Working Capital Management

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Lecture - 01
Introduction

Welcome students. So in this course that is on Working Capital Management we will be talking about that how to manage the working capital in the business organizations. Working capital if you understand means working capital is the short term finance. You must be knowing that in any business organization, in any business in any form there are different sources of finance, different types of the sources of finance and we shall divide them into 3 categories right.

You must have heard there are 2 categories but actually there are the 3 categories of the sources of the funds and we will learn how to manage the 2 sources under the working capital. So when you talk about the different sources of the finance in any business, we have long term sources of the funds, we have short term sources of the funds and the third one is the spontaneous sources of the finance.

So one is the long term finance, second is the short term finance, and third is the spontaneous finance. You must not have heard about the spontaneous finance which is called as self-adjusting source of finance. So when we talk about the long term sources of the funds, in the long term sources of the funds we include the share capital, we include the debentures or bonds, we include the long term loans and so on and so forth.

But in the short term sources of the funds, first we talk about the spontaneous finance and once the spontaneous source of the finance is exhausted then we move to the next level that is the short term sources of the finance. So if both these sources are not sufficient to fulfill the organization's need or the firm's financial needs then we resort to the long term sources of the funds to fulfill the short term requirements.

Otherwise the requirement, the focus and the need of the hour is that the short term requirements or the current requirements of any firms or that is specially relating to the finance or the financial

short term financial requirements, this should be fulfilled from the spontaneous finance as well as from the short term financial sources. So in this subject, in this particular area as we call it as working capital management, we call it as working capital management.

In the working capital management we will be studying about that how to manage the working capital of any organization, any business undertaking in the best possible manner. Now, you must be wondering that why there is a need or a special need to focus upon the short term sources of the finance as well as the spontaneous sources of finance as the management of the say or the financial management of any firm or any businesses concerned.

I would share with you here that what is the need, what is the requirement, what is the urge to learn about specifically to manage the short term sources of the funds. See when we talk about the long term investment decisions of the firms right, they are called as the capital budgeting decisions. In the other way the other name of these decisions is capital budgeting decisions. We want to venture into a new project. We want to have say a another plant.

We want to have say add new products or services into our existing portfolio of the products or services or we want to do something which you call it as, term it as, as a new project. Now in this case, new project means a long term investment, big investment and this investment is also called as strategic investment. When any firm makes or takes a decisions regarding the long term investment, it is not a simple decision. It is not a decisions to be taken very quickly.

We have to take our own time. We have to think a lot. We have to conduct the surveys of the market that whether if we increase the manufacturing capacity of the firm, if we add a new plant, new additional manufacturing unit in that case whether we will be able to sell the additional production in the market or not; so many things have to be taken into account and finally the decision is based upon something which is called as the DPR or the DPFR you can call it as Detailed Project Feasibility Report.

Detailed Project Feasibility Report, under that report we study everything. We study the marketability of the product, acceptability of the product in the market, marketability of the

product or service we are going to create or generate then is called as the market and demand analysis. Then we go for the technical analysis whether we will be able to manufacture the product in the best possible manner means the best quality product at the lowest price.

Then we go for the say financial analysis. Then we go for the say networking technique analysis everything we try to do. When it is a long term investment decision many people are involved and we take the decision after thorough consideration. We means within the firm and outside the firm. The environment inside the firm, environment outside the firm both are properly analyzed and if need arises the help of the experts in that area is also taken.

Normally, the firm refers this kind of decisions to the experts, market experts so which you can call it the consultants in the market and once they approve that yes your long term investment decision is going to deliver the results, you can add the capacity to the existing production capacity, you can introduce a new product in the market or you can go for say you can call it as the vertical growth of the company or the horizontal growth of the company whatever you want to do that is going to be quite feasible and that is going to be a wise decision.

So it means it is a multi-people decision where so many people are involved in taking that decision. But in case of short term finance working capital management, not large number of the people are involved; only 1 or 2 people are involved. Ultimately, it is the sole responsibility of the CFO of the company, Chief Finance Officer of the company to manage and arrange for the short term sources of the funds and fulfill the short term requirements.

