Cash is King but what's Working Capital?

A practical White Paper by Chris Lang, DBA Expert

Cash is the life-blood of any agency, indeed any company. We need it to pay staff, landlords, suppliers and, more importantly, company owners. It's highly unusual for a company to start with the aim of not making money. So you start a company, full of good intentions; award winning work, clients lining up at the door to work with you, hungry workers battling for places. You work hard for a year, clients loving the work, employees loving working for you and to top it all off your accountants tell you you've made a nice little profit. BUT the bank balance is zero!

How can that be so! Has someone emptied the bank account without you knowing? Then your accountant tells you it's all tied up in Working Capital. But what does Working Capital mean? The definition of working capital is "the capital of a business which is used in its day-to-day trading operations, calculated as the current assets minus the current liabilities." In other words the amount of cash you need to run a company.

Simple Example

A company starts on 1st April. The owner already has a client lined up and staff ready to work. He's found some office space and is ready to get cracking. At the end of the first month he invoices the client £12k, his staff cost him £8k (paid at the end of the month) and rent (paid in advance) £2k. The problem is the client has payment terms of 30 days. So he's paid out £10k and received nothing.

The profit and loss and cash position would look like this:

Month 1

P&L	
Income	**£12,000**
Salaries	£8,000
Rent	£2,000
Costs	**£10,000**
Profit	**£2,000**

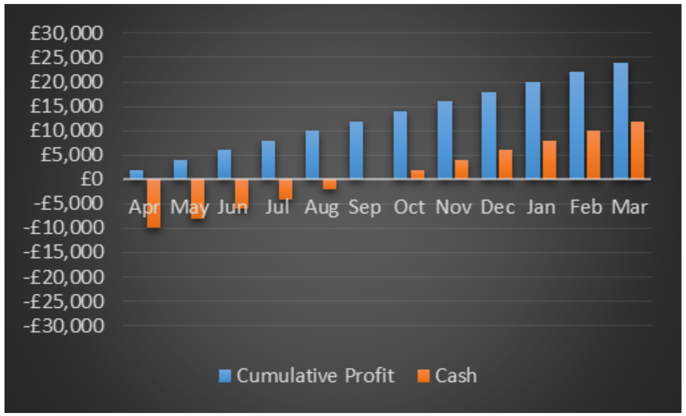
Cash	
Balance at start of month	£0
Income	**£0**
Salaries	£8,000
Rent	£2,000
Outgoings	**£10,000**
Balance at end of month	**-£10,000**

Month 2

P&L	
Income	**£24,000**
Salaries	£16,000
Rent	£4,000
Costs	**£20,000**
Profit	**£4,000**

Cash	
Balance at start of month	-£10,000
Income	**£12,000**
Salaries	£8,000
Rent	£2,000
Outgoings	**£10,000**
Balance at end of month	**-£8,000**

This means the owner would need to find £10,000 of cash in Month 1 to make sure he can pay everyone before money comes in from the client. This is his working capital requirement. If the same happens for the following 12 months things would look like this:



Example where accounting and cash amounts differ

There are occasions when the amount that goes through the P&L is different to the amount of cash that comes out of the bank account for the same thing. An example would be buying a computer. Whilst the full cost of the computer will come out of the bank account, under accounting rules the cost in the P&L should be spread over the expected period of time the computer will be used, usually 3 years.

So if £6k of computers were bought in month one:

Month 1

P&L	
Income	**£12,000**
Salaries	£8,000
Rent	£2,000
Computers	£167
Costs	**£10,167**
Profit	**£1,833**

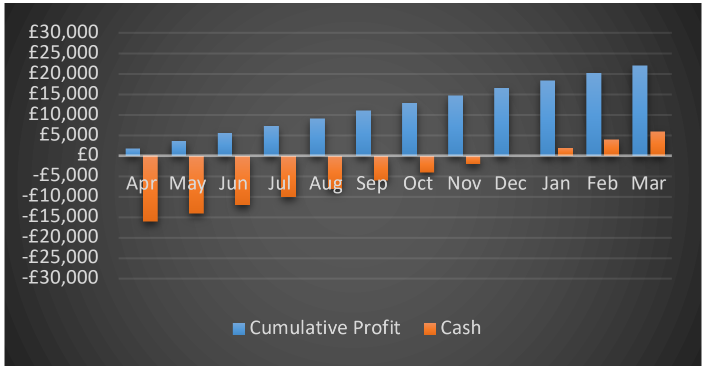
Cash	
Balance at start of month	**£0**
Income	**£0**
Salaries	£8,000
Rent	£2,000
Computers	£6,000
Outgoings	**£16,000**
Balance at end of month	**-£16,000**

This has increased the working capital requirement to £16k.

Month 2

P&L	
Income	**£24,000**
Salaries	£16,000
Rent	£4,000
Computers	£334
Costs	**£20,334**
Profit	**£3,666**

Cash	
Balance at start of month	**-£16,000**
Income	**£12,000**
Salaries	£8,000
Rent	£2,000
Computers	
Outgoings	**£10,000**
Balance at end of month	**-£14,000**

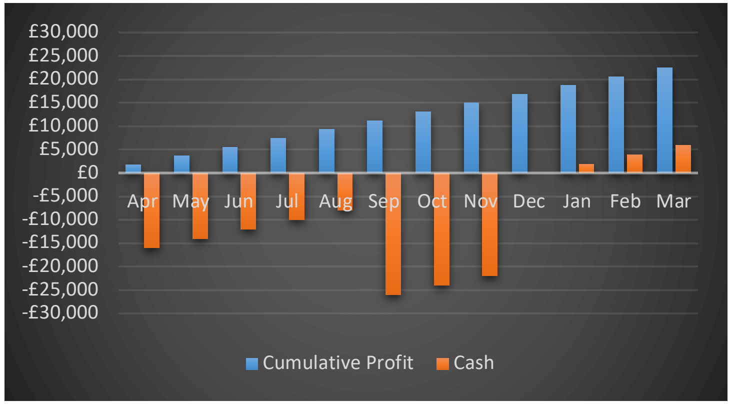


Other items that impact on working capital

There are other items that impact on working capital which are either monthly costs (rates, insurance, travel), quarterly (VAT), annual (Corporation Tax) or one offs (rent deposit).

