DPBS(PG) College, Anoopshahr

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DECISIONS IN WORKING CAPITAL MANAGEMENT

If anybody describes the benefits of working capital management in terms of money, it would most likely be the cost of capital that a business pays on the investment in working capital. The amount of this cost would depend on two things:

1. **Quantum of working capital required**
2. **Cost of working capital**.

The quantum of working capital is decided by the working capital policies of a company whereas the optimization of the cost of capital is worked out with working capital management strategies.

WORKING CAPITAL DECIDING FACTORS – LEVEL AND MODE OF FINANCING

The two main factors that decide the quantum of working capital that a business should maintain are liquidity and profitability. Let's understand the impact of both of these factors in details. Nobody denies the importance of liquidity but most have a question that how much that liquidity should be? What are the right levels of liquidity? We know that a business can't sit on unlimited or too high liquidity because higher liquidity means higher investment in working capital. And higher investment in working capital means higher cost of capital, interest cost in case financed by bank finance. Therefore, the higher liquidity has a direct impact on the profitability as the capital cost rises. In essence, the relation between liquidity and profitability is inverse. On one hand, higher

rather sufficient liquidity is the primary goal of working capital management. Whereas on the other hand, profitability as an objective aligns with the overall objective of an organization i.e. wealth maximization.

WORKING CAPITAL MANAGEMENT POLICIES

Working capital management policies deal with the quantum factor i.e. how much of current assets should be maintained? These policies, in essence, are different levels of the tradeoff between liquidity and profitability. Theoretically, following three types of policies are explained whereas they can be n number of policies depending on where the tradeoff is stricken between the liquidity and profitability.

- **Relaxed Policy / Conservative policy** – This policy has a high level of current assets maintained to honor the current liabilities. Here, the liquidity is very high and the direct impact on profitability is also high.
- **Restricted Policy / Aggressive policy** – This policy a lower level of current assets. Here, the liquidity levels are very low, therefore, the direct impact on profitability is also low.
- **Moderate Policy** – It lies between the conservative and aggressive policy.

WORKING CAPITAL MANAGEMENT STRATEGIES

Working capital management strategies deal with the cost of capital factor. The question is – How the costs of capital are optimized? A business has a choice to select between short-term vs. long-term sources of capital. Normally, the short term funds are cheaper to long-term but risky. Short term funds are risky in terms of risk of refinancing and risk of rising interest rates. Once they mature, they may not be refinanced by the same financial institution and there is a possibility of revision in interest rate every time they are renewed.

Let’s divide a firm’s capital investment into two i.e. investment in fixed assets and investment in working capital. Let’s safely assume that long-term funds finance the fixed assets. Now remaining is working capital. Let us further divide working capital into two i.e. permanent and temporary working

capital. The nature of permanent working capital is similar to fixed assets i.e. that level of investment in working is always present and remaining part keeps fluctuating. The working capital management strategies define how these two types of working capital are financed.

- **Hedging (Maturity Matching) Strategy** – This strategy follows the principal of finance i.e. long-term funds to finance long-term assets and vice versa. In this strategy, the maturities of currents are matched with the maturity of its financing instrument. It does not have any cushion or flexibility in case of any delay in the realization of current assets. Although it is a very ideal strategy but involves a high risk of bankruptcy.
- **Conservative** – It is a safer strategy where the apart from financing the whole of the permanent working capital, it finances a part of temporary working capital also.
- **Aggressive** – It's a high-risk strategy where the apart from financing the whole of the temporary working capital, it finances a part of permanent working capital also.

ADVANTAGES OF WORKING CAPITAL MANAGEMENT

- Working capital management ensures sufficient liquidity when required.
- It evades interruptions in operations.
- Profitability maximized.
- Achieves better financial health.
- Develops competitive advantage due to streamlined operations.

DISADVANTAGES OF WORKING CAPITAL MANAGEMENT

- It only considers monetary factors. There are non-monetary factors that it ignores like customer and employee satisfaction, government policy, market trend etc.
- Difficult to accommodate sudden economic changes.
- Too high dependence on data is another downside. A smaller organization may not have such data generation.
  - Too many variables to keep in mind say current ratios, quick ratios, collection periods, etc.