***Managing Finance* (MNGFIN)**

Week 8: Raising and managing working capital

Raising capital

There is no textbook reading for this topic. Pay special attention to the additional Web-based materials and journal article referenced below.

Businesses run on capital—it is the fuel that is needed to get from point A to point B. Long-term investments require substantial amounts of capital investment in the form of bond issues and sales of stock to purchase land, build facilities, or conduct necessary research. Organisations have various options with regards to how they will obtain the funds necessary to start operations or pursue new projects. While there are numerous variations of capital sources, there are three broad categories: equity, debt, and retained earnings.

Equity is generally seen in the form of stock that organisations sell to raise funds, either to begin operations or to acquire additional reserves for the purpose of long-term investment. Issuing stock or shares of the organisation generally requires that dividends be paid to investors while the share remains outstanding. Therefore, dividends represent a cost to the organisation that must be considered when making investment decisions. The project must be profitable enough to make these payments while also increasing the value of the organisation. By adding value to the organisation, the company itself is worth more, which increases the value of the shares that investors hold. Long-term appreciation is the primary goal of shareholders, so the addition of wealth must also be considered when making investment decisions.

The second category of capital is *debt financing*. Organisations can obtain funds by borrowing from financial institutions or by issuing bonds. Funds obtained through debt must be fully repaid with the addition of interest. Interest represents the cost of obtaining the funds and must be factored in when evaluating investments. Just as with dividends, projects must be profitable enough to cover the cost of interest. Another important consideration with debt financing is the potential tax benefits. The amount of interest paid represents a tax deduction for the organisation, allowing them to reduce their overall tax expense.

Retained earnings represent profits from previous ventures, operations, or activities that a business has chosen to hold as reserves rather than paying them out as dividends. Organisations retain earnings for various reasons, the primary one being for future opportunities. This source of financing may seem like a ‘win–win’ for the organisation, as it comes from profits already obtained and appears to have no costs involved. While there are no nominal costs involved with retained earnings, there are economic costs. By withholding dividends from shareholders, these investors are not receiving a return on their investment. Instead, the organisation is attempting to increase their return by investing profits back into the company. Shareholders will still expect a return of these dividends at some point plus an additional amount for having to wait. Thus, projects undertaken with the use of retained earnings must also have the potential to return not only the initial amount, but an additional amount to satisfy shareholders.

Organisations will rarely raise capital from only one source. Generally, companies will seek funds from a combination of equity, debt, and retained earnings. Averaging the costs of each source produces a cost of capital that is used as a measuring stick for determining the overall profitability of investment. The Web links and supplemental journal article listed below will help to expand these concepts and provide you with a solid understanding of how organisations can raise capital and the issues that must be considered when making investment decisions.

Sources of Finance
(This Web site provides basic information regarding sources of finance.)
http://www.bized.co.uk/learn/accounting/financial/sources/index.htm

Sources of Finance, Finance Sources, Finance Sourcing
(This Web site provides additional insights into sources of finance.)
http://www.economywatch.com/finance/sources-of-finance.html

Carter, R.B. & Van Auken, H. (2005) 'Bootstrap financing and owners' perceptions of their business constraints and opportunities', *Entrepreneurship & Regional Development*, 17 (2), pp.129–144, Business Source Premier [Online]. DOI: 10.1080/08985620500067548 (Accessed: 26 June 2009).
(This journal article provides insightful details about sources of capital financing and delves more deeply into one aspect that is available to entrepreneurs.)

The importance of working capital
Textbook reading (Atrill & McLaney: Ch. 11)

How do businesses operate? They offer a product or service that customers must purchase. But how do businesses acquire the materials they need to manufacture products or pay their bills? It would be simple if all customers paid immediately—businesses would have cash on hand to take care of expenses and acquire more materials. But this is not always possible, as some customers are short on cash and need time to pay. Businesses, seeking to keep and acquire customers, must be willing to extend credit to such customers. However, this leaves businesses with a cash deficit, restricting their ability to pay bills or pursue profitable opportunities and creating the need to raise capital to finance short-term operations.

