

What is working capital?

[Government](#), [Capitalism](#)



Introduction

What is working capital?

Working capital represents a net investment in short-term assets. These assets are continually flowing into and out the business and are essential for day-to-day operations. The various elements of working capital are interrelated and can be seen as part of a short-term cycle (McLaney and Atrill, 2010)

To put this another way, working capital is to a company what water is to a plant. If the plant does not have enough water, it will not grow. Eventually, it will wither and die. If the plant receives too much water, it will drown. Just as plants need the right amount of water in order to grow, companies need the right amount of working capital to achieve desired levels of profitability and liquidity. (Cunningham, Nikolai And Bazley, 2004)

Working capital management

The control and management of working capital directly influences an organization's ability to survive. To illustrate this, consider the fact that many organisations that go out of business are profitable. The reason they can no longer function is that that they have run out of cash; if they cannot pay their creditors on time they are not going to receive any further supplies on credit terms. If they cannot get their supplies, they cannot produce their goods and services; if they cannot do this, they have nothing to sell. If they have nothing to sell, their cash position will deteriorate rapidly and everything will soon grind to a halt (Proctor, 2009)

It is to the firm's advantage to keep the investment in working capital to a minimum but at the same time invest sufficiently in current assets to be able to carry out day-to-day trading activities efficiently. This balance between the cost and the level of working capital must be carefully managed. (Berry and Jarvis, 2006)

Keeping the right amount of working capital requires careful planning and monitoring. So, a company may have excess cash sitting idly in its checking account, or it may need additional short-term financing. (Cunningham, Nikolai And Bazley, 2004)

Working capital cycle

In working capital cycle cash operates as a fuel, circulating the business to work with the flow.

The working capital cycle is utilized to determine the time from any investment outlay or investment in current assets to the inflow of cash derived from the investment. (Berry and Jarvis, 2006)

An example of working capital cycle can be depicted as shown

Cash is used to pay trade payables for raw materials, or raw materials are bought for immediate cash settlement. Cash is also spent on labour and other items that turn raw materials into work in progress and, finally, into finished goods. The finished goods are sold to customers either for cash or on credit. In the case of credit customers, there will be a delay before the cash is received from the sales. Receipt of cash completes the cycle.

(McLaney and Atrill, 2010)

The following information related to Upholland Ltd's financial account at the end of 31st May 2011.

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Turnover 1, 000, 000

Gross Profit 80, 000

Debtors 100, 000

Creditors 150, 000

Capital Employed 600, 000

Opening Stock 60, 000

Closing Stock 80, 000

Cash Balance (CR) 20, 000

In order to analyse the company's present performance and suggest how it may improve it in the coming year it is necessary to calculate some working capital ratios.

Interpreting financial information can be identified by looking at main areas for investigation of accounting information. The use of ratio analysis in each of these areas is introduced below:

Profitability Ratio

Users of account will want to know how much profit a business has made, and then to compare it with previous periods or with other entities. The absolute level of accounting profit will not be of much help, because it needs to be related to the size of the entity and how much capital is has invested in it. (Dyson, 2006)

A.) Gross Profit Margin

The gross profit margin ratio relates the gross profit of the business to the sales revenue generated for the same period. Gross profit represents the difference between sales revenue and the cost of sales. The ratio is therefore a measure of profitability in buying (or producing) and selling goods before any other expenses are taken into account. As cost of sales represents a major expense for many businesses, a change in this ratio can have a significant effect on the 'bottom line'. (Atrill, 2006)

Gross profit ratio = $\frac{\text{Gross profit}}{\text{Sales revenue}} \times 100$

Turnover

= $\frac{80,000}{1,000,000} \times 100$

1,000,000

= 8%

B.) Return on Capital Employed (ROCE)

The return on capital employed is a fundamental measure of business performance. This ratio expresses the relationship between the net profit

generated during a period and the average long-term capital invested in the business during that period. (Atrill, 2006)

ROCE= $\frac{\text{Gross Profit} \times 100}{\text{Capital Employed}}$

Capital Employed

= $\frac{80,000}{600,000} \times 100$

600,000

= 13 %

Analysis and evaluation

It is obvious that the entity doesn't appear to be obtaining a decent level of profitability. Focusing on the very low gross profit margin ratio of 8%, it can be interpreted that the company has entered in a very competitive market, having low or decrease demand of products among customers. Besides, the 13% of ROCE ratios also shows the weak competitiveness against other fierce competitors. According to Dyson (2007). The ratio of 8% was probably caused by a reduction in the mark-up added the cost of goods sold. The company may have tried to reduce the margins in an attempt to maintain its sales. However, the plan was not highly successful as the turnover didn't adequately cover the decrease in the mark-up.

Even though it is unable to know the information of what kind of business the company operates, the company are not performing effectively over the period. However, the fact of a global downturn in the economy during the period should be taken into an account because the

external environment inevitably has significance impact to industries and this could have been the reason why the company earned a low proportion of its profits

Porter's Competitive Forces Model

In Porter's competitive forces model, the strategic position of the firm and its strategies are determined not only by competition with its traditional direct competitors but also by four forces in the industry's environment: new market entrants, substitute products, customers, and suppliers.

