Cash Flow Projection Webinar – Assessing Your Liquidity and Working Capital

Given the recent strong economy, many enterprises have been debt averse and may have grown their working capital beyond the reasonable needs of the business. To evaluate your company's ability to fund near term operations from existing working capital or from borrowings, we believe it is helpful to know where you are starting in terms of your company's liquidity. This information may give you confidence to draw down some of your cash reserves to fund operations or to obtain and/or borrow against a short-term line-of-credit.

You should assess whether your balance sheet does in fact have excess working capital in the form of available cash reserves or liquid investments that could be used to support operations. This can be done by discussing your financial condition with your advisors and by comparing certain ratios or measures of liquidity with your industry.

Working capital is measured by subtracting your current liabilities from your current assets. Current assets and current liabilities are defined as those assets or obligations that can be expected to be converted to cash or consume cash within the next operating cycle normally considered to be a 12-month period.

There are several ways to evaluate potential excess working capital. The first is to calculate your company's current ratio. This ratio is a liquidity ratio that measures whether the enterprise has enough resources to meet its short-term obligations and is expressed as follows:

$$\text{Current Ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

It is important to note that acceptable current ratios vary from industry to industry and therefore for this measure to be meaningful you should compare your results with data available from your peer groups, from industry trade associations or using a resource such as Risk Management Associations financial statement studies.

While a high current ratio is often considered favorable a high current ratio might also indicate that the company is not efficiently deploying its current assets or utilizing short-term financing options. In addition, lower current ratios can be acceptable for those enterprises that can collect cash from customers quicker than the requirement to pay their suppliers, for example those businesses with a high percentage of cash collected at the time of sale.

Another benefit of performing this exercise is it indicate opportunities to generate cash that are residing within your balance sheet. For example, a high current ratio compared with your industry might indicate that you are collecting receivables or turning your inventories slower that others within your industry. Improvements in those areas would convert those assets into cash quicker.

Another measure of liquidity is to compare your companies working capital expressed as a percentage of your company's annual revenues and compare it to industry benchmarks. If your company's percentage of working capital to revenues is considerably higher than your peers, it could be an indication that you have excess working capital that could be used to finance operations over the near term.

In addition to the above measures you may also want to review a prominent Tax Court *case Bardahl Manufacturing v. Commissioner, T.C. Memo 1965-200* which suggest analyzing a company's business cycle to estimate its unique working capital needs and uses that computation to estimate the amount of working capital required to operate the business within that cycle.

You may want to think through your assessment not in terms of whether you should be more conservative or less conservative in addressing the challenges from this pandemic but rather whether you have the appropriate amount of working capital and the appropriate amount of interest bearing debt within your capital structure.

For example, you may have purchased long lived assets such as transportation equipment, furniture and fixtures, or machinery and equipment with your cash reserves recently. Even in good times a general rule for appropriate balance sheet management is to match the repayment obligation with the life of the asset.

In other words, do not use cash reserves or draw against short-term borrowings to finance the purchases of property and equipment. Therefore, you should consider borrowing to finance the purchase of long-lived assets over the next several months.

In addition if you've recently used cash to acquire long- lived assets you may be able to bundle purchases of those assets made over the last 24-36 months and work with your financial institution to obtain financing with those assets serving as collateral against those borrowings.