South Tuen Mun Government Secondary School

Business, Accounting and Financial Studies

Revision_Ch 5_ Working Capital Management

1. The major purpose of **working capital management** is to
   - manage current assets and current liabilities
   - so that the firm has sufficient short-term liquidity for its daily operations.

   If most of the firm's resources are **tied up in non-cash assets,**
   - such as accounts receivable and inventory,
   - it may have difficulty repaying its short-term obligations when they are due.
   - Therefore, in some cases, even though the firm is profitable, it may be forced into liquidation by its creditors. This explains why working capital management is important to a firm.

   Working capital management is important to a firm because
   - it helps a firm maintain sufficient liquidity to support its daily operations.
   - Poor working capital management may lead to financial difficulties.

2. The basic principles of **cash management** include:
   - Accelerating cash inflows: This can be done by shortening the collection float and encouraging payments in cash.
   - Delaying cash outflows: This can be done by lengthening the disbursement float.
   - Matching the timing and amount of cash inflows and cash outflows: A firm should adjust its cash inflows and outflows so that the existing cash balance plus cash inflows are sufficient to meet cash outflows.

3. **Increasing working capital will**:
   - a company is likely to be able to repay short-term debts: E.g., capital is available for repaying accounts payable.
   - weaken profitability: E.g., excessive cash or inventory will hinder investments in marketable securities or other projects.

   Decreasing working capital will:
   - make the company more likely to be unable to repay short-term debts: E.g., shortage of cash for repaying debts to suppliers.
   - boost profitability: E.g., cash will be available for long-term investment in developing projects of a higher rate of return.

4. The basic goal of **cash management** is
   - To maintain adequate cash for business operations at a minimum cost.
   - As a firm can **increase its cash** on hand by
     - shortening the collection float and lengthening the disbursement float,
     - float management can help the firm maintain adequate cash.
   - Therefore, float management is important in cash management.

5. A firm can deal with a **cash deficiency** in the following ways:

- Borrowing from banks
- Selling assets (e.g., inventory and fixed assets) at a deep discount for cash
- Factoring accounts receivable
- Deferring cash outflows (e.g., wages, accounts payable and interest expenses)
- Shortening its collection float and lengthening its disbursement float
- Altering its accounts receivable policy to accelerate cash collection (e.g., increasing the cash discount, shortening the credit period, raising credit standards and reducing credit sales)

6. A firm can improve its **liquidity** by:

- A firm can **accelerate cash inflows** and delay cash outflows to increase its amount of available cash. As a result, the firm's liquidity improves.
- The firm may also **match the timing and amount of cash inflows and cash outflows** so that the existing cash balance plus cash inflows are sufficient meet cash outflows.
- By doing so, the firm can ***avoid a cash shortfall and can improve its liquidity***.

7. The firm can **increase liquidity by changing its credit policy** in the following ways:

- **Raising its credit standards:** This is because more creditworthy customers usually settle their payments earlier.
- **Offering a shorter credit period to customers:** This is because customers have to settle their payments earlier.
- **Offering a higher cash discount to customers:** This is because some of the non-cash discount takers (among existing customers) will take the higher cash discount by paying earlier.

8. The **operating cycle** is the time period from when a firm "buys its inventory on credit" to when it "receives a cash payment from selling its products".
The ***shorter*** the operating cycle, the more ***efficient*** a firm is in managing its working capital.

The **cash conversion cycle** is the time period from when a firm pays cash to buy inventory to when it receives cash back from the sale of products.

The ***two cycles are equal*** when the firm purchases its inventory with ***cash*** instead of on credit.

9. The major **cost to a firm of maintaining a low cash balance** is
a higher risk of being unable to meet obligations.
When a cash shortfall occurs, the firm has to *obtain money by financing* and must pay financing costs.

The major **benefit to a firm of maintaining a low cash balance** is
higher profitability. This is because the firm can *invest the money* to earn interest.

10. **Float is the lag between**
the time a *cheque* is sent by the payer and
the time the money can be spent by the recipient.

Float exists because it takes time to deliver cheques by mail and to process cheques through the banking system.

We can **lengthen the disbursement floa**t in Hong Kong in the following ways:

- Mailing cheques just before weekends or long holidays, e.g., Christmas and Chinese New Year
- Issuing post-dated cheques
- Mailing cheques from remote districts such as outlying islands

11. If the firm foresees a **cash surplus**, it should invest the amount in marketable securities to earn a return. This can reduce its cash balance and the opportunity cost of holding cash (i.e., the loss of interest income).

If the firm foresees a **cash deficiency,** it should obtain additional financing in order to have adequate cash to pay for unexpected expenses.

