assets. Current assets can also be purchased with funds. Working capital is the money required for paying salaries, buying inventory, and other ongoing costs. Current assets will be constantly changing and involving the flow of money, with the original cash changing into different stages of inventory, debtors, and back to cash. The procedure is often referred to as the cash cycle or operating cycle. Working capital operating cycle is a novel idea that has grown in significance recently. The following figure illustrates the typical business organization's operating cycle.

OPERATING CYCLE / CASH CYCLE



To maximize benefits, the company should continue to invest at an optimal level in the various components of its current assets. Depending on the type of current asset, high or low levels of investment could cause money to get blocked up or disrupt the cash cycle's regular flow. Ensuring a smooth and swift flow of funds throughout the operating cycle is the goal of working capital management, as this will boost the company's working capital efficiency and profitability. Since these factors will determine the business enterprise's profitability, it is imperative that current funds be managed prudently and that working capital requirements be accurately estimated and controlled. The idea of an operating or cash cycle is also used to calculate how much working capital a company will need.

The working capital to fixed capital ratio affects a company's profitability as well. When all else is equal, the profitability of the business will decrease if working capital rises while held fixed assets remain constant. Thus, maintaining the proper ratio of fixed capital to working capital should be one of the management's goals. While working capital actually enables the efficient use of fixed assets, the firm's assets actually generate the goods for sale, establish an operational base, and generate earning potential. Working capital is the body, and fixed assets are the skeleton, according to Yasaswy.

One of the most important aspects of financial management is working capital management. Working capital is a two-edged sword: from the perspective of the business unit, both excessive and inadequate working capital positions are extremely dangerous. Lack of working capital causes inefficiencies and disruptions in trading and production, which further lowers the firm's profitability. Ensuring that working capital is managed effectively is crucial for the smooth operation of business processes.

Divergent opinions exist concerning the notion of working capital. In general, "Gross and Net" working capital concepts are popular. Working capital, as defined by the "gross" concept, is the amount of money allocated to various current assets that are in circulation and have the potential to be turned into cash during an accounting year. Gross working capital is sometimes referred to as current capital or circulating capital due to its nature. Cash, short-term securities, debtors, accounts receivable, and stocks are among the assets. According to accounting convention, current assets are only those that are anticipated to be turned into cash within a year.

A different definition of working capital is "Net" working capital, which is the sum of all current assets less all current liabilities and provisions. According to this theory, net working capital is the total amount of current assets that would be left over after all current liabilities have been settled. This idea states that working capital can only exist if current assets exceed current liabilities. On the other hand, "If current liabilities exceed current assets, a working capital deficit exists."

Current liabilities, which typically comprise creditors, bills payable, bank overdrafts, and unpaid expenses, are those claims made by third parties that are anticipated to mature for payment within an accounting year.

The two ideas mentioned above are equally crucial. Because it concentrates attention on the levels of current assets, the gross concept is quantitative in nature. This opinion was backed by economists because current assets do contribute to earnings. The argument for the quantitative approach was that current and fixed assets are similar. As stated by them:

(i) The amount of profit is the outcome of the complementary and reciprocal roles that current and fixed assets play. They are comparable to each other. Current assets are regarded as representing working capital, and fixed assets are intended to represent fixed capital. Both forms of capital have returns above and beyond the cost of interest when they are borrowed. Day-to-day fluctuations in current assets necessitate routine inspections and careful assessments of account balances in line with the company's goals.

(ii) It is further argued that net working capital does not account for the increase in borrowings. because taking out a loan would increase the company's cash and current liabilities. Everybody gets better. Actually, for every increase in borrowing, working capital increases proportionately.

(iii) As a going concern, the company is interested in this concept. The management must focus on current assets and devote more time to their management because the total of all current assets makes up the total amount of funds available for operating purposes.

(iv) In the case of a sole proprietorship, where the business's net worth is represented in the owner's capital account, or a partnership, where each partner's account represents the entirety of the company's "net worth," the gross concept of working capital is more appropriate. There is close communication between ownership and management in both situations. In the case of a joint stock company, which exists as an entity apart from its shareholders, this is not the case. The control of fixed and current assets has not received much attention since ownership, management, and control are separated.

The investment of money in different current asset components, including cash, short-term securities, receivables, prepayments, short-term loans, advances, and inventories, is known as gross working capital. The accounting convention restricts them to those that are anticipated to be turned into cash in less than a year7. Another way to think of current assets is as those that, in the regular course of business, can be turned into cash in a year or less without losing value or causing any disruptions to the organization.

Prominent economists such as Adam Smith, A.S. Dewing, Kenneth Field, John C. Baker & D.W. Mallor, Edwards Mead, and A.K. Sen endorse the broad definition of working capital.

