# WORKING CAPITAL MANAGEMENT

## 1. FM EXAM SCOPE: SEC A/B/C
## 2. THEORY + CALCULATION
## 3. BOOK READING IS COMPULSORY

### WHAT IS WORKING CAPITAL?

Working capital is the name given to net current assets which are available for day-to-day operating activities.

There are number of different definitions of working capital but most widely accepted is that it represents current asset minus current liabilities.

Current asset includes cash, inventories, receivables, short term investments and prepayments

Current liabilities includes payables and bank overdrafts
Working capital = Net Current Assets

### CASH OPERATING CYCLYE

*Explain the meaning of the term **cash operating cycle**?*

Discuss the **relationship between the cash operating cycle and the level of investment in working capital**.

Your answer should include a discussion of relevant working capital policy and the nature of business operations. **(7 marks)**

**Explanation 2 Marks**

The cash operating cycle is the **length of time** between the company's **cash outlay on raw materials, wages and other expenditures and the inflow of cash from collection of cash from the customers.**

The cash operating cycle in a typical **manufacturing business** equals the average time that **raw materials** remain in inventory plus the average time taken to **produce the goods (WIP)** plus average time taken to **sell the finish goods** plus average the time taken by **customers to pay** for the goods **less** the average period of **credit taken from suppliers/wagers/overheads.**

**<u>Cash operating cycle and the Level of investment in working capital 5 MARKS</u>**

There is a **relationship** between the cash operating cycle and the level of investment in working capital.

***<u>1 Mark</u>***

The **length** of the cash operating cycle **depends** on the ***working capital policy*** which will determine the level of investment in working capital and also of the ***nature of the business operations.***

EG If the turnover periods for inventories and accounts receivable lengthen, or the payment period to accounts payable shortens, then the operating cycle will lengthen and the investment in working capital will increase and VICE VERSA.

***<u>2 Marks - Working Capital Policy</u>***

The level of investment in working capital depends on the company's working capital policy. Two companies with similar business operations may have significantly different levels of investment depending on whether they adopt a conservative or an aggressive approach. An aggressive policy involves having lower levels of inventory JIT and trade receivables and will therefore mean there is a shorter cash operating cycle. A conservative policy involves having higher levels of inventory and trade receivables and will give rise to a longer cash operating cycle. The longer cash operating cycle (= more investment in wc = more interest cost = will mean profitability) is less than under the aggressive approach, but it reduces risk such of the risk of a stock-out.

*<u>2 Marks - Nature of business operations</u>*

Business operations will have a significant effect on the cash operating cycle. A business supplying services (Banks/Educational Institutes) may have very low levels of inventory whereas a manufacturer (Toyota) may have very high levels of inventory.

A retailer (Super Stores – IMTIAZ/wall-mart) who operates mainly using cash sales will have a significantly lower level of trade receivables than a company who conducts most of its sales by offering credit terms (eg Intermediary products – Chemical Manufacturer or Manufacturer of FMCG where the customers are whole sellers and distributors).

## WORKING CAPITAL MANAGEMENT

This refers to the process with the business of **managing the elements that make up working capital**, and managing working capital as a whole.

Financial Management Objective = MAXIMISE THE WEALTH OF SHAREHOLDER

**WCAP MGMT OBJECTIVE = LIQUIDITY MANAGEMENT**

**WORKING CAPITAL MANAGEMENT = ONE OF THE FM FUNCTION**

- **PROFITIBILITY**
- **LIQUIDITY**

### Objectives of working capital management

The two main objectives of working capital management are to ensure it has **sufficient liquid resources** to continue in business and to **increase its profitability**.

Every business needs adequate **liquid resources** to maintain day-to-day cash flow. It needs enough to pay wages, salaries and accounts payable if it is to keep its workforce and ensure its supplies.

Maintaining adequate working capital is not just important in the short term. Adequate liquidity is needed to ensure the **survival** of the business in the long term. Even a profitable company may fail without adequate cash flow to meet its liabilities. On the other hand, an excessively conservative approach to working capital management resulting in high levels of cash holdings will **harm profits** because the opportunity to make a return on the assets tied up as cash will have been missed.

