CHAPTER III

WORKING CAPITAL MANAGEMENT

The management of current assets and current liabilities and the inter relationship that exists between them may be termed as working capital management.\(^1\) It is also known as current assets management because it requires much of the financial manager's time. It is concerned with the problems that arise in attempting to manage the current assets, the current liabilities, and the inter relationship that exist between them.\(^2\) It involves the administration of short term assets like cash, marketable securities, accounts receivables and inventories. Technically it is an integral part of the financial management, and it attempts to manage and control the current assets and the current liabilities in order to maximise the profitability and ensure proper liquidity in the business. Liquidity and Profitability are two important and major aspects of business life. No firm can survive if it has no liquidity. A firm may even exist without making profits but cannot survive without liquidity.

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The manner of management of working capital to a very large extent determines the success of operations of a concern. Though, often business failures have been attributed to lack of working capital, in the ultimate analysis it is the mismanagement of working capital that could have converted an otherwise successful business into an unsuccessful one.\(^3\)

The proper management of working capital is very important for the success of an enterprise and that is why it has become a basic and broad measure of judging the performance of a firm.

**MEANING OF WORKING CAPITAL**

Working capital, in simple terms, is the amount of funds which a company must have to finance its day to day operations. It can be regarded as that proportion of company's total capital which is employed in short term operations.\(^4\) It represents the firm's investments in cash, marketable securities, accounts receivables and inventories less the current liabilities used to finance the current assets. Some

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refer to this measure as net working capital. But according to Weston and Copeland, if working capital is what is left after taking account of current liabilities it is redundant to add the term "net". Working Capital Management is defined broadly to encompass all aspects of the administration of both current assets and current liabilities.  

**SCOPE AND IMPORTANCE OF WORKING CAPITAL MANAGEMENT**

Working Capital Management is an integral part of overall financial management. It includes a number of aspects that makes it an important topic for study. It attempts to manage and control the current assets and the current liabilities in order to maximise profitability and ensure proper liquidity in business. That is why it has been rightly said that "Working Capital Management has been looked upon as the driving seat of a Financial Manager". It has also been considered as the life blood and controlling nerve centre of a business.  

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Working Capital to a very large extent determines the success of operations of a concern. Constant Management is required to maintain appropriate levels in the Working Capital accounts. Its importance is seen from the following factors:

Investment in current assets represents a substantial portion of total investments. In some cases it has been on an average three fourths of the total assets. In the cases of trading concerns they even account for about 83 per cent of the total investments.\(^8\)

Investments in current assets and the level of current liabilities have to be geared quickly to changes in Sales. To be sure, fixed assets investment and long term financing are also responsive to variations in Sales. However, this relationship is not as close and direct as it is in the case of Working Capital Component.\(^9\)

It has also been found that the largest portion of a financial Managers time is utilised in the Management of Working Capital.


Characteristically, current assets represents more than half the total assets of a business firm. Since they represent such a large investment, this investment tends to be relatively volatile, and hence worthy of the financial manager's careful attention.

Working Capital Management is particularly important for small firms. Although such firms can minimize their investments in fixed assets by renting or leasing plant and equipment, they cannot avoid investment in cash receivables and inventories. Working Capital Management has acquired important position and great significance in the recent past. It is reflected by the fact that financial managers spend a great deal of time in managing current assets and current liabilities. Arranging for Short Term financing, negotiating favourable terms of credit, controlling the movement of cash, administering accounts receivable and monitoring the investments in inventories consume a great deal of time.

WORKING CAPITAL MANAGEMENT AND FIXED ASSETS MANAGEMENT

Management of fixed assets is usually considered to fall within the realm of Capital budgeting, while the administration of current assets falls within the
realm, of Working Capital Management. The management of current assets is similar to that of fixed assets in the sense that in both the cases the firm analyses their effects on its profitability and risk. However, the management of fixed and current assets differ in three important ways: (a) in managing fixed assets, time is very important; consequently, discounting and compounding aspects of time element play a significant role in capital budgeting and a minor one in the management of current assets (b) Secondly, the large holdings of current assets especially cash strengthens firm's liquidity (and reduce risk), but it also reduce the overall profitability. (c) Thirdly, the levels of fixed as well as current assets depend upon the expected sales, but it is only the current assets which can be adjusted with sales fluctuations in the short run.

