THE FINANCIAL STABILITY ANALYSIS THROUGH THE WORKING CAPITAL

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Abstract
The main goal of any business is to maintain the financial stability not only on the short term but also on medium and long term, in other words to maintain a harmony between financial sources and financial needs, respectively the equality between the assets and liabilities from the balance sheet. On short term, maintaining the financial stability involves correlating the temporary resources with the temporary uses by using the necessary working capital, and on the long-term, the financial stability involves comparing the permanent resources with the permanent uses by working capital indicator.

The determination of the financial state of the company at a certain moment represents the key moment in establishing and adopting the economic and financial decisions in the management of the company. Maintaining the financial stability of the company represents one of the main objectives of the financial analysis and management and it also provides the optimum development of the entire economic and financial activity of the company. The analysis of the working capital size is based on the financial statement data and information, and based on this analysis is considered the financial situation of the company, the financial equilibrium state at a certain moment.

The purpose of this article is to highlight the fact that the maintenance of the financial stability on medium and long term is subordinated to the “working capital” indicator, its content and interpretation evolving in time and varying differently from one company to another. The results of this research may have broad applicability in the field of the companies’ activity and it materializes in the complex approach of the working capital regarded as a classic indicator, frequently used in the financial analysis and with profound significance in establishing the financial state in general and the equilibrium state in particular.

Keywords: working capital, permanent capital, fixed assets, current assets, liabilities on short term

Clasificare JEL : D5

1. Introduction

The working capital management involves planning and controlling the circulating assets and debts in the short term. The aim is to maintain a level of capital that should be enough to meet the needs of the immediate obligations, but does not constitute any burden unsupported, in economic terms, for the company. Decisions concerning working capital investments differ from decisions concerning investment in fixed assets for several reasons: [7]

a) determining the level of working capital is the result of several decisions: investment, financing and exploitation;
b) the liquidity risk should be taken into account in decisions related to working capital;
c) the working capital can be “stored” in illiquid form.

A first assessment of the working capital is the traditional one that sees it as the margin of safety for business creditors. The origin of this assessment is in the banking practice. Indeed, a banker evaluating an application for credit is concerned to know whether the company will be able to repay the loan at maturity. Thus, the repayment ability is conditioned by the ratio between the assets liquidity and the liability for business debts. [4]

The existence of the working capital represents a margin of safety (the part of the long-term resources that funds current assets) which increases the trust of the funding partners (shareholders and creditors), which in turn will respond, in terms of funding, depending on the strategy established in compliance with certain financial structure designed to maximize enterprise value. In other words, the working capital represents the safety margin of the company, imposed by the differences between the amounts receivable and the amounts payable, and by the gap between the average time of processing current assets into cash and that the average time in which short-term debts become due.
The working capital is an old concept and there were several attempts of explaining it. The working capital is a concept with deep meanings that keeps its original features in the business practice.[12] It refers to the two basic concepts: the gross working capital that refers to current assets and the net working capital calculated as the difference between current assets and short-term liabilities.

The existence of an efficient working capital, especially in the case of companies with production activity, is determined by the fact that in the case of short-term liabilities the probability of their payment is of 100% while, in the case of current assets, the probability of converting them into cash is not always of 100% due to the existence of some non-moving or with slow-moving stocks, as well as some doubtful claims.

2. Types of working capital

In defining the working capital we start from the idea that, in order to be solvent, an enterprise must meet the minimum financial balance rule which requires that the resources used to finance assets remain at the disposal of the enterprise during a period which must correspond to the minimum, to that of restraint. It should be kept in mind that, in particular, the level of posts with duration "of less than one year" generates continue stability changes, according to the permanent transformation of claims and debts. The strict application of the rules on the minimum balance is insufficient in relation to the importance of claims and debts, because of that the company must provide a margin of safety materialized in the working capital. From many definitions of the working capital, we believe that the most important ones is the following: the net working capital represents the surplus of permanent sources that can be used to cover or to finance current assets after the overall financing of the net fixed assets. In other words, the working capital is the part of the permanent capital that exceeds the value of net fixed assets and may be used for financing the current assets.[12]

The working capital can be defined as all the resources needed to finance current production activity of the enterprise. The concept of working capital is one of the most important indicators reflecting the financial stability of the company. Of all the definitions regarding the working capital from the literature, it remains to be discussed and confronted four concepts, among the current ones.

