An introduction to working capital

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To understand what *working capital* is, we first need a definition of what *capital* is

All businesses need capital to get started and to grow –
some more than others

Keep this in mind;
capital can come from two sources

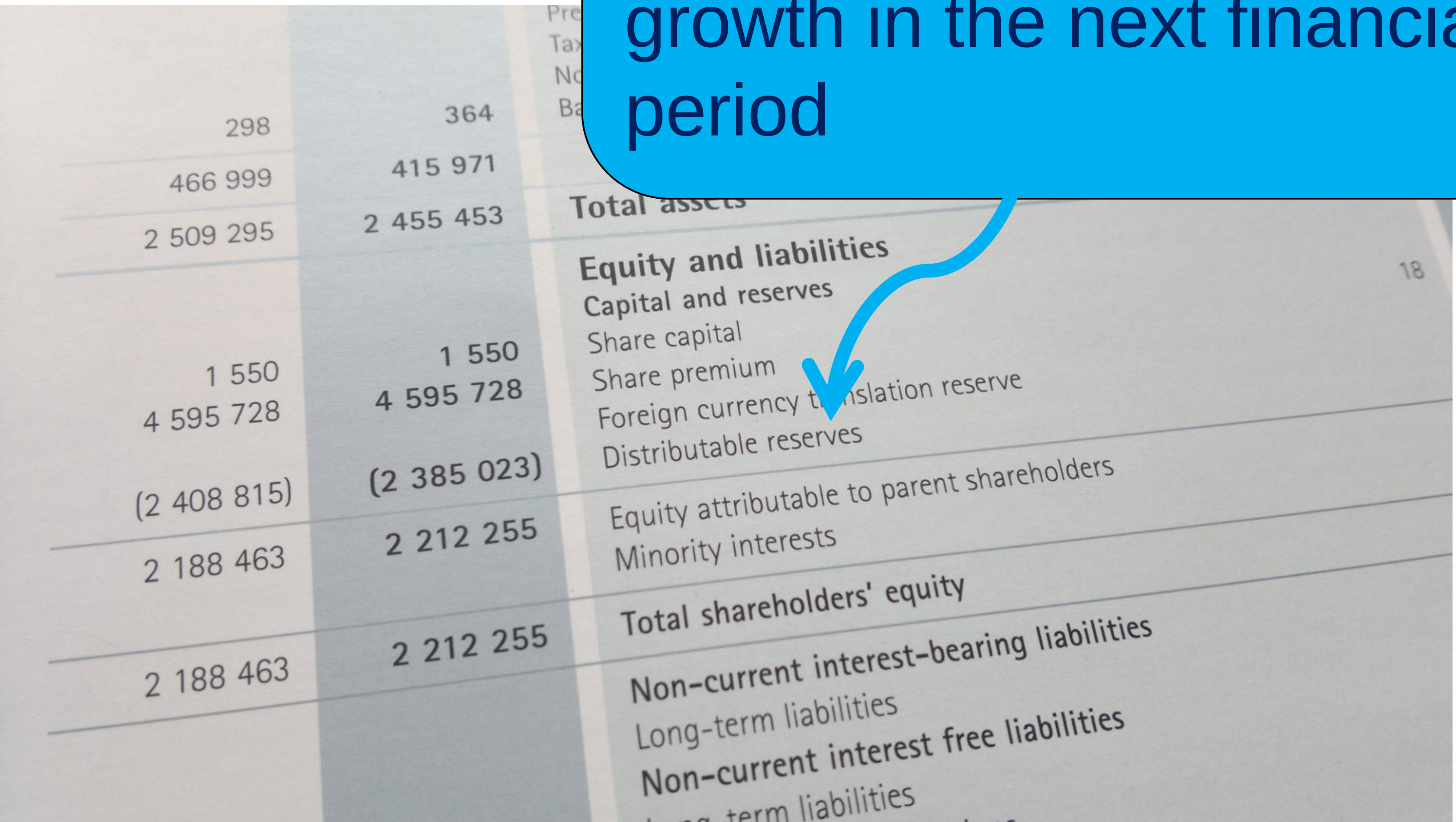
Business owners can put their own cash into a business

