A back-to-basics guide to the art and science of working capital management

It is imperative that companies focus on working capital management to free up funds and optimize liquidity, especially when access to bank credit and short-term funding is limited. Essentials of Working Capital Management gets you up to speed by providing vital guidance for your firm’s efficient utilization of current assets and liabilities throughout each phase of its business operating cycle.

This comprehensive primer examines the latest trends around working capital and provides numerous real-world examples to illustrate how your business can be successful even in difficult times. From the planning and management of the company’s collections to the gathering of information and forecast data, Essentials of Working Capital Management covers the main components of working capital, so you can always be one step ahead of the game.

Inside, you’ll find:
• A range of working capital topics, including cash management, banking relations, accounts receivable, inventory, accounts payable, and international working capital
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• A look at cultural and corporate practices affecting working capital
• An overview of the planning, monitoring, and management of your company’s collections, disbursements, and concentration banking
• Strategies for choosing working capital information systems

Written for busy professionals wanting “just the facts,” Essentials of Working Capital Management is filled with valuable tips, techniques, exhibits, and best practices to help you stay up to date on the newest thinking, strategies, developments, and technologies in this increasingly important financial area.

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Preface

This book is one of a series on essentials of finance. As the publisher observed the near chaotic conditions in the credit markets that began in 2008, it became apparent that there was a need for an explanation of business processes and specific ideas on changes to company structures and procedures.

Managers, regulators, and senior government officials have lived through the failure of Lehman Brothers and other organizations; the forced acquisitions of Merrill Lynch, Wachovia Bank, and many other firms; the decline in the Federal Reserve’s benchmark lending rate to nearly zero; and the official U.S. unemployment hovering just below 10 percent. To survive, companies have been forced to make drastic changes in hiring, product development, expenses, and, of particular interest to our reader, in their management of working capital.

Working capital management is the art—and increasingly the science—of organizing a company’s short-term resources to sustain ongoing activities, mobilize funds, and optimize liquidity. The most important elements are:

- The efficient utilization of current assets and current liabilities of a firm throughout each phase of the business operating cycle.
- The planning, monitoring, and management of the company’s collections, disbursements, and bank account balances.
- The management of receivables, inventories, payables, and international transactions to minimize the investment in idle resources.
The gathering and management of information to effectively use available funds and identify risk.

The liquidity crisis presently being experienced in the United States has been the subject of numerous articles, Congressional hearings, and general debate. Available data indicates that adjustments have been ongoing and may eventually lead to the opportunity for future business expansion once this period comes to an end. Despite some bankruptcies, companies have adjusted remarkably well to the contraction of credit and liquidity and to weakened economic conditions. Our discussion focuses on how businesspeople can continue to be successful in these difficult financial times, particularly in the context of limited access to bank credit and other sources of short-term funds.

Concept of the Book

Essentially, this book is a back-to-basics guide. In developing this approach, several components have been included to assist the reader.

- Chapters are of manageable length, typically less than 5,000 words.
- Each chapter contains brief sections of Tips and Techniques and In the Real World. Tips and Techniques are specific ideas to manage working capital in the context of the chapter topic. In the Real World includes explanations of how actual companies have implemented changes.
- Sections of a comprehensive working capital case—the Widget Manufacturing Company (Parts I, II, and III)—begin each major section. The purpose of this case is to demonstrate real-life situations that involve various management issues concerning current assets and liabilities. The questions at the end of the case are designed to generate thoughtful consideration of appropriate actions. Suggested solutions are included in Appendix A.
Other useful material is contained in Appendices B, C, and D to supplement the coverage in the main part of the text.

In planning the content, the author and publisher had in mind the needs of several types of readers:

- New working capital managers, including students and recent appointees to any of the functions of working capital.
- Current managers who need a succinct, well-written reference.
- Members of allied professions, including accountants, information technology specialists, marketing and production managers, and others who want to expand their knowledge base.
- Readers outside of the United States who either plan to do business here or are observing their economy as evolving into a United States–type of capitalism.
- Senior managers who need an “executive summary” to understand working capital without becoming too enmeshed in detail.

