

Working Capital Management: A Study of Maharashtra's Bulk Drugs Listed Companies

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Abstract

The paper analyzes the working capital management of bulk drugs companies that are listed on the Bombay Stock Exchange. Working capital management is very important because a company that neglects its working capital management will soon run out of cash and may even have to close down. Data was collected from companies that are listed on the Bombay Stock Exchange. The reason for choosing the listed companies is because the financial statements for these companies are readily available and often more reliable than those of unlisted companies. The research findings reveal that the listed companies adopted a conservative approach in the management of their working capital. The findings also suggest that working capital policy is not static overtime, but Varies with the changes in the state of the economy.

Introduction

Financial management practices can be considered as providing a sound framework for asset management. Investment in fixed assets is an area of management focus. This situation can be contrasted with working capital management which until recently received relatively little attention from researchers. At the same time, the efficient management of working capital is likely to yield significant results and its neglect can be highly problematic. The literature on corporate failure contains a rich set of evidence, linking poor working capital management as an important factor in corporate collapse.

Lazaridis and Tryfonidis (2006) investigated the relationship between corporate profitability and working capital management using listed companies on the Athens Stock Exchange. They discovered that a statistically significant relationship existed between profitability and the cash conversion cycle. They concluded that businesses can create profits for their companies by handling correctly the cash conversion cycle and keeping each component of the cash conversion cycle (that is accounts receivable, accounts payable, and inventory) to an optimum level. Parosh and Tamari (1978) developed a predictor model for Israeli companies and included the current ratio as one of the variables of the model. Deloof (2003) also found that the way working capital is managed has a significant impact on the profitability of businesses.

Working capital management is also important from the perspective of sources and uses of funds. We describe working capital as a spontaneous source and use of funds as it arises from trading activities based on a significant number of business transactions. In many companies the amount of funds committed to current assets can and often exceed that of fixed assets. Decisions relating to working capital and short-term financing are referred to as working capital management. These involve managing the relationship between a firm's short-term assets and its short-term liabilities. The goal of Working capital management is to ensure that the firm is able to continue its operations and that it has sufficient cash flow to satisfy both maturing short-term

debt and upcoming operational expenses. A business can fail because of lack of cash than for want of profit. If a business is operating profitably, then it should generate cash surpluses. If it does not generate cash surpluses, then the business will eventually run out of cash and close down. Kargar and Blumenthal (1994) in their study showed that businesses can go bankrupt even when they are making profits owing to working capital mismanagement.

Working Capital Defined

Gross working capital refers to current assets, and net working capital (or simply working capital) refers to current assets less current liabilities.

Composition of Working Capital

The elements which normally make up the figure of working capital are:

Current Liabilities: Trade creditors, creditors for expenses, bank overdrafts, bank loans, bonuses payable, interest on members' savings and member's savings, and other short-term liabilities.

Current Assets: Stock of goods, trade debtors, staff advances and loans, investments in fixed deposits, prepayments, bank balance, and cash and loans to members.

Working Capital Policy

Working capital policy refers to the basic policy decisions regarding:

- Target levels for each category of current assets; and
- How current assets should be financed

This essentially involves two basic questions: (1) what is the appropriate level of current assets? (2) How should this level of current assets be financed?

The answers to the above questions will disclose the company's working capital policy.

Current Asset Investment Policies

Basically there are three such policies. They are 'conservative', 'moderate', and 'aggressive'. Under conservative policy, a greater portion of current assets are used to support sales, whereas in the case of aggressive policy, the holdings of cash, securities stock, and debtors are kept low. The moderate policy falls between these two extreme cases.

Financing Policies

Most business enterprises are subjected to seasonal fluctuations. But whatever may be the degree of such fluctuations, current assets of firms rarely fall to zero and this has led to the development of the concept of 'permanent current assets' in any business. The manner in which these permanent and temporary current assets are financed defines the company's financing

policy on working capital.

There are three approaches to the financing policy on working capital.

Moderate Approach

Under this approach, the firm attempts to approximate asset and liability maturities. The advantage of this approach is that it minimizes the level of risk involved in meeting its obligations.

