Working Capital Management

David Neuberger, a Silver Fox Advisor

All business owners are very aware of the importance of cash in effectively managing a business. Thus, the often-used expression “that cash is king.” This cash is created from the management of working capital. For the purposes of this monograph we consider working capital to be the total of accounts receivable, inventory, and accounts payable. If a business owner cannot control these three activities he cannot manage his cash and therefore there is almost certainty that the business will fail. This monograph will provide some thoughts on how to manage working capital effectively. We review important concepts for each of the three elements of working capital. At the conclusion we will provide a tool to develop a comprehensive measurement of working capital management. For each of the three elements, important analytical measurement tools will also be provided.

INVENTORY—Many service businesses and virtually every manufacturing business owns inventory. For a service business it might be elements that are consumed in providing the service. But to effectively operate the business is required to maintain an inventory of these consumables. Often these consumables might be items such as paper, notebooks, and any supply that is regularly consumed or provided the customer. In manufacturing, inventory includes a combination of finished goods, the end product manufactured, and raw material, the parts that are consumed to produce the finished goods.

In managing these inventories there are certain critical elements that must be considered:

1. Identification of the inventory element—each item in inventory should have a part number
2. Acquisition cost—the cost of acquiring the item. The value of the inventory is the multiplication of the quantity on hand times the acquisition cost. There are many procedures available to value inventory items. The simplest approach would be to calculate the average value of the item by averaging the different purchase prices.
3. Reporting the consumption of the inventory when the goods or service is provided to the customer.
4. Maintenance of a perpetual inventory of the items-- In a simple business this inventory can be maintained manually. In more complex business it should be maintained in a computer. Ideally if computerized the consumption of the product will update the perpetual inventory. When items are acquired the inventory for the specific part is increased and when the service or sale is completed the inventory of the specific part is decreased.

5. Create a report of total inventory value. At least monthly the business should calculate the value of its inventory by multiplying the quantity on hand times the acquisition cost.
6. Periodically, the business should count its inventory and verify that the value of the inventory counted agrees with the value maintained in its accounting system. We would count inventory at least quarterly.
7. When reviewing the inventory become cognizant of parts that haven't moved recently or perhaps are no longer required. Parts with excess inventory and obsolete need to be removed.

The simplest way to measure inventory is to calculate the days of inventory on hand. This calculation can be developed by dividing the cost of sales for the month by the number of days in the month. This value can be calculated by developing the daily average of cost of goods sold. Then compare the value of the inventory on hand with this daily average value. In this formula the numerator is the ending value of inventory and the denominator is the daily average of cost of goods sold. The result is the days inventory on hand. The lower this value the more efficient the inventory is being managed. To effectively manage the inventory, it is important to make this calculation at least monthly and chart the result indicating the progress the business is making in managing this asset. The lower the number of days in inventory, the business gains valuable insight into its cash management as the purchase of inventory consumes cash.

RECEIVABLES—When a customer purchases a product or service, the selling business creates a receivable. This receivable remains outstanding until the customer pays the seller. In many businesses, the buyer uses a credit card when purchasing. In this case, the time to convert the sale into cash can be accelerated to a few days or perhaps even hours. However, many items can be purchased where the buyer and seller have agreed that payment will occur in a specified period of days. In the US this convention requires the seller to make payment 30 days from the invoice date. This discussion will deal mainly with this type of transaction.

In effectively managing receivables the following should be considered.

1. Invoice the customer quickly after the sale is made and record the sale in the record of the accounts receivable
2. On the invoice clearly identify the payment terms that have been negotiated with the buyer.
3. Understand the procedures your customer uses in paying your invoice. This information can be critical if it is necessary to track the customer's payment.
4. Develop a method to track the customers' payment timeliness. If the invoice becomes past due a maximum of five days call the customer and inquire when the payment will be made.
5. If payments become more than 30 days past due, develop mechanisms to demand payment.

Develop a method to track the effectiveness of receivable management. A simple method is to calculate days sales receivable. This first step is develop the average daily sales in a month. Then compare this daily average with the outstanding receivables balance at month end. In this formula, the total receivables are in the numerator and the average daily sales are in the denominator. The lower this number, the faster the business is converting sales into cash. If payment terms are 30 days for example, this calculated ratio should be close to 30 days.

PAYABLES—In order to operate a business, the company needs to buy the various materials, services and personnel it needs to run the business. The company's vendors send invoices from which the company pays the vendor. Customer invoices generally require payment in 30 days. In effectively managing payables the following should be considered.

1. In negotiating a purchase include in the negotiation the payment terms to the vendor.
2. These negotiations should attempt to develop the longest possible payment terms without the vendor increasing its purchase price.
3. If possible, the company should pay its vendors in the same frequency in which its customers settle their receivables. For example, if the company calculates its receivable turnover as 30 days. It should pay its vendors in 30 days. Following this practice balances the receivable balance with the payable balance.
4. Maintain a listing of all outstanding invoices.
5. Don't pay vendors until you are convinced the vendor has forwarded goods and services that meet the agreed upon standards that have been negotiated with the vendor.
6. Review this outstanding list of payables to ensure that no invoices are outstanding and past due.

CONSOLIDATED WORKING CAPITAL MANAGEMENT—In the company's accounting system there should be ledgers that track inventory balances by part number, outstanding receivables by customer, and outstanding payables by vendor. From an analytical perspective, inventory and accounts receivables are assets while payables are liabilities. Working capital is the net result of adding these three elements. The lower the overall balance of working capital, the more effective the company is managing its working capital. One easy measure to review the effectiveness of working capital management is to calculate the ratio between sales and working capital. In this ratio, the numerator is net working capital while the denominator is sales. The lower this ratio percentage the better the company is managing its working capital. This is the fourth measurement tool developed in this monograph.

We have discussed:

1. A measurement of inventory days outstanding.
2. A technique to measure outstanding receivables day outstanding
3. There a no easy measurement of payables
4. But its management is included in the calculation of the ratio of sales to working capital.

In reviewing this subject, remember there is a direct linkage between working capital and cash management. Effective working capital management requires frequent reviews for excess inventory, past due receivables and payables that have not been paid according to the agreed upon payment terms. Companies that avoid these issues are generally the best run companies because they have mastered the management of working capital and as a result have maximized the management of their cash. ♦