Chapter Content

The layout of the chapters and supplemental material is described in this section.

Order of the Chapters

As previously noted, the beginning two-thirds of the book discusses concepts relating to significant working capital accounts. The last third focuses on the infrastructure of working capital—those activities that are essential for managers to proceed. Specific content is as follows: international working capital (Chapter 8), information and working capital (Chapter 9), and management of the working capital cycle (Chapter 10). For readers who want a quick recommendations summary, a list of ideas is in this final chapter.
**Tips and Techniques and In the Real World examples are presented in every chapter.** *Tips and Techniques* are suggestions to the reader regarding action steps to improve working capital. *In the Real World* examples are brief case situations from our experience in working with companies to improve working capital performance. At the end of the regular text content, we have included helpful appendices. As noted above, Appendix A contains a suggested solution for the comprehensive case, Widget Manufacturing I, II, and III; Appendix B covers basic capital structure concepts; Appendix C lists sources for additional information; and Appendix D is a glossary of important finance concepts.

**Metrics**

Ratio analysis and other metrics are used to provide a comparative basis for a hypothetical company versus its industry. We use plastics manufacturing as the industry comparison, although the reader should understand that each industry is unique. For example, companies that manufacture men’s clothing experience a very long receivable cycle, often six months, while grocery stores and supermarkets are expected to pay their suppliers for certain food products in about one week.
Acknowledgments

The author is indebted to Michèle Allman-Ward, with whom he authored an earlier book in the Wiley Essentials series, *Essentials of Managing Corporate Cash* (2003), for her assistance in Chapter 8. Michèle is a distinguished consultant and lecturer and has an encyclopedic knowledge of global treasury management practices.

Chapter 9, Information and Working Capital, was coauthored with Arthur C. McAdams, a senior lecturer in the management department in the School of Business at the University of Bridgeport (CT). He was senior vice president and director of Information Systems at People’s Bank (CT) leading the implementation of several strategic initiatives, and has many years of experience in systems development, project and process management, and business planning. Dr. McAdams has had articles published in leading technology journals.

Acknowledgment is also extended to Timothy Burgard, Helen Cho, and Laura Cherkas, my Wiley editors; and to my former colleagues and clients at First National Bank of Chicago (now JPMorgan Chase) and the team at Sagner/Marks.

You may have questions about the ideas presented in this book. If so, e-mail the principal author at jsagner@bridgeport.edu with your inquiries. However, a good place to start is to ask your bankers for ideas—often they are on the leading edge of current practice and have access to helpful product information.
CHAPTER 1

Concepts in Working Capital Management

After reading this chapter, you will be able to:

• Understand the concept of working capital.
• Appreciate the components used in managing working capital.
• Determine how ratio analysis is used in understanding working capital.
• Consider traditional and modern ideas of working capital management.

Working capital is the arithmetic difference between two balance-sheet-aggregated accounts: current assets and current liabilities. This calculation is done in a currency, such as U.S. dollars, which is the convention we will be using in this book.

Working Capital Concepts

Both current assets and current liabilities are comprised of several ledger accounts as shown in italics in Exhibit 1.1. For the company presented in this balance sheet—we’ll call it the Rengas Company—the amount of working capital is $425,000, calculated as current assets ($650,000) less current liabilities ($225,000).
Description of Working Capital Accounts

The accounts noted in italics are briefly explained below, with chapters of this book devoted to appropriate management procedures.

- **Cash accounts and short-term investments.** These account categories include cash on hand and in bank accounts, and any short-term investments that are expected to be turned into cash within one year. We’ll review the management of cash in Chapters 2 and 3, and of banking relationships in Chapter 4.

- **Accounts receivable.** This category of current assets includes all credit sales where the customer is expected to pay by a future date specified on an invoice. Most companies have small amounts of uncollectible credit sales, and an account called “allowance for doubtful accounts” may be deducted from accounts receivable to reflect this experience. We’ll examine receivables in Chapter 5.
• **Inventory.** Most companies hold some combination of raw materials, work in process (that is, partially manufactured and assembled), and finished goods. There are various accounting practices for valuing inventory and management concepts regarding inventory, which will be discussed in Chapter 6.