In terms of its content, the working capital can be:

a) the gross, total or economic working capital shows all current assets likely to be converted into cash within a period of less than one year, or to be renewed, to go through the phases of an operating cycle (a rotation, a bearing). As a set of active elements, it consists of: various stocks, customer receivables, advances to suppliers, petty cash, bank accounts, in check books issued and so on). This is the gross working capital, meaning the current assets. The computation formula is:

\[ \text{Gross working capital} = \text{Current assets} \]

\[ \text{Gross working capital} = \text{Stocks} + \text{Claims} + \text{Cash} \]

b) the net or permanent working capital (FRN or FRP) represents the part of the permanent capital that can be used to finance current assets or the current assets surplus within a period less than a year, against debts with chargeability term within less than one year. It is equivalent with net working capital and equal in value with permanent working capital. It is computed in the bottom of the sheet. It is determined based on the relations:

I. a) FRN = (Permanent capital – Depreciation and provisions) – Permanent use in their net worth
   b) FRN = (Permanent capital + Depreciation and provisions) – Permanent use in their gross worth
II. FRN = Net current assets (with liquidity less than 1 year) – Current debts less than 1 year

A positive net working capital represents the safety margin of a company, the permanent resources surplus released by the financing investment cycle that can be used to finance the cyclical allocations.

Depending on the funding source and the structure of the permanent capital, the working capital can be:

a) the own working capital (FRP) defines the equity surplus against assets and signifies the company’s autonomy in financing the current assets. In other words, it is calculated when it is the needed the appreciation of the financial autonomy of one company. Also, the indicator expresses the extent to which the company’s own sources cover the long-term investments made. When the indicator is negative it means that the company used other long-term sources (loans and deferred payment for suppliers and other debts) to finance fixed assets. Based on the financial and functional statement, the own working capital is determined based on the relationships:

\[ \text{FRP} = \text{Equity – Net fixed assets} \]
\[ \text{FRP} = \text{Global working capital – Debts on medium and long term} \]

b) the foreign working capital (FRS) can be interpreted as being equal to term debts or equal to the difference between net working capital and own working capital. It can be determined by one of the relations:

\[ \text{FRS} = \text{Net working capital – Own working capital} \]
\[ \text{FRS} = \text{Debts on medium and long term} \]
\[ \text{FRS} = \text{Permanent capital - Equity} \]

Determined based on this relation, it reflects the share of medium and long-term debts that exceed the net assets value and which are intended to finance current assets, it emphasizes the participation of medium and long-term loans in financing current assets. The extent to which it participates in financing the current demand depends on the structure
of permanent capital by source of origin, it being proportional to the share of medium and long term loans in permanent capital: \[12\]

\[\text{FRS} = \frac{\text{ITML}}{\text{Cper}} = \frac{\text{FR}}{\text{Cpr + ITML}}\]  

(1)

where:
- ÎTML - Debts on medium and long term;
- Cper - Permanent capital;
- Cpr - Equity capital.

To ensure the financial stability at the company’s level and its solvency, it is appropriate that the share of foreign working capital in the net working capital to be minimized so that funding the operating and the investment cycle should be made on account of the equity of the company, thereby reducing the indebtedness of the company and the financial expenses on loans. \[12\]

When we analyze and compute the working capital, regardless of its type, we must take into account the sector of activity in which the company operates, as the level and the extent to which it ensures the company a long-term balance differs from one firm to another, from one sector to another. So we can meet the following conditions:

a) in sectors where there are long manufacturing cycles, as well as in heavy industry there has to be an important working capital so as to ensure the financing of stable assets because they are the ones that have a high value and weight;

b) in the case of firms with a cycle of activity of up to six months, the working capital should finance about 40% of current assets;

c) in the case of firms with normal production activity that does not raise issues related to inventory, the working capital must represent approximately 10% of the turnover and 20% of net assets.

