FINOVATION

NATIONAL CLIENT GROUP CLM JOB AIDS

FINANCIAL ACCOUNTING

ASSESS WORKING CAPITAL MANAGEMENT

Assess Working Capital Management practices for maintaining a solid balance between growth, profitability & liquidity to determine net cost of card acceptance.

JOB AIDS:

1. Probing Questions to Assess Your Merchant's Working Capital Structure & Sources of Funding
2. Probing Questions to Assess Your Merchant's Cash Flow
3. Leverage Financial Performance Ratios: Asset & Efficiency Analysis

ASSESS WORKING CAPITAL MANAGEMENT JOB AID

Probing Questions to Assess Your Merchant's Working Capital Structure & Sources of Funding

Probing questions to assess a merchant's sources of financing

- What are your main sources of finance that you rely on to run your day to day business – your Working Capital?
- Can you describe the strategies you have in place for your Accounts Payable and Receivables?
  - What are your payment terms for your vendors?
  - Are the payment terms the same for all of your vendors?
  - What are your payment terms for your suppliers?
- What sort of Inventory management practices are you employing to enhance cash flow? What have you tried before?
- What percentage of your capital is tied up in work in progress?
- Do you have special long term vendor relationships?
  - Can you describe for me how the relationship works?

Probing questions to assess a merchant's cost of financing

- If you could delay making payments to your suppliers, what is the value of this?
- When you consider all your sources of finance, what is the average Cost of Finance you are incurring?
- When looking at investment, what is your hurdle rate for your ROI, e.g. for investing in machinery?
- If I could provide you with a solution to reduce the cost of some of your capital, would that be something you would be interested in?

Probing questions to assess changes in situation that effects a merchant's cash flow

- How has your cash flow situation changed with the current economic issues that are impacting on the economy?
- Are your loans/overdrafts being affected? What about other kinds of short term finance?
- How has it impacted your payment terms with suppliers?
- How has this impacted your customers paying you?
- What Working Capital strategies are you employing to respond to these challenges? What is working? What are you struggling with? What have you tried before?

Probing questions to assess a merchant's vendor relationships

- Are you working with your vendors on Working Capital projects – e.g. to increase DPO?
- Do you have specific targets with certain vendors?
- Are you happy with your current payment terms?
- Are they asking you to make changes?
- Are you looking at changing your payment terms with suppliers?
- Can you walk me through the Procure to Pay process for some of your indirect commodities?

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Probing Questions to Assess Your Merchant's Cash Flow

Probing Questions to assess a merchant's Days Sales Outstanding (DSO)

- When do you get paid?
- What is your average DSO?
- Do you have any initiatives to reduce them?
- What is your DSO goal?
- Describe your invoicing process.
- What are your payment terms?

Probing Questions to assess a merchant's Days Payable Outstanding (DPO)

- What is your average DSO?
- How many invoices do you generate monthly?
- What is your card acceptance policy for invoice payments?
- How do you communicate Card Acceptance to your Customers? Invoice, Online, POS, Via Phone, etc

Probing Questions to assess a merchant's Days Inventory Outstanding (DIO)

- What is your average DIO?
- What are your pricing terms with manufacturers?
- What is your current/planned marketing strategy/campaigns?
- What is your business's strategy for pricing?
- Describe your supply chain - tracking, storing, warehousing inventory, etc?

Probing Questions to assess a merchant's Working Capital Cycle

- What is your Order to Pay process? What are specific pain points?

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Leverage Financial Performance Ratios: Asset, Profitability & Efficiency Analysis

Working Capital Ratio (Current Ratio)

How much in liquid assets is available to build the business?

Working Capital Ratio (Current Ratio) =
Current Assets ÷ Current Liabilities

Measures a Merchant's ability to pay off its current liabilities (payable within one year) with its current assets such as cash, accounts receivable, and inventories.

↑ A ratio above 1 means current assets exceed liabilities. The higher the ratio, the better liquidity position and greater flexibility to expand operations and secure debt. An ideal ratio would be between 1.2 and 2.0.

↓ Below 1.0, it could mean that the Merchant isn't operating at a proper efficiency level. If a business has too many current assets, it could be an indication of a bloated business.

Working Capital Turnover Ratio

How effective is the Merchant in using its working capital?

MFT Working Capital Turnover =
Revenue ÷ Average Working Capital

Measures how many times per year a Merchant deploys working capital in order to generate sales and indicates how capital is being used to build their business.

↑ A high ratio is better. The more sales brought in per dollar of working capital deployed, the better off the Merchant is. It demonstrates efficiency in using short-term assets and liabilities for supporting sales and has limited need for additional funding. However, an extremely high ratio, typically over .8 (80%), may indicate there is not enough capital to support sales growth. This can lead to insolvency if working capital is not adjusted to its sales ratio.