• **Payables.** The accounts payable account represents the amounts owed to creditors for purchases. Payroll is the other significant component of payables. Issues regarding payables will be reviewed in Chapter 7.

• **Other working capital accounts.** Prepaid expenses and accrued expenses often appear on balance sheets. Prepaid expenses are assets paid in advance of expenses as incurred. For example, insurance is paid in advance of the incurrence of the expense. Accrued expenses are costs that have been incurred as of the date of a balance sheet but not paid. An example is payroll for employees whose expenses have been incurred but not yet paid.

There are numerous considerations in the optimal management of working capital. For example, what are appropriate procedures to manage cash? To reduce accounts receivable? To improve the performance of accounts payable? We will examine these and many other issues throughout this book.

**Ideas Basic to Working Capital**

Various concepts and conventions are used to explain and illustrate ideas on working capital management.

• The term *bank* refers to commercial banks, although other financial services companies and some vendors provide many of the services described. Vendors are noted when the relevant topic is discussed; for example, payroll services are provided by four leading firms that are noted in Chapter 7. Freight invoice
auditing firms are also discussed in that chapter, but there are so many companies in that business that we have not attempted to list them.

- Float is critical to an understanding of working capital. The concept of float refers to funds in the process of collection or disbursement. While the complete elimination of float is impossible, the calculation of the amount of float is critical in considering alternative processes. For example, in Chapter 2 we will examine the bank product of lockboxing. In deciding on the use of this service, we need to know the potential to save collection float as compared to the current system.

- Concepts that are basic to finance but not defined as working capital are reviewed in Appendix B. These include fixed assets, long-term liabilities and owners’ equity on the balance sheet, and relevant income statement accounts. In addition, we demonstrate the calculation of the cost of capital (also called weighted average cost of capital or WACC), which is used to value float. The WACC is the weighted average of a firm’s cost of debt (after tax) and cost of equity (common stock and retained earnings), and is expressed as a percentage.

- Opportunity audits should be conducted by relevant functions to analyze each element of working capital. For example, in payables, managers examine the percentage of payments made by check, the cost of those transactions, the extent of cash discounts offered and taken, the results of account reconciliation, the incidence of fraud, and other issues. As an essential part of this process, it is useful to document the delays and organizational units involved in the movement of forms, files, and other records including computer systems; see Tips and Techniques: How to Be a Working Capital Consultant.
How to Be a Working Capital Consultant

The traditional functional scheme of corporate management—such as sales, manufacturing, finance, and technology—prevents any one manager from having direct responsibility for working capital. Most often the only common manager is the chief executive officer (CEO) or chief operating officer (COO), who seldom has knowledge of or interest in the specific functioning of those activities. In order to better understand and analyze working capital flows, here are the suggested steps in a process often referred to as an opportunity audit.

1. Prepare a “payment stream matrix” listing the working capital flows by name, dollar volume, and manager. The matrix becomes a road map to understanding and improving the business by indicating those major activities that drive short- and intermediate-term successes and failures. A working capital flow is an activity of the organization that generates a cash inflow or outflow. Inflows, or collection flows, are often products or services; outflows, or disbursement flows, are accounts payable (to vendors for purchases), payroll, and other uses of cash.

2. Use the matrix to bring other disciplines within your organization into your working capital review. It is usually necessary to involve managers in all of the functional areas of the business, including sales, operations, and finances. Input from customers and vendors can be helpful in understanding how a transaction occurs from their perspective, and to make the process more efficient and effective for all parties.

3. Focus on the major flows—usually those that have $1 to 2 million per month in activity—to allow you to develop improvements through the application of technology, redesign of existing processes, and consideration of outsourcing to banks.
Once opportunities for improvement are identified and solutions evaluated, senior management should be consulted for permission to proceed. See *Tips and Techniques: How to Overcome Resistance to Change* for ideas on coping with internal resistance.

### Tips and Techniques

**How to Overcome Resistance to Change**

Bringing change to companies is often an extremely difficult task regardless of the logic of an innovation or the demonstrable savings that will result. Here are some ideas on meeting internal resistance.

