

Bookkeeping Systems

Working Capital – Life Blood Of A Business

Report Prepared For:

[Client Name]

5 March 2010

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1. Working Capital Structure

- One of the most sensitive, and critical areas in the financial management of a business, is its working capital structure. Sensitive because the components in the structure are in a constant state of movement: critical because they move fairly fast and if they should move in the wrong direction, financial problems are sure to occur. Although these problems may be short term initially, they can develop into long-term problems and become serious. If not corrected they can cause business failure.
- The concept of working capital is not new. Economists have long recognised that in most business enterprises there is a group of assets that are constantly changing their form - moving through a cyclical movement from cash to cash. This group of assets and the concept of cyclical movement are quite relevant. The term most commonly used for the group of assets is 'current assets' and they form one side of the working capital ratio. The other side consists of 'current liabilities'.
- These two groups appear to be in a constant struggle with one another, the current assets striving to match the challenges and pressures of the current liabilities. If the challenges are successfully met, all is well. If they are not, financial problems are likely to arise.
- The keynote of the working capital structure is liquidity - the ability of current assets to generate cash flows large enough in numbers of dollars, and at a sufficient speed to meet the pressures from current liabilities

2. Definitions

- Current Assets

Are those items owned by a business that could be or are planned to be turned into cash within a twelve-month period

Examples of current assets are:

- Cash
- Bank Accounts with money in them (In Funds)
- Stock
- Work in Progress
- Sundry Debtors
- Deposits
- Cash Floats
- Goods and Services Tax (in some cases - but more likely to be a Current Liability)

- Current Liabilities

Are those amounts owed by the business that are due to be paid (or could be demanded to be paid) within twelve months

Examples of Current Liabilities are:

- Bank Overdraft
- Loan Repayments due to be paid within the next 12 months
- Sundry Creditors
- Holiday Pay that is owing
- Long Service Leave that is due
- Taxation that is due
- Goods and Services Tax
- PAYE

- Working Capital

The excess of Current Assets over Current Liabilities

- Quick Ratio

The relationship between current assets less stock and work in progress, and Current Liabilities less bank overdraft. This ratio is another measure of a firm's liquidity.

3. The Business Cash Cycle

The business cash cycle indicates the complete cyclical movement of the current assets from cash through various stages to cash again.

- Manufacturing Enterprises Cash Cycle has long activity cycles and typical movements are as follows:

Cash - Supplies - Store - Production - Sub-Assembly - Work in Progress - Assembly - Stock - Sales- GST (if turnover over \$1.3m) - Debtors - Cash - GST (if turnover under \$1.3m)

- A Retail Cash Cycle would be along these lines:

Cash - Goods - Store - Stock - Sales - GST (if turnover is over \$1.3m) - Debtors - Cash - GST (if turnover is under \$1.3m)

- Professional Services Cash Cycle may be as follows:

Cash - Work in Progress - Sales - GST (if turnover is over \$1.3m) - Debtors - Cash - GST (if turnover is under \$1.3m)

- Trades and Service Industry Cash Cycle may be as follows:

Cash - Stock - Work in Progress - Sales - GST (if turnover is over \$1.3m) - Debtors - Cash - GST (if turnover is under \$1.3m)

- A Financial Industry Cash Cycle may be as follows:

Cash - Sales - GST (if turnover is over \$1.3m) - Debtors - Cash - GST (if turnover is under \$1.3m)

4. Critical Points Re Working Capital

There are a number of matters that must be of concern to management, if working capital is to function efficiently and effectively. These are:

- The level of investment in stock or Work in Progress
- The level of investment in debtors
- The payment of creditors
- Loan Repayments
- Periodical commitments such as income tax, GST payments, dividends, and capital expenditure

5. Cash Flow Budget

The cash flow budget can be used as both a planning and controlling device, but it will not do the control job. This is Management's responsibility. It will merely point-out financial tight spots in the first place and serve to indicate weaknesses as the period progresses and actual cash flows are measured. The actual flow of cash is basically important because it is necessary to have cash available at the appropriate times to meet commitments.

6. Causes Of Shortage Of Cash

There are a number of different events that may cause a shortage of cash even though the budget has shown an expected availability of cash:

- A reduction in expected sales revenue
- Debtors being slower than expected in paying their accounts
- Unplanned purchases which seem favorable to the business e.g. large unplanned stock purchase (Maybe a curse rather than a blessing!)
- Increase in prices of materials, supplies, labour and operating costs
- More credit sales than cash sales (processed through to debtors) than were budgeted for
- Unplanned large expenditures, i.e. disallowance of a large expense claim for tax purposes, legal action requiring a heavy damages payment etc
- Not trading profitably
- Taking too much money out of the business
- Creditors and Suppliers demanding earlier payment (likely to be a consequence of GST and Provisional taxation payments)
- Unplanned taxation commitments

7. Control Of Cash Dependent On Other Items

- The cash position is dependent on a number of separate but interwoven items such as sales, debtors, inventories (stock and work in progress), operating expenses, GST payable and Income Tax payable etc
- The control of cash involves control in a number of other areas
- A departure from budget expectations in any of these areas must reflect on the cash position and, if corrective action is not taken promptly, financial embarrassment is likely to follow

8. Summary Of Working Capital

Poor control of cash can affect the very existence of the business - thus emphasising that Working Capital is the Lifeblood of a Business.

It is recommended that you read the separate papers on:

Credit Sales Debtors	(Paper 02.36)
Introduction To Factoring	(Paper 02.38)
Stock (Inventory) Control	(Paper 02.80)
Work In Progress	(Paper 05.10)
Cost Control And Overview	(Paper 37.01)
Budgets And Cash Flow Forecasts	(Paper 05.35)

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