↓ A low ratio indicates a business is investing in too many accounts receivable and inventory to support its sales, which could lead to an excessive amount of bad debts or obsolete inventory.

Return on Invested Capital Ratio

How well is cash used to generate returns?

MFT Return on Invested Capital (ROIC) = Net Operating Profit After Taxes (NOPAT) ÷ Invested Capital (IC)

Measures the return earned on invested capital by comparing a Merchant's return on invested capital with its weighted average cost of capital (WACC) thus revealing whether invested capital is being used effectively.

↑ A high ratio or is considered more than .02 (2%) of the Merchant's cost of capital (WACC/COF) indicating the Merchant is considered a value creator.

↓ A low ratio is considered less than .02 (2%) of the Merchant's cost of capital (WACC/COF). This suggests the Merchant may be considered a value destroyer. Some Merchants run at a zero-return level, and while they may not be destroying value, these companies have no excess capital to invest in future growth.

There are some companies that run at zero returns, whose return on the value of capital lies within the set estimation error, which in this case is .02 (2%).

Debt to Capital Ratio

What proportion of debt is used to finance operations as compared to capital?

MFT Debt-to-Capital Ratio = Total Debt ÷ (Total Debt + Total Equity)

Measures a Merchant's use of financial leverage by comparing its total obligations to total capital.

↑ If the ratio is greater than 1, the Merchant has more debt than capital. This indicates a high-risk Merchant. If any more liabilities are acquired without an increase in earnings, there is potential for bankruptcy.

↓ If the ratio is less than 1, the debt levels are manageable, and the Merchant is considered less risky. Suggests that significant portion of the company's capital is funded by equity capital.

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Leverage Financial Performance Ratios: Asset, Profitability & Efficiency Analysis

Accounts Receivable Turnover Ratio

How quickly does the Merchant collect outstanding cash balances?

MFT Accounts Receivable Turnover= Net Credit Sales ÷ Average Accounts Receivable

Measures how quickly a Merchant collects outstanding cash balances from its customers during an accounting period.

↑ A high ratio indicates that collection of accounts receivable is efficient. A high accounts receivable turnover also indicates a high-quality customer base that is able to pay their debts quickly. It also suggests a conservative credit policy such as net-20-days or even a net-10-days policy.

↓ A low ratio suggests a poor collection process. This may be due to extending credit terms to non-creditworthy customers who experience financial difficulties, extending its credit policy for too long, and or excessive amount of bad debt.

It is useful to track accounts receivable turnover on a trend line in order to see if turnover is slowing down; if so, an increase in funding for the collections staff may be required, or at least a review of why turnover is worsening.

Asset Turnover Ratio

How successfully is a Merchant using its assets to generate revenue?

MFT Total Assets Turnover Ratio = Net Sales ÷ Average Total Assets

Measures a Merchant's ability to generate sales from its assets by comparing net sales with average total assets. In other words, this ratio shows how efficiently a company can use its assets to generate sales.

↑ A higher ratio, the better. Indicates a more efficient use of assets and more revenue per dollar of assets is being generated. Generally, in the retail sector, 2.5 or more is considered "good", while in the utilities sector is more likely to aim between 0.25 and 0.5.

↓ A lower ratio indicates assets aren't being used as efficiently. This might be due to excess production capacity, poor collection methods, or poor inventory management.

Calculates net sales as a percentage of assets to show how many sales are generated from each dollar of company assets. For instance, a ratio of .5 means that each dollar of assets generates 50 cents of sales.

Inventory Turnover Ratio

How efficiently is a Merchant managing its inventories?

MFT Inventory Turnover = Cost of Goods Sold ÷ Average Inventories

Measures how many times average inventory is "turned" or sold during a period. .

↑ A high ratio is always favorable as it indicates that goods are sold fast ensuring reduced storage and other holding costs. A "good" ratio is around 4.

↓ A low ratio suggests weak sales and excess inventories or inefficient inventory management

Return on Assets Ratio

How have assets been used to generate profit?

MFT Return on Assets (ROA) = Annual Net Income ÷ Average Total Assets

Measures how much after-tax profit a Merchant generates for every one dollar of assets it hold and the asset intensity of a business.

↑ The higher ratio, the more asset efficiency. It shows solid performance as far as finance and operations. and indicates that the Merchant is using its assets effectively in order to get more net income. It also suggests its less asset-intensive (i.e. a software company). As a general rule, a return on assets above .2 (20%) is considered an asset-light business. The higher the ROA, the better, because the Merchant is earning more money on less investment.

↓ A low ratio indicates that the Merchant is not able to make maximum use of its assets to maximize profits. The lower the ratio, the lower the profit per dollar of assets, and the more asset-intensive a company is considered to be (i.e. an airline company). As a general rule, a return on assets under .05 (5%) is considered an asset-intensive business.