Nanotechnology Perceptions
ISSN 1660-6795
www.nano-ntp.com

Pros and Cons of Working Capital

Madugula Siva[1], B. V. Satya Prakash[2], N. D. Someswara Rao[2], D. Radha Krishna[3], Y. Kiran Kumar[4], Y. Raveendra Sivakumar[5]

[1]*Associate Professor, Department of Mathematics, B.V.Raju College (Autonomous), Vishnupur, Bhimavaram, Andhra Pradesh, India.*
[2]*Associate Professor, Department of Commerce, B.V.Raju College (Autonomous), Vishnupur, Bhimavaram, Andhra Pradesh, India.*
[3]*Assistant Professor, Department of Mathematics, B.V.Raju College (Autonomous), Vishnupur, Bhimavaram, Andhra Pradesh, India.*
[4]*Associate Professor, Department of Physics & Electronics, B.V.Raju College (Autonomous), Vishnupur, Bhimavaram, Andhra Pradesh, India.*
[5]*Assistant Professor, Department of Commerce, B.V.Raju College (Autonomous), Vishnupur, Bhimavaram, Andhra Pradesh, India.*

Working capital refers to the funds that businesses require to operate daily. It enables companies to pay employees, place orders for items, pay rent, and make payments on business loans. Evaluating how to calculate working capital is crucial to understanding a company's financial health. In this article, we explain what working capital and the working capital formula is, discuss how to use it, review how to manage and use it, consider the merits and demerits of it, and provide an example to help you learn more about the concept. Working capital refers to the money or funds available to a company for day-to-day operations. It's the difference between the company's current assets and current liabilities. You can use working capital to assess a company's financial health because it indicates its ability to make debt payments and function efficiently. Calculating working capital can also help you assess a company's liquidity and ability to pay off debt in the short term, usually within a year. Working capital is a reliable indicator of a company's financial health as it shows investors what may happen if the company used its current assets to pay off its creditors.

Keywords: assets, business, capital, cash flow, company, funds, investors, liquidity, money.

1. Introduction

Working capital and cash flow are two important financial metrics that every business keeps a close watch on. The significance of working capital and cash flow cannot be overstated. These two financial metrics help businesses evaluate whether they can withstand a market downturn or not. In simple terms, working capital is defined as the liquidity level of a company to meet its day-to-day and short-term expenses. There are various benefits of working capital for a company, from paying employees and vendors to planning for future needs. The significance of working capital for a business is remarkably high. As such, working capital meaning is related to the lifeblood of a business.

Advantages of working capital

Working capital offers several advantages, including –

1. Liquidity: Adequate working capital ensures a company can meet its short-term obligations and operate smoothly.

2. Operational Efficiency: With proper working capital management, businesses can ensure timely payment to suppliers and employees, preventing disruptions.

3. Flexibility: It allows a business to invest in growth opportunities and promptly manage unexpected expenses.

4. Creditworthiness: A positive working capital demonstrates financial health, making it easier to obtain loans and favourable credit terms.

5. Cost Management: A high working capital within the business reduces the need for costly short-term borrowing.

Limitations of working capital

While working capital is essential for business operations, it comes with certain limitations, such as

1. Idle Assets: Excessive working capital can lead to idle assets that do not generate returns.

2. Opportunity Cost: Funds tied up in working capital could be invested in higher-return opportunities.

3. Seasonal Variations: Depending on the nature of the business, working capital needs may fluctuate seasonally, affecting cash management.

4. Dependency on External Factors: External factors like economic downturns and market changes can impact working capital requirements.

2. Working Capital Management

Working Capital Management Definition

The term working capital management refers to the efforts of the management towards the effective management of current assets and current liabilities. It is mainly concerned with the fact that funds are not unnecessarily locked in current assets. In other words, efficient working capital management means ensuring sufficient liquidity in the business to satisfy short-term expenses and debts.

Calculation of Working Capital

To calculate working capital, subtract current liabilities from current assets. The formula is:

Working Capital = Current Assets − Current Liabilities

For example, if a company has Rs. 4,00,000 in current assets and Rs. 2,50,000 in current liabilities, the working capital is:

Rs. 4,00,000 – Rs. 2,50,000 = Rs. 1,50,000

This positive working capital indicates the company can cover its short-term obligations.

Importance of Working Capital

Working capital is vital for maintaining business liquidity and operational efficiency. It ensures a company can meet its short-term obligations, such as paying suppliers and employees, without financial strain. Adequate working capital allows businesses to manage operations smoothly, invest in growth opportunities, and handle unexpected expenses.

Moreover, it reflects the business's financial health, enhancing creditworthiness and making it easier to secure loans and favourable credit terms. Proper working capital management is crucial for sustaining business stability, supporting continuous operations, and positioning the company for long-term success.