- Solicit the support of senior management. Promote the program through presentations to middle managers and educational events to explain where opportunities can be found.
- Reward employees who work outside of finance for each idea suggested and accepted, and then again when it is successfully implemented. These incentives really draw company employees into the change process and foster an environment that controls naysayers.
- Use any available marketing devices to publicize the effort, including articles in the company newspaper, announcements at company meetings, e-mails messages, and promotions through cafeteria or lunchroom events. If your company can sell a product or service, it can sell working capital efficiency!
Ratio Analysis

The various accounts on financial statements (the balance sheet and the income statement) can be used to provide critical information about a company to financial managers, bankers, investors, and other interested parties. Ratio analysis allows us to quickly examine a company's financial statements to determine how performance has changed over time and/or how it compares with its competitors.

How Ratios Are Constructed

Data are entered into a numerator and a denominator and then divided to allow the calculation of a relationship that is considered meaningful. We can compare these data to previous years to see if a company's financial position is improving or deteriorating; this is called longitudinal analysis. We can also compare a company to others in the industry in the same time frame; this is known as cross-sectional analysis.

Finding truly comparable companies is difficult because no two organizations are exactly alike. They may have different geographic coverage, varying product lines, significantly dissimilar economies of scale, or other distinguishing characteristics. We'll attempt to compare actual companies in their industry while noting these discrepancies later in this chapter.

There are three sets of ratios in general use: (1) liquidity, (2) activity utilization, and (3) profitability. We'll review the ratios that specifically impact working capital using Exhibit 1.1 data as supplemented by the income statement data shown in Exhibit 1.2.

Working Capital Ratios

The important working capital ratios are noted below. Examples of other ratios will be noted in later chapters. We'll call the fictional business used for this chapter's ratios and throughout this book the Rengas Company.
Liquidity

*Liquidity* refers to a company’s cash position and its ability to pay its bills as they come due. The phrase “cash position” is not limited to cash on hand and in the bank; it includes access to bank loans and short-term investments as well. Liquidity should not be confused with profitability or net worth; a company could earn accounting income with significant assets, and yet go bankrupt for lack of working capital.

The two liquidity ratios are the current ratio and the quick (or acid test) ratio.

- The *current ratio* is calculated as follows:

\[ \frac{\text{current assets}}{\text{current liabilities}} \]

From Exhibit 1.1, the result is 2.9 \((\$65,000,000 \div \$22,500,000)\).

- The *quick ratio* is considered more useful because it eliminates inventory in the numerator, on the theory that this asset could be stale, worn, or not saleable except at bargain prices. The quick ratio is calculated as follows:
(current assets – inventory) ÷ current liabilities
or 2.2 ([$65,000,000 – $15,000,000] ÷ $22,500,000).

There are no standard ratios that solely measure cash (as a current asset) or cash flow (cash receipts – cash disbursements). However, Troy’s Almanac (cited in the section “How Ratios Are Used”) calculates total receipts (revenues from all sources) to cash flow, and cost of goods sold to cash flow. We will discuss this further in Chapter 10.

**Activity Utilization**

The activity utilization ratios indicate how efficiently the business is using its assets. The important working capital utilization ratios are receivables turnover (and its complement, average collection period) and inventory turnover (and its complement, inventory turnover days).

- **Receivables turnover** is calculated as follows:

\[
\text{credit sales ÷ accounts receivable}^{1}
\]

For simplicity in this discussion, we’ll assume that there are no cash sales, with the receivables turnover determined as $150,000,000 ÷ $27,500,000, or 5.5 times.

- **Average collection period** is calculated as follows:

\[
\text{receivables ÷ daily credit sales}
\]

In this example, we’d divide $27,500,000 by ($150,000,000 ÷ 360), with the result of 66 days.

- **Inventory turnover** is calculated as follows:

\[
\text{cost of goods sold ÷ inventory}
\]

or $100,000,000 ÷ $15,000,000, which is 6.7 times.