Conservative Approach

Under this approach, the firm uses long-term capital to finance both permanent assets and seasonal requirements. The company uses only a small amount of short-term credit to meet its peak requirements. The approach is considered to be a very safe working capital financing policy.

Aggressive Approach

A firm that follows an aggressive approach will finance seasonal current assets and part of the permanent current assets with short-term credit. There are varying degrees of aggressiveness. This approach suffers from the risk of rising interest rates and loan renewal problems. However, the advantage of this approach is that short-term credit is cheaper than long-term debt and some business enterprises are really prepared to sacrifice the element of safety to the possible chance of high profits.

The main difference among the three approaches lies, therefore, in the level of short-term credit used to finance fixed and current assets. The aggressive policy uses the most short-term financing, while the conservative policy calls for the least use of short-term credit.

Working Capital Management

Working capital management refers to the financing, investment, and control of net current assets within the policy guidelines. Working capital may be regarded as the lifeblood of the business and its effective provision can do much to ensure the success of the business, while its inefficient management can lead to the downfall of the enterprise. It is, therefore, important that the investment is carefully controlled.

Working capital management can involve a large portion of the firm's total assets; more than half of a typical firm's total investment is in current assets. Working capital management is important for the following reasons:

- A large proportion of the financial manager's time is allocated to working capital management;
- Typically more than half of the total assets are typically invested in current assets; and
- The relation between sales growth and the need to invest in current assets is close and direct

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Cash Management

There are no easy rules that govern decisions as to how much cash a business should hold. The decision will be based partly on management's attitude towards risk. But if a business enterprise decides to keep more cash, then it can easily meet its obligations. It must, however, be noted that there is a price to be paid. Investment in fixed assets brings increased profits and cash holdings reduce the amount available for such investments. However, if a company does not retain sufficient amount of liquidity, it may not be able to take advantage of cash discounts and sometimes it may even lose reliable suppliers due to the late payments. It is, therefore, necessary that the management tries to balance liquidity with profitability.

Cash Conversion Period

The cash conversion period measures the number of days between the actual expenditure of the firm's cash for the purchase of productive resources and the ultimate collection of cash from product sales. Incorporated within the cash conversion period model are management issues involving the control of inventories, the collection of receivables, and the timing of payments for productive resources such as materials and labor. In the cash conversion model, increases in the number of days a product remains in inventory, increases the number of days required to collect receivables following the point of sale, and decreases in the number of days a firm takes to meet its trade credit obligations will increase the firm's cash conversion period. The increased cash conversion period reflects additional resources required in the form of working capital to maintain the firm's operations.

Net Liquid Balance (NLB)

Essentially, the NLB model recognizes that the firm's ability to meet its obligations as they come due is not reflected by the firm's total working capital, but by the amount of working capital remaining once the requirements of the firm's operating cycle are met. Alternatively, the NLB is the difference between the firm's immediately available cash resources and its non-operating, or negotiated, short-term debt. Empirical tests conducted by scholars indicate the NLB to be a superior indicator of corporate liquidity when compared to more widely known indicator such as the quick ratio.

Cash Requirements

There are three main reasons for a company to hold cash. They are the transaction motive, precaution motive, and the speculative motive. A company must be able to conduct its purchases and sales, and its effective management involves an analysis of inflow and outflow of cash. In any business, a part of working capital must be in cash to pay wages and to meet other expenses. The product manufactured or bought by the business has to be sold and if the sale is on credit, it has to wait for sometime before the cash is received. The 'cash cycle', the time that elapses between when the company pays its costs and when it receives the cash from sales, indicates the need for cash for transaction purposes.

Uncertainties on cash flows, penalties of running out of cash, problems on obtaining additional funds at short notice, and the management's attitude towards risk will decide the cash level to be maintained as a precaution. The business enterprises relationship with its bank also influences this decision. One way the bank helps the business to cover short term requirements is through overdrafts. However, overdrafts carry a degree of risk as they may be recalled at very short notice. Also there may be a requirement as part of loan agreements that a certain level of cash be maintained.

