

# The Working Capital Concept

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THE measure of working capital has long been accepted as a useful tool for financial analysis. Yet a critical review of the structure of this concept, as it is currently applied, raises some very serious questions concerning its validity as a measure of current position. This paper examines the foundation upon which this concept rests, in an effort to improve accounting reporting and analysis.

## *Nature of Working Capital*

The core of the working capital concept has been subjected to considerable change over the years. A few decades ago the concept was viewed as a measure of the debtor's ability to meet his obligations in case of liquidation. The prime concern was with whether or not the current assets were immediately realizable and available to pay debts in case of liquidation. In applying this measure a one-year period was frequently used to classify assets and liabilities as current; that is, current assets were those realizable and current liabilities were those due within one year.

The focus of attention in recent years has shifted from this liquidation point of view towards the "operating cycle" point of view. This view emphasizes the ability of the firm to pay its maturing obligations from the funds generated by current operations.

*Accounting Research Bulletin No. 43* characterizes working capital as a "margin

or buffer for meeting obligations within the ordinary operating cycle of the business."<sup>1</sup> In this sense, working capital is a static measure, that is, the amount of working capital at a particular point of time is a measure of the "margin or buffer" for meeting currently maturing obligations.

There is little question that credit grantors, management, stockholders, and others have a need for an analysis and evaluation of working capital. At a minimum two types of analysis can be provided: (1) the presentation of the amount of working capital at a particular point in time to indicate a rough measure of the "margin or buffer" presently available to meet currently maturing obligations (static analysis), and (2) the presentation of the flow of working capital for past periods and the expected flow covering future periods (dynamic analysis). Is the present concept of working capital useful from both of these views?

## *Deficiencies in the Working Capital Concept*

It is not the purpose of this paper to

<sup>1</sup> "Restatement and Revision of Accounting Research Bulletins," 1961 (New York: American Institute of Certified Public Accountants), p. 20.

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isolate and enumerate all of the deficiencies and inconsistencies within the present framework of the working capital concept. Instead, representative deficiencies associated with the present concept are briefly described to establish the thesis that the current concept of working capital is not entirely logical.

*Accounting Research Bulletin No. 43* defines the operating cycle:

The ordinary operations of a business involve a circulation of capital within the current asset group. Cash is expended for materials, finished parts, operating supplies, labor, and other factory services, and such expenditures are accumulated as inventory cost. Inventory costs, upon sale of the products to which such costs attach, are converted into trade receivables and ultimately into cash again. The average time intervening between the acquisition of materials or services entering this process and the final cash realization constitutes an *operating cycle*.<sup>2</sup>

Application of this definition permits the operating cycle to vary significantly among industries. For example, current assets may include inventories that have been held for years, as in the case for distillery firms, or they may include inventories that are turned over many times within a year, as in some retail firms. The user of financial statements must therefore use a different set of standards to guide him in the analysis of working capital for various industries. If working capital analysis is viewed in the static sense, the amount of "margin or buffer" for meeting current obligations for one firm is not comparable to the amount of "margin or buffer" for another firm in a different industry because of the variance in the operating cycle. If working capital analysis is viewed from the flow of funds standpoint, the same limitation applies. This in itself is not an overwhelming objection to the current working concept; but other limitations exist.

Current assets include such resources as prepaid insurance, interest, rents, adver-

tising, and operating supplies. There is some inconsistency in the inclusion of a three-year prepaid insurance premium, for example, as a current asset while excluding machinery and equipment having a three-year life. The reasoning used to justify inclusion of certain prepaid items in the current asset category seems to be that if the services had not been paid for in advance, they would require the use of current assets during the operating cycle. This argument is equally applicable to many other assets not presently classified as current. For example, if machinery and equipment with a three year life is purchased with current assets, the acquisition has the same effect on the flow of funds and on the real "margin or buffer" to meet current obligations as does the acquisition of a like amount of prepaid insurance. In terms of the influence on both liquidity and flow of funds, there appears to be no significant basis for distinguishing between the two acquisitions. If classifying these two expenditures in separate categories serves a useful purpose in describing the nature of the resource available for use by the enterprise, this is one matter; but permitting such classification to influence the measure of working capital seems unfortunate and raises a question regarding the soundness of the present working capital concept.

