WORKING CAPITAL MANAGEMENT UNIT III - FINANCIAL MANAGEMENT

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DIFFERENCE IN THE MANAGEMENT OF FIXED ASSETS AND CURRENT ASSETS

1. In managing fixed assets, time is a very important factor; consequently, discounting and compounding techniques play a significant role in capital budgeting and a minor one in the management of current assets.
2. The large holding of current assets, reduces the overall profitability. Thus, a risk-return trade-off is involved in holding current assets.
3. Levels of fixed as well as current assets depend upon expected sales, but it is only the current assets which can be adjusted with sales fluctuations in the short run. Thus, the firm has a greater degree of flexibility in managing current assets.

CONCEPTS OF WORKING CAPITAL

Gross working capital (GWC)

- GWC refers to the firm's total investment in current assets.

  Current assets are the assets which can be converted into cash with in an accounting year (or operating cycle) and include cash, short-term securities, debtors, (accounts receivable or book debts) bills receivable and stock (inventory).

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- **Net working capital (NWC)**

  NWC refers to the difference between current assets and current liabilities.
- Current liabilities (CL) are those claims of outsiders which are expected to mature for payment with in an accounting year and include creditors (accounts payable),bills payable, and outstanding expenses.
- Since NWC is a difference between two numbers , therefore it can be positive or negative.

Positive NWC=CA>CL

Negative NWC=CA<CL

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Therefore,

GWC focuses on

- ✓ Optimisation of investment in current asset and Financing of current assets

NWC focuses on

- ✓ Liquidity position of the firm
- ✓ Judicious mix of short-term and long-term financing

OPERATING CYCLE

Operating cycle is the time duration required to convert sales, after the conversion of resources into inventories, into cash. The operating cycle of a manufacturing company involves three phases:

- ✓ *Acquisition of resources such as raw material, labour, power and fuel etc.*
- ✓ *Manufacture of the product which includes conversion of raw material into work-in-progress into finished goods.*
- ✓ *Sale of the product either for cash or on credit. Credit sales create account receivable for collection*

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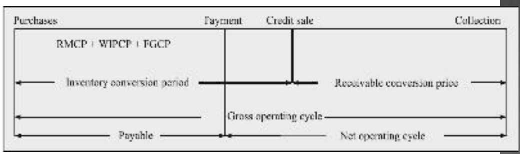
The length of the operating cycle of a manufacturing firm is the sum of:
Inventory conversion period (ICP).
Debtors (receivable) conversion period(DCP).



Operating cycle of a manufacturing firm

GROSS OPERATING CYCLE (GOC)

The firm's gross operating cycle (GOC) can be determined as inventory conversion period (ICP) plus debtors conversion period (DCP). Thus, GOC is given as follows:

Gross operating cycle = inventory conversion period + debtors conversion period

GOC = ICP + DCP

INVENTORY CONVERSION PERIOD

Inventory conversion period is the total time needed for producing and selling the product. Typically, it includes:

- ✓ raw material conversion period(RMCP)
- ✓ work-in-process conversion period(WIPCP)
- ✓ finished goods conversion period(FGCP)

ICP = RMCP + WIPCP + FGCP

DEBTORS (RECEIVABLES) CONVERSION PERIOD

- Debtors conversion period (DCP) is the average time taken to convert debtors into cash. DCP represents the average collection period. It is calculated as follows:

$$\text{Debtors conversion Period (DCP)} = \frac{\text{Debtors}}{\text{Credit sales}/360} = \frac{\text{Debtors}*360}{\text{Credit Sales}}$$

CREDITORS (PAYABLES) DEFERRAL PERIOD (CDP)

- Creditors (payables) deferral period (CDP) is the average time taken by the firm in paying its suppliers (creditors). CDP is given as follows:

$$\text{Creditors deferral period (CDP)} = \frac{\text{creditors}}{\text{Credit purchases}/360} = \frac{\text{Creditors} * 360}{\text{Credit purchases}}$$

CASH CONVERSION OR NET OPERATING CYCLE

- Net operating cycle (NOC) is the difference between gross operating cycle and payables deferral period.

Net operating Cycle = gross operating cycle – Creditors deferral period

NOC = GOC – CDP

Net operating cycle is also referred to as **cash conversion cycle**

PERMANENT AND VARIABLE WORKING CAPITAL

- **Permanent or fixed working capital**

  A minimum level of current assets, which is continuously required by a firm to carry on its business operations, is referred to as permanent or fixed working capital.

  Fluctuating or variable working capital

  The extra working capital needed to support the changing production and sales activities of the firm is referred to as fluctuating or variable working

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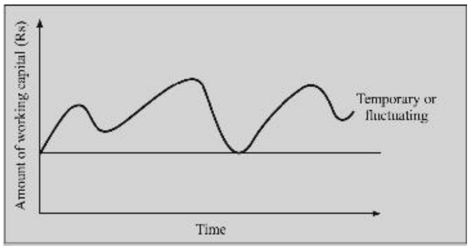


Permanent and temporary working capital

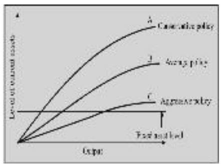
DETERMINANTS OF WORKING CAPITAL

1. Nature of business
2. Market and demand
3. Technology and manufacturing policy
4. Credit policy
5. Supplies' credit
6. Operating efficiency
7. seasonal's fluctuations

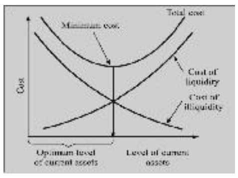
Organizations expected growth rate

ISSUES IN WORKING CAPITAL MANAGEMENT

- ✓ Current Assets to Fixed Assets Ratio
- ✓ Liquidity *vs. Profitability: Risk-Return Trade-off*
- ✓ The Cost Trade-off



Alternative current asset policies



Cost Trade-off

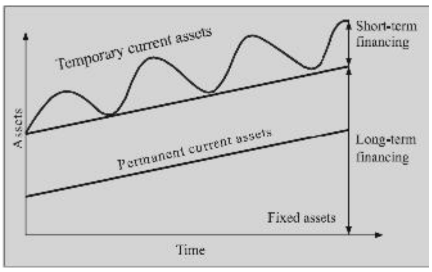
WORKING CAPITAL FINANCE POLICIES

- Long-term
- Short-term
- Spontaneous

Working Capital Finance Policies

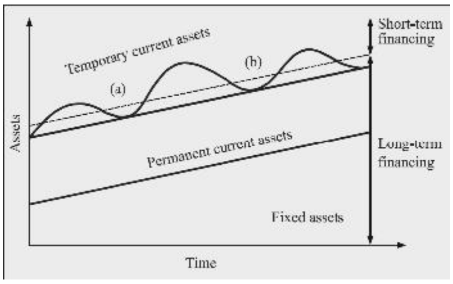
- Matching
- Conservative
- Aggressive

MATCHING APPROACH



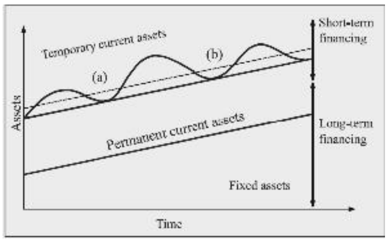
Financing under matching plan

CONSERVATIVE APPROACH



Conservative financing

AGGRESSIVE APPROACH



23*Aggressive financing*

THANK YOU