



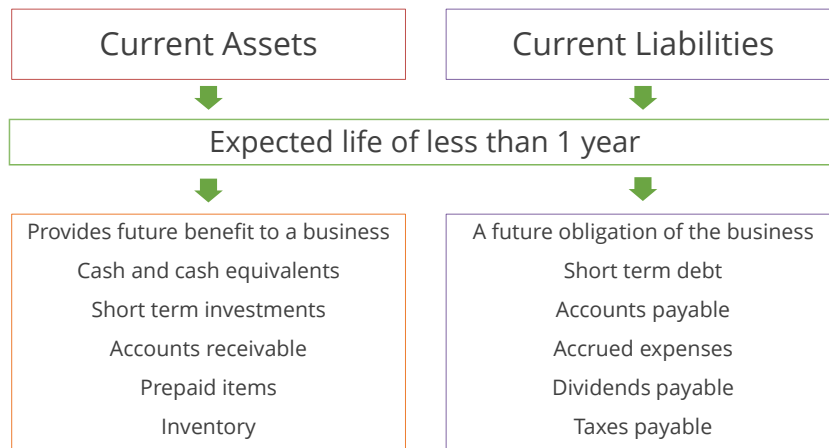
Working Capital

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Contents

- Current assets and current liabilities
- Inventory and LIFO/FIFO
- Working capital
- Operating working capital
- Working capital days and cash cycle
- Tax

Current Assets and Current Liabilities



3

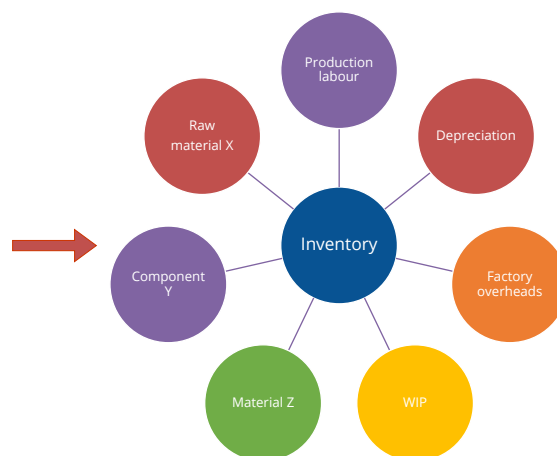
Inventory Valuation

The normal cost of production

Inventory affects:

- COGS
- Profit
- Retained earnings
- Shareholders equity
- Current assets
- Total assets
- Working capital

