

CPA Ireland Skillnet

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The CPA Ireland Skillnet provides excellent value CPE (continual Professional Education) in accountancy, law, tax and strategic personal development to accountants working both in practice and in industry. However our attendees are not limited to the accountancy field as we welcome all interested parties to our events.



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Trainee Accountant Webinar

December 19th 2016

P1 – Managerial Finance Working Capital Management Presented By: Dr Garvan Whelan CPA



OVERVIEW

◆ Introduction

- Objectives; Importance of Working Capital; Terminology

◆ Working Capital Management

- Policies and their impact on Liquidity etc.

◆ Current Practice

- Illustration and Analysis

◆ Conclusions

Working Capital Management

Learning Objective

To improve your understanding of the theory and practice of WCM

- Fundamental concepts and terminology
- Consideration of various WCM policies
- Applied to companies illustrating current issues and best practice

Working Capital Management

Objective

To maximise shareholder wealth by managing current assets and liabilities in order to achieve the optimum balance of:

- Liquidity
- Risk
- Profitability (Note 1)

(Note 1) The information presented in these slides is based on a variety of sources including: Kuhlemeyer (2004); Arnold (2005, 2012); Annual Reports of Tesco PLC and Apple Inc.

Importance of Working Capital Management (WCM)

- Current assets are a significant part of total assets in most firms including those in service industries.
- Excessive levels can result in a substandard Return on Investment.
 - Measured here by ROTA (PAT/Total Assets)
- Current liabilities are the principal source of external financing for small firms.
- WCM metrics are used as KPIs.
- WCM affects the company's risk, return, and share price.

TERMINOLOGY

- Note that there can be differences in the terms used in various firms and textbooks.
- The terms as used here are applied widely in practice and are in accordance with the core text book (Arnold).
- Total Working Capital:
Current Assets – Current Liabilities.
- Cash Conversion Cycle (CCC):
(Inventory Holding Period + Receivables Collection Period)
- (Payables Payment Period)

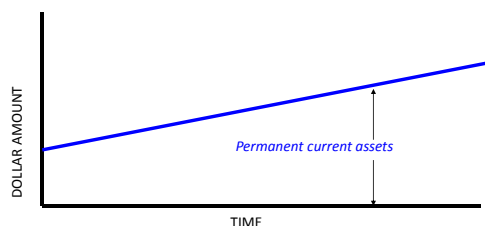
Classifications of Working Capital

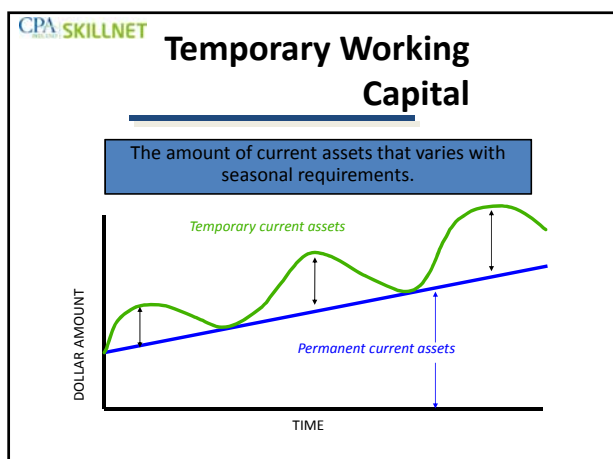
◆ Main Components

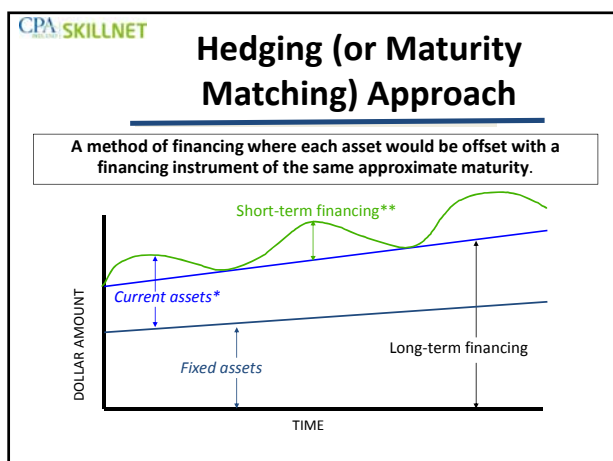
- CAs: Cash, marketable securities, receivables, and inventory etc.
- CLs: Payables, accrued expenses etc.
- Time
 - Permanent
 - Temporary

