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# Discussion Board Articles on Working Capital Management

- Basic Cash Flow Management
- Quick Tips for Improving Cash Flow
- Cash Support for Sales Growth
- The Costs of Financing Inventories
- What is Zero Working Capital?

The above articles were originally posted to the Financial Management Discussion Board which can be found on the internet at [www.exinfm.com/board](http://www.exinfm.com/board)

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# Basic Cash Flow Management

Managing cash must take an equal stature with Net Income. In financial management, "cash is king" is a frequent motto. So your first step in managing cash is to elevate the importance of cash. The basic process for managing cash is straightforward. Try to maintain an adequate level of cash to meet current obligations and invest idle cash into earning assets. Earning assets must have high liquidity; i.e. you must be able to convert investments back into cash quickly. Additionally, you want to protect your cash balance by paying obligations only as they come due.

Managing cash also involves aggressive conversion of current assets into cash. Inventory levels must be converted into accounts receivables and accounts receivables must be converted into cash. Ratios should be used to monitor the conversion of cash, such as number of days in inventory and number of days in receivables. Cash balances are the end result from a combination of cycles: inventory, purchasing, receivables, payables, etc. The key is to properly manage these cycles for conversion into cash.

Once conversion cycles are identified, cash forecasts can be prepared for managing cash. Weekly cash reports are used to monitor balances. Since everything ultimately passes through your cash account, a strong internal control system is required. This involves the separation of duties in handling cash, reconciling cash accounts, adequate support for cash disbursements, and other control procedures. The overall objective is to protect cash just like any other asset through a system of internal controls.

Matt H. Evans, [www.exinfo.com](http://www.exinfo.com)

## Quick Tips for Improving Cash Flow

The first step for improving your cash flow is to understand the history of your cash flow. This requires scheduling cash inflows and outflows. Once you understand the history, you can take steps to cut cash outflows and increase collections.

One of the biggest cash outflows is payroll. Payroll should be managed with flexibility in mind. You need a workforce that works when needed as opposed to 5 days a week, 8 hours a day. Consider diversifying your work force into a mix of temporary workers, part-time workers, and outsourcing of non-value added activities. Also don't forget you can extend your payroll float by distributing payroll checks after 2:00 o'clock on Fridays.

Your purchasing practices should also consider a mixed approach. For example, why do you have to buy everything new? Purchasing used items or renting can save a lot

of cash flow. You may want to purchase in minimum quantities, especially if your cash flow is tight. And don't hold inventory that isn't moving - get rid of it!

Other cash traps include insurance. Don't use insurance to cover all risks. Make sure you retain some risks, especially if the risk is not materially significant and not likely to occur very often. One of the fastest rising insurance outflows is health care costs. Make sure you have a preventive program for your employees. This can include things like annual cholesterol screenings, reimbursement for quit smoking programs, and company participation in outdoor activities. Finally, aggressively monitor your outstanding receivables and begin to take action at the first sign of trouble. If you have doubts about a customer's ability to pay, require an advance deposit.

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## Cash Support for Sales Growth

As sales grow, cash needs will grow. Planning for future sales must include planning for additional requirements for cash. A basic formula can be used to help determine the amount of additional cash needed for new sales. The formula is calculated as follows:

Additional Cash = ((New Sales - Gross Profit) + Additional Overhead) / (Sales Growth Duration in Days x Average number of days to collect Receivables + Safety Factor)

Example: We expect \$ 10,000 of additional sales during the year (365 days) with a corresponding increase of \$ 3,000 in overhead. All payables are paid on time, we do not expect any changes in our collection periods, and we expect a continued gross profit margin of 25%. The average period to collect receivables is 40 days and we will add in a safety factor of 20% into our estimate.

$(\$ 10,000 - \$ 2,500) + \$ 3,000 / 365 = \$ 28.77 \times (40 \times 1.20) = \$ 1,381$  of additional cash is needed to support the \$ 10,000 of additional sales.

The above formula is a quick and rough estimate for estimating how much cash is needed to carry additional sales. Changes in collections and payment cycles need to be considered when using this formula.

- Matt H. Evans, [www.exinfm.com](http://www.exinfm.com)

## The Cost of Financing Inventories

Inventory financing can be used where inventories are highly marketable and no threat of obsolescence exists. The inventory serves as collateral within the financing arrangement. Financing can occur up to 70% of inventory values provided that inventory prices are relatively stable. The costs of financing inventory can be very high; such as 6% over the prime lending rate.

Three types of financing arrangements for inventory are available. They are floating liens, warehouse receipts, and trust receipts. Floating liens place a lien on the overall inventory stock. Warehouse receipts give the lender an interest in your inventory. And trust receipts represent a loan which is released as you sell your inventory. The costs of financing inventory is illustrated in the following example:

You would like to finance \$ 100,000 of your inventory. You need the funds for 3 months. You will use a warehouse receipt arrangement. This arrangement requires that you setup a separate area for the lender's inventory. You estimate an additional \$ 2,000 in costs for storing and maintaining the inventory. The lender will advance you 80% at 16%.

The costs of financing inventory is \$ 5,200 as calculated below:

$.16 \times .80 \times \$ 100,000 \times 3/12 = \$ 3,200 + \$ 2,000$  or \$ 5,200.

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## What is Zero Working Capital?

Working capital is the comparison of current assets to current liabilities. For most organizations, current assets exceed current liabilities and working capital therefore represents the liquid reserves for meeting current obligations. Creditors prefer high levels of working capital since they are concerned about receiving payment. However, management prefers low levels of working capital since working capital earns an extremely low rate of return. Some companies are now driving working capital to record low levels, so-called Zero Working Capital. By keeping working capital at zero, funds are released for many other opportunities.

Zero Working Capital requires major changes in how an organization functions. One way to implement Zero Working Capital is to have a demand-based organization. Demand-based organizations do everything only as they are demanded: Fill customer orders, receive supplies, manufacture products, and other functions are done only as needed. The production facilities run 24 hours a day non-stop according to the demands within the marketplace. There are no inventories; everything is supplied immediately as needed. The end result of this demand driven organization is that little, if any, working capital is necessary to run the business.

Companies like GE (General Electric) and Campbell Soup have made Zero Working Capital a major strategic objective for the organization. As more and more businesses find faster ways of servicing customers, the concept of Zero Working Capital will become more mainstream.

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