

# Patrician College of Arts and Science

Department of Accounting &  
Finance

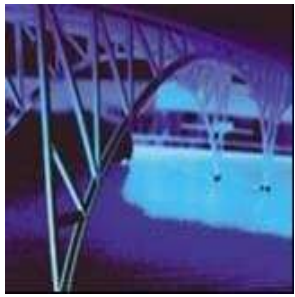
WORKING CAPITAL MANAGEMENT

Subject Code CPG6D

VI Semester

Presented By  
Dr. SUBHA S – Asst.  
Professor





# Overview of Working Capital Management



# ***Overview of Working Capital Management***

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**Working Capital Concepts**

**Working Capital Issues**

**Financing Current Assets:  
Short-Term and Long-Term Mix**

**Combining Liability Structure  
and Current Asset Decisions**



# ***Working Capital Concepts***

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## **Net Working Capital**

**Current Assets - Current Liabilities.**

## **Gross Working Capital**

**The firm's investment in current assets.**

## **Working Capital Management**

**The administration of the firm's current assets and the financing needed to support current assets.**



# ***Significance of Working Capital Management***

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**In a typical manufacturing firm, current assets exceed one-half of total assets.**

**Excessive levels can result in a substandard Return on Investment (ROI).**

**Current liabilities are the principal source of external financing for small firms.**

**Requires continuous, day-to-day managerial supervision.**

**Working capital management affects the company's risk, return, and share price.**



# *Working Capital Issues*

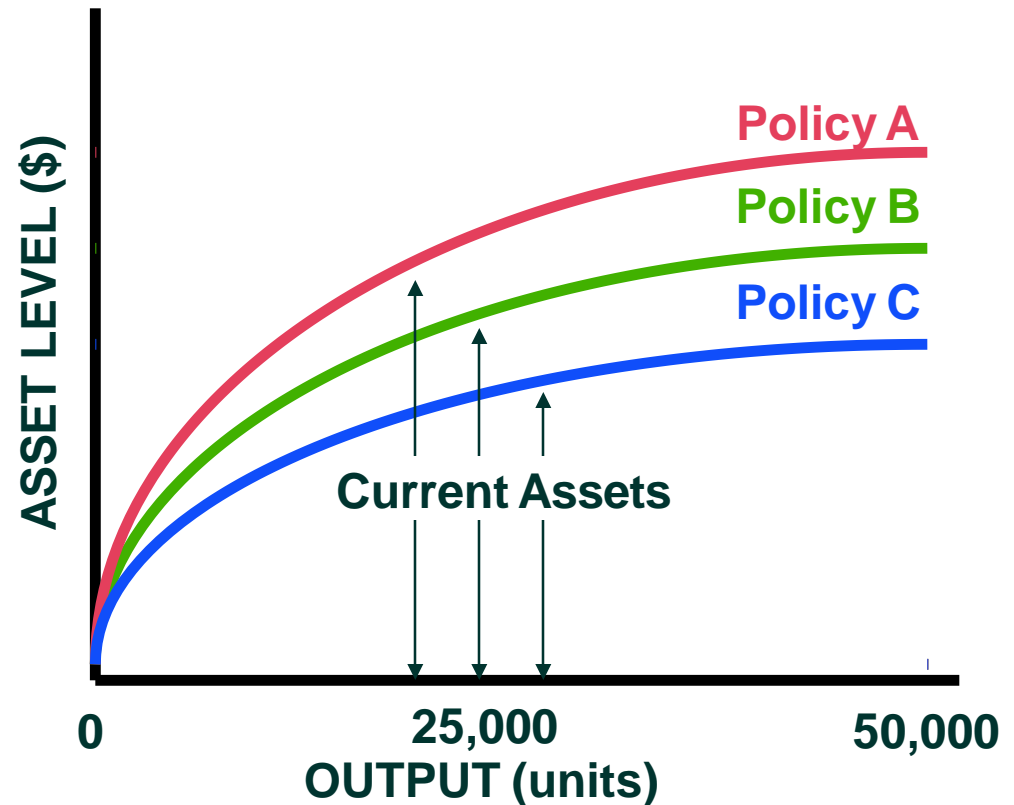
## Optimal Amount (Level) of Current Assets

