

Working Capital: Formula, Components, and Limitations

Learn about company liquidity, operational efficiency, and short-term health

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DEFINITION:

Working capital is the difference between a company's current assets and its short-term liabilities.

KEY TAKEAWAYS

- Working capital measures a company's short-term liquidity by subtracting current liabilities from current assets.
- Positive working capital suggests a company can fund day-to-day operations and meet near-term obligations.
- Negative working capital occurs when short-term liabilities exceed short-term assets and may signal liquidity pressure.
- Excessively high working capital can indicate inefficient use of cash, excess inventory, or missed financing opportunities.



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What Is Working Capital?

Working capital, also known as net working capital (NWC), is the amount of money a company has available to operate after deducting its current liabilities from its current assets. Current assets are items like cash, accounts receivable/customers' unpaid bills, and inventories of raw materials and finished goods. Current liabilities are items such as accounts payable and debts.

Working capital is a commonly used measurement to gauge the short-term financial health and efficiency of an organization.



Working Capital

Credit: Investopedia / Yurle Villegas

Understanding Working Capital

Working capital is calculated using the assets and liabilities listed on a corporation's balance sheet, with a focus on immediate debts and assets that

can be converted to cash within a short period. Calculating working capital provides insight into a company's short-term liquidity. A company with positive working capital generally has the potential to invest in growth and expansion. But if current assets are exceeded by current liabilities, the company has negative working capital and may face difficulties in growth, paying back creditors, or even avoiding bankruptcy.

**IMPORTANT**

In corporate finance, "current" refers to a period of one year or less. Current assets are those that can be converted into cash within 12 months, while current liabilities are obligations that must be paid within the same timeframe. ^[1]

The amount of working capital needed varies by industry, company size, and risk profile. Industries with longer production cycles require higher working capital due to slower inventory turnover. Alternatively, bigger retail companies interacting with numerous customers daily can generate short-term funds quickly and often need lower working capital.

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Working Capital Formula

To calculate working capital, you subtract a company's current liabilities from its current assets. Both figures can be found in public companies' publicly disclosed financial statements. This information may not be readily available for private companies.

Working Capital = Current Assets – Current Liabilities

Working capital is expressed as a dollar figure. For example, if a company has \$100,000 in current assets and \$30,000 in current liabilities, it has \$70,000 of working capital. This means the company has \$70,000 at its disposal in the short term if it needs money for any reason.

A business can either have positive or negative working capital:

- **Positive working capital:** When this calculation is positive, it indicates that the company's current assets exceed its current liabilities, as in the above example. The company has more than enough resources to cover its short-term debt and some leftover cash if all current assets are liquidated to pay this debt.
- **Negative working capital:** When the calculation is negative, the company's current assets are insufficient to cover its current liabilities. This is a warning sign that the company has more short-term debt than short-term resources. It typically indicates poor short-term health, low liquidity, and potential problems in paying its debt obligations.

It's worth noting that while negative working capital isn't always bad and can depend on the specific business and its lifecycle stage, prolonged negative working capital can be problematic.

Components of Working Capital

Working capital consists of current assets and current liabilities. A company's [balance sheet](#) contains all working capital components, although it may not

need all the elements discussed below. For example, a service company that doesn't carry inventory will simply not factor inventory into its working capital calculation.

Current Assets

Current assets are economic benefits that the company expects to receive within the next 12 months. Calculating working capital poses the hypothetical situation of liquidating all items below into cash.

- **Cash and cash equivalents:** All of the company's money on hand, including foreign investments and low-risk, short-term investments like money market accounts
- **Inventory:** Unsold goods, including raw materials, work-in-progress, and finished goods not yet sold
- **Accounts receivable:** Claims to cash for items sold on credit, net of any allowance for doubtful payments
- **Notes receivable:** Claims to cash from other agreements, usually documented with a signed agreement
- **Prepaid expenses:** The value for expenses paid in advance, which, while hard to liquidate, still carry short-term value
- **Others:** Any other short-term asset. For example, some companies may recognize a short-term deferred tax asset that reduces a future liability.

Current Liabilities

Current liabilities encompass all debts a company owes or will owe within the next 12 months. The overarching goal of working capital is to understand whether a company can cover all of these debts with the short-term assets it already has on hand.

- **Accounts payable:** Unpaid vendor invoices for supplies, raw materials, utilities, property taxes, rent, or any other operating expense owed. Credit terms on invoices are often net 30 days, capturing nearly all invoices.
- **Wages payable:** Unpaid salaries and wages for staff members. Depending on payroll timing, this typically accrues up to one month's worth of wages.

