Managing current liabilities

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Effective working capital management is all about keeping the investment in the current assets under control so as to minimise the amount of funding required.

But what if it the business is doing well and more working capital is needed?

Then the working capital has
to be funded somehow

The basic rule when funding assets is that short-term assets are funded by short-term liabilities.....

.......and long-term (capital) assets are funded by long-term liabilities

So it makes sense that working capital (current assets) will be funded by current liabilities

In this context there are really only two current liabilities that can be used for funding the current assets

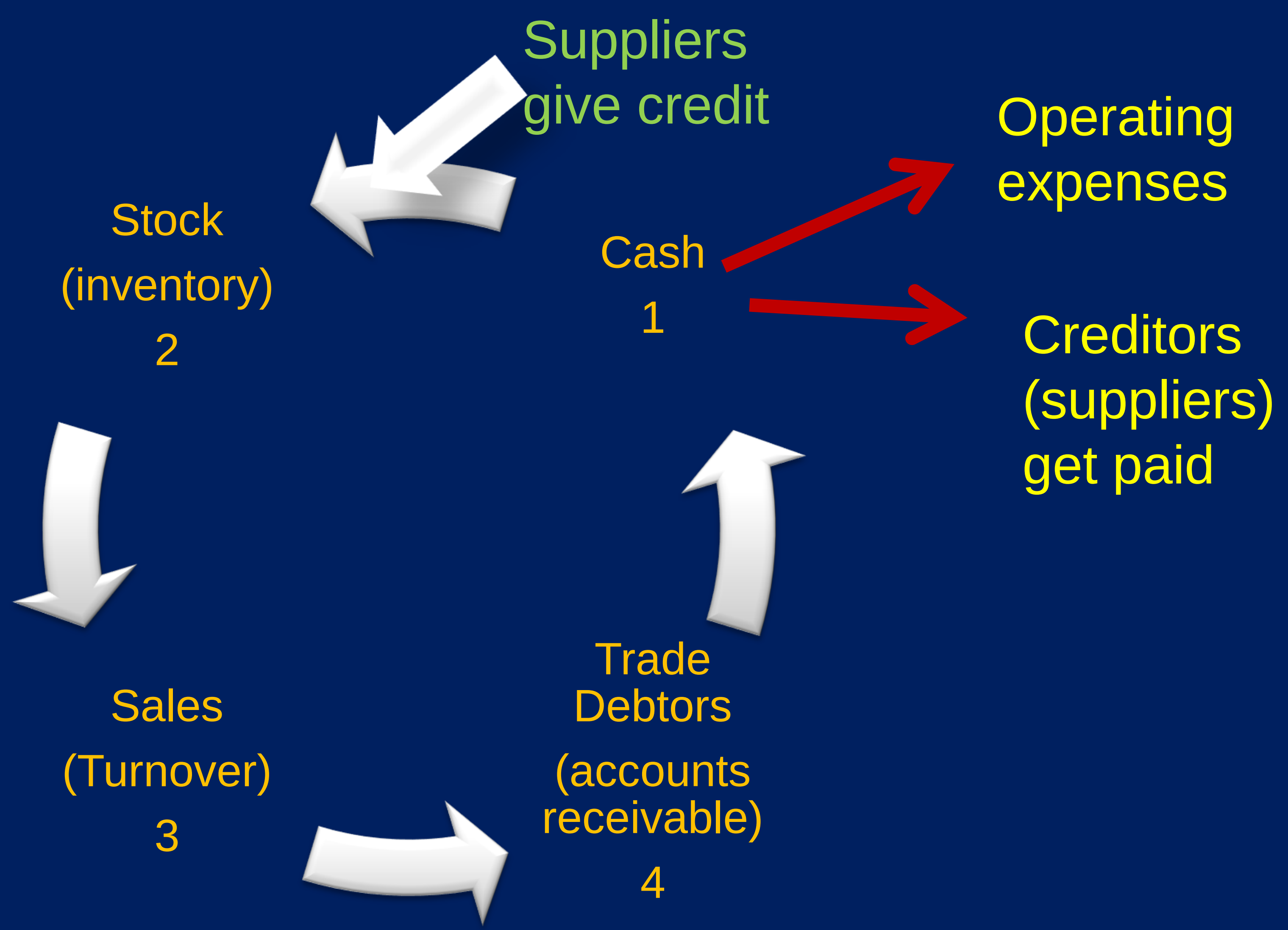
Bank overdraft

and

Trade creditors (accounts payable)

In our Introduction to Working Capital presentation we showed you the working capital cycle and the way it dictates the cash flow of a business

Let’s refresh that……….


Suppliers
give credit
Operating
expenses
Stock
(inventory)
2
Cash
1
Creditors
(suppliers)
get paid
Trade
Debtors
(accounts
receivable)
4
Sales
(Turnover)
3

The big challenge for the business is to keep that cycle turning as quickly as possible to make sure that there is cash available to make payments for operating expenses and trade creditors

But what happens if the trade debtors are not collected in time to pay the operating expenses and the trade creditors when they fall due?

That’s usually when bankers get to meet the business owner/manager

Bank overdraft

Bankers tend to assume that stock (inventory) is funded by trade creditors (accounts payable) so the bank overdraft is intended to partially fund the trade debtors (accounts receivable) figure

So with a given level of stock and trade debtors forming the working capital

Working capital =

Stock (inventory)

+

Trade debtors (accounts receivable)

The accepted way to fund part of the working capital would be;

Trade creditors (accounts payable)

Bank overdraft

A relatively easy way to fund additional working capital or to reduce reliance on expensive overdraft funding would be to increase the funding from trade creditors

....which means negotiating longer credit terms from the suppliers

It’s important that the business doesn’t just take longer to pay without first getting the supplier’s approval – the maxim is;

Use, don’t abuse, suppliers’ credit

But there’s a downside to getting longer credit terms from suppliers;

Suppliers may increase the price of their product to offset the reduction in their cash flow

Suppliers may refuse to supply more product until they have been paid for previous deliveries

Next, check out our presentation and podcast on assessing a business' working capital management

There is much more free learning content for anyone working in a business banking or commercial banking environment
on our website

Please visit us at
www.businessbankingcoach.com