12. The major **benefit** to a firm of **increasing its cash balance** is that the firm will have higher liquidity and lower risk of a cash shortfall.

The major **cost** to a firm **of increasing its cash balance** is that the firm will have lower profitability. This is because it cannot invest the money to earn interest.

13. **Changes in an accounts receivable policy** involve both costs and benefits.

It is possible that a change in policy may result in greater **costs** than benefits.
For example, while **lowering credit standards**, it grants credit to customers more easily, may increase sales, it will also lower the firm's liquidity (as A/R increase because less creditworthy customers are also granted credit and it normally takes more time to collect money from them. If the firm already has poor liquidity, the change may increase its *risk of bankruptcy*.

Therefore, a firm should consider all factors when formulating an accounts receivable policy and strike a balance between costs and benefits.

14. It is true that **relaxing the accounts receivable policy** can attract more customers.
This will increase the firm's sales and have a positive effect on the firm's profits.

However, **accounts receivable and bad debts will also increase**.

- They will have a **negative effect** on the firm's *profits* as investment in accounts receivable involves opportunity costs and *bad debts are a loss* to the firm.
- Hence, the firm's **profits** will not necessarily increase.

15. To decide whether to **grant trade credit to a customer**, a firm should

- assess its **creditworthiness** in the short term. Therefore, the customer's *liquidity ratios*, which measure the customer's ability to repay its short-term liabilities when due, are the most useful for the firm. The firm can look at the customer's *current ratio, quick ratio, inventory turnover, trade receivables turnover and trade payables turnover.*

16. It is not necessarily beneficial for a firm to take a **cash discount** because this involves the following costs:

- As the firm *loses short-term financing*, it may need to **take out a loan and pay interest** when it needs money.
- If the firm has enough cash to repay its accounts payable, this involves an **opportunity cost** because the firm has to forgo the **investment return** from the money.
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17. Firms sometimes **choose not to accelerate cash inflows or delay cash outflows** because the costs of doing so outweigh the benefits. For example:

- It is costly to set up **collection centres** in different major cities.
- In order to shorten the collection float, firms may have to **employ couriers** to collect cheques from customers.
- To *discourage* customers from paying by credit card, firms may ***charge fees for credit card*** payments. However, this may result in the *loss of business*.
- If a firm *delays cash outflows* too much, it may *upset* suppliers or creditors. They may **refuse to grant good credit terms** to the firm in future.

18. By preparing a **cash budget,**

- a company can **forecast** its future cash inflows and outflows.
- This allows it to **foresee** any future cash surplus or deficiency.

If it foresees a **cash surplus,** the firm can plan in advance for short-term investment. It can have more time to analyse different investment opportunities and make better decisions.

If it foresees a **cash deficiency,** the firm can plan in advance for short-term loans. As a result, it can have enough time to search for different financing options and negotiate a loan.

- As a result, the company can **take actions in advance to maintain an adequate amount of cash** (i.e., minimum cash balance required) at a minimum cost.

19. If a firm holds a **sufficient amount of inventory,**

- it is more likely for it to have enough products for sale or raw materials for production.
- Hence, the benefits of holding inventory are the smaller chance of sales loss due to stock depletion or production stoppages.

The **costs of holding inventory** involve storage costs and opportunity costs.

- Opportunity costs are involved because when money is tied up in inventory, it cannot be used for investment.

20. The **objective** of the EOQ model is to
"find the **optimal** order quantity" while **minimizing** total inventory costs.

21. **Limitations of EOQ**

- only applicable to non-perishable products
- only applicable to products with stable demand (constant rate of demand)
- ignores delivery quantities and discounts / stockouts not considered
- assumes storage space is unlimited
- assumes retailer controls delivery scheduling
- Assume fixed order intervals / assume constant holding cost

22. **Reasons that EOQ is an impractical assumption:**

- Carrying costs remain unchanged: Carrying costs such as warehouse rentals and electricity expenses are variable.
- Demand of each year is known: Demand is influenced by external factors.
- Stable sale of goods: Sales are influenced by internal factors and fluctuations are common.
- Shortage of stock will not happen : Delivery from transporter may delay sometimes.
- Fixed ordering schedule throughout the year: The frequency of ordering should be adjusted according to sales.

23. A firm holds **safety stock** to cope with unexpected situations which include:

- A **sudden increase** in sales
- An **unexpected delay** of inventory delivery
- An unexpected production stoppage

24. The **two types of inventory costs** that affect the calculation of the economic order quantity include:

- **Ordering costs:** The costs related to placing an order for inventory from suppliers. Examples include the money costs and time costs incurred from clerical and administrative work when a firm places and receives an order.
- **Carrying costs:** The costs related to holding inventory for a certain period of time. Examples include storage expenses, insurance costs, losses due to inventory deterioration and obsolescence, and the opportunity cost of the money tied up in inventory.

