8. Operating Strategies. Cash Management. Credit Policy

1.1 Working Capital Management

Working capital management involves decisions on current assets (cash, inventories, accounts receivable) and current liabilities (accounts payable, short-term borrowing). The term net current assets (net working capital) refers to the difference between current assets and current liabilities.

A firm's net working capital is sometimes used as a measure of its **liquidity** position. It represents the probability that a firm will be able to meet its financial obligations as they come due with a minimum cost. A firm must maintain sufficient liquidity to make timely cash payments on its operating and financial obligations. Failure to do so could results in insolvency or forced bankruptcy by the firm's creditors.

1.1.1 Decision Criterion

Short-term decisions about current assets and current liabilities should be made in a manner to those about long term investment and financing. Therefore general capital budgeting rules apply. An asset's initial investment is balanced against its discounted benefits and costs. Similarly, current liabilities are just another source of financing that has costs and risks much like those of long-term sources of financing.

The general criterion is to invest in an asset if its net present value is positive. The NPV is calculated as:

(1) $$NPV = \sum_{t=1}^{n} \frac{\Delta CFAT_t}{(1+RRR)^t} - \Delta CFAT_0$$

where

$\Delta CFAT_t$ is the investment's incremental cash flow after taxes at the end of period t,
RRR is the after-tax required rate of return or opportunity cost
$\Delta CFAT_0$ is the initial investment (cash outflow) at time t=0
n is the useful life of investment

If a current asset decision is being made separately from capital budgeting project, a practical solution is to treat the current asset as an ongoing or permanent investment with benefits that will continue for the foreseeable future. This assumption implies that n will approach infinity and $\Delta CFAT_t$ will become an annuity in perpetuity. Realizing this, we can simplify equation (1) to

(2) $$NPV = \frac{\Delta CFAT_t}{RRR} - \Delta CFAT_0$$

1.1.2 Working Capital Policy

The primary consideration in developing an overall working capital policy is the risk-return trade-off associated with

1. the appropriate mix between current and fixed assets
2. the appropriate mix between short-term and long-term financing required to fund the current-asset investment.

A relatively higher level of current assets (conservative policy) produces a favorable effect on liquidity, but at the expense of reducing the rate of return on equity. This exemplifies trade-off between risk and return; risk reduction results in lower returns. More aggressive policy leads to lower liquidity and higher profitability.

Long-term debt usually has a higher explicit cost but a lower risk of illiquidity than does short-term debt. Short-term debt has a greater risk of liquidity for two reasons. First, a firm may not be able to refinance its short-term debt when it matures. Second, short-term rates vary more than long-term rates do.

1.2 Cash management decisions

A firm should retain as little cash as possible, because cash is a nonproductive asset. Business firms hold cash balances for five reasons:

1. transaction purposes
2. compensating balance requirements
3. precautionary reserves
4. potential investment opportunities
5. speculation.

Cash management decisions deal with

1. the efficient collection and disbursement of operating cash
2. the appropriate level of operating cash balances
3. the investment of temporary excess cash in near-cash assets such as marketable securities.

Large cash balances minimize the risk of illiquidity but reduce profitability and possibly firm value. Efficient cash management focuses on accelerating cash receipts and slowing cash disbursements when possible.

1.2.1 Evaluating Cash Management Strategies

Determining whether to adopt a specific cash management technique is analogous to evaluating a replacement decision in capital budgeting. A new technique or system is compared to existing one in an incremental benefit-cost analysis. As cash savings methods involve no initial investment; the equation (2) can be simplified as follows:

$$\text{NPV} = \frac{(\Delta\text{revenues} - \Delta\text{expenses})(1 - \text{T})}{\text{RRR}} \quad (3)$$

where

Δrevenues is the change in annual before-tax cash inflows (income)
Δexpenses is the change in annual before-tax cash outflows (costs)
T is the marginal tax rate
RRR is the after-tax required rate of return, or the opportunity cost of capital

1.2.2 Investing Excess Cash in Marketable Securities

Marketable securities are very liquid, short-term investments that can be taken on and liquidated quickly. Typically, cash in excess of requirements for transactions, precautionary balances, and/or compensating balance purposes is temporarily invested in marketable securities. This implies that the amount of funds invested becomes a „residual” decision. An alternative to holding excess cash for these purposes is to borrow for the short term to finance uncertain cash requirements. Which approach depends on management’s overall working capital policy and the funds available for temporary investment. The financial manager needs criteria for determining which types of temporary near-cash investments best fit his needs. The three most important characteristics to consider are risk, marketability, and term to maturity.

1.3 Managing Accounts Receivable

The issue is how much to invest in receivables in order to maximize shareholder wealth. Too little investment may deprive the firm of the marginal benefits from a higher sales level (reduced profitability). But too much investment may expose the firm to excessive costs by tying up valuable cash (increased liquidity risk).

Managers of accounts receivable

1. establish a credit extension policy,
2. establish a collection policy,
3. monitor the receivables investment

Credit granted to an individual is referred to as consumer credit. Credit extended to another firm is known as a trade credit.

1.3.1 Credit Extension Policy

Credit standards

Credit standards are the criteria that determine which customers will be granted credit and how much. Firms that use accounts receivable must be concerned with the creditworthiness of their customers. A customer must meet or exceed the minimum credit standards. Credit standards often revolve around the **„four C’s of credit”**:

1. character - a customer’s willingness to pay,
2. capacity - a customer’s ability to generate cash flow,
3. capital - a customer’s financial resources, such as a collateral,
4. conditions - current economic or business conditions.

Costs or benefits of a credit extension policy

There are four major costs of a credit extension policy:

1. Cash discounts - a percentage of sales deducted as an incentive to encourage early payment
2. Credit and collection expenses - administrative costs for conducting an inhouse credit operation
3. Bad-debt losses - accounts that are not collectible and are written off as a charge against sales
4. Financing costs - the RRR, or opportunity cost, of capital of funds tied up in a receivables investment.

Deciding whether to adopt a credit policy normally requires comparing a new policy with an existing policy. Once again, it is the incremental benefits and costs that are relevant to this decision. The cash flows from the current credit policy are subtracted from those of the proposed policy to determine the incremental cash flows associated with the proposed policy. The NPV, using equation (2), of these incremental cash flows is estimated, and an accept/reject decision is made.

The best optimal credit policy cannot be determined directly. Rather, the financial manager must evaluate alternative policies an move toward the optimal credit extension policy.

1.3.2 Collection Policy

When accounts are overdue, collection procedures for these delinquent payments must be established, especially because this affects the investment in receivables and hence the return. Collection procedures usually start with a second mailing indicating that the account is overdue, followed by a personal phone call or visit. If these efforts go unrewarded, the account may be turned over to a collection agency, or legal action may be initiated.

1.3.3 Monitoring the Receivables Investment

To manage its receivables efficiently, a firm must monitor and evaluate its receivable collections to detect any changes in their status and composition and to take corrective actions when appropriate.

1.4 Managing Current Liabilities

There are several types and sources of short-term funds. A useful way to distinguish among them is to think in terms of

1. their availability
2. their cost
3. the degree of management discretion in utilizing them
4. whether or not some form of security is required by the creditor