INTRODUCTION

Working capital (abbreviated WC) is a financial metric which represents operating liquidity available to a business, organization, or other entity, including governable entity. Along with fixed assets such as plant and equipment, working capital is considered a part of operating capital. It is calculated as current assets minus current liabilities. If current assets are less than current liabilities, an entity has a working capital deficiency, also called a working capital deficit. Net working capital is working capital minus cash (which is a current asset) and minus interest bearing liabilities (i.e. short term debt). It is a derivation of working capital that is commonly used in valuation techniques such as DCFs (Discounted cash flows).

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\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}
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A company can be endowed with assets and profitability but short of liquidity if its assets cannot readily be converted into cash. Positive working capital is required to ensure that a firm is able to continue its operations and that it has sufficient funds to satisfy both maturing short-term debt and upcoming operational expenses. The management of working capital involves managing inventories, accounts receivable and payable and cash.

Current assets and current liabilities include three accounts which are of special importance. These accounts represent the areas of the business where managers have the most direct impact:

- accounts receivable (current asset)
- inventory (current assets), and
- accounts payable (current liability)
The current portion of debt (payable within 12 months) is critical, because it represents a short-term claim to current assets and is often secured by long term assets. Common types of short-term debt are bank loans and lines of credit.

An increase in working capital indicates that the business has either increased current assets (that is has increased its receivables, or other current assets) or has decreased current liabilities, for example has paid off some short-term creditors.

**Working Capital Management**

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.

**Decision Criteria**

By definition, working capital management entails short term decisions - generally, relating to the next one year period - which is "reversible". These decisions are therefore not taken on the same basis as Capital Investment Decisions (NPV or related, as above) rather they will be based on cash flows and / or profitability.

- One measure of cash flow is provided by the cash conversion cycle - the net number of days from the outlay of cash for raw material to receiving payment from the customer. As a management tool, this metric makes explicit the inter-relatedness of decisions relating to inventories, accounts receivable and payable, and cash. Because this number effectively corresponds to the time that the firm's cash is tied up in operations and unavailable for other activities, management generally aims at a low net count.

- In this context, the most useful measure of profitability is Return on capital (ROC). The result is shown as a percentage, determined by dividing relevant income for the 12 months by capital employed; Return on equity (ROE) shows this result for the firm's
shareholders. Firm value is enhanced when, and if, the return on capital, which results from working capital management, exceeds the cost of capital, which results from capital investment decisions as above. ROC measures are therefore useful as a management tool, in that they link short-term policy with long-term decision making.

**Management of working capital**

Guided by the above criteria, management will use a combination of policies and techniques for the management of working capital. These policies aim at managing the *current assets* (generally cash and cash equivalents, inventories and debtors) and the short term financing, such that cash flows and returns are acceptable.

- **Cash management.** Identify the cash balance which allows for the business to meet day to day expenses, but reduces cash holding costs.
- **Inventory management.** Identify the level of inventory which allows for uninterrupted production but reduces the investment in raw materials - and minimizes reordering costs - and hence increases cash flow. Besides this, the lead times in production should be lowered to reduce Work in Progress (WIP) and similarly, the Finished Goods should be kept on as low level as possible to avoid over production.
- **Debtor’s management.** Identify the appropriate credit policy, i.e. credit terms which will attract customers, such that any impact on cash flows and the cash conversion cycle will be offset by increased revenue and hence Return on Capital (or *vice versa*).
- **Short term financing.** Identify the appropriate source of financing, given the cash conversion cycle: the inventory is ideally financed by credit granted by the supplier; however, it may be necessary to utilize a bank loan (or overdraft), or to "convert debtors to cash" through "factoring".
Every business needs adequate liquid resources in order to maintain day-to-day cash flow. It needs enough cash to pay wages and salaries as they fall due and to pay creditors if it is to keep its workforce and ensure its supplies.

Maintaining adequate working capital is not just important in the short-term. Sufficient liquidity must be maintained in order to ensure the survival of the business in the long-term as well.

Even a profitable business may fail if it does not have adequate cash flow to meet its liabilities as they fall due.

Therefore, when businesses make investment decisions they must not only consider the financial outlay involved with acquiring the new machine or the new building, etc. but must also take account of the additional current assets that are usually involved with any expansion of activity.

Increased production tends to engender a need to hold additional stocks of raw materials and work in progress. Increased sales usually mean that the level of debtors will increase. A general increase in the firm’s scale of operations tends to imply a need for greater levels of cash.

Specific research studies exclusively on the impact of working capital management on corporate profitability of the small manufacturing companies are scanty. The financial management of small firms in developing countries and developing state is altogether an ignored area of research. Keeping this in view and the wider recognition of the potential contribution of the SME sector to the economy of developing countries, our study is a modest attempt to measure and analyze the trend of working capital investment and needs of small manufacturing firms. This study, therefore, attempts to assess the impact of WCM on profitability of a sample of small manufacturing companies and its results are expected to contribute to the existing literature on working capital and SMEs.