

Week 10 & 11 – Working Capital Management

Working capital is what is available for day-to-day operating activities. It is derived from:

Current asset

- § Inventories
- § Trade Receivables
- § Marketable Securities
- § Cash at Bank
- § Cash in Hand



Highly liquid

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What are 2 decisions in working capital policy?

1] Investment decision

The appropriate level of investment in, and mix of current assets are to be decided upon, for a set level of activity.

The efficient management of working capital is crucial from the point of view of liquidity and profitability. Their relationship is negative in the sense that the company faces a trade off between them.

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What are 2 decisions in working capital policy?

1] Investment decision (cont'd)

Poor management of working capital means that funds are unnecessarily tied up in idle assets hence reducing liquidity and also reducing the ability to invest in productive assets such as plant and machinery, so affecting profitability.

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1] Investment decision (cont'd)

Is there an optimal level of working capital?

Generally, it depends on the type of industry and economic condition. However, businesses must avoid the extreme, as these can result in overtrading or overcapitalisation.

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1] Investment decision (cont'd)

What is Overtrading?

Overtrading occurs when a business's working capital increases at a slower rate than the sales volume. When a business expands rapidly, there will be a need to invest in working capital and fixed assets to facilitate the continued growth in sales. Consequently there will be an increasing requirement for a mix of short term, medium term, and long-term sources of finance.

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1] Investment decision (cont'd)

What is Overcapitalisation?

If there are excessive stocks, debtors and cash, and very few creditors, there will be an over-investment by the company in current assets. Long-term funds will be unnecessarily tied up when they could be invested elsewhere to earn profits.

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2] Financing decision

The methods of financing this investment; short-term or long-term finance; they are debt or equity.

Generally, it is true that short-term interest rates are lower than long-term rates as short-term finance is less risky for the lender.

However, short-term finance is not always cheaper and often must be renegotiated when it expires. The 4 principal sources of finance are:

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2] Financing decision (cont'd)

Long-term

Debt	Debentures
	Long-term bank loans
Equity	New shares issues
	Retained earnings

Short term

Debt	Bank overdraft Trade payables
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2] Financing decision (cont'd)

There are **3** types of working capital policy where it shows that structure of total assets is financed by short-term and long-term finance:



➤ **Matching approach**

Generally permanent current assets will be financed by long-term finance while fluctuating current assets will be financed by short-term finance.

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2] Financing decision (cont'd)

➤ **Aggressive approach**

It is a situation where the company is financing most of its working capital using *short-term finance*.

➤ **Conservative approach**

It is a situation where the company is financing its working capital using mostly *long-term finance*.

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