

Making Your Working Capital Work

By
Terry H. Hill

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The more rapidly that your business expands, the greater the need for working capital becomes. If you have insufficient working capital – the money necessary to keep your business functioning – your enterprise is doomed to fail. Many businesses, that are profitable on-paper, are forced to "close their doors" due to their inability to meet short-term debts when they come due. However, by implementing sound working capital management strategies, your enterprise can flourish; in other words, your assets are working for you!

At one time or another, most businesses have the need to borrow money in order to finance their growth. The ability to obtain a loan is based on the credit worthiness of a business. The two major factors that determine credit worthiness are the existence and extent of collateral and the liquidity of the business. Your company's balance sheet is used to assess both of these factors. On your balance sheet, working capital represents the difference between current assets and current liabilities – the capital that you currently have to finance operations. That number, plus your key working capital ratios, indicates to your creditors your ability to pay your bills.

By definition, working capital is a company's investment in current assets – cash, marketable securities, accounts receivable, and inventory. The difference between a company's current assets and current liabilities is known as *net working capital*. Current liabilities include accounts payable, accrued expenses, and the near-term portion of loan or lease payments due. The term "current" is generally defined as those assets or liabilities that will be liquidated within the course of one business cycle, typically a year.

Decisions relating to working capital and short term financing are referred to as *Working Capital Management*. These decisions involve managing the relationship between a company's short-term assets and its short-term liabilities. The goal of *Working Capital Management* is to ensure that your company is able to continue its operations and that it has sufficient cash flow to satisfy both maturing short-term debt and upcoming operational expenses.

The true test of a company's ability to manage its financial affairs rests on how well it manages its conversion of assets into cash that will ultimately pay the bills. The ease with which your company converts its current assets (accounts receivable and inventory) into cash in order to meet its current obligation is called, "liquidity." Relative liquidity is calculated in terms of a ratio---a ratio of current assets to current liabilities. The rate at which accounts receivable and inventory are converted into cash affect liquidity. All other things being equal, a business that has a higher ratio of current assets to current liabilities is more liquid than a company with a lower ratio.

Most business activities affect working capital either by consuming working capital or by generating it. A company's cash passes through a series of stages in the working capital cycle. The working capital cycle begins by converting cash into raw material, then converting raw material into product, converting product into sales, converting sales into accounts receivable, and finally converting accounts receivable back into cash.

The primary objective of Working Capital Management is to minimize the length of time that takes for money to pass through the working capital cycle. Obviously, the longer it takes a company to convert its inventory into accounts receivable, and then, convert their receivables into cash, the greater the cash flow

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difficulties. Conversely, the shorter a company's working capital cycle, the faster cash and profits are realized from credit sales.

Proper cash flow forecasting is essential to successful Working Capital Management. In order to understand the magnitude and timing of cash flows, plotting cash movement with the use of cash flow forecasts, is critical. A cash flow forecast provides you with a clearer picture of your cash sources and their expected date of arrival. Identifying these two factors will help you to determine "what" you will spend the cash on, and "when" you will need to spend it.

The management of working capital includes managing cash, inventories, accounts receivable, accounts payable, and short-term financing. Since the following five working capital processes are interrelated, decisions made within each one of the disciplines can impact the other processes, and ultimately affect your company's overall financial performance.

- **Cash Management:** Cash Management is the efficient management of cash in a business for the purpose of putting cash to work more quickly and to keep the cash in applications that produce income. The use of banking services, lockboxes and sweep accounts, provide both the rapid credit of funds received, as well as, interest income generated on deposited funds. The lockbox service includes collecting, sorting, totaling, and recording customers' payments while processing and making the necessary bank deposits. A sweep account is a prearranged, automatic "sweep" – by the bank - of funds from your checking account into a high interest-bearing account.
- **Inventory Management:** Inventory Management is the process of acquiring and maintaining a proper assortment of inventory while controlling the costs associated with ordering, storing, shipping, and handling. The use of an Economic Order Quantity (EOQ) system and the Just-In-Time (JIT) inventory system provides uninterrupted production, sales, and/or customer-service levels at the minimum cost. The EOQ is an inventory system that indicates quantities to be ordered - which reflects customer demand - and minimizes total ordering and holding costs. EOQ inventory system employs the use of sales forecasts and historical customer sales volume reports. The JIT inventory system relies on suppliers to ship product for just-in-time arrival of raw material to the manufacturing floor. The JIT system reduces the amount of storage space required and lowers the dollar level of inventories.
- **Accounts Receivable Management:** Accounts Receivables Management enables you, the business owner, to intelligently and efficiently manage your entire credit and collection process. Greater insight into a customer's financial strength, credit history, and trends in payment patterns is paramount in reducing your exposure to bad debt. While a Comprehensive Collection Process (CCP) greatly improves your cash flow, strengthens penetration into new markets, and develops a broader customer base, CCP depends on your ability to quickly and easily make well-informed credit decisions that establish appropriate lines of credit. Your ability to quickly convert your accounts receivable into cash is possible if you execute well-defined collection strategies.
- **Accounts Payable Management:** Accounts Payable Management (APM) is not simply, "paying the bills." The APM is a system/process that monitors, controls, and optimizes the money that a company spends. Whether or not it is money that is spent on goods or services for direct input, such as raw materials