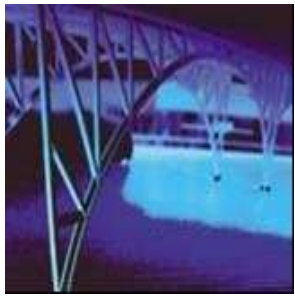
### Assumptions

50,000 maximum units of production

Continuous production

Three different policies for current asset levels are possible





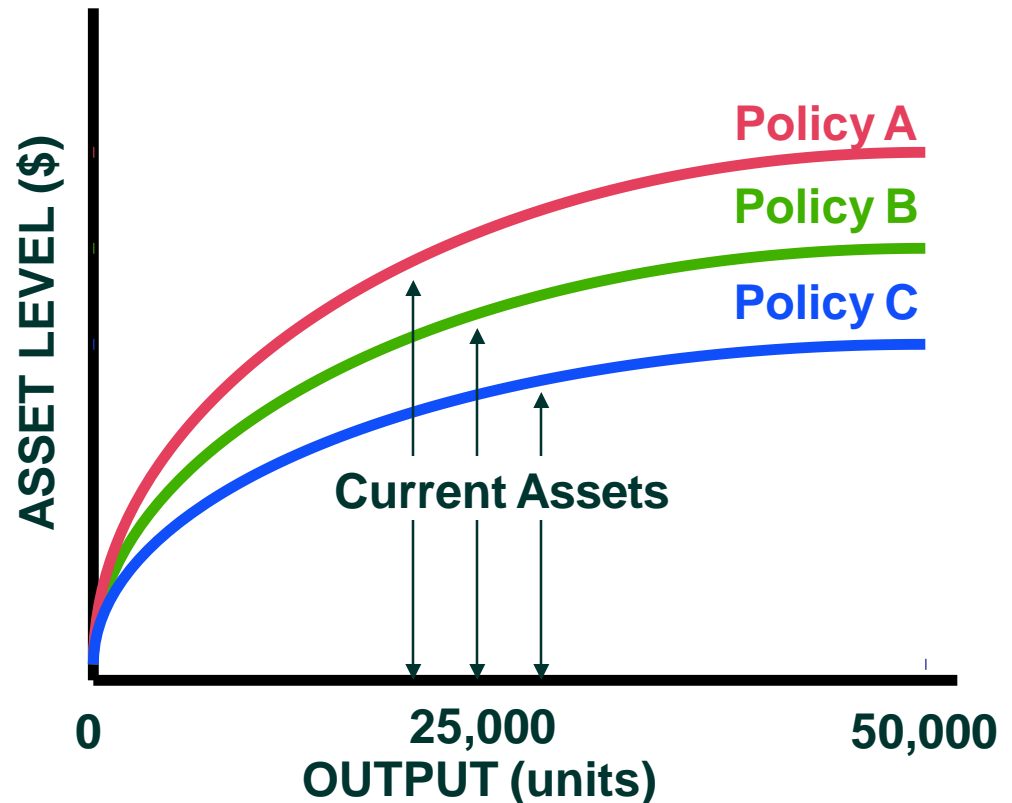
# Impact on Liquidity

## Optimal Amount (Level) of Current Assets

### Liquidity Analysis

<u>Policy</u>	<u>Liquidity</u>
A.	High
B.	Average
C.	Low

Greater current asset levels generate more liquidity; all other factors held constant.





# ***Impact on Expected Profitability***

## **Optimal Amount (Level) of Current Assets**

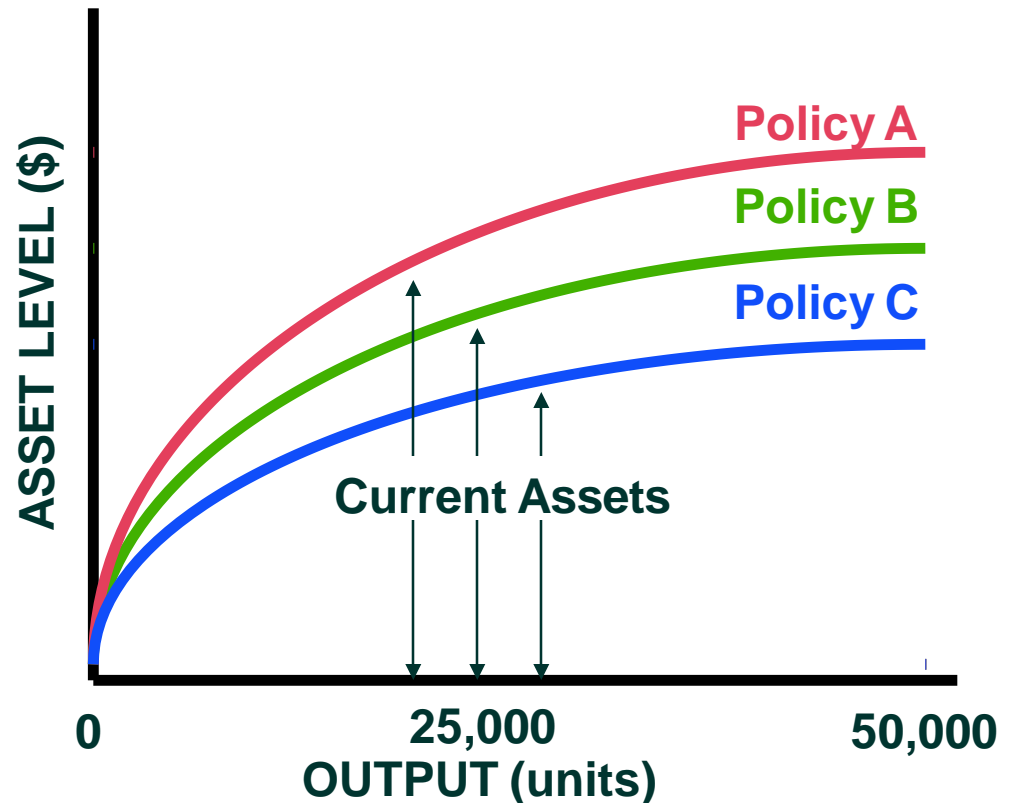
*Return on Investment =*

$$\frac{\text{Net Profit}}{\text{Total Assets}}$$

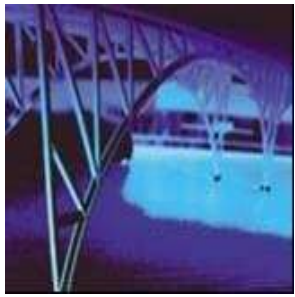
Let **Current Assets** =  
(Cash + Rec. + Inv.)

