Working capital

Finance

The short term assets and liabilities of a company i. e. Current Assets and current liabilities are an important determinant of a company's operational performance. Hence a company should pay a lot of attention to managing its current assets and current liabilities in order to remain in the business in a profitable manner. Companies that successfully manage its working capital do not face liquidity issues and in turn can focus on other aspects of the business (Investopedia, 2013) . Positive working capital is imperative for a company to ensure that it sustains its operations. Working capital of a company is the difference between its current assets and its current liabilities (Watson & Head, 2013). Current assets of a company may include cash, inventory, accounts receivables and prepaid expenses while current liabilities include short term borrowings and accounts payable. Thus, working capital is an indicator of assessing the company's liquidity and higher the working capital of the company, greater the liquidity of the company. A company requires raw materials to produce the goods it wants to sell. When these raw materials of finished goods are produced, these are either converted into finished goods (for a manufacturer) or sold to customers (for retailers). If the sale is made on credit, the company does not receive any cash and an account receivable is created. The sale is complete when this account receivable is converted into cash. Working capital is the requirement of the company to purchase the raw materials until the raw materials are converted into cash. The number of days required to convert raw materials into cash is called a company's cash cycle and higher the company's cash cycle, higher is the company's working capital requirement. The working capital for Tesco group for the year ending February 2012 and February is 2013 is calculated below: 23 February 2013 ? m 25 February 2012 ? m

Current assets Inventories 3, 744 3, 598 Trade and other receivables 2, 525 2, 657 Loans and advances to customers 3, 094 2, 502 Derivative financial instruments 58 41 Current tax assets 10 7 Short-term investments 522 1, 243 Cash and cash equivalents 2, 512 2, 305 12, 465 12, 353 Assets of the disposal group and non-current assets classified as held for sale 631 510 Total Current Assets 13, 096 12, 863 Current liabilities Trade and other payables (11, 094) (11, 234) Financial liabilities: Borrowings (766) (1, 838) Derivative financial instruments and other liabilities (121) (128) Customer deposits and deposits by banks (6, 015) (5, 465) Current tax liabilities (519) (416) Provisions (188) (99) (18, 703) (19, 180) Liabilities of the disposal group classified as held for sale (282) (69) Working Capital (5, 889) (6, 386) As shown above, the working capital of Tesco group is negative which indicates that the company is facing liquidity issues. A very high trade payables is the major reason for the negative working capital. The current ratio is also an indicator of company's liquidity and is calculated by dividing current assets with current liabilities. The current ratio of the company increased from 0. 67 times in FY12 to 0. 69 times in FY13. However, still the current ratio is under 1 which is not a good sign for the company. This shows that the company is facing liquidity issues and this will not bode well for the company's profitability in the years ahead. Tesco will have to borrow from banks to fund its short term needs and improve its liquidity position. Tesco can improve its working capital by ensuring quick payments to its creditors. Currently, the company's creditors are on a very high side which indicates that Tesco delays the payments to its supplier. The business model is also such that the inventory is purchased on credit and the sales are made on cash. However, this cash is not reflected on the company's balance sheets which shows that the company has invested that excess cash elsewhere in noncurrent assets. But Tesco, the retail giant and largest super market chain in the UK, has negative working capital due to nature of its business. Since Tesco is such a large super market chain, it does not need to hold excess inventory. Moreover, the debtors of the company are also low since most of the sales are on cash which explains the low current assets of the company. The company buys its supplies on credit and pays back when the goods are sold which explains very high payables. Due to the nature of retailing business, we can conclude that Tesco's working capital is not that bad and the company is managing its working capital in an effective way. Hence it is important to understand the dynamics of an industry before assessing its working capital management policies. It is imperative that the company adopt working capital management policies that ensure that the company's working capital is managed effectively and efficiently. The goal of working capital management is to achieve the optimum level of working capital so that it is neither excessive nor too less as both can be harmful for the company. Works Cited Investopedia, 2013. Working Capital. [Online] Available at: http://www. investopedia. com/terms/w/workingcapital. asp [Accessed 12 November 2013]. Watson, D. & Head, A., 2013. Corporate Finance. 6th ed. Pearson.