Part 5: Working Capital Management

1/ Definition of Working Capital Management

Working capital management is a business strategy designed to manage a company's working capital. A company's working capital refers to the capital it has left over after accounting for its current liabilities. Working capital management ensures that a company operates efficiently by monitoring and using its current assets and liabilities to their most effective use. The efficiency of working capital management can be quantified using ratio analysis.

Key Takeaways

- Working capital management requires monitoring a company's assets and liabilities to maintain sufficient cash flow to meet its short-term operating costs and short-term debt obligations.
- Managing working capital primarily revolves around managing accounts receivable, accounts payable, inventory, and cash.
- Working capital management involves tracking various ratios, including the working capital ratio, the collection ratio, and the inventory ratio.
- Working capital management can improve a company's cash flow management and earnings quality by using its resources efficiently.
- Working capital management strategies may not materialize due to market fluctuations or may sacrifice long-term successes for short-term benefits.

2/ FACTORS AFFECTING THE WORKING CAPITAL CYCLE

The working capital cycle (the time taken to convert orders to cash received, net of creditors) is illustrated in Figure. The cycle commences when the company receives an order from its customer (or decides to make for stock). Inventories are acquired, which may be converted through the stages of work in progress and fi nished goods. These stocks are held as current assets until the customer buys them. However, at that point no money has changed hands, and the asset of inventory is merely replaced by an asset of trade debtors. It is not until the cash is actually received that the cycle is complete.

The company has to fi nance the business for the whole of the operating cycle. However, it does not need to do so out of its own resources; some of those inventories will have been bought on credit, and trade creditors fi nance part of the working capital investment. Thus, the company's cash requirement is limited to the net of inventories and debtors less creditors.

The working capital cycle for any company is a function of several variables: the country; the industry; the company's business strategy and attitude to risk; and the effectiveness of its systems

The working capital cycle