PRINCIPLES OF WORKING CAPITAL MANAGEMENT

The financial manager of any concern should consider the following principles while exercising Working Capital Management:

1. **PRINCIPLE OF RISK VARIATION**

The word 'risk' refers to the immobility of a concern in maintaining sufficient Working Capital to pay for its liabilities. If the Working Capital varies
relative to sales, the level of risk that a concern assumes will also vary, and the opportunity of loss or gain will increase. In other words, there is a definite relationship between the degree of risk and the rate of return. As a concern assumes more risk, the opportunity of gain or loss increases accordingly. As the level of Working Capital relative to sales decreases, the degree of risk increases. Thus, if the size of the Working Capital goes up, the amount of risk goes down and the opportunity for loss/gain is likewise adversely affected.10

The size of Working Capital depends upon the attitude of management. A conservative management likes to reduce the risk by holding a higher level of Working Capital, while a liberal management assumes higher and higher risk by minimizing this level. The object of a management should, however, be to maintain the level of Working Capital which would optimize the concern's rate of return.

2. PRINCIPLE OF COST OF CAPITAL

There are different sources of finance, and each source has a different cost of Capital. It should be kept in mind that the cost of Capital is in inverse proportion to risk. This means that, if the cost of

Capital is more-implies more of Capital, the resultant risk is less. On the other hand if the cost is less implying less of Capital would lead to more risk. Therefore while raising finance, the finance manager should identify a source which would minimise the risk and maximise the return.

3. PRINCIPLE OF MATURITY OBLIGATION

A firm should make every attempt to relate maturities of obligations to its flow of internally created funds. The failure of such a match of generation to outside demand would accentuate the risk.

4. PRINCIPLE OF EQUITY POSITION

The amount of Working Capital invested in each segment should be adequately justified by a concern's equity position, that is every rupee invested in the Working Capital contribute to the net worth of the concern.  

CONCEPT OF WORKING CAPITAL

Views differ on the concept and definition of Working Capital. The financial concept is the 'gross' concept. The 'gross Working Capital' also known as current Capital or circulating Capital is represented

11. Ibid. p.5.
by the sum total of all current assets of the enterprise. As against this, we have the accounting concept, which is a 'net concept'. The 'Net Working Capital' is the difference between current assets and current liabilities. These two concepts are not to be regarded as mutually exclusive. Each has its relevance in specific situations. 12

The gross concept is a going concern concept, in which management is particularly interested because for the productive utilization of fixed assets all the current assets are necessary. Another aspect of the gross Working Capital points to the needs of arranging funds to finance current assets. Whenever a need for Working Capital funds arises due to the increasing level of business activity or for any other reason, the arrangement should be made quickly. Similarly, if some surplus funds arise suddenly, they should not be allowed to remain idle, but should be invested in short term securities. In short the gross Working Capital is the total of all current assets. Viz., cash, marketable securities, accounts receivable and inventory. As against this, the net concept is useful to gauge the financial

soundness of a firm and is of special interest to sundry creditors and suppliers of short term loans and advances.\textsuperscript{13} This concept also covers the question of judicious mix of long term and short term funds for financing current assets. According to Lawrence J. Gitman, “the Working Capital is the proportion of a firm’s current assets which are financed from long term funds.”\textsuperscript{14}

Both these concepts of Working Capital have their own significance. “If the objective is to measure the size and extent to which current assets are being used, 'gross concept' is useful whereas in evaluating the liquidity position of an undertaking, 'net concept' becomes pertinent and preferable”.\textsuperscript{15}

In summary, the gross and the net Working Capital concepts present two distinct and important facets of Working Capital management. There is no standard prescription setting out the precise amount of gross or net Working Capital, that each enterprise needs. Each company has its own constraints and plans giving rise to individual Working Capital problems and the available data.

have to be identified and analysed to aid proper decisions.\textsuperscript{16}

ADEQUACY OF WORKING CAPITAL

A firm should maintain a sound Working Capital position. It should have adequate Working Capital to run its business operations. Both excessive as well as inadequate Working Capital positions are dangerous from the firm's point of view. Excessive Working Capital means idle funds which earn no profit. Inadequate Working Capital not only impairs the firm's profitability but also results in production interruptions and inefficiencies.\textsuperscript{17}

DANGERS OF EXCESSIVE WORKING CAPITAL

The excessive Working Capital has the following dangers:

1. It promotes unchecked accumulation of inventories, gives room for inventory mishandling, waste, theft and losses.

2. It is an indication of permissive credit policies and slack collection procedures, which may adversely affect the profits.


