Impact of Negative Working Capital on Profitability with Reference To India Cement Limited

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Abstract

In every business an optimum level of Working Capital is to be maintained for the purpose of day to day remittances. Any Business cannot grow in absence of satisfactory working capital level. In case of shortage of working capital the business may suffer scarcity of resources. But it should also be kept in mind that even working capital in excessive quantity, possibly will result into superfluous cost. Therefore, the management of business firm should goal an optimal level of working capital. Working capital should be ample enough to carry out the current liabilities but should not be much more than the genuine requirement. Taking into consideration this perspective, the study has been undertaken to analyze the impact of negative working capital on the companies facing such scenario which is India cement in the present study.

Company Profile

India cements Ltd was founded in the year 1946 by two men, Shri S N Sankaralinga Iyer and Sri T S Narayanaswami. They had the vision to inspire dreams for an industrial India, the ability to translate those dreams into reality and the ability to building enduring relationships and the future.

Sri T S Narayanaswami, the banker turned industrialist, was the catalyst who saw the project cross through numerous hurdles and emerge as a viable and marketable proposition. He looked beyond cement and ventured into aluminum, chemicals and plastics and shipping. A pioneer industrialist and visionary, Sri T S Narayanaswami played a dynamic role in the resurgence of industrialization in free India.

From a two plant company having a capacity of just 1.3 million tons in 1989, the company has robustly grown in the last two decades to a total capacity of 15.5 million tons per annum. It has 7 integrated cement plants in Tamil Nadu, Telangana and Andhra Pradesh, one in Rajasthan (through its subsidiary, Trinetra Cement Ltd) and two grinding units, one each in Tamil Nadu and Maharashtra.

While retaining cement over the years as its mainstay, India Cements Ltd has ventured into related fields like shipping, captive power and coal mining that has purposeful synergy to the core business.

Introduction

One of the most crucial tasks in the day to day management of the business firm is the management of working capital. Working capital refers to the funds invested in the current assets

i.e. investment in stock, sundry debtors, cash and bank balance. Various current assets and current liabilities components make up the working capital composition. Each component plays important part in any business firm.

If any component of working capital is not adequate, it may bring down efficiency and profitability of the company. The basic objective of Working Capital Management is to avoid over investment or under investment in Current Assets, as both the extremes involve adverse consequences. Over investment in Current Assets may lead to the reduced profitability due to cost of funds. Working capital management is considered to be one of the most important functions of finance, as a very large amount of funds are blocked in current assets in practical circumstances. Unless working capital is managed properly, it may lead to the failure of business. Working capital may be regarded as backbone of a business. Its effective provision can do much ensure the success of the business, while its inefficient management can lead not only to loss of the profits but also the ultimate downfall of what otherwise might be considered as promising concern.

The objective of Working Capital Management is to ensure Optimum Investment in Current Assets. In other words, Working Capital Management intends to ensure that the investment in Current Assets is reduced to the minimum possible extent. However, the normal operations of the organization should not be affected adversely. If the normal operations of the organization are affected adversely, reducing the investment in Current Assets is fruitless.

Review of Literature

A number of studies have been conducted on the topic "working capital management and profitability of the firm" considering various industries. This research is based on a Cement company named India Cements Ltd. This study may perhaps help the top managers and policy makers of different companies about assessment of optimum level of working capital, various methods of managing it moreover, general policies of working capital management. The research paper will provide us with the understanding of relation between the components of working capital and the firm's profitability. It provides concise figures and data for the sake of shareholders, potential customers as well as the creditors of the firm in relation to profitability and efficient working capital management policies. In present scenario, financial soundness and profitability of business enterprises largely depend upon the working capital management by the firm. If there is shortage of working capital it affects the day to day operations of the business firm, if there is excess of working capital, fund become idle it also affects the financial soundness of the firm. In this perspective there is need to manage the working capital effectively in any business.

Chakraborty (1976)[1] evaluated the association between working capital turnover and profitability in Indian cement, sugar and fertilizer industries and found a positive relationship between them. Sarkar & Saha (1987)[2] made an attempt to assess the relationship between profitability crisis and working capital management in the Indian public sector. The study concluded that the profitability of the selected public enterprises suffered due to inefficient management of working

capital. Jain (1988)[3] considered 10 manufacturing, trading and service industries from the state of Rajasthan in his study and concluded that the companies should avoid under-investment in working capital if they wanted higher profit margins.

Arun Kumar and Radharamanan (2012)[4] in their study examined the effect of working capital management on corporate profitability of Indian Manufacturing firms and found positive relationship for number of days of inventory and number of days of accounts payable with the profitability. The study also finds that profitability improves when a shorter cash conversion cycle exists and when current assets and current liabilities are equal.

