WORKING CAPITAL (LIQUIDITY) MANAGEMENT

Working Capital = Current Assets - Current LiabilitieS

Explain why working capital is important to a business.

Too much working capital is as bad as not enough working capital. Explain this statement.

Simon and Kim's Drafting Services has a wide client base and 90% of their fees are on credit. Simon and Kim allow 90 days for payment.

a) Identify the potential problems Simon and Kim's Drafting Services may have in relation to their credit policy.
b) Recommend some changes they should make.

CONTROL OF CURRENT ASSETS

A summary of the main current assets:

*** Cash**

- Most liquid asset
- Easiest way to pay debts
- Most budget flows in and out of business
- Should have system to prevent losses (security)
    - Cash reconciliations eg against each cash register
    - Bank reconciliations to check business records against bank statements
- Efficient use should be made of excess cash

*** Accounts receivable**

- Sales sold on credit (possibly only after credit checks are performed)
- Consists of subsidiary accounts for each debtor
- An invoice system and debt collection process
- To improve cash flow
    - Offer discounts for early payment
    - Reduce time period (at risk of losing customers)
    - Invoice more frequently

*** Inventory**

- Stocktaking to discover discrepancies between records and actual stock (theft or errors) AND to ensure stock is still of value (good condition, fashionable, etc)
- Perpetual inventory system allow automatic changes, usually through computers, to stock accounts every time stock moves in and out of the business
- Periodic inventory system requires physical counting of stock
- Holding a lot of inventory can be costly
    - Doesn't earn interest
    - Storage
    - Risk of loss

Outline why the management of cash is so important to a business.

CONTROL OF CURRENT LIABILITIES

A summary of the main current liabilities:

*** Payables**

- Purchases made on credit
- Some suppliers allow an interest-free time period before bills fall due
- Paying early may result in discounts

*** Loans**

- Control gearing levels
- Ensure cash flows can meet repayments
- Consider interest costs

*** Overdrafts**

- High rates of interest
- Meant for very short term
- To meet temporary shortfalls in cash

Explain why the control of liabilities is important for the management of working capital.

Explain how taking advantage of credit can assist working capital.

STRATEGIES

*** Leasing**

- Gives access to assets without big impact on cash levels
- Spreads impact on working capital over time
- Lease payments are tax deductible

*** Sale and lease-back**

- Initial impact through cash received
- Then has the same effect as leasing

Define *leasing*.

Outline the *sale and leaseback* process.