

## Internal Sources of Finance to Avoid Costly Turn Around Scenarios:

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### What are they?

- The initial source of finance any company should be looking at is internal and revolves mainly around effective Working Capital Management. Working capital refers to the amount of capital that is readily available to the organisation. It is the difference between current assets and current liabilities.
- Current assets - Cash, Stock, WIP, Debtors.
- Current Liabilities - Bank Overdraft, Creditors and other short-term liabilities (PAYE etc.)

### Why is it important to have Good Working Capital Management?

- Successful business centres on investing in innovative ideas, the right equipment and skilled human resources. To invest, business needs capital - either from the owners, retained profits or from others willing to advance credit, loans or investment.
- Money invested in one area may "cost" opportunities in other areas. For example, if stocks are too high it may "cost" the inability to take advantage of other discounts or reduce the money available to invest in training, promotions, etc.
- Even profitable companies fail if they have inadequate cash flow. Liabilities are settled with cash not profits. The primary objective of working capital management is to ensure that sufficient cash is available to:
  - Meet day-to-day cash flow needs;
  - Pay wages and salaries when they fall due;
  - Pay creditors to ensure continued supplies of goods and services;
  - Pay government taxation and providers of capital - dividends;
  - Ensure the long-term survival of the business entity.

### What are the Approaches to Working Capital Management?

- The objective of working capital management is to maintain the optimum balance of each of the working capital components. This includes making sure that funds are held as cash in bank deposits for as long as and in the largest amounts possible, thereby maximising the interest earned. However, such cash may more appropriately be "invested" in other assets or in reducing other liabilities.



- Working capital management takes place on two levels:
  - Ratio analysis can be used to monitor overall trends in working capital and to identify areas requiring closer management.
  - The individual components of working capital can be effectively managed by using various techniques and strategies.
- When considering these techniques and strategies, companies need to recognise that each has a unique mix of working capital components and requirements.

### What Ratios can be use to Analyse Working Capital?

- There are a number of ratios that you can use to analyse working capital. As with all ratios, these should be used as a guide not as a definitive answer.
  - Working Capital Ratio =  $\text{Current Assets} / \text{Current Liabilities}$
  - Liquid Ratio =  $\text{Current Assets (less stocks)} / \text{Current Liabilities}$
  - Stock Turnover =  $\text{Average Stock Level} / \text{Cost of Sales} \times 365$
  - Debtors Ratio =  $\text{Credit Sales} / \text{Average Debtors} \times 365$
  - Creditors Ratio =  $\text{Credit Purchases} / \text{Average Trade Creditors} \times 365$
- The **Working Capital Ratio** (or current ratio) attempts to measure the level of liquidity, that is, the level of safety provided by the excess of current assets over current liabilities.
- The **Liquid** or "quick ratio" excludes stocks from the current assets, considering only those assets which are quickly realisable. There are also other possible refinements.
- There is no particular benchmark value or range that can be recommended as suitable for all companies. However, if the working capital ratio is tracked over a period of time, the trends- the way in which the liquidity is changing- will become apparent.
- The **Stock Turnover** ratio applies only to finished goods. It indicates the speed with which stock is sold, or to look at it from the other angle, how long stock items remain on the shelves. It can be used for the stock balance as a whole, for classes of stock or for individual stock items.
- The figure produced by the stock turnover ratio is not important in itself, but the trend over time is a good indicator of the validity of changes in stock policies.
- In general, a higher turnover ratio indicates that a lower level of investment is required to serve the company's operations.
- With the **Debtors ratio** there is a close relationship between **debtors and credit sales** to third parties. If sales increase, debtors will increase, and conversely, if sales decrease, debtors will decrease.
- The best way to explain this relationship is to express it as the number of days that credit sales are carried on the books.
- Where trading terms are 30 days net cash, and customers buy from day-to-day during the 30 day period and pay 30 days after an invoice is issued, a collection period of 45 days (the average between 30 and 60 days) would be expected.
- If the average collection period extends beyond 60 days, debtors are holding cash that should have flowed into the company and increases the possibility of bad debts.
- The debtors ratio does not solve the collection problem, but it acts as an indicator that an adverse trend is developing. Remedial action can then be instigated.

