

Estimating Temporary and Permanent Working Capital to Discern a Firm's Asset Financing Strategy

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Working capital management, specifically managing the distinction between temporary and permanent working capital in the context of a firm's asset financing strategy, is an important topic in corporate finance. But academic research has given little attention to this distinction, and finance textbooks typically note the distinction only conceptually without attempting to measure the two categories of working capital. This study estimates the two categories of net operating working capital (NOWC) for a quasi-fictional firm based on data from the firm's year-end financial statements over a three-year period. The results suggest the firm's NOWC was largely permanent and the firm was following a non-matching aggressive asset financing strategy over the study period. However, potential bias due to possible adjusting of year-end working capital calls for further research into the mix of temporary and permanent working capital.

INTRODUCTION

An important topic within corporate finance is working capital management, specifically managing the distinction between temporary and permanent working capital in the context of a firm's asset financing strategy. Such a strategy may be one of maturity matching (hedging) or non-matching and, if non-matching, either conservative or aggressive. A maturity matching strategy involves financing temporary working capital with short-term debt and permanent working capital, along with fixed assets, with long-term funding (debt and equity). By contrast, a non-matching conservative strategy involves financing little or none of the firm's temporary working capital with short-term debt and the remainder of the temporary working capital, permanent working capital, and fixed assets with long-term financing. Finally, a non-matching aggressive strategy involves financing the firm's temporary working capital and at least part of the permanent working capital with short-term debt and the remainder of the permanent working capital and fixed assets with long-term financing.

Despite the importance of working capital management in the broader context of corporate finance, previous academic research has given little attention to the distinction between temporary and permanent working capital. Finance textbooks on the other hand typically recognize the distinction but only conceptually. Rarely do textbooks discuss how to measure temporary and permanent working capital, and those that attempt to do so usually focus on seasonal variations in working capital over the course of a year. By contrast, this study estimates a firm's temporary and permanent working capital at year-end from the firm's financial statements, namely the year-end balance sheet and the accompanying annual income statement. This, in turn, allows us to compare the results with the firm's year-end short-term and long-term financing to determine which of the asset financing strategies the firm is following.

The next section looks at previous academic research dealing with working capital management. The third section then examines the treatment of temporary versus permanent working capital and asset financing strategies across a sample of introductory finance textbooks. The fourth section estimates the year-end temporary and permanent working capital, specifically net operating working capital (NOWC) over several years for a quasi-fictional firm modeled after a real company with simplifying edits to its financial statements for this study. The fifth section completes the analysis by comparing the firm's mix of temporary and permanent working capital with its year-end mix of short-term and long-term funding to discern the asset financing strategy being followed by the firm. The last section is a summary and conclusion, including a discussion of possible bias in our results due to adjusting of year-end working capital.

ACADEMIC RESEARCH DEALING WITH WORKING CAPITAL MANAGEMENT

Over the years considerable academic research has been devoted to working capital management, divided into two broad veins of inquiry. One vein has focused on overall working capital management, specifically the efficiency of working capital management and the implications for profitability and firm value [Shin & Soenen (1998), Gill et al. (2010), Kieschnick et al. (2013), Singh & Kumar (2017)]. More recently, Frankel et al. (2017) extended the study of working capital management and operating efficiency by focusing on firms' incentives to reduce their overall working capital levels in the fourth fiscal quarter followed by a reversal in the first following fiscal quarter.¹ The second vein of study has examined the management of the several components of working capital, either individually or in concert with other working capital components [Lee (2012), Kester (2012), Camerinnelli (2010), Lifland, S. (2011/2012), Singh (2008), Bauer (2007), Ranganatham (2014)].

One issue, however, in working capital management that has been largely neglected by researchers is the distinction between temporary and permanent working capital. In fact, only two studies of which we are aware have addressed the issue. Specifically, Nunn (1981) seeks to measure permanent working capital and explore the factors that account for cross-sectional variations, where permanent working capital is measured by a four-year average (mean) of a business' accounts receivable and inventory.² The reason for the multi-year average is to lessen the effect of short-term variations in working capital, in which case the long-term (four-year) average level of working capital is assumed to be largely permanent. As will be shown later, however, a simple average of a firm's working capital over a multi-year period is plagued by a measurement problem.

The second study highlighting the distinction between permanent and temporary working capital and the funding sources of the two working capital categories is Chauhan (2015). However, Chauhan (2015) makes no effort to measure the two categories but rather simply describes them conceptually as in most finance textbooks and then discusses the norms for short-term bank lending to business firms in India.

