Change In the Working Capital Requirements: In the Textile Industry

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Abstract

The working capital requirements of concern depend upon a large number of factors such as nature and size of business. The character of their operations, the length of production cycles, the rate of stock turnover and the state of economic situation. In manufacturing business, the requirements of working capital increases in direct proportion to length of manufacturing process. Longer the process period of manufacture, larger is the amount of working capital required. The longer the manufacturing time, the raw materials and other supplies have to be carried for a longer period in the process with progressive increment of labour and service costs before the finished product is finally obtained. Working capital in general practice refers to the excess of current assets over current liabilities. Management of working capital therefore is concerned with the problems that arise in attempting to manage the current assets, the current liabilities and the inter-relationship that exists between them. The purpose of this study is to examine the changes in the working capital requirements in the textile industry.

Keywords
Working capital, manufacturing firms, production cycle.

INTRODUCTION

Working capital is a financial metric of operating liquidity which describes the amount of cash tied up in operations and defines the short tem condition of a company. A positive working capital position required for the continuous running of the company's operations to pay short term debt obligations and to cover operational expenses. A company with a negative working capital balance is unable to cover its short term liabilities with its current assets.
Working capital is calculated by the following formula:-

Working capital = current assets-current liabilities

The above formula includes three important balance sheet accounts which all have a direct impact on the business, namely accounts receivable, accounts payable and inventory. These accounts are often referred to as the three areas of working capital.

- **Accounts receivable: -** money owned to the company for products and services that have been delivered to customers but not yet paid for.

- **Inventory: -** the raw materials, work in progress goods and finished goods that are ready or will be ready for sale. Inventory represents the key asset to most businesses as

the turnover of inventory is a primary source of revenue generation and subsequently earnings for the shareholders, owners of the company.

- **Accounts payable: -** money owned to supplies for goods and services that the company has purchased on credit.

Clearly the importance of above components differ between companies and industries and whereas for example retailers and manufacturers often have large inventories of finished goods, work in progress and raw materials, banks and insurance companies do not hold any traditional inventory. However regulation requires both banks and insurance companies to maintain certain reserve levels. In addition to the required reserves these types of businesses typically hold major positions of liquid assets and large portfolios of interest bearing investments in which deposits and premiums received from customers are invested. The uncertainty of cash flows allows varies significantly between industries and many retailers have little to worried about when it comes to accounts receivables as the customer pays on site at the time of purchase. On the other hand banks and insurance companies are privileged by the fact that they receive deposits and premiums before having to make any payments but are also subject to unpredictable cash outflows when customers decide to withdraw their funds or when insurance claims come in.

The appropriate level of working capital depends of both macro factors such as the market conditions in which a company operates and micro factors such as the set up the value chain within the company. As working capital spans over a wide range of different businesses activities the parameters in the equation must be set in relation to the overall strategy and business model to determine the optimal level of working capital. Even though a positive working capital balance is extremely important too high working capital levels can indicate a company has serious problems in its value chain. A company with a large amount of capital tied up in operations may have to either borrow or attract additional capital from external shareholders. A major challenge for many businesses is therefore to find a balance and there are generally numerous benefits to gain from a working capital reduction. Such benefits includes better growth prospects, higher profitability due to lower provisions for bad debt and or slow moving inventory and a reduction of interest bearing on loans. All these benefits serve to increase a company's overall competitiveness and thus improve its long term position in the market.

The three main motives for a company to hold cash and these motives provides a good explanation as to why a company decides to maintain a higher level of working capital as follows:-

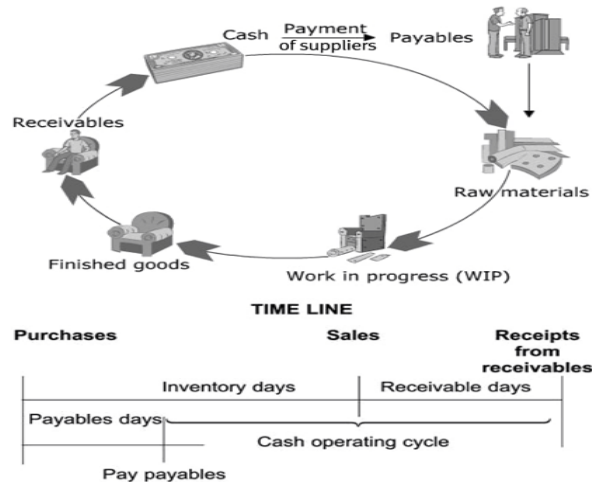
- **The transaction motive: -** cash is held in the company to pay for purchased goods and services.

- **The precautionary motive: -** cash is held to provide for eventualities or opportunities that require sudden expenses.

- **The speculative motive: -** cash is invested in for example stocks and bonds to provide a return for investors.

