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Working Capital – An Effective Business Management Tool

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ABSTRACT: *This paper represents an overview of Working Capital – An Effective Business Management Tool. It depicts the importance of Working Capital in business management and its success. It is one of the most importance and vital issue to be discussed of the business world and must be discussed in the most vivid way to provide a clear understanding of the term Working Capital and its important components. The study basically focuses on the theoretical background of the term Working Capital and its major components. Although, Working Capital has been discussed million times in the past and will be discussed more in the future. But even then, the term Working Capital remains under the hazy cloud of explanation. Hence this article tries to provide a clear understanding of the term Working Capital along with its related concepts.*
Keywords: *Working Capital, Current Ratio, Current Asset, Management, and Liquidity.*

I. INTRODUCTION

In the upcoming pages of this article, Working Capital and its related concepts are discussed in a vivid manner for a clear understanding of the vital business aspect. The prime objective of this article is to provide a general understanding of the term Working Capital and its importance along with its related concepts for any business irrespective of its size and nature. This article is basically based on the secondary work previously done by different researchers and private organizations, over a span of time as well as website information and other internal reports. The study was basically carried out through secondary information as well as discussions with different officials and finance managers as well as accountants. Before discussing the term Working Capital, its significance, along with its associated terms, an introduction of the term Working Capital will be supportive enough to create a platform of understanding of the terms and concepts of Working Capital.[1]

The term Working Capital refers to that part of firm's capital, which is required for financings short-term or current assets such as cash, marketable securities, debtors, and inventories. Hence funds which are invested in current assets keep revolving fast and are constantly converted into cash and this cash flow out again in exchange for other current assets. Working Capital is also known as revolving or circulating capital or short term capital.[3]

Working Capital is a measure of both a company's efficiency and its short-term financial health. It is basically the difference between the current assets and the current liabilities; hence it is also known as net Working Capital. It can be calculated as:

Working Capital = Current Assets - Current Liabilities

The Working Capital ratio (Current Assets/Current Liabilities) indicates whether a company has enough short term assets to cover its short-term debt. Anything below 1 indicates negative Working Capital. While anything over 2 means that the company is not investing excess assets. Most managers believe that a ratio between 1.2 and 2.0 is sufficient.[1]

II.TYPES OF WORKING CAPITAL

Working Capital frequently changes its form and is sometimes also referred to as circulating capital. It can transition from cash to inventories and/or receivables and then back to cash. Working Capital is the capital / funds required for day to day operations of the business. Working Capital is invested usually in all types of inventories such as raw materials, spares, finished goods etc and credit extension to debtors and cash in hand. Working Capital is divided into various types based balance sheet view and operating cycle view. Operating cycle is basically the time which is required to convert the raw materials into cash.[16];[1]

Balance sheet view divides Working Capital into gross Working Capital and net Working Capital and the operating cycle view divides the Working Capital into permanent and temporary Working Capital. Permanent Working Capital is further divided into seasonal and special Working Capital whereas temporary Working Capital into regular and reserve Working Capital.

Gross Working Capital is all the current assets in the balance sheet of a company are known as gross Working Capital. Current assets are those short term assets which can be converted into cash within a period of one year. The grey area in the management of current assets or gross Working Capital is its unpredictability i.e. it is very difficult to ascertain the exact time of conversion of such assets. It is because the liabilities occur at their time and do not wait for the current asset to realize. This mismatch or the gap creates a need for arranging Working Capital financing.[2];[10]

Net Working Capital is a very frequently used term. There are two ways to understand net Working Capital. First, one says it is simply the difference between current assets and the current liabilities on the balance sheet of a business. The other understanding discloses little deeper or hidden meaning of the term. As per that, Net Working Capital, it is that part of current assets which are indirectly financed by long-term assets. Compared to gross Working Capital, net Working Capital is considered more relevant for effective Working Capital financing and management.[2];[10]

Permanent Working Capital is the minimum amount of Working Capital that must always remain invested. It is typically a combination of cash, stock and account receivables that is always locked in. Necessary for daily operations and the existence of the business, these funds are drawn from long-term sources. It is sometimes also referred as fixed Working Capital or hardcore Working Capital. Permanent Working Capital implies that the base investment amount in all types of current resources which is respected at all times to carry on business activities. The value of current assets has been increased or decreased over a period of time. Even though, there is a need of having a minimum level of current assets at all times in order to carry on the business activities effectively. The basic features of Permanent Working Capital are as follows: [2];[10]

a) The gross value of permanent Working Capital remains constant but the value of components of current assets is differing from each other.

b) There is a positive correlation between the size of the business and the amount of permanent Working Capital.

c) Only long term sources of funds are used for permanent Working Capital.

