A SPLIT DECISION

Taking a two-pronged approach to working capital questions will really pay dividends, says Peter Woolley

When questions ask about aggressive and conservative approaches to managing working capital, students often confuse the fact that there are actually two separate, decisions to make – an Investment Decision and a Financing Decision.

In terms of double entry bookkeeping, the Investment Decision is the size of the 'debit' you plan to have on your balance sheet – how much you intend to invest in inventory and receivables, less payables. The Financing Decision is where the credit comes from – either short-term or long-term sources of finance. Breaking your discussion down into these two areas is analytical and constructive – and very good for maximising marks.

The Investment Decision

Investing in working capital is about balance – essentially balancing customer/supplier goodwill with cash flow and profitability. Keep excessive inventories and you'll always have something to sell, but you'll have to pay to store it, it needs to be paid for before you sell it (so costing you finance charges) and risks obsolescence or 'shrinkage' (workers taking a 'five-fingered discount' home in the boot of their car…). However, too little inventory and you could run out of things to sell and lose business.

High receivables again needs financing (it's

money in your customers' bank accounts, not yours) and increases the risk of default. Too little might mean you're chasing customers too aggressively – so, again, risking losing business to the competition.

High payables (a credit balance, remember) might be a tempting source of finance but it may mean you're paying your suppliers late. They will de-prioritise you and they may even put you 'on stop', or sue you.

In summary, the investment decision is a matter of careful balance – big debit ('conservative') or smaller debit ('aggressive').

The Finance Decision

Finance (or corresponding 'credit' to the 'debit') can be more from short-term ('aggressive') or long-term ('conservative') sources. This is more a matter of choice, or risk appetite.

A mix that includes more short-term finance is profitable but risky. 'Profitable' because short-term finance is generally inexpensive – it's lower risk from the lender's perspective, overdrafts only incur charges when used, and trade payables may even be free. And 'risky' because of renewal risk (with short-term finance you have to go back to the bank more often to renew the finance, increasing the chance of them saying no in any period) and rate risk (when you renew the finance, you don't know the interest rate you will be charged).

To decide between aggressive and conservative, apply commercial logic and support your opinion. For example, an already risky business may not want to compound that risk by financing working capital aggressively.

Split your analysis into the Investment Decision and the Finance Decision to keep a cool head, and watch your marks rack up. PQ

• **Peter Woolley, Reed Business School**