Now, in case of the long term investment decisions if for example decision goes well. We invested say for example 100 crores. In the say new additional capacity or maybe adding a new product line or maybe say in the new project which the company started maybe whether it was it is in the same existing field of the business or it was altogether a new area.

So company invested 100 crores and the project did very well and the product which came out of that project was finally acceptable to the people in the market and means finally the project is successful so it means everybody will take the credit. But on the other side if the project fails, if

the project does not do well and ultimately that 100 crores investment which is made by the company goes down in the drain, who is responsible?

Because it is a multi-people decision again so it means everybody has to take the responsibility and in that case everybody's responsibility is nobody's responsibility. So it means nobody will be fired, nobody will be solely held responsible and nobody will be say paying the price for taking a wrong decision because it was not a one-man decision. It was a team decision and if the team's assessment has gone wrong in that case you cannot do anything.

But in case of the short term finance or the working capital finance, as I told you that it is the sole responsibility of the CFO, Chief Financial Officer of the company and he has to provide the short term finance to the firm as and when it is required. When you require the short term finance now, when you require the working capital, what is the need of the working capital in any firm, where the working capital is used?

Now for example we are a manufacturing firm. We are manufacturing some product and when we are manufacturing that product we need raw material and to buy the raw material you need to have funds. If you are paying to the suppliers on time they will continue to supply the raw material to the firm. Otherwise, they will stop. So if we default in making the payment to the supplier on the due date then what will happen?

Suppliers will see once or twice. After that they will stop doing the business with the firm and the onus will be of the CFO. Similarly, we hire employees, we hire plant workers, we hire office employees and everybody has to be paid after 30 days. Normally, in Indian system, we have to pay after 1 month. So you need to have sufficient working capital, short term finance to make the payment of wages as well as salaries to the people.

Similarly, you have so many utilities, power, water, lubricants, similar other kinds of the small size and the you can call it as the small quantity materials. All these materials, all this power supplies, water supplies, we need to pay after certain period of time and the Indian say payment system is for 1 month. After 1 month you have to make the payment to the all these utility

suppliers and if you are not able to make the payment on the due date I think they will not tolerate anymore. We do not have any liberty to delay the payments.

So in that case you have to have the finance, you have to have the funds for your day to day expenses. You should have material, you should have all other inputs, you should have employees, you should have workers on the plant, everybody. And for that you need to make the payments, not on daily basis, sometime not on weekly basis, even not on the fortnightly basis. But you have to make the payment on the monthly basis.

So here arises a need of working capital. So it means we are going to learn many things here that what is there to manage in the short term funds. The important point to learn here is that the short term finance should be available in any business organization in the quantity in the amount as much it is required in the firm. If you keep more than that, the cost of funds will go up and return will not be there. So the loses will increase.

Again, the responsibility will be on the finance department. You are over capitalized as far as the working capital is concerned, is bad. If you are not able to meet your obligations, not able to make the payments on the due date it means we would not be able to honor the commitment of the firm and because the reason is there is a no availability of the short term finance. We do not have the easy finance, we do not have the cash, we do not have the bank balance, sufficient bank balances I would say and you are defaulting in making the payments.

It will spoil the reputation of the firm and sometimes your suppliers, your say other input providers will stop providing the supplies to the firm. So whose fault it would be considered as, of the finance department. Everybody would say, purchase department would say we requested for this much of the funds from the finance people they did not provide it.

All other means if the workers are not being paid on time, if employees are not being paid on time so what will happen? They will say that we asked for the funds. Personal department will say we asked for the funds from the finance but they have not provided. So ultimately the onus

will be on the finance department or on the CEO of the firm. So it means in that case who is responsible, only one person. Only one department, not even person, only one department.

Because it is a day-to-day decision and we have to be very efficient. So if you keep more than the required amount of funds your cost of keeping the funds will increase, your returns will go down and profitability will be affected. Contrary to this, if you keep the funds means the lesser than the requirements so as to increase the profitability of the firm. So what will happen?

We would default in making the payments because we do not have the required amount of the finance with us and in that situation what could be the problem, that there is a situation of the technical insolvency of the firm. Technical insolvency of the firm means, firm would not be able to meet its obligation, payment obligations on the due date at the due time. So it means this is called as the state of technical insolvency.

