Chapter 05: Section 1, 2 and 3

The Fundamentals of Working Capital Management

Section 01: Importance, Elements and Funding of Working Capital

1. terms

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1. **Working Capital:** Ability of a company to meet its short-term obligations using its short-term assets.
2. **Current Assets:** Assets expected to be realized within twelve months or the operating cycle.
3. **Current Liabilities:** Obligations expected to be settled within twelve months or the operating cycle
4. **Net Working Capital:** The excess of current assets over current liabilities

5. VerticAL Analysis

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You apply this method to compare the company's composition against industry benchmarks and identify potential inefficiencies

	2018		2017	
	Amount	Percent	Amount	Percent
ASSETS:				
Current assets	$ 550,000	48.3%	$ 533,000	43.3%
Long-term investments	95,000	8.3%	177,500	14.4%
Plant assets (net)	444,500	39.0%	470,000	38.2%
Intangible assets	50,000	4.4%	50,000	4.1%
Total assets	$ 1,139,500	100.0%	$ 1,230,500	100.0%
LIABILITIES:				
Current liabilities	210,000	18.4%	243,000	19.7%
Long-term liabilities	100,000	8.8%	200,000	16.3%
Total liabilities	$ 310,000	27.2%	$ 443,000	36%
STOCKHOLDERS' EQUITY				
6% preferred stock	150,000	13.2%	150,000	12.2%
Common stock	500,000	43.9%	500,000	40.6%
Retained earnings	179,500	15.7%	137,500	11.2%
Total stockholders' equity	829,500	72.8%	787,500	64.0%
Total liabilities and stockholders' equity	1,139,500	100.0%	1,230,500	100.0%

6. HORIZONTAL Analysis

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Horizontal analysis compares financial data across multiple periods to identify patterns and changes. This technique reveals whether working capital management is improving or deteriorating over time.

Balance Sheet			Horizontal Analysis	
($ in millions)	2020A	2021A	($)	(%)
Cash and Equivalents	$80	$100	$20	25.0%
Accounts Receivable	50	65	15	30.0%
Inventory	40	45	5	12.5%
Prepaid Expenses	10	10	--	--
Total Current Assets	**$180**	**$220**	**$40**	**22.2%**
PP&E, net	200	220	20	10.0%
Total Assets	**$380**	**$440**	**$60**	**15.8%**
Accounts Payable	$60	$75	$15	25.0%
Accrued Expenses	35	40	5	14.3%
Total Current Liabilities	**$95**	**$115**	**$20**	**21.1%**
Long-Term Debt	85	100	15	17.6%
Total Liabilities	**$180**	**$215**	**$35**	**19.4%**
Total Equity	**$200**	**$225**	**$25**	**12.5%**

Corporate Liquidity Enhancement Through Working Capital Management

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1. Managing Operating and Cash Conversion Cycles
2. Accelerating Receivables Collection
3. Optimising Payables Management
4. Implementing Cash Flow Forecasting

Profitability Optimization Through Working Capital Efficiency

1. Analysing Working Capital Ratios
2. Implementing Inventory Control System
3. Managing the Cost of Trade Credit

Strategic Working Capital Management and Competitive Advantage

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1. Using Credit Policy as a Market Penetration Tool
2. Leveraging Inventory for Service Excellence
3. Building Supply Chain Resilience Through Payment Strategy
4. Adapting Strategy to Industry Context
5. Visualizing Strategic Trade-offs

Working Capital Financing Options

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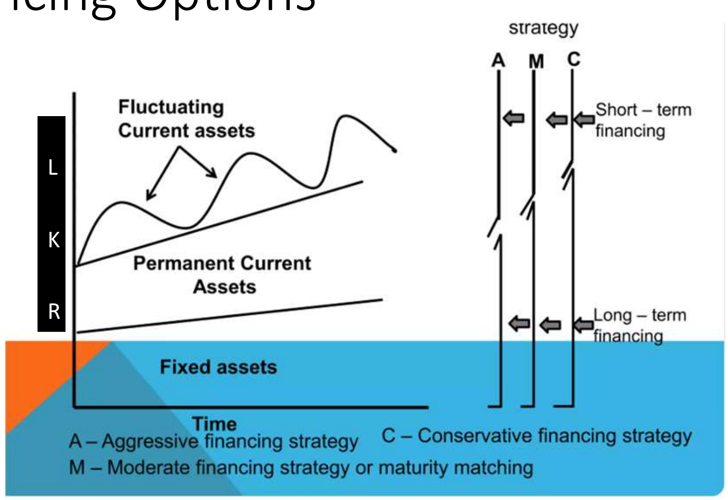
1. Aggressive strategy
2. Moderate Strategy
3. Conservative Strategy

