

Study on Working Capital Financing Practices: With Special Reference to Risks

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ABSTRACT

In working capital, short term investment and financing activities are considered. Working capital is known as an important component of financial management. Profitability and liquidity of a firm depends on the working capital of that firm. It is very significant for corporate finance management.

In order to reduce the risk factors, all the current assets and liabilities are managed by working capital management in such a way that excessive investment in these assets can be avoided. The management of short-term assets and liabilities should be done carefully as the profitability and risk management of a firm can be affected by the working capital management. The current paper highlights the impact of working capital on risk factors.

1. Introduction

The liquidity is maintained on daily basis in order to maintain the working capital. This is very essential to know whether the business is growing in right direction or not. During this process, the current assets and current liabilities are allowed to match and if a mismatch is observed then it is managed by the management. It is also observed that the growth of a business tends to decline if current assets and liabilities are not matched. Hence, appropriate actions should be taken by the management if any such mismatching occurs.

The performance of a firm can also be enhanced by the effective policy of working capital which further results in profitability. The profitability of a firm tends to decrease if current assets are found in excessive levels. Similarly, liquidity of a firm tends to decline if low level of current assets is observed.

For the survival of a business, the flow of funds is very important. Generation of more and more cash receipts is the only way of succeeding a firm or business. In some cases, it is found that due to poor financial management, the problems of cash flow arises which results in the damaging the firm performance.

There are two approaches to implement financial risk management. First method is to implement a diversification planning in the businesses conducted by the organization and second method is the engagement of organizations in financial transactions. In the first approach, organizations are moved to financial markets which deal with the volatility of their earnings. Hence, many alternatives methods have been emerged for the financial markets to reduce volatility by investing directly.

With the introduction of derivative markets, now it has become easier financial risks which are outside managerial control. Before the concept of derivative markets, there were some exchange traded derivatives; but they were not so much efficient that could control the risk factors. Derivative markets play a major role in managing the financial risk.

In practical, it seems consistent to use financial derivatives as risk management practices. It is observed that an organization can reduce the cash-flow volatility by hedging the associated financial risks such as commodity risk, interest rate and currency etc. Further, the value of expected future cash flow can be increased by reducing the expected financial costs.

Sufficient internal funds for future investment can be improved by minimizing the cash flow volatility. A risk management program can be operated with the help of flexible set-up cost. In some cases, it is found that a lot of organizations are not hedged at all after exposing to the financial risks. The major benefit of hedging programs is observed in organizations with large size.

2. Working capital financing practices: with special reference to risks

A firm can be very profitable, but if this is not translated into cash from operations within the same operating cycle, the firm would need to borrow to support its continued working capital needs. Thus, the two objectives of profitability and liquidity must be synchronized and one should not impinge on the other for long. Investments in current assets are inevitable to ensure delivery of goods or services to the ultimate customers and a proper management of same should give the desired impact on either profitability or liquidity. The separation was made in order to cover all the possible operational risks and to concentrate on the most significant causes of the severity of loss met day by day. Thus the operational risk can be interpreted as a vulnerability of the financial institution that can be reduced or eliminated through an increased control.

Distressed firms have limited financial slack and cash generating ability, and the strain of financial distress may cause firms to reduce investment in operating working capital by collecting on receivables, tightening credit terms, liquidating existing inventory, and by stretching credit terms granted by suppliers.

Working capital management is the management of the net of current assets and current liabilities with the objective of

reaching the right balance between profitability and liquidity. To discuss the different approaches to financing working capital, it is important to identify that ordinarily, company may use short-term sources of finance to finance its short-term activities, such as working capital activities and long-term source of finance for its capital investments in non-current assets. The choice of which source of finance a company uses to finance its working capital and other activities depend on several factors such as: availability of fund, the length of time such funds may be required for, the purpose for which the funds is required, the size of the company, the rate of interest but for the discussion of the financing of the working capital, the two main factors that needs to be considered are the risk of the finance used and the cost of finance; either by financing working capital using short or long-term source of finance. The risk and cost factors are inversely related, in that if a company goes for a low risk source of finance, it is related to a high cost source of finance and vice versa. Based on risk, short-term source of finance is assumed to be more risky than a long-term source of finance.

In general, current assets are considered as one of the important component of total assets of a firm. A firm may be able to reduce the investment in fixed assets by renting or leasing plant and machinery, whereas, the same policy cannot be followed for the components of working capital.