So it means we have to avoid both the situations. We should neither be over capitalized, we should not be undercapitalized. We should be optimally capitalized as far as the management of the or as far as the short term funds are concerned so it means how to have optimum level of the working capital finance short term finance from the sources like spontaneous finance like short term finance that we are going to learn in this subject.

So we will start just with the introductory part and then we will build up the story. With the passage of time we would learn about managing the total, all the current assets in any firm and the current liabilities in the firm. So it means you must have heard about because this course you must have heard about something about the basic finance or the financial management earlier then you would be able to have interest in this particular area in this source of finance or in the management of short term funds or the working capital.

So I expect that you know the financial management and you have learnt something about it in the past. So when we talk about any firm and any business organization its financial statements include say a profit and loss account, cash flow statement, and third one is called as balance

sheet. In the balance sheet we have 2 important components; one is the asset and other is the liabilities.

Liabilities provide the funds to the firm for running its business, for running its show and assets are technically the properties of the firm which help the firm to go for the desired production, then selling that production in the market and then continuing the production process all the times. So you talk about these assets and liabilities. When you talk about these two, you have long term assets called as fixed assets and current assets.

On the other side, in the liabilities, you have long term liabilities that is called as the long term liabilities and the short term liabilities or the current liabilities. So this makes the balance sheet of the firm. If you talk about the total balance sheet of the firm, we would say that there are 2 important parts of the balance sheet and in this case I would say that here is the balance sheet of a company.

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Balance-Sheet of ABC Ltd. As on 31st Dec, ...

	Liabilities & Capital	Amount	Assets	Amount
	Share Capital		Land	
Add	Reserves & Surplus		Buildings	
Less	Drawings		Plant & Machinery	
	....		Furniture & Fixtures	
	Debentures		Goodwill	
	Long Term Loans			
	Mortgages			
	Current Liabilities		Current Assets	
	Creditors		Inventories	
	Bills Payable		Debtors	
	Short-term loans		Bills Receivables	
	Outstanding wages		Pre-paid Expenses	
	Outstanding overheads		Advance Deposits	
	Provision for Dividend		Marketable Securities	
	Provision for Taxation		Cash at Bank	
	Advance from Customers		Cash in Hand	
	Other Current Liabilities		Other Current Assets	

If you look at the balance sheet of a company you have on the one side liabilities and capital, on the other side you have assets and we have normally we have divided this balance sheet into 2 parts. One part is dealing with the, this upper part of the balance sheet deals with the long term part and the lower part of the balance sheet talks about the current or the short term part. Long

term part when you talk about, on the liability side you have long term sources of the funds that is it is starting with the share capital.

Then it is the debentures and bonds, long term loans and other things. On the asset side you have long term assets which you call them as fixed assets and these are the fixed assets. Fixed assets where you start with the land, buildings, plant, machinery, furniture, and then we have something like intangible assets but again a long term asset which is called as goodwill. So this is the upper part of the balance sheet.

If you prepare the balance sheet in the order of permanence then on the upper part of the balance sheet you have the long term liabilities on the one side and the long term or the fixed assets on the other side. We are not going to talk about the upper part of the balance sheet in this subject. Because if you are going to talk about both the components of balance sheet that is the long term liabilities, short term liabilities, long term assets, short term assets in that case what is going to happen. You are going to talk about the subject called as financial management.

I am not going to talk about both the things. Financial management means complete, nothing. We are going to talk about the, in this subject we are going to learn how to manage the lower part of the balance sheet. Lower part of the balance sheet where you talk about current liabilities and current assets. Short term liabilities and short term assets.

Here if you are able to manage the lower part of the balance sheet properly, to a larger extent upper part of the balance sheet will be managed automatically or to a larger extent. But still I told you that when we take the long term investment decision, say for example we borrowed money from financial institutions or we issued debentures in the market or we issued additional shares in the market and that long term funds were invested into a say strategic investment decision under strategic investment decision into a new project and the project does not say work well. It is not viable, it fails.