25. **Variables in computing the EOQ:**

- **Annual demand for the goods:** The amount of products purchased for production of noodles
- **Ordering cost of each order:** The cost and expenditure involved in placing an order with the supplier
- **Carrying cost per unit:** The cost and expenditure involved in holding the goods for one year
- **Economic Order Quantity:** The quantity of goods purchased at the time when total inventory cost is the lowest

26. **Factors of considering the level of safety stock include:**

- **Availability of storage facilities:** If the firm does not have much available storage space, it may maintain a lower level of safety stock.
- **Fluctuations in demand:** If the demand for inventory is unstable, the firm may keep a higher level of safety stock to meet unexpected needs.
- **Deterioration of inventory:** If the inventory deteriorates easily (e.g., fruits), the firm may keep a lower level of safety stock to avoid losses due to inventory deterioration.

27. When the firm **shortens its cash discount** periods, this has the following effects:

Sales will decrease as customers have to pay earlier in order to enjoy the discount. Some discount takers may purchase from other firms instead.

- As sales decline and **some existing discount takers pay earlier to obtain the cash discount**, the average amount of accounts receivable will decrease. However, as credit terms become less attractive, **some existing discount takers may give up the cash discount and pay later.** This will increase the average amount of accounts receivable. *Hence, the overall effect on accounts receivable is **uncertain**.*

- **Bad debts will increase.** This is because fewer customers will take the cash discount due to the shorter cash discount period. As more customers pay later, the chance that customers will be unable to repay their debt increases.

28. If the firm **raises the cash discount,** this has the following effects:

- The **sales volume increases** as more customers (cash discount takers) are attracted by the higher cash discount.
- Some of the existing non-cash discount takers will take the higher cash discount by paying earlier. Hence, customers will generally pay earlier. As a result, the average amount of accounts receivable is likely to decrease.
- **Bad debts will decrease** as more customers pay earlier, reducing the chance of default.

29. Reasons that a firm
doesn't take the cash discount offered by its creditors and
does not settle payment until the end of the credit period:

- The firm **does not have sufficient cash** to settle payment earlier and the borrowing rate is higher than the annual rate on the cash discount. Hence, it is not beneficial for the firm to borrow money to settle payment earlier.
- **Business conditions are worsening** and the firm expects that it will take longer to collect accounts receivable. As a result, the firm gives up the cash discount in order to maintain higher liquidity.
- The firm **needs extra cash in the near future to invest**. As a result, the firm gives up its cash discount and holds the capital obtained through financing (i.e., the trade credit) for a longer period.

30. The department store can **encourage its customers to pay in cash** in the following ways:

- **Issuing membership cards** which allow customers to accumulate points by paying with cash or an Octopus card. The points can be redeemed for gifts.
- **Offering discounts** to customers who pay for more expensive items (e.g., televisions, wardrobes) in cash

31. Grant/offer trade credit to customers/channel members (B to B):

The company's sales would increase. This is because:

- The trade credit can ***attract customers*** (i.e., channel members) who cannot afford to purchase in cash. Customers can use the goods to earn profits and the cash receipts to settle payments.
- The trade credit ***offers greater payment flexibility*** to customers. This benefits customers as they can keep more cash on hand.

The company's profitability would decrease. This is because:

- When trade credit is granted to customers, ***money will be tied up*** in accounts receivable. The company has to forgo the potential return from investing the money.
- When the company is unable to collect cash from customers, some accounts receivable will become ***bad debts***. In this case, the company will suffer a loss.

The company's ***liquidity*** would decrease.
This is because the company cannot receive cash immediately from credit sales.

32. **Granting trade credit to customers may lower a firm's profitability because:**

- When trade credit is granted to customers, money will be tied up in accounts receivable. The firm has to forgo the potential return from investing the money.
- When the firm is unable to collect cash from customers, some accounts receivable will become bad debts. In this case, the firm will suffer a loss.

33. **Trade credit is a source of short-term financing**.

Advantages of short-term financing include:

- Normally, short-term financing is ***cheaper*** than long-term financing. For example, the total interest charged on short-term bank loans is usually lower than the total interest charged on long-term bank loans. (Number of installment
- Short-term financing is more ***flexible*** than long-term financing. If a firm uses short-term financing, it can adjust the amount of capital according to its short-term needs when refinancing.

