INCREASING IMPORTANCE OF WORKING CAPITAL IN THE CONDITIONS OF CURRENT ECONOMIC CRISIS

CREŞTEREA IMPORTANŢEI FONDULUI DE RULMENT ÎN CONDIŢIILE ACTUALEI CRIZE ECONOMICE

DIANA TĂGĂDUAN[1], CRISTINA NICOLAESCU[1]

[1]"Aurel Vlaicu" University Arad, Romania; dianatagaduan@yahoo.com

Abstract: *The economic crisis that comprised the whole world didn´t leave the Romanian companies unaffected. The policy of working capital adopted by the companies might prevent or diminish the negative effects of the crisis, improving the liquidity and the cash-flow of the companies.*

Key words: *working capital, crisis, liquidity*

INTRODUCTION

The study of the working capital and of the policy of the working capital is a very important domain especially in conditions of economic crisis. This paper aims to reveal the fact that in special conditions such as those of economic crisis, the policy of financing the operating cycle must be changed and that the role of the working capital as a safety element in financing necessities for short-term in these conditions grows a lot.

MATERIALS AND METHODS

The working capital can be defined either on the basis of the elements at the top of the balance sheet or of the elements at the bottom of it. Based on the elements at the top of the balance sheet, the working capital can be difined as being the surplus of the permanent capital over the net worth capital. Starting from the elements at the bottom of the balance sheet we can talk about the net working capital and the gross working capital. The gross working capital equals the current assets (stocks, debts and available) and the net working capital equals the difference between the current assets and debts of the operating cycle (debts on short term).

Further on we can talk about the policy of the working capital. Working capital policy refers to the firm´s policies regarding target levels

for each category of current assets that will be financed. [1] Actually, the policy of the working capital includes three alternatives regarding the finance of the current assets, namely:

- an aggressive policy that aims to carry on the activity financing the current assets on the basis of short-term debts and not on the basis of the working capital. This policy supposes a high profitability which arises from the fact that most short-term debts have a low cost or are free sources (for example debts to suppliers that are mostly free of charge), but at the same time a high risk generated on the one hand by the need for these debts to be renewed periodically and on the other hand by the short term in which these debts have to be repaid. Conventionally, it has been seen that if a company desires to take a grater risk for bigger profits and losses, it reduces the size of its working capital in relation to its sales[2];
- a prudent policy which seeks to finance the current assets on the basis of the working capital released on the top of the balance sheet. This policy supposes that the company has permanent funds that exceed the immobilizations of capital. In this case the profitability is lower because of the cost of financing the current assets, but the risk is also lower because there´s no need to permanently renew the sources of financing and the company can very easily deal with unexpected events (as for example the slowing rotation of current assets or even not collecting some debts having direct effects on the possibility of paying the debts). A business that has no working capital or very little working capital will likely have difficulty in paying short-term debt obligations from operational sources of cash in sustained or sudden declines in sales;
- a moderate policy that stands between the two extremes and which supposes that the financing of current assets to be made both on the basis of the working capital as well as on the bases of some short-term resources, either drawn or borrowed.

What is really important, is that the managers, those who manage the small sized companies to understand the importance of correct proportioning of the working capital in the sense of mantaining the best level of it. The financial crisis that overcame the international financial market starting from the summer of 2007, affected the majority of companies. Strategies which can be adapted within the firm to improve liquidity and cash-flows concern the management of working capital and cash management, areas which are usually neglected in times of favourable

business conditions. Indeed if we look at the situation of Romanian companies during the economic crisis we can observe the importance of ensuaring the liquidity necessary for running the operating cycle, liquidities that can be ensured on the basis of own working capital or of the borrowed working capital. In conditions of economic crisis, the policy of the working capital should be adapted to new requirements. This way the whole strategy of financing the operating cycle should be modified in the sense of increasing the share of financing on the basis of the working capital towards the policy adopted during favorable economic conditions, when the accent is mainly on financing mostly from attracted sources. The companies that weren´t ready for using this type of financing were the first to be affected by the economic crisis. The most conclusive example is that of the companies from the pharmaceutical industry. Thus we performed an analysis in which, because of the lack of adjustment of the funding strategies, some of these companies weren´t able to fund the operating cycle and got into insolvency and bankruptcy.

RESULTS AND DISCUSSIONS

From the result of the conducted analysis regarding the influence of the economic crisis on the companies from the pharmaceutical industry, which we assumed they were unprepared in terms of working capital strategy adopted, we could really see how they have been badly affected primarily because they used the resources attracted as main source of financing the operating cycle, so an agressive policy of working capital. Among those affected were the pharmacies that used favorable gaps between receipts and payments for financing their operating cycle. In 2009 the Health Insurance Fund decided to increase the terms of payment of invoices to 210 days. During this period, almost 4 months, the Health Insurance Funds have not made any payment to pharmacies, the latter facing a shortage of money necessary for paying the operating costs of the pharmacy. In these circumstances, even if the pharmacies in turn delayed payments to suppliers, most of them have restored to bank loans to cover the operating costs, as well as for paying taxes and duties for the uncollected invoices from the Health Insurance Funds. This was the most difficult period for pharmacies, given the fact that not all of them were able to

contract long-term loans to cover their expenses, being actually the period when the pharmacies got into insolvency or bankruptcy.

If these companies would have anticipated this lack of liquidity and would have maintained the previous year´s profit for increasing the working capital for financing their expenses from resources of their own without relying on collection of debts, they would not have faced this problem.

Even if the Health Insurance Funds resumed payments to pharmacies starting with January 2010, the long terms of payment continued to affect the cash flow of pharmacies. But not only the pharmacies were affected by very long payment terms, also other operators in the market: wholesale distributors and manufacturers of medicines. Being in the impossibility of recovering money for the goods supplied for pharmacies, the distributors have been forced , due to diminishing liquidity, to increase in their turn, the terms of payment of the pharmacies, reaching to at least 210 days, as the legal terms are stipulated in the contracts of pharmacies. Thus, the distributors assumed in their turn some of the financial impact of the extension of terms of payment, meeting some costs.

Of course not only the pharmacies were those which, due to neglecting the policy of the working capital, couldn´t counteract the effects of the economic crisis. The examples could continue with companies from various fields of activity.

CONCLUSIONS

The companies should revise their funding strategies and implement a proper policy of the working capital adapted to special conditions from the economic and financial crisis periods and thus prevent a situation where they may become victims of this crisis.

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