Working Capital Financing

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WHAT'S COVERED

In this lesson, you will learn about the primary objectives of working capital management. Specifically, this lesson will cover:

1. Understanding the Needs of the Business

Working capital is a financial standard of measurement which depicts the operating liquidity available to a business. It is considered a part of operating capital in conjunction with fixed assets, like a plant and equipment. Adequate working capital is necessary to guarantee that a firm is able to continue its operations, that it has enough funds to pay off maturing short-term and long-term debts, as well as pay for impending operational expenses. However, too much working capital can bring a greater cost of capital.

> EXAMPLE A company may be enriched with assets and profitability but lack liquidity if those assets cannot be easily converted into cash.

The management of working capital comprises administering inventories, accounts receivable, accounts payable, and cash.

1a. Calculation of Working Capital

When we calculate working capital, we are referring to net working capital, calculated as current assets minus current liabilities.

FORMULA TO KNOW

Working Capital

$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

The resulting figure is widely used in valuation techniques like discounted cash flows. Now, if current assets are less than current liabilities, then this business or firm is said to have a working capital deficiency, also known as a working capital deficit.

Under the umbrella of current assets and current liabilities are three important accounts that represent the scope of the business where managers have the most explicit impact:

- Accounts receivable (current asset)
- Inventory (current asset)
- Accounts payable (current liability)

A company ideally wants accounts receivable to be collected as quickly as possible in order to have as much use of the funds as possible. Conversely, a firm strives to put off the settlement of accounts payable as long as possible for the same reason.
The current portion of debt is also critical because it represents a short-term claim to current assets and is often secured by long-term assets. Common types of short-term debt are bank loans and lines of credit.

Inventory is a special case in which even non-financial managers have a stake. Too much inventory on hand will reduce the risk of a company failing to satisfy customer needs, but it can also reduce profitability.

> EXAMPLE In the computer industry, an example of reduced profitability is where inventories regularly lose value because of the fast-moving nature of the industry.

1b. Profitability and Liquidity Tradeoff

In any company, large or small, there is an inherent tradeoff between liquidity and profitability. Large companies possess resources to help them manage this tradeoff, such as an accounting department, negotiating power with their suppliers, or access to the capital markets. For the entrepreneur, however, who is often resource-starved and doesn't have enough operating history to secure additional credit, managing this tradeoff can feel like walking a tightrope.

> EXAMPLE Consider the case of a new customer for a small company. This new customer has the potential to offer huge growth in the company's sales, but this growth in sales will be accompanied by a subsequent growth in variable costs. The company may not have the resources (i.e., working capital) to meet these variable costs that come with increased sales.

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2. Long-Term Approach

Recall that working capital is a calculation of the overall operating liquidity an organization has access to at a given moment, derived through a simple calculation from the balance sheet, where we subtract current liabilities from current assets.

- Current assets are items a business owns that are either current cash, or assets that can be rapidly converted to cash, such as accounts receivables, cash, cash equivalents, short-term investments, and inventory.
- Current liabilities are debts owed in the short term, such as accounts payable, short-term debts, and other obligations within a short operational cycle.

When you subtract what is owed in the short term from what is available, an organization can project how much free working capital is on hand during the operating cycle. This free working capital can be utilized in a variety of ways. Working capital that is underutilized incurs the opportunity costs associated with the time value of money, and organizations must use financial planning to ensure appropriate utilization of this capital over the longer term.

While short-term planning is predominantly what is used in respect to working capital (due to the short-term nature of the inputs and outputs involved), it is reasonable to set long-term policies and strategies for incorporating changes in working capital into financial strategy. The primary benefits of leveraging working capital are liquidity and profitability, each of which can be viewed through a longer-term lens.

- *Liquidity:* When discussing long-term objectives, the focal point is broader strategy (as opposed to tactics). From a strategic perspective, there is a certain amount of liquidity a business would like to maintain at any given moment to ensure that they can capture external opportunities in the market. Having easily accessible working capital at any given moment enables organizations to minimize the opportunity cost of foregone opportunities, and careful regulation of working capital strategic criteria can ensure the appropriate amount is available.
- *Profitability:* The other broader objective of working capital is how effectively it is utilized over a given time period. From the long-term perspective, this profitability metric will be quite a bit different than the short term. From a longer-term perspective, working capital profitability decisions revolve around how much should be available within any short-term time frame in order to maximize the return (on average) of existing working capital. By looking at differences in working capital availability over a long period of historical data, the organization can make rough estimations of the optimal amount of working capital availability that allows optimal growth.

BIG IDEA

Despite the potential advantages of longer-term planning in working capital, it is still largely a field of shorter-term decision making. Generally, working capital should be considered within a one year or less time frame, making it more often a shorter-term decision.