3. The rates used in the analysis of the working capital

The main rates used in the analysis of the working capital are:[13]

- **financing of the fixed assets (FI)**, calculated as the ratio between fixed assets and capital:

\[FI = \frac{\text{Kper}}{\text{AI}} \times 100\]

This rate allows us to appreciate the way the assets are funded, that have to be financed through permanent resources, so the level of this rate must be greater than 100%. It can be seen as a form of expression of the working capital in relative sizes. When \(\text{Kper} > \text{AI}\), it means that the enterprise has a positive working capital which is a premise to ensure the financial balance. Otherwise, the company has a working capital deficit because a part of fixed assets are funded by short-term debt, with adverse consequences on maintaining the financial equilibrium.

- **fixed assets financing through equity (FI\(_{\text{Kpr}}\))**, measures the proportion in which equity finances fixed assets available to a company. Its level is calculated as the ratio between equity and fixed assets:

\[FI_{\text{Kpr}} = \frac{\text{Kpr}}{\text{AI}} \times 100\]

A favorable situation is recorded when this rate tends to increase.

- **the coverage of capital invested (AKI)** requires the permanent resources to finance not only fixed assets but also the working capital fund requirements (NFR). It is calculated using the relation:

\[AKI = \frac{\text{Kper}}{\text{AI + NFR}} \times 100\]

The level of this rate should be around 100%, which means that permanent resources are sufficient to fund assets, but also the most part of the NFR.

- **the share of FR in the permanent capital (GKper)** serves in characterizing the permanent capital structure depending on its allocation way:

\[G_{\text{Kper}} = \frac{\text{FR}}{\text{Kper}} \times 100\]

The level of this rate must be pursued in connection with the financing needs of the operating cycle. Thus, for companies with slow rotation of circulating assets is necessary that a good portion of them to be covered on the basis of the working capital, so it requires a high level of this rate. At the same time, a level too high may reflect some deficiencies in the use of resources, as the permanent capital are generally more expensive than those in the short term.

- **the rate of financing the current assets (R\(_{\text{Ac}}\))**:

\[R_{\text{Ac}} = \frac{\text{FR}}{\text{AC}} \times 100\]

It allows the appreciation of the proportion in which the working capital covers, from the financial point of view, current assets. For an industrial company, it is considered that a level of more than 20% of this rate is sufficient.
the rate of inventory financing \((R_{ST})\):
\[
R_{ST} = \frac{FR}{ST} \times 100
\]
It is considered that the working capital provides a normal funding of the stocks if it covers 2/3 of their total.

the rate of coverage of the necessary of working capital \((R_{NFR})\):
\[
R_{NFR} = \frac{FR}{NFR} \times 100
\]
With this rate we measure the proportion in which permanent resources finance the operating cycle. If its level is greater than 100\%, it appears that the working capital has secured the overall financing of the working capital necessary and a part of the treasury. A value less than 100\% means the existence of a negative net treasury. In order to ensure the financial equilibrium, the level of this rate must not fall below 50\%.

the funding rate of turnover (RCA) or the speed of rotation of the working capital, expresses the number of days in which the working capital is rebuild through turnover. It should be determined by the relationship:
\[
R_{CA} = \frac{FR}{CA} \times 365
\]
A declining level of this rate means a faster recovery of funds and so, a less necessary of permanent resources for the same turnover. It is said that for most businesses that rate must be between 30 and 90 days, however, it must be compared with the operating lifecycle.

4. Methods for determining the working capital

The economic theory imposed the concepts of net working capital computed based on the financial statement and overall working capital determined based on the functional statement. [11]

The net working capital \((FRN)\) represents a computation size which results from processing the information in the financial statement and can be determined as follows:

a) based on permanent elements of the top of the financial balance sheet which consist of fixed assets and permanent capital:
\[
FRN = \text{Permanent capital} – \text{Net fixed assets}
\]
The working capital is the permanent capital part used to finance current assets. The relationship reflects the financial stability on long-term and focuses on working capital origin.