According to Adam Smith, "the merchant's goods bring him no income or profit unless he sells them for money, and the money brings him some income until it is exchanged for goods once more. His capital is always leaving him in one form and coming back to him in another, and the only way it can make him money is through this kind of circulation, or series of exchanges. Therefore, it would be appropriate to refer to this capital as circulating capital15. In actuality, Smith referred to what we now refer to as "circulating capital."

It is evident that the issues surrounding the day-to-day management of specific current assets in business operations are addressed by gross working capital management. These assets typically make up more than half of the company's total assets. Current assets make up between 50 and 60 percent of the investment in consumer cooperatives. The financial executive can assess different financial offerings and constraints, both current and proposed, with the aid of working capital management. Furthermore, it takes a lot of time and effort to manage current assets profitably; it also requires more effort. The amount of current assets determines the business unit's risk and return. Both risk and return would decrease as current asset sizes increased, and vice versa.

Investments in current assets, which management expects to remain active, are comparatively risky. These assets regularly and continuously run out of cash and come back into cash in a going concern. Every company wants to accelerate this conversion process because a higher conversion rate requires less working capital and requires less investment in current assets.

By definition, current assets are a manageable portion of investments, especially in a trading company. Additionally, making an effort to maximize the investment in each of these assets' component parts would undoubtedly guarantee savings on needless expenses and ultimately result in profitability. Every business wants to invest its current assets as optimally as possible because this maximizes return and minimizes risk. If this isn't done, it will negatively affect the company and cause an unprofitable business operation that will result in losses as well as negatively affect the company's liquidity position. Thus, finding a balance between liquidity and profitability is crucial.

Any business that doesn't make sure that its current assets flow smoothly will suffer from negatively impacted operations. As a result, there may occasionally be a severe shortage of current assets and occasionally an excess of others, both of which are detrimental to the operations of the business. A shrewd financial manager will act quickly and decisively to accelerate the flow of current assets without compromising the caliber of output or customer service. The care he takes consequently affects the company's profitability. In order to keep up with business operations, these assets must be properly planned, directed, and the necessary action must be taken. They must also be continuously inspected. All of these demand that the financial executives have a solid understanding of the short-term investment landscape and know how to use financial resources to optimize returns.

Components of Gross Working Capital

We can better comprehend the components of current assets if we have a general understanding of the gross working capital components, which are covered below.

Inventory

A significant amount of gross working capital is allocated to inventory, which is the actual stock of goods kept in storage to ensure the seamless operation of a business. Raw materials, work-in-progress, completed goods, goods in transit, and goods stored in a warehouse that are ready to be sold are all examples of inventory. It serves as a barrier between the customer and the supplier, who often provides material in large quantities at a consistent rate. Without inventory, businesses could suffer negative effects.

In order to effectively manage inventory, one must strike a balance between carrying costs and losses from lowered sales as a result of a production program interruption. Lower inventory levels can cause frequent production process interruptions, which can lead to underutilization of production capacity and unprofitable sales volume. Conversely, higher inventory levels result in higher interest and storage costs. Additionally, the cost of keeping inventory locked up increases with the amount invested. This has a negative impact on the company's profitability and idles resources that could be put to better use elsewhere. Organizations that invest a large and excessive amount of money in inventory run the risk of becoming very dangerous. The ideal inventory investment is what's required, one that maximizes profits while minimizing expenses. As a result, inventory management demands close attention.

Accounts receivable

Accounts receivable in any manufacturing or commercial business typically indicate credit extended to clients. The firm's and the industry's credit and collection policies determine how much money is invested in debtors. It entails weighing the trade-off between the profits from increased sales brought about by the company's generous credit facilities and the additional expenses incurred in servicing these debts. The cost of debt collection, interest rates, and the frequency of bad debts are all factors in liberal credit policies.

Similar to the previous example, a strict credit policy reduces sales volume because some customers may choose to do business with rivals who have more lenient terms, which has a negative impact on the company's profitability.

In addition to establishing a company's credit policy, managing debtors necessitates a thorough analysis of the risk involved in extending credit to different parties. Effective debtor follow-up and a prompt credit collection policy are essential components of managing non-primary debtors.

Short term Investments

A company would invest excess cash in short-term securities since they are easily convertible into cash in a short amount of time and are easily marketable. It would increase profits without compromising liquidity by producing a return on the excess cash.

Cash and Bank Balances

All of a company's assets, including cash, are the most liquid and essential because every transaction involves the inflow or outflow of cash. An executive in finance must anticipate their cash needs well in advance. This would involve more than just keeping safe cash balances; it would also involve money for quickly fulfilling the company's obligations.

Since cash is the most liquid and least productive asset, any excess or deficiency in its level is unnecessary and ought to be avoided. A large cash balance tends to reduce profitability, but a cash shortage can result in a more serious situation where the business's operations are disrupted. To put it briefly, there should always be an ideal level of cash on hand to meet demands. In actuality, this arrangement maintains profitability as well as liquidity.