Then I say that I told you that responsibility is not with the one person or the one department because it is a multi-angle activity, multiple people are involved. Lastly products gets succeeded

but sometime once in a while they get failed also. So it means ultimately it will be considered as a firm level decision. Nobody individually is held responsible but in the management of the lower part of the balance sheet that is the current liabilities and current assets here only is the responsibility of the one department that is finance department of the firm and the one largely the one person that is the Chief Financial Officer of the company.

So we have to here learn that in this balance sheet how to manage the lower part of the balance sheet where we talk about the current liabilities and we talk about the current assets. Now you must have heard about the working capital. We have 2 concepts of working capital. One concept is of gross working capital and second concept is of networking capital. In the gross working capital, gross working capital is basically the total of the current assets in the balance sheet.

Total of the current assets in the balance sheet is called as the gross working capital. But when you subtract the current liabilities from gross current assets then that difference is that is the current assets minus the current liabilities is the net working capital. It means the total current assets, inventory, receivables, debtors, cash, bank balances, marketable securities or any other prepaid expenses, any other current assets first they have to be financed from or by current liabilities.

And if current liabilities are fully exhausted we have fully utilized the current liabilities available with the firm then we have to move to the long term sources of the funds and when you talk about the current liabilities it include both the sources of funds that is the spontaneous finance as well as the short term finance.

Once these 2 sources are fully exhausted and still if there is a need to finance the current assets, we need to build up the level of current assets which is not possible to be financed from the say short term funds and spontaneous sources of the funds, then you have to resort to the third source that is the long term sources of the finance. Now why I am saying that this priority is required because what happens.

Finance or the financial resources, they are not free they have a cost and in India we have term structure of interest rates, term structure of interest rates. When you talk about the term structure of interest rates I would say that term structure of interest rate is like the rate of interest of any on any loan is related directly to the duration of that loan. Longer the maturity period or duration of the loan, higher would be the interest rate and shorter is the duration of the loan or the maturity period of that loan, lesser will be the interest rate.

So as I am talking to you that the long term funds to be used for the short term purposes, long term funds are more costly, more expensive because they are borrowed for a longer period of time and with the time period, time horizon cost of the funds increases. So if the cost of funds is high and the returns available from the asset in which they are invested in the that is the current assets, if the return is lesser from those assets in that case there will be a mismatch between the cost and the revenue available.

So it means there is a cost is higher and the income is lesser so there is a mismatch and when there is a mismatch so what will happen it will directly add to the losses of the firm or minimize the profits because financial cost nowadays is a very important component. So you cannot think of means afford largely or maybe beyond a extent to invest long term sources of the funds to meet the short term requirements beyond a level.

If it is a marginal difference you can use the long term sources for the short term requirements or funding the current assets or short term assets but if it is a regular habit more say the magnitude is bigger of the funding the current assets with the long term funds then it is not going to be in the interest of the firm because cost of the funds is higher because of the term structure of interest rates. Returns available on the assets in which they are invested is lesser.

In that case what is going to happen? There is going to be a mismatch between the cost and revenue and finally the ultimately this will be a situation of the loss, not of the profit and not of the no profit no loss. So we have to avoid that situation. So we are going to learn here that how to make maximum possible use of the spontaneous finance and short term finance to finance the

current assets and the investment of the long term sources of the funds to fulfill the current assets the investment requirements is minimized or it is done to a minimum possible extent.

Now in this case I would say that I am saying that current assets are less productive or less say profitable as compared to the long term assets and investment of the expensive funds that is the long term funds into the assets which are either not productive, not profitable, or least productive or least profitable should be as low as possible. Now, we would come to a discussion that how current assets are least productive, least profitable, or sometime not at all productive, not at all profitable.

See when you talk about the assets, you must be knowing about the definition of asset. Asset means the property, whether is of an individual, any business organization whether is a sole proprietorship it is the partnership firm or a company form of organization. If anybody has the assets, it indicates he, she or that firm or that organization has this much amount of the properties and when you talk about anything is the asset anything is the property means it will give you some return.