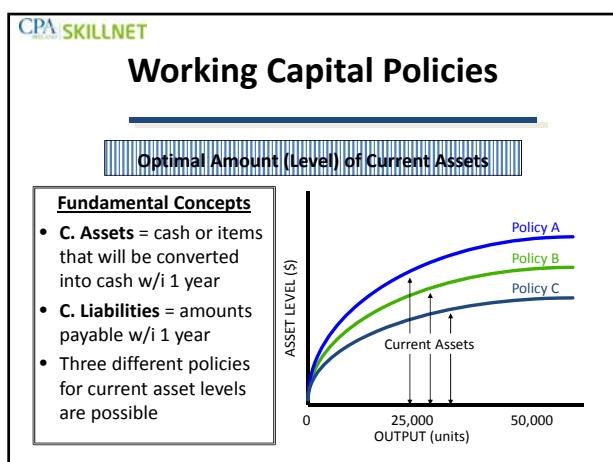
Permanent Working Capital

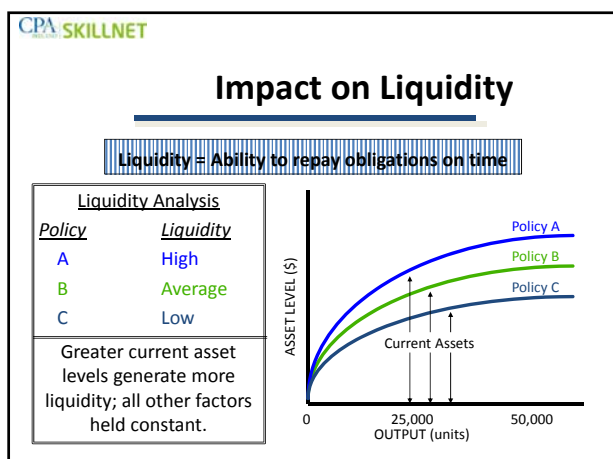
The amount of current assets required to meet a firm's long-term minimum needs.

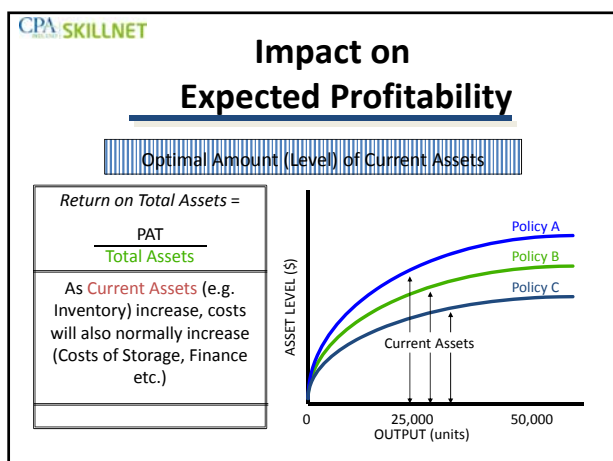


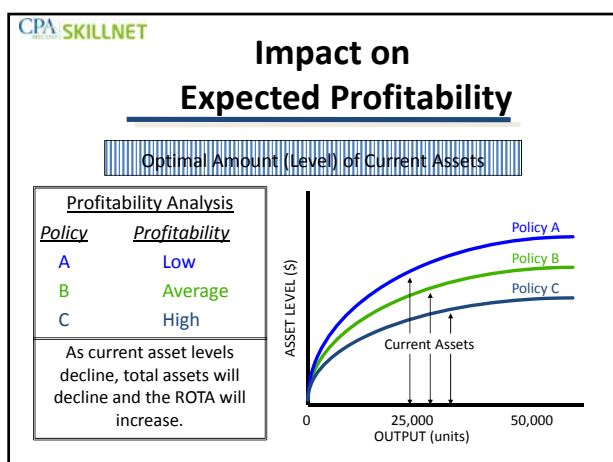












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Impact on Risk

Optimal Amount (Level) of Current Assets

- **Decreasing cash** reduces the firm's ability to meet its financial obligations. **More risk!**
- Stricter credit policies **reduce receivables** and possibly lose sales and customers. **More risk!**
- **Lower inventory levels** increase stock-outs and lost sales. **More risk!**

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Impact on Risk

Optimal Amount (Level) of Current Assets

Risk Analysis

Policy	Risk
A	Low
B	Average
C	High

Risk increases as the level of current assets are reduced.