Negative working capital

Negative working capital is when a company's current liabilities exceed its current assets. This situation suggests that the company may struggle to meet its short-term financial obligations and face liquidity issues. Negative working capital is often seen in businesses with rapid inventory turnover and efficient receivables management. In these cases, companies can operate successfully with negative working capital by quickly converting sales into cash. However, consistently negative working capital can affect the business, indicating potential financial distress and an inability to cover short-term debts. It may result from poor cash flow management, excessive short-term borrowing, or declining sales. Companies with negative working capital need to carefully manage their cash flow, optimise receivables and payables, and ensure they have access to sufficient short-term financing.

3. Methods to increase working capital

Since working capital depends on your current assets and liabilities, increasing the working capital involves either increasing your current assets or decreasing the current liabilities.

Some of the ways to achieve this include –

1. Accelerating and improving the collection of accounts receivable.
2. Reducing excess inventory to free up cash.
3. Negotiating longer payment terms with suppliers to allow better cash management.
4. Obtaining short-term loans or credit lines to cover gaps, especially during seasonal fluctuations.

Working capital can be understood as a measure of both a company's competence and its short term financial healthiness. For a layman, it purely means the distinction among the current assets and current liabilities. It is the firm's property of current, or short-term, assets. Working capitalis normally alienated in two types, viz. gross working capital and net working capital. Gross Working Capital is nothing but the sum of current or circulating resources. Net working capital, means current assets minus current liabilities which provide an exact appraisal of the liquidity situation of firm with the liquidity-profitability dilemma solidly validated in the financial plan of obligations which mature within a twelve-month duration. As we have seen, the two main parts of the working capital are assets and liabilities. First, short-term, or current liabilities comprise the section of funds which have been intended for and raised. Since administrations have to be concerned with correct financial arrangement, these and other funds must be raised sensibly. Short-term or current assets comprise a part of the asset investment conclusion and necessitate meticulous appraisal by the firm's executives. Further, since there exists a close association between sales fluctuations and invested amounts in current assets, a watchful preservation of the appropriate asset and funds should be ensured.

Significance of Working Capital:

Working capital is the life blood and nerve centre of a company. Just as movement of blood is necessary in the human body for marinating existence, working capital is very necessary to uphold the horizontal running of a company. No business can run productively without an sufficient amount of working capital. The main compensation of maintaining ample amount of working capital is as under:

1. Solvency of the company:

Sufficient working capital helps in maintaining solvency of the company by providing continuous flow of manufacture.

2. For Goodwill of business:

Sufficient working capital enables a business concern to make punctual payments and hence helps in creating and maintaining goodwill.

3. Easy availability of loans:

A business having sufficient working capital, high solvency and good credit standing can assemble loans from banks and other on easy and positive terms.

4. To avail cash discounts:

Enough working capital also enables a concern to avail cash discounts on the purchases and hence it reduces costs.

5. Normal supply of raw materials:

Enough working capital ensures usual supply of raw materials and regular production.

6. Usual payment for day-to-day commitments:

A company which has plenty working capital can make usual payment of salaries, wages and other day-to-day commitments which raises confidence of its employees, increases their competence, reduces wastages, costs and enhances manufacture and profits.

7. Utilization of favorable market situation:

Only concern with sufficient working capital can exploit positive market conditions such as purchasing its necessities in bulk when the prices are lesser and by holding its inventories for upper prices.

8. Capability to face crisis:

Sufficient working capital enables a concern to face company crisis in emergency periods such as gloominess because during such periods, usually, there is much pressure on working capital.

9. Rapid and regular return on investments:

Every sponsor wants a quick and regular return on his investments. Adequacy of working capital enables a organization to pay quick and usual dividends to its investors as there may not be much force to plough back profits. This gains the assurance of its investors and creates a positive market to raise additional funds in the prospect.

10. High confidence:

Sufficiency of working capital creates an surroundings of safety, confidence, and high self- esteem and creates overall competence in a business.

Factors affecting working capital necessities:

The working capital necessity of a concern depends upon a huge numbers of factors such as nature and size of business, the character of their operations, the length of manufacture cycles, the rate of stock proceeds and the state of economic condition. It is not probable to rank them because all such factors of diverse significance and the influence of individual factors changes for a firm eventually. However the following are significant factors normally influencing the working capital necessity:

1. Nature of Business:

The working capital necessity of a firm fundamentally depends upon the nature of the business. Public usefulness activities like electricity water supply and railways require very restricted working capital because they offer cash sales only and provide services, not products and as such no funds are coupled up in inventories and receivables. Usually speaking it may be said that public utility activities require small amount of working capital, trading and financial firms necessitate comparatively very large amount, whereas manufacturing activities require considerable working capital between these two limits.

2. Scale of Operations:

The working capital necessity of a concern is directly influenced by the size of its company which may be calculated in terms of scale of operations.

