

Working Capital

Introduction to the Management of Working Capital



Introduction

- **All businesses need cash to survive**
- **Cash is needed to:**
 - Invest in fixed assets
 - Pay suppliers and employees
 - Fund overheads and other fixed costs
 - Pay tax due to the Government
- **Nearly all businesses use much of their cash resources to finance investment in “working capital”**
- **Managing working capital effectively is, therefore, a vital part of making sure the business has enough cash to continue**

What is Working Capital?

What is Working Capital?

Working capital is the cash needed to pay for the day-to-day operation of the business

How is It Calculated?

Working capital is the **difference** between the **current assets** of a business and its **current liabilities**

Definition of Working Capital

**Current
Assets**

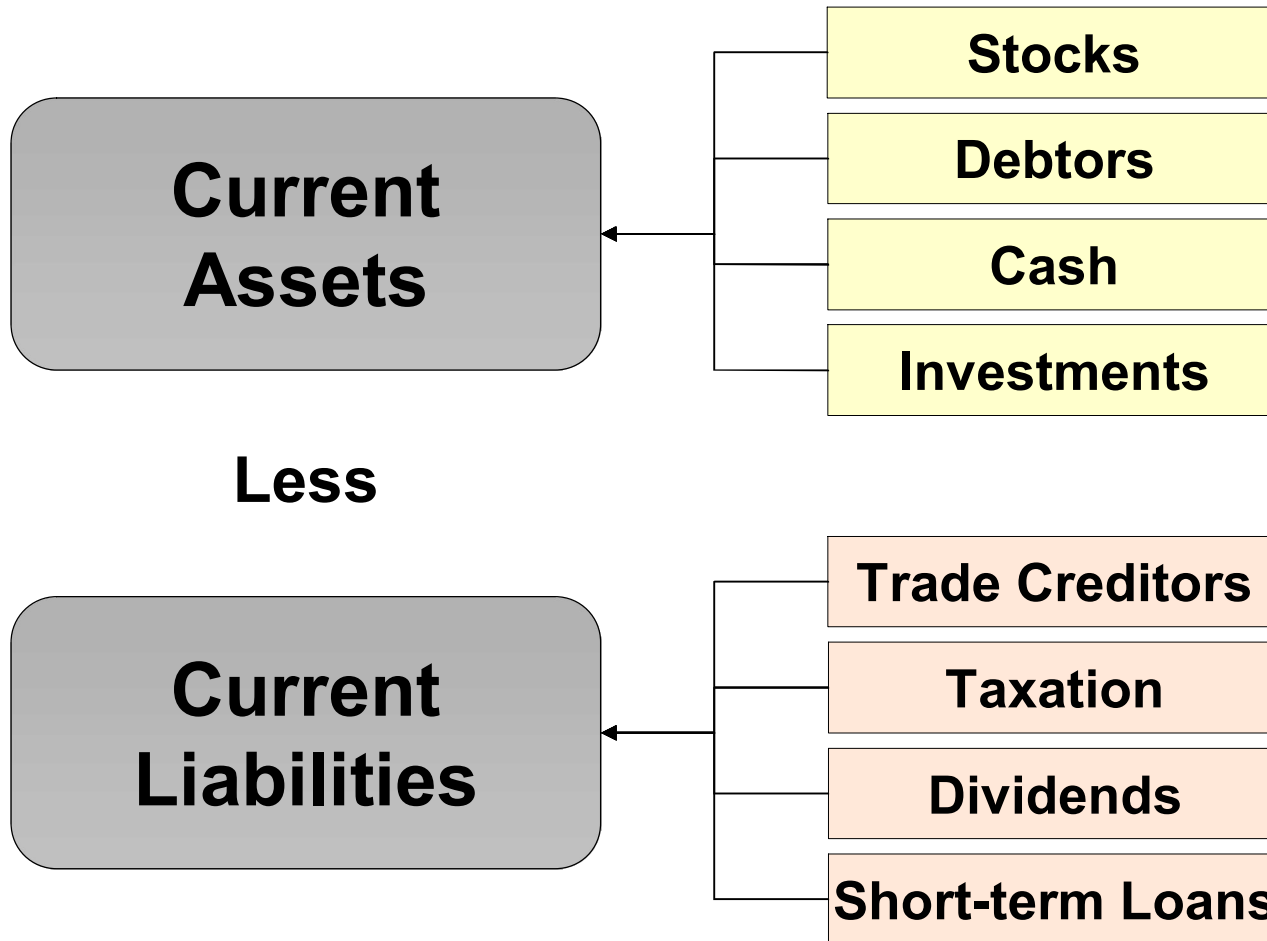
Assets of the business held in cash form (e.g. at the bank) or that that can quickly be turned into cash

