# 7 Management of working capital

## About this chapter

In Chapter 3 the concept of cash flow was discussed in detail and guidelines were given for the preparation of the indirect style of cash flow in accordance with IFRS1 guidelines. The monitoring of cash flow is a vital task for all businesses regardless of size. This chapter introduces the concept of working capital, which focuses on the current assets and current liabilities from the balance sheet, highlighting the liquidity of the business. Each aspect of working capital will be reviewed with guidelines for managing the overall liquidity of the business.

### Learning objectives

On completion of this chapter, you should be able to:

- ☐ Understand the importance of liquidity
- ☐ Understand the significance of cash flow management versus profit management
- ☐ Apply techniques for controlling inventory levels
- ☐ Understand the importance of managing debtor levels
- ☐ Apply techniques for monitoring creditors.

## Introduction

A key feature consistent with many of the business failures in the UK has been the fact that businesses have been too late in realising the importance of short-term and long-term cash availability. Obviously creating profit is important but maintaining sufficient cash funds for financing the payment of suppliers (trade creditors) and payroll, as well as for financing capital expenditures, is vitally important for the long term success of the business. The business model will determine how and when cash is received. Tour operators often receive revenues in advance via deposits and final payment prior to the trip taking place, and this can greatly assist with cash flow management. For businesses such as those in the meeting and events sector, payment from customers may come after the event, increasing the risk to the business, which should be mitigated by taking deposits in advance where possible.

When there are insufficient funds in the form of cash, the business may at worst face liquidation if creditors are not being paid, but such a shortage also limits the ability of a business to pursue a strategy of expansion through revenue growth. This chapter considers the management of working capital in total, as well as a review of the key aspects of each of the components including the value of monitoring:

- Working capital cycles
- Working capital ratios
- Debtors (accounts receivable)
- Creditors (accounts payable)
- Stock or inventory levels
- Cash levels

## Working capital

Working capital is normally defined as the cash value of current assets less the current liabilities. According to the ACCA (2023) working capital management is central to the effective management of a business because:

- Current assets comprise the majority of the total assets of some companies
- Shareholder wealth is more closely related to cash generation than accounting profits
- Failure to control working capital, and hence to manage liquidity, is a major cause of corporate collapse.

Poor management of the working capital can lead to:

- Inefficient use of resources if cash or inventory levels are too high and are not generating additional revenues. Too much beverage inventory held on site at a restaurant for example, represents cash tied up waiting to be released.
- Overtrading, which occurs when a business is growing, and trying to maintain a level of revenue to meet demand which is higher than the current levels of working capital can sustain. This can lead to a business struggling to keep up with purchasing sufficient inventory or investing on operational resources to meet demand.

When the current assets exceed the current liabilities at a particular point in time as illustrated by the balance sheet, this is known as positive working capital, where current assets are funded partly from the current liabilities such as trade creditors and bank overdrafts and also from long term sources of funds such as bank loans or equity. Negative working capital arises when current liabilities exceed current assets. In this case current liabilities are funding both current assets and a proportion of long-term assets.

In general, a business should seek to minimise the level of each type of current asset held such as stock, debtors and cash, and maximize the benefits from short term financing arising from the delayed payment of creditors. In practice this

means only stocking the inventories required for immediate sale and reducing the credit offered to customers. However, other factors influence the working capital policy such as the possibility of lost sales through not offering credit to potential customers, lost sales through holding insufficient stocks when demand surges, and increases in operating costs due to poor supplier relationships. The management of working capital should be based on achieving a balance between these factors. The problem lies in the fact that the level of funds required is constantly changing, particularly where there are seasonal sales which will affect stock, debtor and creditor levels. As a result, forecasting working capital requirements becomes difficult in cases where the level of future sales and the timing of cash flows are not known with accuracy. However, it is essential that every attempt is made to accurately predict the business cash requirements and the increasing importance of monitoring the levels of cash generated in an operation is now widely recognised. It is recommended therefore to prepare forecasted cashflows on a regular basis, monthly, weekly and even daily for some businesses.

There are various approaches to monitoring cash levels and working capital requirements and these will now be considered.

## Working capital cycle

In order to maintain liquidity in a business it is necessary to strike a balance to ensure that the level of available current assets is kept sufficiently high to cover payments to outstanding suppliers when they fall due. These cash balances mean that the business incurs an opportunity cost for interest lost or the earnings that could have been made if the cash had been invested elsewhere. The exact amount of idle cash held can be managed effectively by understanding and controlling the working capital or cash operating cycle. This calculation specifies the period taken in days between the cash payment to suppliers and the cash being received from customers for sales. In a business in the manufacturing sector where products are made in a factory environment, a large portion of the cash cycle will focus on days required to manufacture the finished product from the raw materials, and the incomplete finished goods are known as 'work in progress'. The cash operating cycle for a manufacturing business is illustrated below.

| | |
|---|---|
| Number of days raw materials held in stock | *x* days |
| Number of days needed to produce goods | *x* days |
| Number of days finished goods held in stock | *x* days |
| Number of days debtors take to settle accounts | *x* days |
| LESS | |
| Number of days taken to pay trade suppliers | *x* days |
| EQUALS | |
| Cash operating cycle | *x* days |

The aim is to reduce the cash cycle to zero so that a balance is achieved between the current assets and the current liabilities. A cash operating cycle above zero represents a less risky level of working capital but as the value increases more inefficiencies arise.