The first motive is primarily a practical reason for holding cash whereas the latter to offers a more strategic view on why a company may decide to keep cash. With these three motives in mind all companies must determine their appropriate targets level of working capital and in doing so they are managing their working capital.On its day to day operational expenses. Moreover it can also result in a situation where the growth prospects and overall profitability are held back. If swift actions are not taken to improve the management of working capital such issues may negatively affect the

company's ability to compete in a market. Successful management of the customer to cash process requires time to cash focus and close collaboration throughout the entire organization and especially between sales, order fulfillment and finance.
The cash operating cycle is the length of time between the company's outlay on raw materials, wages and other expenditures and the inflow of cash from the sale of goods.



REVIEW OF LITERATURE:-

Sagan in his paper (1955) perhaps the first theoretical paper on the theory of working capital management emphasized the need for management of working capital accounts and warned that it could vitally affect the health of the company. He realized the need to build up a theory of working capital management. He discussed mainly the role and functions of money manager inefficient working capital management. Sagan pointed out the money manager's operations were primarily in the areas of cash flow generated in the course of business transactions. However money manager must be familiar with what is being done with the control of inventories, receivables and payables because all these accounts affect cash position. Thus Sagan concentrated mainly on cash component of working capital. Sagan indicated the task of money manager to provide funds as and when needed and to invest temporarily surplus funds as profitability as possible in view of his particular requirements of safety and liquidity of funds by examining the risk and return of various investment opportunities. He suggested that money manager should take his decisions on the basics of cash budget and total current assets position rather than on the basis of traditional working capital ratios. This is important because efficient money manager avoid borrowing from outside even when his net working capital position is low. The study pointed out that there was a need to improve the collection of funds but it remained silent about the method of doing it. Moreover this study is descriptive without any empirical support.

Walker in his study (1964) made a pioneering effort to develop a theory of working capital management by empirically testing through partially three propositions based on risk-return trade off of working capital management. Walker studied the effect of the change in the level of working capital on the rate of return in nine industries for the year 1991and found the relationship between the level of working capital and the rate of return to be negative. On the basis of these observations Walker formulated three following propositions:-

Proposition 1:- if the amount of working capital is to fixed capital, the amount of risk the firm assumes is also varied and the opportunities for gain or loss are increased. Walker further stated that if a firm wish to reduce its risk to the minimum it should

employ only equity capital for financing of working capital. However by doing so the firm reduced its opportunities for higher gains of equity capital as it would not be taking advantage of leverage. In fact the problem is not whether to use debt capital but how much debt capital to use which would depend on management attitude towards risk and return. On the basis of this second proposition.

Proposition 2:- the type of capital (debt or equity) used to finance working capital directly affects the amount of risk that a firm assumes as well as the opportunities for gain or loss. Walker again suggested that not only the debt-equity ratio, but also the maturity period of debt would affect the risk-return trade off. The longer the period of debt the lower be the risk. For management would have enough opportunity to acquire funds from operations to meet the debt obligations. But at the same time long term debt is costlier. On the basis of this he developed his third proposition.

Proposition 3:-the greater the disparity between the maturity of the firm's debt instruments and its flow of internally generated funds greater the risk and return vice versa.
Thus Walker tries to build up a theory of working capital management by developing the three propositions. However Walker tested the empirically the first proposition only. Walker's study would have been more useful had he attempt to test all the three propositions mentioned above.

Vanhorne in his study (1969):- recognizing working capital management as an area largely lacking in theoretical prospective attempted to develop a framework to develop a probabilistic cash budget for evaluating decisions concerning the level of liquid assets and the maturity composition of debt involving risk-return trade off. He proposed calculation of different forecasted liquid asset requirements along with their subjective probabilities under different possible assumptions of sales, receivables, payables and other related receipts and disbursements. He suggested preparing a schedule showing under each alternatives of debt maturity, probability distributions of liquid asset balance for future periods, opportunity cost, maximum probability of running out of cash and number of future periods in which there was a chance of cash stock out. Once the risk and the opportunity cost for different alternatives were estimated the form could determine the best alternative by balancing the risk of running out of cash against the cost of providing a solution to avoid such a possibility depending on management's risk tolerance limits. Thus Vanhorne study presented a risk return trade off of working capital management in entirely new prospective by considering some of the variables probabilistically. However the usefulness of the framework suggested by Vanhorne is limited because of the difficulties in obtaining information about the probability distributions of liquid asset balances the opportunity cost and the running out of cash for different alternatives of debt maturities.

OBJECTIVES:-

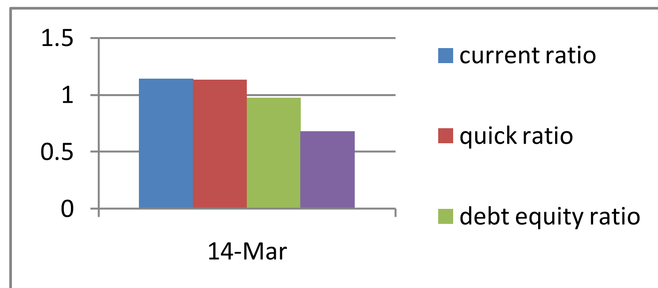
1. Understanding about the working capital management in the running business organization.
2. To analyze the working capital management of the company.
3. To know the future need of working capital requirements in the rerunning business operations.

