



INTERNATIONAL JOURNAL OF RESEARCH IN COMMERCE AND MANAGEMENT

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WORKING CAPITAL MANAGEMENT AND PROFITABILITY – A CASE STUDY OF ANDHRA PRADESH POWER GENERATION CORPORATION

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ABSTRACT

Working capital management is important component of financial management. Usually it is found that short term management of capital is ignored, consequently leading to failure of businesses. Thus the study focus to make item wise analysis of each component of Gross Working capital for APGENCO using percentages and examine the impact of Working capital on profitability by using statistical tool such as Correlation analysis for the study period of 2005 to 2010. In the analysis working capital ratios such as current ratio, Liquid ratio, working capital turnover ratio, Inventory turnover ratio, receivables turnover ratio, cash turnover ratio and Return on Investment ratio has been used. The study found that Debtor share a major proportion of gross working capital and cash balances has been ignored by the company. Further WTR and DTR showed a high degree of positive correlation and CR, LR, and ITR showed a high degree of negative correlation between variables and profitability. Hence, the study of the impact of working capital ratios on profitability showed both negative and positive impact.

KEYWORDS

Working capital, Current assets, Debtor, Inventory, Cash.

INTRODUCTION

The funds required either to pay for expenses or to meet obligations for goods or services Purchased by the firm are known as working capital. According to shubin "working capital is the amount of funds necessary for the cost of operating the enterprise." Managers can create profits for their companies by handling optimal level of cash conversion cycle and keeping each different component (accounts receivables, accounts payables, inventory) to an optimum level. According to Deloof "the way that working capital is managed has a significant impact on profitability of firms". This result indicates that there is a certain level of working capital requirements which potentially maximizes returns. Gill & et al, found that the management of working capital may have both negative and positive impact of the firm's profitability, which in turn, has negative and positive impact on the shareholders' wealth. Therefore there is a negative relationship between profitability of a firm and cash conversion cycle, thus it is possible to increase firm's profitability through more efficiency of working capital management. In case of the process of an asset-liability mismatch may occur which may increase firm's profitability in the short-run but at a risk of its insolvency.

ABOUT THE POWER INDUSTRY IN INDIA

India is the fifth largest electricity generation capacity in the world. The total installed capacity of India is -150,000 MW, of which the majority of generation, transmission and distribution capabilities lie either with public sector companies or with State Electricity Boards (SEBs). The overall power generation in the country has increased from 723.793 billion unit (BU) during 2008-09 to 771.551 BU during the year 2009-10. In the month of August 2011, the Total Installed Capacity of state, central and private sector is 181,558.12. The power is generating through various sources such as Thermal, Hydro (Renewable), Nuclear, Renewable Energy Sources, each contributing a percentage of 65.21, 21.04, 2.63, and 11.10 respectively.

ABOUT APGENCO

Andhra Pradesh Power Generation Corporation Limited (APGENCO) is the electricity generation company of the Government of Andhra Pradesh state in India. APGENCO came into existence on 28.12.1998 and commenced operations from 01.02.1999 after unbundling the activities relating to Generation, Transmission and Distribution of Power. The installed capacity of APGENCO as on 30.01.2011 is 8384.9 MW comprising 4382.50 MW Thermal, 3790.40 MW Hydro and 2 MW Wind power stations, and contributes about half the total Energy Requirement of Andhra Pradesh. It is the Third Largest Power Utility in India and Second highest Hydel Installed Capacity in India. Apart from operation & Maintenance of the power plants it has undertaken the execution of the ongoing & new power projects scheduled under capacity addition programme and is taking up renovation & modernization works of the old power stations. APGENCO has an equity base of Rs.2107 crores with 11,000 dedicated employees as on 30.06.2009. The company has earned a net profit of Rs.288.66 crores as against a profit Rs.246.46 Crores for the previous year 2008-2009.

OBJECTIVES OF THE STUDY

Working capital management is important component of financial management. Usually it is found that short term management of capital is ignored, consequently leading to failure of business. The study has the following objectives:

1. To make item wise analysis of each component of Gross Working capital using percentages.
2. To examine the impact of Working capital on profitability by using statistical tool such as Correlation analysis.