Other current assets

Prepayments, advances and loans, interest accrued, pre-paid taxes, and so forth are examples of these assets.

Additionally, working capital can be divided into two groups according to time.

1. Permanent or Fixed Working Capital
2. Variable or Temporary Working Capital

Fixed Working Capital

The bare minimum needed to maintain the flow of current assets and guarantee the efficient use of fixed facilities is known as fixed or permanent working capital. The organization constantly needs a minimum amount of current assets in order to conduct regular business operations. Since this portion of capital is permanently blocked in current assets, every company is required to maintain a minimum level of current assets, also known as permanent or fixed working capital. Regular working capital and reserve working capital are additional categories of permanent working capital that are needed as a business expands to maintain the flow of current assets from cash to inventories, receivables to cash, and so forth. The excess over regular working capital requirements is known as reserve working capital, which can be set aside for unforeseen events like price increases, labor strikes, downturns, etc.

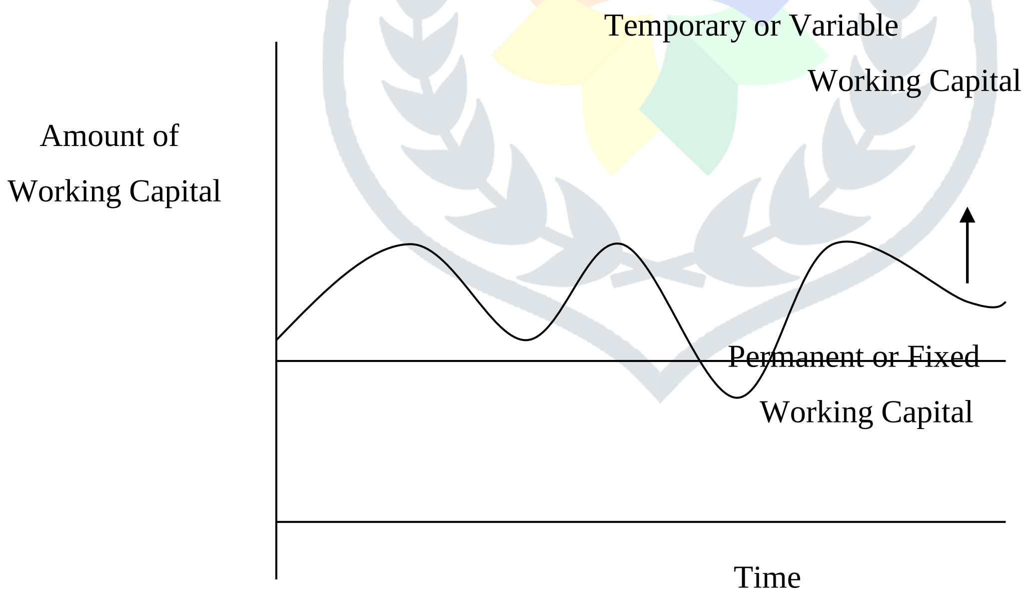
Variable Working Capital

The amount of working capital needed to cover sporadic demand and certain unique situations is known as variable or temporary working capital. Special and seasonal working capital are two more categories into which variable working capital can be subdivided. The majority of businesses must supply extra working capital to cover sporadic and unique demands. Seasonal working capital is the money needed to cover an organization's seasonal demands. The portion of working capital known as "special working capital" is needed to cover particular needs, like the start of large-scale marketing campaigns or the completion of research projects.

In contrast to permanent working capital, temporary working capital is needed temporarily and cannot be used indefinitely for financial gain within the company. The distinction between temporary and permanent working capital is demonstrated by the following figures.

