

Liquidity and working capital management

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Abstract

Liquidity of an organization plays a very critical role in smooth functioning of its day to day operations. Management of working capital ensures that liquidity of firm is maintained and assets are optimally utilized. Fixed and Current assets plays very important role in the success of any firm. Current assets are necessary for continuous business operations and optimal utilization of fixed assets is necessary to maximize the return on investment in fixed assets hence the firm will have to keep adequate level of working capital to harmonize the capacity utilization and value realization. The increase in working capital helps in improving its liquidity, scarcity of working capital will firstly lower the capacity utilization secondly will lower turnover and because of that profits decreases. Surplus working capital will remain idle and can't be utilized and this could be the main reason for decreased profits. Consequently, a company should maintain balance between both the variables liquidity and the profits of the firm. There is a positive relationship between the liquidity and working capital. As business expands, the firm will have to make huge investments in inventories and debtors and these investments will increase as the business grows. If a firm maintains inadequate level of working capital, it will have to face financial difficulties or sometimes even bankruptcy, whereas maintaining excessive levels can decrease the corporate profitability. A finance manager should be aware of such needs and plan the working capital management methods accordingly. Auditing is necessary to maintain the safe level of the different elements of working capital, like cash, inventories and current liabilities etc. Liquidity of a firm depends upon the availability of cash so that firm can fulfill daily needs, scale up operations dispose of liabilities or bills at the time of their maturity. Liquidity management has a greater significance for small firms in managing their current assets and current liabilities.

Keywords: profitability, liquidity, current ratio and quick ratio, working capital

1. Introduction

Finance is an integral part of every business to carry its day to day operations and to meet its objectives. Working capital management is an attitude and not just the application of models. It is basically the routine of the management. Working capital ratio are a very important tool for measuring financial position and efficiency of an organization. Working capital is defined as the difference between the current assets and current liabilities. To efficiently handle the finances of organization managing working capital is a very vital factor, it has a positive effect on profits of the firm as well as liquidity position of the company. Liquidity position and the profits of the firm are two different sides of same coin. Liquidity plays a very important role in the successfully managing of a business firm. Liquidity may also be referred to as the ability to realize value in money. A firm will have to assure that it should not suffer from lack of liquidity. Otherwise, it will not be able to run the business, which would result in bad credit ratings and possible closure of the company. At the same time, great intensity of liquidity is also bad, as idle assets earn nothing. Therefore, a firm should arrange an adequate liquidity framework of assets and liabilities. There are two objects of liquidity management, first object is to make sure that the firm can continue its operations without any financial hassles which means it has efficient cash flow to satisfy short-term debts and upcoming operational expenses and the second

object is to manage the firm's current assets and current liabilities in such a way that a satisfactory level of liquidity can be maintained. Otherwise, a firm can be insolvent. A firm should always have an object of optimizing its liquidity and profit positions while conducting its day to day business operations. There are many aspects of working capital management which make it an important function of the financial manager. There is a positive relationship between a firm's growth and its working capital needs. As sales grow, the firm will invest more in inventories and debtors. These needs become very frequent and fast when sales grow continuously. A finance manager should be aware of such needs and finance them quickly. Inadequate level of working capital can result in serious financial difficulties and even bankruptcy, excessive levels are likely to reduce corporate profitability. Constant management is required to maintain appropriate level of the various constituents of working capital, like cash, inventories, accounts receivables and current liabilities etc. Management of working capital is synonymous with the management of short-term financial liquidity. If the relative size of working capital is small, the overall profitability may improve, but it will damage the liquidity position and will increase the risk. Conversely, if the relative size of working capital is more, it will strengthen the firm's liquidity position, but profitability will be adversely affected. However, a large holding of fixed assets is not

similarly related with liquidity.

2. Defining liquidity and working capital management

2.1 Meaning and Concept of Liquidity

Liquidity actually performs a very important role in the successful functioning of a business firm. Liquidity is the degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity may also be referred to as the ability to realize value in money. A firm should be sure for successful running of a business so that it does not suffer from lack of liquidity. Otherwise, it will not be able to run the business, which would result in bad credit ratings and possible closure of the company. At the same time, a very high degree of liquidity is also bad, as idle assets earn nothing. Therefore, a company should plan an appropriate liquidity structure of assets and liabilities. In accounting, liquidity is a measure of the ability of a debtor to pay debts as and when they fall due. Liquidity is an intangible concept and there is no specific formula for measuring it. However, liquidity is often calculated by using liquidity ratios.

2.2 Meaning and concept of working capital

The Importance of working capital for effective management of daily business activities cannot be overlooked. It is very difficult to find a professional firm which does not require efficient amount of working capital for executing its business activities. Every firm require different amount of working capital and these requirements solely depends upon many factors e.g. Quantity of production, type of production, cost of raw material etc. The word working capital is the combination of two words, "working" and "capital". Working means the way the firm or a company functions or operate its professional activities and capital means holdings in the form of cash or assets which are possesses by a person known as proprietor or by an organization known as firm or company used for the purpose for starting or investing in a venture. Therefore, in simple words working capital means the funds which is needed by a firm for completing its daily activities related to business. In financial term it is considered as the liquidity available with the firm, company or any other business entity to continue its operating activities, for effective running of the business. Working capital management is known as the decisions which are related to working capital. In other words working capital can be defined as that part of firm capital which is required for funding current assets e.g. debtors, securities and cash etc., which is considered as the lifeblood of a business.