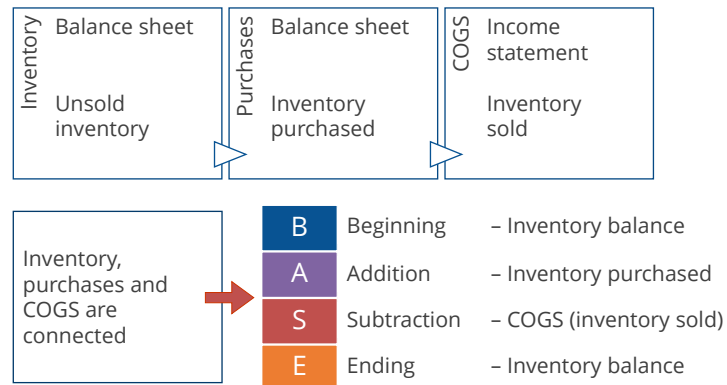
Valuation is key



4

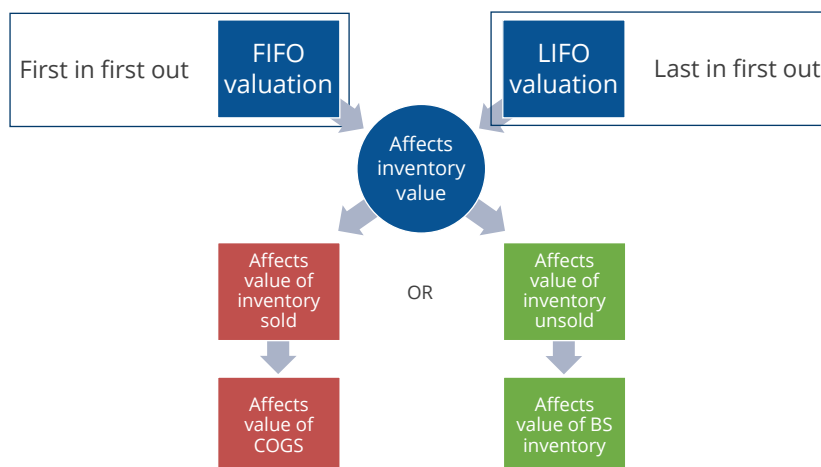
Inventory in the Financial Statements

Financial statements contain many links to inventory



5

Inventory Valuation – FIFO and LIFO



6

Inventory Valuation – FIFO and LIFO

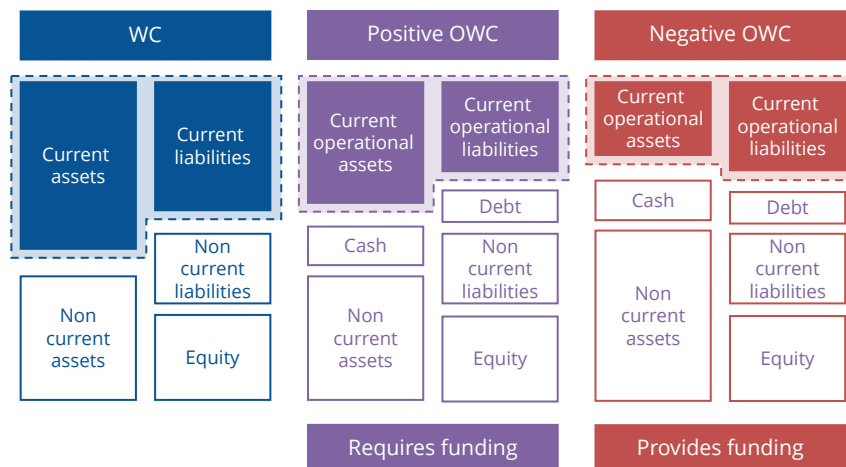
Purchases			
Day	Purchases	Cost	Total Cost
1	1 unit	5.0	5.0
2	1 unit	7.0	7.0
3	<u>1 unit</u>	9.0	<u>9.0</u>
	3 units		21.0

FIFO – 1 Unit Sold		
COGS		5.0
Inventory	= 7.0 + 9.0	16.0

LIFO – 1 Unit Sold		
COGS		9.0
Inventory	= 5.0 + 7.0	12.0

7

Working Capital and Operating Working Capital



8

Operating Working Capital and Funding

Includes current assets and current liabilities that are operating

Operating working capital (OWC) =
Operating current assets (OCA) less
Operating current liabilities (OCL)
OWC = OCA - OCL

Operating BS items

OWC measures funds needed to maintain operations

Includes accounts receivable, accounts payable, inventory, etc

Financing BS items

Financing items like cash *provide* the funds for OWC

Includes cash and debt obligations

9

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Why Does Operating Working Capital Matter? Funding

	Example 1	Example 2	Example 3	Example 4
Inventory	1,000.0	1,000.0	0.0	0.0
Accounts receivable	0.0	0.0	0.0	2,500.0
Accounts payable	0.0	1,000.0	1,000.0	1,000.0
Operating working capital	+1,000.0	0.0	(1,000.0)	+1,500.0

Positive OWC

Requires funds to be invested

Common

Zero OWC

Requires no funds to be invested

Desirable

Negative OWC

Provides funds to the rest of the business

Highly desirable

Level of OWC depends on the nature of the industry

10

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Why Does Operating Working Capital Matter? Cash Flow