One of the biggest potential drains on a company's cash are things a company buys that it then recharges to their client. This often depends on the sector a company specialises in; design and digital agencies often have few costs that they buy on behalf of their clients. Events companies and advertising agencies usually buy goods and services that they recharge to their clients and these can run into hundreds of thousands, if not millions, of pounds. If these items are paid for by the company before the money for them is received from the client it will have a demonstrable effect on the company's cash.

If the company purchased goods worth £20k for a client in September but didn't receive the money for this from the client until December the chart would look like this:



Managing working capital

As can be seen from above it is important for companies to manage their cash carefully, especially if it's in short supply. Only making sure there's enough cash in the bank at the end of the month to pay salaries (and yourself) can be very dangerous. It may get you through the end of the month but you might not have allowed for the large VAT payment coming out the following week. Ideally a company should have enough cash to cover three to six months' worth of the company's costs even if no more sales invoices were sent out.

The key to managing this is forecasting and planning. Ideally companies should have a detailed 13 week cash flow forecast that details all the amounts due to come in and all the amounts that need to be paid out on a week by week basis. This should then be supported by an overview forecast on a month by month forecast looking at between 6 and 12 months in the future.

The information necessary to make these forecasts as accurate as possible (it's a forecast so never going to be 100% accurate) are:

Income Pipeline – This is often challenging, especially as so many companies work on a project basis and knowing what projects are coming up in 3 months' time is difficult. However, projects will come up and it's a matter of using realistic judgement as to the value of projects likely to come up.

Budgeted costs – Using a budget to try to predict costs that will be incurred in the future, including budgets for buying things like computers and furniture.

Other expenditure – The amount and timings of VAT and Corporation Tax payments and any other exceptional costs such as office moves.

Another important part of managing cash is having good invoicing and credit control procedures, ensuring invoices to clients go out as quickly as possible and understand the clients payment process and procedures (such as payment terms, purchase orders and sign off process) to ensure cash is received as quickly as possible. Where you need to pay a supplier quicker than you normally receive payment from a client it's imperative that you ask and get the client to pay you first. The general rule should be to never pay a supplier until the client has paid you. Otherwise you are bank rolling the client!

Fix a working capital shortfalls

Even with careful management it is sometimes not enough to solve the problem of a lack of cash. The above examples demonstrate that even a profitable company can encounter problems with cash. The earlier a problem is spotted the easier it is to find a solution. Here are some potential solutions:

Client Payment Terms – Negotiate with your clients on payment terms. No matter what a client says they are negotiable! One inducement for clients to do this is to offer them a discount for paying earlier (usually a couple of percent).

Supplier Payment Terms – It's important to try and match the terms you use to pay your suppliers to the ones you receive from your clients. If most of your clients pay on 60 days then you should pay most of your suppliers on 60 days. Managing your suppliers' expectations on when they will receive payment is important (remember they will be planning their own cash needs as well!)

Payroll Date – Companies pay their employees on different days of the month, 24^{th}, 25^{th}, 28^{th}, last working day of the month. If you're paying employees on the 24^{th} of the month and most of you clients pay on the last working day of the month this can often cause cash flow problems in the intervening period. Change the payroll date. Most employment contracts state that employees are paid for the calendar month regardless of the date they actually receive the cash. With a bit of careful HR management it should be possible to change the date to one that makes more sense for the company. After all the company needs cash to pay them.

Bank Overdrafts/Loans – Banks are willing to lend to most companies if they can demonstrate that they're profitable. Sometime they will secure the amount against the assets of the company, especially if you have a large amount owed to you by clients, other times they may ask for personal guarantees from company owners. The latter option should be avoided where possible. A company is an entity in its own right and should be able to stand on its own two feet.

Invoice Factoring/Discounting – This is where you in effect sell most of the value of a client invoice to a third party. For example you raise an invoice for £100 to a client who normally pays you on 60 days. You "sell" this invoice to a factoring company at the time you raise it. They give you £80 there and then with the remainder being paid when the client has paid them. The factoring company will obviously charge you a fee for this, how much usually being dependent on the value involved and the likely length of time it will take them to be paid by the client.

Sell Shares to Investors - If you're running a profitable company there's a good chance that an investor will pay money for a share of your company. Rather than buying shares from the company owners (in which case the money would go directly to the owners) the company could issue more shares and the investor can buy these from the company. That way the cash would go directly into the company's bank account. How much an investor will pay is obviously dependent on many factors.

So we've seen through this document that cash really is king. It is possible for companies to run at a loss and keep going (just look at Facebook in the early days) but it' pretty much impossible for a company to operate without cash regardless of whether they are profitable or not. The most important thing is to plan your cash, ideally for a year ahead, so you can spot any problems in time for you to do something about them.

Chris Lang has been working in the Marketing Communications industry for over 30 years. In 2007 he formed Flash Partners Ltd with the aim of providing small and medium sized companies with a full internal finance function without the full time cost.

Chris and his team have worked with many companies overto past 5 years to help improve their financial performance,not only by processing day-to-day data but also improving processes and commercial awareness throughout the company. This approach ensures high quality information and therefore better decision making at the top level.

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