3. Excessive Working Capital may develop a false complacence which may ultimately degenerate into managerial inefficiencies. Impulsive decisions on expansion may have to be taken without examining long term implications on profits and growth.

4. Tendencies of accumulating inventories to make speculative profits grow. This may tend to make dividend policy liberal and difficult to cope with in future when the firm is unable to make speculative profits.

DANGERS OF INADEQUATE WORKING CAPITAL

While the adequacy of the Working Capital is a virtue the inadequacy is fraught with following dangers:

1. It stagnates growth. It becomes difficult for the firm to undertake profitable projects for want of working Capital funds.

2. It becomes difficult to implement operating plans and achieve profit target.

3. Operating inefficiency creeps in when it becomes difficult even to meet day to day commitments.
4. Fixed assets are not efficiently utilized for the lack of Working Capital. Thus the rate of return on investments slumps.

5. Paucity of Working Capital renders the firm unable to avail attractive credit opportunities.

6. The firm loses its reputation when it is not in a position to honour its commitments. As a result, the firm faces tight credit terms.

Financial managers should, therefore maintain a right amount of Working Capital on a continuous basis, only then a proper functioning of the business operations will be ensured. Liquidity ratios and operating cycle period are the two important methods of assessing the adequacy of Working Capital.

S.K. Bhattacharya and others have identified some ratios to judge the effectiveness of Working Capital management and they are

1. Profit after tax as percentage of Sales (PAT/Sales)

2. Sales as number of times to total assets (Sales/Total assets).


4. Average receivables as number of days Sales.
   (AR/No. of days Sales)

5. Interest paid as percentage of profit before interest and tax.

Another indicator of the adequacy of Working Capital is the operating cycle period of an enterprise. Operating cycle can be determined on a stage-wise basis. After computation of operating cycle period of a concern, Working Capital turnover rate can be calculated and then their turnover rate can be used to determine the Working Capital requirements of an undertaking. Placing this along with the required amount of Working Capital will give the excess amount locked up in the enterprise. The comparison of the norms suggested by Tandon Committee relating to maintenance of Working Capital to the actuals obtained in the undertakings will also give a better understanding of the excess or deficit Working Capital. For the smooth running of any enterprise, adequate amount of Working Capital is necessary and in its absence, the fixed assets cannot be gainfully employed.
Apart from the above, there is yet another method of estimating Working Capital. It is conventional method. According to the conventional method, cash inflows and outflows are matched with each other. More emphasis is laid down on liquidity and greater importance is attached to current ratio, liquidity ratio etc., which pertain to the liquidity of an enterprise.

STRUCTURE OF WORKING CAPITAL

Structure of Working Capital means the components of the Working Capital. The basic components of the Working Capital are current assets and current liabilities. The main elements of current assets are cash and Bank Balances, receivables, inventories and other quick resources like short term investments. Current liabilities include payables, bank over drafts, outstanding expenses proposed dividends, tax payable and incomes received in advance.

The management of an enterprise should try to take maximum utilisation of its components at the minimum possible cost. This is highly dependent on
the structure of Working Capital. The following are the important factors in the analysis of the structure of Working Capital.

INVENTORY

Inventory generally constitutes a major portion of current assets. The profitability of the business to a larger extant depends upon the turnover of the Working Capital and this in turn depends upon the turnover of the inventory. The term 'Inventory', means the aggregate of those items of tangible personal property which (1) are held for sale in the ordinary course of business, (2) are in the process of production of sales, or (3) are to be currently consumed in production of goods or services to be available for sale.

The inventory according to the above definition includes the following: Raw materials, work-in-progress and finished goods.

RAW MATERIALS

Raw Materials means the items which are held in their original form, for processing and production. It is essential that the production should not suffer

for want of stock. For ensuring this, the purchase of raw materials in large quantities may minimise purchasing overheads, increase the discounts, at the same time, excessive raw materials may lead to incurring higher carrying costs and wastages. Therefore this should be controlled by properly setting the maximum and minimum levels of stocks, reordering level and reorder quantities etc.

