Working Capital

by Sophia

WHAT'S COVERED

In this lesson, you will learn about the basics of how or when to adjust working capital levels. Specifically, this lesson will cover:

1. Calculating Working Capital

Working capital (WC) is a financial metric which represents operating liquidity available to a business, organization, or other entity, including governmental entity. Along with fixed assets, such as a plant and equipment, working capital is considered a part of operating capital.

Working capital can be found through the following formula:

FORMULA TO KNOW

Working Capital

$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

Current assets is an accounting term that refers to assets that can easily be turned into cash. For instance, cash is a current asset, but so are most accounts receivable. **Current liabilities** is an accounting term that refers to the amount of liabilities that are expected to be settled in cash within a year (or the operating cycle of the company).

The difference between the two, which is equivalent to the working capital, is a measurement of liquidity. It signals whether or not the company has enough assets to turn into cash to pay off upcoming liabilities. It is not a perfect signal, however.

Since most expenses and debt must be paid in cash, having positive working capital shows that the company has the ability to pay off expenses and debt that will arise or come due in the short term. Working capital,

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though, does not guarantee that a company can pay off all short-term expenses or liabilities. Simply having a positive WC does not necessarily mean that a company will be able to pay off all expenses.

IN CONTEXT

Suppose that a company has current assets of $100: $20 of cash and $80 of accounts receivable. They also have $50 of current liabilities.

$$\text{Working Capital} = \$100 - \$50 = \$50$$

That means that the company has working capital of +$50.

One of their accounts payable comes due tomorrow, so the company owes $40. They have $20 of cash on hand, but can't get the other $20 by tomorrow because they can't collect $20 of accounts receivable by tomorrow. The company cannot pay a short-term expense, even though a positive WC says that the company should be able to pay off most expenses and loans in the short term.

BIG IDEA

WC is not a guarantee that the company will have enough cash for each expense, merely that they have operating liquidity.

TERMS TO KNOW

Working Capital
A financial metric that is a measure of current assets of a business that exceeds its liabilities and can be applied to its operation.

Current Assets
Assets on the balance sheet, such as cash, accounts receivable, and inventory that are expected to be sold or otherwise used up in the near future, usually within one year or one business cycle, whichever is longer.

Current Liabilities
All liabilities of the business that are to be settled in cash within the fiscal year or the operating cycle of a given firm, whichever period is longer.

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2. Controlling the Components of Working Capital

Each company has different demands for how much working capital they need, but all companies prefer to have positive working capital.

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- Having too little working capital impairs a company’s ability to meet its financial obligations. It is hard to pay expenses or debts that come due in the short term.
- Having too much working capital can also be bad because it means that there are assets that are not being invested. Holding too many short-term assets slows future growth of the company.

Thus, managing working capital to an acceptable level is one of the most important jobs of management. Working capital can be adjusted by increasing or decreasing its two components:

Increase Working Capital	Decrease Working Capital
Increase Current Assets OR Decrease Current Liabilities	Decrease Current Assets OR Increase Current Liabilities

3. Managing Working Capital

Working capital is important for businesses of any size in order to properly manage liquidity. Recall that we calculate working capital as the difference between current assets and current liabilities. Because of this, businesses need to carefully manage cash and cash equivalents, accounts receivable owed by customers, inventory, and short-term debt, such as trade credit.

Working Capital Management	Description
Cash	In establishing the appropriate level of cash, a business needs to make sure that it has cash on hand for daily operations in the delivery of products and services. It also needs to have cash on hand to service any short-term debt that is due to be paid. There also needs to be an additional level of cash on hand to meet critical expenses, like payroll. Finally, there is also a need to keep cash on hand to take advantage of any unforeseen investment opportunities that might present themselves. It would be easy to say that a business should just keep as much cash as possible on hand to meet these needs, but that would lead to idle cash not being properly invested in other assets to meet income goals.
Accounts Receivable	This involves the development and delivery of an appropriate credit policy that optimizes sales to customers while minimizing bad debt expense. It is important to have appropriate processes in place to make credit decisions. It is also important for businesses to know their customers!

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Inventory	Working capital management involves identifying the appropriate level of inventory that ensures businesses who deliver products have the raw materials and finished inventory on hand to meet the demands of their customers. They also must avoid overproduction, which increases inventory storage costs.
Short-Term Financing	A business needs to be sure that it has the credit available to purchase raw materials needed to manufacture products or the inventory of supplies needed to support the delivery of services. Most often, businesses can take advantage of credit terms, where suppliers will offer terms for payment which may include the delivery of discounts. In the absence of trade credit, a business will want to have a working capital line of credit from a financial institution.

☆ BIG IDEA

By adjusting these four primary influencers on current assets and current liabilities, management can change working capital to a desirable level.

4. Importance of Working Capital

Working capital is an important metric for all businesses, regardless of their size. Working capital is a signal of a company's **operating liquidity**. Having enough working capital means that the company should be able to pay for all of its short-term expenses and liabilities.

Large companies pay attention to working capital for the same reason as small ones do; working capital is a measure of liquidity, and thus is a measure of their future creditworthiness. Companies who want to borrow by issuing bonds or purchasing commercial paper (a market of large, short-term loans for big companies) will find it more expensive if they do not have enough working capital. If they are a public company, their stock price may fall if the market doesn't believe they have adequate working capital.

For small businesses and start-ups unable to access financial markets for borrowing, working capital has more dire implications. Working capital can also be described as the amount of money that a small business or start-up needs to stay in operation. Start-ups need to pay attention to their working capital because it is the amount of money they need to keep the business running until they break even or start earning a net profit.

On one hand, working capital is important because it is a measure of a company's ability to pay off short-term expenses or debts. On the other hand, too much working capital means that some assets are not being invested in the long term, so they are not being put to good use in helping the company grow as much as possible.

☆ BIG IDEA

Working capital is only one measure of a company's operating liquidity. It is not the only measure, and it is certainly not a guarantee of a company's ability to pay. A company may have positive working capital, but not enough cash to pay an expense tomorrow. Similarly, a company may have negative working capital but

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may be able to adjust some of their debt into long-term debt in order to reduce its current liabilities. Working capital is an important metric but is not the whole story of a company's financial health.

TERM TO KNOW

Operating Liquidity
The ability of a company or individual to quickly convert assets to cash for the purpose of paying operating expenses.

SUMMARY

In this lesson, you learned that **working capital is calculated** by subtracting a company's current liabilities from its current assets, and is an important measure of a company's liquidity. Although positive working capital may indicate that a company has the ability to meet its short-term debts, this is not universally the case. Companies can **control the components of working capital** to achieve an optimal level of liquidity. They **manage working capital** by adjusting one or more of the following variables: cash and cash equivalents, accounts receivable owed by customers, inventory, or short-term debt. In sum, **working capital is an important** indicator of a company's financial health, and can impact its ability to borrow and grow.

Best of luck in your learning!

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FORMULAS TO KNOW

Working Capital

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