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Understanding working capital

One of the most valuable skills you can develop is a good understanding of working capital. This guide explains the concept of working capital and its management, and how this benefits your business.

What is working capital?

Working capital is normally defined as current assets less current liabilities (CA – CL = WC). In practical terms, working capital is having enough money to pay the current bills as they fall due. Working capital is easy to define, but not so easy to understand or apply on a day-to-day basis because it is constantly changing. It's really a process or flow you need to understand through such tools as cash flow and profit and loss forecasts.

Working capital and business cycles

The essential point about working capital is that it is money (or near money) required for the day-to-day running of operations. **Generally, the longer the business cycle the more working capital you require.** A business cycle is the time taken for a product to be made (or bought in) then on-sold, money received and cleared at the bank. For a hairdresser, this could be one day, for a 'spec' builder or an architect this could be six months or longer. The builder or architect would generally need to pay more attention to working capital management than the hairdresser. They would also need more working capital to keep their businesses afloat until money from completed work starts coming in.

Why is it so important to manage working capital?

Working capital is mostly about timing this means having funds available **when** they are needed. Many business people fall into the trap of thinking that if they are making enough profits, then the working capital will automatically look after itself.

This is not always the case - if you have a business with a longer business cycle than a hairdresser, you need to address both issues: the **timing** of cash movements in your business and **profitability**; **they do not automatically flow together**.

Why?

Here are a few traps that can cause a crisis:

- 'Forgotten' tax payments on those higher profits
- Excessive withdrawals of cash by the business owner
- Acquisition of major assets out of day-to-day operating profits
- Expanding orders may incur more expenses and at the same time lengthen the business

cycle
- Large customers may exercise ‘muscle’ by postponing payment.

The quality of working capital

A further factor to consider is the **quality** of your working capital. To restate the definition: working capital is current assets less current liabilities. The major **current assets** for most businesses are:

- Cash in the bank
- Debtors (customers who have not yet paid you)
- Inventory (stock on the shelves).

The major **current liabilities** are:

- The overdraft at the bank
- Creditors (suppliers who have not yet been paid).

Considering the practical definition of working capital, that is, the ability to pay your bills as they fall due, note that there are four key ingredients that determine your ability to pay bills:

1. Debtors (customers who have not yet paid)

Questions to ask here are:

- Do you have a debt collection policy?
- Do you credit check customers **before** giving them your goods or services on credit?
- How efficiently do you collect payments due? Is this in line with your debt collection policy?
- Do you act promptly, firmly and fairly with your slow debtors?
- Have you set goals to lower the average collection time?

2. Inventory (stock on shelves)

Consider these issues:

- How good are you at ordering stock? How accurately do you predict consumer demands?
- How much dead or slow moving, stock do you have on your shelves right now?
- How willing are you to sell this stock at cost (or below) to free up cash?
- What is your annual rate of stock turn? Is this in line with your industry average?

3. Creditors (suppliers)

Consider these questions:

- How quickly do you pay your creditors? If you’re paying your creditors faster than your

customers are paying you, then you're actually providing free working capital for other businesses. This will cost you interest on your overdraft and make your working capital requirement larger than it needs to be)
- Can you get better credit terms from your suppliers? If you have built up a solid reputation for paying on time (or before due date) then suppliers might be prepared to extend extra credit when you really need it.

4. The Bank

If you're always up to your overdraft limit this may be a sign that:

- You're not trading profitably
- You're taking too much cash out of the business as personal drawings
- You need to manage your working capital more skilfully.

To determine the **quality** of your working capital look at:

- The 'age' of your debtors
- The quality and amount of stock on hand
- Your ordering techniques.

Poor monitoring of your debtors, stock, and creditors leads to high levels of low-quality working capital. This in turn means you have to approach your Bank for extra money, possibly incurring extra interest charges and lowering your profitability and efficiency.

Every business is different

Standard advice on managing working capital doesn't work for everyone. Every industry is different and every business within an industry has its own set of unique factors such as:

- Seasonal cycles
- Length and stages of the business cycle
- Owner's attitudes on liquidity
- Customer power (to delay payments)
- Supplier power (to demand payment)
- Competitors' methods of operation
- Optimum levels of stock.

All these factors impact differently on different businesses and they can change daily. But this is no excuse for poor working capital management. Keep focused on:

- Shortening **debtors' collections**
- Minimising **overstocking**
- Getting **better terms from creditors** so they help to finance your debtors

Cash flow forecasting

An alert business operator will constantly monitor the big three: **debtors**, **stock** and **creditors**.

This monitoring leads naturally to:

- Better business planning
- More direct, proactive management
- Less reactive ‘crisis management’ behaviour on finding out about a severe cash shortage during or after it has happened
- A better relationship with your Bank and other lenders.

An understanding of working capital management leads to the next important skill in short to medium business planning: cash flow forecasting. Regularly updated cash flow forecasts enables you to predict the temporary periods when you need short term finance to bridge gaps in your working capital, such as October/November when you’re stocking up for the Christmas customer shopping spree. The ability to foresee such events puts you in a much stronger position with your Small Business Specialist than if you approach the Bank after a ‘crisis’ has occurred.

Looking for a cash flow template? Download our free **Cash Flow Template** from The SB Hub. Simply look under ‘Cash Flow Management’ in the Resources section.

Your financial health

Finally, use these quick test ratios to assess the current financial health of your business:

Working Capital ratio

The Working Capital ratio indicates the ability of your business to meet its short- term liabilities using current or more liquid assets. To assess your Working Capital (or Current) ratio, divide your **Current Assets** by your **Current Liabilities**. If the answer is less than 1:1, you have a problem.

Quick asset or liquidity ratio

The Quick Asset ratio tests whether your business can meet its short-term liabilities without impacting on the operation of the business. Calculate the ratio by dividing your Quick Assets (Assets which can be converted into cash immediately, i.e. Bank and Debtors) by Quick Liabilities (Liabilities which may become payable immediately, i.e. Bank Overdraft, Creditors). If the result is greater than 1:1, your position is acceptable.

Average age of debtors

This ratio measures the effectiveness of your credit control. The shorter the average period it takes you to collect payments, the better. Calculate it by dividing your **Debtors at the**

end of a set period by the **Average daily credit sales**. An answer that is less than 60 days is acceptable, but you could set a target of reducing your average debtor days.

Average rate of stock turn

This ratio measures the number of times the stock turns over in your business. It is calculated by dividing the Cost of Goods Sold by the Average Stock on Hand. If this rate is lower than your industry average you have more stock on hand than required.

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