Working Capital

Working capital represents the ability of a business to pay its way. These thoughts from a Director of Williams & Glyn's Bank suggest ways in which it can be most effectively utilised.

The life blood of any business, whatever its size, is working capital. Manage it effectively, and you head for success. Mismanage it, and you head for grief.

In round terms, working capital represents your ability to pay your way. Putting it formally, it consists of the assets of a circulating nature employed in your business, essentially for current use. These can be tabulated as follows:

Current Liabilities	£
Creditors (amounts you owe to your suppliers)	000
Bank overdraft	000
Amounts due to Inland Revenue	000
	000

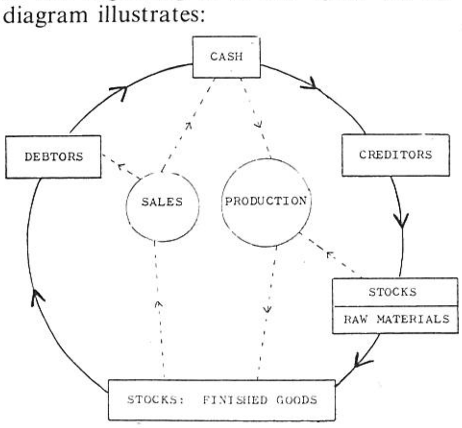
Current Assets	£
Cash in hand	000
Cash in the Bank (credit balances)	000
Stocks of raw materials	000
Stock of work-in-progress items	000
Stocks of finished goods	000
Debtors (amounts owed to you)	000
	000

The difference between all your current assets and your current liabilities is your working capital. You may wish to work out what the working capital of your business is by taking the appropriate figures from your last balance sheet.

The key to understanding working capital is to appreciate its cyclical nature, and its link with the pattern of trading. You start your business with an amount of cash in hand—your own capital, perhaps, may be supplemented by loans from your friends and from your bank. You use some of this cash to buy stocks, and these would also appear on your balance sheet; as will creditors too, to the extent that the stocks have not been paid for.

You then have to produce the goods that you're in business to sell, and you'll either receive cash or give credit for these; in the latter case, debtors will have been created on your balance sheet.

Eventually, they pay you, which boosts your cash balance, and you are back to cash at the beginning of a new cycle—as our diagram illustrates:



The length of time taken to convert the initial cash or capital into goods and then into cash again is the length of your working capital cycle—and you must know this if you are to manage your working capital. You should note that the working capital cycle is much longer than the time taken for your production and sales and one of your aims should be to reduce the length of this cycle to the very minimum.

Obviously the length of the cycle varies from business to business. A taxi firm, for example, has a relatively short working capital cycle, while a firm operating process plant has a relatively extended one. One business's cycle may be measured in weeks, while another's may be measured in years.

As your business expands, you will find that your cycles overlap, which will give you a smoother flow of working capital. Nevertheless, you will appreciate that at particular times you are more likely to have liquid funds than at other times, just as occasionally you will be subject to a shortfall.

Whatever the length of cycle that is appropriate to your kind of enterprise, the rule is always that the faster the turn round of working capital, the greater the profitability, the reason for this being that you have to pay for less funds and for shorter periods your assets are used more efficiently, and your turnover is greater.

Achieving the fastest possible turn round depends on good management of your working capital. Managing your working capital effectively depends on detailed planning, in such a way that your purchasing, stocks and sales are always known; and planning in turn is finally dependent on knowing the length of your working capital cycle, and the troughs and peaks that you will encounter during this cycle. The whole purpose of planning is to ensure that your working capital is at the right level to pay your creditors at all times, and ensure that they do not force you into liquidation.

The amount of working capital that you will need is determined by several factors, and it is not possible to be dogmatic. There are certain ratios which will be useful in ascertaining your requirement, but these must be considered in the light of the conduct and state of your business.

The three ratios with which you are concerned for this purpose are:

—your current ratio, i.e. $\dfrac{\text{current assets}}{\text{current liabilities}}$

This needs to be of the order of 2 to 1.

—your liquid ratio, i.e. liquid assets $\dfrac{\text{(cash or near cash items)}}{\text{current liabilities}}$

This needs to be of the order of 1 to 1, so that you are always able to meet the demands of your creditors.

—your working capital ratio, i.e.

$$\frac{\text{current assets—current liabilities}}{\text{sales}}$$

This is a ratio which, when you have established what it should ideally be, you will want to keep constant in times of expanding sales. An increase in business must involve an increase in working capital.

You may wish to work out these ratios for your business.

Of course nothing stands still in business, and your working capital requirement will be affected by your business policies. Sales, production and cash inevitably interact, and a decision in one area will be directly reflected in the others. If you increase sales, for example, then there must either be an increase in production, or a reduction in stocks. If you plan to increase production, there will probably be an increase in stocks of raw materials; and higher wages and operating costs should be reflected in your cash budget. Any change in the conduct of your business will affect your working capital ratio, and you will see the consequent adjustments that need to be made if your working capital is to be kept at the right level: hence the vital need to plan each step most carefully.

One cannot over-emphasise the importance of planning, if you are to control your business and get in the working capital that is to be used again for further trading. Ideally, you will be working to a planned working capital budget, prepared by considering your cash, purchasing and production, and sales budgets.

Let us therefore look in more detail at each of the three items which make up your current assets: cash, stocks and debtors.

Cash follows the normal pattern of life, with surpluses at some times and shortages at others. There are two things that you want to do. One is to smooth the pattern, and the other to reduce the amount of ready cash that you hold—because the more liquid an asset is, the less profitable it is likely to be (money invested in your business or in the money market, for example, is earning more for you than money lying idle in your tills).