The final motive of speculation is not particularly common in normal manufacturing or trading companies. Undoubtedly, some companies do hold large cash balances at certain times to take advantage of speculative opportunities such as a takeover bid. It is important that such companies ensure that the gains arising from such speculative opportunities are greater than gains arising from normal investments.

Inventory Management

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It is generally said that stock is 'money in disguise'. An efficient stock control policy is an important requirement for the successful management of manufacturing and distributing companies. In manufacturing companies, stock may represent 20 percent to 25 percent of the total value of assets. A typical company will hold three types of inventories-raw materials, work in process, and finished goods. If stock levels are too low, the following are the associated costs:

- Delay in production
- High prices for emergency purchases. Loss of customer goodwill, and
- Administrative costs resulting from high volume of reorders

To control the stock levels, organizations use stock control models which are easily developed these days with the aid of computers. Mathematical models are used to fix reorder levels, reorder quantity, minimum and maximum stock levels.

Just-in- Time (JIT) Purchasing

Nowadays, companies increasingly use this system in place of the traditional stock control systems. Under this system, goods are delivered by the suppliers just before they are required so that the stock level is as near to nil as possible. The danger of stock-outs and holding of surplus stocks is removed, provided information systems are efficient and plans do not change rapidly within lead times. An effective just-in-time system means the supplier must be reliable and must guarantee the quality of the goods delivered.

Management of Accounts Receivable

It is a normal practice for firms to sell goods on credit. This will be a costly exercise to the seller if necessary steps are not taken by the firm before handing over the goods to the buyer. Credit control is, therefore, an important aspect of working capital management. It is always beneficial for the business to generate a large volume of sales through credit sales provided necessary precautions are taken to ensure that the large volume of sales is not at the expense of

liquidity. This requires some steps to ensure that debtors' balances remain at an acceptable level;

- When prospective customers request credit facilities, they should be asked to provide names of referees who should preferably be their bankers or suppliers. These referees should be contacted immediately;
- Ask for copies of published accounts for the last five years and calculate some liquidity and profitability ratios to study the trends;
- If the result of the above actions is positive, set a credit limit for the customer and do not supply goods on credit above that limit;
- Credit limit should not be increased unless it is asked for by the customer; and.
- There must be proper sales ledger documentation.

It must be noted that the above steps are not foolproof, but to a very large extent assist the firm to reduce the possibility of losing cash due from customers. Some firms encourage customers to settle accounts within a specified time period by offering cash discounts. Before a firm offers cash discount, it must weigh the cost with the benefits. If the costs outweigh the benefits, there is no point in offering that incentive.

Management of Accounts Payable

Creditors supply goods and services to the firm on credit. The longer the firm holds suppliers' money, the better it is for cash flow. But it should be noted that holding creditors' money for too long a period can be a threat to the continued existence of the firm. It is, therefore, important that the firm has adequate information about possible suppliers of goods and services. This will help the firm to compare prices, credit terms, quality of goods, discounts, and other settlement terms of various suppliers. Suppliers also offer cash discounts to help their cash flows. Here also it is important for the firm to compare the benefits with the costs. If it is more advantageous to settle by the specified time on the invoice, then this should be the course of action. Otherwise, the firm should wait for the full credit period to settle the accounts.

Objectives Of The Study

This study aims to analyze the working capital management in the listed bulk drug companies in Maharashtra. The main objectives are:

- To identify the sources of working capital in the organizations studied
- To ascertain how the current assets are financed
- To discover the relative importance of various current asset components
- To find how they handle and manage receivables (debtors);
- To ascertain how they manage payables (creditors) and Management of inventory (stock)

Methodology

Listed Bulk Drug Companies in Maharashtra

This study targets all the bulk drug domestic companies. The study covers a period of three years.