Establishing the working capital starting from the top of the balance sheet focuses on the financing structure of forming the working capital, on the origin of the working capital, being also called the external analysis of the working capital.[2]

Depending on the level of the permanent capital and fixed assets, in practice we find the following situations:
[13]

\(K_{per} \succ Ai \Rightarrow FR \succ 0\) when it is considered that the long-term financial stability is assured, with additional permanent resources that will be used to finance current assets;

\(K_{per} \prec Ai \Rightarrow FR \prec 0\) when we have a financial imbalance situation to be analyzed according to the specific of the developed activity; The company will have difficulty in paying short-term debt, having liquidity problems.

b) based on short-term elements from the bottom part of the financial balance sheet which consists of current assets and liabilities on short-term:
\[
FRN = \text{Net current assets} – \text{Liabilities on short term}
\]
Establishing the working capital starting from the bottom part of the balance sheet shows for what the working capital is used (funding the current assets), this method is also known as the internal analysis of the working capital. [2]

The global working capital \((FRG)\) or the functional working capital is a classic indicator, frequently used in the financial analysis and represents the sustainable resources surplus towards stable needs, surplus designed to finance the operating cycle operations. It is also defined as the part of the stable resources allocated to finance the stable assets.

You can use two methods of computation: [12]

a) starting from the liabilities of the functional balance sheet:
\[
FRG = \text{Stable resources} – \text{Stable needs}
\]
or
\[
FRG = \text{Permanent capital (including amortization and provisions)} – \text{Gross fixed assets}
\]
There are two types of stable resources:

- own stable resources: internal (reserves, retained earnings, year result, amortization and provisions) and external (capital, premiums related to capital, investment subsidies).
- borrowed stable resources: debenture loans, bank loans on medium and long terms, other loans and other liabilities.
Determined by this method, the overall working capital expresses the surplus of stable resources in relation to fixed values available to finance operating cycle operations.

**Scheme no. 1**

*Global working capital starting from the liabilities of the functional balance sheet*

*Source: Popa Ion L., Miculeac Melania, Analiză economico-financiară, Ed. Mirton, Timișoara, 2012, pag.75*

\[ FRG = (\text{Cyclical assets} + \text{Assets Treasury}) - (\text{Cyclical liabilities} + \text{Liabilities Treasury}) \]

or

\[ FRG = (\text{Operating cyclical assets} + \text{Cyclical assets outside exploitation}) + \text{Assets Treasury}) - (\text{Operating cyclical liabilities} + \text{Cyclical liabilities outside exploitation} + \text{Liabilities Treasury}) \]

Under this method of determination, the working capital signifies the amount of cyclical needs and cash remaining unfunded by cyclical and cash resources.

**Scheme no. 2**

*Global working capital starting from the liabilities of the functional balance sheet*

*Source: Popa Ion L., Miculeac Melania, Analiză economico-financiară, Ed. Mirton, Timișoara, 2012, pag.75*

The global working capital represents: a necessity for most businesses, a margin of safety for the company and its creditors, a prerequisite to ensure the financial independence to third parties.[12]

In the financial analysis, to assess the overall working capital can be used the following indicators:

1. **the rotation speed of FRNG:**
   \[ \frac{FRNG}{CA} \cdot 360 \]  
   \[ (2) \]
   *where: CA - Turnover.*

2. **the degree of financing the requirements of working capital based on FRNG:**
   \[ \frac{FRNG}{NFR} \cdot 100 \]  
   \[ (3) \]
   *where: NFR - Net fixed assets.*

3. **the rate of funding the operating cyclical assets based on FRNG:**
   \[ \frac{FRNG}{ACE} \cdot 100 \]  
   \[ (4) \]
   *where: ACE – Operating cyclical assets.*

**Changing the working capital** may have as main causes: registration of profit or loss, distribution of dividends, new contributions of shareholders, changes in financial liabilities on medium and long-term, sale of fixed assets, new investments in intangible, tangible and financial assets etc.
Theoretically, the working capital must be positive, but in some situations the working capital may also be negative. A positive working capital can be a margin of safety for the company allowing it to provide a minimum level of current assets necessary for the operation, the current assets being higher than the short-term debt. A negative working capital signifies an alarming situation for the company, it does not have sufficient long-term capital to ensure the financing of fixed assets or disposes of current assets inferior to debts payable on short term, that cannot be paid.

