Working Capital Management and Money Market Instruments

Working capital also known as gross working capital is defined as the short-term investment i.e. in assets like marketable securities, stock, accounts receivables and even cash (these are the four main components of working capital). Other terminologies of working capital include: net working capital which is current assets less current liabilities, net-operating working capital which is current assets less non-interest bearing current liabilities (marketable securities, inventories, cash, and account receivables less accruals and account payables. Note that this definition assumes cash and marketable securities are at their normal levels and the firm has no excess cash. In summary excess levels of cash and marketable securities are not components of working capital (PWC 2007, p.3).

Other ratios pertinent to liquidity of a firm are: current ratio which is current assets divided by current liabilities, this is a measure of liquidity; and quick ratio/acid ratio is the difference between current assets less inventories and then divided by current liabilities. Thus the quick ratio is also a measure of liquidity and it is an “acid test” of a firm’s capacity to meet its current responsibilities. In retrospect, the cash budget is arguably the most comprehensive way of accessing a company’s liquidity position. A cash budget forecasts cash inflows and outflows.

Working Capital management and policy

Working capital is considered useful by firms; however its usefulness varies from industry to industry. For example the financial services sectors consider it to be less useful while the retail industry consider it to be very useful. In the auto industry more than 80% of respondent in a survey carried out by PWC regard working capital information as ‘very useful’. On a more balanced view, equity analysts apply working capital to a number of activities such as accessing liquidity while fixed income analysts utilize this information as an input to cash flow models. The debate still remains if working capital should be measured using current values or whether historical costs remains to be the most appropriate measure. Working capital policy involves policies the levels or targets of current assets and their financing (PWC, 2007, p.4).

In analysing the components of working capital, a common underlying thread can easily be observed in the management of current assets. Current assets are necessary in conducting business, the higher the holding of current assets, the lower the risk of running out of business this means low operating costs. However, it is costly to hold working capital, holding extra large inventories means that the firm’s assets are earning zero or even losses in case of high storage and spoilage costs. Usually, firms must generate capital to buy assets (inventories), this is at a cost, thus excessive cash and receivables are risky. Thus, firms strive to keep working capital at minimum where the business is running smoothly.

The concept of working capital management is said to originate from the ‘Old Yankee peddler’. The Yankee peddler used to borrow to buy stock; he would then sell the inventory to pay his bank, the cycle would go on in that manner. This very concept has now been applied to even more complex business situations. Firms purchase inventory, sell on credit, and collect receivables. This is a cycle known as the “cash conversion cycle”.

Working Capital: A review of Ford Motor Company

Introduction

Ford Motor Company is a multination company located in Michigan; the company has about 108 plants globally and is affiliated to several brands such as Volvo, Ford, Jaguar, Land Rover, Mazda, Lincoln, and Mercury. Ford has automotive related services run by Ford Motor Credit Company. The continued success of Ford can be measured by looking at the management of working capital, especially the maintenance of a healthy liquidity position. This paper analyzes the performance of Ford with regard to the analysis of working capital. A firm’s short-term health together with efficiency is best measured using working capital. Working capital is calculated by getting the difference between current assets and current liabilities-a positive figure means that a firm is able to meet its short-term obligations. However, a negative answer implies that the firm unable to cover its short-term liabilities.

The working capital of Ford Motor Company has significantly fluctuated over the years. The fluctuation can be easily associated to the fact that current assets and liabilities of the financial services arm are excluded from the computation of the total current assets and liabilities.

Financing of Working capital

Ford’s funding strategy is aimed at maintaining high liquidity levels. This is done by holding considerably high cash balances; this allows the company to meet its short-term obligations. This has led to lower credit ratings which have in turn increased its funding costs. Ford Credit accesses the unsecured debt market and has also enhanced its use of securitization which is more cost effective and offers as wider range of lenders as compared to unsecured funding. With time, the company may see it fit to further reduce receivables and operating leases. However, reducing Ford’s receivables would have a negative impact on profits (Ford, 2010).