WORK IN PROGRESS

Work in progress inventory is a common item in all the manufacturing concerns, because, no firm may be able to complete the manufacturing instantaneously. At any phase of production, there will be semifinished goods or work in process. At times the production process will be delayed so as to satisfy the particular choice, taste and expected demand of customers.

FINISHED GOODS

It is very important to maintain a proper level of finished goods in a concern. Danger would be felt on situations of excess or lower inventory. If a firm does not have enough stock of finished goods, it will not be in a position to meet sudden demands of customers.
It may sometimes lose sales because the needed stock of finished goods may not immediately be available. It may be economical to hold a reasonable quantity of finished goods. The flexibility afforded by such an inventory makes it possible for a firm to meet sudden or unanticipated demand of customers relatively at lower costs.

There are two advantages of high level of finished stock: They are (a) minimisation of loss of sales and (b) minimisation of high additional costs due to many number of production operations. However, the otherside of the picture is, the high inventory means high investments, which results in high carrying costs (the main factor of which being interest). Therefore management should strike a proper level of finished goods inventory, keeping in view the various factors affecting it. The objective of the inventory management would be the minimisation of idle cost of men and machine caused by shortage of raw materials, stores and spare parts and also to keep low the inventory ordering cost, (2) carrying cost, and the (3) investment in inventory and obsolescence losses.
In most of the business organisations, the bulk of sales would be on credit. This is probably because of the fact that when liberal credit facilities are made available, the sales would increase. In this sense, receivables play an important role in ensuring a higher turnover for the firm concerned. The practice of carrying receivables has a few advantages such as (1) the reduction of collection costs over cash collection, (2) reduction in variability of sales, and (3) increase in the level of near term sales.

Credit and collection policies significantly influence Working Capital requirements. When properly formulated and executed, reduce the need of Working Capital for operational purposes. Good credit and collection policies aid in sales promotion, so that the profits become more. Soundly conceived and executed credit collection policies tend to reduce the cost of business. Finally, credit and collection policies are necessary for the maintenance of good customer relations.
Receivables constitute a major component of Working Capital, and so it require the same type of planning and control as cash and inventories. The volume of receivables outstanding at any one time is determined by an enterprise's credit and collection policies. The role of receivables in the total financial structure depends on the enterprises credit and collection policies which in turn is very much related to Working Capital.

CASH AND BANK BALANCES

Cash is the most liquid asset that a business owns. It includes money and other instruments as cheques, money orders or bank drafts etc. Cash to a business is akin to the blood for a human body. As the blood imparts life and strength, the cash imparts profits and solvency to an enterprise.

A large bank balance reveals a sound liquid position. However from financial management's point of view this practice is disapproved as it leads to the holding of an asset which is devoid not only of earning power but is on the contrary, expensive to retain. 20 While the proportion of current assets held

20. Ibid. p.22.
in the form of cash is very small, often between one per cent and three per cent its effecient management is crucial to the solvency of the business because in a very important sense cash is the focal point of funds flow in a business. The objectives of cash management are to make the most effective use of funds on the one hand, to accelerate the inflow and to decelerate the outflow of cash on the other hand.

INVESTMENTS IN MARKETABLE SECURITIES

It has become a practice with the modern business organisations to invest a part of their earnings in assets which are easily convertible into cash (Marketable Securities) to avoid too much redundant cash. Such assets may be Government Securities, bonds debentures and shares that are readily saleable without loss of value.

CURRENT LIABILITIES

Current assets are not the only factor which count in designing the structure of Working Capital. There is the liabilities side also, such as trade creditors, bills payable, bank overdrafts, tax payables,

proposed dividends, outstanding expenses etc. Taxes and proposed dividends have major influence on the Working Capital structure of a business. Corporate income tax reduces the net earnings of an enterprise. However, the management does not usually have a high degree of flexibility in these matters and hence the focus of the management is therefore limited to handling of current assets.22

DETERMINANTS OF WORKING CAPITAL

There are no set rules or formulae to determine the Working Capital requirements of the firms. A large number of factors influence the Working Capital needs of the firm. All the factors are of different importance. Also, the importance of those factors change from firm to firm and also for a firm over time. Those factors are: (1) Nature and size of business, (2) Manufacturing cycle (3) Business fluctuations (4) Production policy (5) Firms credit policy (6) Availability of credit (7) Growth and expansion activities (8) Profit margin and profit appropriation (9) Price level changes and lastly

(10) Operating efficiency. Depending upon the applicability of these concepts to the firm, the composition and quantity of Working Capital may vary from firm to firm.