Variable Working Capital fluctuates frequently due to various factors and requirements of the business. These funds are drawn from short-term sources. It is also known as Fluctuating or Temporary Working Capital. There is a close relationship prevailing between temporary Working Capital and the level of production and sales. There is no uniform production and sales throughout the year. If the heavy order is received for production and there are a lot of credit sales, there is a need of more amount of temporary Working Capital. At the same time, if production is carried on in anticipation of demand in near future, temporary Working Capital is required. [2];[10]

In a nutshell, temporary Working Capital is an extra Working Capital required to support the changing production and sales activities. In simple terms, it is the difference between net Working Capital and permanent Working Capital. The main characteristic which can be made out of the example is “fluctuation”. The temporary Working Capital, therefore, cannot be forecasted. [2];[10]

Negative Working Capital: Sometimes, the value of current assets is less than the current liabilities, it shows negative Working Capital. If such type of situation arises, the firm is going to meet the financial crisis very shortly.

Reserve Working Capital: It is otherwise called as Cushion Working Capital. It refers to the short-term financial arrangement made by the business units to meet uncertain changes or to meet uncertainties. A firm is always working with the expectation of some risks which may be controllable or uncontrollable. The reserve Working Capital can be used in order to meet the uncontrollable risks and sustain in the business world. It is the Working Capital available over and above the regular Working Capital. It is kept for contingencies which may arise due to unexpected situations. [2];[10]

Regular Working Capital: The minimum amount of Working Capital to be maintained in normal condition is called Regular Working Capital. It is the permanent Working Capital which is normally required in the normal course of business for the Working Capital cycle to flow smoothly.

Seasonal Working Capital: Some products have seasonal demand. Seasonal demand arises due to the festival. In this way, seasonal Working Capital means an amount of Working Capital maintained to meet the seasonal demand of the product. Seasonal Working Capital is that temporary increase in Working Capital which is caused due to some relevant season for the business. It is applicable to businesses having the impact of seasons, for example, the manufacturer of sweaters for whom relevant season is the winters. Normally, their Working Capital requirement would increase in that season due to higher sales in that period and then go down as the collection from debtors is more than sales. [2];[10]

Special Working Capital: Special programs may be conducted for business development. The programs may be advertisement campaign, sales promotion activities, product development activities, marketing research activities, launching new products, expansion of markets and the like. Therefore, special Working Capital means an amount of Working Capital maintained to meet the expenses of special programs of the company. Special Working Capital is that rise in the temporary Working Capital which occurs due to a special event which otherwise normally does not take place. It has no basis to forecast and has rare occurrence normally. For example, a country where Olympic Games are held, all the business requires extra Working Capital due to a sudden rise in business activity. [2];[10]

It was all about the types of Working Capital. It needs to be managed with several Working Capital techniques so as to have the effective Working Capital management.

III. SIGNIFICANCE OF WORKING CAPITAL

The current assets of a typical manufacturing firm account for over half of its total assets. For a distribution company, they account for even more. Excessive levels of current assets can easily result in a firm realizing a substandard return on investment. However, firms with too few current assets may incur shortage and difficulties in maintaining smooth operations. [1]

For small companies, current liabilities are the principal source of external financing. These do not have access to the longer term capital markets, other than to acquire a mortgage on a building. The fast-growing but larger company also makes use of current liability financing. For these reasons, the financial manager and staff devote a considerable portion of their time to Working Capital matters. The management of cash, marketable securities, accounts receivable, accounts payable, accruals, and other means of short-term financing is the direct responsibility of the financial manager; only the management of inventories is not. Moreover, these management responsibilities require continuous day-to-day supervision. Unlike dividend and capital structure decisions, it is not easy to study the issue, reach a decision and set the matter aside for many months to come. Thus, Working Capital management is important, if for no other reason than the proportion of the financial manager must be devoted to it, to study effect that Working Capital decisions have on the company's risk, return, and share price. Working capital is an important metric for all businesses, regardless of their size. [1];[4];[17]

Working Capital is a signal of a company's operating liquidity . Having enough Working Capital means that the company should be able to pay for all of its short-term expenses and liabilities. The term operating liquidity can be defined as the ability of a company or individual to quickly convert assets into cash for the purpose of paying operating expenses. Working Capital is important for large companies' ability to borrow, increase their share price, pay expenses and short-term debts. Working Capital is important for small companies that cannot access financial markets to borrow, and for start-ups that need to survive until they break even. Working Capital cannot guarantee whether a company is financially sound, but it gives some insight.[7];[9]

Large companies pay attention to Working Capital for the same reason as small ones do: Working Capital is a measure of liquidity, and thus is a measure of their future credit-worthiness. Companies who want to borrow by issuing bonds or purchasing commercial paper (a market of large, short-term loans for big companies) will find it more expensive if they do not have enough Working Capital. If they are a public company, their stock price may fall if the market doesn't believe they have adequate Working Capital.[7];[9]

For small businesses and start-ups, which are unable to access financial markets for borrowing, Working Capital has more dire implications. Working Capital can also be described as the amount of money that a small business or start-up needs to stay in operation. Start-ups need to pay attention to their Working Capital because it is the amount of money they need to keep the business running until they break-even (start earning a net profit). [7];[9]

On one hand, Working Capital is important too because it is a measure of a company's ability to pay off short-term expenses or debts. On the other hand, too much Working Capital means that some assets are not being invested for the long-term, so they are not being put to good use in helping the company grow as much as possible. [7];[9]

Working Capital is only one measure of a company's operating liquidity. It is not the only measure, and it is certainly not a guarantee of a company's ability to pay. A company may have positive Working Capital, but not enough cash to pay an expense tomorrow. Similarly, a company may have negative Working Capital but may be able to adjust some of their debt into long-term debt in order to reduce their current liabilities. [7];[9]

Working Capital is an important metric, but it is not the whole story of a company's financial health, hence certain aspects must be kept under strict observation such as: [7];[9]

- u In a typical manufacturing firm, current assets exceed one-half of total assets.
- u Excessive levels can result in a substandard Return on Investment (ROI).
- u Current liabilities are the principal source of external financing for small firms.
- u Requires continuous, day-to-day managerial supervision.
- u Working Capital management affects the company's risk, return, and share price.

