Working Capital Turnover Ratio: What It Is And How To Calculate It

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Before we can understand the working capital turnover ratio, we must first understand what working capital is. Working capital refers to the money your business has available to spend on essential payments, operations, etc. after all bills and debt installments have been paid.

Every business needs working capital to keep things up and running smoothly between payments from clients or customers. There are many ways startups can manage working capital needs, such as:

- **Building a capital cushion into the budget:** Keeps money set aside in the bank account to help your business manage the normal ebbs and flows of your cash flow cycles. The funds are often in the form of an equity raise or long-term venture debt. As startups grow, their working capital requirements tend to grow alongside them. This means you need to set aside a progressively larger capital cushion.
- **Factoring accounts receivable:** factoring accounts receivable just means that you are selling your receivables to Banks or other financial service providers to increase your cash flow. What you're doing is getting your invoices paid now and then sending the invoice to the factoring company. Keep in mind, however, that factoring costs about an additional 2% every month plus fees. The factoring company usually contacts your customers directly to verify each of the underlying sales.
- **Secure a startup line of credit:** With a line of credit, businesses have a capital cushion to draw from with revolving working capital. You can withdraw funds to pay for regular business operations as you need it and only pay for the capital once you take it and only while you take it. It's an affordable financing solution that is flexible and a low-cost alternative to venture debt or equity.

It's worth mentioning know that just because you have working capital at your disposal doesn't guarantee that you'll be using it effectively. That's where the working capital turnover ratio comes in.

Working Capital Turnover Ratio: Definition

The working capital turnover is a ratio to quantify the proportion of net sales to working capital. It measures how efficiently a business turns its working capital into increase sales. The working capital turnover ratio shows the connection

between the money used to finance business operations and the revenue a business earns as a result.

> *Your working capital ratio is only a small piece of your overall financial health and profitability.*

How to Calculate a Working Capital Turnover Ratio

Before you can calculate your working capital turnover ratio, you must first figure out your working capital. To calculate your working capital, take your current assets and subtract your total current liabilities. Both of these figures should be located on your company balance sheet and other financial statements.

If your organization has $500,000 in current assets and $300,000 in total current liabilities, your working capital is $200,000.

Once you know your working capital amount, divide your net sales for the year by your working capital amount for that same year. The resulting number is your working capital turnover ratio. It indicates how many times per year you deploy that working capital to generate that year's sales figures.

The higher the ratio, the more efficient your business is at meeting short-term debts. A high ratio helps your company's operations run smoothly and limits the need to secure additional funding.

Working Capital Turnover Ratio Formula

Working Capital Turnover Ratio = Net Annual Sales / (Total Assets – Total Liabilities)

Working Capital Turnover Ratio Examples

To bring context and to see why this metric is so important for measuring business efficiency, let’s take a look at a few examples.

Say that Red Company had a net sales of $500,000 last year and working capital of $50,000. Red company’s working capital turnover ratio is 10. That means the company spent $50,000 10 times to generate its $500,000 in sales.

Blue Company, on the other hand, had $500,000 in sales and $125,000 in working capital. That means they have a working capital turnover ratio of 4. Blue Company spent its working capital only four times throughout the year to generate the same level of sales as Red Company.

Judging a Working Capital Turnover Ratio

Not a real surprise that a higher ratio is better. The more sales you can generate per dollar of working capital you spend, the better off you are. It’s typically considered a good thing to redeploy your working capital more times per year to gain your year’s net sales figures. It means that money is easily flowing in and out of your business and is working to make you more money.

In our example above, Red Company’s working capital is doing just that. It’s actually working for the company. It’s working for the company 10 times a year. Blue Company’s working capital is working only four times. Looking at the surface, both companies have generated the same amount of sales. It looks like Red Company’s money works harder than Bue Company’s money is.

How do you know if you have a high turnover ratio? Your working capital turnover ratio is typically considered high when it is greater than the turnover ratios of similar companies within the same industry. Using your competitors’ turnover ratios is a good benchmark because these companies generally sell products like

yours and have a similar business structure.

If three of your closest competitors have working capital turnover ratios of 5, 4, and 6, and you have a ratio of 7, your ratio is high because it exceeds that of your competition.

Benefits of a High Ratio

Typically speaking, a high working capital turnover ratio may give you a Competitive Edge in your industry. Because it indicates you use your working capital more times every year, the idea is that money is flowing in and out of your business quite well. Because of this, you have more spending flexibility which helps to avoid financial trouble. If you experience a higher demand for all your products, you are not as likely to suffer inventory shortages that sometimes accompany rising sales.

That said, if your working capital turnover ratio is too high, it may be misleading. At first glance, it looks as though you're operating at very high efficiency. But, the truth may be that your working capital is dangerously low. If you're working with very low working capital funds, you may run out of money to fund your business.

Let's look at a couple more examples:

Let's say that the Yellow Company finishes the year with $2.1 million dollars in sales and $200,000 and $400,000 in working capital at the beginning and the end of the year. That means Yellow Company has an average working capital of $300,000. The resulting working capital turnover ratio is 7.

Now, let's assume Green Company also finished the year with $2.1 million in sales but has an average of $50,000 in working capital. This translates to a ratio of 42 which is much too large for the industry. This puts them at risk of running out of money to fund their business even though the ratio suggests they are doing better

than the competition.

The working capital turnover ratio may also be misleading when a business is Accounts Payable are incredibly high. This may indicate that the company is having difficulty paying bills as they come due.

What a Low Ratio Indicates

If your company has a low ratio, this could be a sign that you're spending on too many accounts receivable and inventory to support your sales. As such, you could end up with too much bad debt, or a load of obsolete inventory.

Working Capital Management

Working Capital Management involves monitoring cash flow, along with the current assets and current liabilities. It also includes ratio analysis of various elements of operating expenses including the working capital turnover, the inventory turnover ratio, and the collection ratio.

Working Capital Management ensures that your company operates smoothly throughout your net operating cycle which is also known as the cash conversion cycle. This is the amount of time required to convert your net current assets and liabilities into cash. If Company A doesn't have enough working capital to cover its obligations, the lack of funds can result in the liquidation of assets, potential bankruptcy, and legal issues.

Companies focus on inventory management while also paying close attention to accounts payable and accounts receivable to help them efficiently manage their working capital. They also look at various other financial ratios.

The inventory turnover rate indicates how many times the company has sold and replaced its entire inventory during an accounting period. The receivable

turnover rate shows how effectively it extends credit and collects debt on that credit.

It’s useless to look at your working capital turnover ratio in a vacuum. The metric is meant to help you compare how efficient your operations are to your competitors or others in your industry. It’s also meant to shed light on whether your operations are making progress every year.

The working capital ratio is a useful metric to know. It’s simple to calculate and provides a clear indication of how hard your available capital is working for your business. Using it to find out how you stack up against your competitors can help you design better uses for your working capital in the near future.

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