There are different avenues through which organisations can raise the funds needed to finance daily operations. One of the most basic sources is cash reserves. This can be funds currently held or cash that can be acquired quickly through the sale of liquid assets. Working capital can also be acquired through short-term loans or lines of credit from financial institutions. While this source of funds can be helpful if cash is low, it also incurs an interest cost that may lower the profitability of sales. Many businesses finance their short-term operations through the establishment of trade payables. This allows the organisation to delay making payments while also not incurring an interest cost. The elements of establishing and managing working capital will be explored this week.

Businesses need cash to purchase materials and inventories to either manufacture products or sell finished goods to customers. How a business acquires its materials and manages its inventories—either by cash or by credit—is important to consider because of the costs involved. Just as important is the selling of goods to customers, which deals with managing cash flows as well as extending credit to help finance the customer's operations.

This short-term financing of operations must be properly and carefully managed. Running short on cash can result in a business being unable to pay its immediate bills, such as wages or utilities. Extending too much credit to customers increases the risk of bad debts, and holding too much inventory can incur significant and unnecessary costs. The goal of the manager is to walk the thin line between having too much of one thing and not enough of another. The topics for this week examine each element of working capital and important issues for analysing and managing them.

Managing inventories

Textbook reading (Atrill & McLaney: Ch. 11)

Organisations vary with regards to the types and quantity of inventories that they hold. Consider a manufacturer of baked goods, which must purchase raw materials, mix ingredients, bake their products, and then store them until they are sold. The raw materials, such as flour, sugar, baking soda, etc., are considered *raw materials inventories*. Goods being produced and not yet finished, such as batches of dough, would be considered *works in progress* and represent another category of inventories. Finally, *finished goods*, such as cakes, cookies, or pies, would be yet another category of inventory. All of these inventories represent costs to the organisation—either nominal or economic—that require careful management. While it is possible to simply hold substantial quantities of inventories, as this lessens the risk of lost sales revenue from a shortage, it also incurs storage costs, the need for theft prevention, costs to acquire such inventories, and the lost opportunity to pursue other activities because of the funds needed to hold larger quantities than what is required.

Managing inventories requires a substantial amount of time, effort, and resources for many organisations. The acquisition of inventories is accomplished through the establishment of a trade payable or an outflow of cash, both of which are important elements of working capital. Inventories are also essential to the operations of many organisations, especially manufacturing firms, which require a steady flow of materials to ensure that production requirements are met and that customer demand is fulfilled. Because of the importance of inventories to customers and their relationship with other elements of working capital, this area receives a great deal of focus and attention. Your reading will examine several methods, techniques, and approaches for managing inventories, some of which we will explore further.

For some small businesses, inventory management may consist of nothing more than checking how much of a particular good is on hand and ordering more when levels drop below a certain point. However, for larger organisations, with more complex operations that stretch across the globe, analytical procedures must be employed. As you will recall, budgeting for sales is an important process for measuring performance, although this process is just as important for inventory management. Forecasting the demand for goods can help businesses to better schedule the flow of materials and improve the management of inventories.

Central to inventory management is the *economic order quantity* (EOQ) model. The EOQ model is a quantitative tool that derives an optimal order quantity by examining demand for a particular item compared to the cost of placing an order and the cost of holding the unit. This model and its application are key to the management of inventory, and the reading will provide you with an appropriate introduction. Further examination of the model and its uses are beyond the scope of this module.

Computer programs, such as Fishbowl, IntelliTrack, and IBS, have been developed to help track the levels of inventories and schedule for deliveries of raw materials. Many organisations are utilising radio-frequency identification (RFID) that tags goods and materials and allows the organisation to track flow throughout the distribution channels. Such technology is important when following approaches such as *materials requirement planning* (MRP) systems and *just-in-time* (JIT) management. MRP systems are based on the forecasted sales demand and utilise a computer program to assist with the schedule and timing of deliveries. The computer program coordinates the parts and materials needed in the production process to be delivered at specific times, so that materials will always be available while also reducing the need to hold large quantities of parts.

