How To Improve Your Working Capital and Liquidity

Working capital is the money that is available to a company to handle costs for its entire operating cycle after paying its current liabilities.

Having a sufficient amount of working capital available is important for any business. But it's also an important part of any growth strategies you may have for your business, since to grow and expand, you'll need available working capital.

Your available working capital can also be a good indicator of how healthy your business is since it involves the following:

Revenue: Working capital is directly impacted by the amount of revenue you collect. If you're not collecting revenue effectively, or your business is plagued by late payments, it will be reflected in your working capital totals.

Accounts payable: Accounts payable can also impact your working capital totals. Since accounts payable represents most if not all of your current short-term expenses, accounts payable balances and your current payment processes can directly impact your working capital and liquidity.

Inventory management: Inventory management can play a large role in working

capital. For example, having an excess of raw materials on hand that have not been converted to product can impact both short-term debt and your liquidity.

How to calculate working capital for your business

Calculating working capital is one of the simpler accounting calculations, with the required totals easily obtained from your balance sheet. All you'll need is your current asset and current liability totals.

Current Assets – Current Liabilities = Working Capital

For example, if your current assets equal $490,000 and your current liabilities total $405,000, your working capital calculation would be:

$490,000 – $405,000 = $85,000 Net Working Capital

While knowing the amount of working capital available can be helpful, many businesses prefer to calculate working capital as a ratio, finding the ratio a more helpful metric than a dollar amount.

To calculate working capital as a ratio, you can use the following formula:

Current Assets ÷ Current Liabilities = Working Capital Ratio

Using the same numbers as above, your calculation would be as follows:

$490,000 ÷ $405,000 = 1.21 Working Capital Ratio

This result means that for every $1 in current liabilities your business has, there is $1.21 in current assets available to pay for them.

What's a good working capital ratio?

Every company's working capital is different. Generally speaking, a working capital ratio between 1.2 and 2 is considered a healthy ratio, with different types of businesses typically having different working capital ratios.

But there are some standards that your business should aim for that can be used

for any business type.

For example, if your working capital ratio is between 1 and 2, that means that your business is fairly liquid and that your company is able to meet all of its current financial obligations. However, a working capital ratio of less than 1 indicates a lack of liquidity, meaning that your business will likely need to turn to outside resources in order to cover its current liabilities.

But a higher working capital ratio isn't necessarily better. A ratio of more than 2 can indicate that your business is not using your capital resources properly.

What does my working capital ratio tell me about my business?

For such an easy calculation, working capital and the working capital ratio can tell you a lot about the financial well-being of your business.

You already know that a ratio of less than 1 can indicate liquidity issues, while a ratio higher than 2 can show that your company isn't aggressive enough in using its assets. But your working capital ration can also indicate the following:

- ### Whether changes are needed

Calculating your working capital ratio can alert you to potential issues before they happen, allowing you to make changes proactively. If your ratio is low due to a temporary issue, it will sort itself out. But if you continue to have low working capital, you'll knee to address the root cause of the problem.

- ### If your business is attractive to lenders and investors

Your working capital ratio can be particularly important to anyone looking to invest in your business, whether as a potential partner or a lender. If you're in the market for a loan or actively looking for investors, the working capital ratio provides the information they're looking for.

Why is working capital important?

Having access to working capital can sometimes be the difference between remaining in business and closing up shop and can help businesses remain operational even during a temporary downturn. Seasonal businesses in particular find having excess working capital a necessity to maintain their financial health.

For example, Kate runs an ice cream shop in a small resort town. While the population swells during the hot summer months, in the winter, the number of residents drops significantly.

As a result, Kate earns the majority of her revenue during June, July, and August. Once the population drops and the weather gets colder, the number of customers she serves drops as well.

Because Kate plans for this influx of revenue, she is able to survive the cold winter months, when sales are a fraction of what she has in the summer, and is able to remain open for business.

Even service businesses can benefit from having excess working capital. While CPAs handle financial planning and tax consulting services for their clients year-round, their busy season typically runs from January to April 15 each year, with CPA firms that specialize in preparing tax returns earning between 50% to 75% of their yearly revenue in the first four months of the year. But having excess working capital will allow them to continue operations as normal throughout the other eight months of the year.

Having a negative working capital ratio isn’t always a cause for alarm.

Many big business retailers such as Walmart and Amazon have a negative working capital ratio, but because of their massive operations and the fact that they frequently sell products to customers before they’ve even paid their supplier for them, it doesn’t impact their operations.

However, in most cases, smaller businesses don’t often have the luxury of turning items around so quickly, which is why working capital management and cash management should both be a part of regular business operations.

