Course: MCA Part III

Paper: XVII

Topic: Working Capital and Sources

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What Is Working Capital?

Working Capital is basically an indicator of the short-term financial position of an organization and is also a measure of its overall efficiency. Working Capital is obtained by subtracting the current liabilities from the current assets. This ratio indicates whether the company possesses sufficient assets to cover its short-term debt.

Working Capital indicates the liquidity levels of companies for managing day-to-day expenses and covers inventory, cash, accounts payable, accounts receivable and short-term debt that is due. Working capital is derived from several company operations such as debt and inventory management, supplier payments and collection of revenues.

What are the Sources of Working Capital?

The sources for working capital can either be long term, short term or even spontaneous. Spontaneous working capital are majorly derived from trade credit including notes payable and bills payable while short term working capital sources include dividend or tax provisions, cash credit, public deposits, trade deposits, short-term loans, bills discounting, inter-corporate loans and also commercial paper.

For the long-term, working capital sources include long-term loans, provision for depreciation, retained profits, debentures and share capital. These are major working capital sources for organizations based on their requirements.

What are the Types of Working Capital?

There are several types of working capital based on the balance sheet or operating cycle view. The balance sheet view classifies working capital into net (current liabilities subtracted from current assets featuring in the company's balance sheet) and gross working capital (current assets in the balance sheet).

On the other hand, operating cycle view classifies working capital into temporary (difference between net working capital & permanent working capital) and permanent (fixed assets) working capital. Temporary working capital can be further broken down into reserve and regular working capital as well. These are the types of working capital depending on the view that is chosen.

Working Capital Cycle

The Working Capital Cycle or WCC means the time period that is taken to convert net current liabilities and assets into cash by any organization. This is an indicator of the organizational efficiency in terms of effectively managing liquidity position in the short-term and the cycle, which is calculated in days, is basically the time period between the generation of revenue through cash by selling products and the buying of materials for producing these products.

The shorter this working capital cycle, the swifter will the company be able to free up its cash, which is blocked. In case the cycle is long, the capital usually gets stuck without earning returns in the operational cycle. Businesses always strive to lower this working capital cycle with a view towards enhancing liquidity in the short-term.

Working Capital Formula

The formula for working capital is the following:

Working Capital = Current Assets - Current Liabilities

The working capital ratio is the indicator of whether ample short-term assets are possessed by an organization for taking care of short-term debt. A ratio lower than 1 is an indicator of negative working capital while positive/sufficient working capital is usually indicated by a ratio between 1.2 and 2.0. Anything exceeding 2 usually indicates there are excess assets that are not being invested by the company and therefore represents missed opportunity.

The organization may be in trouble if the current assets do not exceed the liabilities at present. Working capital also provides a picture of the efficiency of the organization. Money that is locked in the market, inventory or in the hands of customers-who have not paid up yet, will not be considered viable when it comes to settling obligations.

Advantages

Where businesses are suffering from a negative working capital position, they can improve it using a line of credit from a finance provider. Common working capital finance solutions include overdrafts and invoice finance.

There was a time when a bank would help businesses through short term cash flow difficulties with a loan or overdraft extension, but since the credit crunch of 2008 it has become much tougher to access bank finance. For businesses looking for working capital support, MarketFinance can provide a flexible line of credit through its online invoice finance product.