Excessive levels of current assets may have a negative effect on the firm's profitability whereas a low level of current assets may lead to lower level of liquidity and stock outs resulting in difficulties in maintaining smooth operations (Van Horne and Wachowicz, 2004)[5]. Traditional concept of working capital is the different between assets and current liabilities. Thus working capital management is an attempt to manage and control the current assets and the current liabilities in order to maximize profitability and proper level of liquidity in business. Liquidity and profitability are two important and major aspects of corporate business life (Dr. K.S.Vataliya, 2009)[6]. The problem is that increasing profits at the cost of liquidity can bring serious problems to the firm. Therefore, there must be a trade-off between these two objectives (liquidity and profitability) of firms. One objective should not be at the cost of the other because both have their own importance. If firms do not care about profit, they cannot survive for a longer period. In other round, if firms do not care about liquidity, they may face the problem of insolvency or bankruptcy. For these reasons managers of firms should give proper consideration for working capital management as it does ultimately affect the profitability of firms. As a result company can achieve maximum profitability and can maintain adequate liquidity with the help of efficient and effective management of working capital.

The efficient management of working capital is a fundamental part of the overall corporate strategy to create shareholders value (Nazir and Afza, 2008)[7]. In addition, efficient working capital management leads to improve the operating performance of the business concern and it helps to meet the short term liquidity (C. Paramasivan T. Subramanian, 2009)[8]. Therefore firms try to keep an optimal level of working capital that maximizes their value (Deloof, 2003)[9]. Under this research paper attempt has been made to identify the impact of negative working capital and suggestions to India Cements Ltd regarding this scenario.

Objectives of the Study

The main objectives of this study are to assess and evaluate the working capital management in India Cements Ltd, examine the management outline of inventory, liquidity, cash position and receivables management. This also finds the relationship between Working Capital Efficiency and Profitability.

The aim of the present paper is to evaluate the various concepts of working capital and find out the

feasibility of the concept of working capital in the light of improved planning and control of working capital. Problems of working capital management include the problem of determining the optimum level of investment in each component of current assets i.e. inventory, receivables, cash and other short-term investment.

The fundamental focus in working capital management should be to optimize the firm's investment. An expert in the financial management is of the opinion that crisis of working capital is one of the factors responsible for the low profitability in manufacturing sector. Better planning and control of working capital or proper utilization of optimum quantity of working capital increases the earning ability subject to the existence of operating margin.

Scope of the Study

The research paper focuses on the impact of negative working capital in India Cements Ltd. The study is restricted to the last five years data of India Cements Ltd.

Data Collection

The data is gathered from secondary sources, like annual reports, journals, internet sites, newspapers and other related research papers.

Data Analysis

The collected data is analyses through ratio analysis and only assembled tables are used for data discussion as per research need.

Table 1 - Various Ratios and Working Capital for India Cement

India Cement	2011	2012	2013	2014	2015	Average
Current Ratio	0.55	0.63	0.64	0.74	0.71	**0.65**
Liquid Ratio	0.31	0.41	0.41	0.46	0.45	**0.41**
Cash to Total Assets	0.00	0.00	0.00	0.00	0.00	**0.00**
Debtors Turnover Ratio	18.24	14.03	10.72	10.40	9.05	**11.70**
Average Collection Period	20.01	26.01	34.05	35.10	40.33	**31.20**
Inventory Turnover Ratio	8.50	9.27	8.82	7.95	7.28	**8.32**
Inventory to Working Capital	-0.52	-0.59	-0.63	-1.12	-0.90	**-0.71**
Sales to Working Capital	-4.32	-5.53	-5.37	-8.40	-6.62	**-5.78**
Profit to Working Capital	-0.32	-0.28	0.25	-0.01	-0.27	**-0.13**
Working Capital	-1,078	-938	-951	-605	-739	**-4,311**

Source: Annual reports

Interpretation

The current ratio is a liquidity ratio which estimates the ability of a company to pay back short-term obligations. A higher current ratio indicates the higher capability of a company to pay back its debts. Acceptable current ratios vary from industry to industry and are generally between 1.5 and 2 for healthy businesses. If a company's current ratio is in this range, then it generally indicates good short-term financial strength.

The current ratio helps investors and creditors understand the liquidity of a company and how easily that company will be able to pay off its current liabilities. This ratio expresses a firm's current debt in terms of current assets. A higher current ratio is always more favorable than a lower current ratio because it shows the company can more easily make current debt payments.

The current ratio is an important measure of liquidity because short-term liabilities are due within the next year. This means that a company has a limited amount of time in order to raise the funds to pay for these liabilities. Current assets like cash, cash equivalents, and marketable securities can easily be converted into cash in the short term. This means that companies with larger amounts of current assets will more easily be able to pay off current liabilities when they become due without having to sell off long-term, revenue generating assets.