From another point of view, some of the resources currently classified as current assets have characteristics of fixed properties. Accounts receivable and inventories, although they may turn over several times a year, have the permanency characteristic of plant assets in that as individual items of current inventories are sold and specific accounts receivable are collected, they are replaced by other items in a continuing cycle. In this going-business sense, there tends to be required a minimum

<sup>2</sup> *Ibid.*, pp. 20-21.

permanent commitment of capital in receivables and inventories. Likewise, the current liabilities of a going concern represent a more or less permanent obligation in the going-business sense. For the going concern, trade payables owed in the present are constantly being replaced by other short-term obligations. This leads to an interesting point when considering the "margin or buffer" for meeting obligations within the ordinary operating cycle.

Just how invalid is the measure of the amount of working capital as it is presently computed as an indicator of this "margin or buffer"? In other words, what is the difference between the amount of resources that will become available from the current assets and the amount of resources that will be required to meet the current liabilities? Does the difference between the balance sheet amount of current assets and current liabilities indicate this "margin or buffer"? The amount of resources that will be provided by the current assets is not necessarily the recorded amount. To illustrate, it is not the current amount of inventories that should be considered in computing the amount of working capital. For one thing, when this inventory is sold it will probably have to be replaced. Within the limits of price-level changes, changes in level of operations, and other similar limiting factors, the cost of inventories included in current assets will be offset by costs for replacement and accounts payable. Any "margin or buffer" arising from the acquisition and sale of inventory is represented by the excess of the sales price over the cost to replace the goods. Therefore, to include the current amount of inventory cost in the computation of the amount of working capital does not provide the best measure of the "margin or buffer" to meet maturing obligations within the ordinary operating cycle. If, instead, the amount of resources that will

be provided by the current assets were used in this computation, the usefulness of the working capital concept might be improved. This would lead to reflecting inventory on a present-value basis, i.e., net realizable value for purposes of working-capital analysis.

The problem of the proper "valuation" of current assets and current liabilities for purposes of working capital analysis becomes more apparent if the valuations presently assigned to the individual items of current assets and current liabilities are critically examined. For example, some of the current assets may be stated at cost (prepaid items), some may be reflected at market (marketable securities), some may be stated at lower of cost or market (inventories), some at realizable value (accounts receivable less allowance for doubtful accounts), and some at current value (cash). This inconsistent valuation can only weaken the validity of working-capital analysis. For working-capital analysis, the amount of current assets can best be expressed on a net realizable value basis.

This rather brief analysis of the underlying characteristics of the current working capital concept can be summarized by stating that the present concept of working capital may need to be defined to enhance the usefulness of accounting as a tool for use in financial analysis.

One step that can be taken towards the evolution of a more meaningful and useful measure of working capital is to examine closely the purposes served. What data are needed by the short-term creditor, by management, and by others who are concerned with working capital analysis? The next step would call for revision of the present concept to provide this data in the most useful format. Such a study might well lead to a renovation of the balance sheet and a more extensive use of the funds statement.

*Renovated Balance Sheet*<sup>3</sup>

The present classification of balance sheet items into current asset and current liability categories leads logically to the comparison of these groups. As discussed above, the manner in which this comparison is often made and the resulting determination of working capital and its use in financial analysis can be misleading if the limitations inherent in the concept are not fully understood and taken into account. To improve the over-all interpretation of the financial position, two broad classes on the balance sheet are proposed: resources and equities. These two classes can be subdivided. The number and limits of each subclass would be determined by the differences among the individual resources and equities. Each class would therefore focus on similarities within the resources and equities. No attempt would be made nor implication given that would lead to the practice of relating individual resource items to individual equity items. For example, the following subclasses might be used:

<i>Resources</i>	<i>Equities</i>
Cash resources	Obligations requiring payment currently
Inventories	Obligations requiring payment in the future
Other short-lived resources	Stockholders' equity
Long-term investments	
Other long-lived resources	

The cash resources would include cash and claims to cash expressed in current realizable figures. These would include marketable securities and receivables. These resources represent a category of like resources of cash or near cash items. Inventories would be set out as a separate category because they represent a resource to be sold by the enterprise that should yield cash in an amount in excess of carrying value.