Components of Working Capital

Cash and marketable securities

Holding cash and marketable securities has both its merits and demerits. The obvious advantages are: Ford has greatly reduced its transaction costs, the company doesn’t have to borrow frequently or issue securities more often to raise cash; and cash is readily available to grab growth opportunities and handsome cash bargains. However, holding cash bargains comes with the primary disadvantage of low after tax returns on short-term instruments and cash. This is where all firms face a trade-off between costs and benefits. Since Ford is a firm with high growth opportunities, holding high amounts of cash is beneficial. Recent data from Ford shows that the firm holds (), When a firm has a relatively volatile cash flow it will tend to hold more cash. On the contrary, firms with high credit ratings tend to hold less cash since it is relatively cheap for them to acquire cash from the capital markets. Ford is an outlier when it comes to holding high levels of cash. Despite its enormous size and strength, the company is cash rich.

Inventory

Inventories are categorized as raw materials, supplies, work-in-progress and finished goods. All these are important for all business operations. Inventories depend heavily on sales. Examining Ford's receivables and daily sales indicate the company's strong liquidity position. Sales have increased as indicated by the data. The daily averages of have conversely fluctuated between days and days. The operating cycle of the company has however decreased over time as indicated by the table below (Hyun-Han 1998, pp. 43).

Current Ratio and Acid Ratio

The current ratio in 2006 was and has relatively remained stable, the current ratio has fluctuated between and. On the other hand the acid ratio has fluctuate between and. Fluctuations in current ratio vis a vis the fluctuation in current ratio are associated with the inclusion of inventories in the assets category (Ford Motor Company, 2010).

The money market

The money market is an integral part of the financial markets more specifically for short-term borrowing with maturity periods not exceeding one year. The type of securities traded in the money market include; T-bills, commercial papers, federal funds, commercial papers, cash deposits, federal funds, short-term mortgage and asset backed securities. The money market offers liquidity for firms. In the United States (as it is in developed countries), participants in the money market include-financial institutions, lenders and borrowers.

The money market in the United States and most parts of the world, where Ford Motor Company operates has implemented several changes in this market. Key players in this market are banks, they borrow and lend to each other using instruments such as repurchase agreements and commercial papers. Financial companies are able to raise funds through the money market by floating commercial papers that are backed by assets or even pledged by credit of firms that have high credit ratings.

However, the recent global financial meltdown has raised concerns over the efficiency of the money markets. Analysts have observed that the uncertainty in these markets (as observed in the bankruptcy of Lehman and high redemptions in money market funds) is a major factor that needs attention. Hundreds of money market funds in the United States faced liquidity hardships during the financial turmoil. On the other hand, retail funds continued to show impressive cash flows.

The money market in the US experienced flooding due to “flight to quality” by investors in government securities leading to the recording of the lowest yields in history. Yields were further diluted as portfolios owned by money market funds matured and these new funds were used to purchase new government securities. Profits were evaporated and some players had to close business even as new entrants came into action.

Developments made by fund providers

The crash in the market in 2008 prompted the enactment of new rules to govern the market in order to respond to these problems. The federal government attested to the significance of the money market as well as its magnitude. The first step was the announcement of the “Temporary Guarantee Program for Money Market Funds” which was aimed at protecting the value of investors. Another strategy was the setting up of “Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility” aimed at creating liquidity in the tight market. In addition to these solutions, the U.S treasury department issued a white paper dubbed “Financial Regulatory Reform: A new Foundation”. The report recommended that the regulatory framework be strengthened by the SEC and the susceptibility to ‘illiquidity’ by the market be assessed. The commission also adopted new rules in the money market that will ensure that a balance is struck between the returns and safety of the markets. Among the rules is the requirement that fund managers must comply with maturity standards and qualities of credit that make the funds even more liquid (Donohue, 2010, para.6).

Moreover, money market fund managers are supposed to test their models under different market conditions in order to ensure that their portfolios are standard. Beside these, money market managers are also required to report monthly the performance of their portfolios to the public-on their websites. This must be accompanied by filing a detailed portfolio performance to the commission (Donohue, 2010, para.6).

Other ideas include having a “private liquidity bank, this bank can borrow from the industry-thus providing even more liquidity of which money market funds can take advantage of even after depleting their liquidity. However, the idea of the liquidity bank does not help in reducing credit risk in as much as it will help the money market in dealing with runs.

Conclusion

In conclusion, all the stakeholders involved in the money market must work in harmony to ensure the success of the changes in regulation of the money markets. Since the money market in plagued by systematic risk, the global outlook of such markets is very important. Ford has greatly reduced its transaction costs, the company doesn't have to borrow frequently or issue securities more often to raise cash; and cash is readily available to grab growth opportunities and handsome cash bargains. However, holding cash comes with the disadvantage of low after tax returns on short-term instruments and cash.

Reference

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