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EFFECTS OF WORKING CAPITAL MANAGEMENT ON FIRM'S PROFITABILITY

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Abstract: "Working capital is the lifeblood and controlling nerve centre of a business." The amounts which a firm invests in working capital are often high in proportion to the total assets employed so it is necessary to use these amounts efficiently and effectively. Therefore, working capital management aims to maintain a balance between liquidity and profitability while conducting the day-to-day operations of the business concern. Working capital management plays a significant role in the improved profitability of a firm. With the help of this, firms are capable of gaining sustainable competitive advantage by employing effective and efficient utilization of the amounts of the organization. The main purpose of any firm is to maximize profit but maintaining liquidity is also an important objective. In a firm, there should be a proper balance between profitability and conducting its day-to-day operations. Because inadequacy of working capital may lead to insolvency of a firm and excessive funds implies idle funds which earn no profits. The management can take the help of various techniques like comparative statements, cash flows statements, cost–volume–profit analysis, ratio analysis, etc. to evaluate its financial performance. This paper aims to analyze the effect of working capital management on a firm's profitability.

Keywords: Working Capital, Profitability, Firm, Cash, Management

I. INTRODUCTION

At present time, the availability of funds is necessary for every business. Every firm, whether large or small, needs funds for the short term as well as for the long term. Long-term funds are required to purchase fixed assets. After purchasing these assets, investments in these assets are blocked permanently. Funds are also needed for short-term purposes like payment of daily expenses, purchase of raw materials, etc. Funds for short-term purposes are known as working capital. All individual components of working capital like cash, marketable securities, account receivables, inventory management, etc. play a vital role in the performance of any firm. In short, working capital refers to that part of the capital that is required for financing short-term purposes. In general practice,

Working Capital = Current Assets - Current Liability

Therefore, it is the responsibility of every manager to manage it properly. Thus, working capital management is related to the problems that arise in managing the current assets, current liabilities, and the interrelationship that exists between them. The main objective of it is to manage these in such a way that a satisfactory level of working capital is maintained and it provides the firm with maximum return on its assets and minimizes payments for its liabilities. The working capital should neither inadequate nor excessive. Working capital management has a great effect on the profitability of a firm. The efficiency of management is necessary for manufacturing and construction firms because in these firms a major part of assets is composed of current assets. It directly affects the profitability of a firm. The main purpose of any firm is to maximize profit but maintaining liquidity is also an important objective. In a firm, there should be a proper balance between profitability and conducting its day-to-day operations. Because inadequacy of working capital may lead to insolvency of a firm and excessive funds implies idle funds which earn no profits. It is a difficult task for the management to estimate the proper working capital because the amount of working capital varies from firm to firm over the periods. The requirements of a firm depend upon a large number of factors. Some of them are the following:

- Nature and size of business
- Production, dividend, and credit policy
- Length of the production cycle
- Rate of stock turnover
- Business policy
- Earning capacity
- Price level changes

II. REVIEW OF LITERATURE

Ghosh and Maji (2003) said that an attempt is made to examine the efficiency and effectiveness of working capital management of the Indian Cement Company during 1992 – 1993 to 2001- 2002. During the period of study, it is also tested the speed of achieving the target level of efficiency by an individual firm.

Shin and Soenen (1998) highlighted that efficient working capital management is very important to create and increase value for shareholders. This paper found a negative relationship between the lengths of the firm's net trading cycle and its profitability.

Dutta and Sukamal (1995) evaluated the working capital crisis and working capital management requirements of selected paper mills of West Bengal during the period 1983 – 1984 to 1985 – 86. The study concluded that the overall financial conditions of 40% of the firms were assumed to be precarious.

Mohan and Reddy P. (1991) In Andhra Pradesh, from 1977 to 1986, they examined the various aspects relating to working capital management among six selected large-scale private companies. This study showed that the investment in current assets in the companies was more than that of fixed assets.

Eljelly (2004) According to him, working capital management requires planning and controlling current assets and current liabilities in such a way that it eradicates the threat of inability to meet short-term liabilities and evades excessive investment in these assets.

III. OBJECTIVES OF THIS STUDY

1) To understand the concept of Working Capital Management.

2) To study the various sources of working capital.

3) To study the effect of working capital management on a firm's profitability.

4) To know the different ways to manage the different components of working capital.

IV. RESEARCH METHODOLOGY

This research is based on secondary data. The available magazines, articles, books, journals, research papers, and the information and data available on different websites are extensively used for this research study.

V. SOURCES OF WORKING CAPITAL

The main sources of working capital are as follows:

• Commercial Banks: These banks are the most important source of short-term capital. In the total capital of a firm, a major portion is provided by these banks. They provide loans to meet the requirements of a firm in the form of overdrafts, cash credit, etc.

• Advances: During a transaction, many firms get advances from their customers. It is a cheap and easy way for a firm for financing. Some firms, especially manufacturing firms having long production cycles, to minimize their investment in working capital give preference to take advance from their customers.

• Installment method: It is a method through which the assets are purchased on an installment basis. In this method, the possession of an asset is taken immediately but the payment is made in installments over a while.