---

1. Only credit sales are used because any cash sales would be collected immediately; therefore no receivable would be created. The term receivables refers to accounts receivable.
Inventory turnover days are calculated as follows:

\[
360 \text{ days} \div \text{inventory turnover}
\]

In this example, we’d divide 360 $\div$ 6.7, which is 54 days.

Profitability

Although profitability is not an explicit component of working capital, it is included here because any change to working capital components directly impacts profits. In fact, if profit ratios have deteriorated or are below those of competitors, this may indicate working capital improvement opportunities. Important profitability ratios are profits to sales (ROS) and return on equity (ROE). The term “return” is another word for profits, and these ratios calculate the after-tax returns.

- **Profits to sales** (sometimes called “return on sales” or ROS) is calculated as follows:
  \[
  \text{profits after taxes} \div \text{sales}
  \]
  or $13,650,000 $\div$ $150,000,000, or 9.1 percent

- **Return on equity** (ROE) is calculated as follows:
  \[
  \text{profits after taxes} \div \text{owners’ equity}
  \]
  or $13,650,000 $\div$ $62,500,000, or 21.8 percent

- There are a few industries where the ROE is considered of secondary importance to the ratio that measures the return on assets (ROA). For example, this ratio is widely used in banking to determine the profitability of a bank based on its asset base. The calculation of *return on assets* is as follows:
  \[
  \text{profits after taxes} \div \text{total assets}
  \]
  or $13,650,000 $\div$ $125,000,000, or 10.9 percent

Leverage ratios are discussed separately as there are no direct working capital issues; see *In the Real World: The Other Category of Ratios: Leverage*. However, leverage indirectly affects working capital because of the impact on required cash payments for interest or the expected cash payments for dividends.
How Ratios Are Used

We cannot use these ratios without reference to either earlier results, say from 2008 and 2009, or to those from competitive companies. The issue of finding reasonable “comparables” is made possible through industry ratios published by such sources as RMA Annual Statement Studies (published by the Risk Management Association); and Leo Troy, Almanac of Business and Industrial Financial Ratios (published by CCH [Commerce Clearing House]).\(^2\) Selected ratios are also at Value Line (published by Value Line Inc.); Standard and Poor’s Industry Surveys (www.standardandpoors.com/products-services/netadvantage); Dun

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\(^2\) These three sources are available in the business reference sections of many libraries. See Appendix B for a listing of useful references and web sites. Troy can also be located at www.books.google.com/books?id=5nEsDHFsdFworking capital&dq=leo+troy%2Bcash+flow&source=gbs_navlinks_s.
& Bradstreet (www.dnb.com); and financial web sites like www.hoovers.com.

The main difficulty in using these sources is that each business has its own marketing processes, market coverage, and product lines, and when aggregated into an industry, company uniqueness loses meaning. That problem aside, we can compare the calculated current ratio of 2.9:1 (read as “2.9 to 1”) to the industry’s result. The general rule when using industry comparisons is that any result within the interquartile range is considered normal, and that any result outside of that range is unusual and worthy of further analysis.3

In our situation, 2.9:1 can be too low compared to the industry, which is unlikely, or too high, which is quite possible. In other words, there may be an efficiency problem when ratios are too high, usually indicating that too much of a numerator (such as an asset or a group of assets) are being used to support a denominator (such as a liability or a group of liabilities). It may be a more serious problem when there is too little of a numerator supporting a denominator, as this could indicate a possible future liquidity, activity utilization, or profitability crisis.

Significance of Working Capital

Why is working capital management important? In truth, businesses have not paid sufficient attention to working capital in previous years, and have focused instead on such concerns as raising and using debt and equity capital, choosing information and manufacturing technology to run operations, and attempting to develop domestic and global marketing strategies to sell product. However, recent economic problems have forced companies to consider ways to improve profitability, cut costs, and make business processes efficient. These are not just necessary actions—they are required for survival!

3. The interquartile range refers to the area in an array of results from the twenty-fifth to the seventy-fifth percentiles (or the first to the third quartiles). An array is a listing of the members of a group in either ascending or descending order. The middle item in an array is the median (the fiftieth percentile), while the mean is the arithmetic average of the total of all items divided by the number of items.