УДК 339.7

Z. PESTOVSKA,
senior lecturer
of Alfred Nobel University of Economics and Law
Dnipropetrovs'k

HOW WORKING CAPITAL WAS ACTING IN U.S. COMPANIES LAST YEAR

The working capital is the amount of assets available to pay off the short term expenses such as salaries, equipment rental, inventory, and so on. The assets would be considered cash, accounts receivable, and inventory. The Working Capital demonstrates the amount of liquid assets that are available to sustain and build a business by measuring a company's efficiency and short-term financial health. Working Capital carries great value to those who might be interested in investing in our business or even purchasing it.

Key words: working capital, DIO (day's inventory outstanding), DSO (day's sales outstanding), DPO (day's payable outstanding).

Introduction. We can say that net working capital (WC) is the lifeblood of any business. The formula: WC = Current assets – Current liabilities is The simplest explanation of this figure. If we look at the company's balance sheet we can see that a positive working capital predicts that we have a good basis for expansion, growth, and business building. We can pay all our short term debts, operating expenses, and salaries with extra to re-invest in our business. On the other hand, a negative working capital, in which we have more immediate liabilities than cash assets, especially as a yearly trend, can be a negative sign to investors. This figure indicates that we may not be able to pay our creditors and could end up with bankruptcy. It might also suggest that our sales volume is gradually decreasing for some reason, resulting in our accounts receivable shrinking as well, or perhaps, because of bad management our excessive inventory is tying up too much money. A large amount of outstanding customer debt because of slow collections can also damage our working capital figures. When investors want to look at these working capital numbers, they are trying to foresee financial difficulties.

The main funding. While U.S. companies have displayed slightly improved sales over the first and second quarters of 2010, slow inventories and capital spending reveal a lack of conviction in the recovery, according to David M.Katz [7].

Most manufacturing and retail businesses have inventory which is used to make a final sale and turn a profit. Companies purchase inventory with cash and then turn the inventory into a product which is then sold for cash. The process of turning cash to cash is referred to as the Cash Conversion Cycle (CCC). In general, the faster the process the more efficient the operation, as less capital is tied up in operations. The CCC is a measure of how long it takes for a company to recover its investment in inventory, as Bradly James says [3]. The cash conversion cycle is: CCC = DIO + DSO + DPO. The answer is given in days.

DIO represents days inventory outstanding or the number of days inventory has been on the books. The calculation for DIO is: DIO = Average inventory/COGS (cost of goods sold) per day and Average Inventory = (beginning inventory + ending inventory)/2. Inventory can be found on the balance sheet and COGS can be found on the income statement.

DSO represents days sales outstanding (how long it takes your customers to pay you). The calculation for DSO is: DSO = Average Accounts Receivable (AR) /

© *Z. Pestovska, 2011*

Revenue per day and Average AR= (beginning AR + ending AR)/2. We can find AR on the balance sheet.

DPO represents days payable outstanding (how long it takes you to pay your vendors). The calculation for DPO is: DPO = Average AP / COGS per day and Average AP = (beginning AP + ending AP)/2.

Companies are acting as if the increase in sales and profits isn't sustainable. If they truly believe that revenue growth is here to stay, we should see inventories growing, and we are not seeing that. We should see increased capital spending, and we're not seeing that.

For example, median inventory days remained relatively flat at around 26 in the second quarter of 2010 when compared with first quarter, when the figure was about 24. In the second quarter, median capex as a percentage of revenue was 2.79%, down from 2.83% in first quarter of 2010 and 3.76% in second quarter of 2009, according to CFO.com [5].

Most of firms continued to display sheltering resources and shunning new investments in inventory and capital equipment. Despite the increase in revenues firms weren't beginning to invest for the future. Instead, they appeared to be protecting their cash resources from future unknowns and waiting for a clearer economic picture to emerge.

And those cash resources might be decreasing. After a steady climb that began in the last quarter of 2008 and peaked at 6.69% in the first quarter of 2010, median free cash margin (free cash flow divided by revenue) decreased to 5.97% in the second quarter of 2010 year.

