Assessment of working capital management and their financial mechanism

(A Case of hawassa Flour Company)

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Abstract

The study has been conducted with the purpose of assessing working capital management in Awassa Flour Share Company. The main objective of the study was made to assess working capital at satisfactory level and to keep production on an interrupted throughout physical year in Awassa Flour Share Company. It has also looked to related literatures both the theoretical and empirical part to see where prior studies agree and they disagree. The study is designed in the methodology part to figure how it is to be conducted. After existing literatures has been reviewed the study is conducted based on the design and reached at some conclusions at the end

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CHAPTER ONE

INTRODUCTION

1.1 Background of the study

The goal of working capital management is to manage a balance between profitability and risk that contributes positively to the firm's value. The lower the investment will leads to the higher the risk of not being able to pay debts as they come due. And the higher networking capital or lower current liability and higher current assets, financing also reduces the profit ability due to high cost of financing from long term this to be compensated by reduced risk this gives the firm ability to meet its liability with out difficult. And when the firm finances from short term, implies net working capital will be negative this shows higher current liabilities than current asset as this time, with in short period of time the firm may be un able to meet in short period of time the firm may be unable to meet its liability. Therefore, all these situations greatly leads to lower the firm's value. (Financial management I.M Pandey,2005) . Thus the study of the working capital management and is an essential part of managing day-today activities of the firm.

A firm starts operation maintaining a minimum cash balance on hand and purchases raw materials to produce inventories of finished goods, which is then sold to customers. The sales of these goods realize cash or receivables. When the firm collects receivables, from debtors, it realizes the cash. The purchase of raw materials may also be credit payables after realization of cash from the sale of finished goods; the firm disburses its payables. Therefore, the working capital requirement of a company in turn affected by the size of these stated elements to completes their process. (Eljelly, 2004)

1.2. Statement of the Problem

In every organization the working capital is important to maintain the smooth running of business, the motive power of business enterprise provided by working capital components; current assets such as; cash, receivable, and inventory and current liabilities such as account payable, short term loan, note payable… etc and poor control over these current assets will lead to incurring losses. i.e inventories are valuable only if they can be sold and cash is useful if it is not idle or if there is no shortage of it. Similarly, if the level of the working capital is inadequate to meet requirements of the customers it leads to loss of sale, loss of customers and loss of profit.

In generally, the day-to-day activities failure in working capital management may result in the bankruptcy of the organization.

The effective management of each components of the working capital is essential for the firm so as:

• To control the cost of holding current asset.

• To ensure the adequate level of current asset.

• To avoid the loss caused by in adequate working capital.

• To control technical insolvency.

Working capital is important to provide working capital component essential to the firm control the cost of holding current asset, ensure adequate level of current asset, control technical insolvency and manage the working capital of the organization.

1.3. Objective of the Study

The study was conducted to assess and analyze the working capital management of Awassa flour Share Company. Since the most business decisions are affected directly or indirectly by working capital management decision, specifically manufacturing enterprises are highly sensitive for fluctuations in working capital level and means of financing it.

1.3.1. General Objective

Generally the study was made to assess working capital toward controlling working capital at satisfactory level and to keep production on an interrupted throughout physical year in Awassa flour share company. Finally, general objective of study is to evaluate the working capital management of firm by using deferent techniques.

1.3.2. Specific Objective

The specific objective of the study is as follows:

• To asses factors that influence or affect the proper working capital management of the firm. Such as account receivables ,inventory, account payable etc.

• To identify of the firm that is used to manage various components of its current asset.

• To suggest advice for improving the working capital management of the firm.

1.4 Research question

The study answers the following research questions

1. What are the different strategies used by company to use components of working capital?
2. What source of working capital does the company use?
3. What the company's current capacity to meet its liability looks like?

1.5. Significance of the Study

Because of less awareness of many firms how to manage their working capital and working capital is necessary and current issue. Because of less awareness the firms are going to bankrupt and come to an end their operation. The result of this study is expected to be merit benefit institutions and managers to have awareness of the position of working capital of the firm and it also provides manager some possible techniques for the management of the working capital.

The result is also expected to inspire the firm to manage its working capital in propermanner, to ensure maintaince of solvency to have good image with out side world. Thus, this study is very significant as it focuses on the back bone of the firm. Therefore, it is important to have some knowledge.

This study is extremely important to:

- Provide useful information for proper management of each components of working capital of the firm
- Offer suggestion and comments on the company's operation
- Provide information for further study.

1.6. Scope of the study

This study was conducted in Awassa flour Share Company, which is located, in southern Nations, Nationalities and people's region in Hawassa. The study has attempted to deal with only analysis of working capital management of the company specified above which is Awassa flour Share Company due to time and cost constraint. Therefore, the study has been limited to:

- Management of cash
- Management of receivables
- Management of inventory.

This study has analyzed three years financial statement of hawassa flour Share Company.

1.7 limitation of the Study

When conducting this study, the researcher had faced certain constraint which limited the scope of the study. Among those constraints that most significant are the following.

- Financial problem: This limits the scope of study by blocking the study not progress as if it is needed.
- Time problem or limitation: due to short period of time, it is difficult to gather a complete relevant information.
- Because of high competition among different firms producing the same product like Awassa flour Share Company, the company does not like to give all necessary real information because of secret internal policy, rule, and procedure that company has been using to cope up with the competition.