Results & Discussions

Financial Analysis

Accounting ratios are used in this study to obtain a correct picture of the movements in working capital. These ratios also reveal the policies already applied leading to the current state of business and, at the same time, indicate possible future trends. In addition to the financial accounting ratios, statistical tools such as standard deviation and coefficient of variation are also used in the analysis. Following are the accounting ratios used in the study for data analysis:

- Current ratio
- Liquid ratio
- Long-term liabilities to net working capital
- Working capital over total assets
- Net sales/net working capital
- Creditor payment period = $\text{creditors}/\text{cost of sales} \times 365$
- Debtor collection period = $\text{debtors}/\text{sales} \times 365$

Current Ratio

The current ratio or the working capital ratio is perhaps the most universally used of all the ratios. It measures the short-term debt paying ability of a business enterprise. It is a useful indicator of a situation which may be going wrong. If the ratio has a tendency to violently fluctuate or continuously change, then there is a need for investigation. Although the rule of thumb is two times, the ratio tends to vary widely with the type of business. For example, a business with a rapid

Years	2004	2005	2006
Current Ratio of Selected Enterprises	1.35	1.54	1.32

turnover of stock such as supermarkets will have a low current ratio. On the other hand, businesses that have to keep stock for months and years will have a high current ratio. The current ratios for the selected enterprises were computed from aggregate current assets and current liabilities figures for three years (Table 1).

The current ratio increased by 13 percent in 2005 as compared to that of 2004. This increase was occasioned by an increase in current assets in 2005 by 16 percent compared to 2004, while current liabilities increased by only 3 percent in 2005 as compared to 2004. Current liability items revealed a similar trend. While trade creditors decreased by 12.5 percent in 2005 compared to 2004 figures, sundry creditors exhibited an upward trend. Sundry creditors increased by 55 percent in 2005 compared to 2004 figures, whereas the entire bank overdraft balance was discharged during 2005. The overall effect of these movements in current assets and current liabilities was a current ratio of 1.54 times in 2005.

For the year 2006, the current ratio decreased by 14 percent compared to that of 2005. This was the result of an increase of trade creditors by 25 percent compared to 2005 and also due to the increase of other creditors by 26 percent. A decomposition of current assets indicates that stock increased by a marginal percentage of 5 percent and cash balance also showed an increase of 12 percent as compared to 2005. Debtors, on the other hand, showed a decrease of 6 percent as compared to 2005. As already indicated, the current ratio for 2004 was 1.32 times.

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Acid-Test (or Quick) Ratio

This ratio measures the short-term liquidity of a business enterprise. It is a more severe test of liquidity than the current ratio in that stock is eliminated from the current assets.

Years	2004	2005	2006
Liquid Ratio of Selected Enterprises	0.83	1.03	0.89

The rule of thumb is one times and as indicated in the discussion on current ratio; a more important yardstick is an industrial average. The acid-test ratios for selected enterprises were computed from aggregate quick assets (current assets minus stock) and current liabilities figures for three years (Table 2).

The liquid ratio for 2005 was better than that of 2004. It increased by 24 percent as compared to 2004. This increase was due to an increase in quick assets by 27 percent in 2005 as compared to 2004 and also the result of a marginal increase in current liabilities by 2 percent. Cash balance increased by 124 percent as also other assets of the business by 40 percent in 2005 on the side of quick assets. In the case of current liabilities, trade creditors decreased by 12.5 percent and the entire bank overdraft amount was redeemed in 2005.

In 2006, the quick ratio deteriorated by 14 percent as compared to 2005. This change was brought about by an increase of trade creditors by 25 percent compared to 2005 and also due to the increase of other creditors by 26 percent. Liquid assets indicate that debtors balance decreased by about 6 percent in 2006 as compared to 2005.

On the whole, the liquidity of the companies studied, according to the current ratio, was low in all the three years because the results were below the benchmark. For 2004 and 2006, this assessment is confirmed by the quick ratio which also fell below the benchmark. In 2005, the quick ratio corresponded with the benchmark indicating excess liquidity.

While the low liquidity indicates that the ability of the companies to pay short-term debts from current assets was weak, low liquidity could also indicate better management of working capital by making working capital to circulate and finance operations, rather than locking it in idle current assets. In terms of working capital management, the companies in the study adopted an aggressive approach in the years 2004 and 2006, while following a conservative approach in 2005.

