Chapter 20: Working Capital Management

Cash and Marketable Securities Management

- Are the most liquid of a firm's assets
- Cash consists of currency and deposits in checking accounts
- Marketable securities consist of S-T investments made with idle cash

Investing Idle Cash: The Money Market

The securities normally used for temporary investments are usually purchased in the **money market** where short-term, high quality, marketable securities are traded. When cash needs are known, securities of specific short-term maturity may be selected. If cash is needed, money market securities may be sold quickly, and because there is little price variability if market interest rates change, the cost of selling the securities is kept at a minimum.

One choice of short-term is *Treasury bills*, which mature less than 6 months and are the safest money market securities.

Another choice is high quality investment is *commercial paper*, the short-term notes (maturities usually less than 270 days) issued by industrial and financial corporations.

Certificates of deposits (CDs) are short-term notes issued by commercial banks.

Repurchase agreements (repos), the purchase of securities under agreement to resell (at a higher price) are issued by commercial banks when the checking account of the business is higher than desired. The money stays in the bank and the business has a temporary earning investment.

Reasons for Holding Cash and Marketable Securities:

- **Transactions:** Firms use cash to make transactions (pay bills) until they receive cash from customers.
- **Precautionary:** firms hold cash as a precaution to meet any unexpected demand for cash.
- **Future requirements:** firms hold cash to meet future planned needs (eg. capital expenditure, tax payments, dividend payments, loan payments)
- **Speculative:** firms hold cash to be more flexible ion case any good investment opportunity comes up.

Optimal Cash and Marketable Securities Balance:

Weight the benefits and costs of holding various balances:

- **Holding cash and marketable Securities incur an opportunity cost.** The cash in the bank earn very low rate of return. The firm could have earn higher return by investing this cash in the firm's operation.

- **Running short of cash and marketable Securities also incurs shortage costs:**
  - **Foregone cash discounts:** Suppliers frequently offer trade discounts for paying bills early. From a financing standpoint, the cost of *not* taking these discounts is very high, so firms should always have enough cash on hand to take advantage of them.
  - **Deterioration of the firm's credit rating:** Credit rating take into account the level of liquid assets in the firm (quick ratio and current ratio). An adequate supply of cash helps keep the firm's current and quick ratios high enough to maintain a good credit rating.
  - **High interest expense:** if the firm is not able to pay bills on time, it will have to pay high financing charges.
  - **Possible financial insolvency:** Bankruptcy

Collection and Disbursement of Cash

Managers always try to speed up the collection of cash from customers and to slow down the disbursements of cash to supplies and other parties.

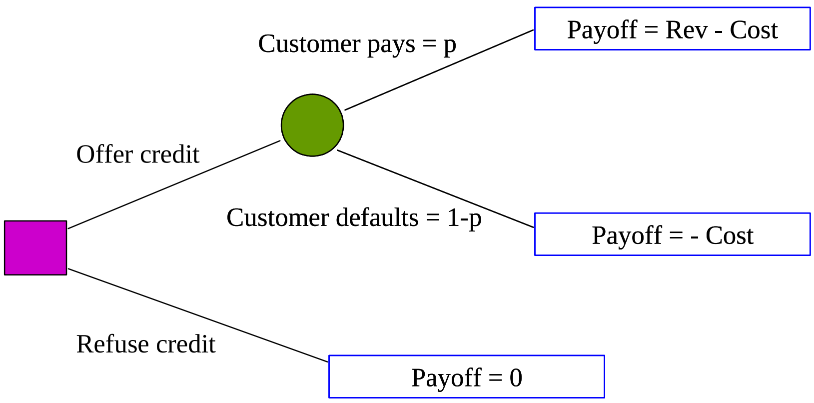
Accounts Receivable Management

Credit Policy

- **Credit standards**
  - **Criteria used to screen credit applications:** Evaluation of Credit Applications.
    - ✓ Gathering information: financial statements, credit reports, banks, prior experience.
    - ✓ Numerical scoring system (Altman *Z* score), see p. 547.
    - ✓ Five C's of credit
      - **Character** : assess customer willingness to meet credit terms
      - **Capacity** : customer's liquidity position
      - **Capital**: customer's financial strength and net worth
      - **Collateral**: customer's assets than can be used as collateral
      - **Conditions**: the general conditions in the economy.

- **Controls the quality of accounts:** quality of account means how long the customer takes to repay the credit granted and the probability of default. The probability of default is measured by the bad-debt loss ratio which is the proportion of account receivable that is uncollected.

Credit should be extended if the expected profit from the credit sale is greater than the expected profit from refusing credit. If paid as agreed, the profit margin will be realized on the sale; if payment is not received, the firm loses the cost of sales. Refusing credit makes no profit. See Figure 20.1.



- **Credit terms :** Conditions under which credit extended must be repaid
  - **Credit period** :Time allowed for payment
  - **Cash discount:** allowed if payment is made within a specific period of time. It specified as % of the invoiced amount. For example: credit terms of (2/10, net 30) mean that customer can deduct 2% of the invoice amount if payment is made within 10 days from the invoice date. If payment is not made within the 10 days, then full invoice amount is due in 30 days from invoice days. Cash discount is used to speedup the collection of account receivable.

- **Collection efforts:** Methods employed in an attempt to collect payment on past due accounts
  - **Balance between leniency and alienating customers**
    - ✓ **Sending notices**
    - ✓ **Telephoning**
    - ✓ **Collection agency**
    - ✓ **Legal action**
  - **Monitoring status:** perform aging of accounts analysis. An aging schedule is a report that actually breaks down a firm's receivables by age. For example, an aging schedule could show what respective portions of

A/R have been outstanding for less than 10 days, for 11-30 days, for 31-45 days, for 46-60 days, etc. If a significant part of the firm's receivables are past due, this indicates that the firm may need to reexamine its collections policies.

Inventory Management

Types of Inventory

- **Raw materials inventory**
  - **Stores of items used in production**
  - **Quantity discounts**: by large quantity to get discount on price
  - **Assure supply in times of scarcity**

- **Work-in-process inventory**
  - Items at some intermediate state of completion
  - Size related to length and complexity of production cycle

- **Finished goods inventory**
  - Items ready and available for sale
  - Permits prompt filling of orders

Costs Associated with an Inventory Policy

- **Ordering costs:** Costs of placing and receiving an order of goods, including inspecting shipments, handling payment, follow up calls and letters.
- **Carrying costs:** Costs of holding inventory for a given period of time, including storage and handling cost, obsolescence and deterioration cost, and opportunity cost of funds invested in inventory.
- **Stockout costs:** Incurred when a firm is unable to fill an order, including losing sales and the extra cost of placing special orders or work overtime to produce the needed product.
- **Just-in-time inventory (JIT):** The firm does not carry inventory. Once the order is received from customers, the order for raw material is placed with the supplier and the product is manufactured. JIT method is used to reduce inventory cost by supplying Inventory at exactly the right time and in exactly the right quantities. Example, Dell Computer Co.