Of the 20 industry sectors the researchers looked at in terms of free cash margin, 11 are stable and 4 are declining, according to Cash Flow Analytics [4]. The industries with declining median free cash margin in the second quarter were materials; transportation; consumer durables and apparel; household and personal products; and technology, hardware, and equipment. The sectors that saw a rise in their margins were commercial and professional services, automobiles and components, food and staples retailing, and health-care equipment and services. So, surplus goods can be a problem for any company, given the inherent difficulty of forecasting.

As a way of controlling their bidding audiences, companies with big sales staffs can auction off excess inventory. The possibilities for auctioning inventory are not always as wide spread as some would like, if you want auction inventory directly to the public where higher margins be achieved.

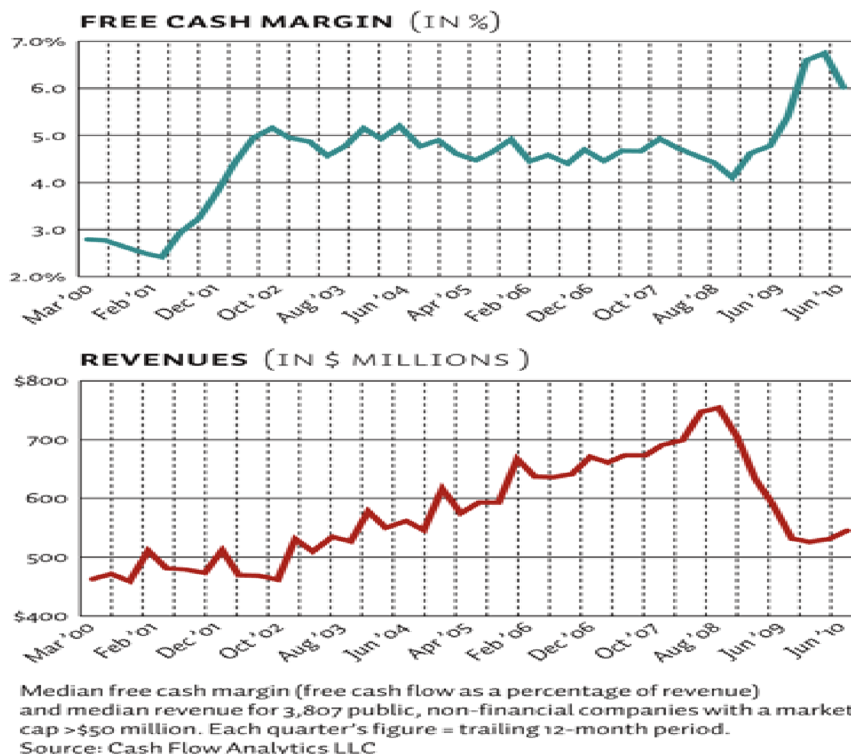
So the recession triggered a meltdown in working capital performance, but also inspired numerous efforts to improve, as David M. Katz says [6].

We can say that 2009 was one of the worst years ever for corporate working capital performance, and certainly the worst that CFO.com [5] has reported since it began keeping track of working capital trends more than a decade ago.

Average days working capital (DWC) for 1,000 of the largest U.S. public companies jumped by 8.2%, according to the CFO.com [5]. That rise, to 38.3 days in 2009 from 35.4 days in 2008, marks the biggest days working capital deterioration in the last five years for large companies.

Among the elements that make up working capital, days sales outstanding (DSO) performance deteriorated by 10.4%, marking a glut in receivables that was balanced almost evenly by an 11.4% jump in days payable outstanding (DPO). And the combination of companies replenishing their inventories after 2008 and those still stuck with unsailable product in 2009 caused days inventory outstanding (DIO) to 8.8%.

The latest figures essentially put companies back to 2006—2007 levels of performance, a period during which working capital was stagnating after years of improvement. The companies should be able to wring more cash from working capital this year without relying on the credit markets. But during volatile economic times,



Median free cash margin (free cash flow as a percentage of revenue) and median revenue for 3,807 public, non-financial companies with a market cap >$50 million. Each quarter's figure = trailing 12-month period.
Source: Cash Flow Analytics LLC

companies often are simply delaying payments to suppliers or stopping production of slow-moving products. Many finance chiefs at American private-equity firms advise us to contact customers before problems arose.

To better manage inventory, the companies would divide its various products into low- or high-volume sellers. Managers then have to made decisions about which products to stock and which to make to order based on sales volumes.