JIT management seeks to reduce the need to hold large stores of materials by having the necessary parts delivered only when they are needed. This inventory management approach is much more involved; by working closely with suppliers to ensure delivery of materials just in time to be used, the organisation nearly eliminates the need to hold inventory. However, this approach hinges on the delivery of quality materials in a timely manner. Poor-quality parts or late deliveries would cause significant delays in the production process. Each of the methods are examined in the reading.

Managing receivables
Textbook reading (Atrill & McLaney: Ch. 11)

Being able to purchase on credit is an important factor for many customers, as it allows them to acquire a product or service without having an initial cash outlay. But for the business extending the credit, there are very significant considerations that must be accounted for if receivables are to augment the performance of the organisation and not hinder it. One of the most important elements to consider when managing receivables is the creditworthiness of the customer. When allowing a customer to delay payment, it is necessary to assess the ability of the customer to eventually pay. The five *C*s of credit, which are described in your reading, outline the factors that need to be evaluated when investigating the ability and willingness of the customer to pay the amount owed.

Even if an organisation is able to identify those types of customers who are likely to pay their debts, they must still set appropriate credit terms, such as amount of credit, repayment period, discounts, and collections policies. Having the most creditworthy customers will do little good for the organisation if it allows them too long a period of time to repay, as this puts a strain on the availability of cash flow and restricts the ability to pursue other activities. Offering discounts to customers who pay within a short period of time can increase repayment; however, it also may result in less revenue. As you will see, managers must again walk that fine line between too much and not enough. Credit terms that are too constrictive may deter customers from purchasing and drive them to another organisation.

Collection policies are procedures for handling credit customers after the purchase has taken place. Effective collection policies should result in customers fully knowing the credit terms, which means they know what is expected of them. The authors outline several steps that can be taken to help encourage successful collection of payment from customers.

Managing cash
Textbook reading (Atrill & McLaney: Ch. 11)

Having a surplus of cash seems like a nice problem to have. However, for businesses, having too much cash represents idle funds that could otherwise earn interest or be used for pursuing other profitable projects. At the same time, it is necessary to hold some reserves of cash to meet daily needs. How much cash to hold depends on the requirements of the individual organisation. Smaller businesses may require less cash, as there are fewer employees to compensate and fewer bills to pay. Larger organisations will require substantially larger reserves of cash to manage their daily requirements while also positioning themselves for the possibility of pursuing new opportunities.

While the levels of cash needed will obviously vary between organisations, how to determine the amount of reserves needed does not. Businesses of all types and sizes need to utilise budgets that assist in identifying points at which more cash will be needed or when cash is less in demand. Cash budgets help to identify surpluses and deficits, providing managers with more information when making decisions regarding projects, borrowing, or liquidating assets.

Understanding the operating cash cycle will also provide managers with greater detail about cash requirements. The *operating cash cycle* is the length of time it takes from the purchase of inventories to the receipt of cash. Knowing this cycle is vital to managers when making financing decisions. If the cycle is short, cash will be received quickly and generally be on hand. This would lessen the need to finance the inventories and improves the cash flow of the organisation. If the cycle is long, cash will be received much later in the future, increasing the need to finance the inventories and putting constraints on cash flow.

Managing trade payables

Textbook reading (Atrill & McLaney: Ch. 11)

The discussion on management of inventories and receivables mentioned that it may be necessary to finance such purchases. This may occur through actual borrowing of funds from a financial institution. However, most financing is the result of the extension of credit from the selling organisation to the buying organisation. The establishment of trade receivables for a selling organisation results in a trade payable for the buying organisation. This represents an important source of financing for many businesses, as they often receive this financing free of interest costs when paid on time.

It is important that organisations manage this element of working capital as well. Purchasing on credit does help an organisation that may be short on cash; however, this liability must still be repaid at some point in the future. Simply purchasing on credit without future consideration of cash flows may result in a deficit of cash needed to settle debts. Buying organisations may also have the option to repay early and receive a discount. While it may seem better to delay the payment and hold the cash, forfeiting a discount may also incur opportunity costs. Example 11.6 in your reading helps to illustrate this point.