

Working Capital

an article by author's name

sme's guide to handling your working capital

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Capital Investment

All businesses require capital investment, often thought of as significant expenditure on buildings, machinery, fixtures & fittings and vehicles.

Such 'Fixed Capital' investment is usually funded on a medium to long-term basis by term loans, equipment leases and shareholders' own funds.

These costs are relatively predictable and the investment is usually planned in advance.

Working Capital Investment

In contrast, the funds required for the day-to-day running of a business tend to fluctuate with levels of activity and short-term performance.

As a result, they are more difficult to predict and are often inadequately planned and financed.

It is no exaggeration to suggest that 'Working Capital' is the lifeblood of a business.

It is needed to pay wages, suppliers and other expenses before sales revenues are received from customers.

Working Capital Requirement

The 'Working Capital Requirement' of a business is not just its bank balance - it is also its investment in stocks, debtors and creditors.

Businesses that have to spend money up-front on supplies and then wait for some time before payment is received from their customers (such as manufacturers or distributors) will have higher working capital requirements than 'cash' businesses such as retail shops, bars or restaurants.

Core Requirement

It is often thought that because working capital can fluctuate so frequently in the short-term, it can be financed on a short-term basis.

This can be one of the most common and serious mistakes that a business can make.

Despite what may be considerable fluctuations, there will always be a 'core' working capital requirement - a 'base' level of working capital that should be treated as permanent in nature and financed accordingly.

Business growth...watch for overtrading

It may be hard to believe that sales can be soaring, the business may never have been more profitable, yet this performance doesn't seem to correspond to a healthy bank balance!

In most growing businesses, the 'base' level of working capital required will steadily increase.

If the investment in working capital does not increase at least at the same rate as sales, the cash position of the business is likely to deteriorate. If sales double, so too should the amount of available working capital.

Failure to plan for increasing working capital needs can lead to serious cash flow problems.

Indeed businesses that grow too rapidly, even if they appear to be profitable, may risk business failure by 'overtrading' without an adequate capital base.

How can this be avoided?

Avoiding Business Failure

- 1: One cure for working capital crises including overtrading is cutting back on sales – but try telling that to the sales and marketing people!

A focus on profitable sales, rather than just on sales growth, will allow better use of the available working capital.

- 2: Arranging adequate longer term finance – from financiers or investors – is a better cure.
- 3: As is improved working capital management – when you pay your suppliers and collect from your customers.

Closer attention to the credit terms agreed with your customers can have a significant effect on working capital – those who pester most usually get paid earlier!

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The Irish Small Firms Association has produced a very good booklet "how to get paid on time".

Many of our clients and their Accountants have found this booklet useful and we can highly recommend it. You can get one from the Small Firms Association (www.sfa.ie) or if you contact us at info@sme.ie we'll arrange for you to receive a copy.

Planning

Arranging adequate, longer term, finance and closer attention to working capital management requires planning

Although working capital situations can vary, there is little doubt that proper planning, including regular cashflow forecasting, can prevent unexpected cash shortfalls.

The Directors of SME Financial Systems have all led Finance Functions for significant businesses during difficult economic times.

We know from first hand experience what it is like to manage falling sales, rising costs and tight cashflow.

We are also well aware that Cashflow Forecasting is not the easiest of tasks, yet can play an important role in the success or indeed survival of your business.

That is why we have designed a tool to assist you in this task.

It is described in the Cashflow Forecasting section of our site.

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