Working capital and its life cycle (1) (2/20/19)

Every company should be able to keep up its daily cash flows and have sufficient finances to cover its labour costs, taxes and trade payables as they fall due. Optimum working capital (WC) levels should be maintained in both the short and the long term. This article explores the concept and related matters.

Working capital (WC) is the part of a company's capital it uses in its core business. This part is measured as current assets less current liabilities. WC shows the company's ability to settle its liabilities arising in the course of business. Efficient use of WC directly affects the company's profits and cash flows.

Current liabilities are total liabilities falling due in the next 12 months. Current WC shows any cash and other assets available for settling current liabilities.

Working capital cycle

The balance sheet can be thought of as a WC snapshot at the balance-sheet date. The management take constant care of paying debts, buying inventory, generating revenue, and monitoring receivables. This ensures business continuity by creating a working capital cycle ("WCC") measured in days from ordering inventory to receiving cash for sales. WCC consists of –

- inventory days, i.e. the average number of days from buying inventory to selling finished goods;
- receivable days, i.e. the average number of days from selling finished goods to receiving cash; and
- payable days, i.e. the average number of days from receiving inventory and services to paying the suppliers.

While the WCC offered by economic theory mainly relates to classic business (production of goods), it can be applied to other companies offering tangible goods, such as catering, retail, and consumer services.

Companies that offer intangible products, such as training courses and management consulting services, have the following WCC:

- Inventory days are the average number of days from taking an order to filling it. The cost typically has a low inventory percentage and significant labour costs;
- Receivable days are the average number of days from providing a service to receiving cash;
- Payable days are the average number of days from buying goods and services to paying the suppliers.

To maintain WCC efficiently, the company should have complete control over four items on the balance sheet:

1. cash and cash equivalents,
2. receivables,
3. inventory, and
4. payables.

Next week we will go through an example to provide a better understanding of WCC.