1.8 Organization of the paper

The study was five chapters the first chapter s presents the introduction part, which includes background of the study, statement of the problem, significance, objectives, scope, limitation, organization of the research report and research question. Chapter two presents with review of related literature. Chapter three states research methodologies. Chapter four also deals with results and discussion. Final chapter which is chapter five represents of major conclusion and recommendation.

CHAPTER 2

REVIEW OF LITERATURE

2.1 Theory

2.1.1. Concepts and nature of working capital management

The current assets, commonly called working capital represent the portion of investment that circulates from one form to another in the ordinary conduct of business. This idea embraces the recurring transaction from cash to inventories, then to receivables and back to cash that forms the operating cycle of the firm.

There are two types of working capital; permanent and temporary (fluctuating variable) working capital.

Permanent working capital is a minimum amount (safety stocks of cash and inventories) required to be kept in the form of current assets. It is a fund required for the data-to-day operational activities of the firm.

Temporary working capital (fluctuating/seasonal) is the amount required to meet seasonal demands. Current liabilities represent the firms short term financing because they include all debts of the firm that come due (must be paid) in one year or below one year.

Net working capital is defined as the difference between the firm's current assets and current liability. If the firm has positive net working capital, it is the portion of the firms current assets are financed with long-term funds, meaningless short term funds financed with more long-term funds. And if the firms networking capital is negative shows the current liabilities exceed the current assets. So, the firm is financing from less long-term funds with more short-term fund (aggressive. Strategy)

The concept of net working capital is useful to groups interested in determining the amount and nature of assets that may be used to pay current liability. (V.K Bhalla, 2003; Working capital management ANONI Publication new Delhi).

There are three strategies, but two of them are more basic (aggressive and conservative) for determining an appropriate mix of short-term or current liability and long-term financing.

An aggressive financing strategy calls for firm financing to meet at least its seasonal requirements and possibly some its permanent requirements with short-term funds, the balance is

financed with long-term funds under which restricted policy current assets are turned over more frequently and the holding cash, securities, inventories and receivables are minimized (firm is financing more from short-term fund). This increases profitability of the firm. However, is risk, the firms ability to meet its liability is less when it comes due or unable to meet liability.

Conservative financing strategy under this strategy relatively large amounts of cash, marketable securities and inventories are carried, and sales are stipulated by liberal financing policy (relaxed collection period) to customers a corresponding high level of receivables are bound to occur (firm finances more from long-term funds). Use shot-term financing in the event of an emergency or unexpected out flow of funds. It is difficult to imagine how this strategy could actually be implemented, because the use of short-term financing tools, such as account payables and accruals are virtually un avoidable unlike the aggressive strategy, the conservative strategy required the firm to pay interest for un needed funds. The lower the cost of aggressive strategy. Therefore, makes it more profitable than the conservative strategy. However, it involves much more risk (aggressive strategy).

For most firms, trade off between extremes represented by those two strategies should result in an acceptable financing strategy. (Lawerence J. Gitman 693).

Many authors agree that the two concepts. Such as, liquidity ratio and techniques of managing current assets are important in managing working capital effectively under techniques of managing current assets: the cash conversion cycle, technique of maintaining cash, factors influencing the choice of marketable securities, factors used to investigate potential customers. Inventory management and source of short-term financing are included.

(Bodil dick in son B.J campsey Eugene F. Briahm, 1997).

According to the opinion of ration analysis (financial ratio analysis) provides the following information.

- Ratio analysis is the one of the most important concepts in analysis of effective working capital management. Because it provides the meaningful comparison to its industry and it is the most powerful tools of financial analysis.
- Ratio analysis is the method of calculating and interpreting financial ratio to asses the firm's performances and status.
- Financial ratio shows the relationship among statement accounts, enable quick comparison of firms in a given industry and comparison is made to some industry.

- From different group of financial ratio, liquidity ratio is concerned in this study. Because it provides the information that is critical to the short-turn operation of the firm.

2.1.2. Liquidity

Liquidity refers to the solvency of the firms over all financial position there as with which can pay its bills. The three basic measures of liquidity are:

- Net working capital
- The current ratio
- Quick (acid-test) ratio

Liquidity ratio has two parts, current ratio and quick ratio. Current ratio is the measure or expresses the relationship between firm's current assets and its current liability, and it is calculated as current assets divided by the current liability. The result shows the liquidity position of the firm.

To high current ratio indicates the firms holding of excessive current asset. To low current ratio indicates poor ability to satisfy short tem obligation or liability. A current ratio of 2.0 is occasionally cited as acceptable but, a value depends on the industry in which the firm operates reference. (Financial management I. M Pandey, 2005.

Current ratio measures short-term solvency of the firm. High ratio indicates good liquidity position, increase in current liabilities faster than current assets indicates to the firm a bad liquid position that means the firm unable to meet its liability when comes due. Quick ratio is also called acid-test ratio, it is the strength test of liquidity, it is calculated by dividing the firm's current asset minus inventories by current liabilities; quick ratio= Current asset=Inventory

A quick of 1.0 or greater is occasionally recommended, but an acceptable value depends largely on the industry.

Excessive liquidity reduces a firm's risk of being unable to satisfy short-term obligation as they come due, but sacrifices profitability, because;

Current assets are less profitable than fixed assets and

Current liabilities are less expensive financing sources than long-term funds. Quick ratio measures the ability to pay of its short-term obligation with out relying on the sale of inventory. The higher ratio, the higher the firm's liquidity position.