In this competitive market, the environment of businesses and firms is found to be risky due to complexity, volatility and unpredictability. For the success of a business, the strategies related to risk factors of cost and resources have become significant with the analysis and measurement of risk management.

It is also observed that these financial derivatives play an important role in reducing the risk factors. In case of banks, financial derivatives are used as a tool of risk management to hedge on transactions of balance sheets by controlling the interest rates, exchange rates and commodity prices. These benefits of financial derivatives motivate an organization or firm to employ the financial derivatives as risk management so as to increase the efficiency of the firm/organization.

These financial derivatives are capable of determining the risk so that effective steps can be taken against the risk so that no external factor can influence the growth of the organization. Further, risk management can be used to influence the volatility of stock market.

The high level of current assets may reduce the risk of liquidity associated with the opportunity cost of funds that may have been invested in long-term assets. Efficient working capital is really a prerequisite to growth and existence of corporate enterprises because it dictates the level of production, inventory and sales.

3. Discussion

When any company manages its working capital well, it has every leverage opportunity to continue in business indefinitely both in profitability and in liquidity. Based on this research work, the researcher has proffered the following recommendations: The financial manager should have

knowledge of the sources of working capital funds as well as investment opportunities where idle funds may be temporarily invested.

Financial risk analysis and corporate risk management are important activities within financial as well as non-financial corporations. Firms are exposed to different sources of business and financial risks (risk exposures), which can affect the value of the firm. Business risks relate to the firm's investments and investment opportunities (i.e., its real assets), whereas financial risks relate to the way these investments are funded (e.g., a higher level of debt increases the financial risk for the shareholders).

Corporate risk management is the process of trying to influence the effect of these risk exposures on firm value. Hedging a risk exposure is the process of trying to reduce the dependence of firm value on this risk exposure, whereas speculation means increasing the dependence on a risk exposure. The present study deals with the use of derivative securities in order to alter different risk exposures of a firm.

The value of a firm can be influenced by, for instance, changes in exchange rates, interest rates, or commodity prices. Therefore, a corporate risk manager must understand how the exposure of a firm is related to the different types of hedgeable risks. It is very important that the exposures are quantified correctly; otherwise the hedge will lead to an inappropriate result. After the exposures are quantified, a manager must choose the hedging instruments.

In order to hedge different kinds of risk, firms can rely on forwards, futures, swaps, over-the-counter options, exchange-traded options, structured derivatives, and hybrid debt.

Theoretically, hedging can increase firm value if it reduces the expected tax liability, expected costs of financial distress, and agency costs of debt. Furthermore, expected utility of management can explain the corporate use of derivatives.

Empirical evidence for reducing the agency costs of debt is more supportive. Firms with more growth opportunities, as measured by R&D, and low accessibility to external financial capital hedge cash flows in order to reduce the agency costs of debt.

Evidence for the use of derivatives in order to maximize managers' expected utility is also mixed. Evidence regarding firm size, finally, is very convincing. Large firms, as compared to small firms, make far greater use of derivatives. This may show that transaction costs of hedging play an important role in explaining the corporate use of derivatives. Larger firms are in a better position of paying the large initial costs of setting up a risk management program, and contracting specialized employees.

Many firms are simply not acquainted with the potential benefits of hedging, like minimizing expected tax payments and costs of financial distress. Probably, the same kind of simulation approach has to be applied in order to numerize the effects of reducing the expected costs of financial distress and

the agency costs of debt. Quantifying these effects will probably be tricky since the estimation of the costs will be difficult. Another problem may be that corporate risk managers may not behave as rational as assumed in the theoretical models.

Risk is the potential of losing something of value, weighed against the potential to gain something of value. Values (such as physical health, social status, emotional wellbeing or financial wealth) can be gained or lost when taking risk resulting from a given action, activity and/or inaction, foreseen or unforeseen. Risk can also be defined as the intentional interaction with uncertainty.

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4. Conclusion

The current assets at all times should be sufficiently in excess of current liabilities to constitute buffer for maturing obligations within the ordinary operating cycle of a business. The management decisions concerning working capital should not be left to the financial manager alone. Other departmental heads should partake for optimality to be attained easily. The decision on how to optimize and finance current assets should be highly considered with care. Finally, the owners and investors should be careful to analysis of accounting data of financial statements to gain access to the financial status of firms to try to make a proper assessment and improve the overall performance as well as risk of the firms.