

Course: PGDFM

Paper II

Topic: Objectives of Working Capital Management

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Working Capital Management

Working capital management is a business strategy designed to ensure that a company operates efficiently by monitoring and using its current assets and liabilities to the best effect. The primary purpose of working capital management is to enable the company to maintain sufficient cash flow to meet its short-term operating costs and short-term debt obligations.

A company's working capital is made up of its current assets minus its current liabilities.

Objectives of Working Capital Management

The primary objective of working capital management is to ensure a smooth operating cycle of the business. Secondary objectives are to optimize the level of working capital and minimize the cost of such funds.

The superior objective of financial management is wealth maximization and that can be gained by profit maximization accompanied by sustainable growth and development. For sustainable growth and development, the objectives of all the stakeholders including customers, suppliers, employees, etc should be aligned to the growth of the organization.

SMOOTH WORKING CAPITAL OPERATING CYCLE

This implies that the operating cycle i.e. the cycle starting from the acquisition of raw material to its conversion to cash should be smooth. It is not easy, it is as good as circulating 5 balls with two hands without dropping a single one. If the following 6 points can be managed, this operating cycle can be managed well.

1. It means raw material should be present on the requirement and it should not be a cause to stoppages of production.
2. All other requirements of production should be in place before time.
3. The finished goods should be sold as early as possible once they are produced and inventoried.
4. The accounts receivable should be collected on time.
5. Accounts payable should be paid when due without any delay.
6. Cash should be available as and when required along with some cushion.

LOWEST WORKING CAPITAL

Working capital here refers to the current assets less current liabilities (net working capital). It should be optimized because higher working capital means higher interest cost and lower working capital means a risk of disturbance of the operating cycle.

OBJECTIVES OF WORKING CAPITAL MANAGEMENT

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MINIMIZE RATE OF INTEREST OR COST OF CAPITAL

The cost of capital utilized in working capital should be minimized so as to achieve higher profitability. If the investment in working capital involves bank finance, interest rates should be negotiated with the bank.

The cost can be minimized by utilizing long-term funds but in a proper mix. While deciding the mix of working capital, the fundamental principle of financial management should be kept in mind that fixed assets and permanent assets should be financed by long term sources of finance of approximately same maturity and short-term or temporary assets should be financed by short-term sources of finance.

OPTIMAL RETURN ON CURRENT ASSET INVESTMENT

The return on the investment made in current assets should be more than the weighted average cost of capital so as to ensure wealth maximization of the owners. In other words, the rate of return earned due to investment in current assets should be more than the rate of interest or cost of capital used for financing the current assets.