2.1.3. Current asset management

This is also another important concept in working capital management. The technique of current asset management includes: Technique of cash management, receivable management, marketable security management, inventory management and source of financing them. Two major objective of current asset management.

I. Being to minimize cash operating cycle, and

II. Being to finance those assets as effectively as possible with the over all objective of optimizing the return on total capital employed.

2.1.4. Cash management technique

Cash is ready currency to which all liquid assets can be reduced, cash balances are significantly influenced by firm's production and ales. Techniques and by its procedures for collecting sales receipt and paying for purchases. These influences can be better understand through analysis of the firms operating and cash conversion cycle (CCC).

2.1.5. Operating cycle

Operating cycles the amount of time that elapse from the points when the firm begin to build the inventory to the point when cash is collected from the sale of the resulting finished product. The cycle is made up of two components the average age of inventory (ABI), and the average collection period of ales. The firm operating cycle (OC) is the sum of average age of inventory (AAI) and the average collection period (APC). OC = AAI + ACP

Average age of inventory is the length of the time requited to produce and sale the product.

$$AAI = \frac{\text{Average Inventory}}{\text{Cost of asles/365 days}}$$

The average collection period (ACP) represents the length of time required to collect the sales of recipes.

$$ACP = \frac{\text{Account receivables}}{\text{(Annual credit sales)/365}}$$

2.1.6. Cash conversion cycle (ccc)

The cash conversion cycle represents the amount of time the firms which is tied up between payment for production in put and receipt of payment from the sale of the resulting fished products. It is calculated as by the number of days in the firms operating cycle minus the average payment period for in puts to production. Cash conversion cycle= operating cycle-Average payment period (ccc=oc-APP).

Average payment period (APP) is the length of time the firm is able to different payment on its various resource purchase.

Ideally, the firm like to have a negative cash conversion cycle, means the average payment period exceeds the averages of inventory plus the average collection period. In contrast the manufacturing.

Firms will usually not have negative cash conversation unless they extend their average payment period on unreasonable length of time. But a firm needs to pursue strategies to minimize it with out causing harm to the company in form of lost sales or in ability to purchase on credit. The basic strategies that should be employed by the firm to manage cash conversion cycle are:-

Turn over inventory as quickly as possible avoiding stock outs that might result in loss of sale

Collects accounts receivable as quickly as possible with out losing future sale because of high pressure collection technique.

Pay accounts payable as late as possible with out damaging the firm's credit rate. (James C. Van Horne, 1998). And (Bodil Dickinson B.J campsey Eugene F. Briahm, 1997).

2.1.7. Management of market table securities

Marketable securities are short term interest earning. Money market instrument used by the firm to obtain a return on temporarily idle fund.

When fund are being hold for other than immediate transaction purpose (cash) they should be converted from cash to interest bearing marketable securities from return point up to upper limits is achieved.

Under normal conditions, the longer the maturity period of securities, the higher they yield.

A wide variety securities, differing in terms of default risk; interest rate risk, liquidity risk, inflation risk and expected rate of return available to firm that choice to hold marketable securities (Fundamental of financial management. Theory and practice Brightam, Ehrardt, 2002).

2.1.8. Management of Account Receivables

Account receivables represent the extension of credit by which the firm gives to its customers. The extensions of credit to customers by most manufactures are a cost of doing business. By keeping its money tide up in account receivable, the firm loses time value of money and runs the risk of non payment by its customers.

The level of account receivable should not be judged too high or too low based on historical standards of industry norms, but the test should be whether the level of return we are able to earn from this asset equal or exceeds the potential gain from other investments. We must ask whether we are optimizing our return in light of appropriate risk and liquidity consideration.

Generally, the firm's financial manager directly controls account receivable through involvement in the establishment and management of

Credit policy

Collection policy

Credit policy is the determination of credit selection, credit standards and credit-terms. Credit selection is the decision whiter to extend to credit to customer and how much credit to extended.

The collection policy should consider the both firm's had debt because of extended collection period and the customers of the firm. It is bad for the firm extended collection period, but preferable by customers of the firm. Therefore, the collection period has to consider both the firm's and its customer interest. Too high and too low collection period is not acceptable to be both internets kept.

2.1.9. Inventory Management

In manufacturing company, inventory is usually divided in to there basic categories: raw material, work in process (partially finished good) and fully finished good. (This is ready for sale) All these forms of inventory need to be financed, and their efficient management can increase the firms profitability.

In developing inventory managing techniques we must evaluate two costs associated with inventory, the carrying cost and ordering cast. Carrying cost includes internets on funds tied up in inventory and cost of ware house space, insurance premium and materials handling expenses. There is also implicit cost associated with the danger of obsolescence or profitability and paid price changes. The large the order, we placed the greater average inventory we will have on hand and the higher carrying cost.

Ordering costs if we maintain relatively low average inventory in stock we must order many times and total ordering costs will be higher. As the order size increases, carrying cost go up because have more inventory on hand.

Economic ordering quantity (E) (D) the most advantageous amount for the firm to order each time mathematically it can be determined as

$$EOQ = \sqrt{\frac{2x5x0}{C}}$$

Where S= Total sales in unit

O = Ordering cost for each order

C = Carrying per unit in dollar

(Bodil dickinion B.J Campsey Eugene (F. Birahm, 1997).