TEMPORARY VERSUS PERMANENT WORKING CAPITAL AND ASSET FINANCING STRATEGIES IN INTRODUCTORY FINANCE TEXTBOOKS

To illustrate textbook coverage of temporary versus permanent working capital and alternative asset financing strategies, we reviewed thirteen introductory finance texts published (copyrighted) between

2013 and 2018.³ Of these, all but one—Brooks (2019)—discuss temporary versus permanent working capital and alternative asset financing strategies. Most commonly, the texts present a set of graphs showing growing levels of permanent current assets and fixed assets along with time-varying amounts of temporary current assets arising from seasonal variations in working capital needs.⁴ The graphs, in turn, are typically overlaid with markings indicating the mix of short-term and long-term financing of the several asset groups (temporary working capital, permanent working capital, and fixed assets), depending on the asset financing strategy of the firm.

Despite their general uniformity in discussing (with graphical expositions) different strategies for financing the various asset categories, textbooks rarely suggest how to measure a firm's temporary and permanent working capital. In fact, of the twelve books that address temporary versus permanent working capital and alternative asset financing strategies, only two—Berk, et al. (2018, p. 635) and Gitman & Zutter (2015, p. 613)—discuss how to measure a firm's two categories of working capital. Using a numeric example showing the level of net working capital (cash + accounts receivable + inventory – accounts payable) over the course of a year, both texts point to the minimum level of net working capital as the firm's permanent working capital and the time-varying amount above this level as temporary working capital.⁵ However, neither book nor any of the other reviewed texts follows through to show a year-to-year trending level of minimum working capital as the growing level of permanent working capital that the typical textbook illustrates graphically. This is unfortunate as it disallows a recognition of the firm's temporary working capital and a growing level of total permanent assets (permanent working capital and fixed assets) to compare with the firm's mix of short-term and long-term funding to assess the firm's asset financing strategy.

ESTIMATING A FIRM'S TEMPORARY AND PERMANENT WORKING CAPITAL

As an alternative to the estimating process used in Nunn (1981), we estimate a firm's permanent working capital from year-end financial statement data in a series of steps. As a by-product, we arrive at an estimate of the firm's temporary working capital. First, we calculate the year-end actual days outstanding in sales for each of the current operating assets and liabilities along with NOWC for each of several years. Next, an average (mean) days sales outstanding for each item is calculated for the study period. Third, using the average days sales outstanding as the firm's permanent days outstanding in sales and working backwards, we calculate an estimate of the year-end permanent level of each of the current operating assets and liabilities along with NOWC for each year. Finally, we subtract the estimated year-end permanent level of NOWC from the actual year-end level of NOWC for that year to obtain the estimated year-end temporary level of NOWC.

Though not immediately obvious, our process is superior to Nunn's (1981) simple average of net working capital calculated as an estimate of the firm's permanent working capital. The reason is that our process uses the firm's actual level of sales for each of the years. By contrast, Nunn's process implicitly assumes a constant level of sales over the study period. To illustrate, assume a constant level of annual sales of \$50,000 for each of three years. Assume also net working capital of \$7,000, \$6,500, and \$7,500 for each of the years, giving an average level of net working capital of \$7,000. Calculating the days sales in net working capital for each of the three years and averaging the results yields an average days sales outstanding in net working capital of 51.10 days. Using this figure and working backward gives an average level of net working capital of \$7,000, equal to the simple average level of net working capital calculated above. But this result occurs only because of the constant level of sales over the three years.

Continuing with our process, consider Tables 1-3 for quasi-fictional firm Brindley Electronic Systems, Inc. (BESI) for 2015-2017.⁶ BESI is modeled after a real company with simplifying edits to its financial statements for this study. The company manufactures and distributes point of sale (POS) terminals (cash registers and optical scanners) and checkout stands with optional conveyor systems. Cash registers and scanners are produced in Denver, Colorado, and other products consisting of wood, plastic, and metal are made by a subsidiary firm, Centurion Mfg., Inc. (CMI), located in Mexico. BESI purchases POS terminal

software and then customizes it for each installation. Increases in CMI's net equity, of which BESI owns 50%, are included in BESI's income statements and balance sheets.