On the infrequent vendors it might be easy just to extend terms till the time when new purchases are made. On the higher-volume vendors, we can sometimes offer them more volume for better payment terms.

Even at companies with abundant cash flows, the recession provided much more disciplined process around working capital. Such a companies would set aggressive working capital targets for the rest of senior management, as well as for the company's regional directors and controllers, not only for top financial managers.

"More cash is a good thing," says one of the finance chiefs, because it allows the company to fund business-development opportunities without having to rely on the capital markets or banks for funding, according to the Cash Flow Analitics [4].

The more a company can finance it's business from internally generated funds, the better its business model will be going forward. Therefore, the quicker the company can turn inventory, the more cash will be available to meet the payments. On the other

side, if cash gets tied up as inventory a company run the risk of obsolescence, as the latest technology keeps refreshing.

If the economy improves, even the most successful companies will have a hard time holding on to the working capital performance levels they achieved in 2009. We can see than the weak working capital performance turned in by U.S. companies in 2006 and 2007 may have been due to the swelling credit bubble. When cash is cheap and easy to obtain, companies often lose the incentive to find it in their own operations.

The Days Working Capital metric that improved the most in 2009 was Days Payable Outstanding (DPO) which was up 11.4% as a result of longer supplier payment terms. The problems with increasing supplier payment terms is ensuring these actions don't destabilize the supply chain and that costs aren't simply shifted back to the "buyer" in the form of higher prices. Further, DPO may be the working capital lever most susceptible to backsliding as the economy recovers, suppliers regain some leverage and the focus on working capital wanes, as Bob Kramer says [2].

One of the best ways to support a "sustainable working capital program" is using Supply Chain Finance (SCF) to allow suppliers to get paid whenever they choose. With SCF suppliers can access low cost financing on demand over the Internet, thus eliminating the negative cash flow impact of a terms extension. Costs are reduced and cash flow improved throughout the supply chain rather than simply shifting the financial problems from buyer to supplier. Through this type of collaboration working capital improvements can be sustained.

One of the recommends for companies is to categorize critical vendors into one of three labels: high risk (meaning, they have had a "disruptive shock" to our own supply chains or serious damage to our brand or market share); medium risk (our quality has gone down and we appear to be having working-capital troubles) and low risk.

Also we can recommend for companies in their vendor contracts to require some sort of access to current financial information (and now may be a good time to renegotiate contract terms). Any reluctance from a supplier to turn over financial information could in itself be a warning that the vendor is in serious trouble.

The companies would check if their partners have: repeatedly missed projections, aging receivables and high inventory levels, lots of impairment charges, indicating previous investments were not correctly valued, experienced high turnover among senior executives, lack of enthusiasm among the employees and disagreement among top managers.

Then we can suggest for companies using the process of LCM – Life cycle management. Life cycle management has been developed to make life cycle costing a reality. It combines advanced cost management techniques, new performance measures, and the portfolio concept of investments. The goal is to provide more useful information about an investment throughout its life.

Because the investment decisions are integrated with the budgeting process through functional budgeting, LCM enhances the continuous improvement of processes by establishing achievement goals for productivity, cost, quality, and time. LCM helps the managers locate where they need to focus their efforts. The impact of process improvements and functional budget improvements will eventually affect the product cost. By measuring the changes in the discounted cash flows of investments over their life cycles as a result of specific improvements or failures, the effect of the changes being made can be measured. The top managers can use this to make future decisions on the investment as they make small changes to improve their processes.

The technology for a LCM approach requires transaction-based software that can perform complex data manipulations. It must either replace or become integrated with existing cost accounting systems. This software must be able to translate small changes in a process into effects based on an investments life cycle. I think this information will be useful in both tactical and strategic decision making.

Managers are unable to monitor an investments impact on an organization once it has been implemented. LCM will provide current information about investments just after beginning. Managers will be able to better deal with changes in the markets, and respond quicker to ensure a continuous improvement in the process involved.

Summary. The most important reason people look at a balance sheet is to find out a company's working capital position. It reveals more about the financial condition of a business than almost any other calculation. It tells you what would be left if a company collected all of its short term resources, and used them to pay off its short term liabilities. The more working capital, the less financial strain a company experiences. By studying a company's position, you can clearly see if it has the resources necessary to expand internally or if it will have to turn to a bank and take a loan.