2.2.1 Need for working capital

The need for working capital to run the day-to- day business activities cannot be over emphasized. We will hardly find a business firm which does not require any amount of working capital. Indeed, firms differ in their requirements of the working capital. We know that a firm should aim at maximizing the wealth of its shareholders. In its Endeavour to do so, a firm should aim at maximizing should earn sufficient return for its operations. Earning a steady amount of profit requires successful sales activity. The firm has to invest enough founds in current assets for generating sales. Current assets are needed because sales do not covert into cash instantaneously. There is always an operating cycle involved in the conversion of sales into cash. (Financial Management I.M Pandey. 8th edition)

2.2.2 Balanced working capital position

The firm should maintain a sound working capital position. It should have adequate working capital to run its business operations. Both excessive as well as inadequate working capital positions are dangerous from the firm's point of view.

Excessive working capital means idle funds which earn no profits for the firm. Paucity of working capital not only impairs the firm's profits ability but also results I prevention interruption and inefficiencies.

The dangers of excessive working capital and as follows:-

It results in unnecessary accumulation of inventories Thus, chances of inventory mishandling, waste, theft and losses increase.

Excessive working capital makes management complacent which degenerates into managerial inefficiency.

Tendencies of accumulating inventories tend to make speculative profits grow. This may tend to make dividend policy liberal and difficult to cope with in future when the firm is unable to make superlative profits.

Fixed assets are not efficiently utilized for the lack working capital funds. Thus, the firm's profitability would deteriorate.

Operating inefficiencies creep in when it becomes difficult even to meet day – to day commitments.

Paucity of working capital founds render the firm unable to avail attractive credit opportunities etc.

2.2.3 Determinates of working capital

There in no set pales or formulate to determine the working capital requirements of firms. A large number of factors, each having a different importance, influence working capital needs of firms. Also, the importance of factors changes for a firm overtime. Therefore, an analysis of relevant factors should be made in order to determine total investment in working capital. The following is the description of factors which generally influence the working capital requirements of the firms.

1. Nature of Business

Working capital requirements of a firm basically influenced by the nature of its business. Trading and financial firms have a very small investment in fixed assets, but require a large sum of money to be invested in working capital. retail stores, for example, must carry large stocks of a variety of goods to satisfy varied and continues demands of their customers. Some manufacturing business, such as tobacco manufactures and construction firms, also have invest substantially in working capital and a nominal amount in fixed assets. Public vitalities have a very limited need for working capital & have to invest abundantly in fixed assets. Their working capital requirements are nominal because they may have only cash sales and supply services, not products.

Working capital requires most of the manufacturing concerns to fall between the two extreme requirements of trading firms and public utilities, such concerns have to make adequate investment in current assets depending upon the total assets structure & other variables.

2. Sales and demand condition

The working capital needs of affirm are related to its sales. It is difficult to precisely determine the relationship between volumes of sales and working capital needs. In practice, current assets will have to be employed before growth takes place. It is, therefore, necessary to make advance planning of working capital for a growing firm on continuous basis.

A growing firm may need to invest funds in fixed asset in order to sustain its growing production and sales.

Sales depend on demand conditions. Most of the firms experience seasonal and cyclical fluctuations in the demand for their products and services. Their business variations affect the working the working capital requirement, specially the temporary working capital requirements of the firm. When there is an upward saving in the economy, sales will increase; correspondingly, the firm's inventories and debtors will also increase. Under boom, additional investment in fixed assets may be made by some firms to increase their productive capacity this act of firms will require further additions of working capital.

3. Technology and Manufacturing policy

The manufacturing cycle (or the inventory conversion cycle) comprises of the purchase and use of raw materials and the production of finished goods. Longer the manufacturing cycle, large will be the firm's working capital requirements. For example, the manufacturing cycle in the case of abiler, depending on its size, may range between six to twenty-four months. On the other hand the manufacturing cycle of products such as detergent power, soaps and chocolate etc.

4. Credit policy

The credit policy of the firm affects the working capital by influencing the level of debtors. The credit terms to be granted to customers may depend up on the norms of the industry to which the firm belongs. But affirm has the flexibility of shaping its credit policy within the constraint of industry norms & practice.

The firm should use discretion in granting credit terms to its customers. Depending up on the individual case, different terms may be given to different customers. A liberal credit policy, without rating the credit-worthiness of customers, will be determine to the firm and will create a problem of collecting funds later on. A high collection period will mean tie-up of large funds in book debts, slack collection procedures can increase the chance of bad debits.

In order to ensure that unnecessary funds are not tied up debtors, the firm should follow a rationalized credit policy based on the credit standing of customers and other relevant factors. The firm should evaluate the credit standing of new customers and periodic any review the credit worthiness of the existing customers.

The case of delayed payments should be thoroughly investigates.

5. Availability of credit

The working capital requirements of affirm are also affected by credit terms granted by its creditors.

A firm will need less working capital if liberal credit terms available to it. Similarity, the firm. A firm, which can get bank credit easily a favorable conditions, will operate with less working capital than a firm without such a facility.

