BUSINESS VITAMINS

Working Capital

Introduction

Working Capital (WC) is a measure of a company's liquidity, operational efficiency, and short-term financial health. If a company has substantial positive WC, then it should have the potential to invest and grow. If a company's current assets do not exceed its current liabilities, then it may have trouble growing or paying back creditors. It might even go bankrupt. A company has negative WC if its ratio of current assets to liabilities is less than one. Positive WC indicates that a company can fund its current operations and invest in future activities and growth. High WC isn't always a good thing. It might indicate that the business has too much inventory or is not investing its excess cash. Manufacturing facilities.

Definition

When to Use it

Working Capital is used to gauge the financial health of a company in the short run as working capital is used to fund operations and meet short-term obligations. If a company has enough working capital, it can continue to pay its employees and suppliers and meet other obligations, such as interest payments and taxes, even if it runs into cash flow challenges.

Details

WC estimates are derived from the array of assets and liabilities on a corporate balance sheet. Current assets listed include cash, accounts receivable, inventory, and other assets that are expected to be liquidated or turned into cash in less than one year. Current liabilities include accounts payable, wages, taxes payable, and the current portion of long-term debt that's due within one year. To calculate WC, compare the former with the latter—specifically, subtract one from the other. The standard formula for NWC is current assets minus current liabilities. A company has negative NWC if the equation produces a negative number or if its working capital ratio, which is current assets divided by current liabilities, is less than one. In the corporate finance world, "current" refers to a time of one year or less. Current assets are available within 12 months; current liabilities are due within 12 months.

Positive NWC indicates that a company can fund its current operations and invest in future activities and growth. NWC that is in line with or higher than the industry average for a company of comparable size is generally considered acceptable. Low NWC may indicate a risk of distress or default.

Example:

Net working capital (NWC) is calculated by taking a company's current assets and deducting current liabilities. For instance, if a company has current assets of $100,000 and current liabilities of $80,000, then its NWC would be $20,000.

Consider the case of XYZ Corp. When XYZ first started, it had NWC of only $10,000, with current assets averaging $50,000 and current liabilities averaging $40,000. To improve its NWC, XYZ decides to keep more cash in reserve and deliberately delay its payments to suppliers to reduce current liabilities. After making these changes, XYZ has current assets averaging $70,000 and current liabilities averaging $30,000. Therefore, its NWC is now $40,000.

On the next page is a snapshot of the balance sheet of a company. Let us try to find out its Working Capital. The answer is given at the bottom of the table.

Assets		Liabilities & shareholders' equity	
Cash	5	Accounts payable	20
Accounts receivable	55	Credit card debt	5
Inventory	50	Bank operating credit	25
Pre-paid expenses	10	Accrued expenses	10
		Taxes payable	5
		Current portion of long-term debt	5
Current asset	120	Current liabilities	70
Vehicles	15	Bank debt	70
Equipment	50	Other long term notes payable	60
Land and buildings	100		
Investments	5	Long-term liabilities	130
Patents/goodwill	10		
Fixed assets	180	Total liabilities	200
		Equity from common shares	25
		Equity from preferred shares	25
		Retained earnings	50
		Total shareholders' equity	100
Total assets	300	**Total liabilities and shareholders' equity**	300

Using figures from the balance sheet excerpt below, working capital and working capital ratio would be:
Working capital = \$120—\$70 = \$50
Working capital ratio = \$120,000 / \$70.000 = 1.7 (rounded)
With \$1.70 for every \$1 of current liabilities, the company has a healthy working capital ratio for its industry.