CLASS NOTE

B.COM: SEM--6

Subject: FINANCIAL MANAGEMENT

CHAPTER: WORKING CAPITAL - II

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LECTURE NO. 03

SUB: FINANCIAL MANAGEMENT

CHAPTER: WORKING CAPITAL - II

TOPIC; Policies relating Current Assets – Conservative, Aggressive and Balanced ; Various sources of finance to meet working capital requirements; Financing current assets: Strategies of financing (Matching, Conservative, and Aggressive policies) ; Management of components of working capital (debtors management only–credit period -simple type)

Sub Topic – 3: Financing current assets: Strategies of financing (Matching, Conservative, and Aggressive policies)

FINANCING STRATEGIES FOR CURRENT ASSETS / WORKING CAPITAL

ANSWER:

An organization can finance the Current Assets / Working Capital by using the following financing strategies:

MATCHING APPROACH

As per this financing strategy, the organization matches the expected life of the current asset with the estimated life of the source of fund to raise these financial assets. For example, a machine whose life expectancy is 5 years can be funded using a loan of 5 years. The flip side of using this approach to finance your assets is that it may not be practically possible to match the life of an asset with that of its source of fund. Similarly, for working capital financing, the matching approach aims to match the assets and liabilities to maturities. Thus, for every asset on the balance sheet, there is a corresponding liability that matures on the same day as the asset.

CONSERVATIVE APPROACH

As per this financing strategy, the organization relies on the long-term funds to acquire permanent assets and a part of temporary assets. As this financing strategy uses long-term funds, it has less risk of a shortage of immediate funds. For working capital financing, this financing strategy requires an organization to maintain high levels of current assets in relation to its sales. Such surplus current assets can incorporate any changes in the sales and thus avoid disruption in the production plans.

AGGRESSIVE APPROACH

As per this financing strategy, the organization uses its short-term funds to finance a part of its permanent assets. This is a very risky approach as there are chances that the organization might have a hard time dealing with its short-term obligations. However, many organizations use this financing strategy for its advantages of lower financing cost and higher profitability.

For working capital financing, under this approach, the reliance is on short-term funds that are used for maintaining the current assets. These current assets are maintained only to meet the current liabilities and do not provide any cushion for the variation in working capital requirements.

CONCLUSION

Financing strategies are imperative for all the organizations to help in planning their financial future. A financing strategy can assist you in setting clear-cut goals and working towards becoming a financially secure business organization. It takes into account your current financial status, your financial objectives and the best possible steps to achieve them

We will compare these three approaches on 5 parameters viz. liquidity, profitability, risk, asset utilization, and working capital.

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| **Factors** | **Term Significance** | **Conservative** | **Aggressive** | **Hedging** |
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| **Liquidity** | It is extremely important in business for a smooth operation of the day to day business activities and to grab occasional opportunities thrown by the business. | Liquidity is **high**, because of heavy usage of long-term funds. It can take advantage of sudden opportunities. | Liquidity is **low** due to greater dependability on short-term funds even for a part of long-term assets. It does not keep idle funds and therefore saves interest cost on them. | Liquidity is **balanced** i.e. neither high nor low. It attempts to strike a balance between liquidity and cost of idle funds. |
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| **Profitability** | Profitability is the final goal of any business. Each and every step of a manager should finally boil down to profitability. | Under normal circumstances, profitability is less in this strategy because of too much idle and costly funds. Higher rate and bigger magnitude of interest cost reduce the profitability. | Since the interest cost is minimized in this approach, higher profitability is obtained. | Because of cut to cut management, a balance is achieved between interest cost and loss of profitability. Moderate profitability is maintained here. It is greater than conservative and lesser than aggressive. |
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| **Risk** | The risk here refers to the risk of bankruptcy. | There is a very low risk of bankruptcy as a higher level of liquidity is maintained in the business in this approach. | There is a high risk of bankruptcy due to extremely tight liquidity position being maintained. | The risk is balanced here. The firm will bow down to bankruptcy only in an extremely bad situation. |
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| **Asset utilization** | Asset utilization here is the utilization of [current assets](https://efinancemanagement.com/working-capital-financing/current-assets-key-features). | Too high level of current assets makes its utilization ratio low. | Similarly, too low level of current assets makes the utilization ratio high. | Moderate |
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| **Working capital** | Working capital is the capital used to fill the gap between current assets and current liabilities. | More working capital is required to execute the conservatism. Higher working capital avoids all risks. | Very low working capital is maintained. Low working capital increases risk but saves the interest cost. | Moderate working capital is maintained to stay somewhere between conservative and aggressive strategies. |

SHORT TERM VS. LONG TERM FINANCING VIS A VIS RISK AND PROFITABILITY TRADEOFF

PROFITABILITY STANDPOINT

In general, short-term interest rates are cheaper to long-term interest rates because of the term premium. That means short-term has lower interest cost and higher profitability whereas long term has higher interest cost and lower profitability. Especially, when the long-term funds are utilized to finance the working capital, unnecessary interest is paid for the periods when the funds are not utilized. In essence, the short-term financing wins the race if profitability is the concern. Let’s now look at the risk concern.

RISK STANDPOINT

There are two risks involved in short-term financing viz. Refinancing Risk and Risk of Interest Rate Fluctuations with Refinancing. Refinancing is very uncertain and if the lender denies it for any reason, the options left to the borrower for making payment is either to sell off the assets and pay or file for liquidation if failed to realize the assets. The risk of adverse change in interest rate, while refinancing may increase the cost of financing and this risk, leads to low profitability. On the contrary, long-term financing neither has to refinance risk nor the risk of change of interest rate frequently. Here, the long-term financing wins the race.

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