*Return on Investment =*

$$\frac{\text{Net Profit}}{\text{Current} + \text{Fixed Assets}}$$







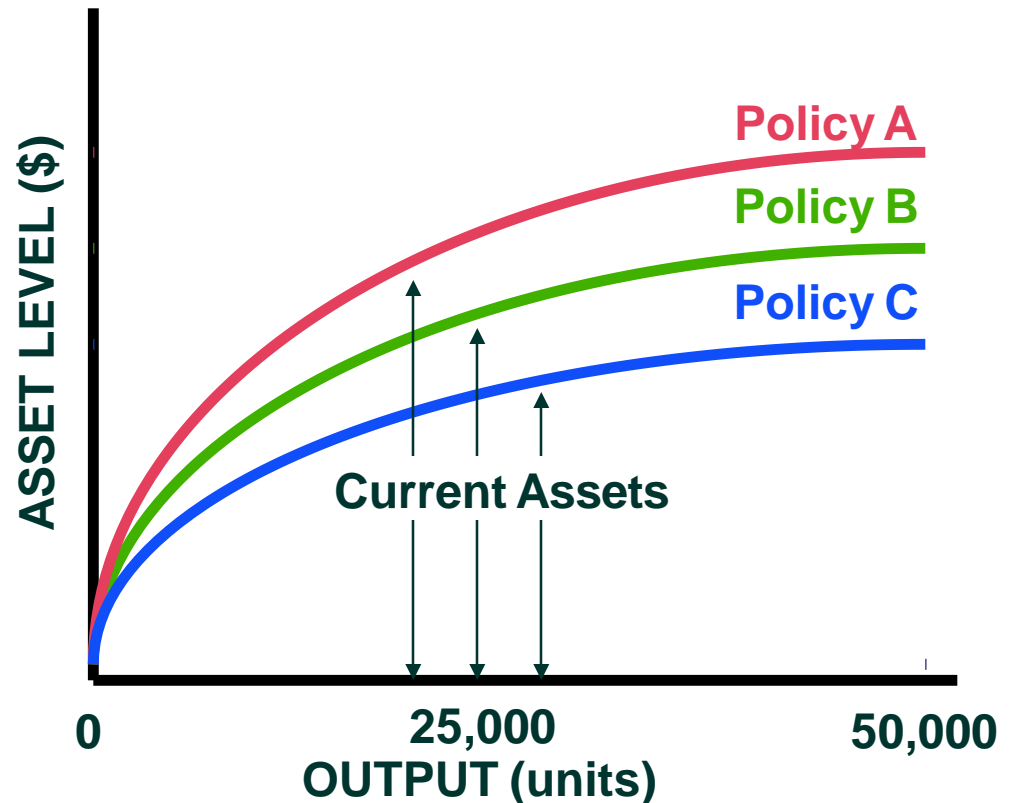
# Impact on Expected Profitability

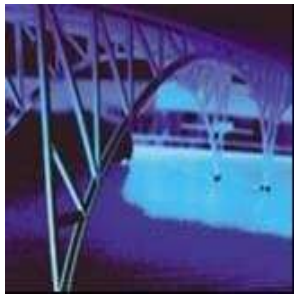
## Optimal Amount (Level) of Current Assets

### Profitability Analysis

<u>Policy</u>	<u>Profitability</u>
A.	Low
B.	Average
C.	High

As current asset levels decline, total assets will decline and the ROI will rise.





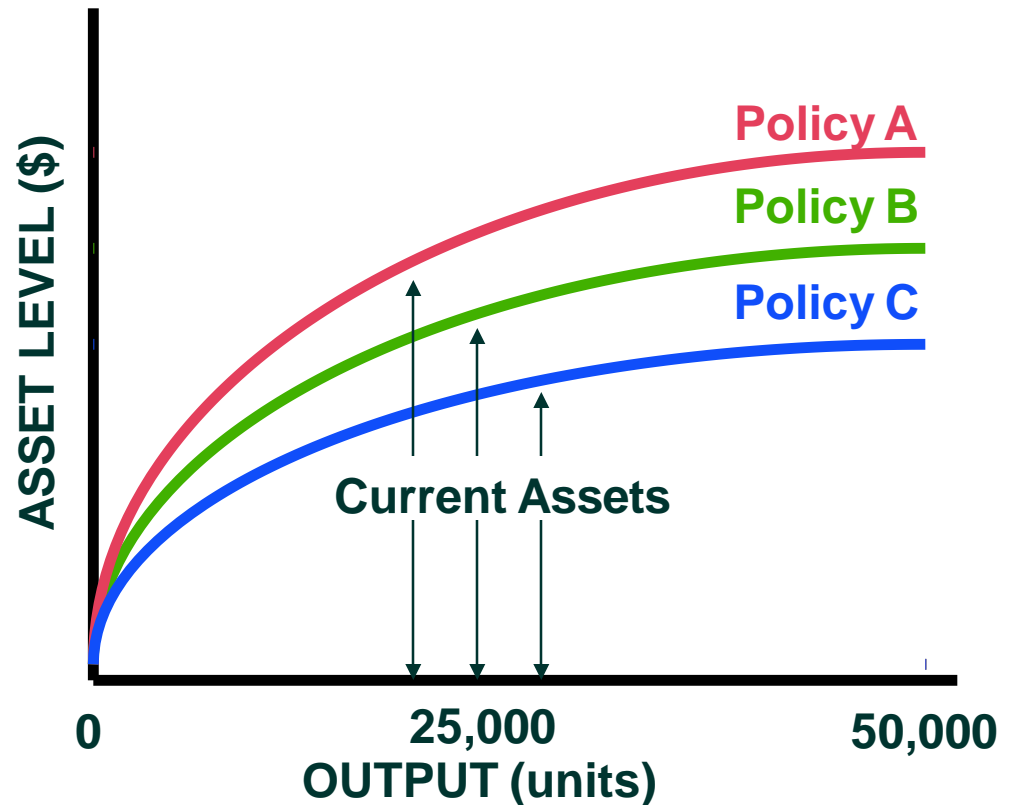
# Impact on Risk

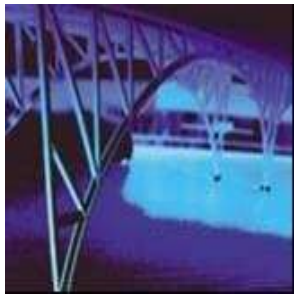
## Optimal Amount (Level) of Current Assets

Decreasing cash reduces the firm's ability to meet its financial obligations. **More risk!**

Stricter credit policies reduce receivables and possibly lose sales and customers. **More risk!**

Lower inventory levels increase stockouts and lost sales. **More risk!**





# Impact on Risk

## Optimal Amount (Level) of Current Assets

### Risk Analysis

Policy

Risk

A.