Synoptically, the factor which determine the modification of the working capital is presented as:[11]

<table>
<thead>
<tr>
<th>Factors that diminish the FR</th>
<th>The growth factors of FR</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The increase of the current assets through:</td>
<td>1. The reduction of current assets:</td>
</tr>
<tr>
<td>- investments: intangible, tangible and financial</td>
<td>- depreciation</td>
</tr>
<tr>
<td>- reevaluation</td>
<td>- sale of fixed assets</td>
</tr>
<tr>
<td>2. The decrease of the permanent capital:</td>
<td>2. The increase in permanent capital:</td>
</tr>
<tr>
<td>- the reduction of equity: the withdrawal of shareholders, distribution of stocks, distribution of dividends, losses from previous years, the reduction or cancellation of the regulated provisions</td>
<td>- increase of equity: accumulation of reserves, receiving subsidies, distribution of profits, the regulated provisions</td>
</tr>
<tr>
<td>- repayment term loans of more than 1 year</td>
<td>- contracting loans for a term exceeding 1 year</td>
</tr>
</tbody>
</table>

4. Case study on determining the working capital:

For a better understanding of the concept of working capital, regardless of its type, we will achieve a synthetic case study based on three ways of determination of the working capital, as follows:

a. The working capital = permanent equity + provisions for liabilities and charges – permanent need

Where:

- permanent capital = equity + debt on medium and long term
- permanent need = fixed net assets

**Determination of the working capital**

<table>
<thead>
<tr>
<th>Nr. crt.</th>
<th>Indicators</th>
<th>Period</th>
<th>Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>N</td>
<td>N+1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.</td>
<td>Equity</td>
<td>85.167.061</td>
<td>128.028.217</td>
</tr>
<tr>
<td>2.</td>
<td>Debts &gt; 1 year</td>
<td>1.698.665</td>
<td>25.581.435</td>
</tr>
<tr>
<td>3.</td>
<td>Provisions for liabilities and charges</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>4.</td>
<td>Permanent capital(1+2)</td>
<td>86.865.726</td>
<td>153.609.652</td>
</tr>
<tr>
<td>5.</td>
<td>Fixed assets</td>
<td>66.826.822</td>
<td>88.479.334</td>
</tr>
<tr>
<td>6.</td>
<td><strong>FINANCIAL WORKING CAPITAL (4+3-5)</strong></td>
<td>20.038.904</td>
<td>65.130.318</td>
</tr>
</tbody>
</table>

This way of determining the working capital highlights the financial equilibrium on the long term, the working capital representing that part of the permanent capital after financing the fixed assets, which the company uses to finance current assets.

b. Working capital = (current assets + prepaid expenses)-(short-term debt + deferred income)

**Determination of the working capital**

<table>
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</tr>
</thead>
<tbody>
<tr>
<td>N</td>
<td>N+1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.</td>
<td>Current assets</td>
<td>66.112.411</td>
<td>103.158.520</td>
</tr>
<tr>
<td>2.</td>
<td>Prepaid expenses</td>
<td>380.593</td>
<td>297.815</td>
</tr>
<tr>
<td>3.</td>
<td>Short term debt</td>
<td>45.566.936</td>
<td>37.286.542</td>
</tr>
<tr>
<td>4.</td>
<td>Deferred income</td>
<td>887.164</td>
<td>1.039.474</td>
</tr>
<tr>
<td>5.</td>
<td><strong>FINANCIAL WORKING CAPITAL (1+2)-(3+4)</strong></td>
<td>20.038.904</td>
<td>65.130.318</td>
</tr>
</tbody>
</table>

This method highlights the impairment and the finality of the working capital, which is financed from the circulating assets, the working capital showing the surplus of net current assets unfunded by temporary debts, highlighting the potential liquidity surplus as a security margin of the company’s solvency.
c. The working capital = (total assets-liabilities < 1 year)-fixed assets
Fund working capital = current assets, net current liabilities

\[
\text{Table no.3}
\]

<table>
<thead>
<tr>
<th>Nr. crt.</th>
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</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>N</td>
<td>N+1</td>
</tr>
<tr>
<td>1.</td>
<td>Total assets - liabilities &lt; 1 year</td>
<td>86,865,726</td>
<td>153,609,652</td>
</tr>
<tr>
<td>2.</td>
<td>Fixed assets</td>
<td>66,826,822</td>
<td>88,479,334</td>
</tr>
<tr>
<td>3.</td>
<td>Current assets, current liabilities</td>
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<td>4.</td>
<td>FINANCIAL WORKING CAPITAL (1-2)</td>
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</tr>
</tbody>
</table>

From the data obtained, the working capital increases reflecting a favorable dynamic of the margin of safety. The financial equilibrium on the short and long term is assured as a result of a margin of safety given by the positive financial working capital and the financial independence of the company proves to be satisfactory, even if the share of equity in permanent capital was reduced.