Liquidity Ratios

Liquidity ratios measure the extent to which assets can be turned into cash quickly. In other words, they try to assess how much cash the entity has available in the short term. (Dyson, 2007)

C.) Current Ratio

The current ratio measures the relative level of current assets compared with current liabilities. It indicates the extent to which all current liabilities are covered by all current assets. If the ratio is greater than 1: 1, the entity can meet all of its current liabilities out of current assets. Many companies operate with this ratio in the region from 1: 1 to 1. 5: 1 If the ratio is higher than this, the current liabilities are very safely covered. (Weetman, 2010)

Current Ratio = Current Assets

Current Liabilities

= Closing Stock + AR+ Cash

AP

$$= 80,000 + 100,000 + 20,000$$

150,000

$$= 1.33: 1$$

D.) Quick Asset Ratio

It may not be easy to dispose of stocks in the short term as they cannot always be quickly turned into cash. In any case, the entity would then be depriving itself of those very assets that enable it to make a trading profit. It seems sensible, therefore, to see what would happen to the current ratio if stocks were not included in the definition of current assets. (Dyson, 2007)

Quick Asset Ratio = Current Assets Excluding Stock

Current Liabilities

$$= AR + Cash$$

AP

$$= 100,000 + 20,000$$

150,000

$$= 0.8: 1$$

Analysis and evaluation

In comparison of the current and quick assets ratio, (Weetman, 2010) it indicates that the company possibly has possessed the excessive level of stock with a possible risk of out-dated inventory. According to the current ratio, the ratio is lower than the norm which means the firm doesn't have adequate liquid resources to deal with its immediate financial commitment. It is incurred because money are being tied up in the company considering a high proportion of stock in the current assets. Similarly, the quick assets ratio shows the firm's cash position is relatively risky, having insufficient cash to cover its debt and this may result in the inability to make payments for the current liabilities for next period. Overall, all of the information signify that the entity are in the vulnerable position of liquidity. .

Efficiency Ratio

E.) Debtor Ratio

A business will usually be concerned with how long it takes for customers to pay the amounts owing. The speed of payment can have significant effect on the business's cash flow. The average settlement period for debtors calculates how long, on average, credit customers take to pay the amounts that they owe to the business. (Atrill, 2006)

$$\text{Debtors Ratio} = \text{AR} \times 365$$

TURNOVER

$$= 100,000 \times 365$$

$$1,000,000$$

= 37 days

F.) Creditors Ratio

Creditors Ratio = AP x 365

PURCHASE

= 150,000 x 365

940,000

= 58 days

In some cases that purchase is not provided it can be calculated by the following equation:

Purchase = Turnover - Opening Stock

= 1,000,000 - 60,000

= 940,000

G.) Cash Conversion Cycle

Cash conversion cycle = Inventory Days + AR days - AP days

= 28 + 37 - 58

= 7 days

Calculate Inventory Days = Average Stock x 365

Cost of Sales

$$= 1 (\text{Opening} + \text{Closing Stock})$$

2 Cost of Sales

$$= 1 (60,000 + 80,000) = 70,000$$

2

$$= 70,000 \times 365$$

920,000

$$= 28 \text{ days}$$

Finding Cost of Sales = Turnover – Gross Profit

$$= 1,000,000 - 80,000$$

$$= 920,000$$

Analysis and evaluation

Judging at the ratio the trade debtor collection period is efficient, debtors are not slow at paying debt. Presumably, The firm is treated by debtors with consideration and those settlements are done quickly by debtors' every effort. Importantly, its number is less than the trade creditor period which is 58 days. This refers a sign of company's good credibility with its creditors (Dyson, 2007). Therefore, the company doesn't necessarily watch the trade debtor's position very carefully. Moreover, cash conversion of 7 days is beneficial as it indicate on average 7 days to convert current assets to cash. The efficiency in collecting and paying debt increase the chance that

the entity may not run into the problem of cash flow in the near future considering the company's unhealthy liquidity.

Summary

Based on the data provided the company apparently earn a small amount of profit due to the strong competition in the particular market. It is clearly exposed to the vulnerable liquidity position, having insufficient liquid resources to meet its current liabilities. There is likely that the firm may not be able to make payment in the next period. However, the core competency in managing its debtors and creditors collection period help reducing the risk of facing cash flow shortfalls.

Therefore, to enhance the company's performance, Davies and Boczko(2005) suggest in order to increase the gross profit apart from increasing selling prices but also lower costs of production, another approach is to deduct the overhead expenses of operating a business such as lower distribution costs and administrative expenses. In contrast, Dyson (2007) suggests customer might be encouraged to buy more by a combination of lower selling prices. Anyway, this approach will be effective if only the increase in turnover is sufficient.

To improve the level of liquidity the reduction in stock levels need to be implemented (Davies and Boczko)

In term of efficiency ratio the company can convert transactions into cash faster by setting policies that encourage early payment. Trade debtors might be encouraged to pay quicker by receiving generous credit terms. Similarly,

the company can take advantage of purchase discount available from its suppliers. (Dyson, 2007)

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