

Principles of Finance

Module 08: Working Capital Management

Module Introduction

Readings

Required

Chapter 15 in *Foundations of Finance: The Logic and Practice of Financial Management: Working-Capital Management*

Recommended

Akram, M., Jamil, S., Ali, J., Ali, B., Abdulsattar, W. K., & Khan, W. (2016). **Impact of working capital management on market return: A comparative study of Pakistan and Indian chemical sector (<https://csuglobal.idm.oclc.org/login?url=http://search.ebscohost.com/login.aspx?direct=true&db=bth&AN=115835895&site=ehost-live>)**. *Business Management Dynamics*, 5(10), 10-25.

Chapter 15 PowerPoint slides (media/SEU FIN500 9e Ch15.pptx) – *Foundations of Finance*

For Your Success

Cash is the lifeblood of a business. As Keown, Petty, and Martin (2017) discussed regarding the first principle of finance, cash flow is what matters. Working capital management is a primary component of properly managing cash flow and maintaining a healthy cash position for the business. As you read and study the material on working capital, keep in mind the questions listed at the top of each page. The questions should help you focus on the heart of the reading. The questions will also assist you in developing your own questions based on this material.

Remember to ask questions when you have them. The best questions are the questions asked, so please ask. Now let's read on.

Assignments required in this module

Remember to post your initial response to our discussion question by 11:59 p.m. Mountain Time (MT) on Wednesday, and to respond to at least two colleagues' posts by 11:59 p.m. MT Saturday.

Compare your local time to US Mountain Time (Denver, Colorado, USA) to determine the time you need to submit your assignments based on your local time. Use these time zone converters to help

need to submit your assignments based on your local time. Use these time zone converters to help translate your time:

<http://www.timeanddate.com/worldclock/converter.html?p1=1440>

<http://www.timeanddate.com/worldclock/converter.html?p1=1440>

<http://earthsky.org/astronomy-essentials/universal-time>

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Finance principles for this module

Principle 1: Cash Flow is What Matters – We are concerned with the money in hand, not accounting profit.

Learning Outcomes

1. Understand the rationale and basics of revenue forecasting.
2. Comprehend and synthesize the components of working capital management.
3. Synthesize the process of financial analysis and evaluate the relationships between analysis components.

1. Managing Cash for Success



Questions to ask regarding cash management and cash budgeting:

- What elements of cash budgeting are the most beneficial to a cash manager?
- What problems can cash budgeting help to minimize?
- How often should a manager review a cash budget?

One essential goal for every organization should be to maintain a strong cash position. There should be enough cash to meet payroll requirements, to pay operating expenses, to keep accounts payable current, and to meet the debt service requirements. Knowing how much cash is needed each week, month, and year is the first real step in cash budgeting. In addition, a cash manager should know where to apply surplus cash (cash in excess of requirements) to either increase income or decrease expenses. As an example, surplus cash may be invested in short-term securities to increase investment income for the business. As an alternative, surplus cash may be used to reduce a line of credit (short-term revolving loan) to reduce interest expense for the business. This option often works particularly well if you can borrow money as needed (Keown et al., 2017).

A well-prepared business plan includes projections and cash budgets. The assumptions in the projections and cash budgets start with the premise that a business will continue at the same level as the previous year and grow moderately in subsequent years. These projections should be adjusted as appropriate for any significant event within the business (new line of business is planned) or the economy (higher or lower national growth is projected).

So, how does a cash manager monitor the cash budget to ensure the business has sufficient cash to meet its needs? Many managers schedule weekly meetings, including the inventory manager, the production manager, and other pertinent managers, to discuss the operation schedules for the next four weeks. With this information and the projected collection of accounts receivable, the manager can adjust the cash budget, as needed. After updating the cash budget, the cash manager can then determine that sufficient cash is available to fund scheduled operations.

In this brief video, Investopedia (2016c) covers understanding cash flow and the importance for businesses to properly manage their cash flow. <http://www.investopedia.com/video/play/what-is-cash-flow/> (<http://www.investopedia.com/video/play/what-is-cash-flow/>)

2. Inventory as a Critical Component of Cash Management



Questions to ask regarding inventory management:

- What are the primary materials needed in our operations to produce finished goods?
- What are the benefits of choosing an inventory management such as just-in-time (JIT) with suppliers?
- How does an inventory management system influence cash budgeting?
- Based on the size of a company, how much control can it exert on suppliers to manage the volume of inventory and the delivery schedule?