If you have a extra house, if you have two houses, one in which you stay a second is rented out it means that property is giving you a monthly rental income and that is the income from that property. If you have surplus funds which are more than your say monthly requirements you invest them outside somewhere in the market and if you invest them for the longer duration 4, 5 years means go for the minimum safest mod is the fixed deposits in the banks you will earn a higher rate of interest.

So it means or any other assets you talk about, any assets which is generating income for you that is called as asset or that is called as the property. Here when you talk about the long term assets, land, plant, building, machinery there are certainly going to generate a sufficient revenue, sufficient income for us or the owners of those assets but as with the short term assets are concerned current assets are concerned they do not generate any income.

They facilitate the business process but they do not help or they do not contribute directly into the say income maximization or the wealth maximization of the firm which is the ultimate objective of any and every business. Now how would means how can I say that current assets are not at all productive?

I would say that if given a chance to do the business to me or to anybody in this world without keeping means or by not even by keeping a iota of the level of current assets if anybody is allowed to do the business in this world I think that business would be the best running business. But because as I told you that these assets are facilitated to the business, support to the business though they do not earn any interest or sorry any income or profit themselves.

But without these assets you cannot generate more than a level of profits and you cannot go beyond a level of the business so we are bound to have the current assets. Without current assets we cannot think of running the business but if it is possible to do the business without current assets I think your profit would be maximum and your say return on the investment would also be maximum. So how do I say that current asset do not generate any returns.

First of all I would say, let us take one by one. First one is the inventory. Inventory is the stock, stock of anything. It may be stock of raw material. It may be stock of finished goods. It may be stock of the halfly processed material which is called as the work in progress. It is a stock, it is the inventory and inventory we call as current assets, current property of the firm. And property is expected to generate the return.

But you tell me these inventories do they generate any kind of the return to the firm? If cannot you imagine a situation like let us state a truck load of raw material is coming from the suppliers place going directly to the plant of the firm being converted directly into the finished product and that finished product being kept in the warehouse for some period of time is directly from the plant is going to the market and that to earn cash.

Entire production is going to the market and that to earn the cash. You are in between you are not generating any current assets. There is no inventory, there is no credit sales means sundry

debtors. Will that not will be a best kind of the business situation? Raw material coming, going to the plant, and from the plant the finished product is going to the market and entire production from the plant is going to the market on cash.

Where is the current asset? Where is the need of the current assets? You do not require any inventory. You do not require any debtors which come up in the balance sheet after making the credit sales or selling your product on credit in the market. So inventory, you are keeping inventory but returns just generating to you. What returns is generating to any firm any business organization. It is not generating any return, it has only cost.

When you keep inventory you have to have space and space has a cost, building cost and if it is a perishable product you have to have the cold storage, it has a cost. You have to have human resources to manage your storing facility, it has a cost. You have to have power, water, so many other things, it has a cost. Ultimately you are going to sell that inventory in the market at the price which is called as a selling price.

And selling price who determines, market determines the selling price. We do not determine the selling price. It does not mean that if my because by keeping inventory my cost of say my investment has gone up so or my cost has increased so I would be increasing the selling price. You cannot do that because selling price is decided by the market forces, the market situation. You have to sell the product at the same price as you are selling it today.

After 6 months also you have to sell the price, if the price increases in the market it is fine. If it does not increase in the sometime it goes down so you have to pay the means that case you have to pay the price. So it means inventory is a current asset. Inventory is a property but who would like to have inventory in the business. We would like to have a situation where directly your material comes, goes to the plant.

From the plant finished production goes to the market. No way you are generating any inventory. You are keeping inventory. You are storing your production in the market even for a day an hour

or maybe a moment not at all. No cost nothing and everything is say just in time but it is not possible. We cannot do business without keeping an inventory.

We cannot do business and especially in the Indian conditions if you talk about the Indian conditions the supply chain situation is so bad that you think that for example from suppliers place to the production facility the travel time for a truckload of raw material is say 3 hours but you cannot be sure that certainly the truck will start from there and will reach at the plant at the manufacturing facility within 3 hours or at the end of the third hour.

On the way there can be anything, traffic jam, accidents anything is possible and the truckload of material get can get delayed. When it gets delayed in that case plant's material level will come down to zero inventory level of raw material will come to zero and plant will come to a standstill situation of the standstill. So it means just to avoid that situation you have to keep the inventory of raw material.

