

Working capital and its cycle (2) (2/21/19)

This article completes what we wrote [last week](#).

Working capital cycle

A working capital (WC) cycle is the number of days a company takes to turn its current assets and current liabilities into cash. The earlier you receive cash for the goods sold, and the later you pay your suppliers, the lower WC investment you need.

WC cycle = inventory days + receivable days - payable days



The movement of WC elements

Indicators	Calculation
INVENTORY	
Inventory days	Average Inventory Balance x Number of Days / Cost of Goods Sold
Inventory ratio	Cost of Goods Sold / Average Inventory Balance
RECEIVABLES	
Receivable days	Average Receivable Balance X Number of Days / Revenue from Credit Sales
Receivable ratio	Revenue from Credit Sales / Average Receivable Balance
PAYABLES	
Payable days	Average Payables X Number of Days / Expenses
Payable ratio	Expenses / Average Payables

When measuring the WC elements (inventory, receivables, and payables) derived from economics textbooks, we cannot usually obtain the true cycle. We always need to consider comparables and make adjustments.

This analysis has a number of downsides, though. For example, only quantitative data is used, ignoring qualitative data, and different formulas are used for calculating the same indicator, which compromises comparability.

A comparison with average industry statistics is practically impossible for the following reasons:

- Statistical industries cover a number of business areas, with items in a statistical report being lumped into large groups;
- Each company is unique, so WC levels may vary considerably from company to company operating in the same industry;
- Accounting principles may vary from company to company (e.g. accounting for inventories);
- The percentage of shadow economy in Latvia (e.g. the result of paying cash in hand) leads to distorted financials and statistics;
- The statistics are too generalised and actually not comparable.

A purposeful and professional management of your current assets helps you accelerate your WC cycle and provide a positive cash flow and liquidity. Improving your corporate WC policy will encourage you to find

new and efficient solutions as well as the most appropriate methods.