Working capital is calculated as follows:

Working Capital = Current Assets - Current Liabilities

3. Adequacy and Inadequacy - Working Capital and Liquidity

If any organization want a continuous progress then it should always maintain balance between working capital and liquidity. The excessive as well as inadequate situation of working capital is alarming for any organization. Scarce working capital is a disease. In other term, incompetent working capital is a great threat to any organization. An organization can achieve its targets when it maintains adequate level of working capital. Poor working capital

creates liquidity problems, higher interest charge, low profitability, operating losses, decreased retained earnings and excessive non-operating or additional wages etc. Extreme working capital leads to deserted finances, which remains idle and doesn't earn any profits for the organization. There are many threats of excessive working capital like excess storage of inventories (which results in theft, inventory mishandling), defective credit policies, managerial inefficiency, liberal dividend policy, dissatisfaction in shareholders, incompetency of management and adverse effect upon liquidity and profitability etc. Therefore, to stay away from these problems an organization should maintain adequate working capital, it should neither be less nor be more. In point of view of a business adequacy of working capital is foremost. The amount of working capital should be adequate and sufficient to operate the business in an efficient manner. If an organization maintain balance between working capital and liquidity it can enjoy many benefits like payment of current liabilities as soon as possible, protects form negative consequences of contraction in the value of current assets, avail benefits of cash discounts, helps in providing appropriate credit terms to its customers and helps in time of depression etc.

4. Concept of Working Capital

The concept of working capital can be subdivided into:

4.1 Gross or circulating working capital; and

4.2 Net working capital.

4.1 Gross or circulating working capital

Gross working capital is related to a firm's stake in current assets like inventories, accounts receivables (sundry debtors, bills receivables, etc.), loans and advances (short-term loans, investment of surplus funds, accrued incomes and prepayments) and cash (cash at bank and cash-in-hand). This concept is qualitative. After organizing the degree of current assets, a firm will have to decide how these should be financed. The investment in current assets may be broken into two parts: permanent current assets and temporary current assets. The former represents what a firm requires regularly. The latter reflects variable components and seasonal fluctuations.

4.2. Net working capital

Net working capital means current assets minus current liabilities. In other words, the excess amount of current assets over current liabilities is called working capital or net assets. The concept of working capital is quantitative.

5. Types of Working Capital

5.1 Positive Working Capital or Net Funds or Net Assets or Net Working Capital

Positive working capital means current assets exceed current liabilities. It is also known as net funds or net assets or net working capital. If current assets and current liabilities are equal, it means lack of working capital. Surplus of current assets over current liabilities is known as net working capital and gross working capital is calculated by totaling the current assets.

5.2 Negative Working Capital

Negative working capital means current liabilities overcome

current assets or current liabilities are greater than current assets. In other words, a company is basically in a very adverse situation, company is running without capital because the company's liabilities surpass the available assets that's why it is incapable to meet essential payments on certain liabilities, if additional funds are not acquired.

5.3 Fixed or Permanent Working Capital

To meet the business requirements, every firm has to maintain a minimum cash balance, inventory, short-term loans and advances, etc. This segment of current assets is called fixed working capital or permanent working capital.

6. Factors Affecting Working Capital

The factors which affect working capital are:

6.1 Nature of Business

Requirement of working capital of a firm is affected by the attributes of its business. A trading concern requires relatively less investment in fixed assets than in working capital. A manufacturing company requires a great amount of working capital than a company that operates a retail store, because of greater investment in raw materials, work-in-process and finished goods.

6.2 Size of Business

Size may be determined in terms of the scale of operations. A business organization with larger scale of production will need more working capital than a small business organization.

6.3 Volume of Turnover

The working capital requirements are directly related to the volume of turnover. An increase in sales would require more working capital for raw materials, stocks of finished goods, etc., and vice versa.

6.4 Manufacturing Process

The procedure of transforming raw material into finished goods is called the manufacturing cycle. If the manufacturing cycle is long, the need of working capital would be more and, if the manufacturing cycle is short, the need of working capital would be less. If an entrepreneur has to choose a manufacturing cycle from among many cycles, he would choose the shortest manufacturing cycle.

6.5 Seasonal Demand

In case of products with seasonal sales, when the season comes, the requirement of working capital increases and when the season goes, the requirement decreases, e.g., in the case of a sugar mill, additional working capital is required at the time of harvesting and manufacturing.

