Working Capital Demystified Part I

One of the most puzzling aspects about running a business, selling a business or buying a business is determining how much working capital the business needs to operate efficiently and effectively. Good management of working capital is a critical aspect of operating a business effectively. After all a reasonable person wants to decrease excess cash in the company bank account because cash can earn a return if invested elsewhere. But more importantly knowing how much working capital a business needs can keep the business out of financial trouble.

First things first

The best place to start this conversation is to define working capital. A text book definition is current assets i.e., cash, receivables, inventory, etc. minus current liabilities i.e., accounts payable, credit cards payable, wages & taxes payable, etc. The current assets are the liquid assets needed to pay the current liabilities or bills that are expected to be paid within one year. By way of example, as of December 31st of the most recent year Superman, Inc. has current assets of $50k and current liabilities of $40k so net working capital is $10k ($50k net current assets – 40k in current liabilities). Furthermore an analysis of the company's balance sheets revealed that the net working capital balance fluctuated between $5k - $15k for the prior twelve months. Therefore, we conclude that Superman, Inc. normally operates with about $10k of working capital.

SUPERMAN, INC.	
Balance Sheet (Current Assets & Liabilities Only)	Current Year
Current Assets	
Cash	$10,000
AR	$5,000
Inventory	$5,000
Total Current Assets	$20,000
Current Liabilities	
Accounts Payable	$5,000
Other Current Liabilities	$5,000
Total Current Liablities	$10,000
Current Assets - Current Liabilities	$10,000

What does this tell us about the company

There are some important insights we learn from this analysis. Most importantly this business currently has $10k in net working capital. This indicates that the company is very liquid and financially sound in the short term. If the company's liabilities exceeded their assets, the working capital would be negative and therefore lack short term liquidity for now. In addition to calculating the net working capital we can calculate the working capital ratio by dividing current assets by current liabilities. This will return a ratio such as 2:1 (twice as many assets) or 1:1 (equal assets and liabilities).

Current Assets ÷ Current Liabilties = Working Capital Ratio
($20,000 ÷ $10,000 = 2)

Using the figures from our example, the working capital ratio for the company would be 2.0. ($20,000/$10,000).