3. Production strategy:

In certain organizations they require is subject to wide fluctuations due to seasonal variations. The necessities of working capital in such cases depend upon the production strategy.

4. Manufacturing procedure:

In manufacturing company the necessity of working capital increases in direct proportion of length of manufacturing procedure. Longer the procedure period of produce, larger is the amount of working capital required.

5. Seasonal disparity:

In certain companies raw material is not obtainable throughout the year. They have to buy raw materials in bulk in the season to make sure and continuous flow and process them during the entire year.

6. Rate of stock proceeds:

There is a high degree of inverse co-relationship between the quantum of working capital; and the rapidity or speed with which the sales are affected. A firm having a high rate of stock turnover will need lesser amount of working capital as compared to a company, having a low rate of proceeds.

7. Credit strategy:

The credit strategy of a company in its dealing with debtors and creditors influence significantly the necessity of working capital. A company that purchases its necessity on credit and sell its products/services on cash require smaller amount of working capital.

8. Business rotation:

Business cycle refers to alternate development and contraction in common business actions. In a period of bang i.e., when the business is prosperous, there is a need of bigger amount of working capital due to amplify in sales, rise in prices, optimistic expansion of business contracts sales decline, difficulties are faced in collection from debtors and organisations may have a large amount of working capital lying inactive.

9. Rate of expansion of company:

The working capital requirement of a concern increase with the growth and expansion of its business activities. Though it is difficulties to decide the relationship between the expansion in the volume of a company and the increase in the working capital of a business, yet it may be accomplished that of normal rate of expansion in the volume of business, we may have retained profits to provide for additional working capital but in fast growth in concern, we shall require bigger amount of working capital.

10. Price stag exchange:

Changes in the price stage also result on the working capital necessity. Generally the increasing prices will require the firm to maintain bigger amount of working capital as more funds will be essential to maintain the same current assets.

4. Conclusion

Working capital advantages include improved profitability and creditworthiness. Businesses can easily avail of working capital loans. A working capital loan meaning entails a type of business loan that lenders offer to meet daily business operational expenses. Thus, we can conclude that working capital management is a very efficient tool at the hands of the management to allocate its current assets towards its current liabilities properly. It offers many pros to the entity, but it comes with slight disadvantages too. But to conclude, its merits outweigh its merits by a huge margin. Thus, business managers must use it, keeping in mind the situational needs of the business.

References

1. Baños-Caballero S, García-Teruel PJ, Martínez-Solano P. How does working capital management affect the profitability of Spanish SMEs? Small Business Economics. 2012;39(2):517–529.
2. David JS, Hwang Y, Pei BKW, Reneau JH. The performance effects of congruence between product competitive strategies and purchasing management design. Management Science. 2002;48(7):866–885.
3. Deloof M. Does working capital management affect profitability of Belgian firms? Journal of Business Finance and Accounting. 2003;30(3-4):573–587.
4. Ding S, Guariglia A, Knight J. Investment and financing constraints in China: does working capital management make a difference? Journal of Banking & Finance. 2013;37(5):1490–1507
5. Faulkender M, Wang R. Corporate financial policy and the value of cash. Journal of Finance. 2006;61(4):1957–1990.
6. Frecka TJ, Lee CE. Generalized financial ratio adjustment processes and their implications. Accounting Research. 1983;21(1):308–316.
7. Groth JC. The operating cycle: risk, return and opportunities. Management Decision. 1992;30(4):3–11.
8. Hamlin AP, Heathfield DF. Competitive management and working capital. Management and Decision Economics. 1991;12(3):207–217.
9. Kieschnick R, LaPlante M, Moussawi R. Working capital management and shareholder wealth. Working paper. 2011
10. Kim YH, Chung KH. An integrated evaluation of investment in inventory and credit: a cash flow approach. Journal of Business Finance & Accounting. 1990;17(3):381–390.
11. Luo Y, Park SH. Strategic alignment and performance of market-seeking minces in China. Strategic Management Journal. 2001;22(2):141–155.
12. Raheman A, Afza T, Qayyum A, Bodla MA. Working capital management and corporate performance of manufacturing sector in Pakistan. International Research Journal of Finance and Economics. 2010;47:151–163.
13. Smith KV. State of the art of working capital management. Financial Management. 1973;2(3):50–55.
14. Valos MJ, Bednall DHB, Callaghan B. The impact of Porter's strategy types on the role of market research and customer relationship management. Marketing Intelligence & Planning. 2007;25(2):147–156.
15. Wang Y. Liquidity management, operating performance, and corporate value: evidence from Japan and Taiwan. Journal of Multinational Financial Management. 2002;12(2):159–169
16. Wenelfelt B. A resource-based view of the firm. Strategic Management Journal. 1984;5(2):171–180.