6. Operating Efficiency

The operating efficiency of the firm relates to the optimum utilization of resources at minimum costs. The firm will be affectively contributing in keeping the working capital investment at a lower level if it is efficient in controlling operating costs and utilsing current assets. The use of working capital is improved and place of cash conversion cycle is accelerated with operating efficiency. Better utilization of resources improves profitability and, thus, helps in releasing the pressure on working capital. Although it may not be possible for a firm to control prices of materials or wages of labour, it can certainly ensure efficient use of its materials, labor and other resources.

7. Price level changes

The increasing shifts in price level make functions of financial manger difficult. He should anticipate the effect of price level changes on working capital requirements of the firm. Generally, rising price levels will requires a firm to maintain higher amount of working capital. Some levels working current assets will need higher investment when prices are increasing. However, companies which can immediate rise levels will not face a severe working capital problem. Further, effects of increasing general price level will be felt differently by with firms as individual prices may move differently. It is impossible that some companies may not be affected by rising prices others may be badly hit by it.

Thus, effect of rising prices will be different for different companies. Some will face no working capital problem, while working capital problems of others may be aggravated.

2.2.4 Issues in working capital Management

Working capital management refers to the administration of all aspects of current assets, namely cash, marketable securities, debtors and (stock) inventions and current liabilities. The financial manager must determine levels and composition of current assets. He must see that right sources are tapped to finance current assets, and many current liabilities are paid in time.

There are many aspects of working capital management which it make it an important function of the financial manager.

Time working capital management requires much of the financial manger's time.

Investment working capital represents a large portion of the total investment in assets.

Criticality working capital management has great significance for all firms but it is very critical for small firms.

Growth the need for working capital is directly related to the firm's growth.

Working capital management is critical for all firms, but partially for small firms. A small firm may not have much investment in fixed assets, but it has to invest in current assets, small firms in India face a severe problem of collecting their debtors (book debts or receivables). Further, the role of current liabilities in financing current assets is for more significant in case of small firms, as unlike large firms, they face difficulties in raising long-term finances.

There is direct relationship between affirms growth and its working capital needs. As sales grow, the firm needs to invest more in inventories and debtors. There needs become very frequent and fast when sales grow continuously. The financial manger should be aware of such needs and finance them quickly. Continues growth in sales may also require additional investment in fixed assets.

It may, thus, be concluded that all relations' should be taken for the effective and efficient management of working capital. The finance manger should pay particular attention to the levels of current assets & the financing of current assets.(Financial Management, I.M Pandey. 8th edition)

2.2.5 Estimation Working Capital needs

The most appropriate method of calculating the working needs of a firm is the concept of operating cycle. However, a number of other methods may be used to determine working capital needs in practice. We shall illustrate here three approaches which have been success fully applied in practice:

Current assets holding period- To estimate working capital requirements on the basis of average holding period of current assets & relation them to costs based on the company's experience in the previous year. This method is essentially based on the operating cycle concept.

Ratio of Sales – To estimate working capital requirements as a ratio of sales on the assumption that current assets change with sales.

Ratio of Fixed investment – To estimate working capital requirement as a percentage of fixed investment.

2.2.6 Source of Finance

A firm can adopt different financing policies vis' – a-vis' current assets.

Three types of financing may be distinguished:

1. Long – term financing – The source of long-term financing include ordinary share capital. Preference share capital, debentures, long-term borrowings from financial institutions and reserves and surplus (retained earnings)

2. Short – term Financing – The short term financing is obtained for a period, less than one year. It is arranged in advance from banks and other suppliers of short –term finance in the money market. Short-term finance in clued working capital funds from banks, public deposits, commercial paper, factoring of receivable etc.

3. Spontaneous Financing - Spontaneous financing refers to the automatic sources of short term funds arising in the normal course of a business. Trade (suppliers') credit and outstanding expenses are examples of spontaneous financing.

There is no explicit cost of spontaneous financing. A firm is expected to utilite these source of finance to fullest extent. The real choice of financing current assets, one the spontaneous source of financing have been fully utilized, is between the long-term and short –term source of finances.

Depending on the mix of short-term and long –term financing, the approach followed by a company may be referred as:-

- Matching approach
- Conservative approach
- Aggressive approach

Matching approaches

The firm can adopt a financial plan which matches the expected life assets with the expected life of the source of funds raised to finance assets. Thus, a ten year loan may be raised to finance a plant with an expected life of ten years; stock of goods to be sold in thirty days may be financed with a thirty –day commercial paper or a bank loan. The justification for the exact matching is that, since the purpose of financing is to pay assets, the source of financing & the asset should be relinquished simultaneously. Using long-term financing for short –term assets is expensive as founds will not be utilized for the full period. Similarly, financing long-term assets with short-term financing is costly as well as inconvenient as arraignment for the new short term financing will have to be made on a continuing basis.

When the firms follows matching approach (also known as hedging approach), long term financiering will be used to finance fixed assets and permanent current assets and short –term to finance temporary or variable current assets. However, it should be realized that exact matching is not possible because of uncertainty about the expected lives of assets.

Conservative approach

A firm in practice may adopt a conservative approach in financing its current and fixed assets. The financing policy of the firm is said to be conservative when it depends move on long –term funds for financing needs. Under a conservative plan, the firm finances its permanent assets and also a part of temporary current assets with long-term financing. The periods when the firm has no need for temporary current assets. The idle long-term funds can be invested in the tradable securities to conserve liquidity. The conservative plan relies heavily on long –term financing and, there for, the firm has less risk of facing the problem of shortage of funds.

