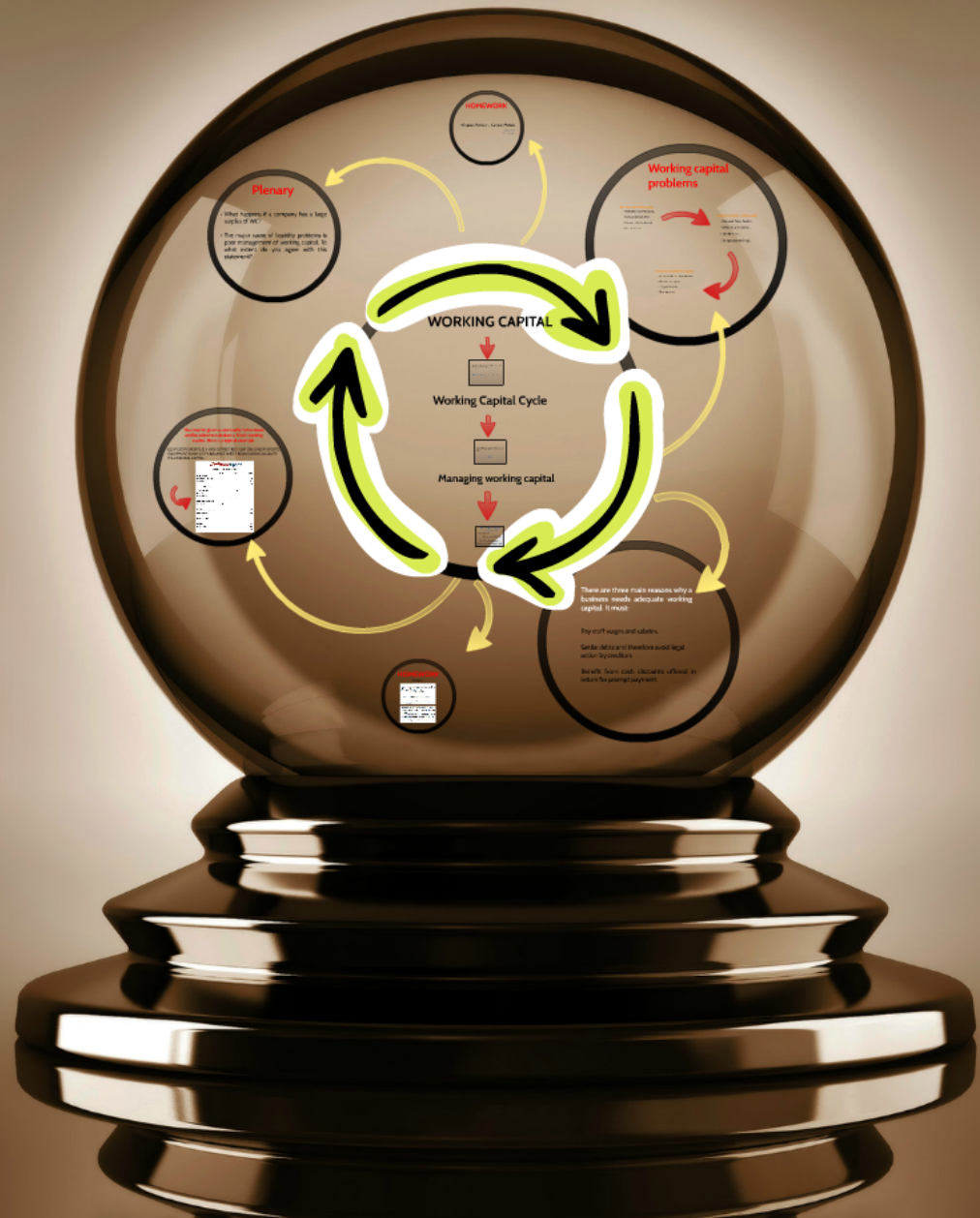


Working Capital

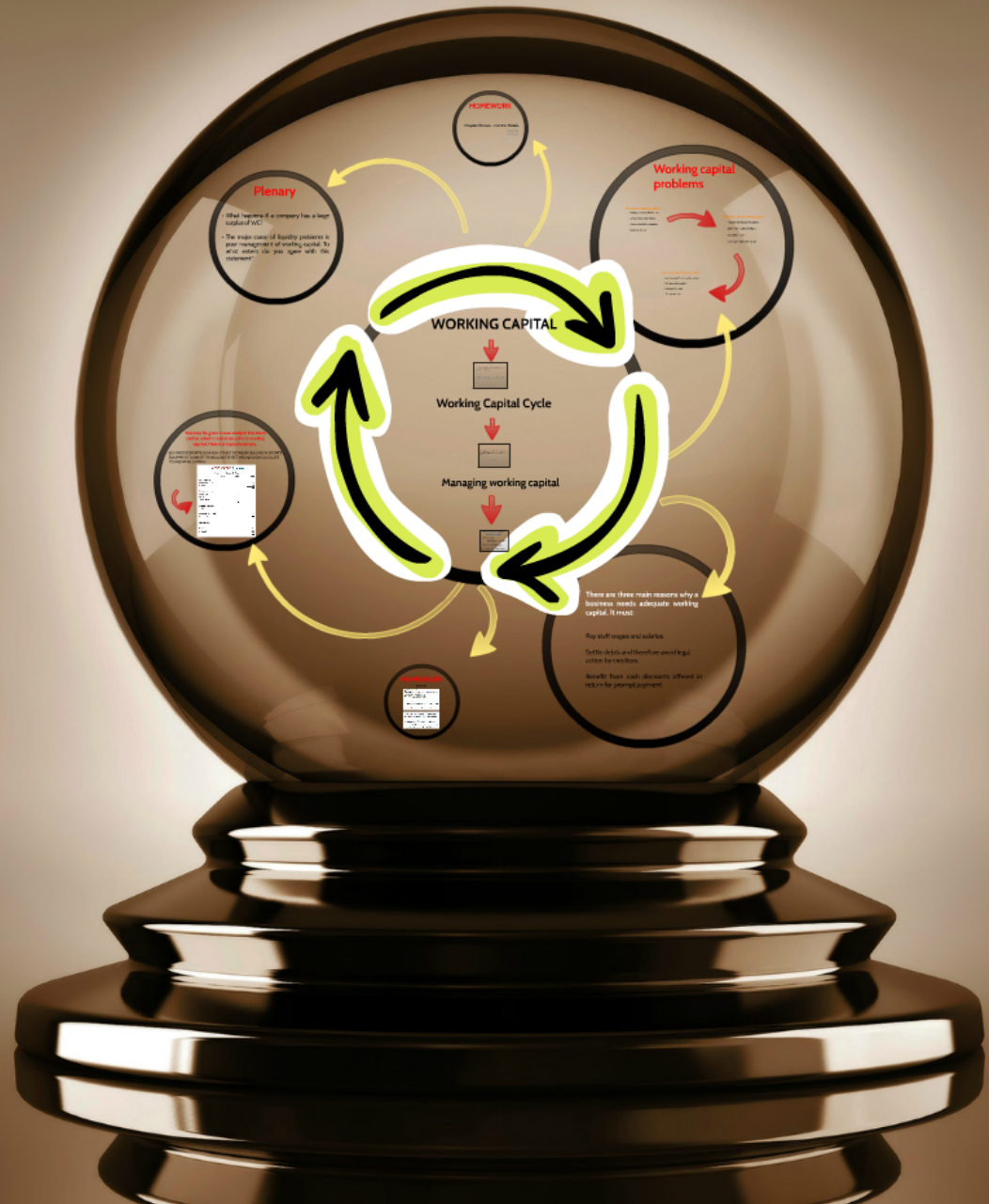


Chapter 27 SdP



Working Capital

Chapter 27 SdP



Learning objectives

- Understand what is working capital and why is it so important;
- Understand how to manage working capital;
- To know how can a business run short of working capital;
- Understand some methods of improving working capital.

- Get an overdraft or a short-term loan;
- Get some fresh capital;
- Sell goods for cash;
- Delay payments.

WORKING CAPITAL



Working capital is the amount of money needed to pay day-to-day expenses.

$\text{Working capital} = \text{current assets} - \text{current liabilities}$

Working Capital Cycle



The working cycle shows the movement of cash and other liquid resources into and out of a business.

Activity sheet

Managing working capital



How can businesses improve their working capital?

Improving business efficiency

Reducing production time

Reducing the time to sell finished goods (inventory)

Reducing the time to collect cash from customers (debtors)

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▪





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Activity sheet



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[Activity sheet](#)

Managing working capital



How can businesses improve their working capital?

Delaying payments to suppliers


Reducing production time

Reducing the time goods are stored before they are delivered to customers

▪

Reduce the time it takes for customers to pay





There are three main reasons why a business needs adequate working capital. It must:

Pay staff wages and salaries.

Settle debts and therefore avoid legal action by creditors.

