Managing cash flow and working capital

Written by EY Building a better working world

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Introduction

Cash flow remains one of the key challenges for any business big or small, inexperienced or experienced. EY's contribution covers how a business can better manage their cash flow and working capital. The impact of ineffective working capital management can be complex and just as debilitating for a business. Establishing effective cash flow management practices can lead to generating more cash from their businesses, but also more flexibility to take advantage of opportunities as they arise and ultimately making them less dependent on external financing.

Definition of 'Working Capital Management'

A managerial accounting strategy focusing on maintaining efficient levels of both components of working capital, current assets and current liabilities, in respect to each other. Working capital management ensures a company has sufficient cash flow in order to meet its short-term debt obligations and operating expenses.

Many companies still underestimate the importance of working capital management as a lever for freeing up cash from inventory, accounts receivable, 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.

> *(Net) Working capital = current assets - current liabilities.*

Current assets are assets which are expected to be sold or otherwise used within one fiscal year. Typically, current assets include cash, cash equivalents, accounts receivable, inventory, prepaid accounts which will be used within a year, and short-term investments.

Current liabilities are considered as liabilities of the business that are to be settled in cash within the fiscal year. Current liabilities include accounts payable for goods, services or supplies, short-term loans, long-term loans with maturity within one year, dividends and interest payable, or accrued liabilities such as accrued taxes.

Working capital, on the one hand, can be seen as a metric for evaluating a company's operating liquidity. A positive working capital position indicates that a company can meet its short-term obligations. On the other hand, a company's working capital position signals its operating efficiency. Comparably high working capital levels may indicate that too much money is tied up in the business.

The most important positions for effective working capital management are inventory, accounts receivable, and accounts payable. Depending on the industry and business, prepayments received from customers and prepayments paid to suppliers may also play an important role in the company's cash flow. Excess cash and non-operational items may be excluded from the calculation for better comparison.

As a measure for effective working capital management, therefore, another more operational metric definition applies:

> *Operative networking capital = inventories + receivables – payables - advances received + advances made.*

Defining Working Capital Cycle

Cash flows into, around and out of a business. It is the business's life blood and every manager's primary task is to help keep it flowing and to use the cashflow to generate profits. If a business is operating profitably, then it should, in theory, generate cash surpluses. If it doesn't generate surpluses, the business will eventually run out of cash and expire.

Click here for more information about the vital distinction between profits and cashflow.

The faster a business expands the more cash it will need for working capital and investment. The cheapest and best sources of cash exist as working capital right within business. Good management of working capital will generate cash will help improve profits and reduce risks. Bear in mind that the cost of providing credit to customers and holding stocks can represent a substantial proportion of a firm's total profits.

There are two elements in the business cycle that absorb cash:

i) **Inventory** (stocks and work-in-progress) and **Receivables** (debtors owing you money). The main sources of cash are
ii) **Payables** (your creditors) and **Equity and Loans**.

Each component of working capital (namely inventory, receivables and payables) has two dimensions, TIME, and MONEY. When it comes to managing working capital - **TIME IS MONEY**. If you can get money to move faster around the cycle (e.g. collect monies due from debtors more quickly) or reduce the amount of money tied up (e.g. reduce inventory levels relative to sales), the business will generate more cash or it will need to borrow less money to fund working capital. As a consequence, you could reduce the cost of bank interest or you'll have additional *free* money available to support additional sales growth or investment. Similarly, if you can negotiate improved terms with suppliers e.g. get longer credit or an increased credit limit; you effectively create *free* finance to help fund future sales.

Useful Links

Cash flow planning information

- Prepare `projections
- Make cash flow forecasts
- Get free planner
- Write business plan
- Seek planning advice
- Improve cash flow
- Raise finance

Strategic planning of cash flow and working capital

- Develop strategic plan
- Write strategic plan
- Get planning insights
- Plan to plan
- See planning surveys
- Business plan guide

Software Tools

- Financial Planner
- Cash flow Forecaster
- Business Planner
- Expert Business Planner
- Marketing Planners
- Free Planners

Buy Software

- Financial Projections
- Cash flow Forecasts
- Business Plans
- Marketing Plans
- Strategic Plans

If you.....	*Then.....*
Collect receivables (debtors) faster	You release cash from the cycle
Collect receivables (debtors) slower	Your receivables soak up cash
Get better credit (in terms of duration or amount) from suppliers	You increase your cash resources
Shift inventory (stocks) faster	You free up cash
Move inventory (stocks) slower	You consume more cash

It can be tempting to pay cash, if available, for fixed assets e.g. computers, plant, vehicles etc. If you do pay cash, remember that this is now longer available for working capital. Therefore, if cash is tight, consider other ways of financing capital investment - loans, equity, leasing etc. Similarly, if you pay dividends or increase drawings, these are cash outflows and, like water flowing down a plug hole, they remove liquidity from the business.

