Cash is King

(A working capital discussion paper)

The concept of "Working Capital" and Cashflows in your business is a critical area to understand. Whether you have a multi million dollar turnover or are a small trader turning over $40,000 a year it is very important to monitor both your working capital, (the amount of money you need to operate and fund your business through an operating cycle) and cashflow which fuels your business if you are to survive and grow.

If you are a Director of an insolvent company or Trustee of an insolvent Trust you could find yourself personally liable for the debts of the business. For this reason you need to understand some indicators of solvency in your business. A business is considered to be insolvent when it is "unable to pay its debts as and when they fall due".

A quick test of solvency is a financial ratio known as the "Working Capital Ratio". This is calculated using the formula below and is expressed as a ratio –

$$\frac{\text{Current assets}}{\text{Current Liabilities}}$$

As a rule of thumb the ratio should be 1:1 or better. If it is less than this, it is an indication that the business does not have sufficient current assets to meet its current liabilities. You need however to look at your industry and what is normal for your type of business.

If the ratio is very high you may need to consider if you have excessive money tied up in liquid assets. Perhaps some of this capital could be put to better use elsewhere in your business.

Accountants often calculate a tougher ratio that is considered to be a better indicator of solvency. This is the Quick Asset Ratio or "acid test" and it is generally accepted that this should be no less than 0.8:1 throughout the year. This is calculated using the formula below and is also usually expressed as a ratio –

$$\frac{\text{(Current assets - stock)}}{\text{(Current Liabilities - Bank Overdraft)}}$$

One way to assist your business to improve its cash position and meet the quick asset test is to ensure that work-in-progress is converted to accounts receivable as quickly as possible. The billing of work at the earliest available point reduces the time between doing the work and being paid.

The rate of turnover of your stock, rate of conversion of work-in-progress and time taken to collect your accounts receivable will determine your cash cycle and hence the amount of working capital your business needs to operate. Faster turnover means you need less in cash reserves because less "cash" will be tied up in stock, work-in-progress and accounts receivable.

It is recommended that you have a documented system for each of these areas of your business and you ensure that your business follows your system.

It is also important that you ensure your customers understand your terms of trade and that you expect these to be met, in the same way that you meet your obligations. It requires good management and communication.

Prepare annual Budgets and Cashflow Projections and monitor these throughout the month with your actual results. Focus on the Cashflow projection for 3 to 4 months ahead and you shouldn't have any nasty surprises that you hadn't identified early. This allows you to proactively manage your working capital and operate a more successful enterprise.

Remember "Cash is King". Your debtors, stock and work-in-progress don't pay the bills until they are converted to cash. Profit can be recognised when the sales are made but it isn't real until you are paid. Don't be a profitable business that fails because you don't have agood understanding of working capital.

Talk to your business focussed accountant about how to improve your performance in this critical area of business and financial management.

Contact us now to find out how to apply this information in your business.

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