Chapter 11

The management of working capital

Introduction

In this chapter we draw together a number of issues and learning points from previous chapters as we introduce the topic of working or 'operating' capital management. Our first concern will be to consider the role of working capital within the firm and how companies gear the asset side of their balance sheet to optimise the levels of the two types of capital in the business. We then turn our attention to the problem of managing inventories to ensure that the firm's commitment to stock holding is kept to a minimum. Similarly we discuss the problems of managing credit and in particular the difficulties firms have in controlling their receivable accounts. Finally, we turn our attention to cash and discuss the extent to which it can be in a firm's interest to build significant cash balances and how to manage the treasury function of the firm. Working capital management is a central concern in most businesses and even for small firms this area of financial management and control can be the most difficult. One route that some firms have pursued is to install resource management systems. We will explore the development of these systems and the facilities that one leading software system offers.

Learning objectives

The learning objectives for this chapter are as follows:

The role of working capital

- To understand the role of working capital in the firm.
- To be able to trace the flows of working capital through the accounts of the business.
- To be able to identify whether a working capital management policy is 'aggressive', 'neutral' or 'defensive'.

Inventory management

- To be able to calculate an economic order quantity and reorder level for a given stock line.
- To understand how the process of cost minimisation described in Chapter 8 is required to create a Just-in-Time inventory management system.
- To have an outline understanding of the role of MRP, MRP2 and enterprise resource planning software.

Managing credit policy

- To be aware of the importance of managing credit for the ongoing liquidity of the firm.
- To be able to conduct a credit risk assessment.
- To be able to measure the benefits of reducing average debtor ages.
- To understand the strategies for minimising the costs and risks of late payment.

Managing cash

- To understand the principal reasons why firms should hold reserves of cash.
- To be aware of the role of the short-term financial markets and the role of the treasury manager.
- To be able to estimate the maximum holding of cash using the Baumol model.

The role of working capital

Working capital consists of inventories, accounts receivable (debtors) and cash on the asset side of the balance sheet less accounts payable on the claims side. One of the undesirable side-effects of studying accounting is that it is too easy to see the different parts of working capital as distinct categories which need to be managed in different ways. In reality the working capital of a business is a dynamic system where financial resources are being continuously transformed from one type of asset to another in what is known as the 'operating cycle' of the business. Working capital management is the process of ensuring that all aspects of this system operate efficiently: inventories are maintained at the minimum level necessary to meet the needs of production and of customers; receivables and payables are settled promptly and bad debts are minimised; and, finally, cash is put to use quickly within the business or is returned to investors.

To understand how the operating cycles of the business work we will return for a moment to the extended trial balance as described in the first chapters of this book. In Exhibit 11.1 we have expanded the equation to include three types of inventories: raw materials, work in progress and finished goods. This typology of inventories is most relevant to a manufacturer but is also found to a lesser extent in other industries where conversion of real assets forms