- **Current portion of long-term debt:** Short-term payments related to long-term debt. Only the upcoming 12 months' payments are included in working capital calculations.
- **Accrued tax payable:** Obligations to government bodies, including accruals for tax obligations not due for months but payable within the next 12 months
- **Dividend payable:** Authorized payments to shareholders. While a company may decline future dividend payments, it must fulfill obligations on already authorized dividends.
- **Unearned revenue:** Capital received in advance of completing work. If a company fails to complete a job, it may need to return this capital to the client.



What Is Working Capital?

Credit: Theresa Chiechi Â© Investopedia, 2019

Limitations of Working Capital

Working capital can be very insightful in determining a company's short-term health. However, there are some limitations that can make the metric misleading. Here are four limitations of working capital:

1. **Changing values:** Working capital is always changing. If a company is fully operating, several—if not most—current asset and current liability accounts will likely change. Therefore, by the time financial information is accumulated, it's likely that the company's working capital position has already changed.
2. **Nature of assets:** Working capital fails to consider the specific types of underlying accounts. For example, a company with positive working capital, whose current assets are entirely in [accounts receivable](#), may face liquidity issues if customers delay payments.
3. **Asset devaluation:** On a similar note, assets can quickly become devalued. This may happen due to factors beyond the company's control, such as customer bankruptcy affecting accounts receivable, or inventory becoming

obsolete or stolen. Physical cash is also at risk of theft, impacting working capital.

4. **Unknown debt:** Working capital calculations assume all debt obligations are accounted for. In fast-paced environments or during mergers, missed agreements or incorrectly processed invoices can skew the accuracy of working capital figures.

Special Considerations

Most major new projects, like expanding production or entering into new markets, often require an upfront investment, reducing immediate cash flow. Therefore, companies needing extra capital or using working capital inefficiently can boost cash flow by negotiating better terms with suppliers and customers.

FAST FACT

Companies can forecast future working capital by predicting sales, manufacturing, and operations. [Forecasting](#) helps estimate how these elements will impact current assets and liabilities.

On the other hand, a high working capital amount isn't always a good thing. It might indicate that the business has too much inventory or isn't using excess cash as well as it could. Alternatively, it could mean a company fails to leverage the benefits of low-interest or no-interest loans.

Another financial metric, the current ratio, measures the ratio of current assets to current liabilities. Unlike working capital, it uses different accounts in its calculation and reports the relationship as a percentage rather than a dollar amount.

Example of Working Capital

To understand working capital, look at a company's balance sheet. Subtract the total current liabilities from the total current assets.

For example, if a company has \$150 billion in current assets and \$120 billion in current liabilities, its working capital is \$30 billion, which represents the amount by which short-term resources exceed short-term obligations, indicating financial flexibility to meet near-term operating needs.

Explain Like I'm Five

Working capital is the amount of liquid assets a company has available, after accounting for its upcoming payments. It tells you how much money the company has available to pay employees, suppliers, and other day-to-day business needs.

Working capital is calculated from the current assets (assets the company can sell or spend easily within one year) minus any upcoming debt payments due over the next year.

How Do You Calculate Working Capital?

Working capital 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 working capital would be \$20,000. Common examples of current assets include cash, accounts receivable, and inventory. Examples of current liabilities include accounts payable, short-term debt payments, or the current portion of deferred revenue.

Why Is Working Capital Important?

Working capital is crucial for businesses to remain solvent. Even a profitable business can face bankruptcy if it lacks the cash to pay its bills. For example, if a company has \$1 million in cash from retained earnings and invests it all at once, it might not have enough current assets to cover its current liabilities.

Is Negative Working Capital Bad?

Generally, yes, if a company's current liabilities exceed its current assets. This indicates the company lacks the short-term resources to pay its debts and must find ways to meet its short-term obligations. However, a short period of negative working capital may not be an issue depending on the company's stage in its [business life cycle](#) and its ability to generate cash quickly.

How Can a Company Improve Its Working Capital?

A company can improve its working capital by increasing current assets and reducing short-term debts. To boost current assets, it can save cash, build inventory reserves, prepay expenses for discounts, and carefully extend credit to minimize bad debts. To reduce short-term debt, a company can avoid unnecessary borrowing, secure favorable credit terms, and manage its spending efficiently.

The Bottom Line

Working capital is critical when gauging a company's short-term health, liquidity, and operational efficiency. You calculate working capital by subtracting current liabilities from current assets, providing insight into a company's ability to meet its short-term obligations and fund ongoing operations.

Positive working capital generally means a company has enough resources to pay its short-term debts and invest in growth and expansion. Conversely, negative working capital indicates potential cash flow problems, which might require creative financial solutions to meet obligations.

Working capital is a useful measure to track. Still, it's important to look at the types of assets and liabilities and the company's industry and business stage to get a more complete picture of its finances.



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