The major **disadvantage** of short-term financing is that it is ***riskier*** for a firm.
While long-term financing provides a ***more stable source of capital***, the firm needs to refinance frequently if it uses short-term financing.

34. **The working capital management strategy is not necessarily beneficial to the firm.**

It is true that by collecting accounts receivable as soon as possible and deferring payment of accounts payable as long as possible, a firm can increase its liquidity and reduce the opportunity cost associated with investment in accounts receivable. However, there are also ***costs*** of doing so. They are explained below:

If the firm *accelerates its collection of accounts receivable* by offering a ***shorter credit period***, sales will decrease. This may decrease the firm' profits.

If the firm ***increases its cash discount***, the net profit per unit of goods sold will decrease. This may decrease the firm's profits.

If the firm ***defers payment of accounts payable*** beyond the cash discount period, it loses the cash discount. This is the same as borrowing at the annual rate on the cash discount.

If the firm ***repeatedly fails to settle its accounts payable*** before the due date, the firm may lose future trade credit.

Holding cash involves opportunity costs as the firm cannot use the cash for investment. The firm has to trade profitability for liquidity.

Thus, it is important to **strike a balance** between the costs and benefits in choosing a working capital management strategy.

35. **Major components of a trade credit policy.**

- credit standards (to whom the business will sell on credit)
- credit terms (the conditions on which credit will be provided)
- collection strategies (how debts and receivable should be collected)

36. Elements of an accounts receivable policy include:

- **Credit standards:** the minimum level of creditworthiness that a customer must have in order to obtain credit from a firm.
- **Credit terms:** state the repayment conditions for purchasing goods on credit. They consist of a credit period, a cash discount and a cash discount period.
- **Collection policy:** a set of guidelines covering actions for collecting overdue accounts receivable before they turn into bad debts.

37. The three elements of **credit terms** include:

- Credit period: This refers to the time period within which a debtor has to settle payment.
- Cash discount: This refers to the discount given to a debtor who pays within the cash discount period.
- Cash discount period: This refers to the period within which a debtor has to pay in order to receive a cash discount.

38. Elements that the bank may consider when deciding whether to grant credit to Co include:

- **Capital**: The amount and quality of capital the business owner has invested/ has enough capital to back up the debts
- **Capacity**: The company's capacity to repay the loan/ has enough cash flows to repay the debts
- **Collateral**: The collateral provided by the company as security/ can secure the debt with sufficient assets

  Condition: The overall economic environment surrounding the industry and the business, as well as the intended purpose of the loan. General economic conditions and industry outlook
- **Character**: The owner's character (i.e., whether he is trustworthy or has a sense of responsibility to meet the obligation)

39. The company can **reduce bad debts** by the following methods:

- Raising its credit standards
- Offering a shorter credit period to customers
- Offering a higher cash discount to customers
- Offering a longer cash discount period to customers
- Screen customers before granting credit by establishing a workable credit policy
- Enable each customer to know in advance the company's credit terms by establishing a written policy
- Putting more resources into collecting overdue accounts receivable to prevent them from turning into bad debts
- Send invoice for payment promptly
- Follow-up those accounts that are overdue by establishing immediate follow-up measures

40. **Four actions that a firm may take to collect overdue accounts receivable before they turn into bad debts:**

- Giving friendly reminders to the customer
- Sending warning letters or emails to the customer
- Visiting the customer's office to collect overdue accounts receivable
- Employing a collection agency to collect overdue accounts receivable
- Taking legal action against the customer

41. **During a recession,**

- some of the company's customers may face ***financial difficulty*** or
- their companies may even be forced to shut down.
- As a result, ***payment delays or bad debts*** will increase.
- Moreover, the company's ***sales*** will decrease during a recession.

These factors will decrease the company's ***liquidity*** and may even lead to ***business failure***.
Cash management can help the company maintain adequate cash and credit management can help the company control bad debt expenses and its investment in accounts receivable.

Therefore, they are especially important to the company during a recession.

42. **Credit standards** refer to the minimum level of **creditworthiness** that a customer must have in order to obtain credit from a firm.

By introducing **tight credit standards**, only customers with **better** creditworthiness can obtain credit. Other customers have to purchase in cash.

As customers who are more creditworthy have **less chance of default**, the Company can avoid bad debts.

43. **Tight inventory policy** will affect the operations of a retail store:

- There could be stockout and loss of sales
- The pressure to make accurate sales forecast would be very high

44. **Inventory turnover:** Measures sales efficiency

A low inventory turnover:
Reflects that a relatively long time is needed for sales of products.

A (excessively) high inventory turnover:
Poor inventory management