CA BUSINESS SCHOOL

POSTGRADUATE DIPLOMA IN BUSINESS & FINANCE

SEMESTER 3: Financial Strategy

Working Capital Management & Financing

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Introduction

Every company needs adequate cash flows to maintain its day-today routine operational activities comfortably. Maintaining adequate level of working capital will not only preserve short term going concern but it also have an impact on long term survival of the business.

It is a responsibility of key management to maintain ideal level of working capital since neither lowest nor highest is the best suited. Ideal level of working capital obviously determined by many factors including industry in which company operates and size of the business/operational activities.

Working capital of an organization refers total money invested in current assets. Structure of CA depend on the nature of the organization. Some mistakenly defined that working capital is balance available after eliminating CL from CA. This interpretation is wrong. When you eliminate CL from CA; it should be net working capital but not WIC.

Factors Affecting the Level of WIC

Arguably, every organization must maintain material level of working capital at all the times. But, needs for working capital and essentially its size depend on numerous factors.

- Nature of the business : level of importance on CA over business.
- Seasonal effect on key operational activities : seasonal fluctuations of sales affect WIC requirement.
- Production policy : whether to maintain static production or not.
- Market conditions : highly competitive environment or not.
- Conditions of supply : trust of the suppliers and predictability level.

Measuring WIC

Working capital of an organization measures either considering only CA or CA with CL. Different types of formulae used as a basis of measuring WIC.

- Current Ratio
- Quick Assets Ratio/Acid Test Ratio
- Stock Turnover
- Stock Residency Period
- Debtors’ Turnover
- Debtors’ Collection Period
- Creditors’ Turnover
- Creditors’ Payment Period
- Activity/WIC Cycle
- Cash Cycle

Overtrading

Overtrading is all about conducting too much of business too quickly with too little long term capital. Hence, overtrading evidence when company carry out its business mainly from the short term capital (current assets)

At initial phase, overtrading businesses doing well are recorded profit even. But, gradually this will turn into serious trouble due to shortage of money.

Some of the symptoms;

- There will be rapid increase in revenue
- Rapid growth of profit at initial phase
- No dramatic increase of equity capital
- Trade creditors will be dissatisfied
- Bank will impose more rules/regulation (even penalty)

Key Elements in WIC

As we already understand, composite of working capital depends on numerous factors. Nature of the business and industry in which company operates are the main factors of determining elements in WIC.

Following are seems common;

- Inventory
  - R/M
  - WIP
  - FG
- Trade Debtors
- Cash & Cash Equivalents

Managing Key Elements in WIC

It is essential to understand the key characteristics of working capital in order to manage them properly. Among numerous such characteristics, following are key;

- Short life span
- Swift transformation into other asset forms

Working capital management is all about ensuring sufficient liquid resources are maintained by the company. This involves achieving a balance between the requirement to minimize the risk of insolvency and the requirement to maximize the return on assets.

It is a responsibility of company's key management to decide the level of investment made in current assets. There can be flexible and restrictive policy.

Managing Key Elements in WIC (Contd.)

Flexible/conservative policy : this refers company is maintaining high level of current assets at all the times.

Restrictive/aggressive policy : this is quite opposite of conservative in which company practice to maintain low level of current assets at all the times.

Company must maintain an optimum level of CA by considering costs that rise with CA and costs that fall with CA. costs which are rising can identify as carrying costs while costs which are falling can identify as shortage costs.

Although optimum level of CA determined by considering above two factors in a graphical manner, it will reasonably vary based on the dramatic (unplanned) change taking place.

Managing Key Elements in WIC (Contd.)

C/Assets
- Cash & Cash equivalents
- Trade Debtors
- Inventories

C/Liabilities
- Accrued wages & taxes
- Trade Creditors
- Bank Overdraft
- Commercial bills & promissory notes
- Factoring/Trade finance
- Inventory loans or floor – plan finance

Managing Key Elements in WIC (Contd.)

Management of Cash

An entity must manage its cash due to following;

- Need to have sufficient cash
- Timing of cash flows
- Cost of cash
- Cost of not having enough cash

The need to have sufficient cash

An entity must always maintain sufficient level of cash balance in hand in order to meet its financial obligations.

When determining the level, trade-off between risk & return should taken in to consider.

Risk - inability to meet financial obligations.

Return - return by making an investment.

Managing Key Elements in WIC (Contd.)

The timing of cash flows

An entity must ensure the timing of its cash requirement.

- Mode of cash-inflows
  - Cash Sales
  - Collection of money from debtors
  - Sale of assets (idle)
  - Capital injections
  - Short-term Loans
  - Long-term Loans

- Mode of cash outflows
  - Purchase of inventories
  - Purchase of Labor, R/M & other services
  - Purchase of assets
  - Payment of taxes

Managing Key Elements in WIC (Contd.)

