



What is Working Capital and why is it important? (3 mins read)

## Description

Most of us want to open a business. We all might have different reasons to open our business be it becoming your own boss, [earning more money](#), passion, etc. Due to different reasons, our dream business idea also changes. But the one thing that remains the same is how business works and the technicalities that go around running a business. Supply chain, credit, debt, balance sheet, stock maintenance, working capital, assets, liabilities, etc are some of the key aspects of running a business. One of the most important of these aspects is Working Capital.



## WHAT IS WORKING CAPITAL?

Working Capital is basically the capital available to a business to pay for day-to-day operations. It is represented by the difference between a company's current assets like cash, unpaid bills from customers, raw materials, etc, and current liabilities like employees' salaries, debts, etc. It defines the financial health of an organization.

**WORKING CAPITAL (WC) = CURRENT ASSETS – CURRENT LIABILITIES**

## COMPONENTS OF WORKING CAPITAL

As per the above formula, WC comprises two key components: the Company's current assets and current liabilities. So let us look at both of them in detail here.

### CURRENT ASSETS:

These are the assets that a company has or will receive within a year. It can be divided into the following categories:

- a. Cash and equivalent: It is the liquid money that a company has with them. It can be the bank balance, liquid investments, or any foreign currency with the company.

- b. Inventory: Raw material, goods under production, and unsold finished goods all constitute the inventory of a company. Hence, it also contributes to the current assets and hence forms a major portion of WC.
- c. Accounts receivable: These are the payments that are to be received against the goods sold. However, a margin of safety is taken for the payment which is doubtful to be received.
- d. Advance Paid: If you have paid for any goods or service in advance then it can also be counted in current assets. However, these are very difficult to liquidate.

## CURRENT LIABILITIES:

These are the debts that a company has to pay within the next 12 months. It can be divided into the following categories:

- a. Accounts Payable: These are the payments that a company has to make within the next 12 months. It can be the rent, property tax, unpaid raw material bills, and other third-party payments.
- b. Salary Payable: It is the unpaid salaries for all the employees taken together.
- c. Long-term Loan portion: It is the EMI or portion of the loan which is due to be paid within the next 12 months.
- d. Dividends: The payment to the shareholders to be made as authorized dividends.

## EXAMPLE OF WORKING CAPITAL

Let us try to understand what working capital is through examples.

Example – 1: There is a company X whose [balance sheet](#) looks like this:

S.No.	Current Asset	Value
1.	Cash	INR 25,00,000/-
2.	Inventory	INR 35,00,000/-
3.	Accounts Receivables	INR 10,00,000/-
	<b>TOTAL</b>	<b>INR 70,00,000/-</b>

S.No.	Current Liabilities	Value
1.	Accounts Payable	INR 20,00,000/-
2.	Salary Payable	INR 2,50,000/-
3.	Long-term loan portion	INR 1,00,000/-
	<b>TOTAL</b>	<b>INR 23,50,000/-</b>

Therefore the WC of company X will be:

$$\begin{aligned} \text{Total Current Assets} - \text{Total Current Liabilities} &= \text{INR } 70,00,000 - \text{INR } 23,50,000 \\ &= \text{INR } 46,50,000/- \end{aligned}$$

Example – 2: This example is about a retail store. Let us say a retail store “Y” purchases 10,000

packets of chips from the supplier and has to pay for them during the next 1 month. The store puts the product right away for the customers and sells all of the packets in just 15 days. Then the company doesn't need working capital as cash in hand to pay for accounts payable and can afford to have working capital negative.

Many Big companies like McDonald's, and Amazon works on very less or negative WC which shows the effective business management of these companies.



## IMPORTANCE OF WORKING CAPITAL

Managing working capital efficiently can do wonders for an organization. It is an essential part of running the business in the following ways:

### 1. The situation of Cash Crunch:

Managing liquid funds and maintaining healthy working capital can help you easily pay your daily expenses in the business. It prevents a situation of cash crunch to occur.

### 2. Liquidity Management:

Proper management of working capital i.e. income, expenses, amounts payable, inventory, etc. can help you plan your liquidity for the future also.

### 3. Decision Making:

If your working capital is high which shows good financial health then it becomes easy to make decisions as you have that margin of safety with you.

### 4. Expansion:

If you want to expand your business in other cities or venture into a new product line then high working capital will always be beneficial for it.

### 5. Short-Term Profits:

If you have high working capital and you don't see any expenses coming in the near future then the liquid capital can be invested for the short term to earn profits.

### 6. Good Working Environment:

Maintaining a healthy working capital gives a sense of security to the employees as it is an indication that their salaries, perks, and benefits won't get delayed.

### 7. Market Value:

On-time payment to suppliers, lenders, and other service providers is only possible if you have managed your working capital well. This will lead to good face value in the market which will, in turn, attract more investors and good suppliers to your business.

So readers now that you know what working capital is, how to calculate it and what its importance is, it is time to implement your knowledge into your business. Feel free to share this article with your peers. Follow us on Instagram ([wealth\\_drift](https://www.instagram.com/wealth_drift)) for valuable and easy-to-implement tips on personal finance.

#### Category

1. General

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