Long-Term Liabilities to Working Capital

Table 3: Long-Term Liabilities to Net king Capital of Selected Enterprises for Three Years

Years	2004	2005	2006
Long-term Liabilities to Working Capital	15%	50%	76%

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To ensure that the firm does not run into liquidity problems, the management should always try to keep' long-term liabilities of the business below the net working capital of the business. In 2004, long-term liabilities constituted 15 percent of the firms' working capital. In 2005, the ratio showed an increase of 233 percent over 2004. This is due to an increase of 423 percent in long-term liabilities in 2005 as compared to 2004, whereas the working capital of the firms increased only by 57 percent. Year 2006 showed a further deterioration in the ratio as long-term liabilities constituted 76 percent of the working capital (Table 3).

This was again due to an increase of 14 percent of long-term liabilities. It should also be noted that the working capital position deteriorated in 2006 as compared to 2005 by 25 percent. This situation is well illustrated by the decreasing percentages of current and liquid ratios for 2006. The overall results indicate that although the ratios are positive, there are indications that the firms are to be cautious about their long-term liabilities and also should ensure that their working capital position does not deteriorate.

Working Capital Over Total Assets

This liquidity ratio records net liquid assets relative to total capitalization and is the most valuable indicator of a looming business disaster. Consistent operating losses could cause current assets to shrink relative to total assets. A negative ratio which could result from negative net working capital spells serious problems.

This ratio stood at 14 percent in 2004. Calculations indicate that there was 43 percent increase in this ratio in 2005 as compared to 2004. This was mainly due to a 10 percent increase in total assets and a 57 percent increase in working capital in 2005 as compared to 2004. It may be noted that this ratio fell to 19 percent in 2006, a decrease of 5 percent as compared to 2005. This was the result of a marginal increase in total assets and a 25 percent decrease in working capital in 2005 as compared to 2005 (Table 4). It is heartening to note that in all the three years this ratio showed a positive figure to indicate that situations are under control.

Table 4: Working Capital to Total Assets of Selected Enterprises for Three Years

Years	2004	2005	2006
Working Capital to Total Assets	14%	20%	19%

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Net Sales over Working Capital

The ratio is used to ascertain whether the business is too heavy in fixed or slow moving assets. A high ratio signals overtrading. A high ratio could also indicate that the business requires additional funds to support its financial structure. The ratio is calculated as: Net sales/ net working capital.

It can be observed from Table 5 that this ratio stood at 16 times in 2004 which fell by 60 percent in 2005 as compared to 2004. This was mainly due to a decrease in sales in 2005 by 2 percent and also due to an increase of working capital by 57 percent in 2005 as compared to 2004. Year 2006 indicates an increase in this ratio by 30 percent due to an increase in sales by 2 percent in 2006 as compared to 2005 and a decrease in working capital by 25 percent.

Table 5: Net Sales to Working Capital of Selected Enterprises for Three Years

Years	2004	2005	2006
Net Sales to Working Capital	16 times	10 times	13 times

Debtors Collection Period

This ratio shows the relationship between the amounts the debtors owe to the business at the end of the period and the sales made to them. This ratio reveals the efficiency of the debtors department in collection of debts. The ratio is expressed in days. Every business allows a certain number of days (credit period) to customers to settle the account and this ratio enables the proprietor to know whether customers clear their debts within the stipulated period.

Table 6: Debtors Collection Period of Selected Enterprises for Three Years

Years	2004	2005	2006
Debtors/ Sales x 365	31 days	25 days	23 days

The ratio on debtor's collection improved in 2005 as compared to 2004 by 20 percent indicating that the credit control departments in the selected enterprises were efficient in debt recovery. This ratio further improved in 2006 as debtors were settling accounts on an average period of 23 days. This is clearly illustrated by a reduction of debtors balance by 20 percent in 2005 as compared to 2004 and a further reduction of this balance by 6 percent in 2006 as compared to 2005 (Table 6). On the whole, the indication is that there was proper control over outstanding debts in selected enterprises during the three-year period.

Creditors Payment Period

Table 7: Creditors Payment Period of Selected Enterprises for Three Years

Years	2004	2005	2006
Creditors/Cost of Sales x 365	59 days	54 days	67 days

This ratio like debtor's collection period shows whether the business settles accounts with its creditors on time. This ratio is also expressed in days. It is important that the business settles accounts with its creditors within the stipulated period so that suppliers do not hesitate to supply quality goods in future. Also, early settlement attracts cash discounts and builds confidence in the minds of suppliers.

