If Cash Is King, then Working Capital Is God

Management of a company's working capital is crucial for day-to-day functioning and long-term survival

by **Dennis Niven**

WORKING CAPITAL MANAGEMENT is the most important management activity in emerging and mid-sized companies because of the significant financial impact that it has on the company's well-being. While most CEOs and business owners have heard and accept that "Cash is King," working capital is often the least understood and most poorly managed area of their companies.

When working capital is not adequately managed, the deterioration of cash flow critically affects a company's ability to fund operations, reinvest in the business and, ultimately, to survive. With adequate working capital management, cash flow supports a company that thrives in the marketplace.

'Working Capital' Defined

Working capital for business is often referred to as simply the excess of short-term assets over short-term liabilities. Short-term assets include cash and other assets expected to be turned into cash within one year: marketable securities, accounts receivable, short-term notes receivable, inventory and prepaid expenses. Short-term liabilities include those expected to be paid with cash within one year: accounts payable, short-term debt such as credit lines, the short-term portion of long-term debt and accrued expenses.

What is Adequate Working Capital?

Adequate working capital for business varies, often extremely, from one business to another, and it varies from one day to the next. What might be adequate is quite different between times when excess cash needs to be invested and times when the business owner has no idea how to fund the next day's payroll.

Some industries (e.g., manufacturing) require a high level of working capital. They incur a long period of time from the time cash is first paid for what is eventually sold to the time cash from the sale is finally collected. Other industries (e.g., large retailers) require little working capital because they sell products for cash before it is required to pay for the product, and profits are readily available for reinvestment in the business.

Working Capital Financing

Ideally, companies finance working capital for business through adequate capitalization by owners and profits reinvested in the business. Business funding of various types is often needed, however, especially in the day-to-day operations of growing businesses.

Common types of working capital financing include owner contributions and loans, extended vendor terms, bank financing secured by receivables and inventory, revolving business credit card debt, merchant credit card advances, and factoring of accounts receivable. Note that this does not include loans for long-term assets, such as buildings and equipment, which do not revolve and should be financed with term-debt secured by the long-term assets. A company might turn to venture capital in extreme, established growth situations.

Cash Conversion Cycle

The biggest single use of the cash provided by a growing company's profits is growth itself, because goods sold on open accounts require an outlay of cash well before cash is received from the sale of the goods. This is especially true in businesses that sell out of an inventory of goods, but applies in the sales of services as well.

Simply explained with an example, if a business holds inventory for an average of 82 days, takes an average of 36 days to collect accounts receivable and pays its accounts payable in an average of 28 days, the business will have a cash conversion cycle of 90 days (82 + 36 - 28). Ideally the carrying cost of the cash conversion cycle is included in the sales price of products, but what does this mean to this company that is going to grow from $10 million in sales to $14 million in sales this year (with a 35-percent gross profit and 10-percent selling, general and administrative expenses while increasing inventory by only 20 percent)? The company will require a cash injection of more than $779,000 to finance the cash conversion cycle, while the CEO or business owner may be naively expecting to have $400,000 more in cash from profits. The swing between perception and reality can be quite shocking, especially when the available credit line going into the year is, for instance, $200,000.

This does not mean growth is bad. It does mean it must be carefully forecasted and managed. The biggest step is finally recognizing that growth requires a lot of cash.

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Dennis Niven, CPA, CGMA, CM&AA, is a Scottsdale, Arizona, partner in B2B CFO®, The World's Largest CFO Consulting Firm™. Niven specializes in Finding The Exit® and The Exit Strategy™ consulting, and provides articles on the subject on his website (www.dennisnivencfo.com).

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