Finding Additional Sources of Working Capital

Sources of additional working capital include the following:

- Existing cash reserves
- Profits (when you secure it as cash!)
- Payables (credit from suppliers)
- New equity or loans from shareholders
- Bank overdrafts or lines of credit
- Long-term loans

If you have insufficient working capital and try to increase sales, you can easily over-stretch the financial resources of the business. This is called **overtrading**. Early warning signs include:

- Pressure on existing cash
- Exceptional cash generating activities e.g. offering high discounts for early cash payment
- Bank overdraft exceeds authorized limit
- Seeking greater overdrafts or lines of credit
- Part-paying suppliers or other creditors
- Paying bills in cash to secure additional supplies
- Management pre-occupation with *surviving* rather than managing

Frequent short-term emergency requests to the bank (to help pay wages, pending receipt of a cheque).

Handling Receivables (Debtors)

Cash flow can be significantly enhanced if the amounts owing to a business are collected faster. Every business needs to know, who owes them money, how much is owed, how long it owes, for what it is owed.

> *Late payments erodes profits and can lead to bad debts.*

Slow payments have a crippling effect on business; in particular on small businesses who can least afford it.

> *If you don't manage debtors, they will begin to manage your business.*

You will gradually lose control due to reduced cashflow and, of course, you could experience an increased incidence of bad debt. The following measures will help manage your debtors:

1. Have the right mental attitude to the control of credit and make sure that it gets the priority it deserves.
2. Establish clear credit practices as a matter of company policy.
3. Make sure that these practices are clearly understood by staff, suppliers and customers.
4. Be professional when accepting new accounts, and especially larger ones.
5. Check out each customer thoroughly before you offer credit. Use credit agencies, bank references, industry sources etc.
6. Establish credit limits for each customer... and stick to them.
7. Continuously review these limits when you suspect tough times are coming or if operating in a volatile sector.
8. Keep very close to your larger customers.
9. Invoice promptly and clearly.
10. Consider charging penalties on overdue accounts.
11. Consider accepting credit /debit cards as a payment option.
12. Monitor your debtor balances and ageing schedules, and don't let any debts get too large or too old.

Recognise that the longer someone owes you, the greater the chance you will never get paid. If the average age of your debtors is getting longer, or is already very long, you may need to look for the following possible defects:

- Weak credit judgement
- Poor collection procedures
- Lax enforcement of credit terms
- Slow issue of invoices or statements
- Errors in invoices or statements customer dissatisfaction.

Debtors due over 90 days (unless within agreed credit terms) should generally demand immediate attention. Look for the warning signs of a future bad debt. For example;

- Longer credit terms taken with approval, particularly for smaller orders
- use of post-dated checks by debtors who normally settle within agreed terms
- Evidence of customers switching to additional suppliers for the same goods
- New customers who are reluctant to give credit references receiving part payments from debtors.

The act of collecting money is one which most people dislike for many reasons and therefore put on the long finger because they convince themselves there is something more urgent or important that demands their attention now.

> *There is nothing more important than getting paid for your product or service. A customer who does not pay is not a customer.*

Here are a few ideas that may help you in collecting money from debtors:

- Develop appropriate procedures for handling late payments.
- Track and pursue late payers.
- Get external help if your own efforts fail.
- Don't feel guilty asking for money.... it's yours and you are entitled to it.
- Make that call now. And keep asking until you get some satisfaction.
- In difficult circumstances, take what you can now and agree terms for the remainder. It lessens the problem.
- When asking for your money, *be hard on the issue - but soft on the person*. Don't give the debtor any excuses for not paying.
- Make it your objective is to get the money - not to score points or get

Managing Payables (Creditors)

Creditors are a vital part of effective cash management and should be managed carefully to enhance the cash position.

Purchasing initiates cash outflows and an over-zealous purchasing function can create liquidity problems. Consider the following:

- Who authorises purchasing in your company - is it tightly managed or spread among a number of (junior) people?
- Are purchase quantities geared to demand forecasts?
- Do you use order quantities which take account of stock-holding and purchasing costs?
- Do you know the cost to the company of carrying stock?
- Do you have alternative sources of supply? If not, get quotes from major suppliers and shop around for the best discounts, credit terms, and reduce dependence on a single supplier.
- How many of your suppliers have a returns policy?
- Are you in a position to pass on cost increases quickly through price increases to your customers?
- If a supplier of goods or services lets you down can you charge back the cost of the delay?
- Can you arrange (with confidence!) to have delivery of supplies staggered or on a just-in-time basis?