METHODOLOGY

In this paper an effort has been made to make an empirical study of Andhra Pradesh Power Generation Corporation. For this study the third largest power utility in India namely APGENCO has been purposively selected evaluating the impact of working capital on its profitability during the period of 2005 to 2010. The following are the methods and techniques adopted for collection of data and their analysis in this study.

COLLECTION OF DATA

The data of APGENCO has been availed from secondary sources such as annual reports of the company and CMIE proccess database for the period of 2005 to 2010.

VARIABLES

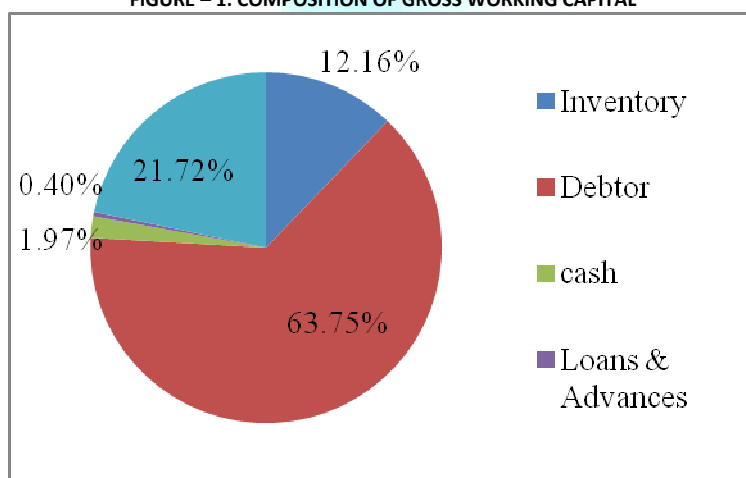
In the study, working capital ratios such as current ratio, Liquid ratio, working capital turnover ratio, Inventory turnover ratio, receivables turnover ratio, cash turnover ratio and Return on Investment ratio has been used. The statistical test such as simple correlation analysis has been applied to explain the relation between working capital ratios and profitability. The Ratio used can be explained below:-

- Current Ratio = Current asset/Current liabilities
- Liquid Ratio = Quick asset/Current liabilities
- Working capital Turnover = Cost of Goods sold/Net Working Capital
- Inventory turnover Ratio = Cost of goods sold/ average Inventory
- Debtor turnover Ratio = Total Sales/Average Receivables
- Cash Turnover Ratio = Cost of Goods Sold (excluding depreciation)/Cash
- Return on Investment = Net Profit x 100 / Capital employed
- Capital employed = Net fixed assets + Working capital

DATA ANALYSIS AND INTERPRETATION: COMPOSITION OF GROSS WORKING CAPITAL

The variable wise analysis of gross working capital will enable to examine in which each element the gross working capital funds are locked in. The Table – 1 exhibit the share of each variable calculated in percentages for each year of the study period and the averages of the six year time period are calculated for each component of gross working capital.

FIGURE – 1: COMPOSITION OF GROSS WORKING CAPITAL



Note: Average percentages from 2005 to 2010.

The average inventory represents 12.16% of the gross working capital. The debtors contribute highest with 63.75% of the total current assets. The debtors have moved from 84.59% in 2005 to 63.75% in 2010. Excess funds in the debtor may lead to more bad debts and losses. This indicates that collection of debtors should speed up to increase efficiency. The most of the funds are locked in Sale of Power within State, Inter-state Sale of Power and O&M Contracts. The due from APTRANSCO represents 95% or more of the total debtors. Debtors for sale of power to DISCOMS are subject to review and reconciliation pending finalization of power purchase agreement as per APERC Orders. Therefore this may not give a correct picture of the financial position of the company. The cash balance was recorded a Minimum of 0.69% in 2005 and maximum is 2.90% in 2010 with an average of 1.97% for the study period. The company has not maintained required level of cash balance during the study period and this may pose harm to the liquidity of the company. The Loans and advances contribute 0.40% of the gross working capital which is merely negligible part of the gross capital. It has showed a declining trend from 0.93 in 2005 and 0.09 in 2010 with an average of 0.40. Lastly other current assets contribute 21.72% of gross working capital.