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Summary of Working Capital Policies

SUMMARY OF OPTIMAL CURRENT ASSET LEVELS

Policy	Liquidity	Profitability	Risk
A	High	Low	Low
B	Average	Average	Average
C	Low	High	High

- Profitability varies inversely with liquidity.
- Profitability moves together with risk. (risk and return go hand in hand!)

Illustration: Strategic Business Unit (SBU) & Industry Benchmarks

	<u>SBU</u>	<u>Industry</u>
Current	1.9 : 1	2.3 : 1
Quick	0.8 : 1	1.2 : 1
Inventory Holding Period	72 days	50 days
Average (Receivables) Collection Period	45 days	30 days
Payables Payment Period	36 days	42 days
Net Profit Margin (PAT/Sales)	3.2%	7.5%
ROTA (PAT/TA)	2.5%	8.7%

SBU's WCM policy compared with industry benchmarks

- Assumed that WCM policy is reflected in a firm's current ratio etc.
- The ratios calculated above indicate that SBU has large amounts of working capital relative to its level of sales. Thus, SBU appears to be following a conservative policy.

Is SBU inefficient or just conservative?

- A conservative policy may be appropriate if it reduces risk more than profitability.
- However, SBU is much less profitable than the average firm in the industry. This suggests that the company may have excessive working capital.

Evaluation of WCM Policy: Caveat

- Beware of the possibility of 'Window Dressing'.
- Use of a wide range of metrics:
 - CFO/C. Liabilities
 - Cash etc./Liabilities
 - CCC etc.
- Additional insights from analysis of other business sectors.



Illustration of WCM Policies

Cash Conversion Cycle

Focus on the time periods when goods are ordered, converted into sales, monies are received from sales, and payments made to suppliers.

$$\begin{array}{ccccccc} \text{Cash} & & \text{Inventory} & & \text{Receivables} & & \text{Payables} \\ \text{Conversion} & = & \text{Holding} & + & \text{Collection} & - & \text{Payment} \\ \text{Cycle} & & \text{Period} & & \text{Period} & & \text{Period} \end{array}$$

CASH CONVERSION CYCLE

Ratio or Metric	SBU (days)	INDUSTRY BENCHMARK (days)	TESCO (days)	APPLE (days)
Inventory Holding Period	72	50	22	6
Receivables Collection Period	45	30	13	27
Payables Payment Period	36	42	65	104
Cash Conversion Cycle				

CASH CONVERSION CYCLE				
Ratio or Metric	SBU (days)	INDUSTRY BENCHMARK (days)	TESCO (days)	APPLE (days)
Inventory Holding Period	72	50	22	6
Receivables Collection Period	45	30	13	27
Payables Payment Period	36	42	65	104
Cash Conversion Cycle	81	38	-30	-71

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WCM POLICIES: CURRENT PRACTICE				
Ratio or Metric	SBU	INDUSTRY BENCHMARK	TESCO	APPLE
Current Ratio	1.9 : 1	2.3 : 1	0.65 : 1	1.4 : 1
Quick Ratio	0.8 : 1	1.2 : 1	0.47 : 1	1.3 : 1
Cash Conversion Cycle (days)	81	38	-30	-71
Net Margin	3.2%	7.5%	1.5%	21%
ROTA	2.5%	8.7%	6.2%	14.2%

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Managerial Finance Advise to SBU	
<p>◆ <u>Change in WCM Policy</u></p> <ul style="list-style-type: none"> ➤ Reduced Inventory & Receivables through outsourcing and strategic alliances, factoring etc. ➤ Negotiated longer credit terms with suppliers. <p>• <u>Outcomes</u></p> <ul style="list-style-type: none"> ✓ Satisfactory levels of Liquidity and Risk ✓ Increased Profitability and Cash-flow 	

CONCLUSIONS

- ◆ WCM as an Integral Part of Managerial Finance
 - “[Company]forecasts will include projections for fixed capital expenditure and additional investment in working capital as well as sales, profits, etc.” (Arnold 2005: 364)
- Key Learning Outcome
 - ✓ The understanding and application of fundamental WCM concepts informed by analysis of current best practice can help to maximise shareholder wealth.