IV. OBJECTIVES OF WORKING CAPITAL MANAGEMENT

The primary objective of Working Capital management is to ensure smooth operating cycle of the business. Secondary objectives are to optimize the level of Working Capital and minimize the cost of such funds. The superior objective of financial management is wealth maximization and that can be gained by profit maximization accompanied with sustainable growth and development. For sustainable growth and development, the objectives of all the stakeholders including customers, suppliers, employees, etc should be aligned to the growth of the organization. At some point in time, almost all small businesses access their short term assets and short term financing to conduct daily business. This controlling and overseeing of these assets and liabilities are defined as Working Capital management and it is an essential part of the financial management of the business.[15];[11]

Maintaining the Working Capital operating cycle and its smooth operation is vital for a business to function. The operating cycle or lifecycle of a business goes from the acquisition of the raw material to the seamless production and delivery of the end products. This is one of the main objectives of Working Capital management.[14];[12]

Keeping the cost of capital to a minimum level is also an important objective that Working Capital management strives to achieve. The cost of capital is what is spent on maintaining the Working Capital. It is imperative that the cost of maintaining healthy Working Capital are carefully monitored, negotiated and managed.[14];[11]

The other main objective is to maximize ROI or return on current asset investments. The ROI on currently invested assets should be more than the weighted average cost of the capital. This ensures wealth maximization.[14];[11]

V. WORKING CAPITAL MANAGEMENT

Decisions relating to Working Capital and short-term financing are referred to as *Working Capital management*. These involve managing the relationship between a firm's short-term assets and its short-term liabilities. The goal of Working Capital management is to ensure that the firm is able to continue its operations and that it has sufficient cash flow to satisfy both maturing short-term debt and upcoming operational expenses.[5];[1]

A managerial accounting strategy focusing on maintaining efficient levels of both components of Working Capital, current assets, and current liabilities, in respect to each other. Working Capital management ensures a company has sufficient cash flow in order to meet its short-term debt obligations and operating expenses. The management will use a combination of policies and techniques for the management of Working Capital. The policies aim at managing the *current assets* (generally cash and cash equivalents, inventories and debtors) and the short-term financing, such that cash flows and returns are acceptable. For example, [5];[1];[8]

- **Cash management**: The cash balance which allows for the business to meet day to day expenses, but reduces cash holding costs, must be identified.
- **Inventory management**: The level of inventory which allows for uninterrupted production but reduces the investment in raw materials—and minimizes reordering costs—and hence increases cash flow, should be identified beforehand. Besides this, the lead times in production should be lowered to reduce Work in Process (WIP) and similarly, the Finished Goods should be kept as low level as possible to avoid over production.
- **Debtors management**: An appropriate credit policy, i.e. credit terms which will attract customers, such that any impact on cash flows and the cash conversion cycle will be offset by increased revenue and hence Return on Capital (or *vice versa*), must be identified.
- **Short-term financing**: It is also necessary to identify the appropriate source of financing, given the cash conversion cycle: the inventory is ideally financed by credit granted by the supplier; however, it may be necessary to utilize a bank loan (or overdraft) or to "convert debtors to cash" through "factoring".

Working Capital management involves the relationship between a firm's short-term assets and its short-term liabilities. The goal of Working Capital management is to ensure that a firm is able to continue its operations and that it has sufficient ability to satisfy both maturing short-term debt and upcoming operational expenses. The management of Working Capital involves managing inventories, accounts receivable and payable, and cash. [5];[1];[8]

VI. WORKING CAPITAL STRATEGIES

Working Capital is a key indicator of the health of the business. Working Capital can demonstrate whether or not the company can meet all of its short-term debts, such as salaries and supplier invoices, when they become due. The requirement for Working Capital which a business needs is unique to each one – it can depend on the type of business and its industry, for example. Retail companies usually have a greater need for Working Capital, as the purchase of stock ties up their money until the stock is sold, which can take time. It can be more difficult for smaller businesses to raise finance quickly than larger businesses, so in order to operate a small business, it's important to maintain positive Working Capital.[13];[14]

The conservative strategy involves low risk and low profitability. With this approach, the permanent and the variable Working Capital are financed from the long-term sources, which eases the cost capital. While the risks of interest rate fluctuations are significantly lower, there is an increase in cost capital.[13]