Long-term investments would also be set out as a separate category because these

resources are not directly identified with primary enterprise activities and are not similar to cash resources or inventories. Likewise, the classification of the remaining resources would stress the nature of the resources, that is, how they will be utilized by the enterprise. To keep this article focused on its main thesis, the division of the resources will be concluded by merely setting up two additional categories—other resources to be used in the short run and other resources to be used over the long run. To distinguish the short run from the long run, a cut-off period of one year might facilitate financial analysis since the fiscal year is a common period for financial reporting. An important point is that there would be no implied relationship between any specific resource and any specific equity interest. (A relationship such as specific resources pledged as security for debt could be disclosed parenthetically. This point is discussed again in the following paragraph.)

The equity interests frequently referred to as liabilities would be classified as obligations requiring payment currently and obligations requiring payment in the future. In this way there will be no implied relationship between any one resource group and any specific equity group. This is as it should be. Currently maturing obligations can be met by many means—payment from cash on hand, payment from cash arising from the sale of inventories, creation of other currently maturing obligations, creation of long-term obligations, and sale of stock, for example. Even in situations where specific assets are pledged as

<sup>3</sup> Proposals to renovate the balance sheet have been suggested by many writers. For an interesting discussion on this topic see William A. Paton and William A. Paton, Jr., *Corporation Accounts and Statements*, Chapter 14. The authors' presentation of a "sequence" form of statement of financial position is an attempt to make the statement clearer and more intelligible for the reader.

security for debt, this classification would be followed. From the going-concern viewpoint, such a pledging of assets is largely irrelevant. Thus, this relationship can best be disclosed by a parenthetical note to the balance sheet. Again the period of one year to distinguish between current and long-term obligations might best serve financial analysis.

The equities section would be completed by the stockholders' equity classification to represent the interests of the stockholders in the resources of the enterprise. Again there is no implied relationship between this equity interest and any specific resource. From the going-concern view, all stockholders' equity interests rank equally as relates to claims in resources.

Such a classification of balance sheet items which suggests the manner in which the resources will be used by the enterprise would better highlight the resources available for use by the enterprise than does the present classification. The equities in the enterprise resources would be shown by category of interest. The confusion that may result from the present classification of balance sheet items would be avoided. No longer would current liabilities, for example, be defined as obligations whose liquidation is reasonably expected to require the use of existing resources properly classified as current assets or the creation of other current liabilities. Short-term obligations would indicate debts that must be settled currently. Obviously, there are many means of settling these debts. Such illogical relationships as the implied availability of prepaid items such as insurance and operating supplies to satisfy current liabilities would be avoided. All such resources would be classified according to the service they will provide for the enterprise.

#### *More Extensive Use of Funds Statements*

The revised classification of the balance sheet should facilitate interpretation and working capital analysis. However, for effective working-capital analysis much more is needed. The determination of "margin or buffer" available to meet currently maturing obligations can be helpful in working capital analysis. A report indicating the flow of working capital during past periods would also be useful. In addition to the usual funds statement, a statement indicating the anticipated flow of funds for future periods would be especially useful for long-range planning. In other words, a combination of reports indicating the amount of working capital, the flow of funds during past periods, and the expected flow of funds covering future periods might provide the basis for a thorough evaluation of the working-capital position.

#### *Conclusion*

The proposed renovation of the balance sheet obviously needs considerable thought before all the various resources and equities are given proper identification. The point remains however that the present classification of balance sheet items, especially working capital items, may lead to difficult if not erroneous conclusions about the financial position. The present classification of balance sheet items should be carefully studied in an attempt to provide a more useful statement for interpretation by the user.

The use of a funds statement covering past operations is useful in making financial decisions related to working capital. However, adding projected funds statements to historical funds statements might provide even better data for making financial decisions.