Aggressive approach

A firm may be aggressive in financing its assets. An aggressive policy said to be followed by the firm when it uses more short-term financing than warranted by the matching plan. Under an aggressive policy, the firm finances a part of its permanent current assets with short-term financing. Some extremely aggressive firms may even finance a part of their fixed assets with short-term financing.

Short-term Vs. Long-term financing: A risk-return Trade-off

A firm should decide whether or not it should use short-term financing. If short-term financing has to be used, the firm must determine its position in total financing. This decision of the firm win be guided by the risk-return trade-off.

Short-term financing may be prepared over long-term financing for two reasons.

I, the cost advantage and

II, Flexibility, but short term financing is more risky than long-term financing.

2.2. Empirical Studies

Many researchers have studies working capital from different views and in different environment. The following.

(Eljelly, 2004) indicated that efficient liquidity management involves planning and controlling, current assets and current liabilities in such a manner they eliminates the in ability to meet due short term obligation and a voids excessive investment in these asset. The relation between profitability and liquidity was examined as measured by current ratio and cash gap (cash conversion cycle) on a sample of joint stock companies in save; Arabia using correlation and regression analysis. The study found the cash conversion cycle was more important as a measure of liquidity tan current ratio that affects profit ability. The site variable was found to have significant effect on profitability as the industrial level. The results were stable and has important implication for liquidity management in various saved; companies. First it was clear that there was a negative relation ship between profitability and liquidity indicator such as current ration and cash gap in the saved; sample examines second the study also revealed that there was great variation among industries with respect to the significant measure of liquidity.

(Deloof, 2003) discussed that most firms had a loss amount of can in working capital. It can therefore be expected that the way in which working capital is managed will have a significant impact on profitability of this firms wing correlation and regression tests. The researcher found a significant negative relationship between gross operating income and number of days account receivables, inventories and account payable of Belgians firms. On the basis of their results be subsists that mangers could create value for their shareholders by reducing the number of day account receivables and inventories to are asonable minimum. The negative relationship between account payable and profitability is consisted with the view that less profitable firms wait longer to pay the bills

2.3 Conclusion and Knowledge gap

AThe objective of (Eljelly, 2004) is to meet due short – term obligation and avoids excessive investment in the assets. Method used is sampling by using and regression analysis. The researcher found that the cash conversion cycle was more important as a measure of liquidity than current ratio.

(Delof, 2003) also use correlation and regression analysis. And found as significant negative relationship between gross operating income and number of days account receivables. But, the objectives of this research to investigate the impact of working capital management of the company on liquidity and profitability and use a sampling method.

CHAPTER THREE

RESEARCH METHODOLOGIES

3.1 INTRODUCTION

This chapter deals with methodology of the study. It includes research design, research approach and research methods, and data collection technique, population and sample size. Sampling method and also, data analyses technique.

3.2. Research design

According to Creswell john (2009) search design is the set of method and procedure used in connecting analyzing measure of the variable specified in the research problem. Also it mean area work that has been created to find answers to research questions

3.3. Data source and type

The researchers used secondary data. Secondary sources are ABC analysis (categorize inventory), financial statements, documents etc. The later included secondary information which include written documents and companies financial statements.

3.4. Data collection technique

The study used secondary data. Secondary data obtained from financial records and financial statements hawasa flour Factory. Focused finance department, inventory management department, and, marketing department.

. The data collection techniques in addition to documentary analysis and financial statements. .

3.5. Population and Sample size

Population means all member that meet the specification or a specified criterion .It is so difficult to study selected department of the company due to the consumption of time and financial resources. So to make effective the study the researcher used the samples that are small number of the total population. So in hawasa Flour Company there are three departments related with this study. These are the financing department, marketing department and inventory management department.

3.6 sampling method

Those departments selected by using purposive sampling method because they are small in number.

3.7. Sampling design

The sampling technique of this study based on judgmental sampling of non-probabilistic sampling technique. The reason behind selectness this technique is;

- It enables the researchers to freely that best fits to the questions
- It will consume less time to get respondents

CHAPTER FOUR

DATA ANALYSIS AND PRESENTATION

4. RESULTS AND DISCUSSIONS

4.1 LIQUDITY MEASURE

Position of factory is shown using different liquidity ratios which are useful to judge a company's ability to meet short-term obligations. The following basic liquidity measures are used to compare financial position of Awassa flour Share Company for past three year's balance sheet if used as source of data.

4.2. Net working Capital

Net working capital is one of the most commonly cited financial ratios to meet firm's short-term obligation, which is denoted as current assets minus current liabilities and it expresses the difference between the two. Networking capital = current asset – Current liability

Table-1 Net working capital

Year	**2004**	**2003**	**2002**
Current Asset (CA)	11,843,337	11,764,403	10,837,928
Current liability (CL)	7,988,154	8,971,714	5,755,410
CA – CL	3,855,183	3,692,689	5,082,518

Source: Balance sheet from year (2002 – 2004)

As above table shows the company's networking capital for past three years was positive. However, current asset and liability have been increasing not in the same rate. For year 2004 current asset was increased from year 2003, and 2003 current asset increased from year 2002. But current liability decreased from year 2003 to 2004.

Positive networking capital shows that current asset is greater than current liability. From this researcher concluded that the greater margin by which the company's current assets cover its short-term obligation, the better able it to pay its debt as they come due in generally the company has been showing good position in meeting its current liability.

