Managing Working Capital – A Practical Approach

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Abstract

Working capital management plays a significant role in improved profitability of firms. Firms can achieve optimal management of working capital by making the trade-off between profitability and liquidity. Though there are too many researches has been conducted on the topic working capital management and its impact on profitability, but there is no major research has been done for the negative working capital and its impact on profitability. All the studies on working capital generally states that for the improvement in profitability we should manage our working capital effectively and most of the studies recommended to have good amount of working capital in the organization. All the researches on this topic conclude that the companies should avoid under-investment in working capital if they want higher profit margins. With negative working capital there can be a danger of insolvency but it is not true forever. If the company is having a good image in the market and good relation with their creditors it can get the benefit from the negative working capital also.

Various studies shows that though there is a positive relationship between working capital and profitability, yet it does not hold good for all the cases and that too always. We have seen companies generating good profit with a negative working capital as well as companies not able to generate good profit even with having good amount of positive working capital. However, it can be said that negative working capital indicates non-liquidity or less liquidity within the firm which is not desirable at each and every stages of business.Hence, the question arises that having negative working capital is good for an organization or not and if a company is earning profit continuously with having negative working capital, can we say that it is a sign of managerial efficiency or there might be the chances of possible bankruptcy of the company?

Key Words: Working Capital, Profitability, Liquidity, Bankruptcy, Working Capital Cycle.

Introduction

What is working capital management and why is working capital management important to your business?In its most basic form, working capital is the cash available to a business to pay its day-to-day operating expenses, such as salaries and raw materials.Yet with businesses still finding it difficult to gain access to finance, managing working capital has become more important than ever

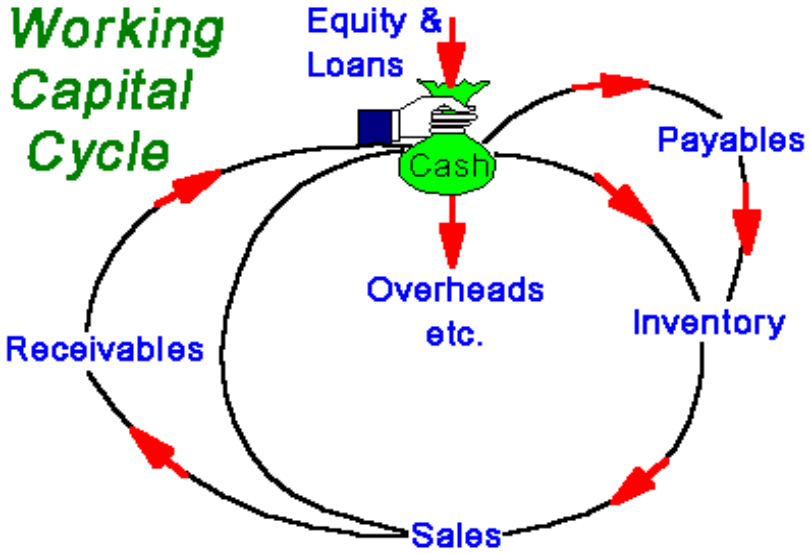
before.Effective management will mean working at both ends of the equation, by managing the cash coming in as well as the cash going out.

Understand the Working Capital Cycle

Cash flows in a cycle into, around and out of a business. It is the business's life blood and every manager's primary task is to help keep it flowing and to use the cash flow to generate profits. If a business is operating profitably, then it should, in theory, generate cash surpluses. If it doesn't generate surpluses, the business will eventually run out of cash and expire.

The faster a business expands the more cash it will need for working capital and investment. The cheapest and best sources of cash exist as working capital right within business. Good management of working capital will generate cash will help improve profits and reduce risks. Bear in mind that the cost of providing credit to customers and holding stocks can represent a substantial proportion of a firm's total profits.

There are two elements in the business cycle that absorb cash - Inventory (stocks and work-in-progress) and Receivables (debtors owing you money). The main sources of cash are Payables (your creditors) and Equity and Loans.



Each component of working capital (namely inventory, receivables and payables) has two dimensions .....TIME ..... and MONEY. When it comes to managing working capital - TIME IS MONEY. If you can get money to move faster around the cycle (e.g. collect monies due from debtors more quickly) or reduce the amount of money tied up (e.g. reduce inventory levels relative to sales), the business will generate more cash or it will need to borrow less money to fund working capital. As a consequence, you could reduce the cost of bank interest or you'll have additional free money available to support additional sales growth or investment. Similarly, if you can negotiate improved terms with suppliers e.g. get longer credit or an increased credit limit; you effectively create free finance to help fund future sales.

