Definition of 'Working Capital'

A measure of both a company's efficiency and its short-term financial health. The working capital is calculated as:

Working Capital = Current Assets - Current Liabilities

The working capital ratio (Current Assets/Current Liabilities) indicates whether a company has enough short term assets to cover its short term debt. Anything below 1 indicates negative W/C (working capital). While anything over 2 means that the company is not investing excess assets. Most believe that a ratio between 1.2 and 2.0 is sufficient.

Also known as "net working capital".

If a company's current assets do not exceed its current liabilities, then it may run into trouble paying back creditors in the short term. The worst-case scenario is bankruptcy. A declining working capital ratio over a longer time period could also be a red flag that warrants further analysis. For example, it could be that the company's sales volumes are decreasing and, as a result, its accounts receivables number continues to get smaller and smaller.

Working capital also gives investors an idea of the company's underlying operational efficiency. Money that is tied up in inventory or money that customers still owe to the company cannot be used to pay off any of the company's obligations. So, if a company is not operating in the most efficient manner (slow collection), it will show up as an increase in the working capital. This can be seen by comparing the working capital from one period to another; slow collection may signal an underlying problem in the company's operations.

Things to Remember

- *If the ratio is less than one then they have negative working capital.*
- *A high working capital ratio isn't always a good thing, it could indicate that they have too much inventory or they are not investing their excess cash.*