OWC requires or provides funding

Changes in OWC have a cash flow impact too

	Year 1	Year 2	Year 3
Positive OWC			
OWC	1,000.0	800.0	1,100.0
Cash flow impact		+200.0	(300.0)
Negative OWC			
OWC	(10.0)	(15.0)	(2.0)
Cash flow impact		+5.0	(13.0)

Cash inflows Cash outflows

OWC has credit implications

11

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Working Capital Days Ratios

$$\text{Receivables days} = \frac{\text{Ending receivables}}{\text{Sales}} * \text{Number of days of sales}$$

$$\text{Inventory days} = \frac{\text{Ending inventory}}{\text{Cost of goods sold}} * \text{Number of days of COGS}$$

$$\text{Payables days} = \frac{\text{Ending payables}}{\text{Cost of goods sold}} * \text{Number of days of COGS}$$

Average balances can be used to calculate the ratios. Average balances are commonly used by credit analysts, ending balances for forecasting

12

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Working Capital Cycle Days Impact Funding

Working Capital Days				
	Year 1	Year 2	Year 3	
Receivable days	30.0	29.0	24.0	Decreased receivables days Less funds required
Inventory days	19.0	22.0	25.0	
Payable days	34.0	32.0	26.0	Decreased payable days More funds required
Working capital cycle	15.0	19.0	23.0	

Increased **inventory days**
More funds required

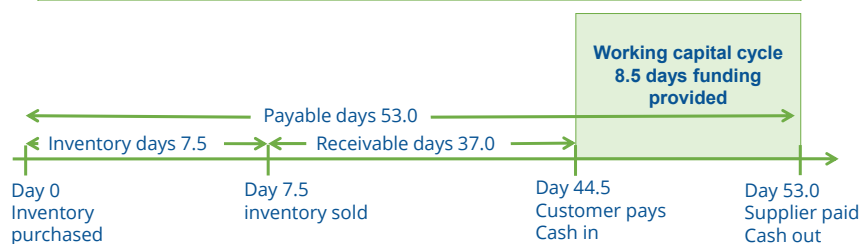
13

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Working Capital Cycle

Just In Time Manufacturer

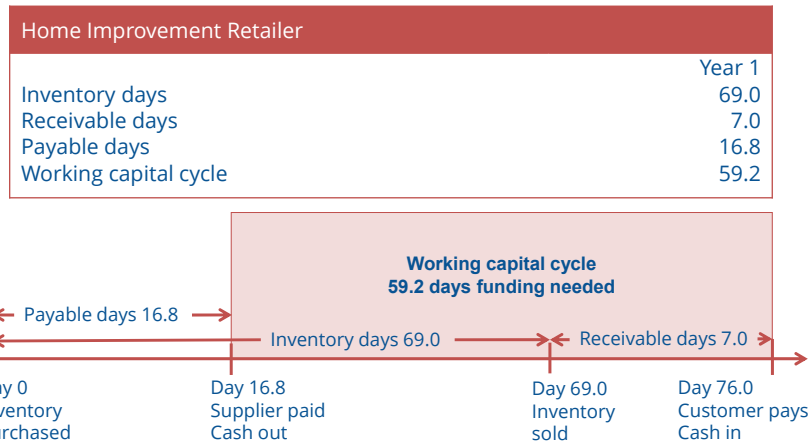
	Year 1
Inventory days	7.5
Receivable days	37.0
Payable days	53.0
Working capital cycle	(8.5)



14

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Working Capital Cycle



15

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Taxes – IS, BS and CFS

Taxes payable are usually current liabilities and a part of OWC. But beware, there are many types of taxes in financial statements

IS	BS	CFS
Tax expense	Tax payable	Tax paid
On profits	To tax authority	In the period
Uses matching	Paid in arrears	For prior period

Tax expense, liability and paid are connected but often different figures

B	Beginning	- Tax payable
A	Addition	- Tax expense
S	Subtraction	- Tax paid
E	Ending	- Tax payable

16

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