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Overview of Working Capital Management: Effective Measures in Managing Working Capital Components to Entrepreneurs

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Abstract
Efficient working capital management determines the success or the failure of the business in the short term or long term because it determines the liquidity and profitability balance of a business. The success of any business depends on how financial managers in this case the entrepreneurs effectively manage working capital components which includes mainly cash, debtors, creditors and inventories. It's important for a business to maintain a balance between profitability and liquidity while carrying out its day to day operations.
Keywords: Working Capital Management, Working Capital Components, Profitability, Liquidity

1. Overview of Working Capital Management

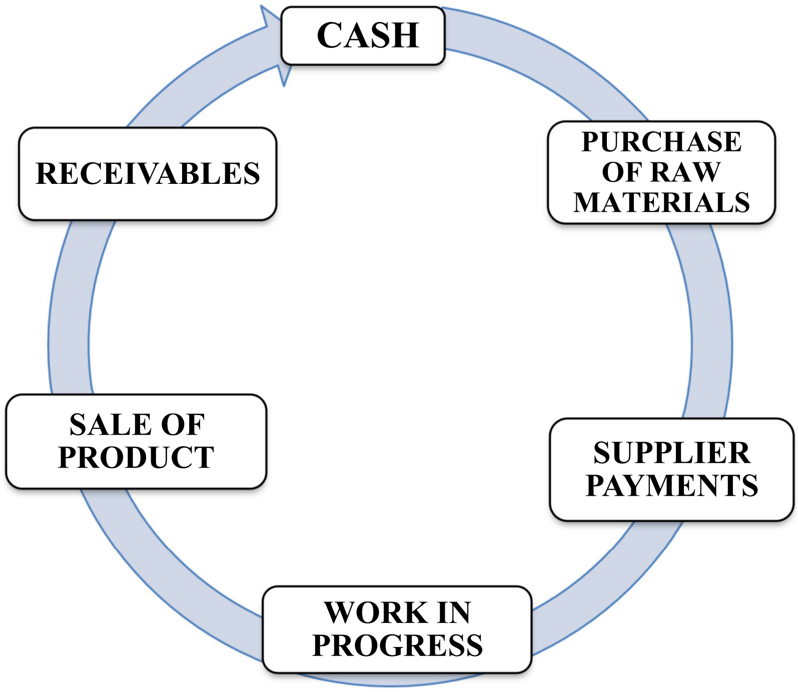
In business operations day to day decisions are based primarily on guaranteed cash flows which facilitate proper management of available resources to ensure effective operations and sustainability of business. Business should be managed efficiently and profitably to increase the amount of cash flows (Kesseren, 2006). Business managers can adopt either aggressive or conservative working capital management strategies to manage working capital components. This idea is supported by agency theory which describes modern firms in such a way that the principal and agent are distinct parties who should be bound by common interest which is not the case in most firms (Bowie and Freeman, 1992).

When business operations grow, it's important for a business to set controls and measures to make comparison between actual figures and projected figures. This is supported by management control theory which argues that there is need to control agents operations and management actions prior to any action been taken (Smith & Bertozzi, 1998). Most businesses put more focus on liquidity at the expense of profitability. Liquidity is defined as a condition in which business or companies or firms are able to meet short term obligations when they are due with or without challenges. However the fail to analyze the risk- return tradeoff expected after implementing alternative working capital management policies. It's important for a business to understand liquidity and profitability tradeoffs when striving to maximize shareholders value (Gitman, 1984 and Bhaltacharya, 2001).

Working capital is defined as the available short-term assets such as cash, inventories, receivables to meet short term liabilities e.g. payables overdraft when they fall due. According to Kesimli and Gunay (2011) working capital management is defined as the process of managing short term assets and short term liabilities which are expected to mature or to be paid within a period of one year or operating cycle whichever is shorter. The entrepreneur should determine the net working capital by factoring major elements in the working capital cycle which includes inventories, receivables, cash and payables which are mainly defined by time and money. Net working capital is given by the difference between current assets and current liabilities.

Figure 1: Working Capital Cycle

Working capital cycle links directly with cash operating cycle which is the time period taken by a business to realize cash after producing goods or providing services. Working capital cycle which is calculated by the number of days is the time period between which raw materials or goods are purchased for production and the time when cash revenue is collected after a sale. Working capital cycle is also understood as the amount of time required to convert short term assets and short term liabilities into cash.



If the working capital cycle is too long for a business, capital is tied up in working capital which doesn't bring returns into business. Growing business requires cash and being able to free up cash and shortening working capital is the cheapest way to grow a business. Business can shorten its working capital by reducing its credit period to its customers, giving cash discounts, streamlining production process, increasing sales and negotiating for better credit period from creditors and suppliers. For a business to operate effectively and efficiently, it requires a positive working capital cycle which balances cash inflows and cash outflows to reduce net working capital cycle and maximize to free cash flow.

