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Working Capital Management: Backbone of the Company

KEYWORDS

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ABSTRACT *Cash is the lifeline of a company. If this lifeline deteriorates, so does the company's ability to fund operations, reinvest and meet capital requirements and payments. Understanding a company's cash flow health is essential to making investment decisions. A good way to judge a company's cash flow prospects is to look at its working capital management (WCM). Many companies still underestimate the importance of working capital management as a lever for freeing up cash from inventory, accounts, and accounts payable. By effectively managing these components, companies can sharply reduce their dependence on outside funding and can use the released cash for further investments or acquisitions. This will not only lead to more financial flexibility, but also create value and have a strong impact on a company's enterprise value by reducing capital employed and thus increasing asset productivity.*

High working capital ratios often mean that too much money is tied up in receivables and inventories. Typically, the knee-jerk reaction to this problem is to apply the "big squeeze" by aggressively collecting receivables, ruthlessly delaying payments to suppliers and cutting inventories across the board. But that only attacks the symptoms of working capital issues, not the root causes. A more effective approach is to fundamentally rethink and streamline key processes across the value chain. This will not only free up cash but lead to significant cost reductions at the same time.

Introduction:
Working capital management entails the process of balancing the needs of short-term assets and short-term liabilities. Aspects of working capital management include short-term loans, merchandise purchased on credit, goods and services provided on credit and merchandise, goods and services paid for upon delivery. Managing working capital essentially entails managing the cash flow of a business on a daily, weekly and monthly basis in such a way that satisfies all debts while reserving enough capital to continue operations and the generation of profits.Two basic definitions exist for working capital. The more technical of the two explains working capital as the difference between all short-term assets and short-term liabilities. Assets in business refer to anything of value a company owns.

Liabilities are outstanding debts, such as loans and credit. The simpler definition describes working capital as the cash available for the day-to-day operations as a business. Daily operations cash comes from assets such as the sale of merchandise, and excludes money used to pay liabilities; therefore, the two definitions are essentially the same. Term working capital management problems can be solved by swapping short-term debt for long-term debt and putting money allocated for short-term debt into the generation of profits for paying off long-term debt.

Literature Review:
1: ***Impact of Working Capital Management on Firms' Performance:*** **Evidence from Non-Financial Institutions of KSE-30 index.... Dr. Muhammad AZAM and Syed Irfan HAIDER**

The purpose of this study is to investigate the impact of working Capital Management on firms' performance for non-financial institutions listed in Karachi Stock Exchange (KSE-30) Index. A panel data has been used in this study for 21 Kse-30 Index listed firms over a period for the year 2001 to 2010. The results are obtained by using Canonical Correlation Analysis for identifying the relationship between working capital management and firms' performance. The findings show that working capital management has significant impact on firms' performance and it is concluded that managers can increase value of share holder and return on asset by reducing their inventory size, cash conversion cycle and net trading cycle. Increase in liquidity and time period to supplier will also lead firms' overall Performances.

2: Relationship between Working Capital Management and Profitability: A Study of Selected FMCG Companies in India.... B Bagchi, B Khamrui
The purpose of this paper is to investigate the relationship between working capital management and firm profitability and to identify the variables that most affect profitability. Working capital management is considered to be a vital issue in financial management decision and it has its effect on liquidity as well as on profitability of the firm. Moreover, an optimal working capital management positively contributes in creating firm value. In this study, we have selected a sample of 10 FMCG (Fast Moving Consumer Goods) companies in India from CMIE database covering a period of 10 years from 2000–01 to 2009–10. Profitability has been measured in terms of return on assets (ROA).Cash conversion cycle (CCC), interest coverage ratio, age of inventory, age of creditors, age of debtors and debt-equity ratio have been used as explanatory variables. Pearson's correlation and pooled ordinary least squares regression analysis are used in the study. The study results confirm that there is a strong negative relationship between variables of the working capital management and profitability of the firm. As the CCC increases, profitability of the firm decreases, and managers can create a positive value for the shareholders by reducing the CCC to a possible minimum level. There is also a stumpy negative relationship between debt used by the firm and its profitability.

What is working capital management?
Working capital refers to the cash a business requires for day-to-day operations, or, more specifically, for financing the conversion of raw materials into finished goods, which the company sells for payment. Among the most important items of working capital are levels of inventory, accounts receivable and accounts payable. Analysts look at these items for signs of a company's efficiency and financial strength. Take a simplistic case: a spaghetti sauce company uses $100 to build up its inventory of tomatoes, onions, garlic, spices etc. A week later, the company assembles the ingredients into sauce and ships it out. A week after that, the checks arrive from customers. That $100, which has been tied up for two weeks, is the company's working capital. The quicker the company sells the spaghetti sauce, the sooner the company

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can go out and buy new ingredients, which will be made into more sauce sold at a profit. If the ingredients sit in inventory for a month, company cash is tied-up and can't be used to grow the spaghetti business. Even worse, the company can be left strapped for cash when it needs to pay its bills and make investments. Working capital also gets trapped when customers do not pay their invoices on time or suppliers get paid too quickly

The better a company manages its working capital, the less the company needs to borrow. Even companies with cash surpluses need to manage working capital to ensure that those surpluses are invested in ways that will generate suitable returns for investors. Not All Companies are the Some companies are inherently better placed than others. Insurance companies, for instance, receive premium payments up front before having to make any payments; however, insurance companies do have unpredictable cash outflow as claims come in.

