

For any further information regarding this article please contact Michael Norrish on 0408 914 051

UNDERSTANDING WORKING CAPITAL REQUIREMENTS

In simple terms working capital requirements is the amount of funds required by the business to meet its short term obligations. i.e. in the next twelve months.

Working Capital and Cashflow are often confused with each other. Cashflow is the amount of funds available in the business to meet its future obligations.

The key words above are “required” and “available”. The difference between the two can be vast and cause funding headaches if not properly managed and considered.

Working capital requirement is affected by the management of several factors in a business. These are: -

- Stock
- Work in Progress
- Outstanding debtor (customer) amounts, and;
- Outstanding Creditor (supplier) amounts

So how do you calculate “Working Capital Requirement? Here’s a formula that explains how to do so.

Working Capital % equals Outstanding Debtors plus (Work in Progress or Stock) minus Outstanding Creditors) divided by Revenue multiplied by 100

Here is an example where a business has the following: -

- Debtors of \$150,000
- Work in Progress of \$300,000
- Outstanding Creditors of \$100,000
- Revenue of \$1,000,000

The calculation of working capital requirement would be: -

$$(\$150,000 + \$300,000 - \$100,000)/\$1,000,000 \times 100 = 35.00\%$$

This means that for every sale of one hundred dollars in this business \$35.00 is required to fund the sale. i.e. to allow for the time: -

- Customers are taking to pay
- Work is in progress prior to invoicing; and
- The business is taking to pay its suppliers

Minimising Capital Requirements

The way to minimise working capital requirement is: -

- **Stock** – aim to minimise the length of time it sits on the shelf sucking up cash
- **Work in Progress** – aim to minimise the length of time jobs are in progress prior to invoicing or arrange to invoice a job progressively
- **Outstanding customer payments** – aim to minimise the length of time customers take to pay.
- **Outstanding supplier payments** – aim to maximise the length of time available to pay suppliers.

To meet these objectives you need systems and processes in place to constantly manage these factors and minimise working capital requirement.

Some people ask if they sell more, will that provide the working capital? A common fallacy is that if a business sells more, working capital will take care of itself.

A problem arises when the abovementioned factors are not managed and the cash gets tied up in stock, work in progress, customers and suppliers etc. You can then have difficulty paying costs such as wages, superannuation and meeting other overheads.

There have been many examples where a business was purchased for what seemed like a good price, and the issue of working capital was completely ignored.

The purchaser gets a rude shock when the extra business doesn't equate to more cash in the bank. The moral here is to think very carefully before you take on extra business or buy a competitor. Consider the extra working capital required to fund that business before taking it on.

A common trap SME's fall into is focussing on profit without considering working capital. High working capital requirement will bring a business undone far quicker than low profit margins.

Understanding the **Working Capital or Current Ratio** is also very handy. That can be easily ascertained by using the following method: -

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

That is, Current Assets divided by Current Liabilities. Obviously, these figures are obtained from your Balance Sheet.

This will produce a ratio and the rule of thumb I use is that a ratio of somewhere between 1.5 – 2.0:1.0 is considered acceptable. That means for every Current Liability you have it is covered by up to twice as many Current Assets and demonstrates a most satisfactory position in the majority of cases.

A more stringent indicator is the "**Acid Test Ratio**" which that determines whether a firm has enough short-term assets to cover its immediate liabilities without selling inventory. The acid-test ratio is far more strenuous than the working capital ratio, primarily because the working capital ratio allows for the inclusion of inventory assets.

To calculate an "acid test ratio" the methodology is: -

$$\frac{\text{Cash plus Accounts Receivable plus Short Term Investments}}{\text{divided by Current Liabilities}}$$