Working Capital

Working Capital (WC) is essential for a firm to operate and function on a day-to-day basis: Proper WC management ensures that raw material purchased, salaries, wages or utility bills can be paid on time. Efficient WC management deals – among others - with speedy collection of receivables and inventory turnover velocity.

WC comprises components on both, the active and the passive side of a firm´s balance sheet: In Corporate Finance terms, the core elements of WC are a firm´s cash and cash equivalents, its receivables and inventory, as well as its payables. Therefore, WC combines most positions of a firm´s current assets as well as its current liabilities: However, short-term debt (i.e. short-term interest bearing liabilities), for example, would not be considered part of the WC. – When talking about WC, frequently analysts and investors actually refer to net working capital, defined as WC assets minus WC liabilities.

To assess whether a firm´s WC is used efficiently, one may determine for how long each of its components are held, or: how fast they are turned over. This is amid firms rather tending to keep net WC low (at times, and if feasible, even negative), as a net-positive WC position must eventually also be funded.

For example, the collection period of a firm indicates how fast customers pay for goods delivered or services provided: Whilst a firm´s revenues reflect goods and services already having been delivered, it is the receivables which represent the amount that customers are still required to pay. To calculate the collection period (i.e. the number of days outstanding), one may simply divide a firm´s receivables position by its daily revenues generated. – Evidently, the faster a firm collects from its customers, the sooner this cash can be re-employed, and the lesser funding is required. - Of course, the collection period a firm can optimally achieve will not least depend on a firm´s standing within an industry as well as its bargaining power vis-à-vis its customers. Whilst a supermarket chain typically benefits from a very short collection period (i.e. customers frequently pay in cash or cash equivalent at the till), this may stretch over many months, such as in sectors delivering complex industrial products.

On the other hand, if a firm can afford to do so, then it may decide paying its suppliers as late as possible. – In a Corporate Finance context, late payments can be interpreted in suppliers actually extending credit (i.e. loans) to a firm, with the additional caveat that payables do not bear any interest either. In consequence, pursuing such a strategy would reduce a firm´s funding requirements by means of interest bearing debt (from commercial lenders). – Of course, also the length of a payment period depends on the industry a firm is operating in and its bargaining power vis-à-vis its suppliers. – Days payable – or the payment period - is commonly defined by dividing a firm´s payables by its cost of goods sold per day. Whilst this may not be an entirely accurate approach, it assumes that the vast majority of payables is linked to goods and services delivered to a firm, which are subsequently further processed in operations.

Finally, firms holding relatively smaller inventories are generally seen as being more efficient: Also, such would indicate that inventory is turned over relatively faster, and – once again - less funding would be required. Lean production, among others aggressively pursued in the automotive industry since the 1980s (lean management), has also its downsides, though: Even minor, temporary disruptions in a supply chain can have disastrous consequences for entire production processes. - The approximate number of days a firm´s inventory is bound can be calculated by dividing the inventory position by the cost of goods sold per day. Similar as when calculating days payable, this approach assumes that most of the raw material, semi-finished and finished goods – together forming a firm´s inventory - will be further processed in operations.

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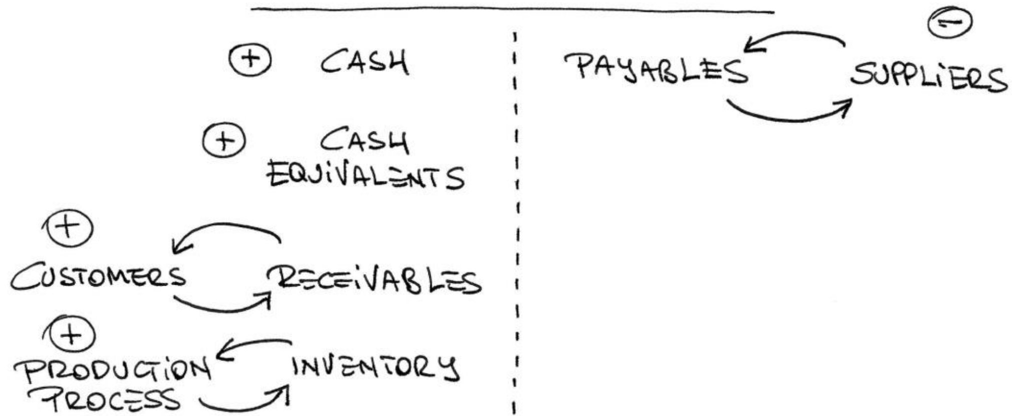
BALANCE SHEET



(+) BINDS WORKING CAPITAL
= INCREASES FUNDING REQUIREMENTS

(−) RELEASES WORKING CAPITAL
= REDUCES FUNDING REQUIREMENTS

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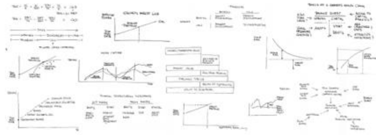

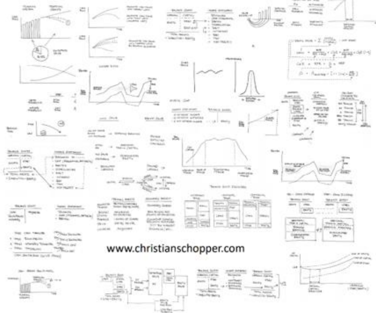

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