OPTIMUM LEVEL OF CURRENT ASSETS

The financial manager should determine the optimum level of current assets so that the wealth of the share holders be maximised. In fact, optimum level for each type of current assets should be fixed.

CURRENT ASSETS AND FIXED ASSETS

A firm needs fixed and current assets to support a particular level of output. However, to support the same level of output, the firms may have different levels of current assets. As the firm's output and sales increases, the need for current assets also increases, but not in direct proportion to output, it increases at a decreasing rate, because of the economies of large scale operations.

The level of Current assets can be measured by relating it to fixed assets. Assuming a constant level of fixed assets, a higher current asset/fixe
assets ratio indicates a conservative current assets policy and a lower Current assets/Fixed assets means an aggressive current assets policy. Other things remaining constant, conservative policy implies greater liquidity and lower risk; while an aggressive policy indicate a higher risk and poor liquidity. The current assets policy of the most firms may fall between these two extremes.

LIQUIDITY VS PROFITABILITY: RISK-RETURN TANGLE

The firm would make just enough investments in current assets, if it were possible to estimate working capital needs exactly. Under perfect certainty, the current assets holdings would be at the minimum level. A large investments in current assets would mean a low rate of return on investment, a smaller investments in current assets, on the other hand, would mean interruption in production and sales, because of frequent stock outs, and inability to pay for creditors in time.

However, as it is not possible to estimate working capital needs accurately, the firm must decide about the levels of current assets to be carried. The current assets holding of the firm will depend upon its working capital policy. It may follow a conservative or an aggressive policy. These policies have different risk-return implications. A conservative policy means lower returns and risk, while an aggressive policy leads to higher return and higher risk.

Apart from the, working capital policy leading to risk-return tangle, a firm may face two important but conflicting aims of working capital management, namely profitability and solvency. Solvency refers to the firm's continuous ability to meet maturing obligations. To ensure solvency, the firm should be very liquid, tying up of current assets in idle investments increasing cost and decreasing profitability. To have higher profitability, the firm may have to sacrifice solvency and maintain a relatively low level of current assets. Its profitability may improve as less funds are tied up in idle current assets, but solvency would be threatened as a consequence to it.
In determining the optimum level of current assets, the firm should balance the profitability solvency tangle by minimising the total cost (cost of liquidity and cost illiquidity).

**Fig.III.1 COST TRADE OFF**

![Graph showing cost trade off between total cost, cost of liquidity, and cost of illiquidity.]


That level of current assets where the sum of these two cost is minimum is the optimum level of current assets.

**TYPES OF WORKING CAPITAL**

The working capital that a firm would require may be broadly divided into two namely permanent, fixed or regular working capital and temporary, fluctuating/variable or seasonal working capital.
Permanent working capital is that level of current assets which is continuously required by the firm to carry on its business operations without any interruptions. Temporary/variable working capital is that level of current assets which are required over and above the permanent working capital, depending on the changes in production and sales levels. Both, the types of working capital are necessary to facilitate production and sales through operating cycle. Some times it is classified into three viz., permanent, temporary and seasonal. These classifications of working capital concept is necessary for the purpose of taking financing decisions.

![Fig. III.2 PERMANENT AND TEMPORARY WORKING CAPITAL](image)


The permanent working capital is stable over time, while temporary working capital is fluctuating sometimes increasing and some other times decreasing, as in Fig. III.2. However for a growing firm, the permanent working capital may not be stable, it would also be increasing as it grows and therefore the permanent working capital line will not be horizontal straight line as in the previous case. It will be gradually rising as is shown in Fig. III.3.

Fig.III.3. PERMANENT AND TEMPORARY WORKING CAPITAL OF GROWING COMPANY

Optimum level of working capital has been emphasised because both excessive as well as inadequate working capital positions are dangerous from the firm's point of view. While excessive working capital means idle funds which earn no profits for the firm, paucity of working capital not only impairs firm's profitability but also results in production interruptions and inefficiencies.