4.3. Current Ratio

Current ratio is one of the most commonly cited financial ratios to meet the firm's short-term obligations when and as they fall due or at maturity. It expresses the relationship between the firm's current assets to current liability.

$$\text{Current ratio} = \frac{\text{Current asset}}{\text{Current liability}}$$

Then, it can be interpreted as, for one birr of current liability as if how much the companies birr could able to present from its current asset. (Financial management I.M pandey, 2005)

Table-2 Current ratio

Year	**2004**	**2003**	**2002**
Current assets (CA)	11,843,337	11,764,403	10,837,928
Current liability (CL)	7.988.154	8.071.714	5.755.410
$\frac{CA}{CL}$	1.5	1.4	1.9

Source: Balance sheet of AFSC from (2002-2004)

The greater margin by which firm's current assets covers its short-term obligation, the better able it will be to pay bills as they come due. In general the liquidity position of firm is0 relatively weak respectively.

4.4 Quick Ratio

This ratio is some what more accurate guide to liquidity and it is the same as current ratio except that it excludes inventory which is least liquid asset. (Financial management I.M Pandey, 2005)

$$\text{Quick ratio} = \frac{\text{Current asset – Inventory (CA-I)}}{\text{Current liability}}$$

Table-3 Quick (acid test) ratio

Year	**2004**	**2003**	**2002**
CA – Inventory	6.251.301	5.081.577	3.814.246
Current liability	7.988.154	8.071.714	5.755.410

Quick ratio	0.85	0.63	0.66

Source: Balance sheet of AFSC from year (2002-2004)

The quick or acid test ratio of 1.0 or greater is occasionally recommended, but as with current ratio an acceptable value depends largely on the industry, this ratio provides a better measure of over all liquidity only when a firm's inventory can not be easily converted in to cash. Inventories are typically the least liquid of firms current assets, thus they are the assets on which losses are most likely to occur in the event of liquidation. Therefore, a measure of firm's ability to pay off short-term obligation with out relying on the sale of inventory is important.

From general over view of the above note it was seen that the quick ratio of the firm was below the general standard and this implies the company can not be able to pay off its creditors in time due to larger proportion of stock in current assets. On the other hand there was a large part of current asset of the firm which is tied up in slow-moving and unsalable inventories and slow paying debts. Therefore, less liquidity assets than current liabilities makes the firm's financial position concern shall be demand to be unsound.

4.5. Profitability and risk trade off

The effect or changing the levels of the companies' current assets on its profitability and risk trade off can be demonstrated by using the ratio of current assets (CA) to total asset (TA)

Table-4 Ratio of CA to TA

Year	**2004**	**2003**	**2002**
CA	11,843,337	11,764,403	10,837,928
TA	12,645,125	12,629,221	11,739,188
CA/TA	0.94	0.93	0.92

Source: Balance sheet of AFSC from (2004-2002)

As above table 4. Indicates, the ratio of current asset to total asset is increasing Via out the given trend. This shows the amount of total asset of the firm has been declining throughout the period; therefore, the profitability of the company has been also declining relatively. This is mainly due

to total asset is more profitable than current asset, when ever, the current asset increases while the fixed asset decreases or remain a constant. Then, CA to TA ratio increases,. As above result shows, the amount of fixed asset of the firm is very less and this implies that the company become less profitable, that contributes a lot to generate revenue. The risk effect decreased as the ratio CA to TA increase because the risk and profitability are directly proportionate.

Table-5. Ratio of current liability (CL) to total asset (TA)

Year	**2004**	**2003**	**2002**
CL	7988154	8.071.714	5755410
TA	12645125	12629221	11739188
CL/TA	0.6	0.6	0.5

Source: Balance sheet of AFSC from year (2002-2004)

Based on the above table 5. The effect of changing the level of factory's current liabilities on its profitability and risk trade off can be demonstrated. When the ratio of current liability to total asset decrease the profitability and risk are also decrease. The ratio of CL to TA of the company which was under study is increasing from year to year from 2002 – 2003 so, the profitability and risk trade off also increase in the same manner, this is because the firm may uses more of less expensive current liabilities and short-term financing.

4.6 Cash Management

A company needs cash to carry day to day activities of the business. Companies' level of operation affects working capital requirement, it affects the need for cash.

Table-6 Cash and Sale figures

Year	**2004**	**2003**	**2002**
Cash balance	3751630	2185662	224564
Total Sale	10591035	8645383	6802431

Source: Balance sheet and Income statement of (2002-2004)

If the volume of sale increase, cash will be received from customers and expanded for materials and wages in large amount, as shown in the table 6 above the sale from year 2002 – 2004 has been increasing to cover the transaction needs. Therefore, the company's ability to pay its bills would have been increasing meaning the company improving its cash management from the year 2002 – 2004.