Permanent Working Capital: Minimum level of current assets required to sustain normal operations

Temporary/ Fluctuating Working Capital: Additional current assets required for seasonal or cyclical peaks.

A retailer maintaining minimum inventory of Rs.50 million year-round.

The same retailer needing extra Rs.30 million inventory during December



Maturity Matching Principle

Your company needs Rs. 10 million for seasonal inventory that will be sold in 90 days. You secure a 90-day short-term loan at 8%per annum. The cash generated from sales repays the loan, perfectly matching the asset's life with the financing term.

Debt Factoring

A financial transaction whereby a business sells its accounts receivable to a third party.

You sell invoices worth Rs. 500,000 to a factor. The factor advances 80% (Rs. 400,000) immediately. After collecting the full amount from customers, the factor pays you the remaining Rs.100,000, minus fees totalling Rs.15,000.

Recourse and Non-Recourse Factoring

The difference is based on who bears the customer defaulting.

Recourse Factoring: A factoring arrangement where the business must buy back invoices the factor cannot collect.

Non-Recourse Factoring: A factoring arrangement where the factor assumes the risk of customer non-payment

Invoice Discounting

A working capital financing solution where businesses borrow money against their outstanding sales invoices. A financier advances a high percentage (typically 80–95%) of the invoice value immediately, allowing companies to access cash instantly rather than waiting 30–90 days for client payment, while retaining control over collections.

Unlike factoring, customers remain unaware of the financing arrangement.

Section 02: Working Capital Cycle and Cash Operating Cycle

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Cash Operating and Cash Conversion Cycles

Cash Operating Cycle = Inventory days + Receivable days

Cash Conversion Cycle = Inventory days + Receivable days – Payable days

- **Manufacturing:** Examining the impact of long production processes and high inventory investment
- **Retail:** Analysing the effects of rapid inventory turnover and seasonal demand
- **Service:** Investigating the challenges of managing receivables and labour costs without physical inventory

Optimizing Early Payment Discounts

Effective Annual Cost of Forgoing Discount

$$\left(\frac{\text{Discount \%}}{100\% - \text{Discount \%}}\right) \times \left(\frac{365}{\text{Full Payment Period} - \text{Discount Period}}\right).$$

Early Payment Discount Analysis	
Parameter	**Value**
Invoice Amount	Rs. 500,000
Credit Terms	2/10, net 45
Discount Amount	Rs. 10,000
Days of Additional Credit	35 days
Effective Annual Cost of Forgoing Discount	**21**.3%
Company's Bank Overdraft Rate	15.0%
Recommendation	**Take the discount**

Table 2.2.4: Early Payment Discount Analysis

Section 03: MANAGING INVENTORY

Inventory Obsolescence Write-Down

According to accounting standards (LKAS 2), inventory must be valued at the lower of cost and net realisable value.

Trident Logic Ltd holds a line of networking equipment that cost Rs. 2,000,000. Due to the release of a new generation of technology, these products are now considered obsolete and can only be sold in a clearance sale for an estimated net realisable value (NRV) of Rs. 450,000. Calculate the required inventory write-down.

Safety Stock

Extra quantity of an item held in inventory to reduce the risk of stockout.

Economic Order Quantity (EOQ)

The order quantity that minimizes the total costs of ordering and holding inventory.

Inventory Tracking And Control System Implementation

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1. Technology-Aided Tracking Systems
2. Physical Control Procedures
3. Cycle Counting for Continuous Accuracy
4. Management Reporting Systems
5. System Implementation Process