Low

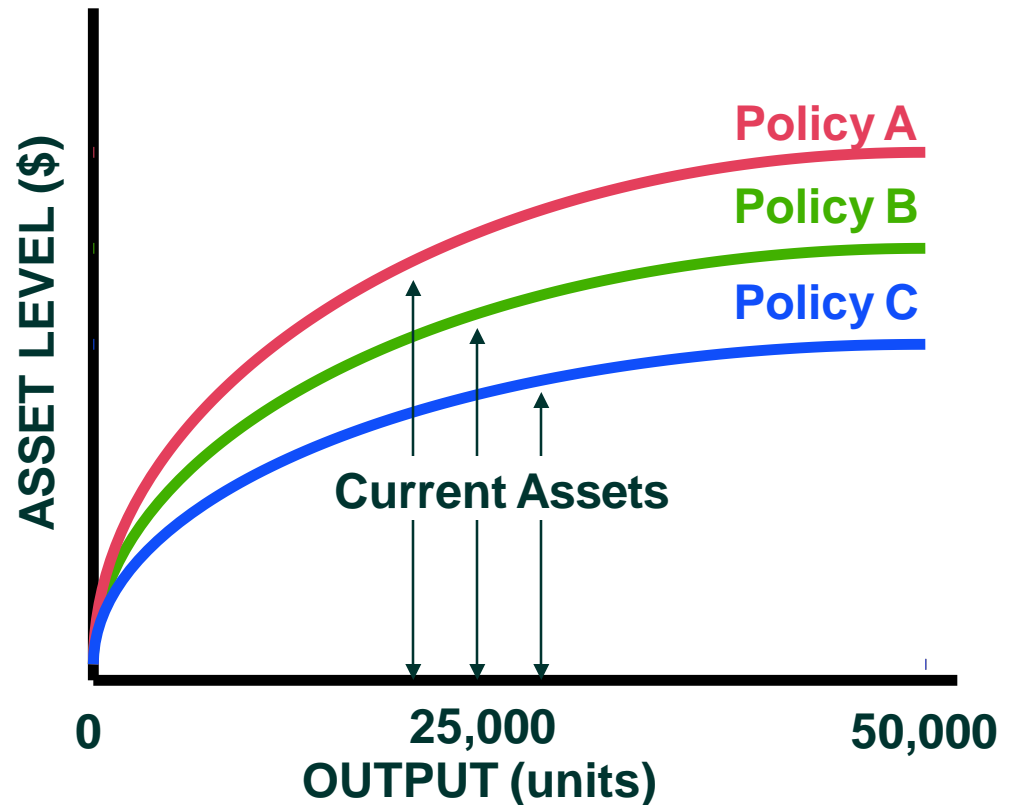
B.

Average

C.

High

Risk increases as the level of current assets are reduced.





# ***Summary of the Optimal Amount of Current Assets***

## ***SUMMARY OF OPTIMAL CURRENT ASSET ANALYSIS***

<b><u>Policy</u></b>	<b><u>Liquidity</u></b>	<b><u>Profitability</u></b>	<b><u>Risk</u></b>
<b>A</b>	<b>High</b>	<b>Low</b>	<b>Low</b>
<b>B</b>	<b>Average</b>	<b>Average</b>	<b>Average</b>
<b>C</b>	<b>Low</b>	<b>High</b>	<b>High</b>

- 1. Profitability varies inversely with liquidity.**
- 2. Profitability moves together with risk. (risk and return go hand in hand!)**



# ***Classifications of Working Capital***

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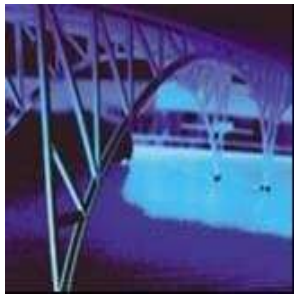
## ***Components***

