

Working capital: What is it and why is it important?

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Working capital — the money you have on hand to run day-to-day operations — affects many aspects of your business, from paying employees and vendors to planning for [sustainable long-term growth](#). In short, working capital is the money available to meet your current, short-term obligations and is a terrific indication of a company's health. Having enough working capital can make all the difference in building a business that's thriving and ready to seek new opportunities.

To ensure you have the appropriate level of working capital to support your business and to be ready for the unexpected, you could calculate current working capital levels, project future needs and consider solutions to secure access to capital so you always have enough cash.

How to calculate working capital

Netlist EX2105
Samsung v. Netlist
PGR2025-00071



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- **Working capital ratio formula:**

Current assets / Current liabilities = Working capital ratio

If you have current assets of \$1 million and current liabilities of \$500,000, your working capital ratio is 2:1. That would generally be considered a healthy ratio, but in some industries or businesses, a ratio as low as 1.2 to 1 may be adequate.

Net working capital tells you how much money you have readily available to meet current expenses/obligations.

- **Net working capital formula:**

Current assets – Current liabilities = Net working capital

For these calculations, consider only short-term assets and liabilities. **Short-term assets**, also known as current assets, include the cash in your [business account](#) and accounts receivable — the money your customers owe you — and the inventory you expect to convert to cash within 12 months. **Short-term liabilities** include accounts payable — money you owe vendors and other creditors — as well as other debts and accrued expenses for salary, taxes and other outlays.

Understanding your needs

Getting a true understanding of your working capital needs may involve plotting month-by-month inflows and outflows for your business. A landscaping company, for example, might find that its revenues spike in the spring, then cash flow is relatively steady through October before dropping almost to zero in late fall and winter. Yet on the other side of the ledger, the business may have many expenses that continue throughout the year. Working capital is the money you have available at any given time to pay your short-term obligations once your business liabilities are subtracted from its assets.

Forecasting your working capital needs could require making educated guesses about the future, something that could be challenging for some companies to do in an uncertain environment. While you can be guided by historical results, you'll also need to factor in new contracts you expect to sign or the possible loss of important customers. It can be particularly challenging to make accurate projections if your company is growing rapidly.



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Reasons why your business might require additional working capital

- Seasonal differences in [cash flow](#) are typical of many businesses that may need extra capital to gear up for a busy season or to keep the business operating when there's less money coming in.
- Extra working capital can help improve your business in other ways. For example, it may enable you to take advantage of supplier discounts by using cash on hand to purchase in bulk. This can save you the interest you might have to pay using a credit card, which could be higher than for other types of credit.
- Working capital can also be used to pay temporary employees or to cover other project-related expenses.
- Working capital can help your business handle unexpected costs that arise in an uncertain environment.

Finding options to cover shortfalls in working capital

An [unsecured, revolving line of credit](#) can be an effective tool for augmenting your access to capital. [Lines of credit](#) are designed to finance temporary working capital needs. Their terms are more favorable than those for business credit cards. Your business can draw on the line for capital whenever it's needed and pay down the outstanding balance when business [cash flow](#) improves.

While [a business credit card](#) can be a convenient way for you and top employees to cover incidental expenses for travel, entertainment and other needs, it's usually not the best solution for working capital purposes. Drawbacks include higher interest rates, higher fees for cash advances and the ease of running up excessive debt.

Qualifying for a working capital line of credit

A working capital line of credit provides access to financing for short-term operating costs that are hard to predict, such as the need to [purchase extra inventory](#) during a sudden spike in demand. When you apply for a working capital line of credit, lenders will consider the overall health of your



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Since small business owners' [business and personal finances](#) tend to be closely intertwined, lenders will also examine your personal financial statements, credit score and tax returns. You may be asked for a personal guarantee of repayment. For a more detailed overview of what lenders look at, see "[Factors that impact loan decisions \(and how to increase your approval odds\)](#)."

Although many factors may affect the size of your working capital line of credit, a rule of thumb is that it shouldn't exceed 10% of your company's revenues.

Avoid working capital missteps

- Don't confuse short-term working capital needs and longer-term, permanent requirements.
- While it can be tempting to use a working capital line of credit to purchase machinery or real estate or to hire permanent employees, these expenditures call for [different kinds of financing](#). If you tie up your working capital line of credit on these expenses, it won't be available for its intended purpose.

Your small business banker can help you better understand your working capital needs and what steps you might want to take to be prepared for any situation. While you can't predict everything about running a company, a clear view of working capital can help you operate smoothly today — and set you up for long-term growth tomorrow.

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