COVID-19 : Working capital - A precious tool for businesses to lean on

Why do you need working capital? How do you calculate it? Most importantly, how do you improve it? Working capital seems more complicated than it is. But it's important to have a strong understanding of a tool that's crucial to your business. Here's what you need to know.

What is working capital?

Working capital isn't that complicated. Essentially, it allows you to determine your short-term liquidity and your ability to pay your bills on time in order to prevent a cash shortage. "If you're selling and restocking your inventory three times a year but have to pay off your accounts payable once a month, you may run out of money eventually," adds Simon Lapointe, director, business and analytics intelligence at the National Bank.

To calculate your working capital, subtract your company's short-term liabilities from its short-term assets for the next year. "Your short-term assets include any assets you'll have in the next year: cash, accounts receivable, inventory stock. Short-term liabilities consist of all the accounts payable you'll have to pay off in the next year, including the short-term portion of a long-term debt – the capital reimbursement for the next year – as well as your credit line, if you have one," Simon Lapointe indicates. Real-estate assets aren't included in short-term assets.

Why do you need working capital?

"A business's working capital allows it to fund its operations and finance its growth. It allows you to have liquidity and gives you flexibility if you want to achieve your goals and invest. It reduces the amount of interest you'll have to pay if you have a credit line," explains Simon Lapointe.

How do you calculate your working capital ratio?

Take stock of your working capital periodically to stay abreast of any devaluation.
Here's the formula for this:

Short-term assets ÷ short-term liabilities

"If the resulting number is positive (more than 1), that means you have more money coming into your business than going out for anything you have to pay off. And conversely, if it's negative (less than 1), you don't have enough cash to pay off your short-term liabilities," says Simon Lapointe. However, please note that the standard for a good ratio depends on the industry.

Here's an example for calculating working capital. A manufacturing company has $3.8M in accounts receivable and $2M in inventory stock, which amounts to $5.8M in short-term assets. On the other hand, it has $3.2M in accounts payable and a $0.5M credit line, for a total of $3.7M in short-term liabilities. It has a positive working capital ratio of 1.57 ($5.8M ÷ $3.7M).

But that's not the only thing that accounts for a business's financial health. "There are profitable companies that have a lack of liquidity. They find themselves with a negative working capital ratio after paying out their dividends or buying equipment without financing it, for example. And there are other businesses that experience incredible growth, but their liquidity doesn't follow suit," the expert adds.

Quick ratio is another way to calculate your working capital ratio. It includes everything among your short-term assets that can be sold off quickly. It excludes stock, because that's harder to get rid of quickly. In this situation, you could have liquidity issues and negative working capital if you invest massively in inventory that you can't sell.

What other current ratios should you calculate?

To have good liquidity, you also have to pay attention to "the number of days until you collect your accounts receivable, the numbers of days until you go through your inventory, and the number of days you have to pay your accounts receivable," Simon Lapointe specifies.

- The average collection period ratio determines the average number of days your clients take to pay you and whether your payment policy is effective (2/10 Net 30, for example). Here's how you calculate it:

  Number of days included in the financial year (usually 365 days) × average balance of your accounts receivable ÷ net business numbers

- The inventory turnover ratio can help you determine the number of times you restock your inventory in a year. Here's how it's calculated:

  Number of days included in the financial year (usually 365 days) × average value of your inventory ÷ cost of goods sold (COGS)

- The average collection period ratio determines the average number of days you take to pay your suppliers. In this case, the shorter the period, the better. Here's how it's calculated:

  Number of days included in the financial year (usually 365 days) × average balance of your accounts payable ÷ purchases

What are working capital requirements?

Working capital requirements refer to the cash conversion cycle. "It's the length of time during which the money in your account is frozen and can't be used," Simon Lapointe explains.

Here's how it's calculated:

Days sales outstanding (DSO) + days of inventory outstanding (DIO) - days payables outstanding (DPO)

"If it takes you a month to collect your accounts receivable, two months to sell off your inventory, and two weeks to pay off your accounts payable, then the conversion cycle amounts to 2.5 months, which is the length of time when the money is frozen and can't be used," Simon Lapointe explains.

How do you increase your working capital and liquidity?

Make sure you collect your accounts receivable

"Collection is crucial. If it takes more than two or three months to collect an account receivable, depending on the type of business, there's a problem. A sale isn't considered as closed as long as you haven't been paid," Simon Lapointe explains. You can also look into invoice factoring to quickly monetize your client accounts.

Delay paying your suppliers

This will allow you to hold on to your money for as long as you can, until you have to use it for payment. Of course, you still need to follow the payment policy that was agreed upon.

Delay cash outflows

"You can do this by using a credit card to pay for certain liabilities. If you're able to make good use of it and pay it off on time, you'll gain a month on your payment conversion," the expert adds.

Take advantage of credit lines

"Credit lines compensate for a lack of liquidity in between paying for your inventory and collecting money for sales," Simon Lapointe points out. If your business is suffering from a lack of liquidity, you can also get long-term financing for goods that were paid in cash. You could also ask for an injection of capital from shareholders. Talk it over with your advisor to identify your best option.

Minimize inactive inventory

"Inventory isn't always an asset. Having too much inventory can be detrimental because you have to pay to store and finance it, and it loses value over time," the expert reveals.

Make allies of your clients and suppliers

"If you follow up appropriately and respect their terms, you'll put yourself in a better position to negotiate collection deadlines and payment terms," Simon Lapointe explains.

To sum up, try to sell off your inventory quickly and collect your accounts receivable as soon as possible. This will help you to maintain a good relationship with your clients and suppliers. And remember that the more cash you have, the more you'll be able to finance your business's growth!

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