FINANCING OF WORKING CAPITAL

The financial manager should determine the optimum level of working capital (Gross) so that the wealth of the shareholders be maximised. The firm needs fixed and current assets to support a particular level of output. However, to support the same level of output, the firm can have different levels of current assets. The current assets of a firm may be financed by either long term or short term and or spontaneous sources of financing. The important long term sources of finance are shares, debenture, preference shares retained earnings and debts from financial institutions. Short term sources of finance are short term credit (Bank loan, commercial papers and factoring receivables). Spontaneous
financing refers to the automatic sources of short term funds like trade credits and outstanding expenses. They are cost free. Thus, the real choice of financing current assets is in between short term and long term sources. Even assuming that the level of spontaneous current liabilities is determined by extraneous factors (like business practice, income tax and dividend policies etc.) the important question in gross working capital/current assets financing is: What should be the relative proportion of short term and long term source of finance. To find out a solution for the above question, the following three approaches are resorted to by the finance managers.

The different approaches for financing the current assets are: (1) matching approach, (2) conservative approach and (3) aggressive approach.

MATCHING APPROACH

A firm can adopt a financial plan which involves the matching of the expected life of the assets with the expected life of the source of funds raised to finance it. Thus a ten year loan may be
raised to finance a plant with an expected life of ten years; Stock to be sold in thirty days may be financed with a thirty days bank loan and so on.
The justification for the exact matching is that, since the purpose of financing is to pay for the assets, the financing should be relinquished when the asset is expected to be relinquished. Using long term finance for short term asset is expensive as the funds will not be utilised for the full period. Similarly, financing long term assets with short term finance is costly as well as inconvenient as arrangements for the new short term-finance will have to be made on a continuing basis. Thus, when the firm follows matching approach (also known as hedging approach), long term finances will be used to finance fixed assets and permanent current assets and short term source to finance temporary or variable current assets. However, the exact matching is not possible because of uncertainty about the expected lives of assets. This is shown in Fig.III.4.
The firm's fixed assets and permanent current assets are financed with long term funds and as the level of these assets increases, the long term financing level also increases. The temporary or variable current assets are financed with short term funds and as their level increases, the level of short term financing also increases.
CONSERVATIVE APPROACH

An exact matching plan may not be possible to be adopted in practice. A firm may adopt a conservative approach in financing its current and fixed assets. The financing policy of the firm is said to be conservative when it depends more on long term funds for its financing needs. i.e., the firm may finance its permanent current assets and a part of temporary current assets with long term finances. Thus, in periods when the firm has no temporary current assets, it stores liquidity by investing surplus funds into marketable securities. The conservative plan relies heavily on long term financing, and therefore, is less risky.

AGGRESSIVE APPROACH

A firm may said to be aggressive in financing its assets when it uses more of short term finance than warrented by the matching plan. Under an aggressive policy, the firm finances a part of its permanent current assets also with short term financing. Some extremely aggressive firms may even finance a part of their fixed assets with short term financing. The relatively more use of short term finance makes the firm more risky. This is illustrated with the help of the following Figure.
A study of the causes of changes that take place in the working capital balances from time to time is necessary. The objectives of such an analysis is to find out whether the management is utilising the working capital effectively or not, or to find out whether the amount of working capital

is adequate, excess or inadequate. It may also be to find out whether the firm in question is in a position to pay its short term debts promptly or not and finally it may find out the source of working capital.

There are so many techniques to analyse the working capital of an enterprise. Among them, the most frequently used are (1) Ratio analysis (2) Funds flow analysis, (3) trend analysis and (4) Cost volume profit analysis etc.

RATIO ANALYSIS

Ratios are simply a means of highlighting in arithmetical terms the relationship between figures drawn from financial statements. 26 Ratio analysis takes two forms: (1) behaviour of ratios over a period of years to determine trend, (2) comparing ratios of one concern with those of other concern in the same line of business. This can be used by management as a technique of analysis to judge the efficiency with which working capital is being used in an enterprise.

The important ratios that can be used for management of working capital are: (1) turnover of working capital (net sales/net working capital) (2) current ratio (3) current debt to tangible net worth ratio (current liabilities/tangible net worth).

Although ratio analysis is used widely, it should be kept in mind that "no one ratio will give the entire picture, but they do tend to give indications, which cumulatively assist considerably in appraisal of financial positions and operations of the organisation."

