# Working Capital Management Strategies

By: Deanna Salo and Roger Reitz

In the past, working capital management strategies has been a responsibility designated to those managers in the accounting and finance departments. However, today's economy is changing those roles and many managers who traditionally were not part of this process are being called upon to take proactive steps in reducing the risk associated with working capital.

Working capital may be a foreign term to some managers and so we should first begin by defining this term. Generally working capital represents those current assets such as cash, marketable securities, accounts receivable, inventory and pre-paid expenses. Furthermore net working capital would take the calculation further and reduce working capital by the current liabilities such as accounts payable, short-term borrowings and accrued liabilities.

Understanding these terms is crucial because a company's daily activities typically result in dramatic fluctuations in the accounts comprising working capital. The manager's ability to anticipate the fluctuation and proactively make decisions to curtail the negative impact of such fluctuations will help maintain liquidity even in the toughest of circumstances.

A company's ultimate long-term success is based upon all departments within the organization coming together to fulfill its business purpose or mission. The same ideology should be used in managing the company's working capital strategies. As stated earlier, working capital comprises various accounts and to minimize risk appropriately the company should first identify what the largest asset comprising working capital is. Since the largest asset on a balance sheet for many companies typically is accounts receivable, we will use this as an example.

How does a company develop a working capital strategy and get "buy in" from all departments within an organization? The answer lies in assigning each department a vested interest in the ultimate outcome of the strategy. The lifeblood of a company is its ability to generate sales that results in timely cash inflows that exceed the amounts needed to fund its operating expenses. Since the business cycle begins with sales, we will begin with the sales department.

Incentives for the sales department may be better suited if they are tied to cash collection instead of merely sales generated. Furthermore, offering greater incentives to sales personnel for cash collected within 15 days of invoice date compared to 30 days or longer may assist the company in receiving the cash on a timelier basis. Another way to get "buy in" from the sales department is to show them the impact of slow payments on cash flow. Slow payments cost a company real dollars. A formula that helps explain this is the compensating sales volume (bad debt divided by profit margin). If a sale goes uncollected and eventually has to be written off, then the sales department will need to work extra hard in order to break even. For example, $2,000 of bad debts at a profit margin of 20% will take an additional $10,000 of sales in order to break even. These approaches may assist in vesting the sales department in generating sales with those customers that are able to fully satisfy its obligation with the company.

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Slow payments result in other departments having to absorb additional costs that reduce a company's profitability. For example, the purchasing department may be more adept to borrow on a line of credit in order to get the materials in house in order to complete the work tied with a particular sale. This practice results in interest charges being incurred and the overall company profit decreases accordingly. Often times the purchasing department is not fully aware of the increase in expenses as these expenses are reported in the other income/expense section of the income statement.

At the same time the production departments may be approving overtime to get a sale completed for a customer who is notoriously slow in remitting payments to the company. Additional labor costs are incurred and bottom line profitability suffers. The purchasing and production departments are usually ill advised when it comes to both collection matters and the "real" costs of slow collections to the company as a whole. These departments may need to be shown the real costs of slow payments on cash flow. The following formula that computes lost dollars from late payments may help to vest these departments:

**Gross annual sales X Annual interest rate X Days Delinquent divided by 365**

For example, a company with annual sales of $10,000,000 that pays approximately 5% on short term borrowings, collecting accounts 30 days late results in a monetary loss of over $40,000.

It is probably not in the best interest of the company to provide all departments with every aspect of the current financial condition. However, each department is making daily decisions that dramatically affect working capital. Communication of working capital strategies using terminology that is targeted to the individual departments will assist companies in reaching their financial goals and objectives by keeping all personnel on the "same page".

**SOURCE:** Corporate Finance Weekly Update (WG&L)

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