**Cash, marketable securities, receivables, and inventory**

## ***Time***

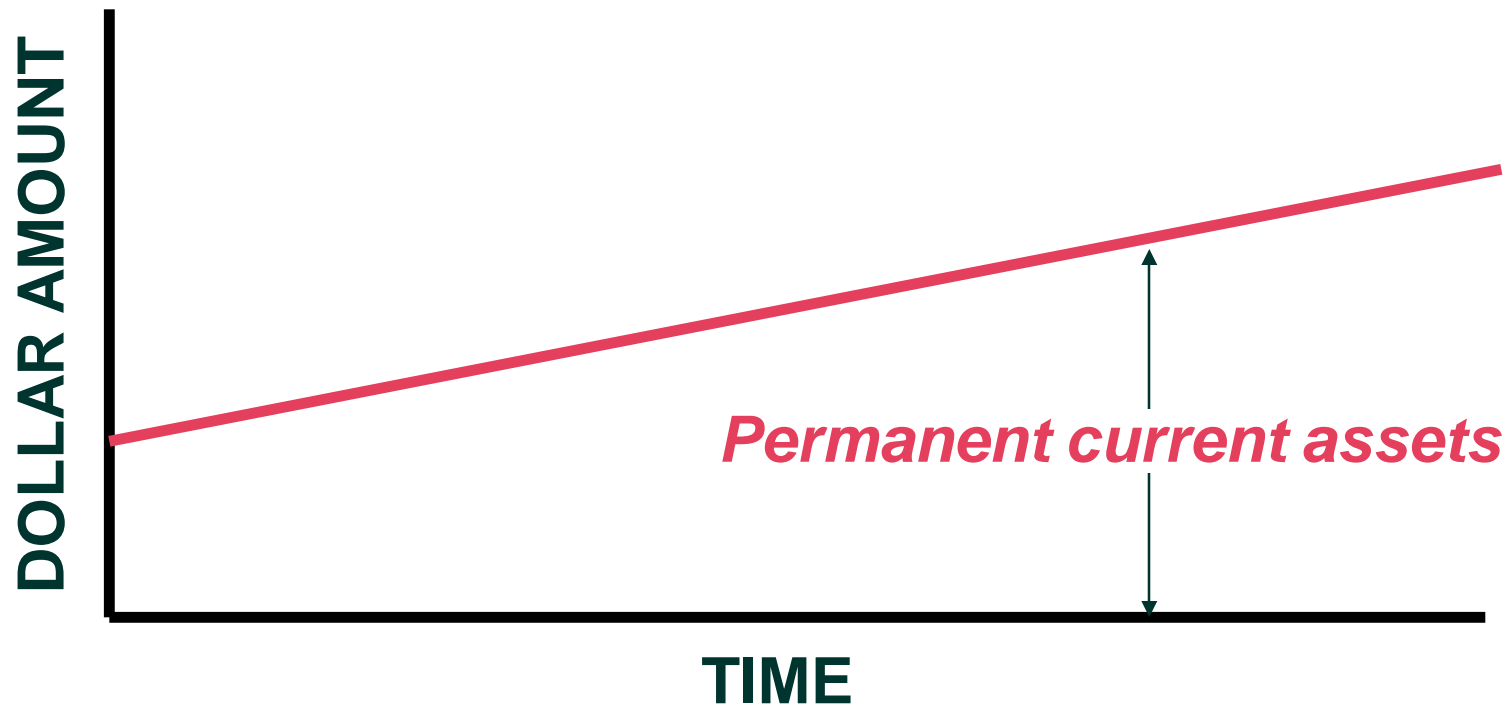
**Permanent**

**Temporary**



# ***Permanent Working Capital***

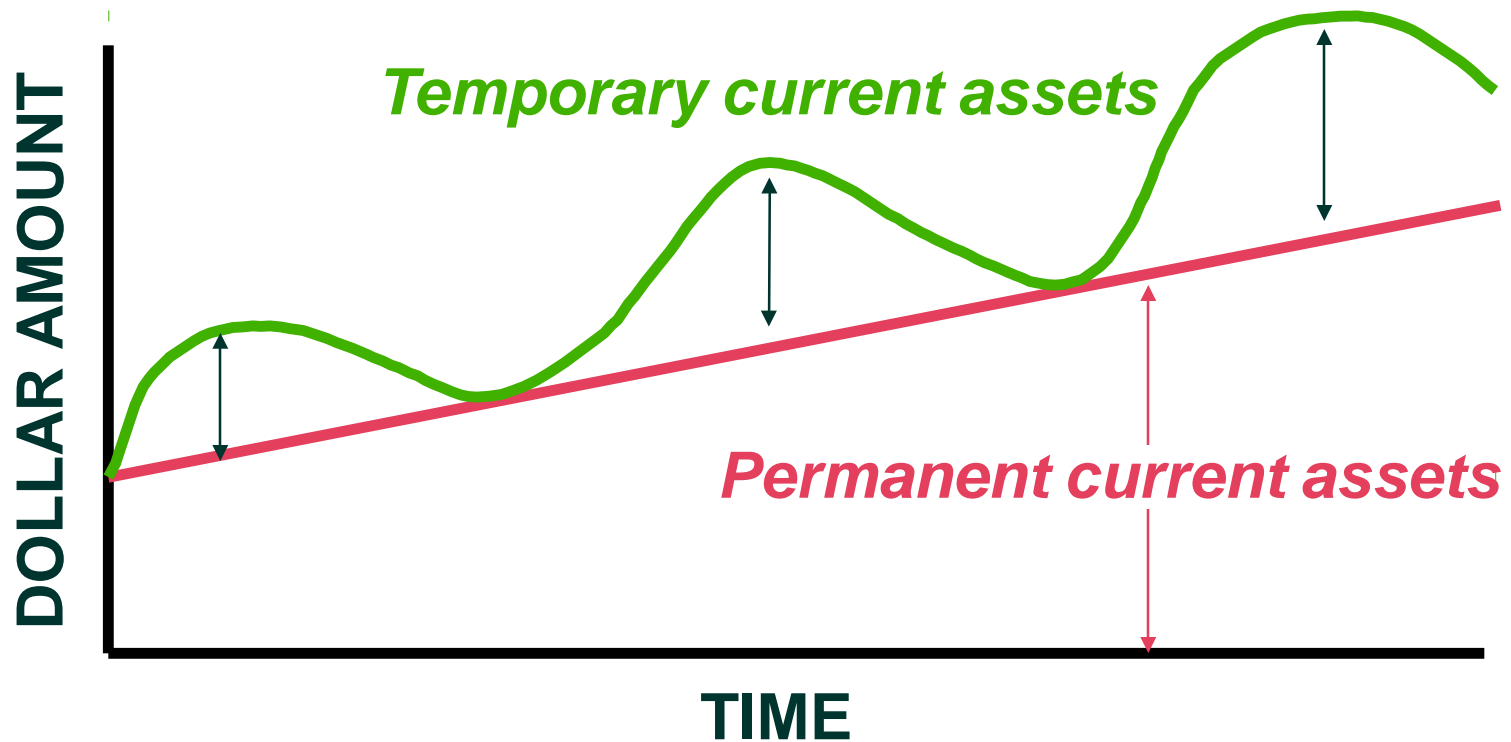
The amount of current assets required to meet a firm's long-term minimum needs.

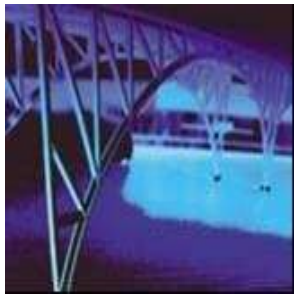




# ***Temporary Working Capital***

The amount of current assets that varies with seasonal requirements.





# *Financing Current Assets: Short-Term and Long-Term Mix*

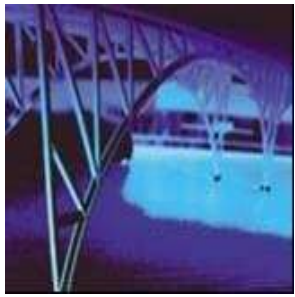
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**Spontaneous Financing: Trade credit, and other payables and accruals, that arise spontaneously in the firm's day-to-day operations.**