Normally, a big retailer like Wal-Mart (NYSE:WMT) has little to worry about when it comes to accounts receivable: customers pay for goods on the spot. Inventories represent the biggest problem for retailers; as such, they must perform rigorous inventory forecasting or they risk being out of business in a short time. Timing and lumpiness of payments can pose serious troubles. Manufacturing companies, for example, incur substantial upfront costs for materials and labour before receiving payment. Much of the time they eat more cash than they generate. (Find out how to do an analysis, in Evaluating A Company's Capital Structure.)

Evaluating Companies

Investors should favour companies that place emphasis on supply-chain management to ensure that trade terms are optimized. Days-sales outstanding, or DSO for short, is a good indication of working capital management practices. DSO provides a rough guide to the number of days that a company takes to collect payment after making a sale. Here is the simple formula:

Receivables/ Annual Sales/365 Days

Rising DSO is a sign of trouble because it shows that a company is taking longer to collect its payments. It suggests that the company is not going to have enough cash to fund short-term obligations because the cash cycle is lengthening. A spike in DSO is even more worrisome, especially for companies that are already low on cash. The inventory turnover ratio offers another good instrument for assessing the effectiveness of WCM. The inventory ratio shows how fast/often companies are able to get their goods completely off the shelves. The inventory ratio is following

Cost of Goods Sold (COGS)/Inventory

Broadly speaking, a high inventory turnover ratio is good for business. Products that sit on the shelf are not making money. Granted, an increase in the ratio can be a positive sign, indicating that management, expecting sales to increase, is building up inventory ahead of time. For investors, a company's inventory turnover ratio is best seen in light of its competitors. In a given sector where, for instance, it is normal for a company to completely sell out and restock six times a year, a company that achieves a turnover ratio of four is an underperformer. Computer giant and stock market champion, Dell (Nasdaq:DELL), recognized early that a good way to bolster shareholder value was to notch up working capital management. The company's world-class supply-chain management system ensures that DSO stays low. Improvements in inventory turnover increase cash flow, all but eliminating liquidity risk, leaving Dell with more cash on the balance sheet to distribute to shareholders or fund growth plans. Dell's exceptional WCM certainly exceeds those of the top executives who do not worry enough about the nitty-gritty of working capital management. Some CEOs frequently see borrowing and raising equity as the only way to boost cash flow. Other times, when faced with a cash crunch, instead of setting straight inventory turnover levels and reducing DSO, these management teams pursue rampant cost cutting and restructuring that may later aggravate problems. Businesses face bankruptcy when insufficient capital resources prevent them from paying debts owed. Successful working capital management allows a business to pay all debts as they mature, or come due, while continuing profitable business operations. At the very least, successful working capital management allows a business to break even. Therefore, working capital management is directly responsible for the avoidance of bankruptcy. Unsuccessful working capital management can lead directly to bankruptcy by preventing a business from paying off liabilities or by preventing the generation of new capital with which to pay future debts.

Improving Working Capital and Management:-

Several methods of improving working capital and working capital management exist. Methods of improving working capital management begin with simple tasks such as monitoring expenditures and upcoming debts daily, weekly and monthly and planning in advance how to balance the two. Lowering production costs while maintaining sales revenue increases profits, thus providing more cash for working capital management.

- Working capital (also known as net working capital) is a financial metric that measures a company's operating liquidity.
- Working capital is defined as current assets minus current liabilities. A positive position means that a company is able to support its day-to-day operations—i.e., to serve both maturing short-term debt and upcoming operational expenses.
- One of the metric's shortcomings, however, is that current assets often cannot be liquidated in the short term. High working capital positions often indicate that there is too much money tied up in accounts receivable and inventory, rather than short-term liquidity.
- All companies should therefore focus on the tight management of working capital. Inventory, accounts receivable, and accounts payable are of specific importance since they can be influenced most directly by operational management.
- Companies that improve their working capital management are able to free up cash and thus can, for example, reduce their dependence on outside funding, or finance additional growth projects.
- If done right, working capital management generates cash for growth together with streamlined processes along the value chain and lower costs.

Conclusion

Cash is king - especially at a time when fundraising is harder than ever. Letting it slip away is an oversight that investors should not forgive. Analyzing a company's working capital can provide excellent insight into how well a company handles its cash, and whether it is likely to have any on hand to fund growth and contribute to shareholder value.