By taking higher risks, the main goal of an aggressive strategy is to maximize profits. With this approach, all of the variable Working Capital, part or all of the permanent Working Capital and occasionally even the fixed assets are funded from short-term sources. An aggressive effort to maximize profit results in lower cost capital and significantly higher risks.[13]

A moderate strategy, sometimes referred to as hedging, involves moderate risks and moderate profitability. With this approach, the fixed assets and the permanent Working Capital are financed from long-term sources while the variable Working Capital is sourced from the short-terms sources.[13]

VII. WORKING CAPITAL FINANCING

No matter what type of business one may have or what capital management strategy has been implemented, the business may experience a working capital shortfall. It could be an equipment failure, lack of inventory to fill a big order or to bridge the gap between invoicing and collection. When this occurs, the business will need additional working capital fast to keeps the lifestyle of the company running smoothly. That is when the need of working capital financing arises. This shortfall can be managed by the business either out of profits accumulated over time, borrowed funds or by both. Let us look at the sources of funding which can be used to manage the gaps in the working capital cycle.[15]

- **Lines of Credit:** The Company can borrow from banks for a short-term (usually 30 – 60 days) against a line of credit given by the bank. The same can be paid off once sales proceeds are collected from debtors.
- **Trade Credit:** Often good relations with creditors can be used for extending credit period as one of the cases in case of a large order and enable financing at a lower cost.
- **Factoring:** Factoring or discounting of receivables can shorten the working capital cycle and generate cash, however, this is usually at a higher cost.
- **Short Term Loans:** Companies who may not be able to get a line of credit may look for the short-term working capital loan from a bank.

In the case of long term financing, the organization can go for debt financing or equity financing. Debt financing occurs when a firm raises money for working capital or capital expenditures by selling bonds, bills or notes to individuals and/or institutional investors. In return for lending the money, the individuals or institutions become creditors and receive a promise the principal and interest on the debt will be repaid. The other way to raise capital in the debt markets is to issue shares of stock in a public offering; this is called equity financing.[14];[15]

When a company needs money, it can take three routes to obtain financing: cash, debt or some hybrid of the two. Equity represents an ownership stake in the company. It gives the shareholder a claim on future earnings, but it does not need to be paid back. If the company goes bankrupt, equity holders are the last in line to receive money. The first investors in line are the lenders. These are the investors that provide the company with debt financing. The amount of the investment loan referred to as the principal must be paid back. Companies can obtain debt financing through banks and bondholders. [14];[15]

Debt financing can be difficult to obtain, but for many companies, it provides funding at lower rates than equity financing, especially in periods of historically low-interest rates. Another perk to debt financing is the interest on the debt is tax deductible. Still, adding too much debt can increase the cost of capital, which reduces the present value of the company. [14];[15]

VIII. MEASURES OF WORKING CAPITAL

Working Capital management has an important role to play in the success of a business. Over 75% of companies that are running at a loss or struggling financially would be profitable and liquid only if the power of Working Capital management in releasing down capital that could otherwise be put to productive use is released. Many finance professionals of business organizations would prefer not to take the extra care in striving for optimum utilization of resources tied in Working Capital just because they only look at the work involved in carrying out proper Working Capital management exercise.[1];[8];[9]

Working Capital management is a strategic management tool that has the potential of guaranteeing long-term success. Activities like: cash management, accounts receivable management, accounts payable management, marketable securities management, and accruals management are crucial responsibilities of the financial managers that require constant supervision from the chief financial officer. [1];[8];[9]

The measures of Working Capital management are those vital tools which help any business irrespective of its size or nature to identify its health status. The important measures of Working Capital can be discussed as follows: [1];[8];[9]

Measure of Liquidity

- **Liquidity ratios**
- Current ratio: Ability to satisfy current liabilities using current assets

Current Ratio = Current Assets/Current Liabilities

- Quick ratio: Ability to satisfy current liabilities using the most liquid of current assets

Quick Ratio = Cash+ Short-Term Investments+ Receivables
Current Liabilities

- **Ratios indicating management of current assets**
- Receivables turnover: How many times accounts receivable are created and collected during the period

Receivables Turnover= Total Revenue/ Average Receivables

- Inventory turnover: How many times inventory is created and sold during the period

Inventory Turnover= Cost of goods sold/Average Inventory

- **Operating & Cash Conversion Cycle**

✓ Number of days of inventory = Average time it takes to create and sell inventory
Number of days of inventory =Inventory/ Average day's cost of goods sold
Number of days of inventory = 365/Inventory Turnover

✓ Number of days of receivables = Average time it takes to collect on accounts receivables
Number of days of receivables = Receivables/Average day's of revenue
Number of days of receivables = 365/Receivables Turnover

✓ Number of days of payables = Average time it takes to pay its suppliers
Number of days of payables = Accounts Payable/ Average day's purchase
Number of days of payables = 365/ Accounts Payable Turnover

✓ Operating cycle =Number of days of inventory +Number of days of receivables

✓ Net operating cycle or Cash conversion cycle = (Number of days of inventory + Number of days of receivables) − Number of days of payables

