



Agricultural Marketing Resource Center
Value-added Agriculture Profile
Iowa State University

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Lesson 9: Working Capital Needs of a Value-Added Business

Funding was provided by the Agricultural Marketing Resource Center.

OBJECTIVES:

After completion of this unit, the students will be able to:

1. Describe the role working capital plays in a value added business;
2. Estimate the amount of working capital that would be needed to operate a value added business on a financial sound basis.

MATERIALS/REFERENCES NEEDED:

The importance of working capital (2003). Philip McCosker
http://www.accountancy.com.pk/articles_students.asp?id=77

VISUAL MASTERS(VM):

See V-A Lesson 09.ppt

INTEREST APPROACH:

Knowledge of the importance of working capital is a key part of a business's financial management. The level of working capital can serve as an indicator of potential financial problems. In order to maximize the growth of a business, the management must have working capital available. The availability of working capital can also minimize financial shortcomings in the future. Sufficient working capital is the result of proper financial planning and consistent earnings of the business. Business management (if not the owner) must be in a position to explain why a business cannot return all profit to the owner and why the business must have reserves available.

QUESTIONS:

1. What is working capital?

Answer: The amount of internal funds available to finance day-to-day events of the business.

2. Why is working capital important?

Answer:

- As an indicator of potential financial problems.
- Can maximize growth.
- Can help minimize future financial shortcomings.

3. How can you determine the amount of working capital needed?

Answer:

- Current assets minus current liabilities.
- The more closely assets are to cash the lower the amount of working capital needed.
- Example: The more rapidly the turnover of inventory, the lower the amount of cash (working capital) needed.
- The working capital ratio is determined by current assets divided by current liabilities
- A declining ratio indicates the business is not paying its debts.

4. What are some working capital guidelines?

Answer: Below are some common guidelines for a working capital.

1. \$2 of current assets for each \$1.00 of current liabilities.
2. The ratio may vary a great deal depending on:
 - a. Permanent inventory levels.
 - b. Number of locations or branches.
 - c. Type of business

5. Why should the managers of a business pay special attention to working capital?

Answer:

Management must ensure that a business has sufficient working capital. Too little will result in cash flow problems highlighted by an organization exceeding its agreed overdraft limit, failing to pay suppliers on time and being unable to claim discounts for prompt payment. In the long run, a business with insufficient working capital will be unable to meet its current obligations and will be forced to cease trading even if it remains profitable on paper.

On the other hand, if an organization ties up too much of its resources in working capital it will earn a lower than expected rate of return on capital employed. Again this is not a desirable situation.

6. What is the optimum level of working capital?

Answer: As a guide, many text books suggest that to be safe an organization requires a 2:1 ratio of current assets to current liabilities. That is for every \$1 of current liabilities, \$2 of current assets is required to ensure that the organization does not run into cash flow problems. However, this is much too simplistic, and the required level of working capital will vary from business to business.

See Table 2 in the reference, [The importance of working capital](#) (2003) by Philip McCosker which provides a comparison of the optimum level of working capital by industry.

7. What are some ways to reduce capital needs?

Answer:

1. Consolidation
 - Pooling to reduce costs
 - Influences efficiencies
 2. Joint Ventures
 - Between the business and other partners
 3. Partner with firms with superior market strength
 - Gain access to markets rather than control the markets
- ☐ Value-Added Ag Businesses are attempting to meet the challenge by:
Avoiding redundant capital use
- Areas where this is happening:
- Sugar beet industry
 - Corn processing
 - Dairy industry
 - Citrus industry
- Primarily in the form of limited liability companies or cooperative businesses.

CONCLUSION

During the course of this lesson, we have looked at the items that make up working capital and considered how organizations can improve their management of working capital. We have seen that the ideal level of working capital is difficult to calculate and will vary from one organization to another depending upon the industry in which they operate. What is essential is that a business avoids both the situation of too little or too much working capital.

Too little working capital is known as over-trading and is common when a business is starting up or is experiencing a period of rapid growth. The situation will then arise where a business may be

profitable on paper but has insufficient funds available to pay debts as they become due. In the short term, this situation can be solved through a combination of measures including:

- Obtaining an increased overdraft facility.
- Negotiating a longer credit period with suppliers.
- Encouraging debtors to pay faster.

However, in the long term a business is unlikely to survive without a combination of:

- New capital from shareholders/proprietor.
- Better control of working capital.
- The building up of an adequate capital base through retained profits.

Almost as bad is too much working capital or over-capitalization. Poor management of working capital will result in excessive amounts tied up in current assets. Such a scenario will lead to a business earning a lower than expected return.

It must be remembered that the shorter an organization's working capital cycle, the faster cash, and hence profits, from credit sales will be realized. To achieve this, an organization must regularly review its working capital, taking action where necessary.