

CPA BEC - STUDY UNIT 8

Working Capital Policy and Management: Core Concepts

A. Financial Management

1. The **objective of the firm** is to maximize the shareholders' wealth in the long term. The **market price** is the result of the firm's investment and financing decisions.
 - a. Management must make **investment decisions**, i.e., obtain a proper mix of productive assets. It must then obtain **financing** of these assets. These decisions are not independent.
 - b. The amount and **composition of assets** are directly related to the amount and composition of financing. Given current and expected industry and overall economic conditions, the resulting mix of assets, liabilities, and capital determines **business risk**.
 - c. **Taxes** are frequently 25% to 50% of all costs. Thus, tax planning is important in investment and financing decisions.
2. **Working capital finance** concerns the optimal level, mix, and use of current assets and the means used to acquire them, notably current liabilities. The objective is to minimize the cost of liquidity while guarding against technical insolvency.
 - a. A **conservative policy** seeks to minimize liquidity risk by increasing working capital. The result is that it forgoes the potentially higher returns available from using the additional working capital to acquire long-term assets.
 - b. An **aggressive policy** reduces the current ratio (and liquidity) and accepts a higher risk of short-term cash flow problems.

B. Cash Management

1. The **cash budget** details projected receipts and disbursements, preferably for planning inflows and outflows.
2. Cash is held as a **medium of exchange**, as a **precautionary measure**, for **speculation**, and as a **compensating balance**.
3. **Cash collections** should be expedited. Invoices should be mailed promptly, and credit terms must be competitive but geared to encourage prompt payment. **Slowing cash disbursements** increases available cash. Payment beyond normal credit terms, however, creates vendor ill will and may incur interest charges. Payments should be made within **discount periods** if the cost of not taking a discount exceeds the firm's cost of capital.
4. The **cash on hand** should be determined by cost-benefit analysis. Thus, the **economic order quantity (EOQ)** model is applicable to cash management. Excess cash should be placed in an investment with a high return and little risk, such as treasury bills, certificates of deposit, money-market accounts, and high-grade commercial paper.

C. Marketable Securities Management

1. Short-term marketable securities (e.g., T-bills and CDs) are sometimes held as substitutes for cash but are more likely to be temporary investments. They are usually chosen for reasons that make high-yield, high-risk investments unattractive. Hence, a higher return may be forgone in exchange for greater safety.

D. **Receivables Management**

1. The **objective** of managing accounts receivable is to have the optimal amounts of receivables and bad debts. This balance requires a trade-off between the benefits of credit sales, such as more sales, and the costs of accounts receivable, e.g., collection, interest, and bad debt costs.
2. The **optimal credit policy** does not seek merely to maximize sales (e.g., by lowering credit standards, offering longer discount periods, or charging lower interest) or to minimize default risk. Thus, a firm should extend credit until the marginal benefit (profit) is zero (considering opportunity costs of alternative investments).

E. **Inventory and Supply Chain Management**

1. **Inventory management** concerns the effective and efficient acquisition, use, and distribution of inventory. A firm carries inventories because of the difficulty in predicting the amount, timing, and location of supply and demand. Thus, one purpose of **inventory control** is to determine the optimal level of inventory necessary to minimize the costs of ordering and carrying inventory, safety stock, and stockouts. Although traditional inventory management **minimizes inventory** and the related holding costs, and modern just-in-time methods may seek to eliminate it altogether, some firms may still use inventory as a hedge against inflation as well as a guarantee of future availability.
2. **Purchasing** encompasses choice of suppliers, contract negotiation, the decision whether to purchase centrally or locally, and value analysis.
3. **Inventory models** control inventory costs by determining the optimal time to place an order (or begin production) and the optimal order quantity (production run). The **basic EOQ model** minimizes the sum of ordering (setup) and carrying costs. The following are the characteristics of this model: (a) Demand is known and uniform throughout the period, (b) the fixed costs of ordering are eliminated when the total cost equation is differentiated to arrive at the EOQ, and (c) cost per order (setup) and unit carrying cost are constant.
4. Modern inventory control favors the **just-in-time (JIT)** model. **Reductions in inventory levels** result in less money invested in idle assets; reduction of storage space requirements; and lower inventory taxes, pilferage, and obsolescence risks. The focus of **quality control** under JIT shifts to the prevention of quality problems. Higher quality and lower inventory go together.
 - a. JIT systems are based on a **manufacturing philosophy** that combines purchasing, production, and inventory control. Minimization of inventory is a goal because many inventory-related activities are viewed as **nonvalue-added**. Indeed, carrying inventory is regarded as a symptom of correctable problems, such as poor quality, long cycle times, and lack of coordination with suppliers.
 - b. JIT also encompasses changes in the **production process** itself. JIT is a **pull system**. Items are pulled through production by current demand by the next operation. Components and materials arrive just in time to be used. To implement this approach and to eliminate waste, the factory is reorganized to permit **lean production**.
5. The **supply chain** consists of flows from sources of materials, components, finished goods, services, or information through intermediaries to ultimate consumers. These flows and the related activities may occur across the functions in an organization's **value chain** (R&D, design, production, marketing, distribution, and customer service). These flows and the related activities also may occur across separate organizations. The activities in the supply chain, wherever they occur, should be integrated and coordinated for optimal cost management.