# HOW TO ESTIMATE WORKING CAPITAL BROCHURE

Working capital is a very important measure in your business.  Put simply it measures a business's ability to pay its bills.

## The accounting stuff

The definition of working capital is "current assets minus current liabilities".
"Current assets" includes cash, accounts receivable (money a business is owed) and inventory (stock).  I will refer to this as 'revenue'.
"Current liabilities" includes accounts payable, loan repayments, operating costs. I will call this 'bills' or 'expenses'.
The working capital ratio = current assets divided by current liabilities
For example if you have $1000 of current assets and $800 of current liabilities your working capital ratio is 1000/800 = 1.25.  In very simple terms this means that for every $1 of bills, you have $1.25 of revenue in your business.
Your working capital ratio needs to be more than 1.00 otherwise it means your current liabilities are more than your current assets, that is you don't have sufficient money to pay your bills.

Understanding the working capital needs of your business is imperative to the survival of your business.  This is particularly important when buying a new business but it is also something you need to monitor on an ongoing basis.
The working capital requirements of different business models and industries can vary enormously.  We will explore 2 of these:  retail food and mobile service industries.

**Retail Food Business**

When you are looking at buying a retail food business you will consider:

- Set up costs
- Working capital requirements
- Ongoing capital expense requirements

The set up costs will include on the costs associated with setting up your business such as a franchise fee, professional fees (legal, financial and accounting advice) and fitout costs. When buying a franchise you can use the Disclosure Document as a starting point to identify how much it will cost you to set up the business.  For retail food businesses fitting out your store will generally be an expensive exercise. By knowing the set up costs you can ensure that you have sufficient capital (money) to cover these costs, whether the capital comes from savings or a loan.
The next step in any financial due diligence is determining how much working capital you will need.  When setting up a new business you need to allow time for the revenue to build up.  It may take time for customers to realise you exist, to decide to leave their favourite cafe and try the new one that's just opened.

## Retail Food Business continued…

And it will take time to develop a loyal following of regular customers. During this time where the business is getting established and growing you will have certain costs that need to be met. Some are fixed costs such as rent (these costs are the same regardless of how much revenue the business generates) and some are variable costs such as food and beverage supplies (inventory) and wages (costs go up as the business revenue goes up). Initially it is reasonable, and most likely prudent, to assume that the working capital ratio will be less than one – business revenue will be less than business expenses. When looking at setting up a new business it is imperative that you consider how long it will take for the business to reach and sustain the breakeven point, the point where revenue = expenses or the working capital ratio is 1. You will need to forecast and calculate how much the shortfall between revenue and expenses will be for the period prior to breakeven and ensure you have these funds available to access and utilise in your business. One of the benefits of a food retail business is that customers generally pay as they order so the accounts receivable days are very low.

## Mobile Service Business

Mobile service business are business where fixed premises such as a shop or office are not required and inventory requirements are low. Well known examples would be a lawn mowing, painting, mortgage broking, bookkeeping and home based legal services businesses. Just like a retail food business, in setting up a mobile service business you will need to consider:

- Set up costs
- Working capital requirements
- Ongoing capital expense requirements

These 3 costs tend to be lower in a mobile service business. The set up cost will include items such as the franchise fee, professional fees, a vehicle and some equipment (gardening tools or a laptop). Many of these businesses don't require staff at first (possibly not ever) and this, along with the absence of a shop or warehouse, saves the business owner thousands in set up and working capital costs. It is still important to determine when your business is likely to achieve sustained breakeven and how much working capital you require to get you through to this point. A consideration for working capital in a mobile service business is the accounts receivable days. For example a mortgage broker may get paid 60 days after a loan settles, a lawyer may get paid 14 days after an invoice is issued and a lawn mower may get paid 7 days after an invoice is issued. Finding ways to reduce the accounts receivable days can improve your working capital situation quite a bit.

## An important ingredient


A very important consideration in the working capital calculations is whether the owner of the business needs to draw an income from the business. Best practice would be for a business owner to complete a household budget. If they have a partner who earns sufficient income to cover all these costs a business owner may decide not to draw an income from the business for a period of time. Eventually though the business owner needs to be compensated for their time and effort at least to the level of what the typical salary would be for someone to perform the tasks they do.

If the business owner does not have a partner or their partner's income will not cover all household expenses then a salary / drawings for the business owner needs to be included in the working capital calculations. For example if household expenses are $8,000 per month for living expenses, rent, school fees and loan repayments and the business owner's partner will retain their job earning $5,000 per month net there will be a monthly shortfall of $3000 per month. This amount (or more if drawn as salary and withholding tax applies) needs to be included as an expense in the business' working capital calculations.

## Established businesses

A Determining the working capital requirement is important not only when setting up a new business but also:

- When buying an established business because:
  - The previous owner may be selling because the business was not performing well
  - You may run the business slightly differently to the previous owner and that impacts the projected revenue and costs of the business
  - The income you need to draw form the business may be different to the previous owner
- When considering a capital expense, reinvestment back into the business and taking on a new loan in the business. During these events you need to determine what the impact will be to the business' working capital. For example does the business have sufficient working capital to absorb the loan repayments for a $150K new commercial kitchen in the café?

Written by

**Maria McQuillan**

Director / Senior Finance Broker
M: 0413 041 646
maria@concinnatefs.com.au