Similarly, when the production process is getting stuck or halted, in that case your finished production going to the market will also be getting affected and you cannot say that as and when there is a demand in the market you would be supplying the finished product in the market. There might be the orders from the market but we are out of stock and out of stock itself has a cost. And in between you have to keep the inventory of WIP which is called as work in process.

So everywhere at all the stages, raw material stage, WIP stage, finished goods stage you are bound to keep inventory but this inventory is not adding any value to the firm. It is increasing our cost and affecting your profitability because you cannot change the selling price so in that case inventory is an asset but it is such kind of the asset which only you can say is facilitated to the business process, is not earning anything directly for us.

It means if given a chance to do the business without inventory or even by keeping an iota of inventory I would not like means that would be the happiest situation for me, for any firm, any business organization but doing the business without inventory is you can say just not possible.

Even under just in time which is a technique say came from Japan. Under just in time also you are not keeping zero level of inventory.

You are keeping minimum level of inventory so it means everywhere you have to keep the inventory. You only can manage with the stock level of inventory. Sometimes very high level, sometime it is a low level, sometime it is in between. So you have to sometime you can keep a low level of inventory but you have to keep inventory which will increase the cost, will not earn anything for us. So it means inventory is a asset but a current asset.

So I have to finance it. I need the funds for it and if you invest more funds into inventory, keep a high level of inventory your cost will increase, your returns will be getting affected, profitability will be getting affected. So you have to keep the optimum level of inventory that we will learn how to maintain the optimum level of inventory in the firms. Similarly, we talk about the second asset which is the second asset in the say overall priority level which is called as sundry debtors.

Sundry debtors appear in the balance sheet when, sundry debtors appear in the balance sheet by selling your finished production in the market on credit not on cash. You have 2 ways to sell your production in the market. You can sell your production in the market either on cash or on credit. Your first choice would be that I would be selling maximum of my production in the market on cash but sometimes it is not possible.

If you want to do the business only on the cash basis the volume of your business will be seriously affected and it will come down. So what you have to do is you will have to do the business on credit also. But you see when you do the business on the credit again it is going to increase your cost not the returns. You are going to charge the selling price almost the same selling price but you are going to sell him on the credit.

So any if I am selling on cash today immediately I am passing on the product to the buyer and I am getting the cash back. But under the credit system, I am passing on the product today and I am getting the cash back after the credit period which maybe 1 month, 2 month, or 3 months or

sometimes it is more than that. So what would you like to do? Would you like to have the payment today or you would like to have the payment after 30 days or 60 days or 90 days?

If given a chance to me to do the business on cash I would be the happiest person. Any firm would be the happiest organization but it is not possible. You have to do the business on credit. You have to sell on the credit and when you sell on the credit sundry debtors appear which is a next asset current asset in the balance sheet sundry debtor they appear in the balance sheet and you have to manage those sundry debtors those credit sales.

So it means this is a second current assets. We call it as current asset but this asset is also not generating any returns for you, rather it has a cost. But you cannot do the business simply by doing the business on cash. You have to do the business partly on credit also and when you do the business on credit it means sundry debtors appear in the balance sheet and we have to bear those sundry debtors and we will have to do the business by selling on the credit.

Everything cannot be on cash but if my choice would be that I should be selling everything on cash but I cannot do that. So we should manage under this subject by studying the working capital management how to manage all these current assets. We just discussed about inventory, we discussed about say sundry debtors that is the credit sales. Similarly, we will be discussing about the other current assets but I would again say all these current assets have the cost.

Now say returns means returns only come when they are sold in the market and sold on cash in the market. So that would be possible even today when you are able to sell everything on cash and that too today in the market but that is not possible. So it means if it is not possible so inventory also appear in the balance sheets, sundry debtors also appear in the balance sheet and some other current assets also appear in the balance sheet.

And we to finance those current assets you need the funds which come from the spontaneous sources, short term sources and once these two sources are fully exhausted then partly the funds can be supplied from the long term sources also. About the other current assets and other discussion on this particular area I will be talking to you in the next class. Thank you very much.