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that are used in the manufacturing of products, or money spent on indirect materials, as in office supplies or miscellaneous expenses that are not a direct factor in the finished product, the objective is to have a management system in place that not only saves you money, but also controls costs.

- **Short-Term Financing:** Short-Term Financing is the process of securing funds for a business for a short period, usually less than one year. The primary sources of short-term financing are trade credit between companies, loans from commercial banks or finance companies, factoring of accounts receivable and business credit cards.

Trade credit is a spontaneous source of financing in that it arises from ordinary business transactions. In a prearranged agreement, suppliers ship goods or provide services to their customers, who in turn, pay their suppliers at a later date.

It is a wise investment of your effort/time to prearrange and to establish a revolving line of credit with a commercial bank or finance company. In the event that a need to borrow cash should arise, the funds would then be readily available. By arranging a line of credit prior to the capital (cash) need, your company will not experience sales or production interruptions due to cash shortages.

Factoring is short-term financing that is obtained by selling or transferring your Accounts Receivable to a third party - at a discount - in exchange for immediate cash. The percentage discount depends upon the age of the receivables, how complex the collection process will be, and how collectible they are.

A business credit card is quick and easy and eliminates funds approval. Using your business credit card will also protect you from losses if, perhaps, you receive damaged goods or fail to receive merchandise that you have already paid for. Depending on the type of credit card that you choose for your business, you can earn bonuses, frequent flyer miles, and cash back. However, keep a close watch on your spending and pay most, if not all, of your debt each month.

In order to effectively manage working capital, it is prudent to measure your progress and control your processes. A good rule of thumb is- - ***If you cannot measure it, you cannot control it.*** The five working-capital ratios that help you assess and measure your progress are:

1. **Inventory Turnover Ratio (ITR):** $ITR = \text{Cost of Goods Sold} / \text{Average Value of Inventory}$.
The ITR indicates how quickly you are turning over inventory. This ratio should be compared to averages within your industry. A low turnover ratio implies poor sales, and therefore, excess inventory. A high ratio implies either strong sales or ineffective buying.
2. **Receivables Turnover Ratio (RTR):** $RTR = \text{Net Credit Sales} / \text{Receivables}$.
The RTR indicates how quickly your customers are returning payments for products/services rendered. A high ratio implies that either a company operates on a cash basis or that its extension of credit and collection of accounts receivable is efficient. A low ratio implies that the company should re-assess its credit policies in order to ensure the timely collection of imparted credit that is not earning interest for the firm.

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- 3. Payables Turnover Ratio (PTR):** $PTR = \text{Cost of Sales} / \text{Payables}$.
Calculate this ratio to determine how quickly you are paying your vendors. If you are consistently beating the industry norm, then you may have developed leverage which will facilitate in negotiating discounts or other favorable terms.
- 4. Current Ratio (CR):** $CR = \text{Total Current Assets} / \text{Total Current Liabilities}$.
The CR is used primarily to determine a company's ability to pay back its short-term liabilities (debt and payables) with its short-term assets (cash, inventory, accounts receivable). The higher the current ratio, the more capable the company is of paying its obligations.
- 5. Quick Ratio (QR):** $QR = (\text{Total Current Assets} - \text{Inventory}) / \text{Total Current Liabilities}$
Also known as the "acid test ratio," the QR predicts your immediate liquidity more accurately than the current ratio because it takes into account the time needed to convert inventory to cash. The higher the QR, the more liquid the company is.

Working Capital Management is critically important for small businesses because a large portion of their debt is in short-term liabilities versus long-term liabilities. Small business may minimize its investment in fixed assets by renting or leasing plant and equipment. However, there is no way of avoiding an investment in accounts receivable and inventory. Therefore, current assets are particularly significant for the owner of a small business. By effectively shortening the working capital cycle, you become less dependent on outside financing. In other words, your working capital is truly working for you.

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