- The **Creditors ratio** is much the same as the debtor ratio. It expresses the relationship between credit purchases and the liability to creditors. It can be stated as the number of days that credit purchases are carried on the books.
- Note that non-credit purchases (such as salaries) and non-cash expenses (such as depreciation) need to be excluded from "credit purchases" and any provisions need to be excluded from "creditors".
- There is no need to pay creditors before payment is due. The company's objective should be to make effective use of this source of free credit, while maintaining a good relationship with creditors.
- As with debtors, if a company has been granted credit terms of 30 days net cash, credit purchases should not be carried on the books for more than an average of 45 days. If payment is withheld for 60 days or more there is a likelihood that creditors will become impatient and impose stricter and less convenient trading terms, for example, "cash on delivery" and also refer late payers to credit rating agencies. This can have a negative impact when trying to raise additional finance/credit and can also exclude companies from becoming suppliers to other companies.

## What can be done to Improve Working Capital Management?

### Stocks

- Raw materials, work in progress or finished goods waiting to be consumed in production or to be sold are all types of stock.
- Stock records are needed:
  - To provide an account of activity within each stock line.
  - As evidence to support the balances used in financial reports.
  - A company also needs a system of internal controls to efficiently manage stocks and to ensure that stock records provide reliable information.
- Good financial management necessitates the careful analysis of individual stock lines.
- Stock management is an important aspect of working capital management because stocks themselves do not earn any revenue. Holding either too little or too much stock incurs costs.

Costs of carrying **too much** stock are:

- Opportunity cost of foregone interest
- Warehousing costs
- Damage and pilferage
- Obsolescence
- Insurance

Costs of carrying **too little** stock are:

- **Stock out costs:**
  - lost sales
  - delayed service
- **Ordering costs:**
  - freight
  - order administration
  - loss of quantity discounts.
- Carrying costs can be minimised by making frequent small orders although this increases ordering costs and the risk of stock-outs. Risk of stock-outs can be reduced by carrying "safety stocks" (at a cost) and re-ordering ahead of time.

- The best ordering strategy requires balancing the various cost factors to ensure the company incurs minimum stock costs. The optimum stock position is known as the Economic Reorder Quantity (ERQ). There are a number of mathematical models (of varying complexity) for calculating ERQ. (Any standard accounting text will provide examples of these).
- Analytical review of stocks can help to identify areas where stock management can be improved. Slow moving items, continual stock outs, obsolescence, stock reconciliation problems and excess spoilage are signals that stock lines need closer analysis and control.
- However, it is important to keep an overall perspective. It is not cost-effective to closely manage a large number of low value stock lines, nor is it necessary. A usual feature of stocks is that a small number of high value lines account for a large proportion of stock value.
- The "80/20" rule (PARETO) predicts that 80% of the total value of stock is represented by only 20% of the number of stock items. Those high value lines need reasonably close management. The remaining 80% of stock lines can be managed using "broad-brush" strategies.
- The overall management philosophy of an organisation can affect the way in which stock is managed. For example, "Just In Time" (JIT) production management organises production so that finished goods are not produced until the customer needs them (minimising finished goods carrying costs), and raw materials are not accepted from suppliers until they are needed. (Large organisations have the power to insist that suppliers hold stocks of raw materials and thereby pass the carrying cost back to the supplier). Thus, JIT stock strategies reduce bottlenecks and stock holding costs.
- Here an effective on-line web based solution can act as an extremely efficient method of linking suppliers, producers and customers. The increased use of "Business Webs" and virtual organisations through company Intranets and Extranets has enabled organisations to become extremely agile when responding to customer demand.
- **In summary:**  
There is a trade-off to be made between carrying costs, ordering costs and stock out costs. This is represented in the Economic Reorder Quantity (ERQ) model.
  - Stocks should be managed on a line-by-line basis using the 80/20 rule.
  - Analytical review can help to focus attention on critical areas.
  - Stock management is part of the overall management strategy.

## Debtors/Receivables

- Debtors (Accounts Receivable) are customers who have not yet made payment for goods or services that the company has provided.
- The objective of debtor management is to minimise the time-lapse between completion of sales and receipt of payment. The costs of having debtors are:
  - Opportunity costs (cash is not available for other purposes)
  - Bad debts.
- Debtor management includes both pre-sale and debt collection strategies.
- Pre-sale strategies include:
  - Offering cash discounts for early payment and/or imposing penalties for late payment
  - Agreeing payment terms in advance
  - Requiring cash before delivery
  - Setting credit limits
  - Setting criteria for obtaining credit
  - Billing as early as possible
  - Requiring deposits and/or progress payments

- Post-sale strategies include:
  - Placing the responsibility for collecting the debt upon the department that made the sale;
  - Identifying long overdue balances and doubtful debts by regular analytical reviews;
  - Having an established procedure for late collections, such as
    - a reminder
    - a letter
    - telephone calls
    - cancellation of further credit
    - use of a collection agency
    - legal action.
- **Outsourcing the Sales Ledger** function (to factors/invoice discounters) can prove an extremely effective method of reducing debtor collection days and bad debts. These companies have specialist skills and the best ones offer a great deal of flexibility so that you maintain a level of control over their activities. They can prove particularly useful when dealing with international sales.