Less

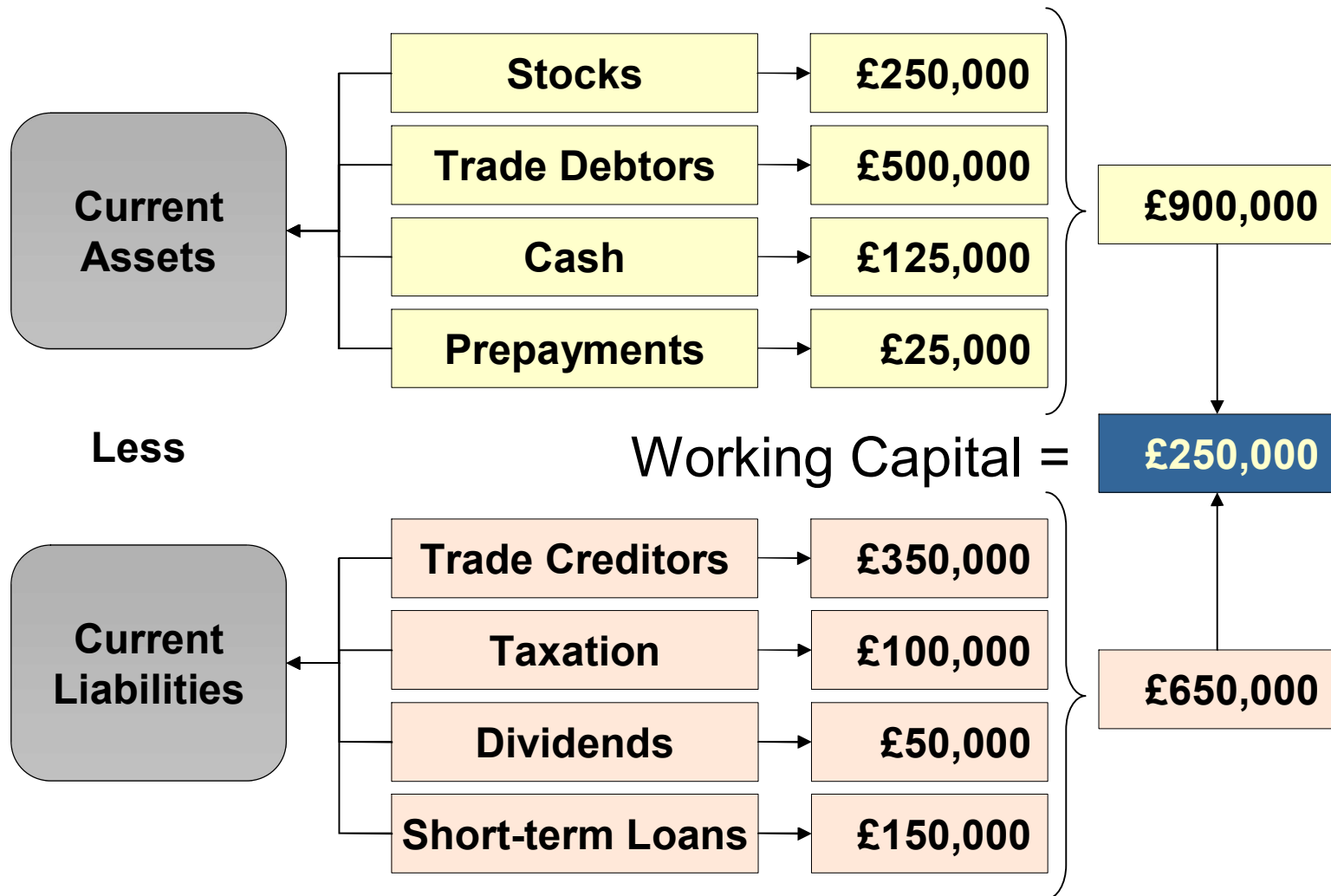
**Current
Liabilities**

Money owed by a business which will need to be paid in the next 12 months

Definition of Working Capital



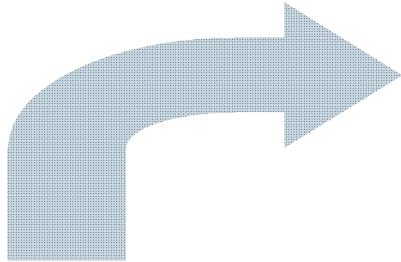
Calculating Working Capital - Example



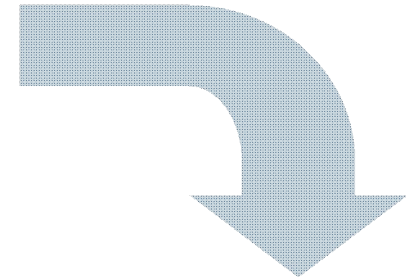
The Working Capital Cycle

- **Not all businesses have the same need to invest in working capital**
- **Much depends on**
 - (1) The nature of the production process (i.e. what and how something is being produced), and
 - (2) The way in which the product is distributed to customers
- **The working capital cycle is:**
 - The period of time between the point at which cash is first spent on the production of a product and the final collection of cash from a customer

Working Capital Cycle - Illustrated

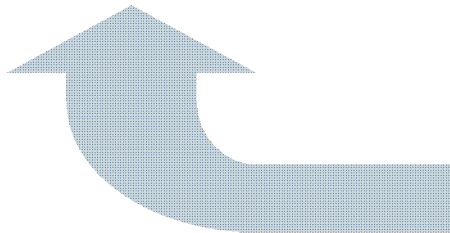


Raw Materials ordered from suppliers and put into stock awaiting production. Cash is used up to finance stocks (by paying the suppliers)

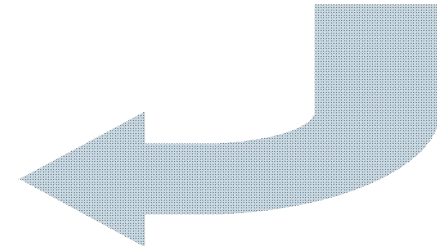


More cash is used to finance the production process – employ staff, run the factory and other support operations

Finally the product starts to generate cash – as customers pay the amounts they owe. Then the whole process starts again



More cash is used up to store finished products and distribute them to the intended markets. Trade customers are allowed to buy now and pay later – so debtors increase”



Working Capital Ratios (liquidity)

- **The “liquidity position” of a business refers to its ability to pay its debts – i.e. does it have enough cash to pay the bills?**