Working Capital is the easiest of all the balance sheet calculations. Here's the formula. Current Assets – Current Liabilities = Working Capital

One of the main advantages of looking at the working capital position is being able to foresee any financial difficulties that may arise. Even a business that has billions of dollars in fixed assets will quickly fall into bankruptcy if it can't pay its monthly bills. Under the best circumstances, poor working capital leads to financial pressure on a company, increased borrowing, and late payments to creditor – all of which result in a lower credit rating. A lower credit rating means banks charge a higher interest rate, which can cost a corporation a lot of money over time.

Companies that have high inventory turns and do business on a cash basis (such as a grocery store) need very little working capital. These types of businesses raise money every time they open their doors, then turn around and plow that money back into inventory to increase sales. Since cash is generated so quickly, managements can simply stockpile the proceeds from their daily sales for a short period of time if a financial crisis arises. Since cash can be raised so quickly, there is no need to have a large amount of working capital available.

Companies, that makes, for example, heavy machinery is a completely different story. Because these types of businesses are selling expensive items on a long-term payment basis, they can't raise cash as quickly. Since the inventory on their balance sheet is normally ordered months in advance, it can rarely be sold fast enough to raise money for short-term financial crises (by the time it is sold, it may be too late). It's easy to see why companies such as this must keep enough working capital on hand to get through any unforeseen difficulties.

Working capital is used to pay short-term obligations such as your accounts payable and buying inventory. If your working capital turns too low, you risk running out of cash. Even very profitable businesses can run into trouble if they lose the ability to meet their short-term obligations. The calculator assists you in determining working capital needs for the next year.

Furthest researching. If we divided current assets by current liabilities we had got a current ratio that would help us to determine if we have enough working capital to meet our short-term financial obligations. A general rule is to have a current ratio of 2.0. Although this will vary by business and industry, a result above 2 may indicate a poor use of capital; a current ratio under 2 may indicate an inability to pay current financial obligations with a measure of safety.

So we can research and measure the effect that was affected by measuring the changes in the discounted cash flows of investments over their life cycles as a result of specific improvements or failures. The managers can use this to make future decisions on the investment as they make some changes to improve their processes.

References

1. Adamany, H.G. and F. A. J. Gonsalves. 1994. Life cycle management: An integrated approach to managing investments. Journal of Cost Management (Summer): 35–48.

2. Bob Kramer Vice President, Working Capital Solutions PrimeRevenue, Inc.
3. Bradley James Bryant, eHow Contributor updated: February 6, 2010.
4. Cash Flow Analytics LLC.
5. CFO/REL Working Capital Scorecard, http://www.cfo.com/media/201006, http://www.cfo.com/track_pdf.cfm.
6. David M. Katz – CFO Magazine June 1, 2010.
7. David M. Katz – CFO Magazine September 3, 2010.

Оборотный (рабочий) капитал – это сумма активов, доступных для оплаты краткосрочных расходов, таких как заработная плата, аренда оборудования, инвентарь и т. д. Активы подразумевают денежные средства, дебиторскую задолженность и запасы. Оборотный капитал отражает количество ликвидных активов, которые необходимы для поддержания и развития бизнеса путем оценки эффективности компании и краткосрочного финансового состояния. Оборотный капитал важен для тех, кто может быть заинтересован инвестировать в наш бизнес или даже его купить.

Ключевые слова: оборотный капитал, размер запасов в днях, дебиторская задолженность, кредиторская задолженность.

Оборотний (робочий) капітал – це сума активів, які можна використати для сплати короткострокових витрат, наприклад, заробітна плата, оренда обладнання, інвентар та ін. Активи – це грошові кошти, дебіторська заборгованість та запаси. Оборотний капітал відображає кількість ліквідних активів, що необхідні для підтримки та розвитку бізнесу шляхом оцінки ефективності компанії та короткострокового фінансового стану. Оборотний капітал є важливим для тих, хто може зацікавитися інвестуванням у наш бізнес або навіть його придбанням.

Ключові слова: оборотний капітал, розмір запасів у днях, дебіторська заборгованість, кредиторська заборгованість.

Надійшло до редакції 15.04.2011.