7. Concept of Liquidity

Liquidity means liquid assets or cash available in a company or a firm. In other words it can be described as the degree of comfort, the more comfortably assets can be converted into cash, asset is considered as highly liquid asset or Assets that can be easily bought or sold are known as liquid assets. Money, or cash-in-hand, is known as the most liquid asset because it very easy to use. Managing liquidity is the most

essential job of financial manager of a company. Effective liquidity management means administering assets and liabilities in that way that there should not any problem in maintaining cash inflow and outflow cycle. Liquidity is needed not only for accomplishing internal operating activities of the firm but there should also made some provisions to meet external unfavourable conditions of the firm e.g. government new unfavourable industrial policy, new taxes, inflated raw material, decrease in supply of labour etc. The basic aim of liquidity management is to make sure that the firm is capable of running its operations without any barriers, the firm has efficient cash to pay short-term debts as well as day-to-day operating expenses. Liquidity management is crucial for all the firms, but particularly for those firms which have small turnovers. The priority of small firms is to invest in current assets, they are not interested in making large investments in fixed assets. Small turnover firms in India face a severe problem of collecting their debts. Constant liquidity management is needed to maintain fluent and efficient working of a firm. The following are the important aspects of liquidity management, which make it a crucial affair of a finance manager:

Time: Liquidity management requires much of a finance manager's time.

Investment: Liquidity represents an excessive allocation of the total investment in assets.

Criticality: Liquidity management is considerably important for all firms, but it is very critical or small turnover firms.

Growth: Working capital is positively related to a firm's growth, as firm grows working capital is needed in an increasing manner.

The liquidity has two aspects quantitative and qualitative. The quantitative aspect includes the quantity, and utilization of liquid assets. Qualitative aspect, indicates the ability to accomplish the present and future demand of cash arises for effective operations of the firm so that costs can be minimized and profits can be maximized. Thus, liquidity is an essential factor in business. Liquidity should be properly maintained in an organization because excess as well as deficit of liquidity can damage the operational efficiency of the organization. A broad level of liquidity cannot produce results because idle assets cannot earn anything. Excess liquidity guarantees solvency, formulation of very liberal credit and dividend policies, reflects lower profitability, declination in managerial efficiency and increased speculation.

Inadequate liquidity leads to frustration, business objections, decreased rate of return, losing of profitable business opportunities, weakening of morale, bad credit image and drop in confidence of creditors, etc. That's why it is very crucial for a financial manager of a firm to maintain effective balance between liquidity and lack of liquidity position of a firm. According to Collins Dictionary liquidity ratios defined as the ratio of those assets which can easily be exchanged for money to the total assets of a bank or other financial institutions, and are also known as liquid assets ratio, working

capital ratio or short-term solvency ratios. The liquidity ratios measure the liquidity of a firm and its ability to meet its short-term obligations. These ratios are also termed as 'working capital ratios' or 'short-term solvency ratios'. The ratios which measures the liquidity of a firm are: Current Ratio; Acid Test/Quick Ratio and cash Ratio.

7.1 Current Ratio

The current ratio measures the company's current assets against company's current liability. It is the most fundamental liquidity examination. Normally the current ratio greater or equal to one indicates the high goodwill. Higher current ratio implies that the firm's current assets are greater than firm's current liabilities and can easily pay all of its short term debts and lower ratio or less than one ratio states that company is in a bad liquidity condition means firm's current liabilities are greater than its current assets so firm will face difficulty in settling it's short term debt obligation and will find difficulty in running day to day operations.

Current Ratio = (Current Assets) / Current Liabilities

7.2 Quick Ratio or Acid Test Ratio

Quick ratio is more improved then current ratio. It measures how well a company can meet its short term liabilities. Quick ratio focuses on accounts receivable, cash and short term investments.

Quick Ratio = (Cash + Accounts Receivable + Short-Term or Marketable Securities) / (Current Liabilities)

7.3 Cash Ratio

As the name states that it is the ratio of cash. This ratio looks only at assets that can be most easily used to pay off short-term debt, and it disregards receivables and short-term investments.

Cash Ratio = Cash & Equivalentents ÷ Current Liabilities

8. The Present Study-Importance and Objects

The present study, "*Liquidity and Working Capital Management*", is intended to analyses the concept of liquidity and working capital management in the segment of financial management. The significance of the study can be revealed by the fact that failure or success of an organization is wholly depend on the management of current assets and current liabilities. If the management is sound it means organization is not facing any problem in meeting its day to day expenditures the business will run smoothly and the organization will grow rapidly and at constant pace, but if there is a problem of managing working capital and liquidity means it is getting very difficult to meet short term current expenditures the organization can even on the verge of the insolvency. Many times, when a business fails, shortage of working capital is said to be its prime reason. Mismanagement of working capital and liquidity can turn a successful business into an unsuccessful one. Deficiency of working capital and liquidity is sometimes can be a factor, but by no means the reason of business failure. The basic difficulties faced by organizations in effectively managing working capital and liquidity is, inflation, Shortage of resources etc. The organization can handle these problems only by optimum use of available resources and preparing a sound and effective working capital

management plans, this will enable them to increase the profitability of the concern and meet the current obligations well in time. Consequently impressive management of working capital and liquidity is extremely considerable for the success of the firm.

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