If you.....	Then.....

• Collect receivables (debtors) faster	You release cash from the cycle
• Collect receivables (debtors) slower	Your receivables soak up cash
• Get better credit (in terms of duration or amount) from suppliers	You increase your cash resources
• Shift inventory (stocks) faster	You free up cash
• Move inventory (stocks) slower	You consume more cash

It can be tempting to pay cash, if available, for fixed assets e.g. computers, plant, vehicles etc. If you do pay cash, remember that this is now longer available for working capital. Therefore, if cash is tight, consider other ways of financing capital investment - loans, equity, leasing etc. Similarly, if you pay dividends or increase drawings, these are cash outflows and, like water flowing down a plug hole, they remove liquidity from the business.

Sources of Additional Working Capital

Sources of additional working capital include the following:

- Existing cash reserves
- Profits (when you secure it as cash!)
- Payables (credit from suppliers)
- New equity or loans from shareholders
- Bank overdrafts or lines of credit
- Long-term loans
- If you have insufficient working capital and try to increase sales, you can easily over-stretch the financial resources of the business. This is called overtrading. Early warning signs include:
- Pressure on existing cash
- Exceptional cash generating activities e.g. offering high discounts for early cash payment
- Bank overdraft exceeds authorized limit
- Seeking greater overdrafts or lines of credit
- Part-paying suppliers or other creditors
- Paying bills in cash to secure additional supplies
- Management pre-occupation with surviving rather than managing
- Frequent short-term emergency requests to the bank (to help pay wages, pending receipt of a cheque).

More businesses fail for lack of cash than for want of profit.

Handling Receivables (Debtors)

Cash flow can be significantly enhanced if the amounts owing to a business are collected faster. Every business needs to know.... who owes them money.... how much is owed.... how long it is owing.... for what it is owed.
Slow payment has a crippling effect on business; in particular on small businesses who can least afford it.

If you don't manage debtors, they will begin to manage your business as you will gradually lose control due to reduced cash flow and, of course, you could experience an increased incidence of bad debt. The following measures will help manage your debtors:

- Have the right mental attitude to the control of credit and make sure that it gets the priority it deserves.
- Establish clear credit practices as a matter of company policy.
- Make sure that these practices are clearly understood by staff, suppliers and customers.
- Be professional when accepting new accounts, and especially larger ones.
- Check out each customer thoroughly before you offer credit. Use credit agencies, bank references, industry sources etc.
- Establish credit limits for each customer... and stick to them.
- Continuously review these limits when you suspect tough times are coming or if operating in a volatile sector.
- Keep very close to your larger customers.
- Invoice promptly and clearly.
- Consider charging penalties on overdue accounts.
- Consider accepting credit /debit cards as a payment option.
- Monitor your debtor balances and ageing schedules, and don't let any debts get too large or too old.

Recognize that the longer someone owes you, the greater the chance you will never get paid. If the average age of your debtors is getting longer, or is already very long, you may need to look for the following possible defects:

- weak credit judgment
- poor collection procedures
- lax enforcement of credit terms
- slow issue of invoices or statements
- errors in invoices or statements
- customer dissatisfaction.

Debtors due over 90 days (unless within agreed credit terms) should generally demand immediate attention. Look for the warning signs of a future bad debt. For example.....

- longer credit terms taken with approval, particularly for smaller orders
- use of post-dated checks by debtors who normally settle within agreed terms
- evidence of customers switching to additional suppliers for the same goods

- new customers who are reluctant to give credit references
- receiving part payments from debtors.

Profits only come from paid sales.

The act of collecting money is one which most people dislike for many reasons and therefore put on the long finger because they convince themselves there is something more urgent or important that demands their attention now.

There is nothing more important than getting paid for your product or service. A customer who does not pay is not a customer. Here are a few ideas that may help you in collecting money from debtors:

- Develop appropriate procedures for handling late payments.
- Track and pursue late payers.
- Get external help if your own efforts fail.
- Don't feel guilty asking for money.... it's yours and you are entitled to it.
- Make that call now. And keep asking until you get some satisfaction.
- In difficult circumstances, take what you can now and agree terms for the remainder. It lessens the problem.
- When asking for your money, be hard on the issue - but soft on the person. Don't give the debtor any excuses for not paying.
- Make it your objective is to get the money - not to score points or get even.