- **The balance sheet of a business provides a “snapshot” of the working capital position at a particular point in time**
- **There are two key ratios that can be calculated to provide a guide to the liquidity position of a business**
 - Current ratio
 - Acid test (“quick”) ratio

Current Ratio

Calculation
Formula

Current Assets

Current Liabilities

Example Calculation

	£'000
Stocks	1,125
Trade debtors	1,750
Cash balances	650
Current Assets	3,525
Trade Creditors	1,025
Other short-term liabilities	235
Current Liabilities	1,260

3,525

1,260

=

2.8

Acid Test (“Quick”) Ratio

Calculation
Formula

Current Assets (less Stocks)

Current Liabilities

Example Calculation

	£'000
Stocks	1,125
Trade debtors	1,750
Cash balances	650
Current Assets	3,525
Trade Creditors	1,025
Other short-term liabilities	235
Current Liabilities	1,260

2,400

1,260

=

1.9

Interpreting the Ratios

- **A business needs to have enough cash (or “cash to come”) to be able to pay its debts**
- **Obviously, a current ratio comfortably in excess of 1 should be expected – but what is comfortable depends on the kind of business**
- **Some businesses find it hard to turn stock and debtors into cash – so need a high current ratio**
- **Some businesses (e.g. supermarkets) turn stock into cash very rapidly and have low debtors – so they can happily exist with a current ratio of less than 1**
- **The acid test ratio is often considered to be a better test of liquidity for businesses with a low stock turnover**

