Essay on working capital management

Government, Capitalism

Working capital is the difference between current assets, particularly cash, accounts receivable, and inventory, and current liabilities, particularly accounts payable and short term debt. Working capital management is the discipline and process of managing a company's operating cycle and working capital investment decisions, focusing on risks and returns, in a way that improves profitability, enhances market positioning, and increases share value. This essay examines working capital in practice in the businessenvironmentas opposed to in theory in anacademicenvironment.

Successful strategies employed in thetechnologysector will be analyzed and challenges or barriers faced by the consumer products sector will be discussed and analyzed. Effective working capital management policies reduce the time it takes to converts accounts receivables to cash, and includes credit setting standards and collection activities. Effective policies reduce the amount of time it takes to convert raw materials to finished goods for sale, and reduces the time it takes to sell finished products. This is inter-connected the receivables cycle.

Effective policies maximize cash available by taking advantage of discounts and time on accounts payable. Other sources of debt are analyzed with the goal of reducing the overall cost of capital to a company. On a daily basis CFOs face the challenging of bridging the gap between working capital management in theory and in practice. Those who do so effectively can free up significant amounts of cash flow, and proportionately reduce their company's debt levels. Working Capital in the Current Business Environment

In practice the objectives of working capital management include understanding the cause and effect relationships that affect working capital policy and to implement the right strategies that maximize working capital. CFOs must focus on non financial internal and external factors that affect the business and operating cycles including the legal and regulatory environment, changes in technology that affect both the company’s internal operations and across the industry in which the company operates. Managementgoalsare another important factor.

Management goals define the objectives related to working capital management policy including inventory management, and receivables and payables policies. A decision in any of these areas can lead to a change in the company’s credit rating with lenders and suppliers or may cause an existing customer to another supplier who offers better terms on receivables. Andrew Harris (2005) suggests that these factors lead to many unforseen situations that are not easily forecasted. He suggests a practical approach to managing the unknown factor in working capital management - control, predict, react.

Companies can control working capital issues by giving more attention to aggressive cash flow forecasting that precedes and provides a guideline for investment and operating decisions. Companies can predict working capital issues through comprehensive departmental, operating unit, or regional planning and forecasting. The forecasting process must be broken down into small enough units whereby the CFO and other managers can note trends in smaller units that will ultimately affect the entire company.

Finally, companies must react through decision making and by implementing only measurable objectives based on proven success in the industry and among the company's competitors. Other strategies must rely on and match the entrepreneurial drive that facilitated the company's success to date. Working Capital Management In Action A McKinsey and Company study concluded that 24 top companies in the United States could increase profits by five to nine percent by changes in the receivables and payables processes. Gundavelli, May 2006) Ernst and Young has published a report on working capital management in the consumer products sector . The report concludes that the consumer products industry as a whole can free up $15 billion to $29 billion dollars, reducing their total net debt position by 16% through better working capital management policies. (Ernst and Young, December 2008) Working capital management policies in the consumer products industry has been particularly affected by investments in brand acquisitions which have a goal of reducing competition and enhancing market position and company value.

These results underscore the importance of weighing and planning for the effect of management goals on working capital policies. Several Global 2000 companies, mainly in the technology sector, have successfully reduced days sales by as much as 25% and improved the accuracy of cash flow forecasts by 35%. (Gundavelli, May 2006) These improvements are the result of utilizing technology specially designed for cash flow management, implementation of best practices related to working capital management, and investment in training personnel involved in the working capital management process.

These results underscore the importance of and need to effectively transition from an environment of application of academic theory to application of real world corporate principles and practices related to working capital management. Conclusion Working capital management is the decision making, policy setting, and strategy implementing process that focuses on maximizing a company’s current assets and minimizing current liabilities.

CFOs are are effective working capital managers increase profits and share prices for their companies. Industries with poor working capital management strategies find themselves subject to competitive concerns that facilitate the need for investment policies and decisions that reduce cash flow and increase debt levels. Industries with excellent working capital management strategies have implemented training and technology aimed at enhancing forecasting and planning abilities that have a positive impact on working capital management.