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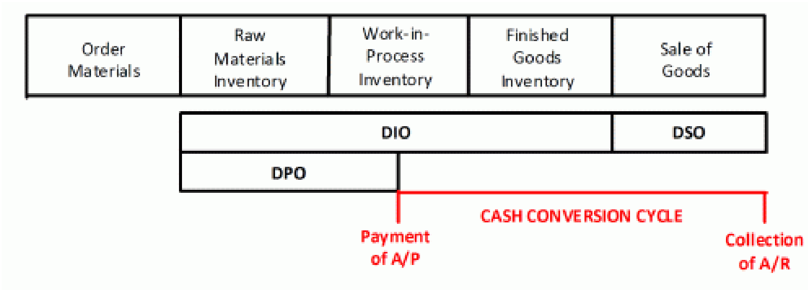
3. Short-Term Approach

Working capital is the amount of capital that is readily available to an organization. Working capital is the difference between cash resources or assets readily convertible into cash (current assets) and cash obligations (current liabilities). As a result, the decisions relating to working capital are almost always current (i.e., short term) decisions. In other words, working capital management differs from capital investment decisions – specifically in terms of discounting and profitability.

Working capital management applies different criteria in decision making. The main considerations are cash flow/liquidity and profitability/returns on capital. The most widely used measure of cash flow is the net operating cycle or cash conversion cycle, a metric that shows the length of time a business will lack cash, in the event it diverts investment dollars into resources to bolster customer sales.



The cash conversion cycle indicates the firm's ability to convert its resources into cash and informs management of the liquidity risk entailed by growth. Because this number effectively corresponds to the time that the firm's cash is tied up in operations and unavailable for other activities, management generally aims at shortening the cash conversion cycle as much as possible.

However, there are risks involved in shortening the cycle. It is possible that a firm could attain a negative cash conversion by securing payment from customers before paying suppliers, but such a tactic of enforced collections and slack payments is not generally viable long-term.

The purpose of studying and calculating the cash conversion cycle is to modify the policies connected to credit purchase and credit sales. A firm can adjust its requirements for payment on credit purchases and obtaining payment from debtors based on the cash conversion cycle. If the firm is in a position of effective cash liquidity, it can continue its former credit policies.

4. Choosing a Policy

A firm's management uses an amalgam of policies and techniques to manage its working capital, steered by guidelines surrounding cash flow, liquidity, profitability, and return on capital. These policies purport to manage the current assets, which are typically cash and cash equivalents, inventories and debtors, and the short-term financing, in a manner that results in acceptable cash flows and returns. In keeping with any determination involving the management of capital, the goal of the firm should be to reduce the overall cost of capital to a minimum while raising the value to the shareholders to a maximum. To optimally manage cash flow, a firm should determine that cash balance that ensures the business can meet daily expenses, but that lessens cash holding costs, or the opportunity cost of holding cash versus investing it.

Businesses should determine the amount of inventory that enables continuous production but decreases the investment in raw materials and respective reordering costs, thereby resulting in increased cash flow. Businesses also need to address the concerning issue of managing debtors, by adopting the appropriate credit policy that ensures that any impact on cash flows and the cash conversion cycle will be counterbalanced by increased revenue and return on capital. In addition, management should put relevant credit scoring policies and techniques in place to ensure the risk of default on any new business is within an acceptable range.

Lastly, an area of concern for management to consider when choosing a working capital policy is short-time financing. It is imperative for a firm to determine the fitting source of financing, considering the cash conversion cycle. Ideally, inventory is financed by credit bestowed by the supplier, although in certain situations, it may be necessary to use a bank loan.

One of the objectives within working capital management and general financing decisions is to match the maturity of liabilities with the life expectancy of assets. This allows liabilities to be self-liquidating. If the maturity of liabilities is less than the life expectancy of assets, a firm faces refinancing risk since it will have to raise new capital to pay off liabilities. If the maturity of liabilities is longer than the life expectancy of assets, then there should be sufficient working capital available to pay off debts. The mismatching of liabilities with assets can occur if financing is not available.

> EXAMPLE Suppose long-term financing is not available. Short-term sources of financing may have to be used. Mismatching can also be intentional. A company could expect long-term interest rates to fall. The firm may want to finance assets with short-term maturities since it can refinance in a few years at a much lower rate.

SUMMARY

In this lesson, you learned that good working capital management involves **understanding the needs of the business** and making decisions about short-term capital that maximize returns while generating acceptable cash flows. Once business needs are understood and **working capital is calculated**, decisions regarding working capital management impact the **profitability and liquidity tradeoff**.

You also learned that companies can take a **long-term approach** when viewing the utilization of working capital, but working capital is primarily about **short-term** planning. When performing short-term planning, the cash conversion cycle is an important metric for analyzing cash flows. Ultimately, a company has four variables to consider when **choosing a policy** for working capital that meets the needs and goals of the business.

Best of luck in your learning!