Apart from the above ratios discussed there are multiple ratios which state the financial status of the organization. Hence the indicators that measure the proportion of debt in a company's capital structure are known as Capitalization ratios which include the debt-equity ratio, long-term debt to capitalization ratio and total debt to capitalization ratio. The formula for each of these ratios is shown below. [1];[8];[9]

- Debt-Equity ratio = Total Debt / Shareholders' Equity
- Long-term Debt to Capitalization = Long-Term Debt / (Long-Term Debt + Shareholders' Equity)
- Total Debt to Capitalization = Total Debt / (Total Debt + Shareholders' Equity)

While a high capitalization ratio can increase the return on equity because of the tax shield of debt, a higher proportion of debt increases the risk of bankruptcy for a company. These ratios are also known as leverage ratios. [1];[8];[9]

The acceptable level of capitalization ratios for a company depends on the industry in which it operates. Companies in sectors such as utilities, pipelines, and telecommunications – which are capital intensive and have predictable cash flows – will typically have capitalization ratios on the higher side. Conversely, companies with relatively few assets that can be pledged as collateral – in sectors like technology and retail – will have lower levels of debt and therefore lower capitalization ratios.[1];[6];[12]

The acceptable level of debt for a company is dependent on its whether its cash flows are adequate to service such debt. The interest coverage ratio, another popular leverage ratio, measures the ratio of a company's earnings before interest and taxes (EBIT) to its interest expense. A ratio of 2, for instance, indicates that the company generates $2 for every dollar in interest expense. [1];[6];[12]

As with all ratios, a company's capitalization ratios should be tracked over time to identify if they are stable. They should also be compared with similar ratios of peer companies, to ascertain the company's leverage position relative to its peers. [1];[6];[12]

Another important ratio is the debt ratio. It is a financial ratio that measures the extent of a company's or consumer's leverage. The debt ratio is defined as the ratio of total – long-term and short-term – debt to total assets, expressed as a decimal or percentage. It can be interpreted as the proportion of a company's assets that are financed by debt. [1];[6];[12]

$$\text{Debt Ratio} = \frac{\text{Total Debt}}{\text{Total Assets}}$$

The higher this ratio, the more leveraged the company is, implying greater financial risk. At the same time, leverage is an important tool that companies use to grow, and many businesses find sustainable uses for

debt. Debt ratios vary widely across industries, with capital-intensive businesses such as utilities and pipelines have much higher debt ratios than other industries like technology. [1];[6];[12]
A debt ratio of greater than 100% tells you that a company has more debt than assets. Meanwhile, a debt ratio of less than 100% indicates that a company has more assets than debt. Used in conjunction with other measures of financial health, the debt ratio can help investors to determine a company's risk level. [1];[6];[12]
Some sources define the debt ratio as total liabilities divided by total assets. This reflects a certain ambiguity between the terms "debt" and "liabilities" that depends on the circumstance. The debt-to-equity ratio, for example, is closely related to and more common than the debt ratio but uses total liabilities in the numerator. In the case of the debt ratio, financial data providers calculate it using only long-term and short-term debt (including current portions of long-term debt), excluding liabilities such as accounts payable, negative goodwill and "other." The debt ratio is often called the "debt-to-assets ratio." [1];[6];[12]

IX. WORKING CAPITAL CYCLE

The term Working Capital cycle is the amount of time it takes to turn the net current assets and current liabilities into cash. The longer the cycle is, the longer a business is tying up capital in its Working Capital without earning a return on it. Therefore, companies strive to reduce their Working Capital cycle by collecting receivables quicker or sometimes stretching accounts payable.[10];[16]

A positive Working Capital cycle balances incoming and outgoing payments to minimize net Working Capital and maximize free cash flow. For example, a company that pays its suppliers in 30 days but takes 60 days to collect its receivables has a Working Capital cycle of 30 days. This 30-day cycle usually needs to be funded through a bank operating line, and the interest on this financing is a carrying cost that reduces the company's profitability. Growing businesses require cash, and being able to free up cash by shortening the Working Capital cycle is the most inexpensive way to grow. Sophisticated buyers review closely a target's Working Capital cycle because it provides them with an idea of the management's effectiveness at managing their balance sheet and generating free cash flows. [10];[16]

As an absolute rule of funders, each of them wants to see a positive Working Capital. Such situation gives them the possibility to think that your company has more than enough current assets to cover financial obligations. Though, the same can't be said about the negative Working Capital. A large number of funders believe that businesses can't be sustainable with a negative Working Capital, which is a wrong way of thinking, as many big companies such as like McDonald's, Amazon, Dell, General Electric and Wal-Mart are using negative Working Capital.
In order to run a sustainable business with a negative Working Capital, it's essential to understand some key components. [10];[16]
1. Approach the suppliers and persuade them to let business purchase the inventory on 1-2 month credit terms, but keep one should keep in mind that they must sell the purchased goods, to consumers, for money. 2. Effectively monitor the inventory management and make sure that it's often refilled and with the help of the supplier, back up the warehouse.