*These two objectives will often **conflict** as liquid assets give the lowest returns.*

**Efficient Working capital management resulting not only to maintain but can also reduce operating cycle time by:**

- Improving production efficiency – wip
- Improving finished goods and / or raw material inventory turnover
- Improving receivable collection and payables payment periods

# DEBTORS MANGAGEMENT

**OBJECTIVE:**
Optimum level of debtor's level represent a balance between:

- Profit improvement (by offering appropriate level of credits to customers)
- Cost of credit allowed

**COST ASSOCIATED WITH DEBTORS MANAGEMENT:**

**- BAD DEBTS**
**- ADMINISTRATION COST**
**- FACTORING COST (DEBTS COLLECTION OUTSOURCE)**
**- FINANCE COST**
**- LOST SALES/CONTRIBUTION (IF MENTION IN THE QUESTION)**

**DEBTORS – "THE EXTENSION OF CREDIT TERMS" - BUSINESS TOOL TO ENHANCE SALES**

Sales on credit can be used in a business as a business strategy (business tool) to enhance the sale revenue by penetrating in the market to get more (market) share.

**ANALYSIS**
Financial Analysis can be made = BENIFIT VS COST

BENEFIT:
ADDINTIONAL CONTRIBUTION

COST:
ADDITIONAL BAD DEBTS
ADDITIOONAL ADMIN COST
ADDITIONAL FIANANCE COST

**DECISION WILL BE BASED ON NET BENEFIT BASIS**

*Question: Extension of Credit Terms*

*The company have the current situation as mention below and all working capital are financed by 11% bank overdrafts.*

- *Credit sales* *$7,500,000*
- *Debtors* *$1,028,000*
- *Bad Debts* *$50,000*
- *Contribution Margin* *24%*

*The company is considering to extend its credit terms by 30 days and based on analysis the expected results will occur as follows:*

- *Sales increase by 10%*
- *Admin cost increase by 10,000*
- *Bad Debts increase by 40,000*

***Requirement: Analysis the extension of credit terms in financial terms. (Assuming all customers will accept the new settlement terms)***

**ACCOUNT RECEIVABLE/DEBTORS MANAGEMENT POLICY**

This **policy** is basically make **based on these factors**:

- Competitors Terms
- Risk of Bad Debts in the relevant market
- Demand of the product
- Company's own brand/reputation
- Working Capital Investment Policy (Behavior – Aggressive/Conservative/Moderate)
- Cost of Debtors Management (Finance Cost/Bad Debts Cost/Admin Cost)

**Debtors Management Policy - 4 components:**

- Assessment of creditworthiness – 3 Marks – 2 relevant points
- Credit Limit (individual customer & totality)
- Invoice Promptly and Follow up for the collection of over-due debts (Recovery)
- Monitoring – Status of aging

*HW – WRITE DOWN THE DETAILS OF ALL THE 4 COMPONENTS ABOUT DEBTORS MANAGEMENT POLICY? – 12 MARKS*

## DEBTORS MANAGEMENT

**Debtors Management can be made as follows:**

1. Policy implement as mention above (T)
2. Cash Discount Offer (T+C)
3. Factoring (T+C)
4. Invoicing (T)

**Cash Discount Policy**

Cash discounts are given to encourage early payment by customers.

The cost of the discount is balanced against the savings the company receives from having less capital tied up due to a lower receivables balance and a shorter average collection period. Discounts may also reduce the number of irrecoverable debts.

**ANALYSIS CASH DISCOUNT POLICY**

**ADDITIONAL BENEFIT**

- FINANCE COST SAVING
- BAD DEBTS SAVING
- ADMIN COST SAVING

**ADDITIONAL COST:**

- CASH DISCOUNT

***DECISION WILL BE BASED ON NET BENFIT BASIS***

**Question**

| | |
|---|---|
| Credit sales | $4,000,000 |
| Debtors collection days | 60 Days |
| Bad Debts | $50,000 |

The company have the current situation as mention above and all working capital are financed by 12% bank overdrafts.