Although Current ratio of India Cement is showing upward trend but it is less than the ideal current ratio of 2:1 which represents that the company is not maintaining appropriate level of current assets against current liabilities.

The liquid ratio is a guide of a firm's short-term liquidity. This ratio evaluates company's ability to meet its short-term obligations with its most liquid assets. Liquid assets are those that can be quickly turned into cash. Most of the current assets are highly liquid with the exception of inventory, which often takes a longer amount of time to turn into cash.

Ideally, quick ratio should be 1:1. If quick ratio is higher, company may keep too much cash on hand or have a problem collecting its accounts receivable. Higher quick ratio is needed when the company has difficulty borrowing on short-term notes. A quick ratio higher than 1:1 indicates that the business can meet its current financial obligations with the available quick funds on hand.

Firm with adequate quick assets which cover all its current liabilities will be in good position to repay all its obligations, it needs not to sell off capital or long-term assets. Most businesses use long term assets to produce income, selling these assets will hurt the business very badly. Also it will indicate to investors that recent operations are not generating enough income to pay its current liabilities.

Higher quick ratios are more favorable for companies because it shows there are more quick assets than current liabilities. A company with a quick ratio of 1 indicates that quick assets equal current assets. This also shows that the company could pay off its current liabilities without selling any long-term assets. An acid ratio of 2 shows that the company has twice as many quick assets than current liabilities.

Liquidity of business goes up automatically when it observes higher quick ratio. Assets are very easy to convert into cash if there is any requirement. It is very good indicator for investors, but it's even better indicator to creditors because they would want to identify if they will be paid back on time.

The cash to total asset ratio shows highly liquid assets such as cash and bank, marketable

securities with assets of the firm. Figure is utilized to calculate business liquidity or its capability to pay its dues on time. Keeping high cash or marketable securities will impact firm efficiency.

The cash to total asset ratio is most often used by company management to estimate when cash will be available and how much cash will be available for future operations. Management can use this ratio to prepare budgets and future performance predictions. In other words, management can use this ratio to help estimate the availability of cash in future periods based on projected operations.

Investors use cash to total asset ratio to measure the quality of a business earnings. This ratio is resembles of the return on total assets ratio, that calculates how effectively a company utilizes its assets to generate return or revenue. The cash to total assets ratio indicates its investors how efficiently company is at utilizing its assets to gather cash from credit sales and clients. Higher ratio indicates higher efficient in business. The cash to total assets ratio has no relationship with revenue or profit. It plays part in analyzing efficiency of cash flow. In regards to Cash ratios, the company has adverse situation as it has a very low cash balance as compared to the total assets throughout the years.

Debtors Turnover Ratio is an efficiency ratio or activity ratio that measures how many times a business can turn its accounts receivable into cash during a period. In other words, the Debtors Turnover Ratio measures how many times a business can collect its average accounts receivable during the year. This ratio shows how efficient a company is at collecting its credit sales from customers. Some companies collect their receivables from customers in 90 days while other takes up to 6 months to collect from customers.

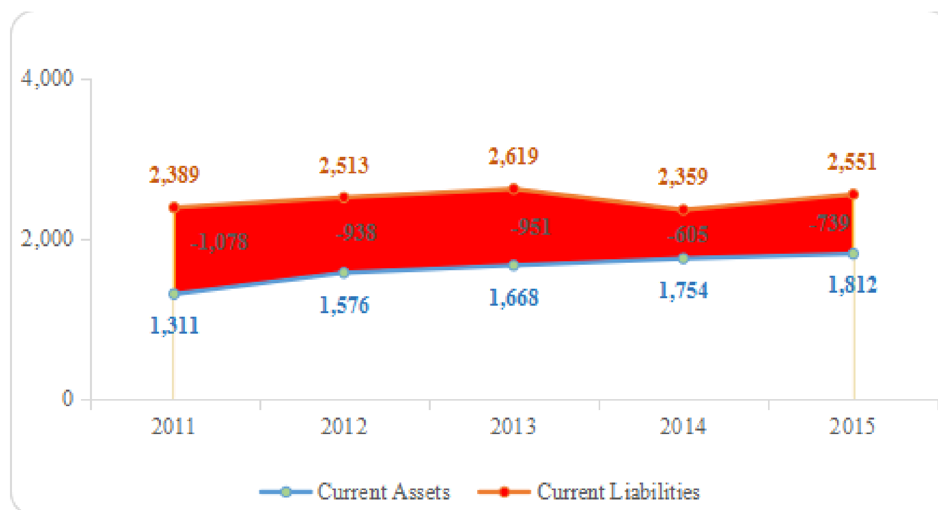
Since Debtors Turnover Ratio measures business capability to effectively gather its accounts receivables, it makes sense that higher ratio is more favorable. Higher debtor turnover ratio means company is collecting their bills receivables more frequently in the year. Higher efficiency is positive sign from a cash flow point as well. Business can gather cash from clients sooner; it would be capable to utilize that cash to pay dues.