Year-end balance sheets for BESI are presented in Table 1, and annual income statements in Table 2. Table 3 presents estimated year-end permanent and temporary net operating working capital (NOWC), where NOWC is defined similarly as in Berk et al. (2009) and Gitman (2009), for each of the three years in Panels A (2015), B (2016), and C (2017).

Looking at Table 3, Panel A, column (a) presents the actual level of each of the current operating assets and liabilities along with NOWC for 2015. As shown, the actual level of NOWC for 2015 was \$12,211. Next, column (b) gives the estimated permanent levels of operating current assets and current liabilities along with NOWC for 2015 based on the reverse calculation described above. As shown, the estimated level of permanent NOWC for 2015 was \$12,048. Finally, column (c) gives the estimated temporary levels of current operating assets and current operating liabilities along with NOWC for 2015, as calculated by subtracting column (b) from column (a). As shown, the estimated level of temporary NOWC for 2015 was only \$163.

Analogous figures for 2016 and 2017 are presented in Table 3, Panels B and C, respectively. Calculated data indicate that estimated permanent NOWC was very close to the actual level of NOWC in all three years, suggesting that year-end levels of temporary NOWC were typically very small relative to year-end levels of permanent NOWC. In fact, in 2016 the estimated permanent NOWC *exceeded* the actual level of NOWC, generating a negative level of temporary NOWC. We interpret this result to mean that BESI recorded no temporary NOWC at year-end 2016; rather, all the firm's NOWC was permanent. In support of these results are the findings in Frankel et al. (2017), namely that firms tend to reduce their working capital levels in the fourth fiscal quarter followed by a reversal in the first following fiscal quarter.⁷ Assuming that such adjustments are focused on firms' holdings of temporary NOWC, then our estimates of year-end temporary NOWC are biased downward.

BESI'S ASSET FINANCING STRATEGY

To discern BESI's asset financing strategy we compare the levels of estimated temporary and permanent NOWC with the firm's short-term notes payable over the three-year study period. As shown in Table 1, year-end short-term notes payable to banks totaled \$7,882 in 2015, \$6,781 in 2016, and \$7,497 in 2017, which greatly exceeded the estimated temporary NOWC of \$163 in 2015, -\$762 in 2016, and \$653 in 2017 but was significantly less than the estimated permanent NOWC of \$12,048 in 2015, \$12,812 in 2016, and \$14,187 in 2017. Thus, it appears that BESI was following a non-matching aggressive asset financing strategy over the study period with short-term financing of its estimated temporary NOWC and over half of its estimated permanent NOWC.

SUMMARY AND CONCLUSION

Working capital management, specifically managing the distinction between temporary and permanent working capital in the context of a firm's asset financing strategy, is an important topic in corporate finance. But academic research has given little attention to this distinction, and finance textbooks typically note the distinction only conceptually without attempting to measure the two categories of working capital. And those textbooks that do try to measure the two categories usually focus on seasonal variations in working capital over the course of a year. By contrast, this study estimates a firm's temporary and permanent working capital at year-end from the firm's financial statements, namely the year-end balance sheet and the accompanying annual income statement. This, in turn, allows us to compare the results with the firm's year-end short-term and long-term financing to determine which of the asset financing strategies the firm is following.

By working backwards using a firm's three-year average (mean) days sales outstanding of its net operating working capital (NOWC), we estimate the firm's permanent NOWC for each year of the study period. Subtracting the firm's permanent NOWC from its actual NOWC, in turn, gives the firm's

estimated temporary NOWC. Both academicians and practitioners should find this measurement methodology useful in analyzing a firm's financial performance and understanding its asset financing strategy.

Using data from a quasi-fictional firm modeled after a real company, the results indicate that year-end short-term notes payable to banks greatly exceeded the estimated temporary NOWC but was significantly less than the estimated permanent NOWC in each year of the study period. This suggests the firm was following a non-matching aggressive asset financing strategy over the study period with short-term financing of its estimated temporary NOWC and much, though not all, of its estimated permanent NOWC. An important caveat, however, is that the firm's average (mean) days sales outstanding of its NOWC, which forms the basis of the estimated permanent NOWC, was constructed from only three years of data. Using a longer study period would likely provide a more accurate estimate of the firm's permanent NOWC and thus of its temporary NOWC.