Business owner

Cash

and

The business can retain some of the profit it makes each year to help fund its growth in the next financial period



Key point to remember;

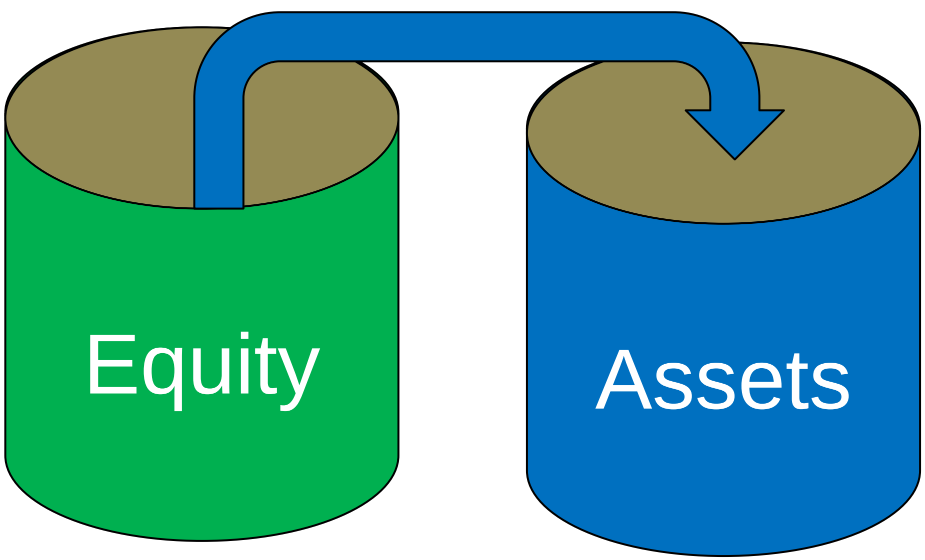
In our world, “capital” and “equity” are basically the same thing, just different words

They both indicate that funds have been contributed to the business by the owners

The accounting equation is

Assets = Equity plus Liabilities

Any additional equity can be used to fund an increase in the assets or.....