Although the selected firms were prompt enough to collect the debts on time, there is an indication that these enterprises were not settling the accounts with suppliers within the same time span that debtors took to settle their accounts. The ratio indicates that the firms took almost two months to settle accounts with creditors in 2004 and this ratio improved by 8 percent in 2005. It is disheartening to note that this ratio deteriorated in 2006. The selected firms were taking 67 days on an average to settle accounts with suppliers where in most cases accounts were to be settled in 60 days. This situation was clearly indicated by an increasing percentage of creditors balance in 2006 which went up by 20 percent as compared to 2005 (Table 7). Thus, there is an urgent need to address the issue of settlement of accounts with suppliers in the selected enterprises before it damages the confidence of the suppliers.

Financing of Current Assets

Firms can finance their current assets from different sources. The major sources are: (a) short-term sources-trade creditors, bank overdrafts, and other creditors; and (b) long-term sources of finance.

As discussed earlier, there are three working capital financing policies - aggressive, moderate, and conservative policies. Ideally, firms should match the maturities of the source of finance with the maturity of the items which are going to be financed. If this policy was followed 100 percent, current assets would equal current liabilities and there would be no working capital. If the firms are following an aggressive policy, the firms would use short-term sources of finance to finance the permanent current assets and part of the fixed assets. This policy results in net current liabilities shown in the balance sheet.

Table 8: Financing of Current Assets in Selected Enterprises for Three Years

Year/ Liabilities	Trade Creditors	Sundry Creditors	Bank Overdraft	Long-Term Borrowing	Total
2004	50	20	3	27	100
2005	38	27	0	35	100
2006	44	32	0	24	100

Here, the different current liabilities components are expressed as a percentage of the total current assets. In 2004, current liabilities were used to finance 73 percent of the current assets, and the remaining 27 percent was financed by long-term sources of finance. Trade creditors accounted for 50 percent of the current assets, while sundry creditors and bank overdrafts accounted for 20 percent and 3 percent respectively (Table 8).

In 2005, the proportion of current assets financed by current liabilities stood at 65 percent, which is lower than the previous year indicating that the selected enterprises adopted a more conservative approach to working capital management., In the same year, the proportion of trade creditors fell from 50 percent to 38 percent and sundry creditors increased to 27 percent. All the outstanding balances in the bank overdraft were discharged this year.

In 2006, the firms pursued a more moderate working capital financing policy. The proportion of long-term financing decreased to 24 percent. The relative importance of trade creditors in the financing mix increased from 38 percent in 2005 to 44 percent in 2006. The proportion of sundry creditors also increased from 27 percent in 2005 to 32 percent in 2006. There was no bank overdrawn in 2006 among the selected firms.

From this analysis it can be concluded that the firms studied followed a conservative working capital policy in 2005, but went for a more moderate working capital management policy in later years.

Conclusion

The following are the main conclusions that were drawn from the study:

The financial analysis revealed that the companies in the sample adopted a conservative approach in the management of their working capital in the years 2005, but went for an aggressive approach in their management of working capital in 2006. Stocks and cash balances increased during the three-year period. On the other hand, debtor's balance dropped over the three-year period. There was a clear indication of comfortable proportion between current and current liabilities during this period. The liquidity level was acceptable in 2005, but deteriorated in 2006. This was essentially due to the increase in trade creditors and other creditors associated with a decline in the balance of trade debtors.

In 2004, the selected firms adopted a moderate approach in the financing of current assets. In the year 2005, the selected enterprises decided to go for a more conservative approach as the proportion of long-term financing in the financing of current assets was increasing. In 2006, the selected organizations reverted to a more moderate approach to finance their total current assets.

The overall conclusion that can be drawn from this study is that working capital policy is not static overtime: it varied with the changes in the state of the economy. Therefore, in times of high business volatility, companies tend to adopt a conservative approach; and they tend to adopt an aggressive approach in times of low volatility.

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