With this information, the inventory manager can order the materials needed and keep track of inventory on hand. Finished goods are often maintained in a separate area, awaiting shipment.

This sounds easy and is as long as the suppliers are paid for the materials in a timely fashion. If a company is late with a payment, the production schedule could be delayed for weeks. This in turn can delay delivery to the customer and result in longer periods for collecting accounts receivable. Bottom line: Inventory management is critical to cash flow, as is timely payments to vendors. The inventory manager has to decide when to order materials based not only on the production schedule but also on

the cash budget. If a large, in-process customer order is delayed, the investment in materials may put a serious strain on working capital. The offset to this is to tap existing cash reserves or to borrow additional funds from a bank to maintain the production schedule and shipment to the customer. This whole process goes back to that company lifeblood . . . cash (Keown et al., 2017).

In this brief video, Investopedia (2016b) explains inventory management and its importance to a company's bottom line. <http://www.investopedia.com/video/play/inventory-management/>
(<http://www.investopedia.com/video/play/inventory-management/>)

Check Your Understanding

Click Here to Begin

3. Accounts Receivable and Credit Management Decisions



Questions to ask regarding accounts receivable and credit management decisions:

- Will more liberal credit terms increase sales?
- How will more liberal credit terms affect cash flow?
- What is the potential effect on credit quality of more liberal terms?
- What are the implications of adopting more conservative credit terms?

As some businesses have experienced, more liberal credit terms often increase sales in the short term. Unfortunately, liberal credit terms usually extend collection periods on outstanding accounts receivable and that can put strain on the business's cash flow. Another factor that can occur with more liberal terms is delayed collection of outstanding accounts receivable from customers that may not be financially sound enough to make timely payments. This again puts stress on the cash flow of the business. Conversely, the implication of adopting more conservative credit terms may be the loss of some sales; however, the offsetting factors for more conservative credit policies are timely payment of invoices by customers and much lower collection problems on outstanding accounts receivable invoices.

Determining the credit terms that a business offers customers can have a significant effect on cash

needs and cash forecasting. While potential customers may have excellent credit ratings and payment histories, actual collection experience may be dependent on how the business performs, how the business follows up, and the current economic cycle.

As noted, the credit quality of potential customers is important to timely collection of accounts receivable. The cash manager should have a credit analysis prepared on all new customers. This process determines the history a potential customer has in paying invoices in a timely fashion and the customer's current ability to make future payments. After credit terms are approved and products shipped, monitoring the collection of accounts receivable is the next step.

To facilitate the collection process, an accounts receivable clerk can call customers to ensure that they received the materials and the invoices and to confirm that the customer had all of the information needed to process the invoice for payment. This practice helps to eliminate unnecessary delays; however, it does not always expedite payment.

Reducing collection periods can have a very positive effect on cash flow and cash budgeting, as this effort often eliminates the need to borrow short-term loans to pay accounts payable or other operating expenses. In the same sense, negotiating extended terms with vendors can help companies better manage the day-to-day cash flow requirements of the organization. Keown et al. (2017) present an excellent discussion of the cash conversion cycle, credit terms, and sources of short-term credit in your text reading this week.

In this brief video, Investopedia (2016a) explains accounts receivable and its importance in a company's working capital. <http://www.investopedia.com/video/play/accounts-receivable/>
[\(http://www.investopedia.com/video/play/accounts-receivable/\)](http://www.investopedia.com/video/play/accounts-receivable/)

Check Your Understanding

Click Here to Begin

References

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<http://www.investopedia.com/video/play/accounts-receivable/>

Investopedia. (2016b). Inventory management. Retrieved from

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Investopedia. (2016c). Understanding cash flow. Retrieved from

<http://www.investopedia.com/video/play/what-is-cash-flow/>

Keown, A. J., Martin, J. D., & Petty, J. W. (2017). *Foundations of Finance: The Logic and Practice of Financial Management* (9th ed.). Upper Saddle River, NJ: Prentice Hall.