Make Your Working Capital Work

Unlocking the value through improving processes

Working capital is the amount of daily operating liquidity available with a firm i.e. for day to day operations of the firm. Apart from this ample working capital can help firms to make use of unexpected opportunities for expansion and also raise loan finances and favorable credit terms against working capital.

Working Capital

Firms need cash to pay for their day to day activities like wages, purchase of raw material and utility bills. Money available with them to do this is called firms working capital. Source of working capital are current assets of the firm. Working capital is defined as the difference between the firms current assets and current liabilities.

Working capital = Current assets — Current liabilities

Current assets include cash, marketable securities, inventory and account receivable. Current liability include account payable, accrued expenses, and near term payment of loan. Working capital is measure of firms efficiency as well as its short term financial health. Positive working capital indicates firms ability to pay its short term liabilities where as negative working capital indicates that firm is unable to meet its short term liabilities. Firms having insufficient working capital– the money that keeps business functional on day to day basis is doomed to fail.

Working Capital Cycle

It is the time lag between injecting money in business and realizing cash out of the business transaction. Inputs include investing in raw material, work in progress, finished goods, wages and other bills and output is sales in cash or on credit. Cash from the credit sales is realized at later date. *Firm having lower working capital cycle can rotate its working capital more frequently*, which will in turn lead to lower the requirement of working capital. Between each stage of working capital cycle there is time delay. For some businesses this time delay may be longer where it takes longer to make and sell the product and than recover the money from the sales, such firms require substantial amount of working capital to survive. Some of the firms that receive cash quickly after paying for inputs (raw material, wages etc) will need less working capital When a firm is operating on lower working capital shortening the working capital cycle becomes critical for its survival.

Apart from lowering working capital requirement, shorter working capital cycle leads to higher profitability by increasing frequency of rotation of working capital. Rotation of working capital means number of times same capital can be used to generate revenue from business in the given financial year. For better understanding of effect of working capital cycle on profit of an organization

Sanjeev is a business consultant of Nimble. He has worked on projects related to retail, project management and manufacturing industries. Sanjeev can be contacted at skp@nimble.in

Contains:

Making working capital work (cont.)

take a case of two firms X and Y doing same type of business.

Company	Working capital	Working capital cycle	Profit from each cycle	No. of cycles in a year	Profit in a year
X	1 million	4 months	100,000	3	300,000
y	1 million	3 months	100,000	4	400,000

Its clear that though two firms are doing same business and using same working capital, firm Y is generating more business by the virtue of its shorter working capital cycle.

Managing working capital to increase profit

The best measure to monitor any company's need for the capital would be its working capital. The less the figure for the working capital the less is need for capital for growth and survival. For small companies where it is difficult to get capital, lowering the working capital requirement is critical. Working capital can be lowered by improving on the processes to reduce working capital cycle of the firm and by effectively managing the different components of working capital.

Working capital = Days working capital (DWC) * Daily sales

Where, DWC = DSO+DSI - DPO

DWC - It is the average number of days taken by a firm to convert working capital into sales revenue.

DSO - Days sales outstanding in receivables (days of sales tied up in receivables)

DSI - Days sales outstanding in inventory (days of sales tied up in inventory)

DPO - Days sales outstanding in payables.

Daily sales = total sales/ 365

For SMEs where total sales figure on yearly basis may not be available , 3 months moving averages of the sales can be taken, than

Daily sales = 3 months moving avg of sales/90

Of the above discussed factors, account receivables and inventory both are current assets and tie up capital that could have been used for other productive purpose. This tied up capital can be freed by effectively implementing current processes and improving on the process wherever required.

Components of working capital

Working capital tie up the capital that could have been used for other productive purpose hence it has opportunity cost linked to it

Making working capital work (cont.)

1. Inventory
2. Cash

Inventory

1. Raw material
2. Work in progress
3. Finished goods.

Raw material

1. Material in transit from supplier
2. Owned material lying with supplier

Finished goods

1. Owned finished good
2. Customer consignment

Cash

1. Receivable
2. Payable

An example can show how each of this components affect overall working capital

Consider a firm having 3 months moving average of sales of 9 million. Month end accounts receivable of 1 million, Total inventory of 3 million (1 million each of raw material, work in progress and finished goods), payables of 2 million.

Based on the given figures

Daily sales = 9,000,000/90= 100,000

DSO = 1,000,000/100,000= 10

DSI = 3,000,000/ 100,000= 30

DPO= 2,000,000/100,000= 20

DWC= 10 + 30 - 20 = 20

Working capital = DWC * daily sales = 20* 100,000= 2 million

Case A

Effect of account payable on working capital

Working capital can be minimized by reducing account receivable and inventory and increasing account payable

Getting better credit in terms of duration and amount increases cash resources

Making working capital work (cont.)

Consider for the case discussed above payment term is of 30 days . In this case payables are of 2 million and total working capital requirement is of 2 million. Now as a method of managing working capital payment term is negotiated and changed to 45 days. In this case -

New Payables = 2,000,000*45/30= 3 million

New DPO = 3,000,000/100,000= 30 days

New DWC = 10 + 30 - 30 = 10

New working capital = 10*100,000= 1 mn

So by increasing payment period there is huge difference in working capital requirement.

Case B

Effect of account receivable on working capital

Consider for the given case credit period for receivables is 45 days. Total receivables are of 1 million and working capital requirement of 2 million. Now as on the methods of managing working capital credit period is negotiated and changed to 30 days. In this case-

New receivables = 1,000,000*30/45 = 650,000

New DSO = 650,000/100,000 = 6.5

New DWC = 6.5 + 30 - 20 = 16.5

New working capital = 16.5 * 100,000 = 1.65 million

So by decreasing the credit period working capital requirement is decreased.

