Working Capital Management

Code - RMB FM04

Section - 1

(b)

What is profitability - Liquidity Trade off. Explain it ?

profitability :-> A large investment in Current assets would ensure uninterrupted production and Sales. Beside, the firm would have no difficulty in meeting the Claims of its Creditors as and when payment are due.

In other words, firms Can avoid Cash Storage and Stk out Situation, if has a Sound liquidity position.

When the firm maintains higher levels of current assets to maintain high liquidity, a Considered amount of firms.

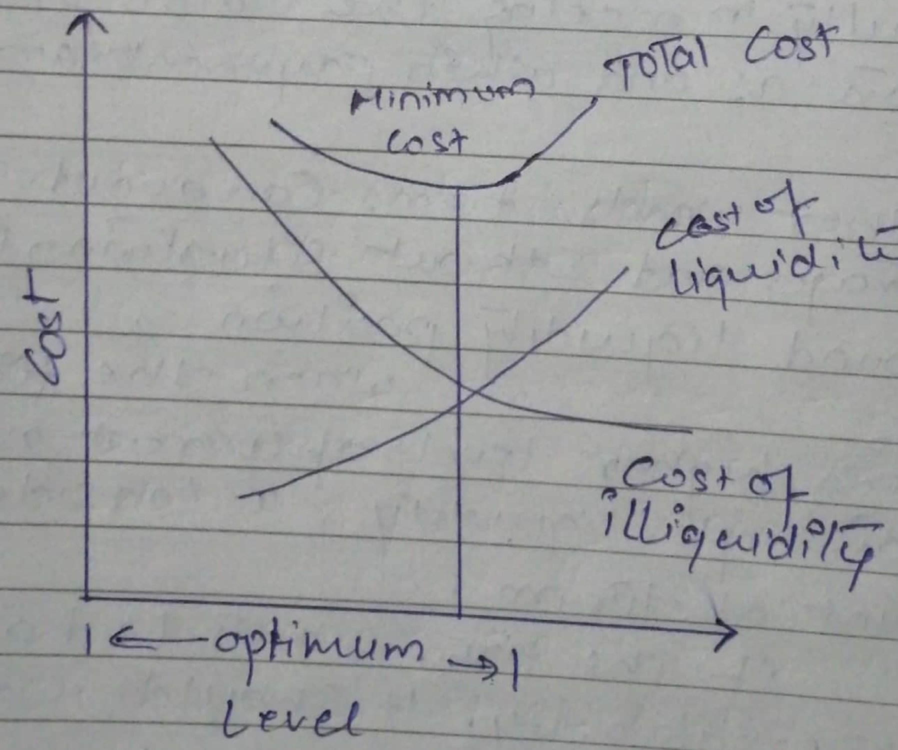
if the firm wants to have higher profitability. It should maintain lower levels of Current assets.

Therefore, firm Should maintain an optimum level of current assets for balancing its probility and liquidity.

There is a define inverse relationship.
b/w the dual obj of profitabilty / liquidity

1. larger investment in current assets with less dependence on short term browwing, increase liquidity and decrease profitability.

2. less investment in C.A with greater dependence on short term borrowing increase the profitability



Level of Current assets

Cost of Trade off

TO maximize Shareholder's wealth, optimum level of Current asset should be determine.

There is always a conflict b/w the liquidity and the profitability objective.

if current assets are held at a level more than the required one, profitability is eroded. if current assets maintained at a level less than required, the solvency of the firm is threatened.

This reduction in profitability can be termed as the cost of liquidity which has a positive correlation with the level of current assets

In case the firm maintain current assets at a level lower than the desire level.

It means that the firm may find difficulty in honouring its commitments are regards repayment obligations.

The optimum level of current assets can be determined by balancing the cost of liquidity and the cost of illiquidity