A low ratio suggests that the company may have poor collecting processes, a bad credit policy or customers with financial difficulty. Theoretically, a low ratio can also often mean that the company has a high amount of cash receivables for collection from its various debtors; it should improve its collection processes. Ideally companies prefer higher debtor's turnover ratio that will result into lower collection period, but India Cement's debtor turnover ratio is diminishing and average collection period is increasing throughout the period.

Inventory turnover ratio measures how fast a company is selling inventory. It is used to measure how efficiently a business is managing its inventories. In general, a high inventory turnover denotes efficient operations. A low inventory turnover compared to the industry average and competitors means poor inventories management. However, a very high value of this ratio may result in stock-out costs. Considering Inventory turnover ratio, India Cement has a downward

trend which means the company is not proficient to increase its sales as proportionate to its inventory level. The Working capital of India Cement has been noticed negative throughout the years due to which the Sales to working capital and Profit to working capital ratios are also decreased.

Table 2 - Current Assets and Current Liabilities of India Cement from year 2011 to 2015



Source: Annual reports

India Cement current liabilities are higher than current assets throughout the study period. Its trade payables and short term borrowings are very high.

India Cement	2011	2012	2013	2014	2015
Cash and bank balances	12	10	7	7	36
Current investments	2	10	2	0	0
Inventories	563	556	602	676	666
Short-term loans & advances	487	508	595	554	545
Trade Receivables	247	491	462	516	565
Current Assets	**1,311**	**1,576**	**1,668**	**1,754**	**1,812**
Other current liabilities	753	682	958	877	937
Short-term borrowings	802	869	678	533	564
Short-term provisions	72	76	0	0	37
Trade payables	762	887	983	948	1,013
Current Liabilities	**2,389**	**2,513**	**2,619**	**2,359**	**2,551**

Source: Annual reports

Table 3 – Anova single factor and F-test for India Cement

India Cement	Years				
	2011	2012	2013	2014	2015
Working Capital	-1,078	-938	-951	-605	-739
Profit Before Tax	349	267	-241	4	203

Summary

Groups	*Count*	*Sum*	*Average*	*Variance*
Working Capital	5	-4,311	-862	35,335
Profit Before Tax	5	582	116	56,145

Anova

Source of Variation	*SS*	*df*	*MS*	*F*	*P-value*	*F crit*
Between Groups	2,394,138	1	2,394,138	52.3426	0.0001	5.3177
Within Groups	365,918	8	45,740			
Total	2,760,056	9				

Source: Annual reports

Interpretation

The ANOVA analysis shows that the calculated value of F is 52.3426 that is more than table value of 5.3177 at 5% level. This analysis rejects the null hypothesis. It may be concluded that the relationship between profit and working capital for the company India Cement is significant.

Findings

On the basis of above analysis, certain findings and conclusions were made which are as follows:

1) It has been observed that the company normally follows a pattern of negative working capital.

2) The inventory in absolute terms is showing decreasing trend which is directly contributing in the reduction of working capital.

3) Debt collection period is very low that is around 32 days which shows the efficiency of the company in collecting its debts. It is also contributing in the decrease of working capital of the organization.

4) The Current Ratio of the company is noticed constantly lower than the standard norms throughout the period of study.

5) The Quick Ratio of the company also noticed less than the standard level throughout the period of study.

6) Working capital turnover ratio shows a negative tendency throughout the period of study.

Suggestions

It is suggested that the company should maintain optimal level of current assets against current liabilities to achieve ideal level. India Cement should increase their liquid assets level in order to achieve ideal liquid ratio. India Cement needs to give attention as its cash and working capital level is decreasing year by year instead of growing. The company should create its current assets optimally so that it can pay all its obligations appropriately out of this. The Debtor's turnover ratio is decreasing besides, average collection period is increasing in all the five companies under study. Therefore, it is recommended as a whole to redesign the collection policy in accordance to make collection faster and robust. India cement must take strict measures as it has very less working capital to carry out its short term projects which is resulting into negative inventory turnover ratio.

Conclusion

Negative working capital indicates non-liquidity or less liquidity within the firm which is not favorable at each and every stages of business. At the same time, companies with higher working capital are having sufficient liquidity, are more successful because of liquidity and they can expand business and grow up to maximum possible extent. However, a company with higher working capital needs higher revenue to maintain their healthy operating ratio. A better credit management system will help these companies to generate higher ROCE in the long run. However, in each and every situation lower level of liquidity is not preferable; a proper tradeoff between liquidity and working capital requirement is needed in the long run.

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