Working Capital

Meaning

The funds invested in current assets are termed as working capital. It is the fund that is needed to run the day-to-day operations. It circulates in the business like the blood circulates in a living body. Generally, working capital refers to the current assets of a company that are changed from one form to another in the ordinary course of business, i.e. from cash to inventory, inventory to work in progress (WIP), WIP to finished goods, finished goods to receivables and from receivables to cash.

There are two concepts in respect of working capital:

1. **Gross Working Capital:** It refers to the firm's investment in all the current assets. It is based on the following premises:

    - With every increase in funds, the gross working capital will increase.

    - The management is more concerned with total current assets as they constitute the total funds available for operating purpose than with the sources from which the funds came.

Example: The ABC limited has a cash balance of Rs. 10,000, debtors of Rs. 50,000, inventory of raw material Rs. 1, 00,000 and inventory of finished goods Rs. 2, 00,000 then gross working capital of ABC limited will be Rs. 3, 60,000.

2. **Net Working Capital:** It refers to the amount of current assets that exceeds current liabilities. It is the amount of current assets financed by long-term liabilities. It is based on the following premises:

    - In the long run what matters is the surplus of current assets over current liabilities.

    - The creditors and investor use this concept to judge the financial soundness of the enterprise.

    - To meet the contingencies one has to rely upon the excess of current assets over current liabilities.

    - It helps to find out the correct financial position of companies.

    Net Working Capital = Current Assets - Current Liabilities

Nature of Working Capital

a) It is used for purchase of raw materials, payment of wages and expenses.

b) It changes form constantly to keep the wheels of business moving.

c) Working capital enhances liquidity, solvency, creditworthiness and reputation of the enterprise.

d) It generates the elements of cost namely: Materials, wages and expenses.

e) It enables the enterprise to avail the cash discount facilities offered by its suppliers.

f) It helps improve the morale of business executives and their efficiency reaches at the highest climax.

g) It facilitates expansion programmes of the enterprise and helps in maintaining operational efficiency of fixed assets.

Planning of Working Capital

1. Assess future funding requirements for running the business

Begin by evaluating the company's short-term funding needs (e.g., meeting payroll and paying suppliers, utilities, rent and taxes). The timing of when these payments are due may not correspond to cash inflows from customers, so you must have a strong understanding of cash requirements in order to meet company obligations.

Companies also need to address long-term funding needs. For example, purchasing buildings or plants and upgrading manufacturing facilities requires capital, which is typically financed. Treasury professionals must secure the requisite funding well before the company finalizes plans to execute a large capital project.

2. Calculate the working capital you will need given various growth scenarios

Conduct a "scenario analysis" to determine if current working capital strategies will support various rates of growth.

First, a business should consider the economy, its industry and marketplace competition to establish a realistic expectation of available growth opportunities. For example, what would happen to your balance sheet if outstanding trade payables grew by 5%? Could you still make payroll?

Next, perform a shock analysis by running the numbers at growth rates well above or below the expected rates in the scenario analysis. This will help with contingency planning.

In addition to revenue growth, assess margins and overhead expenses at various growth levels.

3. Evaluate your current access to working capital and consider diversification

Companies should review their current access to various funding sources, such as working capital lines of credit, cash and investment accounts, accounts receivable and inventory. Make sure those sources are adequate to meet your strategic objectives.

As a best practice, middle-market and larger organizations (those with $100 million or more in annual revenue) may want to consider holding cash and investments in at least two separate institutions. This diversified approach is suggested because in a depressed economy lending tightens up and businesses may lose their access to credit.

4. Review payables and receivables processes and strive to maximize working capital

There are several strategies and processes companies can employ to maximize working capital.

On the accounts receivable side, they can offer direct debit through the Automated Clearing House (ACH) network to customers so payments arrive automatically on a predetermined schedule. This approach is useful for companies selling services that call for regularly scheduled payments, such as utilities and real estate firms. Electronic bill payment can help expedite cash flow by providing consumers electronic options to make bill payment through the Internet, an agent, or interactive voice response while retaining control of when payments are made.

On the accounts payable side, companies can use controlled disbursement accounts to learn early each morning which checks they've issued will hit their account that day. They can also use integrated payables solutions or the ACH network to pay suppliers in their preferred method and in a timely manner without worrying about how fast the postal service will deliver a check.

5. As you grow, don't use up cash; rather, use borrowing or credit facilities

Cash-rich businesses shouldn't automatically tap that cash when it comes time to grow. One reason for this is that a positive cash position will improve a company's access to capital. Additionally, being in a favorable liquidity position reduces the company's cost of capital. So, as the economy improves and investment returns become favorable, it will likely be cheaper for companies to borrow at existing interest rates rather than to dip into corporate cash.

6. Test and update the working capital plan

Formal working capital plans should be updated annually, supplemented by a quarterly or monthly examination of financial results to see if adjustments are necessary. Consider, for example, whether the company's cash forecast or financial drivers have changed dramatically (i.e., the company has downsized or either merged with or acquired another business). As part of this process, companies should periodically assess the current state of the economy and test their access to lines of credit.