Benefit from cash discounts offered in return for prompt payment.

You may be given a case study in the exam
and be asked to calculate a firm's working
capital. Here is a typical example.

GO-FASTER SPORTS IS A HIGH STREET RETAILER DEALING IN SPORTS
EQUIPMENT. LOOK AT ITS BALANCE SHEET BELOW AND CALCULATE
ITS WORKING CAPITAL.

GoFaster Sports			
Balance Sheet as at 31 July			
	£000	£000	£000
Fixed Assets			
Equipment & Fittings			25
Vehicles			15
			<u>40</u>
Current Assets			
Closing Stock		15	
Debtors		5	
Cash at Bank		10	
		<u>30</u>	
Current Liabilities			
Creditors	<u>5</u>		
Net Current Assets			<u>25</u>
Net Assets			<u>65</u>
Financed by:			
Capital			45
Net Profit			<u>20</u>
			<u>65</u>



Working capital problems

Run short of working capital . . .

- Buying too many fixed assets;
- Unexpected expenditure;
- Unexpected fall in demand;
- Seasonal factors.

Implications of poor working capital . . .

- Weakened Market Position;
- Difficulties with creditors;
- Liquidity issues;
- Damage corporate image.

Methods of improving working capital . . .

- Get an overdraft or a short-term loan;
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Plenary

- What happens if a company has a large surplus of WC?
- The major cause of liquidity problems is poor management of working capital. To what extent do you agree with this statement?

HOMEWORK

Chapter Review - Canton Metals

Page 130
Text book

HOMework

Answers

Chapter review - Canton Metals

(a) Define the term working capital.

Working capital is the amount of money needed for day-to-day trading. It is used to buy resources and pay bills such as wages, insurance and advertising. Working capital is the difference between the liquid assets of a business such as cash and stocks, and the money owed by a business which must be repaid within a year. Working capital is shown in the balance sheet and is calculated by subtracting current liabilities from current assets.

(b) (i) Calculate the working capital for Canton Metals in 2007 and 2008.

Working capital = current assets – current liabilities

$$2007 = \$5,783,000 - \$5,441,000 = \$342,000$$

$$2008 = \$6,863,000 - \$8,971,000 = -\$2,108,000$$

(ii) Do the answers in (i) support the view that Canton Metals has a shortage of working capital?

The calculations in (i) do support the view that Canton Metals does have a shortage of working capital. In 2007, working capital is low. It is only \$342,000. It is suggested that current assets should be between one and half and twice the size of current liabilities. This is not the case in 2007. In 2008 the situation is worse. This is because current liabilities are actually higher than current assets. This means that Canton Metals cannot meet its immediate debts.

(c) How might Canton Metals encourage customers to pay immediately for their goods?

Many customers prefer to buy goods using trade credit. This means they have more time to pay their suppliers. However, businesses would prefer their customers to pay immediately. One way to encourage customers to pay cash immediately is to offer discounts. For example, if Canton Metals allowed customers a 5 per cent cash discount, an order for \$30,000 would only cost \$28,500 if paid for immediately.

(d) Analyse how the measures agreed by the board will improve Canton Metals' working capital position.

Canton Metals' directors have agreed two specific measures to help boost working capital. They plan to take out an unsecured loan from a bank and reduce the trade credit period from 90 days to 30 days. Both of these measures should help to boost working capital. However, the loan will come at a cost. Assuming the bank is prepared to lend money interest will have to be paid which will raise costs and reduce profit. It may also be difficult to persuade customers to pay for their goods earlier – particularly as some are already slower payers. They may also lose some customers if they think the reduction in the trade credit period is unreasonable.

(e) Discuss whether Canton Metals is in danger of going out of business.

When a business runs out of working capital there is a danger that the business will collapse. Working capital is needed to pay important bills such as wages, materials and utilities. If these bills cannot be paid the business cannot trade. In this case it could be argued that Canton Metals is threatened with closure unless action is taken. It has run out of working capital and almost exceeded its overdraft. The overdraft is \$2,500,000 and according to the data in Figure 27.5, the company is already \$2,460,000 overdrawn.

However, the directors have identified the problem and appear to be taking action. The crucial point though is the bank loan. If the bank loan is refused the company may collapse. The fall in demand caused by the global recession may worry a bank. They may decide that lending the business more money is too risky in the circumstances. If this happens the company will struggle to survive. The reduction in the credit period from 90 to 30 days will not help much in the short term. The future for Canton Metals does not look good.

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Working Capital

Chapter 27 SdP