The Cost of Cash

An entity might incur cost in following manner when managing its cash.

- Opportunity cost of (merely)holding money.
- Cost of providing physical Security.

The cost of not having (enough) cash

An entity requires money in order to meet its financial obligations. When entity not having sufficient cash, it may not pay the debt at required time which even affect to the going concern. (prone to wind - up the business in long run or even in short period)

Managing Key Elements in WIC (Contd.)

Management of Trade Debtors

An entity must develop a sound system for the debtors' management by addressing all key aspects.

A Debtor create through the credit sales and following benefits and cost would involved;

Benefits
- Enhance customer base
- Increase sales volume
- Attract new customers / markets
- Eliminate some cost of marketing & selling

Cost
- Opportunity cost of money
- Bad & Doubtful debts
- Administration Cost(Handling, Collecting, Recording)

Managing Key Elements in WIC (Contd.)

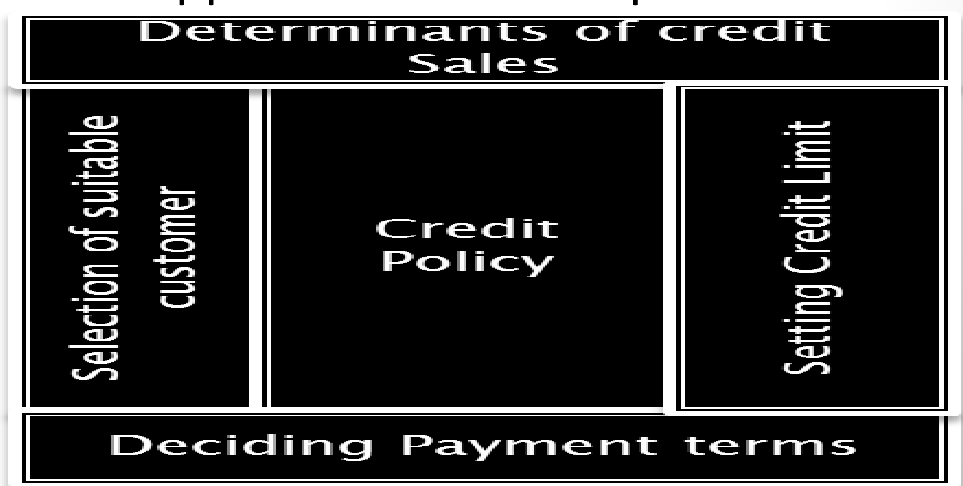
Key factors of determining the suitable level of debtors within the entity.

I. Total Sales

Total Sales → Credit Sales → Trade Debtor

II. Credit Policies

This refers to the internal policies & applications with respect to credit sales & trade debtors.



Managing Key Elements in WIC (Contd.)

III. Collection Policies & Procedures

An entity must develop a system which entails clear policies & procedures with respect to collection of money from the debtors. This might directly affect to bad/doubtful debtors and working capital coupled with the liquidity position of the entity.

IV. The level of credit sales

As mentioned before, a trade debtor will create within the entity as a result of credit sales.

Managing Key Elements in WIC (Contd.)

Management of Inventories

Inventory has become a most common and crucial element represents current asset in the entity. (especially in manufacturing entity) Inventory is essential for the continuous production process.

Form of Inventories
- Raw Materials (RM)
- Work in Progress (WIP)
- Finished Goods (FG)

Benefits

1. Continuous Production - Sales - Profit
2. Retain & gain customers
3. Build good relationship with key players in the market
4. Create & maintain goodwill

Costs

1. Ordering Costs (Broker, Freight, Clearing)
2. Holding Costs -
   - Storage
   - Insurance
   - Deterioration & Obsolescence
   - Theft
   - Financing Costs

Managing Key Elements in WIC (Contd.)

Techniques available to manage the inventory.

- Maintain minimum level of stock
- Managing average turnover period
- Economic order quantity (EOQ)

Maintaining a minimum stock level refers to the buffer stock keep by entity to make sure continuous operations.

$$\text{Average turnover period} = \frac{\text{Average inventory held x}}{\text{Cost of Sales}} \; 365/52/12$$

$$EOQ = \sqrt{\frac{2\,Do}{H}}$$

Where,

D	Total demand for given period
O	Ordering Cost
H	Holding Cost
Q	Quantity

Just in time (JIT) is the technique introduced by Japan (Toyota) through which entity able to produce goods by placing the orders for inventories as and when requirement arise only.