The accounting equation is

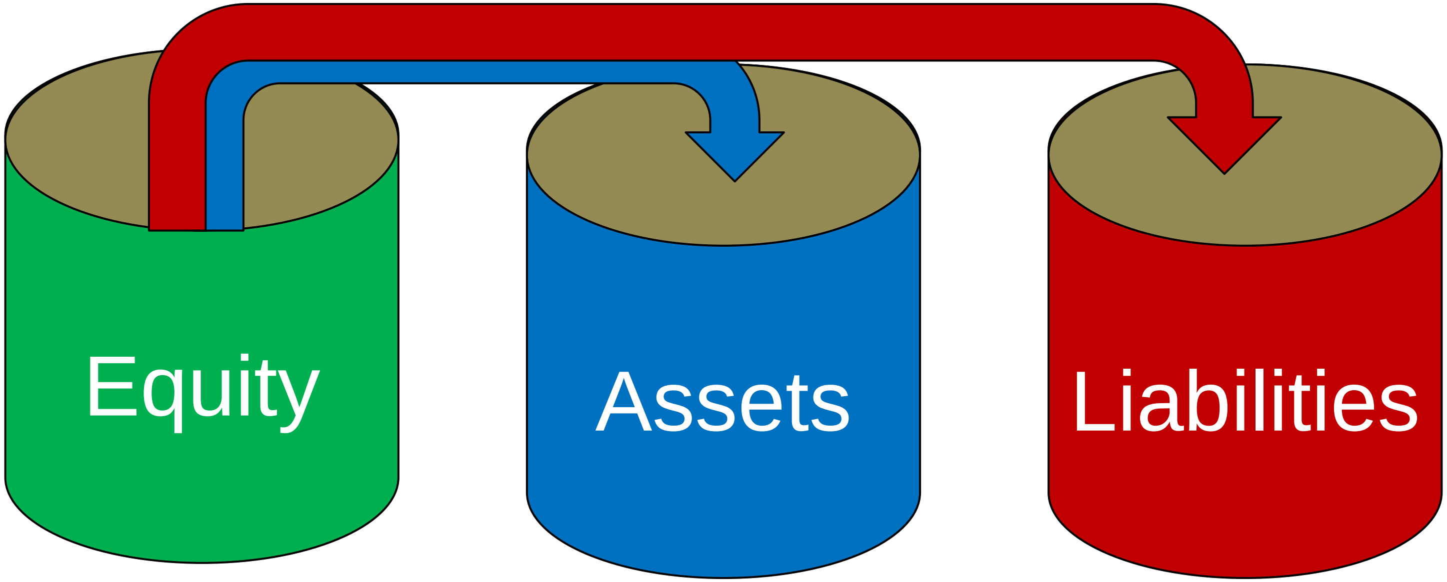
Assets = Equity plus Liabilities

Any additional equity can be used to reduce the liabilities (debts) or .....

The accounting equation is

Assets = Equity plus Liabilities

Any additional equity can be used to both increase the assets by a smaller amount and reduce the liabilities (debts) by a smaller amount



If the equity is invested into assets, there are only two types of assets that it can go into

Non-current assets

Land & buildings
Vehicles
Equipment
Furniture

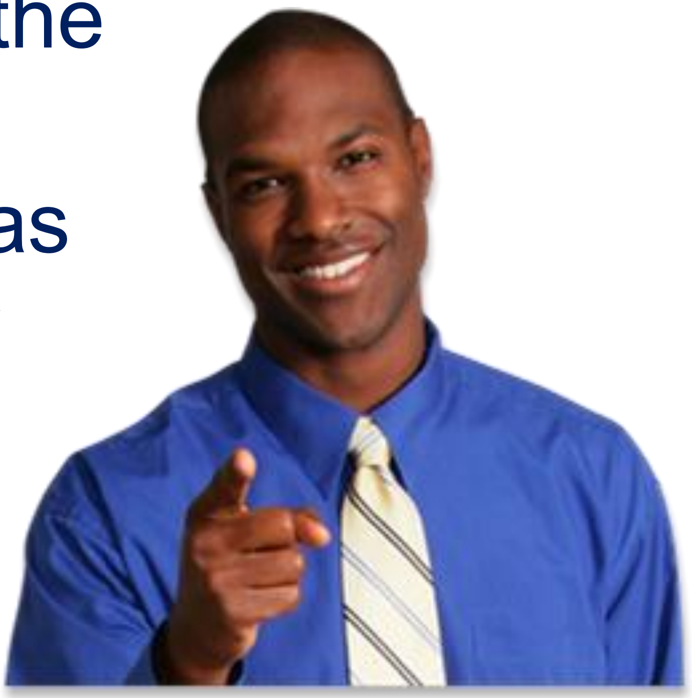
Current assets

Stock (inventory)
Bank
Trade debtors (accounts receivable)

When equity is invested in current assets, that becomes *working capital*

So it's capital that's being used for generating cash flow and profit for the business

So that's why working capital is important to lenders – it's made up of the assets that create the business' cash flow and, as we all know, it's cash flow that repays debt



Let's take a look at the working capital cycle – it indicates the speed and strength of the business' cash flow


Suppliers
give credit
Operating
expenses
Stock
(inventory)
2
Cash
1
Creditors
(suppliers)
get paid
Sales
(Turnover)
3
Trade Debtors
(Accounts
receivable)
4

Beginning with cash at step 1

Stock is bought at step 2 but there is also an option to obtain it from suppliers using trade credit terms instead of using cash

The stock is sold to customers at step 3 but on credit terms – they become trade debtors

Trade debtors pay at step 4 as the cash returns to the business

With the cash, business can pay operating expenses and trade creditors (suppliers) and then buy more stock to start the cycle over

The big challenge for the business is to keep that cycle turning as quickly as possible to make sure that there is cash available to make payments for operating expenses and trade creditors

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