From the above table the amount of cash balance increases from year to year that is from 2002 – 2003. Based on this it is simply to conclude that as a result of increase in sale from year to year and increase in cash balance from year to year the company has moderate cash management,

4.7 Receivables Management

Receivables are asset accounts representing amount owed to the company as a result of the sale of goods and service in the ordinary course of business. For this reason, its funds are unnecessarily locked up in receivables. The following are ratios used for meaning the liquidity of the company's account receivables (A/R)

4.7.1 account receivable turn over

$$\text{Account receivable Turnover} = \frac{\text{Credit sale}}{\text{Average A/R}}$$

$$\text{Average account} = \frac{\text{Beginning balance + Ending balance receivable}}{2}$$

Table -7 Receivable turn over

Year	**2004**	**2003**	**2002**
Credit sale ss	7850739	6460988	6578879
Average Account receivable	3197793	3022727	4385919
Average receivable turn over	2.4	2.1	1.5

Source: Balance sheet and I/statement of (2002-2004)

The receivables turn over ratio is the comparison of the size of the company's sale and size of uncollected bills from customers. If the company having difficult in collecting its money, there will be large receivables balance but has low turn over ratios. To show the accurate picture of turn over ratio of company, the average receivables are taken in the above table 7.

The receivable turn over in the year 2004 is more rapid than others. Even though, the company increases receivable turn over from year to year to take advantage of strict collection policy, there may be losing of future sale due to high pressure collection policy or techniques. This in return results in the shift of customers to another firm, because payment in a short period of time is difficult when it compared with more extended time. As the loss of future sale increases, then, the firm will be come unjustifiable of economy.

The most measure for liquidity of receivables is average collection period (ACP) which compares the receivable balance with daily sales requirement.

Average collection = Account receivable x 365 days period

Total Sale

Table-8 Average collection period

Year	**2004**	**2003**	**2002**
Account receivable	3499671	2895915	3589682
Total sales	10591035	8645383	6802431
Average collection period	120 days	122.3 days	192 days

Source: Balance sheet and Income statement (2002-2004)

The shorter the average collection period, is the better quality of debtors from the above table 8, researcher can clued that company used best collection period in year 2004 as compare to others. The decrease in average collection period in year 2004 was resulted from receivable managing activity of the firm. That is the company has been improving the management of receivables for successive years.

4.8 Inventory Management

The management of inventory has an impact of the cash cycle of the company. Poor inventor management will results in an illiquid company that must continually borrow in order to have enough operating cash on hand. Inventory turn over ratio measures how quickly the inventory is sold. It is the test of efficient inventory managements.

$$\text{Inventory turn over} = \frac{\text{Cost of goods sold (CGs)}}{\text{Average inventory (AV,Inv)}}$$

$$\text{Avg. Inventory} = \frac{\text{Beginning balance + Ending balance}}{2}$$

Table-9 Inventory turnover ratio

Year	**2004**	**2003**	**2002**
CGs	5501195	4140846	4155678
AV. INV	6137431	6634607	7024131
Inv. Turn over ratio	0.896	0.624	0.592

Source: Balance sheet and I/statement of year (2002-2004)

Low ratio of inventory turn over shows that the company is incurring high costs from over stocking finished goods at the same time the company is carrying obsolete goods in its inventory. In the above table 9 the company is on the way of improving its inventor turn over ratio by increasing from year to year. is shows the company's incurring cost is being reduced relatively. But is not saying that the enterprise become effective in inventory management. Still it is in the position of in adequate inventory management due to over holding of stock in the store.

So as to see specifically for how much time inventories are converted in to cash or account receivable is shown in the table below

Table-10 Inventory conversion period (ICP)

Year	**2004**	**2003**	**2002**
Days	365	365	365
Inventory turn over	0.896	0.624	0.592
ICP	407 days	585 days	617 days

Source: Inventory conversion formula and Inv. To taken from table 12

Inventory conversion = $\frac{365 \text{ days}}{\text{Inventory turnover}}$

Although the inventory conversion period decreases from year to year accordingly, it takes more than one year to convert it in to cash. The over
stocking of inventory for long period of time indicates that the presence of unresolved conflict between the marketing and finance function. In other cases the marketing depart has responsibility to facilitate the inventory to be converted in to cash, there fore there is weak side of it. And finally the company's position of inventory management was not good.

CHAPTER FIVE

5. Conclusion and Recommendation

5.1 Conclusion

Awassa flour Share Company is manufacturing enterprise which aims to maximize its profit. So as to achieve such objective, management of working capital is very important. It is known that proper working capital management used to company to achieve adequate liquidity, but the factory lacks sufficient cash to pay its bills when they come due because of over stocking inventory for long period and liabilities among current account is task of minimizing the risk of insolvency but decreases the profitability effect of the enterprise. The result of overall liquidity ratio analysis also reveals the fact that almost all of the ratios calculated show the deteriorating trend over the past three years. Thus, from these and other facts. It can be said that the working capital management of company over past three years was poor.

5.2 Recommendations

On the basis of analysis and interpretation there are problems which hinder the smooth flow of working capital of the company. The researcher gave the following recommendations as a solution that assumed to avoid or reduce identified problems.

Current ratio and quick ratios of the company are below the range of 2.0 and 1.0 respectively. So, the company should increase its current asset over current liability and decrease the amount of stock to meet its current obligation and to its run business in future.

The company takes more than one year to convert inventory or over stoking (keeping unnecessary inventory in store). This results in shortage of cash. Therefore, the company should minimize over stock to maintain the balance of cash needed for transactions, besides to meet its current liabilities when comes due.

Credit policy of the company has been improving in trend, more or less the company is in position of following strict collection policy. This results in the loose of its customers, because the shorter collection period is more difficult to pay who compared it with more extended collection period. Therefore the company should consider both its customers and bad debt of receivables if the time is extended. So, the company should use moderate credit policy.

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