Limitations of Liquidity Ratios

- **Liquidity ratios should be used with care**
- **Balance sheet values at a particular moment in time may not be typical**
- **Balances used for a seasonal business will not represent average values**
- **Ratios can be subject to “window dressing” or manipulation (e.g. a big push to get customers to pay outstanding balances by the year-end)**
- **Ratios concern the past (historic) not the future**
- **Working capital management is very much about ensuring the business has sufficient cash in the future**

Danger of Overtrading

Overtrading happens when a business tries to do **too much, too quickly** with **too little** long-term **capital**

Warning: a profitable business can fail if it runs out of cash

Overtrading - Introduction

- **Overtrading represents an imbalance between the orders a business accepts and the means it has to fulfill them**
- **Overtrading happens when a business takes on customer orders, but does not have enough current assets, or working capital, to meet these demands**
- **Overtrading is particularly common in young, rapidly expanding businesses. It can be extremely serious, even fatal to the business**

How does Overtrading Happen?

- **The length of the working capital cycle gets longer**
 - E.g. trade debtors start taking longer to pay their debts
 - E.g. stocks are ordered earlier and need to be paid for before they are sold
 - E.g. suppliers insist on being paid earlier
- **Business turnover/output increases**
 - E.g. more stock is required (raw materials, greater value of work in progress)
 - E.g. the value of trade debtors grows in line with higher sales

Symptoms of Overtrading

- **Rapid increase in sales/turnover**
- **Rapid increase in the value and volume of current assets (e.g. increase in stocks)**
- **Reduction in stock turnover and increase in average time taken by debtors to pay invoices**
- **Only a small increase in owner's capital – with most of the additional finance coming from higher trade creditors (borrowing from suppliers) and the bank**
- **Significant fall in key liquidity ratios (current ratio / quick ratio)**

Other Sources of Liquidity Problems

- **Internal causes**

- Poor management of operations (e.g. allowing too much stock to be bought and stockpiled)
- Production problems (e.g. equipment failure delaying the processing of raw materials into finished goods, or poor quality standards)
- Poor marketing decisions (e.g. allowing customers unsuitably long credit terms; failure of promotional campaigns leaving the business with unexpectedly high stocks)

- **External causes**

- Economic: e.g. unexpectedly lower demand due to falling customer confidence or change in exchange rates
- Financial failure: e.g. trade debtors going out of business leaving their debts unpaid

Ways to Improve Liquidity

Option	Pitfalls
Reduce the stock holding period for finished goods and raw materials	May result in production delays or shortages if demand increases unexpectedly
Improve the efficiency of the production process (e.g. shorten by using better production methods)	Costly to re-organise production – but may be worth it in the medium-term
Reduce the credit period offered to trade debtors and chase amounts due more aggressively	May upset customers – or cause them to reduce the amount they buy
Extend the time taken to pay creditors	A dangerous option – suppliers may refuse to supply or may charge interest if their payment terms are exceeded
Use invoice discounting or debt factoring to obtain cash from trade debtors	A good way to obtain cash quickly – but usually costly (e.g. factoring firm charges a high commission on debts paid)
Sale and leaseback of assets	Another good way of releasing cash from fixed assets – but leaves the business with higher costs and payment obligations

Key Terms

Working capital	Funds required by the business to pay for the day-to-day operation of the business
Working capital cycle	The period of time between the point at which cash is first spent on the production of a product and the final collection of cash from a customer
Current assets	Assets of the business held in cash form (e.g. at the bank) or that that can quickly be turned into cash
Current liabilities	Money owed by a business which will need to be paid in the next 12 months
Liquidity	The ability of a business to pay what it owes – as those amounts become due. A business that does not have enough cash is described as “illiquid”
Current ratio	Measure of liquidity based on data from the balance sheet. Calculated as current assets divided by current liabilities
Acid test ratio	Another liquidity ratio – better suited to assess businesses that have a low stock turnover
Overtrading	When a business takes on too many obligations without having the finance to pay for them