### Creditors/Payables

- Creditors (Accounts Payable) are suppliers whose invoices for goods or services have been processed but who have not yet been paid.
- Organisations often regard the amount owing to creditors as a source of free credit. However, creditor administration systems are expensive and time-consuming to run. The over-riding concern in this area should be to minimise costs with simple procedures.
- While it is unnecessary to pay accounts before they fall due, it is usually not worthwhile to delay all payments until the latest possible date. Regular weekly or fortnightly payment of all due accounts is the simplest technique for creditor management.
  - u Electronic payments (direct credits) are cheaper than cheque payments, considering that transaction fees and overheads more than balance the advantage of delayed presentation.

### Terms and Conditions of Trade

- Terms can be set to maximise the benefit to the company whilst reducing the risk of bad debts. This includes asking for stage payments e.g. 30% with order, 30% at stage 1 and 40% on completion.
- If a company is expanding and the bulk of its costs are payroll then it is going to need additional finance unless the debts are collected before the payroll is paid (assuming additional capacity is required). Careful consideration needs to be taken when planning increases in production. Many "profitable" companies have failed due to the increased pressure on cash flow.
- Equally, effective negotiation skills need to be developed to obtain the best terms possible from suppliers. This can include:
  - Extended credit
  - Volume discounts
- Care has to be taken to ensure that there is not a short-term gain on cost at the expense of ongoing supplier relations and quality. There is an increasing need to integrate suppliers into the production and development process and to do this companies need to make adequate returns.

### Margins and Internal Controls

- Retained profits are a major source of finance and many companies fail to maintain adequate controls over their costs and sales prices to ensure margins are maximised.
- A simplified view of generating profits revolves around the following factors
  - Lead Generation
  - Conversion rate (including increasing sales to existing clients)
  - Number of Transactions

- Average Value of Sales
- Margins
- The above relate to profits as follows:
  - $\text{Lead Generation} \times \text{Conversion Rate} = \text{Number of Customers}$
  - $\text{No. of Customers} \times \text{No. of Transactions} \times \text{Average Sale} = \text{Turnover}$
  - $\text{Turnover} \times \text{Margin \%} = \text{Profit}$
- Of course this is a simplified snapshot of an organisation but from the above illustration we can see that if any one of the components is improved it will have a direct impact on profits. Conversely, if any is neglected, profits will be reduced.
- The effective use of marketing to ensure that pricing policies are correct, production volumes are in line with forecast demands, trends are incorporated into product offerings, etc. can have a major impact on the profitability of the organisation.
- Reviews of staffing structures can improve profitability. There may be a need to move to flexible working patterns - maintaining a core of essential workers and forming a "virtual" workforce which can vary in size and skill set as demand dictates.
- The way people are rewarded will also impact on margins. Non-cash incentives can be included which have a lower cash value to the company but a high perceived value to employees.
- Effective Internal Controls over purchasing procedures, expenditure on overheads, expenses, etc. can have a dramatic effect on an organisation's ability to retain finance, as does efficient tax planning.
- Controls over the correct recruitment and training of employees will increase motivation, skill levels and efficiency whilst reducing the cost of staff churn.

### Forecasting

- Forecasting skills play a major part in effective management of cash flows. Expenditure on stocks, machinery, premises, people, etc. can all be a reaction to the forecasting process. The need to integrate the organisation into a coherent unit is becoming increasingly essential to ensure ongoing profitability and cash strength.
- Forecasting should have input from and be made the responsibility of all departments in an organisation to ensure that the consequences of actions are fully considered as they impact the organisation as a whole.
- The tools and techniques used in Strategic Planning, Marketing Planning and Business Planning are of benefit when constructing accurate, reliable forecasts.

### What should you do now to improve my Working Capital Management?

- There are many factors to consider when deciding how to improve Working Capital Management and these vary between companies and over time.
- One thing to remember is look at and discuss the issues you have with a Professional Advisor at an early stage to avoid going into a "Turnaround Situation"