Ask SCORE

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Manage Your Working Capital to Maintain Business Success

As the owner of a small business, you may think it has little in common with a large corporation. While it is true that you will likely rely more on trade credit, bank financing, lease financing and personal equity, your long-term investment decisions require the same kind of diligent analysis used by large firms. The key is understanding those factors that affect financial decisions, how they apply to your business's short and long term goals and strategies, and any other influences that may be unique to your situation.

Working capital, the difference between current assets and current liabilities, is a vital issue for every small business. Lack of close control of working capital is one cause of business failure. Every small business owner must be constantly alert to changes in working capital, the reasons for them and any resulting business implications.

It is helpful for the owner to think of working capital in terms of its six components:

1. Cash and equivalents. This most liquid form of working capital requires constant supervision. A good cash budgeting system addresses many important considerations: whether the cash level is adequate to meet current expenses as they come due; timing of cash inflow, cash outflow and peak cash needs; amount to borrow to meet cash shortfalls; and the timing of repayment of loans. These cash issues can be effectively handled by a rolling six-month cash flow projection.
2. Accounts receivable. Almost all businesses extend credit to their customers. Make sure the amount of accounts receivable is reasonable in relation to sales and that receivables are being collected promptly. Identify slow paying customers and have a strategy for dealing with them.
3. Inventory. Inventory often constitutes as much as 50% of a firm's current assets. Is the inventory level reasonable compared with sales and the nature of your business? Know the rate of your inventory turnover compared with others in your type of business. Too much inventory in retailing can be a serious drain on cash when you have availability alternatives represented by UPS and FedEx.
4. Accounts payable. Financing by trade is common in small business and is one of the major sources of funds for entrepreneurs. Understand whether your business's payment policy is helping or hurting your credit rating.
5. Notes payable. Notes to banks or other financial sources represent a popular alternative financing source. A cash flow forecast will enable you to keep track of when payments are due and whether the money will be there.
6. Accrued expenses and taxes payable. These are obligations of the firm at a given time and represent expenses already obligated even if payment is not yet issued. This account must not be used as "honey pot".