**Based on policies regarding payment for purchases, labor, taxes, and other expenses.**

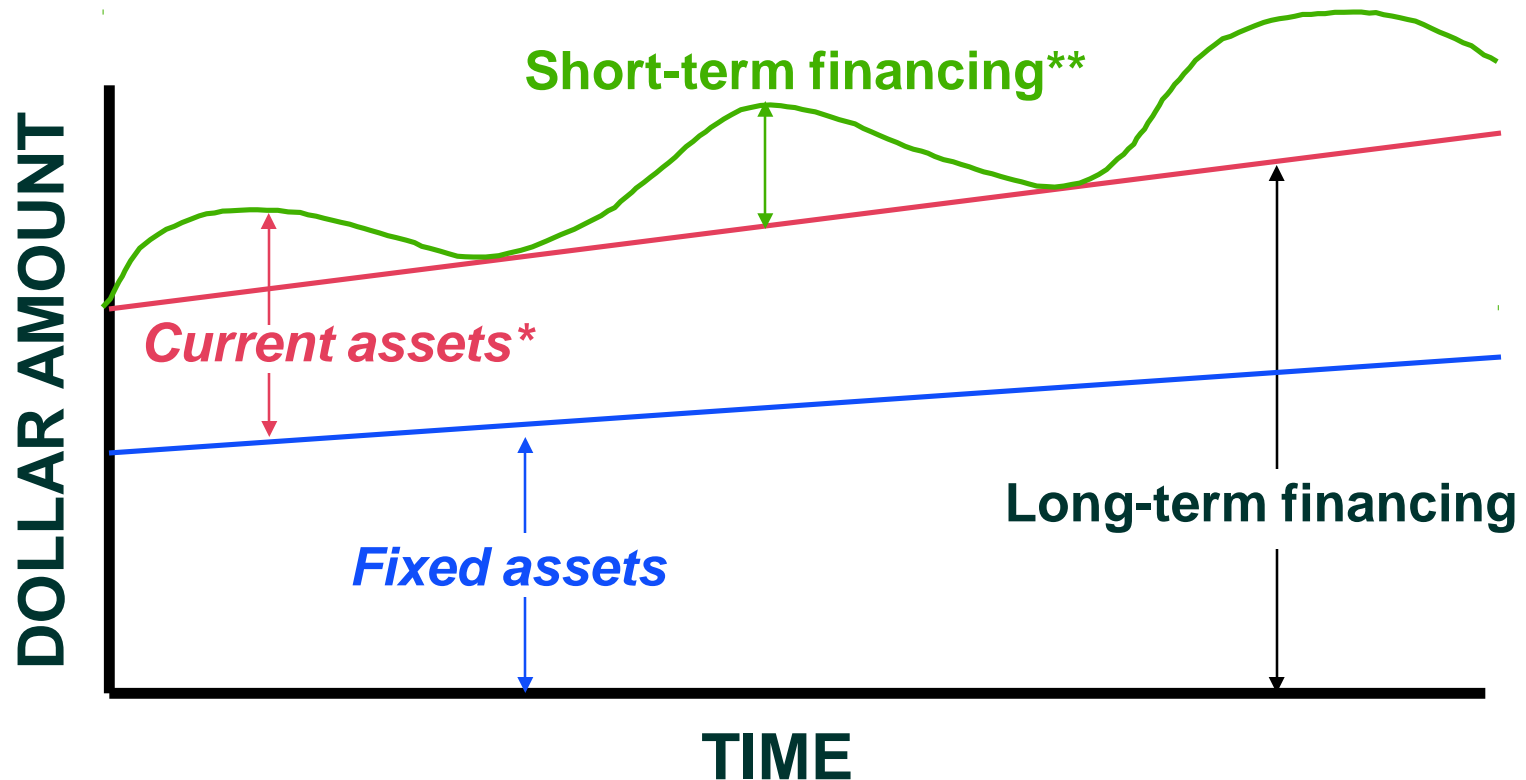
**We are concerned with managing non-spontaneous financing of assets.**

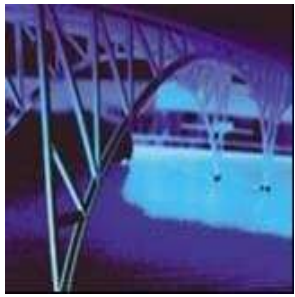




# Hedging (or Maturity Matching) Approach

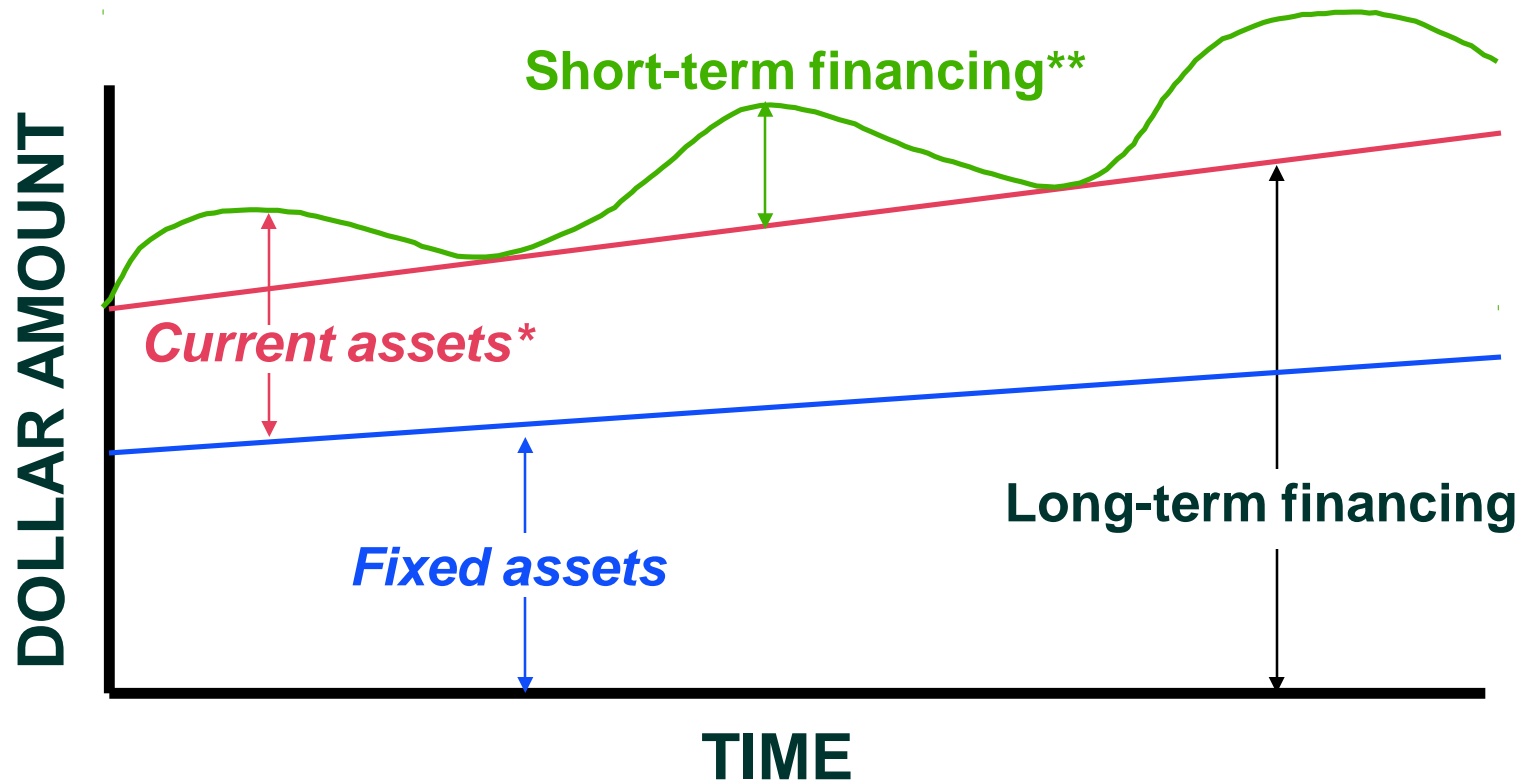
A method of financing where each asset would be offset with a financing instrument of the same approximate maturity.