To manage cash efficiently, then, we come immediately back to planning, with the need to make a cash forecast for this purpose identifying all the cash coming in and going out over a given period. You can get a useful form which has been designed to help you to do just this from any branch of Williams & Glyn's Bank.

The cash flow forecast will show up the time lag in settlements from your debtors, together with the cost of funding them. You will probably consider it a good idea to discuss the completed forecast with your bank manager, since his facilities will play an important role in realising your plans, especially in overcoming temporary cash shortages, and it is always advisable to have forewarned him of these.

Equally, your bank manager can be of assistance in placing cash which is temporarily surplus to your requirements in the money market, for terms which range from "call" or overnight, to several months—rates of interest being competitive, and of course growing larger with the period of the deposit. This market exists just as much for the smaller firm as for the giants of business.

Where a shortfall is expected, there are several ways of planning to meet it, and it should be borne in mind that financing your working capital by long term funds—through loans or shareholders' funds—is more expensive than short-term financing. Means to be considered, then, would first include an overdraft facility, which had been previously agreed with the bank; trade credit, i.e. deferring payment to your suppliers for as long as they are prepared to accept; tighter control of your debtors, i.e. cutting the period of credit given; factoring, or discounting bills of exchange, to obtain advance payment of the bulk of the money owed to you by your customers; and leasing, or hire purchase, to avoid spending cash resources in order to equip your business.

There are formulae, too, to help you measure the efficiency with which you are balancing your cash flow. You can take your cash as a ratio of current assets and compare this with your competitors' performances—a ratio which should be as low as conditions will justify. You can relate sales to your average cash balance, to see the number of times that the cash is being turned over; and the more the average cash balance is utilised, the greater will be its productivity.

The next asset to be considered is stock.

Here, the first point to bear in mind is the very heavy cost involved in carrying and ordering stock—a fact that is not often fully realised: research has shown that it may be as high as 25 per cent of the total stock value. This gives a clear incentive towards efficient stock control in itself, while, on a more visible level, the dangers of excessive holding of slow-moving stocks, or excessively diverse stocks, or disproportionate holding of stocks, can make themselves all too easily felt—as can the under-stocking of fast-moving items, which may lead to delivery dates not being met.

Information on stock levels and stock movements (which implies controlling the size of your inventories) is therefore another important element in your planning to turn round working capital, with the whole purpose being to keep stocks at the lowest possible level consistent with maintaining your production and sales plans.

In assessing the efficiency of your stock control, there are again useful comparisons that you can make; of sale against average stock value and, more relevantly, of the cost of sales against average stock. The quicker the rate of turnover of stock, obviously the greater is the profitability. You will find it useful to maintain a record of the age of your stocks, and also to analyse the age of stock against sales, to identify slow-moving or obsolete stocks.

There are a number of systems available to you to help you to arrive at economic stock levels. Economic ordering quantities can be calculated to keep the cost of ordering goods and holding the balance to a minimum—although this may conflict with the benefits of trade discounts, and here as always a management decision is called for. Also, minimum re-order levels for each stock item can be established. This is the level at which stock should be re-ordered, calculated to ensure that with normal stock usage and normal delivery periods new stocks will be received before the remaining stock is exhausted.

The third asset to consider is your debtors. As soon as you have supplied them, they are, of course, living off your cash until they pay you. Having established the balance between demand from your customers and the cost of extending them credit, it is important to set firm dates for the payment of your invoices, and it may also be helpful to offer incentives, by way of discount, for quick payment. However, if you are considering this, bear in mind that because the incentive has to be attractive to your customer, it will be correspondingly expensive to you.

The bigger and more important to you is your customer, the less constrained he may feel to make payment when you would like it. Nevertheless, it is good planning to establish a schedule which regularly shows you the age of your debtors, and to look at this on a regular basis to see that no significant variations are taking place. Within every firm some particular person (if necessary, the proprietor) should have the responsibility for credit control (establishing references etc.) and credit management (reviewing the age of all outstanding invoices, and chasing the debts); or, if you prefer to delegate the responsibility, in order to devote time to other aspects of your business, you may find it helpful to have a talk with Williams & Glyn's about the possibility of using factoring services.

If you want to use a formula to help you to compare your debtor position against what you are planning for, you can divide your debtors by your annual sales and multiply the result by 365. This will give you the number of days credit that you are actually extending to your debtors. Comparison with your competitors' ratios will tell you whether this is generally acceptable in your line of business.

Finally, we come to your current liabilities, as yet another aspect of your working capital. Working capital is influenced by the amount of credit that your suppliers will give you, and it is wise to take advantage of this, although also bearing in mind that it is a narrow path to tread.

You will normally be well-advised to take advantage of your suppliers' discounts for prompt payment. As we have said, they must be pitched at an attractive rate, compared with the cost of money to you, so it may be worthwhile even to go to overdraft to do it.

Short-term liability always costs less than medium or long term credit, and the greater the proportion of your current liabilities to your total liabilities, the greater is the profitability of your business—provided, of course, the current liabilities do not exceed current assets and the other working capital ratios are maintained.

A formula which you may find useful to see how much credit you are taking from your suppliers is to divide your creditors by your annual purchases and multiply by 365. This will give you in days the exact period of credit you are actually taking. Compare this with the period of credit you are giving to your customers; if the credit you are taking is longer than that which you are giving, the more profitable your business is likely to be.

So, with cash, stocks, debtors and creditors, we have looked at all that goes to make up the working capital required in the course of your trading and have suggested ways which may help you to manage this more efficiently. Useful as they are, however, these are at best techniques: the essential requirements for good management are sound information and detailed planning.

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