RESEARCH METHODOLOGY

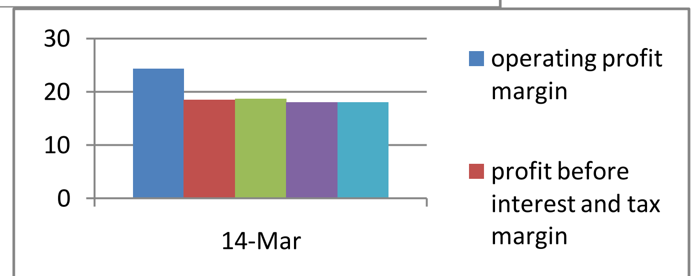
The study being conducted on secondary data. The Vardhman textiles industry is studied to know the affects of working capital requirements in the future to running are business operations successfully. To study the three year annually financial reports of the company to know the need of working capital in day to day operating activities. By actually comparing and analyze the working capital requirement in the manufacturing businesses is more useful as compared to another one. Greater the size of business unit generally larger will be the requirements of working capital. The amount of working capital requirement ids increasing with the growth and expansion of business.

DATA ANALYSIS

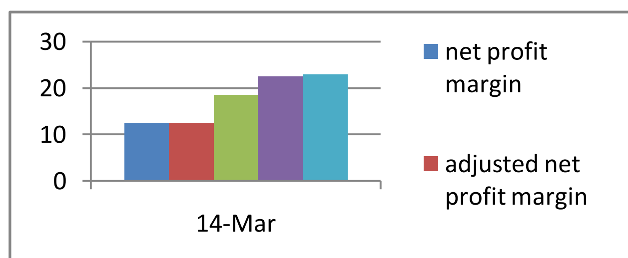
liquidity and solvency ratios:-	14-Mar
current ratio	1.14
quick ratio	1.13
debt equity ratio	0.97
long term debt equity ratio	0.68



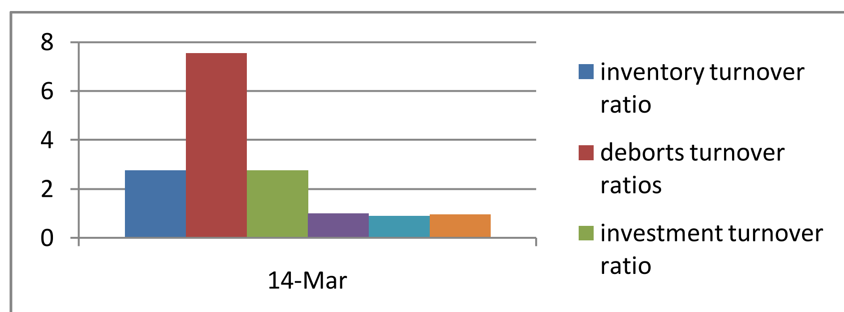
profitability ratios:-	14-Mar
operating profit margin	24.37
profit before interest and tax margin	18.46
gross profit margin	18.69
cash profit margin	18.06
adjusted cash profit margin	18.06



profitability ratios:-	14-Mar
net profit margin	12.45
adjusted net profit margin	12.45
return on capital employed	18.38
return on net worth	22.38
adjusted return on net worth	22.88



management efficiency ratios:-	14-Mar
inventory turnover ratio	2.76
deborts turnover ratios	7.56
investment turnover ratio	2.76
fixed assets turnover ratios	1.03
total assets turnover ratios	0.92
asset turnover ratio	0.97



Working capital is the amount by which the value of a company's current assets exceeds the current liabilities. Also called net working capital sometimes the term working capital is used as synonym for current assets but more frequently as net working capital. Working capital is frequently used to measure a firm's ability to meet current obligations. It measures how many liquid assets a company has available to build its business. Working capital is a common measure of a company's liquidity, efficiency, and overall running of the smooth business. These involve the managing the relationships between an entity's short term assets inventories, accounts, receivables, cash and its short term liabilities.

The number can be positive or negative depending upon how much debt the company is carrying. Positive working capital generally indicates a company is able to pay off its short term liabilities almost immediately. In general companies that have a lot of working capital will be more successful since they can expand and improve their operations. Companies with negative working capital may lack the funds necessary for growth.

CONCLUSION:-

Adequate working capital helps in maintaining solvency of the business by providing uninterrupted flow of production. Sufficient working capital enables a business concern to make prompt payments and hence helps in creating and maintaining goodwill. A concern having adequate working capital, high solvency and good credit standing can arrange loans from banks and others on easy and favorable terms. Adequate working capital also enables a concern to avail cash discounts on the purchases and hence it reduces costs. Sufficient working capital ensures regular supply of raw materials and continuous production.

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