Course: B.Com Part III

Paper: VI

Topic: Working Capital

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What Is Working Capital?

Working capital is money that’s available to a company for its day-to-day operations. Simply put, working capital indicates a company's operating liquidity and efficiency.

A company's working capital reflects a host of company activities, including cash, inventory, accounts receivable, accounts payable, and the portion of debt due within one year (as well as any other short-term accounts). This can extend to inventory management, debt management, revenue collection, and payments to suppliers.

How to Calculate Working Capital

To calculate working capital, you first need to determine a company's current assets and current liabilities.

Current assets include a company's liquid cash as well as other assets that can be converted to cash within one year or less. Some examples of current assets include money in checking accounts, inventory, supplies, equipment, and temporary investments.

Current liabilities include all the expenses and debts that a company needs to pay within one year. Examples of current liabilities are accounts payable, dividends, and income taxes owed.

What Is the Working Capital Formula?

You can calculate the working capital of an organization by using the following formula:

Working Capital = Current Assets - Current Liabilities

Working Capital Example

In the following example, we calculate a company's working capital by reviewing its simplified balance sheet:

Balance Sheet for Company XYZ				
Cash	$60,000		Accounts Payable	$30,000
Marketable Securities	$10,000		Accrued Expenses	$20,000
Accounts Receivable	$40,000		Notes Payable	$5,000
Inventory	$50,000		Current Portion Long-Term Debt	$10,000
Total Current Assets	$160,000		Total Current Liabilities	$65,000

Figure 1

Using the working capital formula and information from the table above, we can calculate the company's working capital:

Working Capital = $160,000 - $65,000 = $95,000 (a positive sum).

What Are Positive and Negative Working Capital?

Positive working capital generally indicates whether a company is able to quickly pay off its short-term liabilities. Negative working capital generally indicates that a company is unable to do so.

This is why analysts are sensitive to decreases in working capital and may suggest that a company is becoming overleveraged, struggling to maintain/grow sales, paying bills too quickly, or collecting receivables too slowly. Increases in working capital, on the other hand, suggest the opposite.

The working capital formula (current assets - current liabilities) demonstrates that if a company has positive working capital, it will be able to repay its payables and other short-term debt, even if business were to suddenly dry up.

Companies with positive working capital may face a problem if they have only enough cash to pay for "day-to-day" operations and not enough cash for further expenses. If this occurs, it might mean that the company is:

- having trouble moving its inventory
- collecting receivables from customers too slowly, or
- paying its vendor's payables too quickly.

If the company has little cash available and is unable to perform well in those three situations, it may run into problems paying bills and vendors.