X. COMPONENTS OF WORKING CAPITAL

Companies must measure risk, develop, and then implement strategies for maintaining a positive cash flow. This strategy is called a Working Capital management strategy. The goal of an efficient Working Capital management strategy is to balance current assets against current liabilities so a company may meet its short-term obligations and maintain operating expenses. The major components of a Working Capital management strategy are discussed below:[18];[8]

- **Current Assets:** Current assets are items that can be turned into cash quickly. Examples of current assets are cash on hand, short-term investments, inventory, and accounts receivable. Accounts receivable must be collected in a timely manner .The sooner you receive money owed, the sooner it can be reinvested to earn a profit. Effective inventory management is also essential. The goal is to have enough inventories to complete orders but not an excess. Excess inventory creates additional costs such as paying for storage space and inventory spoilage.
- **Current Liabilities:** A company normally incurs liabilities during the operating period to meet its operations budget. Examples of current liabilities are inventory purchases, employee wages, taxes and accounts payable. Unearned revenue is also considered a current liability, meaning you've been paid for goods or services but have not yet delivered the product. Generally, current liabilities are expected to be paid during a one-year time period.
- **Positive Cash Flow:** Positive cash flow is the basis investors and owners use to measure a company's cash management strategy. A positive cash flow in simple terms means more money is coming in than going out. Current assets must outweigh current liabilities to maintain a positive cash flow. Controlling inventory, a current asset, is an important means of controlling a company's cash flow position. Short-term notes

payable, a current liability, also has an effect on a company's positive cash flow. The money should be allowed to remain invested and draw interest until needed to pay notes payable is an important means of improving cash flow.

- **Analysis:** Regular analysis of a company's currents assets and liabilities is necessary to maintain an effective Working Capital management strategy. An effective Working Capital management strategy will take into account un forsaw events such as changes in the market and competitor activities. Finding ways of increasing sales income and collecting on accounts receivable will also improve a company's Working Capital. Companies with a positive cash flow can take advantage of expansion opportunities as they arise without having to rely on external financing.

XI. FACTORS INFLUENCING WORKING CAPITAL

Working Capital plays the most vital role in the business. But its category is highly influenced by certain important aspects of the industry. The measure of Working Capital is highly depended upon the following factors such as:[18];[8]

1. Nature of Companies:

The composition of an asset is a function of the size of a business and the companies to which it belongs. Small companies have smaller proportions of cash, receivables, and inventory than a large corporation. This difference becomes more marked in large corporations. A public utility, for example, mostly employs fixed assets in its operations, while a merchandising department depends generally on inventory and receivable. Needs for Working Capital are thus determined by the nature of an enterprise.

2. The demand of Creditors:

Creditors are interested in the security of loans. They want their obligations to be sufficiently covered. They want the amount of security in assets which are greater than the liability.

3. Cash Requirements:

Cash is one of the current assets which are essential for the successful operations of the production cycle. Cash should not adequate and properly utilized. It would be wasteful to hold excessive cash. A minimum level of cash is always required to keep the operations going. Adequate cash is also required to maintain good credit relation. It has been pointed out that cash has a universal liquidity and acceptability. Unlike illiquid assets, its value is clear cut and defined.

4. Nature and Size of Business:

The Working Capital requirements of a firm are basically influenced by the nature of its business. Trading and financial firms have a very less investment in fixed assets but require a large sum of money to be invested in Working Capital. Retail stores, for example, must carry large stocks of a variety of goods to satisfy the varied and continues demand of their customers. Some manufacturing business, such as tobacco manufacturing and construction firms also have to invest substantially in Working Capital and a nominal amount of the fixed assets. In contrast, public utilities have a very limited need for Working Capital and have to invest abundantly in fixed assets. Their Working Capital requirements are nominal because they have cash sales only and supply services, not product. Thus, no funds will be tied up in debtors and inventories. The Working Capital needs of most of the manufacturing concerns fall between the two extreme requirements of trading firms and public utilities. Such concerns have to make adequate investment in current assets depending upon the total assets structure and other variables. The size of business also has an important impact on its Working Capital needs. Size may be measured in terms of the scale of operation. A firm with the larger scale of operation will need more Working Capital than a small firm.

5. Time:

The level of Working Capital depends upon the time required to manufacture the goods. If the time is longer, the size of Working Capital is great. Moreover, the amount of Working Capital depends upon the inventory turnover and the unit cost of the goods that are sold. The greater this cost, the bigger is the amount of Working Capital.

6. The volume of Sales:

This is the most important factor affecting the size and components of Working Capital. A firm maintains current assets because they are needed to support the operational activities which result in sales. The volume of sales and the size of the Working Capital are directly related to each other, as the volume of sales increases in the investment of Working Capital-in the cost of operations, in inventories and receivables.

7. Terms of Purchases and Sales:

If the credit terms of purchases are more favorable than those of sales liberal, less cash will be invested in inventory. With more favorable credit terms, Working Capital requirements can be reduced. A firm gets more time for payment to creditors or suppliers. A firm which enjoys greater credit with banks needs less Working Capital.

8. Inventory Turnover:

If the inventory turnover is high, the Working Capital requirements will be low. With better inventory control, a firm is able to reduce its Working Capital requirements. While attempting this, it should determine the minimum level of stock which it will have to maintain throughout the period of its operations.

