

## Working Capital Control, Philip E Dunn

Many members will be in some way involved with the control of Working Capital and its influence upon business success.

Working capital is a key element in business success.

Successful business is about investing in the right ideas, the right equipment, and the right people. And to invest, businesses need capital – either from the owners, from retained profits or from others willing to advance credit or loans.

There are two types of capital need: for ‘fixed capital’ to invest in things such as buildings, plant and equipment; and ‘working capital’ principally to pay for stock and to cover the amount of credit extended to customers.

**Long Term capital**, as the name implies, tends not to vary in the short term but to move up (or down) in jumps when major investment decisions are made (or assets sold). Working capital, on the other hand, is much more fluid and fluctuates with the level of business. The working capital cycle links directly with the cash operating cycle.

**Working capital** comprises short term net assets; stock, debtors, and cash, less creditors. Working capital management then is to do with management of all aspects of both current assets and current liabilities, so as to minimise the risk of insolvency while maximising return on assets.

Even profitable companies fail if they have inadequate cash flow. Liabilities are settled with cash not profits. The primary objective of working capital management is to ensure that sufficient cash is available to:

- meet day-to-day cash flow needs;
- pay wages and salaries when they fall due;
- pay creditors to ensure continued supplies of goods and services;
- pay government taxation and providers of capital – dividends; and
- ensure the long term survival of the business entity.

Poor working capital management can lead to:

- over-capitalisation (and therefore waste through under utilisation of resources and hence poor returns); and
- overtrading (trying to maintain a level of sales which is higher than working capital can sustain – for businesses which extend credit terms, more sales means more debtors and higher working capital demands).

Characteristics of over-capitalisation are excessive stocks, debtors, and cash, low return on investment with long term funds tied up in non-earning short term assets. Overtrading leads to escalating debtors and creditors, and if unchecked, ultimately to cash starvation. Taking control of working capital means focusing on its main elements.

Control of the debtors element (the amount owed the business in the short term) involves a fundamental trade-off between the cost of providing credit to customers (which includes financing bad debts and administration), and the additional net revenue that can be earned by doing so. The former can be kept to a minimum with effective credit control policies which will require:

- setting and enforcing credit terms;
- vetting customers prior to allowing them credit;
- setting and reviewing individual credit limits;
- efficient invoicing and statement generation;
- prompt query resolution;
- continuous review of debtors position (generating 'aged debtors' reports);
- effective chasing and collection procedures; and
- limits beyond which legal action will be pursued.

Before allowing credit to a new customer trade and bank references should be sought. Accounts can be asked for and analysed and a report including any county court judgements against the business and a credit score asked for from a credit rating business (such as Dun and Bradstreet). Salesmen's views can also be canvassed and the premises of the potential customer visited.

The extent to which all means are called upon will depend on the amount of the credit sought, the period, past experiences with this customer or trade sector, and the importance of the business that is involved. But this is not a one-off requirement. One classic fraud is to start off with small amounts of credit, with invoices being settled promptly, eventually building up to a huge order and a disappearing customer.

Credit checking, even for established customers, should therefore feature in regular procedures.

When the creditworthiness of a new customer is established positive credit control calls for the setting of a credit limit, any settlement discounts, the credit period and credit charges (if any).

Collection is a vital element of credit control and must include standard, polite and well constructed reminder letters, effective follow-up telephone or e-mail follow up. Use of collection agencies should be considered. As could factoring – in its most comprehensive form a loan facility based on outstanding invoices plus a sales ledger and debtors control service.

Efficient control of debtors will assist cash flow, and help keep overdraft or other loan requirements down, and hence reduce interest costs.

Debtors represent future cash – or they should do if property credit control policies are pursued. Likewise stock will eventually become cash, but in the meantime represents working capital tied up in the business. Keeping levels to the minimum required for efficient operations will keep costs down. This means controlling buying, handling, storing, issuing and recording stock.

Inherent in any system of inventory control is the concept of appropriate stock levels – normally expressed in physical units sometimes in monetary terms. The objective of establishing control levels is to ensure that excessive stocks are never carried (and working capital thereby sacrificed) but that they never fall below the level at which they can be replenished before they run out.