# Hedging (or Maturity Matching) Approach

- \* Less amount financed spontaneously by payables and accruals.
- \*\* In addition to spontaneous financing (payables and accruals).



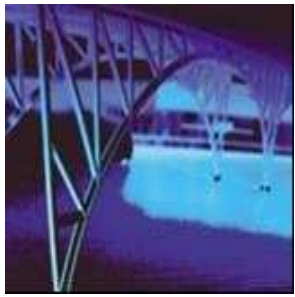


# ***Financing Needs and the Hedging Approach***

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**Fixed assets and the non-seasonal portion of current assets are financed with long-term debt and equity (long-term profitability of assets to cover the long-term financing costs of the firm).**

**Seasonal needs are financed with short-term loans (under normal operations sufficient cash flow is expected to cover the short-term financing cost).**



# ***Self-Liquidating Nature of Short-Term Loans***

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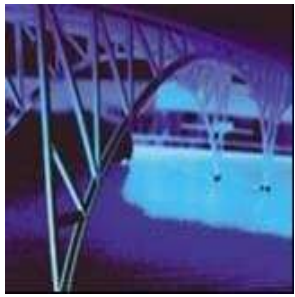
**Seasonal orders require the purchase of inventory beyond current levels.**

**Increased inventory is used to meet the increased demand for the final product.**

**Sales become receivables.**

**Receivables are collected and become cash.**

**The resulting cash funds can be used to pay off the seasonal short-term loan and cover associated long-term financing costs.**



# ***Risks vs. Costs Trade-Off (Conservative Approach)***

## **Long-Term Financing Benefits**

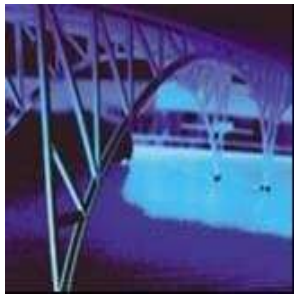
Less worry in refinancing short-term obligations  
Less uncertainty regarding future interest costs

## **Long-Term Financing Risks**

Borrowing ***more than*** what is necessary  
Borrowing at a higher overall cost (usually)

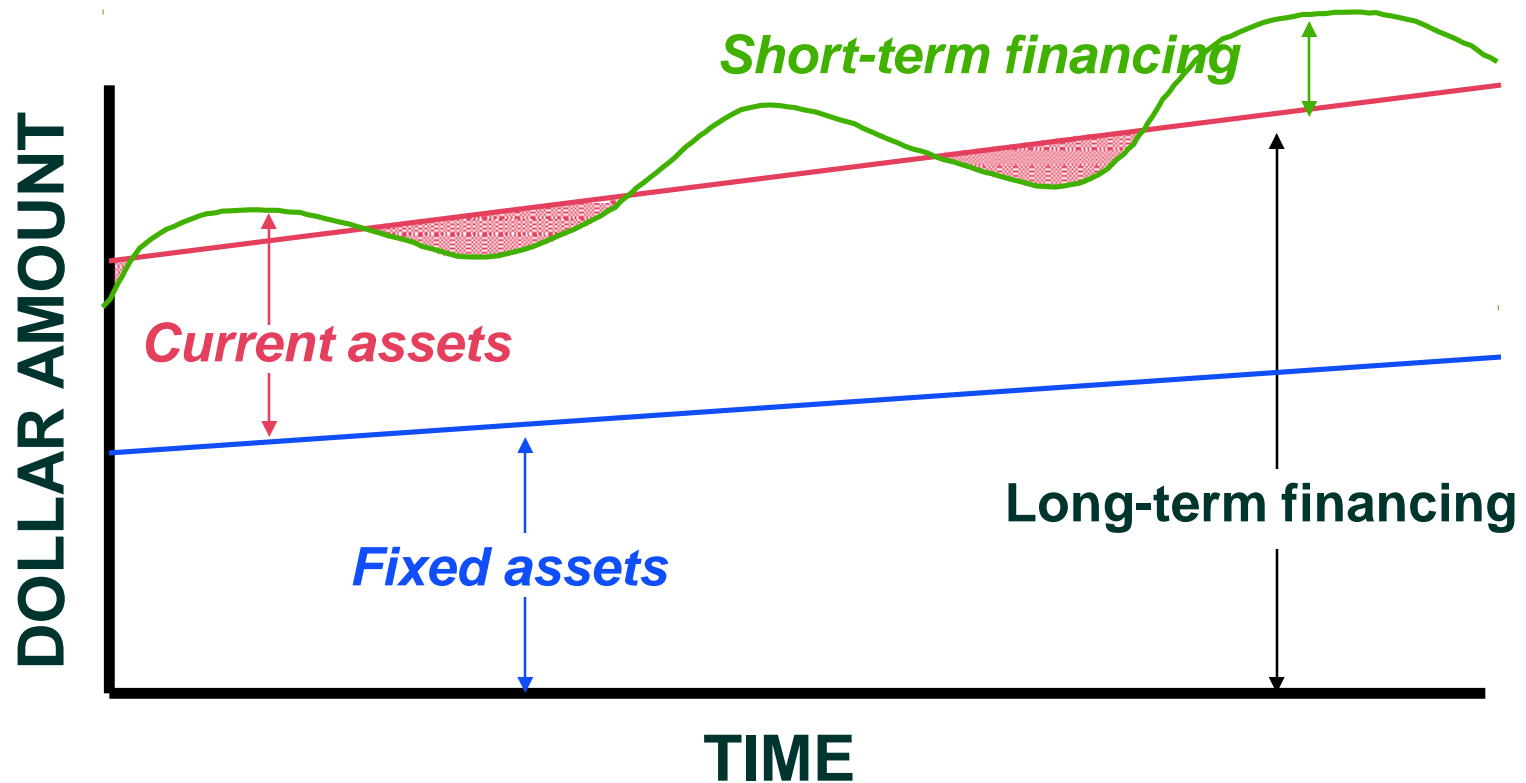
## **Result**

Manager accepts ***less*** expected profits in exchange for taking ***less*** risk.