Late payments erode profits and can lead to bad debts.

Managing Payables (Creditors)

Creditors are a vital part of effective cash management and should be managed carefully to enhance the cash position.

Purchasing initiates cash outflows and an over-zealous purchasing function can create liquidity problems. Consider the following:

- Who authorizes purchasing in your company - is it tightly managed or spread among a number of (junior) people?
- Are purchase quantities geared to demand forecasts?
- Do you use order quantities which take account of stock-holding and purchasing costs?
- Do you know the cost to the company of carrying stock?
- Do you have alternative sources of supply? If not, get quotes from major suppliers and shop around for the best discounts, credit terms, and reduce dependence on a single supplier.
- How many of your suppliers have a returns policy?
- Are you in a position to pass on cost increases quickly through price increases to your customers?

- If a supplier of goods or services lets you down can you charge back the cost of the delay?
- Can you arrange (with confidence!) to have delivery of supplies staggered or on a just-in-time basis?

There is an old adage in business that if you can buy well then you can sell well. Management of your creditors and suppliers is just as important as the management of your debtors. It is important to look after your creditors - slow payment by you may create ill-feeling and can signal that your company is inefficient (or in trouble!). Remember, a good supplier is someone who will work with you to enhance the future viability and profitability of your company.

Inventory Management

Managing inventory is a juggling act. Excessive stocks can place a heavy burden on the cash resources of a business. Insufficient stocks can result in lost sales, delays for customers etc.

The key is to know how quickly your overall stock is moving or, put another way, how long each item of stock sit on shelves before being sold. Obviously, average stock-holding periods will be influenced by the nature of the business. For example, a fresh vegetable shop might turn over its entire stock every few days while a motor factor would be much slower as it may carry a wide range of rarely-used spare parts in case somebody needs them.

Nowadays, many large manufacturers operate on a just-in-time (JIT) basis whereby all the components to be assembled on a particular today, arrive at the factory early that morning, no earlier - no later. This helps to minimize manufacturing costs as JIT stocks take up little space, minimize stock-holding and virtually eliminate the risks of obsolete or damaged stock. Because JIT manufacturers hold stock for a very short time, they are able to conserve substantial cash. JIT is a good model to strive for as it embraces all the principles of prudent stock management.

The key issue for a business is to identify the fast and slow stock movers with the objectives of establishing optimum stock levels for each category and, thereby, minimize the cash tied up in stocks. Factors to be considered when determining optimum stock levels include:

- What are the projected sales of each product?
- How widely available are raw materials, components etc.?
- How long does it take for delivery by suppliers?
- Can you remove slow movers from your product range without compromising best sellers?
- Remember that stock sitting on shelves for long periods of time ties up money which is not working for you. For better stock control, try the following:
- Review the effectiveness of existing purchasing and inventory systems.
- Know the stock turn for all major items of inventory.

- Apply tight controls to the significant few items and simplify controls for the trivial many.
- Sell off outdated or slow moving merchandise - it gets more difficult to sell the longer you keep it.
- Consider having part of your product outsourced to another manufacturer rather than make it yourself.
- Review your security procedures to ensure that no stock "is going out the back door!"
- Higher than necessary stock levels tie up cash and cost more in insurance, accommodation costs and interest charges.

Working Capital Management – The New Approach

Working Capital Management is concerned with the management of the Current Assets and Current Liabilities and the interrelation that exists between them, so to minimize the risk of insolvency and to maximize the return on assets. The ultimate objective of working capital management is to ensure that a firm is able to continue its operations and that it has sufficient ability to satisfy both maturing short term debt and upcoming operational expenses. Working capital management calls for addressing two basic issues how much of current assets an organization should hold and how to finance the investment in them. In the present scenario some companies are using negative working capital and getting a good amount of profits and good return on capital also. Earlier negative working capital is considered as a risk of insolvency of the organizations but at present negative working capital is a sign of managerial efficiency in a business. Earlier it was considered that the companies should avoid under-investment in working capital if they wanted higher profits margins.