9. Receivable Turnover:

It is necessary to have an effective control of receivables. A prompt collection of receivables and good facilities for setting payable results into low Working Capital requirements.

10. Business Cycle:

Business expands during periods of prosperity and declines during the period of depression. Consequently, more Working Capital required during periods of prosperity and less during the periods of depression. During marked upswings of activity, there is usually a need for larger amounts of capital to cover the leg between collection and increased sales and to finance purchases of additional materials to support growing business activity. Moreover, during the recovery and prosperity phase of the business cycle, prices of raw materials and wages tend to rise and require additional funds to carry even the same physical volume of business. In the downswing of the cycle, there may be a brief period when collection difficulties and declining sales together cause embarrassment by the resulting failure to replenish cash. Later, as the depression runs its course, the concern may find that it has a larger amount of Working Capital on hand than current business volume may justify.

11. The value of Current Assets:

Decreases in the real value of current assets as compared to their book value reduced the size of the Working Capital. If the real value of current assets increases, there is an increase in Working Capital.

12. Variations in Sales:

A seasonal business requires the maximum amount of Working Capital for a relatively short period of time.

13. Production Cycle:

The time taken to convert raw materials into finished products is referred to as the production cycle or operating cycle. The longer the production cycle, the greater is the requirements of the Working Capital. An utmost care should be taken to shorten the period of the production cycle in order to minimize Working Capital requirements.

14. Credit Control:

Credit control includes such factors as the volume of credit sales, the terms of credit sales, the collection policy, etc. with a sound credit control policy; it is possible for a firm to improve in cash inflow.

15. Liquidity and Profitability:

If firm desires to take a greater risk for bigger gains or losses, it reduces the size of its Working Capital in relation to its sales. If it is interested in improving its liquidity, it increases the level of its Working Capital. However, this policy is likely to result in a reduction of the sales volume, and therefore, of profitability. A firm, therefore, should choose between liquidity and profitability and decide about its Working Capital requirements accordingly.

16. Inflation:

As a result of inflation, the size of the Working Capital is increased in order to make it easier for a firm to achieve a better cash inflow. To some extent, this factor may be compensated by the rise in selling price during inflation.

17. Seasonal Fluctuations:

Seasonal fluctuations in sales affect the level of variable Working Capital. Often, the demand for products may be of a seasonal nature. Yet inventories have got to be purchased during certain seasons only. The size of the Working Capital in one period may, therefore, be bigger than that in another.

18. Profit Planning and Control:

The level of Working Capital is decided by the management in accordance with its policy of profit planning and control. Adequate profit assists in the generation of cash. It makes it possible for the management to plough back a part of its earnings in the business and substantially build up internal financial resources. A firm has to plan for taxation payments, which are an important
part of Working Capital management. Often the dividend policy of a corporation may depend upon the amount of cash available to it.

19. Repayment Ability:

A firm's repayment ability determines level of its Working Capital. The usual practices of a firm are to prepare cash flow projections according to its plans of repayment and to fix Working Capital levels accordingly.

20. Cash Reserves:

It would be necessary for a firm to maintain some cash reserve to enable it to meet contingent disbursements. This would provide a buffer against abrupt shortages in cash flows.

21. Operational and Financial Efficiency:

Working Capital turnover is improved with a better operational and financial efficiency of a firm. With a greater Working Capital turnover, it may be able to reduce its Working Capital requirements.

22. Change in Technology:

Technological developments related to the production process have a sharp impact on the need for Working Capital.

23. Firm's Policies:

These affect the level of permanent and variable Working Capital. Changing in credit policy, production policy, etc is bound to affect the size of Working Capital.

24. Activities of the Firms:

A firm's stocking on heavy inventory or selling on easy credit terms calls for a higher level of Working Capital for it than for selling services or making Cash sales.

25. The attitude of Risk:

The greater the amount of Working Capital, the lower is the risk of liquidity. Whenever there is a current strain, it has to be immediately diagnosed on the basis of the red signals which manifest themselves in the operations. The restrictions expressed as ratios of the elements of current assets and current liabilities are frequently referred to as current position constraints and include the current ratio, the acid test ratio, and the so-called "compensating balance" ratio. Contracts with fund suppliers frequently provide for current-position constraints.

If stock not moving fast, and if there is an excess inventory buildup corrective steps should be taken to sell the stock or bring down its level. If the receivable has become sticky, effective recovery steps should be taken to reduce the debts and to increase the collections. If the strain is allowed to continue because of involvement in any other business or industry, the consequences may be disastrous. In such situation, the ability to meet current demands deteriorates; short-term credits are not forthcoming; production is affected; sales decline; cash flow decline; income may disappear, and the whole enterprise may get into the red over a period of time. All the above points are the factors determining Working Capital management in all the companies. Some factors are controlled and some factor is not controlled by the management.