There is an old adage in business that *if you can buy well then you can sell well*. Management of your creditors and suppliers is just as important as the management of your debtors. It is important to look after your creditors - slow payment by you may create ill-feeling and can signal that your company is inefficient (or in trouble!).

Inventory Management

Managing inventory is a juggling act. Excessive stocks can place a heavy burden on the cash resources of a business. Insufficient stocks can result in lost sales, delays for customers etc.

The key is to know how quickly your overall stock is moving or, put another way, how long each item of stock sit on shelves before being sold. Obviously, average stock-holding periods will be influenced by the nature of the business. For example, a fresh vegetable shop might turn over its entire stock every few days while a motor factor would be much slower as it may carry a wide range of rarely-used spare parts in case somebody needs them.

Nowadays, many large manufacturers operate on a *just-in-time* (JIT) basis whereby all the components to be assembled on a particular today, arrive at the factory early that morning, no earlier - no later. This helps to minimize manufacturing costs as JIT stocks take up little space, minimize stock-holding and virtually eliminate the risks of obsolete or damaged stock. Because JIT manufacturers hold stock for a very short time, they are able to conserve substantial cash. JIT is a good model to strive for as it embraces all the principles of prudent stock management.

The key issue for a business is to identify the fast and slow stock movers with the objectives of establishing optimum stock levels for each category and, thereby, minimize the cash tied up in stocks. Factors to be considered when determining optimum stock levels include:

- What are the projected sales of each product?
- How widely available are raw materials, components etc.?
- How long does it take for delivery by suppliers?
- Can you remove slow movers from your product range without compromising best sellers?

Remember that stock sitting on shelves for long periods of time ties up money which is not working for you. For better stock control, try the following:

- Review the effectiveness of existing purchasing and inventory systems.
- Know the stock turn for all major items of inventory.
- Apply tight controls to the *significant few* items and simplify controls for the *trivial many*.

- Sell off outdated or slow moving merchandise - it gets more difficult to sell the longer you keep it.
- Consider having part of your product outsourced to another manufacturer rather than make it yourself.
- Review your security procedures to ensure that no stock "is going out the back door!"

Higher than necessary stock levels tie up cash and cost more in insurance, accommodation costs and interest charges.

Key Working Capital Ratios

The following, easily calculated, ratios are important measures of working capital utilization.

Ratio	Formulae	Result	Interpretation
Stock Turnover (in days)	Average Stock * 365/ Cost of Goods Sold	= x days	On average, you turn over the value of your entire stock every x days. You may need to break this down into product groups for effective stock management. Obsolete stock, slow moving lines will extend overall stock turnover days. Faster production, fewer product lines, just in time ordering will reduce average days.
Receivables Ratio (in days)	Debtors * 365/ Sales	= x days	It takes you on average x days to collect monies due to you. If your official credit terms are 45 day and it takes you 65 days... why? One or more large or slow debts can drag out the average days. Effective debtor management will minimize the days.
Payables Ratio (in days)	Creditors * 365/ Cost of Sales (or Purchases)	= x days	On average, you pay your suppliers every x days. If you negotiate better credit terms this will increase. If you pay earlier, say, to get a discount this will decline. If you simply defer paying your suppliers (without agreement) this will also increase - but your reputation, the quality of service and any flexibility provided by your suppliers may suffer.
Current Ratio	Total Current Assets/ Total Current Liabilities	= x times	Current Assets are assets that you can readily turn in to cash or will do so within 12 months in the course of business. Current Liabilities are amount you are due to pay within the coming 12 months. For example, 1.5 times means that you should be able to lay your hands on $1.50 for every $1.00 you owe. Less than 1 time e.g. 0.75 means that you could have liquidity problems and be under pressure to generate sufficient cash to meet oncoming demands.
Quick Ratio	(Total Current Assets - Inventory)/ Total Current Liabilities	= x times	Similar to the Current Ratio but takes account of the fact that it may take time to convert inventory into cash.
Working Capital Ratio	(Inventory + Receivables - Payables)/ Sales	As % Sales	A high percentage means that working capital needs are high relative to your sales.

Other working capital measures include the following:

- Bad debts expressed as a percentage of sales.
- Cost of bank loans, lines of credit, invoice discounting etc.
- Debtor concentration - degree of dependency on a limited number of customers.

Once ratios have been established for your business, it is important to track them over time and to compare them with ratios for other comparable businesses or industry sectors.

Thank you for reading!

Readers of this guide also found the following IIA report useful:

- Embedding strong governance structures
- Meeting tax and accounting regulations

Many thanks to EY for the contribution to this report