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How can I improve my working capital?

You've just calculated your working capital, and you're horrified to find out it's less than 1. There's no need to panic. First, it's helpful to determine what is causing the low working capital.

Once the source has been identified, you can make changes that will improve cash inflow, which in turn will increase working capital. This can be done in a variety of ways including the following:

1. **Keep a close eye on accounts receivable balances:** Bad debts can ruin your business credit and impact operations. Small businesses and startups, in particular, can find themselves in a bind if they provide goods and/or services but fail to collect payment in a timely fashion. Take the time to create a good follow-up plan for late-paying customers to improve your accounts receivable turnaround time. However, if late payments continue to be an issue across the board, you may also want to examine pricing levels to see if they need adjusting.

1. **Institute cost-saving measures:** For businesses that are already on a tight budget, this may not be necessary. However, it's advisable for all business owners and managers to periodically take a look at recurring expenses and see if they're still valid. Monthly subscriptions and recurring bank fees are a great place to start.
2. **Create and use a budget:** Take the time to create a working budget and use it regularly. Many business owners spend a lot of time and energy creating a budget, and then never refer to it again. Managing and using a budget effectively with business budgeting software that provides real-time spend against budget reporting will help make better informed decisions related to your budget. And remember, don't create your budget based on what you'd like to happen, create it realistically based on what you expect to happen.
3. **Offer payment incentives:** Offering good paying customers incentives for paying on time can encourage them to continue to do so. You may also

want to consider offering an early payment discount to your customers. Though the amount can be small, such as 1% if paid in ten days, the incentive can be beneficial for your customers, who will receive a small discount for paying on time, and your business, which gets money in the door a lot quicker.

4. **Reevaluate customer creditworthiness:** Never forego a thorough credit check on any new customer, even if they've come with stellar recommendations. Every potential customer that applies for credit should be subjected to a thorough credit investigation which includes filling out an application. Always ask for vendor references and be sure to call those references to see if your applicant pays their bills on time. Never feel that you have to extend credit to everyone; only certain customers should have the privilege of having credit terms offered to them.
5. **Change credit terms:** If your credit customers pay on time, but you still have cash flow issues, consider changing your credit terms. For example, if you commonly offer 30 net or 45 net payment terms, consider shortening that to 10 or 15 days. In many cases, it won't make a difference to your customers, and for the ones that it does impact, you can negotiate terms that will work for both of you. You may also want to negotiate how much credit you're offering your customers. For example, allowing customers to have multiple accounts receivable invoices open can negatively impact your cash flow, lowering your working capital. Only offer as much credit as you can legitimately afford. While offering a line of credit to your customers can increase sales, it also increases the likelihood of customers paying late or even defaulting on the amount due. If you can't offer credit, don't.
6. **Negotiate more favorable terms with creditors:** Just as you negotiate more favorable terms with your own customers, consider negotiating better terms with your vendors and suppliers. If you offer 30 net terms to your customers, but your vendors and suppliers require you to pay in 15 days, you'll be perpetually short on cash, resulting in a low working capital ratio. If you're a good customer, and you pay on time, the odds are good that your vendors and suppliers will be willing to renegotiate credit terms with you.
7. **Improve inventory management:** To properly manage inventory, you'll first need to accurately forecast sales. This should always be done based on historic sales totals. Ordering more inventory than you can sell results

in overstock, tying up your assets while reducing cash flow. On the other hand, not ordering enough inventory can result in back orders and customers looking for their product elsewhere. Supply chain issues can also pop up from time to time, which is why having a proper inventory management system in place is essential.

8. **Move away from cumbersome manual systems:** If you're still using manual systems to manage your business, it might be time to automate. Even very small businesses can benefit from automating the accounts payable and accounts receivable process. Upgrading your business finance systems can indirectly affect your working capital, and may even lower it temporarily. However the benefits of automation far outweigh the cost, providing you and your employees to devote their energies to increasing sales and developing additional products and services; things that directly impact cash flow and working capital.
9. **Run reports regularly:** The best way to stay on top of cash flow and the working capital is to run financial reports and spend analysis in real-time on a regular basis. Doing so will allow you to address potential issues before they become problematic. Procure-to-Pay software that incorporates Spend Analysis Software can help make this easier.

With the working capital ratio such a simple calculation, there's no good reason not to calculate this metric on a regular basis.

Knowing your working capital position and consistently monitoring and calculating both working capital and your working capital ratio will allow you to manage your business finances properly while providing you with the opportunity to make any working capital improvements when necessary.

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