Case C

Effect of raw material inventory on working capital

For this case consider that raw material inventory is reduced from 1million to 600,000. In this case

New total inventory level = 2.6 million

New DSI = 2,600,000/100,000 = 26

New DWC = 10 + 26 - 20 = 16

New working capital = 16 * 100,000 = 1.6 million

Reducing raw material inventory results in decrease in working capital.

Case D

Collecting receivables faster releases cash from cycle

Moving inventory faster frees up the cash, moving inventory slower consumes more cash

Making working capital work (cont.)

Effect of work in progress inventory on working capital

For this case consider that work in progress inventory is reduced from 1 million to 500,000. In this case

New total inventory level = 2.5 million

New DSI = 2, 500,000/100,000= 25

New DWC = 10 + 25 - 20 =15

New working capital = 15 * 100,000 = 1.5 million

So like raw material inventory reducing WIP inventory also results in decrease in working capital.

Case E

Effect of finished goods inventory on working capital

For this case consider finished goods inventory is reduced from 1 million to 800,0000. In this case

New total inventory level = 2.8

New DSI = 2,800,000/100,000 = 28

New DWC = 10 + 28 - 20 = 18

New working capital = 18 * 100,000 = 1.8 million

Reduction in finished goods inventory leads to decrease in working capital.

Looking at the examples it is clear managing this component tactfully can reduce the requirement of working capital by a substantial margin. While considering the management of working capital companies should consider working capital requirement related to that industry as every industry has different working capital requirements. Working capital requirement of an insurance company which get receivables in advance will be different from a small manufacturing company which have to pay for raw material in advance. So while it may be possible for a company to manage working capital by decreasing account receivable others may not do it as easily.

What are the steps that a company should take to manage and decrease working capital? Most of the activities are related with processes followed in the organization. If organization can modify the business processes according to working capital objectives of the organization and successfully implement the same, management of working capital can be achieved easily.

Working capital management is critically important for small businesses as large portion of their investment is into inventory and current liabilities. Small business may minimize its investment in fixed assets by renting or leasing of plant and machinery, but there is no way to avoid investing in inventory and account receivable

Making working capital work (cont.)

Some of the processes affecting working capital-

Processes for inventory

1. Purchase process
2. Material receive process
3. Stock checking process
4. Material transfer process

Processes for account receivable

1. Set credit limit process
2. Invoicing process
3. Payment collection process
4. Payment follow up process

Raw material handling

Two types of raw material - Own raw material lying with supplier or in transit and raw material lying in own warehouse.

There are a few methods that can be helpful in reducing raw material inventory.

1. Supplier development– It can help in getting raw material at more competitive price and hence decreasing cost of raw material. But the thing to be taken care of here is that cost of supplier development should be in alignment with the decrease in raw material cost.
2. Setting term with supplier for timely delivery. If any delay in delivery from supplier side, make provision for supplier to share the cost of delay. Specially in case of perishable commodity if there is any damage due to delay by supplier it should be bared by supplier.
3. Setting up of purchase schedule depending on the demand cycle of the product. This requires business intelligence related with seasonal variations in demand and supply of the product and also the variation in the cost of the raw material. If raw material is cheaper in during certain period of the year so that it can cover the carrying cost of the raw material than it can be bought and stored instead of following just in time.
4. Purchase order released on time.

Work in progress inventory handling

Work in progress is cross functional activity that requires co ordination between raw material purchase, production schedule and sales of finished goods. Once they are in sync work in progress inventory will be reduced.

Identifying the processes that are soaking up working capital is most critical step in managing working capital

Working capital management should be made a shared goal for whole of organization to achieve desired results as the activities affecting working capital are not confined to any particular department or system

Making working capital work (cont.)

Finished goods inventory handling

1. Issue and deliver material to the client as soon as sale is made so that inventory level is reduced.
2. Production based on market demand and market condition. It requires market intelligence and estimation, hence information gathering process of the company should be strong.

Reduce storage cost of inventory

Storage cost include manpower cost, space and location cost, lighting, telephone cost etc.

Payment receivable handling

1. Reducing credit period without loosing customer– It can be done by offering customers attractive terms like certain discounts if payment is made before due date.
2. More of cash sales and less of credit sales wherever possible - Cash sales can be encouraged by offering customers special discounts on prices if they buy in cash instead of credit.
3. Make payment follow up and payment collection process strong and effective so that late payment and payment defaults can be minimized.
4. Simplify payment terms.
5. Speedy dispute resolution regarding payment and payment delays.

Account payable handling

Stretch payment payback period to suppliers in such a manner so that relation with supplier is not spoiled. It can be done by offering attractive terms to supplier like option of buying more if payment period is increased. This can be done by improving vendor development process.

Outcome of working capital management

Managing of working capital will lead to following positive outcomes for an organization

1. Decrease in cash conversion cycle of the firm.
2. Increase in return on capital.

How Nimble can help

Nimble always aims to create value for organizations by improving processes. Management of working capital is always thought of as a financial process, but Nimble can help organizations to look at It through a different frame i.e. that of process perspective.

1. Nimble will identify if processes linked to working capital are in place in the organization.
2. If processes are existing then to suggest organizations how to improve on the processes.
3. If processes are not in place for working capital management, Nimble helps in mapping, training and implementation of those processes.
4. Nimble can help in linking working capital management with the KPIs of employees

NiMble is a management consulting organization assisting and supporting organizations to understand their needs and sustain growth through improved processes and sound management practices

NiMble Systems Pvt. Ltd.
Tel: +9810008276 (Delhi Office); +9322105859 (Mumbai Office)
E-mail: Contact@nimble.in Website: www.nimble.in