The company is considering to reduce the level of debtors by offering cash discount of 2% for payment made within 10 days.

Based on the analysis it is expected that 70% of the existing customers will accept the policy and level of bad debts will reduce by 25%.

***Requirement: Analysis the cash discount policy in financial terms***

The calculation of the annual cost can be expressed as a formula:

$$\text{Annual cost of discount} = \left[1 + \frac{\text{discount}}{\text{amount left to pay}}\right]^{\text{no.of periods}} - 1$$

$$\text{Where no. of periods} = \frac{365 / 52 / 12}{\text{No. of days / weeks / months earlier the money is received}}$$

Notice that the annual cost calculation is always based on the amount left to pay, i.e. the amount net of discount.

If the cost of offering the discount exceeds the rate of overdraft interest then the discount should not be offered.

**<u>EXAMPLE</u>**

A company is offering a cash discount of 2.5% to receivables if they agree to pay debts within one month. The usual credit period taken is three months.

What is the effective annualised cost of offering the discount and should it be offered, if the bank would loan the company at 18% pa?

The above calculation gives a quick and easy way to evaluate the annual cost and reach a decision on whether to offer an early settlement discount.

**FACTORING**

Factoring is the outsourcing of the credit control department to a third party.
The debts of the company are effectively sold to a factor (normally owned by a bank). The factor takes on the responsibility of collecting the debt for a fee.
The company can choose some or all of the following three services offered by the factor:

1. Debt collection and administration – recourse or nonrecourse
2. Financing
3. Credit insurance.

These are of particular value to:

1. Smaller Firm
2. Fast growing firms

Make sure you can discuss the various services offered and remember that nonrecourse factoring is more expensive as the factor bears the costs of any irrecoverable debts.

**FACTORING:**

Managing debtors using the services of the specialist debtor's collection company. These are basically investment companies.

The services we are getting as follows:

1. Credit control administration - debtors collection (fees charge)

2. Financing of debtors - as per agreement – interest cost

**Factoring by nature:**

**Non-recourse factoring - bad debts will bear by factor (the company will have no bad debt cost) - factoring fees higher**

**Recourse factoring - bad debts will bear by company (the company will have 100% bad debt cost) - factoring fees lower**

**FIANANCIAL ANALYSIS (EXISTING VS FACTORING)**

Additional benefit:

- Saving of administration cost
- Saving of bad debts (in case of no recourse factoring only)
- Saving in finance cost *

Additional cost:

- Factoring fees
- Contribution lost

*Finance cost

Now - same as previous working

New:

- 1st new level of debtors.
- 2nd debtors finance according to the proportion of bank o/d and advance by factor - as per given infromation

**Question**

Extracts from the recent financial statements of Bold Co are given below.

| | $000 |
|---|---|
| Turnover | 21,300 |
| Debtors | 3,500 |

Factoring Arrangement

A factor has offered to manage the trade receivables of Bold Co in a servicing and factor-financing agreement.

The factor expects to reduce the average trade receivables period of Bold Co from its current level to 35 days; to reduce bad debts from 0.9% of turnover to 0.6% of turnover; and to save Bold Co $40,000 per year in administration costs.

The factor would also make an advance to Bold Co of 80% of the revised book value of trade receivables.

The interest rate on the advance would be 2% higher than the 7% that Bold Co currently pays on its overdraft.

The factor would charge a fee of 0.75% of turnover on a with-recourse basis, or a fee of 1.25% of turnover on a nonrecourse basis.

Assume that there are 365 working days in each year and that all sales and supplies are on credit.

**Requirement:**

Calculate the value of the factor's offer:

- on a with-recourse basis;
- on a non-recourse basis. **(7 marks)**

**EXAM QUESTION: FM S/D 2018: OSCAR**

More about debtor's management:

- Factoring Benefit, Other than cost analysis
- What is invoice discounting?
- Factors to consider in formulating a trade receivables management policy
- How the creditworthiness of potential customers can be assessed?