2. Working Capital Components Management Decisions

2.1 Management of Accounts Receivables

Receivables results from sale of goods of provision of services on credit to customers. It's important for entrepreneurs to analyze to know who owes them money, how much is owed, how long it will be paid and for what reason. This helps to avoid circumstances which can lead to losses and increased bad debtors. Receivables management is mainly concerned with implementation of right and appropriate credit policies which includes defining credit terms, credit standards and collections standards which appeal to customers to enable cash flows increase to business. Debtors' management focus mainly on reducing the time caps between sales completion and collection of receivables. Some of the measures that an entrepreneur can adopt manage debtors to ensure fast collections includes;

- Issuing sales invoices to customers without unnecessary delays
- Providing customers statements showing outstanding amounts frequently
- Implementing strict credit checks to new customers
- It's important to get commitment fee or deposit before concluding the transaction
- To encourage customer payments through discounts or price reductions
- The credit policy should be well defined and understood by all stakeholders such as customers, employees etc
- It's important to review customers credit limits
- It's important to include penalties to discourage payment delays
- It's also important to maintain constant communication with your customers
- Frequently, review debt schedules to manage debt portfolios and limits

2.2 Management of Accounts Payables

Payables result from purchase of goods on credit. Accounts payables management are set procedures, policies and practices used by a business to manage its credit purchases from creditors or suppliers. The time factor and amount to be paid should be closely monitored in order to maintain good relationship with credit suppliers. Good business relationship is important to ensure efficient business operations. This can be maintained by protecting and keeping the business trust. The main idea behind the management of payables is to negotiate for favorable credit terms with creditors and suppliers. Importantly, there are different measures and policies that entrepreneur can adopt to manage creditors and suppliers. These measures include;

- Maintaining good record for all credit purchases
- Understand business credit limit
- Acquire favorable terms of purchase
- Manage flow and timing of purchases
- Fulfill payment obligations
- Monitoring the payments to creditors to protect their interest
- Monitoring the credits due dates
- Communicate with suppliers often, make payments and make up to date reconciliations

2.3 Management of Business Inventories

Inventory is defined as the list of raw materials, work in progress or finished goods awaiting production or to be sold to customers. Inventory management affects the average number of days of inventory holding by a business. Effective management of inventories includes identifying inventory levels to minimize production interruptions as well as reducing the amount of capital invested in raw materials which leads to reduced ordering costs and holding costs hence increased cash flows for the business. Excessive and insufficient stocks are dangerous for the business. Huge levels of inventories can place huge burden on the cash resources of a business. Holding inventory below the optimal level can lead to production interruptions which lead to lost sales, customer's dissatisfactions and delays to meet customer demands. The nature of business determines the average holding period. Stocks can be classified as either raw materials, work in progress and finished goods. The main idea behind the management of inventories is to identify the optimal levels of stock whether for slow or fast moving inventory so as to minimize the cash tied up on stocks. Some of the measures that an entrepreneur can adopt to manage inventories includes;

- Determining the projected sales for each product
- Determine the availability of products inputs e.g. raw materials
- Identifying market factors influencing business cycles e.g. weather
- Separating low moving good without interfering with business sales
- Determining the average supplier delivery period
- Reviewing the effectiveness of purchasing and inventory systems
- Determining the stock turnover period for business stock
- Carry out stock count often
- Sell out outdated or slow moving stocks
- Implement strong security procedures to ensure that no stock is stolen
- Minimize wastage and obsolete stock

2.4 Management of Business Cash

Cash is the lifeblood of every business which determines the survival and prosperity of business. Cash management for any business predicts the financial health of a business now and in the future regardless of its stage in the business cycle. Management of cash is a broad term that is directed to the collection, concentration and payments of cash. Management of cash identifies the optimal cash balance required to meet day to day operations at minimal holding costs. Optimal cash balance of a business involves maximizing the availability of cash which is not invested in non-current assets or stocks in such a way to minimize the risk of being insolvent. Insolvency risk is a situation where a business is not in a position to meet its obligations because of inadequate cash which leads to the business being declared bankrupt. Proper cash management improves business profitability and liquidity which reduces the insolvency risk. Cash flows can be a serious problem even when the business has more customers; it's making good sales, has quality products and has lions share in the market. Efficient cash management is important whether you are a start-up, growing or mature business. Some of the measure which can be used to manage cash includes;

- Identifying when, where and how business cash need is expected
- Maintaining good relationship with cash lenders e.g. banks, friends, creditors and family
- Determining business optimal cash balance
- Monitoring cash disbursements

3. Conclusions

When a business sources capital through borrowing to finance its working capital, the borrowed funds attracts interest which increases the amount of business cash outflows which drains business financially. When a business improves on receivables collections, the amount of cash inflows increases which leads to less borrowings to finance working capital. It's important to fast track their receivables and their collections as fast as possible. Negotiating better credit terms from supplier's increases cash resources which can be used to finance short term operation needs. For payables the business should delay payments within the credit period but maintain good credit relationship with creditors. Investing in fast moving inventory frees cash; this can be a good strategy to increase cash resources.

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