FUND FLOW ANALYSIS

This analysis is an effective management tool to study how funds have been procured for the business and how they have been employed. This technique helps to analyse changes in working capital components between two dates.

In spite of its use for owners and creditors in financial decision making, it does not clarify the importance of movements in the working capital structure. Further, this technique can be used only by the internal management in its control of working capital and does not throw light on the questions whether the capital is being used most efficiently or whether the current financial position of the firm has improved or not.

TREND ANALYSIS

Trend analysis makes it easy to understand the changes in an item or a group of items over a period of time and to draw conclusions regarding the changes in data. For this analysis, a base year is chosen and the amount of that item relating to the base year is taken equal to 100 and index numbers are calculated for the other years based on the amounts of that item in those years. This is a dynamic method of analysis showing the changes over a period of time.

Since it indicates the direction in which a firm is going, this analysis may be useful if the analyst wants to study the changes over a long period
of time, it may be applied if at all the period of study is not less than 5 years, so that it may be of help in forecasting the future trends.

COST VOLUME PROFIT ANALYSIS

Under this method cash break even chart is prepared with the purpose of showing cash requirements. Certain items may have to be paid for in cash while others not. Credit may have been allowed to customers for goods and services sold or granted to the enterprise for materials supplied to it during a particular period, and the cash break even chart shows only the actual payments and not the expenses incurred.

A break even point is also the most important technique for analysing the working capital. The cost volume profit analysis deals with the net effect of changes in cost, price and volume on profits. It not only helps the management in profit projection but also is very useful in virtually all decision making areas.
OTHER TECHNIQUES

Some other techniques like cash flow analysis and a few statistical-mathematical techniques like index number, range, correlation and regression analysis are also used in this.

CONCLUSION

The management of current assets and current liabilities and the inter relationship that exists between them may be termed as working capital management. It involve the administration of short term assets like, cash Marketable securities accounts receivable and inventories on the one side and the current liabilities on the other and that is why technically it is considered as an integral part of financial management.

Because of its importance in corporate sector, it has been considered as the life blood and controlling nerve centre of business and also looked upon as the driving 'seat of a financial manager.

A firm requires both the fixed assets and current assets, however the effective utilisation of the fixed assets depends upon the amount and usage of
the current assets. A financial manager has to consider the principles of risk variation, cost of capital, maturity obligations and equity positions in exercising working capital management. These principles may help to understand that adequacy is a virtue surplus is not. To identify the adequate amount of working capital and effective utilization of it the finance manager can also use some of the accounting ratios as well.

The analysis of working capital structure may help to take maximum utilization of its components at the minimum possible cost. This may also help to locate the right proportion of the components like, Inventory, Sundry Debtors, accounts receivable, and cash and Bank balances. The determinants of the Working Capital structure are the nature and size of business, manufacturing cycle, business fluctuations, production policy, firms credit policy, availability of credit, growth and expansion activities, profit margin and price level changes.

While determining the optimum level of current assets, the financial manager may be entangled in the liquidity Vs. profitability and risk Vs. return tangles. While liquidity may reduce the risk, it lacks profitability the profitable use of the current assets may
lack liquidity and in the same way when he invests the current assets in a high income earning investments, it increases the risk, while trying to reduce the risk, he may get a decreased return. Therefore, while determining the optimum level of current assets, the firm should balance the profitability solvancy tangle by minimising the total cost by maintaining its current assets at that level where the sum of the the cost of liquidity and illiquidity is minimum. Fig.III.1.

For any firm, both the permanent and temporary forms of working capital are necessary to facilitate production and sales through operating cycle. The quantum and size of permanent and temporary forms of working capital may differ from firm to firm and also from time to time depending upon the nature of business and levels of activity. Depending upon the requirements, the right sources have to be tapped to minimise the costs and risks and optimise the liquidity and profitability. Even though there are conservative, aggressive and matching approaches of financing of working capital, to guide, the matching concept alone may help achieve the goals of financing.
There are many techniques of working capital analysis and out of them, the ratio analysis, fund and cash flow analysis, trend analysis are more popular. Of course the analysis like correlation, regression, time series and cost volume profit analysis are also used. But however the former group may be for the aggregate use while the latter may have appropriate use while deciding the individual items of the current assets.