Still another possible caveat is suggested by the results of recent research by Frankel et al. (2017), which reports that firms typically reduce their working capital at fiscal year-end followed by a rebuilding of working capital at the beginning of the next fiscal year. In that case, we would expect that any such action would be directed at a firm's temporary working capital, in which case our reported year-end levels of temporary working capital may be biased downward. Thus, further research is needed to understand better the mix of a firm's temporary and permanent working capital.

ENDNOTES

1. Such actions are not unlike the "smoothing" argument that managers may take actions in the fourth fiscal quarter to offset deviations in the reported numbers of the first three quarters from a given "normal" trend that managers desire to report; see, for example, Givoly & Ronen (1981).
2. We assume the four-year average was calculated from year-end balance sheet data; however, it is not completely clear from the text of the study.
3. The textbooks are Berk, et al. (2018), Block et al. (2017), Brealey, et al. (2018), Brigham & Houston (2016), Brooks (2019), Gallagher (2013), Gitman & Zutter (2015), Keown, et al. (2017), Lasher (2017), Melicher & Norton (2017), Moyer, et al. (2015), Parrino, et al. (2018), and Ross, et al. (2017).
4. For a discussion of a firm's working capital requirement using a series of numeric examples, see Plan Projections (2017).
5. Note that both texts effectively speak of *net operating working capital* (NOWC), namely, current operating assets minus current operating liabilities, whereas other texts commonly define working capital as simply current assets.
6. For purposes of this study, we selected a three-year study period. In practice, a longer period, perhaps excluding extreme economic periods, would likely give us better estimates of permanent and temporary NOWC.
7. As reported to the authors by a former employee of one Fortune 500 company, the firm typically reduced its year-end working capital by offering discounts on customer purchases and delaying inventory purchases. The firm had a policy of not maintaining excess cash & equivalents on the balance sheet, so it used this cash to pay down debt.

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APPENDIX

TABLE 1
BRINDLEY ELECTRONIC SYSTEMS, INC.
AS OF DECEMBER 31
(ALL FIGURES IN \$000s)

	2015	2016	2017
Assets			
Cash	728	743	808
Accounts Receivable (net)	8,134	8,293	9,675
Inventory	10,587	10,733	12,781
Prepaid Expenses	673	612	1,194
Total Current Operating Assets	<u>20,122</u>	<u>20,381</u>	<u>24,458</u>
Gross Fixed Assets	15,169	15,922	17,719
Less: Accumulated Depreciation	<u>(8,210)</u>	<u>(8,834)</u>	<u>(9,720)</u>
Net Plant and Equipment	<u>6,959</u>	<u>7,088</u>	<u>7,999</u>
Notes Receivable from Related Co.	0	490	460
Land Held for Investment	132	132	132
Investment in Centurion Mfg., Inc.	<u>1,366</u>	<u>1,486</u>	<u>1,542</u>
Total Assets	<u><u>28,579</u></u>	<u><u>29,577</u></u>	<u><u>34,591</u></u>
Liabilities			
Accounts Payable	6,216	6,636	7,673
Accrued Expenses	1,510	1,487	1,716
State Sales Taxes Payable	<u>185</u>	<u>208</u>	<u>229</u>
Total Current Operating Liabilities	<u>7,911</u>	<u>8,331</u>	<u>9,618</u>
Short-Term Notes Payable - Banks	7,882	6,781	7,497
Current Maturities of Long-Term Debt	361	283	154
Current Maturities of Capital Leases	<u>0</u>	<u>137</u>	<u>147</u>
Total Current Liabilities	<u>16,154</u>	<u>15,532</u>	<u>17,416</u>
Long-Term Notes Payable	3,403	3,523	5,503
Capital Lease Obligations	<u>0</u>	<u>434</u>	<u>278</u>
Total Liabilities	<u>19,557</u>	<u>19,489</u>	<u>23,197</u>
Common Stock	50	50	65
Paid in Capital	450	450	585
Retained Earnings	<u>8,522</u>	<u>9,588</u>	<u>10,744</u>
Total Stockholders' Equity	<u>9,022</u>	<u>10,088</u>	<u>11,394</u>
Total Liabilities and Stockholders' Equity	<u><u>28,579</u></u>	<u><u>29,577</u></u>	<u><u>34,591</u></u>

TABLE 2
BRINDLEY ELECTRONIC SYSTEMS, INC.
(ALL FIGURES IN \$000s)