• Trade credit: At present, commerce is built upon credit. The facility of trade credit is based upon the creditworthiness of a firm and the relationship between the firm and its suppliers. In this, the suppliers of goods extend the credit during the normal course of business. Sometimes, the trade credit also takes the form of bills payable.

• Accrued expenses: The expenses which have been incurred but are not yet due are known as accrued expenses like wages & salary, interest, taxes, etc. These expenses represent the liability that a firm has to pay for the services already received by it. As the period of payment increases, the number of funds available to the firm increases. Thus all accrued expenses can be a greater source of finance for a firm.

VI. EFFECT OF WORKING CAPITAL MANAGEMENT ON FIRM'S PROFITABILITY

As we shorten the cash conversion cycle, cash becomes free for another purpose. We can invest this cash on equipment, infrastructure, innovating manufacturing and selling processes, or lowering the total investments in current assets. As a result, the operating profitability of a firm will increase. In contrast, when we lengthen the cash conversion cycle, cash tides up in the firm's operation activities. Then there will be little chance for other investments of this cash flow. The firm's profitability is decreased as a result. After the above description, we can say that the cash conversion cycle is said to have a negative relationship with the firm's profitability.

On the other hand, the cash conversion cycle can also have a positive influence on a firm's profitability. It could be interpreted with the help of the inventory period and the account receivable period. The longer the inventory period, the lower the cost involved in procrastinating goods. In the meantime, the longer the accounts receivable period, the higher credit sales earned. A higher reputation can be earned for borrowing opportunities by lowering the accounts payable period. Converging the three effects into one place, we can explain an increase in company profitability due to the long cash conversion cycle. In contrast, shortening the cash conversion cycle could harm the company's profitability. The company could face inventory shortages by reducing the inventory conversion period, lose good credit customers by reducing the accounts receivable period, and hamper its credit reputation by lengthening the accounts payable period. In those cases, the cash conversion cycle is said to have a positive relationship with the firm's profitability.

VII. MANAGEMENT OF COMPONENTS OF WORKING CAPITAL

1) Management of Inventory: In many firms, the most important part, nearly about 60%, of working capital is inventory. The large volume of inventories is kept by companies. For this reason, a substantial sum of the fund is necessary to be devoted to them. It is extremely important to administer inventories efficiently and effectively to keep away from needless investment. A company must decrease its levels of inventory to a substantial degree by using simple inventory planning and control techniques, without any unfavorable impact on production and sales. The major objectives of inventory management are:-

a) To keep inventory at an optimal level for the smooth operation of production and sales.

b) To invest the smallest amount of available funds in inventory to maximize the profitability of the firm.

2) Management of Receivables: People tend to take goods and services on credit. Receivables take place when a company sells its goods or services on a credit basis and does not get cash immediately. Concerns should be clear about its credit policies. How much will be the size of receivables based on present credit policies? Though it is not possible to forecast the exact amount in the future some estimation is possible based on experience. Receivables management can be helpful for this purpose. Receivables management is the process of making decisions relating to an investment in trade debtors. The objective is to take a sound decision as regards investment in debtors because there is always a risk of bad debts too.

3) Management of Payables: The purchase of goods creates a commercial credit for both sellers and purchasers. Account payables mean the liabilities of a company. It includes short-term creditors and bills payables (B/P). It is usually understood that the payment to the seller is disbursed within the due date. On the other hand, a company may put off payment ahead of the due date. The following points should be kept in mind effective management of payables: -

a) During an extremely aggressive position, the seller may be eager to extend credit restrictions and times. Evaluate the power of the firm to negotiate and get the most excellent potential transaction.

b) Where a cash discount is not obtainable, clear up the payables on their due date and not in advance. It will provide the full benefit of credit time.

c) Bargain and get the most positive credit conditions with the existing business practice.

4) Management of Cash: Cash is an essential input to establish and run a business unit. It is invested in fixed assets like plant and machinery, land and building, etc. It is a significant component of working capital for the operational activities of a firm. The company ought to maintain adequate cash, neither extra nor inadequate. Cash scarcity will disturb the firm's production activities whereas unnecessary cash will stay idle and there will be no contribution towards the profitability of a firm. Therefore, the main task of the financial manager is to keep a sound cash position. Management of cash is related to the managing of the inflow and outflow of cash. A firm has to maintain an optimum amount of cash for setting the dues in time. There are two approaches to determining an optimal cash balance. These are Cash Budget and Cash Models. A cash budget will help in the proper estimation of cash receipts and cash disbursements. Many cash models are also used to determine the optimal cash balance in Operating Cycle Model, Inventory Model, Stochastic Model, Probability Model, etc.

VIII. CONCLUSION

About the main objective, it may be concluded that working capital is an essential source for the smooth functioning of an enterprise. Its efficient utilization shows the future progress of an enterprise. With its proper utilization, an organization's liquidity position is maintained satisfactorily. At last, for the proper analysis of working capital, different kinds of devices and techniques should be used appropriately to maintain its profitability and liquidity.

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