TABLE – 1: COMPOSITION OF GROSS WORKING CAPITAL (IN CRORES)

Year	Inventory	Debtor	Cash	Loans & Advances	Other current assets	Total
2005	228.31 (10.51)	2031.61 (84.59)	16.81 (0.69)	22.43 (0.93)	102.42 (4.22)	2401.58 (100)
2006	288.85 (10.85)	1979.44 (74.36)	70.72 (2.65)	24.27 (0.91)	298.46 (11.21)	2661.74 (100)
2007	262.39 (10.66)	1656.65 (67.35)	37.08 (1.50)	9.29 (0.37)	494.00 (20.08)	2459.41 (100)
2008	393.88 (13.75)	1489.17 (51.98)	39.82 (1.39)	5.36 (0.18)	936.18 (32.68)	2864.41 (100)
2009	430.94 (12.51)	1698.27 (49.33)	69.74 (2.02)	4.75 (0.13)	1238.52 (35.98)	3442.22 (100)
2010	577.17 (14.05)	2578.60 (62.80)	119.32 (2.90)	4.08 (0.09)	826.78 (20.13)	4105.95 (100)
Total	2181.54 (12.16)	11433.74 (63.75)	353.49 (1.97)	70.18 (0.40)	3896.36 (21.72)	17935.31

Source: compiled Annual Report of the firm

IMPACT OF WORKING CAPITAL ON PROFITABILITY

The co-efficient of correlation between selected ratios relating to working capital management and ROI of Andhra Pradesh Power Generation Corporation is presented in Table 2. The current ratio of APGENCO has declined from 2.08 to 1.36 from 2005 to 2010. The liquid ratio has also decreased from 1.87 to 1.17 for the same period. The mean of CR and LR is 1.7 and 1.5 respectively. These two ratios have been consistently decreasing throughout the study period. Except for 2005 and 2006 there values of current ratio was lower than the ideal value of 2:1. The relationship between current ratio, liquid ratio and profitability showed a high degree of negative association of -0.949 and -0.954 respectively. This means that the increase in current asset will decrease profitability and vice-versa. The correlation between profitability and Working capital turnover ratio, debtor turnover ratio shows a high degree of positive association of 0.802 and 0.796

respectively. It therefore denies the generally accepted rule that the higher investment and greater is the profitability conforms to principle larger the turnover, the lower is the relative investment and greater is the profitability. There is a moderate negative correlation between cash turnover ratio and profitability of -0.485. The high turnover of

TABLE - 2: SIMPLE CORRELATION ANALYSIS BETWEEN SELECTED RATIOS RELATING TO WORKING CAPITAL MANAGEMENT AND PROFITABILITY

Year	CR	LR	WTR	ITR	DTR	CTR	ROI
2005	2.08	1.87	2.29	12.95	2.14	154.69	0.51
2006	2.35	2.08	1.94	11.75	1.93	32.00	0.60
2007	1.73	1.55	2.89	11.62	2.31	67.28	1.27
2008	1.42	1.23	4.14	10.95	2.93	72.91	1.44
2009	1.26	1.10	6.80	9.83	3.90	60.00	1.53
2010	1.36	1.17	4.62	10.15	3.00	36.12	1.60
correlation	-0.949	-0.954	0.802	-0.883	0.796	-0.485	

Source: Compiled Annual Report of the firm

Cash is considered good for the business but at the same time it should be noted that relatively high turnover ratio may not be an indicator. It may indicate that the firm is maintaining a low level of cash. It also indicates that the firm does not possess enough amounts of cash for operational requirements. This explains that larger the cash turnover ratio the greater will be the profit. The association between profitability and inventory turnover ratio is -0.883. The higher the inventory level the lower the profitability, which indicates that there is a high degree of negative relationship between the two. Thus, In the case of APGENCO WTR and DTR showed a high degree of positive correlation and CR, LR, and ITR showed a high degree of negative correlation between variables and profitability. Hence, the study of the impact of working capital ratios on profitability viewed both negative and positive impact.

CONCLUSION

The study has showed both positive and negative relationship between the selected ratios in the area of working capital management and return on investment used as proxy of profitability. The debtor ranged from 84.59% to 63.75% of gross working capital during the study period. Excess funds in the debtor may lead to more bad debts and losses. The Cash balances should be increased to improve liquidity position of the firm. WTR and DTR showed a high degree of positive correlation and CR, LR, and ITR showed a high degree of negative correlation between variables and profitability.

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