Together with the financial working capital a special importance is given to the owned working capital and to the foreign working capital. The first highlights the extent to which the financial stability is provided through equity, and the second reflects the degree of indebtedness of long-term financing needs. To highlight the two types of working capital we follow the data from the next table:

\[
\text{Table no.4}
\]

<table>
<thead>
<tr>
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</tr>
<tr>
<td>3.</td>
<td>OWNED WORKING CAPITAL(1-2)</td>
<td>18,340,239</td>
<td>39,548,883</td>
</tr>
</tbody>
</table>

There has been recorded a positive owned working capital that grew in the period N + 1 to N with 23,882,770 lei, a situation which confirms that the company has a financial autonomy which allows the financing of fixed assets from capital.

\[
\text{Table no.5}
\]

<table>
<thead>
<tr>
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</tr>
<tr>
<td>3.</td>
<td>FINANCIAL WORKING CAPITAL(1-2)</td>
<td>-65,128,157</td>
<td>-62,897,899</td>
</tr>
</tbody>
</table>

It has been recorded a negative foreign working capital both in year N, and also in year N+1 which means that the short term needs cannot be financed through long-term indebtedness.

5. Conclusions

Regardless of the method of calculation, the working capital appears as a “financial safety margin” to allow the company to cope, without difficulty, to various risks that occur in the short term. [2]

The purpose of the analysis and calculation of the working capital together with the need for working capital and cash is determining and characterizing the company’s financial stability. This can be done:

a) post - factum when these indicators show the structure of the financing structure used in developing the activity;

b) ante - factum when these indicators show the extent to which the company needs bank loans (cash loans).

Together with the static analysis of the working capital, respectively its analysis at a given moment, a special importance is given to the dynamic analysis of it, and from this point of view we can meet three situations:

a) when \( FR_N > FR_{N+1} \) is appreciated as a positive situation, but provided that this increase is not due to the increase in the level of long-term indebtedness;

b) when \( FR_N < FR_{N+1} \) is not necessarily appreciated as a negative situation as long as this reduction is not due to a reduction in capital;

c) when \( FR_N = FR_{N+1} \) is appreciated as a possible situation, at least theoretically, because basically it is almost impossible to achieve a total accordance between company’s resources and the necessities of allocating them.
The working capital allows the company to develop a normal economic circuit. In case the working capital is under the necessary to cover current assets, a disinvestment occurs, which creates disturbances for the normal economic circuit and determines the company to use bank loans or not to honor a number of financial obligations to creditors, the state budget etc.

Permanent allocations are, in principle, covered by permanent sources (equity, financial debt). The more the permanent sources outweigh the needs for permanent allocation of funds, the more the company has a margin of safety (security) which provides shelter for unforeseen events. This surplus of permanent sources, released by the financing investment cycle can be “run” for renewal of stocks and receivables. This potential use marked its name, namely the working capital.

The main decisions on the working capital of companies must refer to:

- receipts and payments, one of the first responsibilities is to collect funds from customers and to pay the suppliers, the employees, the obligations to the state etc.
- cash concentration, managers have the responsibility to establish and implement the system of gathering funds from several banks to concentrate the with the view of better administration and investment;
- liquidity management, which occurs through decisions concerning the determination of the cash surplus or deficits, the investment securities portfolio management and the establishment of the type and term for any possible loan;
- relationships with the bank, namely the establishment of the banks to work with and the services to be provided by them;
- trade credit policy or when, whom and how much to sell with later payment or grating discounts in order to obtain payment immediately or faster;
- stocks, namely the determination of the need for investment in stocks and how to finance them.

6. References

[10] Petrescu S., Analiză și diagnostic financiar-contabil, ediția a treia revizuită și adăugată, Ed. CECAR, București, 2010;