XII. ADVANTAGES OF WORKING CAPITAL

The understanding of the term working capital and its effective and efficient usage can be very beneficial for any business irrespective of its size, nature or industry. Hence some of the advantages of adequate Working Capital are given below:[1];[17]

i) It helps in maintaining the goodwill of the firm.
ii) It helps in maintaining the solvency of the firm.
iii) It helps the firm in getting a regular supply of raw material.
iv) It helps the firm in getting a regular return on investment.
v) It helps the firm in getting payment.
vi) It helps the firm to face the crisis.
Vii) It helps the firm in getting loan easily from the banks.

Viii) It helps the firm in getting a cash discount.

XIII. DISADVNATGES OF INADEQUATE WORKING CAPITAL

Despite having the above advantages, the Working Capital is not free from its limitations. No matter how well efficient and effective a system is developed but it has to face its part of limitation. The disadvantages of Working Capital are given below: [1];[17]

i) It leads to excessive debtors.
ii) The spare funds are of no use and earn no profit.
iii) Sometimes the firm fails to maintain the relationship with the banks due to nonrequirement of funds.
iv) It leads to unnecessary purchasing.

XVI. USES OF WORKING CAPITAL MANAGEMENT

There can be countless uses of Working Capital management. But some of the most efficient and effective uses of Working Capital management are as follows:[18];[8];[1]

1. **Expansion of Investment Portfolio:** The funds which are released through sound Working Capital management practice acts as a cheap course of finance that can be used for expansion of existing projects or for investment in new investment opportunities.
2. **Increased Profitability:** Increasing profitability is one of the main objectives of engaging in Working Capital management. One of the ways of increasing profitability through adequate Working Capital management is in saving financing cost that would have otherwise been incurred but for managing short-term assets and liabilities.
3. **Ensure the availability of sufficient resources:** Through the stock market which is a component of Working Capital management, a business is able to ensure that resources are sufficient at all times. Optimal stock level, for instance, is determined using some models outside the scope of this article.
4. **Solidifies the going concern status of a company:** In business, it is very common to find a company that is profitable to go out of the business if it cannot meet up with the immediate cash flow needs of its business. Businesses need to satisfy all its short term and medium term obligations in order to be in business and still remain competitive.
5. **Improves overall efficiency of a company:** The overall operational excellence of a company would be greatly improved when finances are managed in such a way that it poses no hindrance or obstacle to any aspect of an entity.
6. **Helps a company avoid overtrading:** Overtrading is one of the fastest ways to business failure. The major symptom of overtrading is mismatching assets and finances. This includes uncontrolled, out of proportion business expansion.
7. **Maintain good relation with suppliers and other creditors:** Trade creditors and other non-trade creditors are happy to continue doing business with an organization that has the good internal structure of managing its resources - including Working Capital.
8. **Avoid underutilization of resources:** In as much as over trading is bad, under trading can cost a business a fortune in an unearned profit. Through proper management of Working Capital, a company can ensure that there are no idle resources.
9. **Provides better insight into the true financial state of a company:** Through Working Capital ratios, analysts and business valuation experts can gain a better understanding of a business.
10. **Assists management incorrectly allocating the right resources to where they are needed the most:** Through Working Capital analysis and other fundamental analysis, areas with surplus resources and a shortage of resources are identified and using appropriate asset allocation technique, even distribution of resources would be achieved.

XV. CONCLUSION

The Working Capital cycle can range from negative to large positive, one need to answer the question as to what is the optimum level of Working Capital cycle. Basically, one cannot arrive at thumb rules as Working Capital cycle varies from sector to sector.

Comparison with peers in the similar industry is more meaningful when analyzing companies and its operating efficiency. Moreover, the Working Capital cycle may fluctuate depending upon the product manufactured, their seasonality, and shelf life along with many other factors. Sometimes poor forecasting, change in government policies and unexpected events may change the Working Capital cycles and add up to Working Capital financing problems.

Usually, a ratio of Working Capital to sales is used by companies to see if the business is moving in lines with the industry performance/benchmark. The level may also depend on the future plans, sales forecast, product diversification etc.

The relative liquidity of the firm's assets structure is measured by the current assets to fixed assets ratio. The greater this ratio, the less risky as well as less profitable will be the firm and vice versa. Similarly, the relative liquidity of the firm's financial structure can be measured by the short-term financing to total financing ratio. The lower this ratio, the less risky as well as less profitable will be the firm and vice versa.

In shaping its Working Capital policy, the firm should keep in mind these two dimensions – relative asset liquidity and relative financing liquidity of the Working Capital management. A firm will be following a very conservative working policy if it combines a high level of current assets with a high level of long-term financing. Such a policy will not be risky at all and would be less profitable. An aggressive firm, on the other hand, would combine the low level of current assets with a high level of long-term financing. .This will have high profitability and high risk. In fact, the firm may follow a conservative financing policy to counter its relatively illiquid assets structure in practice.

The conclusion of all this is that the considerations of assets and financing mixes are crucial to the Working Capital management. The business community and the world at large will almost certainly not have to worry about business failures and financial crisis if the resources tied in the form of Working Capital can be released for further creation of value.

You will have every reason to be happy if you start repositioning your business today by establishing and maintain a culture of quality Working Capital management. Remember that the content of this article alone cannot guarantee complete business success, other business success factors need to be rightly blended into your management function tool kit.

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