12 Working Capital Management

12.1 Introduction and objectives

Capital is a scarce resource in any business and enormous attention is given to ensuring the right sources of finance are found and properly utilised with respect to the long-term non-current asset requirements of an organisation. However any business will require capital for short-term needs as well as long-term and this is known as working capital.

After studying this chapter you should be able to:

- Understand the importance of working capital to the business
- Evaluate the different working capital policies that can be adopted by a firm
- Understand what the key components of working capital are
- Consider the working capital requirements of a firm with respect to inventory, accounts receivable, cash and accounts payable
- Establish sound policies for the efficient management and control of the key component elements.

12.2 Understanding working capital

In the short term a business needs to ensure that it can pay its expenditure from its income, to generate income it must sell its products or services to customers. In doing this the business will often buy inventory – goods to sell on as a retailer, or raw materials with which to make a finished product such as a meal in a restaurant. The inventory then has to be sold to a customer (at a profit) and when the customer pays, cash flows back in to the business (Figure 12.1). The organisation must ensure it has enough capital invested to ensure that it can buy the required inventory and still pay bills while it waits for the inventory to be sold and the customers to pay. This in essence is the working capital requirement of the business.

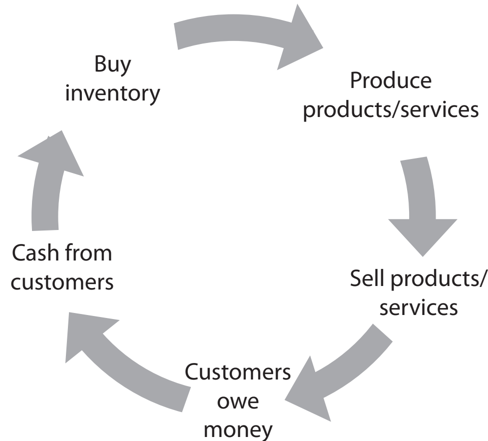

Figure 12.1: The trade cycle

The working capital of a business can be easily measured by looking at its statement of financial position. It reflects the current assets minus the current liabilities.

Money expected to flow in – Money expected to flow out

Working capital management is a matter of ensuring sufficient liquid resources (cash) are maintained this involves achieving a balance between the requirement to minimise the risk of insolvency (running out of cash) and the requirement to maximise the return on assets (be efficient with the cash). It is therefore important from two aspects, liquidity and profitability.

The working capital policy is a function of two decisions within the organisation:

The investment decision – what do I need to buy

The assets of the business can be categorised between non-current assets and current assets, it is generally expected that the non-current assets are financed by long-term sources of funds such as share capital or loans but should the current assets be financed in the same way?

Current assets can be categorised into two groups permanent and fluctuating.

- Permanent current assets reflect that a business will always require a base level of investment into inventory and accounts receivable in order to continue to generate sales.
- Fluctuating current assets reflect that the actual amount of investment required will change depending on a number of factors including seasonal demand, attempts to attract more customers and so on.

The finance decision – where can I access the money

The money can be accessed from long-term sources or from short-term sources, the choice to use long or short-term sources reflects the working capital policy of the organisation.

12.3 Working capital financing policy

Many organisations will use a *matching* policy so that non-current assets and permanent current assets are financed by long-term sources and the fluctuating current assets are financed by short-term sources (Figure 12.2). This is often also known as a moderate policy and will strike a balance between the need to have money available to meet demands but also ensures that money is not borrowed at high interest rates when it is not needed increasing efficiency and profitability.

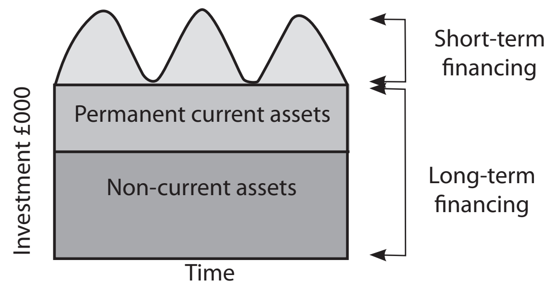

Figure 12.2: Matching policy for funding assets

There are two further policies a business can adopt depending on the managers' attitudes towards taking risks and the ability to clearly understand the organisation's working capital requirements.

The first is a non-risk taking approach known as a *conservative* policy, with this policy not only will all permanent assets be financed by long-term capital sources but some of the fluctuating current assets will also be financed in this way leaving only a small proportion of finance to be found short-term (Figure 12.3).

This tips the balance in favour of liquidity so the business will have fewer problems ensuring there is enough cash to meet needs but as a consequence it will be less efficient and less profitable as it is using more expensive long-term sources of finance even when they may not be required.

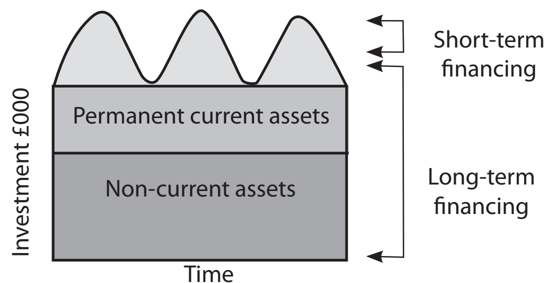

Figure 12.3: Conservative policy for funding assets

Finally the manager can take an *aggressive* policy which is a risk-taking policy (Figure 12.4). The manager will use short-term sources to finance fluctuating and some or all of the permanent current assets with the remainder of permanent current assets and non-current assets to be financed by long-term sources.