The factors to consider when establishing the control levels are:

- working capital available and the cost of capital;
- average consumption or production requirements;
- reordering periods – the time between raising an order and receiving delivery of goods;
- storage space available;
- market conditions;
- economic order quantity (including discounts available for quantity);
- likely life of stock – bearing in mind the possibility of loss through deterioration or obsolescence; and
- the cost of placing orders including generating and checking the necessary paperwork as well as physical checking and handling procedures.

Control policies should include designating responsibility for raising and authorising orders, signing delivery notes and authorising payment of invoices.

Four basic levels will need to be established for each line/category of stock. There are the:

- maximum level (achieved at the point a new order of stock is physically received);
- minimum level – the level at point just prior to delivery of a new order (sometimes called buffer stocks – those held for short term emergencies);
- reorder level – point at which a new order should be placed so that stocks will not all below the minimum level before delivery is received; and the
- reorder quantity or economic order quantity – the quantity of stock which must be reordered to replenish the amount held at the point delivery arrives up to the maximum level.

Once these controls are implemented an efficient system of recording receipts and issues is vital to exercise full control of inventories.

Trade creditors, amounts owed by the business for supplies and services, are a plus in the working capital equation. The higher the figure, the more has been extended by others (usually at no cost) towards working capital needs.

But there are limits to the good news. Firms that go beyond agreed credit limits run into trouble; they lose out of cash discounts, can incur interest charges, upset their suppliers who may refuse future orders, may damage their credit rating, and even find themselves in court with additional costs and penalties to pay.

Credit periods vary from industry to industry with usual terms ranging from 28 days to 90.

Just as in credit control, a settlement policy has to be in place so that invoices are properly authorised for payment (after any queries have been answered and credits claimed), and so that they can be paid when due with appropriate discounts deducted. Again, an eye has to be kept on the overall position with appropriate reports generated.

Cash is both the balancing figures between debtors, stock and creditors, and also the control element. It is not possible to extend credit, order stock or pay creditors if there is not the cash available to meet working capital demands.

There are two levels of control. The first concerns efficient banking – making sure money received is banked as soon as possible, making payments the most efficient way, and ensuring any surplus balances are put to interest earning use.

Here the liquidity, risk and return of investments must all come into play with the length of time before funds are needed playing an important role

More fundamental than this is cash flow control – making sure funds are available when needed. In the short term this is best achieved by preparation of weekly or monthly forecasts for comparison with actual results. If these forecasts indicate unacceptable balances or deficits are likely at some point it will be necessary to decide how these can be covered.

Immediate solutions will include increased borrowing, rescheduling plans and payments, or even sale of an asset.

Longer term cash flow control will embrace all aspects of the business including working capital and fixed capital control capitalisation, trading and dividend policy. For example it may be able to improve cash flow by improvements in operating efficiency or higher sales prices, improved working capital control, or revised fixed asset investment plans.

Cash flow forecasts form an integral part of the budgeting process. The objectives of the cash budget are to:

- integrate trading and capital expenditure budgets with cash plans;
- anticipate cash surpluses and deficits in time to generate plans to deal with these; and
- provide a facility for comparison between budget and actual outcomes.

Top level bookkeepers have an important part to play in all aspects of working capital control – through internal control procedures (such as invoice authorisation) and through reporting processes (such as production of ‘aged debtors’ lists and cash flow forecasts).

They can also bring analytical skills into play, typically by use of ratio analysis. Various ratios are considered important indicators of working capital strength (and can be applied internally or to potential customers).

A broad indication of a firm's short term ability to finance its continued trading can be obtained by applying the 'current ratio'. This is a straight comparison of current assets and current liabilities. If the latter should be less than the former, it is worth looking further. Many businesses operate this way when they start, often for long afterwards, sometimes always. Much will depend on the type of trade and the nature of both current liabilities and current assets.

For example a large element of prepayments to creditors will mean they will not be repaid but will be earned over time. On the other hand, debtors escalating at a faster rate than sales growth could indicate poor credit control and possible bad debt problems.

Generally when it comes to current assets, cash is the most valuable element (it is immediately available to settle bills), and debts are more valuable than stock (they are nearer to being turned into cash).

Hence the tougher test – the 'acid test' – excludes the stock element from current assets. If current assets less the stock element total less than current liabilities the business, on the face of it, may not be able to settle its creditors as they fall due.

And that suggests more finance might be needed, better working capital control will be required, or insolvency may be looming.