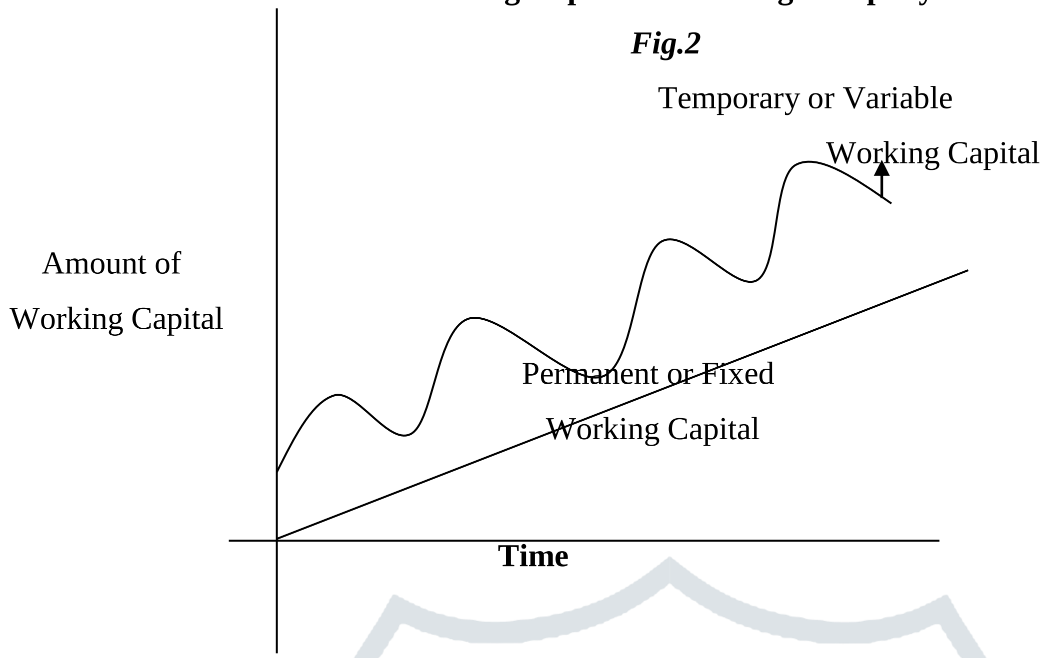
Working Capital in Stable Company

Fig.1



Working Capital in Growing Company

Fig.2



While temporary or variable working capital varies over time, permanent working capital remains constant or fixed in Fig. 1. As the business expands, as shown in Fig. 2, permanent working capital also rises over time; however, it remains constant, unlike variable working capital, which occasionally rises and occasionally falls.

WORKING CAPITAL FINANCING STRATEGIES

The sources of funding for working capital can differ from company to company, across national borders, and periodically based on the state of the economy. It can be divided into four groups:

1. Long-term Financing

2. Short-term Financing

3. Spontaneous financing, and

4. A combination of the previous financing methods.

The following are significant sources of long-term financing: internally generated profits, debentures, preference shares, equity shares, and long-term debt from financial institutions; short-term financing is defined as credit sources that must be paid back by the company within a year. These sources consist of public deposits, trade credit, receivables, factoring, commercial papers, and short-term bank loans. Additionally, banks offer short-term special purpose loans, such as export packing credit. Factoring and commercial papers are relatively new in India. The term "spontaneous financing" describes sources of short-term funds that appear automatically during regular business operations. Outstanding salaries, other costs, provisions, and dividends are the main sources of funding for this kind of project. Unexpected financial resources are free of charge. Consequently, a company wants to use as many free resources as it can to finance its current assets. It is expected of all firms to make maximum use of spontaneous sources. Therefore, there are really only two options for financing current assets: short-term financing or long-term financing.

Adequacy of Working Capital

A business must carefully and strategically plan for the working capital it will need. If not, it might have to deal with the issue of either too much or too little working capital, which is a double-edged sword that could harm the company's finances.

Lack of cash or underinvestment in receivables, marketable securities, and inventory can result in inadequate working capital. The business will suffer greatly from this shortfall since it will result in low liquidity, low profitability, higher interest rates, and underutilization of the productive capacity. Thus, every business needs to plan its working capital very carefully. If not, the company might file for bankruptcy and liquidate early.

Overworking capital, which is also undesirable, results in idle funds that do not generate profits for the company and, as a result, do not allow the company to receive a proper return on its investment. The issue of excessive working capital is brought on by the company's credit policy, pointless inventory purchases, and accumulation of inventory. Occasionally, the directors of the company take advantage of the excess working capital situation for their own gain by paying out large, unjustified dividends. The organization may become inefficient as a whole as a result.

Conclusion

Working capital is an indispensable component for businesses, regardless of their size or nature, bridging the gap between production and cash realization from sales. It's an essential buffer that supports the operating cycles involved in purchasing raw materials, production, sales, and cash collection. In a competitive environment, it enables businesses to maintain ready stock to meet demand and manage credit mechanisms when demand lags. Working capital also serves as a shield against inflationary pressures. Prudent management of working capital is paramount for achieving profit maximization, wealth maximization, and sound liquidity while balancing various needs.

The administration of current assets, particularly accounts receivables and inventories, significantly influences a business's success. Challenges such as sales expansion, dividend declaration, and price fluctuations demand effective working capital management. Businesses must meet financial obligations without compromising profitability to avoid technical insolvency and bankruptcy. Efficient working capital management, which encompasses cash, marketable securities, accounts receivables, and accounts payable, is central to financial executives and departmental heads, ensuring that businesses operate on optimal financial lines, efficiently meet current obligations, and navigate economic uncertainties effectively. In conclusion, working capital is a linchpin for a business's financial health and operational efficiency, and its management remains critical for long-term success.

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