CIMA F3 – Financial Strategy

Determining policy in respect of investment and financing of working Capital

Working Capital Investment

Investment in working capital is mainly a decision of risk and reward.

There are the risks that an aggressive policy may lead to a company running out of inventory, losing goodwill with customers and/or suppliers and ultimately facing insolvency.

On the other hand, a more conservative approach can mean a large amount of long term finance is needed to fund the assets held, and therefore, profitability is eaten away by the high interest rates that accompany such debt.

So what is an aggressive policy?

An aggressive working capital investment policy involves increasing profitability and liquidity by:

1. Reducing long term funding of current assets
2. Cutting inventories
3. Speeding up collections of debtors
4. Delaying payment to suppliers

The *disadvantages* of doing this are that the risks of disruption to day to day operations are increased due to:

- Running out of inventory to supply to customers
- Loss of goodwill with suppliers who have their payments delayed
- Loss of goodwill with customers due to unavailability of stock and/or being chased more aggressively for payment.

How can these disadvantages be overcome?

These problems can be overcome using modern manufacturing techniques such as Just in Time (JIT) production methods and Total Quality Management (TQM).

These methods can help due to:

Inventory and work in progress (WIP) levels being more efficiently managed to meet customer demands

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- Improved quality and timeliness of delivery to customers makes them more willing to accept shorter payment terms.

And a conservative policy?

A conservative working capital investment policy aims to reduce the risk of the disadvantages outlined above occurring.

This can be achieved by:

1. Customers being allowed generous payment terms to encourage their business
2. Inventories are high to ensure availability for customers
3. Raw materials and WIP are high to minimise the risk of production downtime
4. Suppliers are paid on time to maintain goodwill (and minimise the chance of stock outs)

The *disadvantages* of doing this are that:

- A large amount of unproductive assets are held, funded by high interest finance (inefficient and damages profitability)
- Cash flow problems may arise if rapid expansion occurs leading to working capital requirements exceeding readily available funds
- Inventory may become obsolete
- Harder to meet changes in customer demands – funds already tied up

Working Capital Financing

Current assets and non-current assets can either be financed through long term funding or short term funding (or a combination of both).

Short term finance is usually cheaper – less risk on behalf of lender.

The types of assets being funded are:

- Permanent current assets – the level of investment needed in inventory and receivables during normal day to day operations
- Fluctuating assets – assets required to meet changes in demand e.g. seasonality.

An aggressive approach

This is where all fluctuating current assets are financed by short term funding but also some permanent current assets.

As discussed earlier, short term funding is often a cheaper option compared to long term finance, in terms of interest expense and so profitability should increase.

This is also a more flexible approach as short term finance is quicker to obtain to deal with a sudden change in demand that requires increased resources.

However, this policy runs the risk of liquidity and cash flow problems as there is no buffer of longer term finance to deal with instances where short term finance is not enough to cover the cash demands.

A conservative approach

This is where all non-current assets, permanent current assets and part of the fluctuating current assets are financed by long term funding. Therefore, there is only a need to call upon short term finance, such as a bank overdraft, when need for fluctuating current assets are at their highest point (such as at Christmas for a retailer.)

When fluctuating current assets are low, there will be surplus cash which can then be invested in interest bearing securities (e.g. overnight deposit account.) A good example would be a football club in the summer months where requirements to fund day to day operations are much lower out of season.

A moderate approach

This is all about a compromise between risk and reward.

Permanent assets are financed by long term funds and non permanent assets are financed by short term funds - a matching principle.

Factors affecting which policy to use:

Type of industry – Different industries lend themselves to different policies. For instance a house builder such as Bovis will need longer term finance to hold large quantities of raw materials and WIP for a long period as part of their normal business.

On the other hand, in the software industry, products are usually paid for up front (even before being built) and so receivables and inventories will be low requiring less long term funding.

Organisational structure – A more centralised company might be able to be more aggressive in their approach due to having a dedicated credit control team for the whole firm.

Nature of assets – A firm will be more conservative with the levels of inventory and cash it holds in order to prevent stock outs or cash flow problems. However, receivables will want to be minimised.

Potential complications with managing working capital:

- Overtrading – where a business tries to sell too much, too quickly, with too little long term funding to support the growth in sales. Whilst sales would increase, and possibly profit, there is not enough cash to fund this expansion leaving the firm having to finance assets mostly on short term credit. This is a common issue for fast growing start ups.

- Multi-national companies – who deal with a variety of suppliers, customers, distances for goods to travel, political risks, currency fluctuations etc. It is much harder to control inventory levels and collect receivables as supply chains get more complex.

Ways to overcome such problems:

1. Request new investment from existing shareholders to boost equity capital base.
2. Tighter financial controls over inventory and receivables levels
3. Slowing down of sales push and/or holding back on large non-current asset purchases until the business solidifies its financial position.

Have a go at these 3 questions and email me your answers in bullet point form...

Quick Quiz:

Q1) What are the main advantages and disadvantages of a conservative investment policy in working capital?

Q2) What are the main advantages and disadvantages of an aggressive financing policy in working capital?

Q3) Give two or three other factors to consider regarding which approach to take?

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