FIN722 solved 2nd GDB spring 2013

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MSBA (HRM)

Topic: Working Capital Management

Learning Objective:

Students will be able to understand the analytical aspects of working capital management.

GDB:

Sunrise Corporation is a privately held manufacturing company, which generally deals in leather bags. The company currently has an aggressive working capital policy with regard to the level of current assets it maintains. The company has recently decided to switch from aggressive to conservative working capital policy.

Required:

Discuss the impact of this decision on the company's profitability and risk. Also discuss what might be the motives behind adoption of a conservative policy for the companies like Sunrise Corporation with respect to Pakistan. Your comments should be based on logical reasoning.

Important Notes:

§ Answer should be to the point and logical.

§ Definitions and unnecessary details (just to make the comments lengthy) should be avoided.

Solution:

Sunrise Corporation has decide to change its working capital policy form aggressive to conservative working capital policy in order to bring improvement in its short term financing and working capital, as we know that working capital management plays an important role to determine the relationship between a firm’s short term assets and its short term liabilities. However Sunrise Corporation may reduce the risk by opting high level of investment in current assets and by increasing its liquidity level and encourage long term financing by opting conservative working capital policy. Sunrise Corporation would have experience of having plenty of cash on hand, warehouse of this manufacturing unit is full of inventory and status of payable is up to date after taking decision of switching its working capital policy. Although Sunrise Corporation has reduced its risk but on the other hand profitability suffer, as profitability and risk has same direction and to get greater profit we need to take greater risk. It goes without saying that conservatively managed working capital will lower the risks of short-term cash shortages but might hurt your long-term profitability, because excess cash doesn't earn much of a return. However in current economical condition in the country like Pakistan to take higher level of risk in order to maintain and increase profitability is not a wise decision. In this situation we may consider following motives/reason to change from aggressive to conservative working capital policy.

- Borrowing short term is more risky than borrowing long term
- Increase the level of liquidity
- Support high level of production due to high level of inventory
- Reduce the risk of stock outs which ultimately leads to decrease in sales