

Introduction to Working Capital Management

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(A concise, structured guide for students and professionals)

1. What Is Working Capital?

Term	Definition
Working Capital (WC)	The capital a company uses in its day-to-day operations. It is the difference between current assets and current liabilities .
Formula	WC = Current Assets – Current Liabilities
Purpose	Ensures a firm can meet short-term obligations, fund operations, and maintain liquidity.

Typical Current Asset Components

- Cash & cash equivalents
- Marketable securities
- Accounts receivable (trade receivables)
- Inventory (raw materials, work-in-process, finished goods)
- Prepaid expenses

Typical Current Liability Components

- Accounts payable (trade payables)
 - Short-term debt (lines of credit, bank loans)
 - Accrued expenses (wages, taxes)
 - Current portion of long-term debt
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2. Why Working Capital Management (WCM) Matters

Reason	Impact
Liquidity	Guarantees the firm can pay suppliers, employees, and other short-term obligations.

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Reason	Impact
Profitability	Efficient WCM reduces financing costs and can improve margins (e.g., lower interest expense, better discount terms).
Risk Management	Mitigates the risk of cash shortages, production stoppages, and loss of supplier confidence.
Value Creation	Optimized working capital frees cash that can be reinvested, used for debt reduction, or returned to shareholders.

3. Core Elements of Working Capital Management

3.1. Cash Management

- **Objectives:** Maintain adequate cash balances, minimize idle cash, and reduce borrowing costs.
- **Tools:** Cash budgets, cash flow forecasts, treasury management systems, sweep accounts.

3.2. Inventory Management

- **Objectives:** Keep inventory levels low enough to avoid excess holding costs but high enough to meet demand.
- **Techniques:**
 - **EOQ (Economic Order Quantity)** – calculates optimal order size.
 - **JIT (Just?In?Time)** – reduces inventory by synchronizing deliveries with production.
 - **ABC Analysis** – classifies items by value/usage to prioritize control.

3.3. Receivables Management

- **Objectives:** Accelerate cash inflows while maintaining good customer relationships.
- **Key Metrics:**
 - **Days Sales Outstanding (DSO)** = $(\text{Accounts Receivable} \div \text{Net Credit Sales}) \times 365$
- **Practices:** Credit policy design, credit checks, early?payment discounts, factoring, electronic invoicing.

3.4. Payables Management

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- **Objectives:** Extend cash outflows without harming supplier relationships or incurring penalties.
 - **Key Metrics:**
 - **Days Payable Outstanding (DPO)** = $(\text{Accounts Payable} \div \text{Cost of Goods Sold}) \times 365$
 - **Practices:** Negotiating payment terms, using dynamic discounting, centralized purchasing.
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4. Working Capital Financing Options

Source	Description	Typical Use
Trade Credit	Supplier-provided credit (e.g., "net-30" terms).	Primary source for short-term financing of inventory/purchases.
Bank Overdraft / Line of Credit	Revolving credit facility that can be drawn as needed.	Covers temporary cash gaps, seasonal fluctuations.
Commercial Paper	Unsecured short-term promissory notes (usually <270 days).	Large corporations with