	2015	2016	2017
Sales	50,256	53,440	59,179
Cost of Goods Sold	(38,907)	(41,371)	(46,811)
Depreciation	(545)	(602)	(632)
Gross Income	<u>10,804</u>	<u>11,467</u>	<u>11,736</u>
Operating Expenses			
Selling, General and Administrative	(6,982)	(7,437)	(7,232)
Officers, Directors and Owner's Compensation	(846)	(979)	(1,102)
Lease Expense	(286)	(550)	(577)
Depreciation	(124)	(140)	(147)
Provision for Bad Debts	(551)	(231)	(243)
Total Operating Expenses	<u>(8,789)</u>	<u>(9,337)</u>	<u>(9,301)</u>
Operating Profit	2,015	2,130	2,435
Interest Income (Expense)	17	19	25
Gain (Loss) on Sale of Assets	4	(21)	7
Net Rental Income	40	17	18
Other Income	122	119	167
Increase in Centurion Mfg., Inc.	197	120	56
	<u>380</u>	<u>254</u>	<u>273</u>
Interest Expense	<u>(670)</u>	<u>(618)</u>	<u>(802)</u>
Net Profit	<u>1,725</u>	<u>1,766</u>	<u>1,906</u>
Net Income	1,725	1,766	1,906
Dividends Paid	(700)	(700)	(750)
Addition to Earnings	<u>1,025</u>	<u>1,066</u>	<u>1,156</u>

TABLE 3
BRINDLEY ELECTRONIC SYSTEMS, INC.
ESTIMATED PERMANENT AND TEMPORARY NOWC
PANEL A (2015)
(BASED ON SALES OF \$50,256)

	2015 Actual Level	2015 Projected Permanent Level	2015 Temporary Level	Actual Days in Sales	Average Days in Sales
	(a)	(b)	(c = a - b)		
Operating Working Capital Components					
Cash	728	704	24	5.29	5.12
Accounts Receivable (net)	8,134	8,050	84	59.08	58.46
Inventory	10,587	10,511	76	76.89	76.34
Prepaid Expenses	673	754	(81)	4.89	5.48
Total Current Operating Assets	20,122	20,019	103	146.15	145.40
Trade Accounts Payable	6,216	6,324	(108)	45.15	45.93
Accrued Expenses	1,510	1,455	55	10.97	10.57
State Sales Taxes Payable	185	192	(7)	1.34	1.39
Total Current Operating Liabilities	7,911	7,971	(60)	57.46	57.89
Total Net Operating Working Capital	12,211	12,048	163	88.69	87.51

TABLE 3 (CONTINUED)
PANEL B (2016)
(BASED ON SALES OF \$53,440)

	2016 Actual Level (a)	2016 Projected Permanent Level (b)	2016 Temporary Level (c = a - b)	Actual Days in Sales	Average Days in Sales
Operating Working Capital Components					
Cash	743	749	(6)	5.07	5.12
Accounts Receivable	8,293	8,560	(267)	56.64	58.46
Inventory	10,733	11,177	(444)	73.31	76.34
Prepaid Expenses	612	802	(190)	4.18	5.48
Total Current Operating Assets	20,381	21,288	(907)	139.20	145.40
Trade Accounts Payable	6,636	6,725	(89)	45.32	45.93
Accrued Expenses	1,487	1,547	(60)	10.16	10.57
State Sales Taxes Payable	208	204	4	1.42	1.39
Total Current Operating Liabilities	8,331	8,476	(145)	56.90	57.89
Total Net Operating Working Capital	12,050	12,812	(762)	82.30	87.51

TABLE 3 (CONTINUED)
PANEL C (2017)
(BASED ON SALES OF \$59,179)

	2017 Actual Level	2017 Projected Permanent Level	2017 Temporary Level (c = a - b)	Actual Days in Sales	Average Days in Sales
	(a)	(b)			
Operating Working Capital Components					
Cash	808	829	(21)	4.98	5.12
Accounts Receivable	9,675	9,479	196	59.67	58.46
Inventory	12,781	12,378	403	78.83	76.34
Prepaid Expenses	1,194	888	306	7.36	5.48
Total Operating Assets	24,458	23,574	884	150.84	145.40
Trade Accounts Payable	7,673	7,447	226	47.32	45.93
Accrued Expenses	1,716	1,714	2	10.58	10.57
State Sales Taxes Payable	229	226	3	1.41	1.39
Total Operating Liabilities	9,618	9,387	231	59.31	57.89
Total Net Operating Working Capital	14,840	14,187	653	91.53	87.51