Negative working capital is a reverse situation as compared to normal working capital. It is a situation in which current assets are lower as compared to current liabilities. A negative working capital is an indication of managerial efficiency in a business with low inventory and account receivables. This happens because customer pays in advance and so quickly, the business enjoys cash transactions; products are delivered and sold to the customer before the company even pays their suppliers and creditors. Negative Working capital doesn't always mean bad financial condition; it indicates that most of the day to day activities are funded by customers rather than company's own working capital. Some latest examples are movie theaters - customers are paying first and distributors are normally paid later on; Schools/ educational institutions- fees paid in advance by the students annually, whereas faculties are getting salary after one month. When an organisation uses supplier's credit and customers' advance to fulfill their day to day needs, it leads to a situation of lower or negative working capital. Banks, financial institutions, distributors, retailers with cash business or advance payment contract have negative working capital.

Normally, when we analyse working capital, it always refers to normal or positive working capital (excess or current assets over current liabilities). However, there are certain situations in which working capital is in negative form (excess of current liabilities over current assets). In that situation, how can a company manage liquidity with the negative working capital? In modern business, the concept of negative working capital is significant for the following reasons;

• It indicates operational efficiency of a corporate. That means without having or with low current assets the firm is managing day to day operations in an efficient manner. Eventually, it reduces cost of working capital and maximum earnings for the shareholders, which is the ultimate goal of the financial management.

• Concept of negative working capital is important to analyse liquidity position of corporate. When current assets are lower than current liabilities, what about the liquidity position of the corporate, how are they discharging current obligations in theshort period. Traditionally, liquidity ratios are the measurement of liquidity of a firm with the ideal standard of 2:1. Negative working capital indicates lower cost of working capital (another way is higher profitability), but at the same time, it indicates poor liquidity (worried situation for the creditors, etc.) or we can say company is overburdened with current liabilities, which is not good for any situation (specially in a period of recession, etc).

• Another important impact of negative working capital is cash recovery or realisation situation. Negative working capital indicates quick realization of cash recourses (conversion of debtors in to cash) or one can say working capital cycle is shorter (for a days or maybe less than that). At the same time, payable policy of the company is to take longer time for payment against creditor. It indicates significant variations in the credit policy towards suppliers and customers.

To analyse, explain and focus on all these situations, a study of negative working capital and its impact on liquidity, profit earning capacity and overall impact on shareholders' value creation is important in the contemporary scenario. To understand how negative working capital works, let us analyse Warner Brothers / Wal-Mart situation. When Wal-Mart ordered the 500,000 copies of a DVD, they were supposed to pay Warner Brothers within 30 days. What if by the sixth or seventh day, Wal-Mart had already put the DVDs on the shelves of its stores across the country? By the twentieth day, they may have sold all of the DVDs. In the end, Wal-Mart received the DVDs, shipped them to its stores, and sold them to the customer (making a profit in the process), all before they had paid Warner Brothers! If Wal-Mart can continue to do this with all of its suppliers, it doesn't really need to have enough cash on hand to pay all of its accounts payable. As long as the transactions are timed right, they can pay each bill as it comes due, maximizing their efficiency.

There are many ways to create negative working capital. Most important method is to minimise the size of current assets with favorable contract and agreement to the suppliers and other parties (to delay payments) and the same time, try to minimise credit facilities or maximise cash based business (collection of cash before the disbursement of actual payments to the various parties). When maximum customers are paying in advance, low or negative working capital is created. Another way to minimise the size of current assets is to adopt efficient collection method or brand oriented collection policy. Many companies are trying to minimise their cash resources with efficient utilisation of funds. Some companies are effectively using ERP system involving trade partners in planning and monitoring working capital items to reduce the level of working capital.

Efficient cash collection and inventory management system provides an opportunity to run business with the negative working capital, because most of the suppliers are granting 30 days credit in general. Companies who are able to operate and maintain with negative working capital, have advantages to receive funds without cost as a form of credit from their suppliers which will enhance ROI in a significant manner. However, non-availability of liquid resources is not a good situation at any time (especially in the stage of growth and boom). Hence, the question arises that having negative working capital is good for an organization or not and if a company is earning profit continuously with having negative working capital, can we say that it is a sign of managerial efficiency or there might be the chances of possible bankruptcy of the company?

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