# ***Risks vs. Costs Trade-Off (Conservative Approach)***

Firm can reduce risks associated with short-term borrowing by using a larger proportion of long-term financing.





# ***Comparison with an Aggressive Approach***

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## **Short-Term Financing Benefits**

Financing long-term needs with a lower interest cost than short-term debt

Borrowing only what is necessary

## **Short-Term Financing Risks**

Refinancing short-term obligations in the future

Uncertain future interest costs

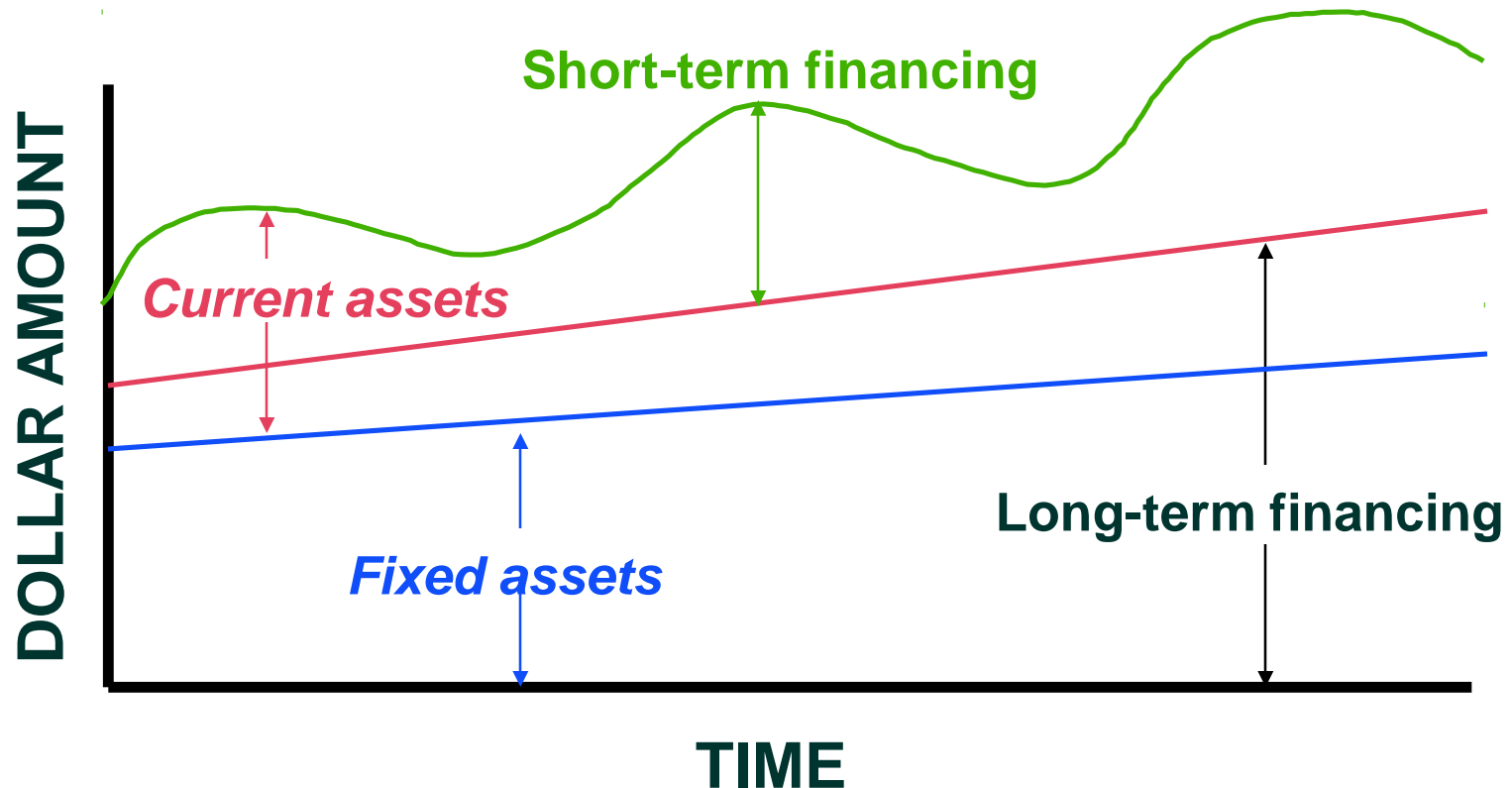
## **Result**

Manager accepts greater expected profits in exchange for taking greater risk.



# ***Risks vs. Costs Trade-Off (Aggressive Approach)***

**Firm increases risks associated with short-term borrowing by using a larger proportion of short-term financing.**







# ***Summary of Short- vs. Long-Term Financing***

<b>Financing Maturity</b> <b>Asset Maturity</b>	<b>SHORT-TERM</b>	<b>LONG-TERM</b>
<b>SHORT-TERM</b> <i>(Temporary)</i>	<b>Moderate Risk-Profitability</b>	<b>Low Risk-Profitability</b>
<b>LONG-TERM</b> <i>(Permanent)</i>	<b>High Risk-Profitability</b>	<b>Moderate Risk-Profitability</b>



# ***Combining Liability Structure and Current Asset Decisions***

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The **level of current assets** and the **method of financing those assets** are **interdependent**.

A **conservative policy** of “high” levels of current assets allows a more **aggressive** method of financing current assets.

A **conservative** method of financing (all-equity) allows an **aggressive policy** of “low” levels of current assets.



# Thank you

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