Net Working Capital Formula – What It Is, How to Calculate It, and Examples

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We've all heard the slogan 'it takes money to make money.' That's what capital is. Capital is the money that is used to manage and grow your business.

Without capital, you can't hire employees, pay your bills, or even stay in business.

But why is working capital important? Is there a specific amount of working capital a business should have?

Can you have too much capital? And if your working capital is low, how can you increase it?

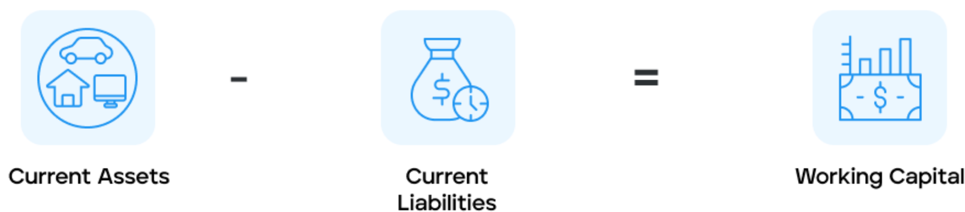
If you're looking for answers to these questions, please read on.

What Is Working Capital and How Do You Calculate It?

Working capital is the difference between a company's current assets and its current liabilities, used to measure your company's short-term ability to pay its bills while providing a view into a company's liquidity.

Like most financial metrics, the working capital formula is easy; simply subtract your current liabilities from your current assets.

The Formula To Calculate Working Capital



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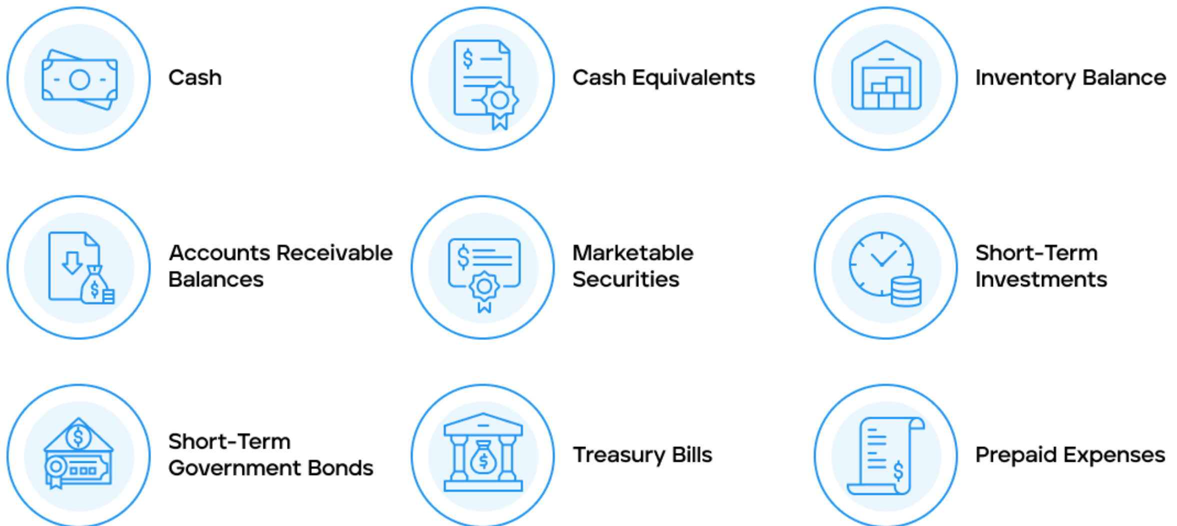
Current Assets – Current Liabilities = Working Capital

The assets you'll need to include in your working capital formula appear on your balance sheet as current assets or short-term assets.

These assets include:



- Cash
- Cash equivalents
- Inventory balance
- Accounts receivable balances
- Marketable securities
- Short-term investments
- Short-term government bonds
- Treasury bills
- Prepaid expenses

All of the above are considered short-term because they can be converted to liquid assets in less than a year.

The liabilities you'll need to include in your working capital formula also appear on your balance sheet, listed as your company's current liabilities or short-term liabilities.

These liabilities include:

- Accounts payable balances
- Short-term loans
- Lines of credit
- Short-term notes payable
- Trade payables

Again, because these liabilities represent debts that will be paid within a year, they'll need to be included in the working capital calculation, which is:

What Is Net Working Capital?

The terms working capital and net working capital or NWC are commonly used interchangeably, but there are differences depending on the calculation used.

For example, some financial analysts consider working capital a total of your current assets alone, with net working capital using the formula above, subtracting current liabilities from current assets.

Generally speaking, the working capital ratio and the net working capital ratio refer to the same calculation.

How Do You Calculate Working Capital in Accounting?

You can use your current balance sheet to calculate working capital.

Below, you'll find a sample balance sheet that displays the information needed to calculate working capital.

Current Assets		**Current Liabilities**	
Cash	$50,000	Accounts Payable	$45,000
Accounts Receivable	$31,000	Notes Payable (less than 1 year)	$30,000
Inventory	$40,000	Accrued Expenses	$15,000
Securities	$10,000		
Total Current Assets	**$130,000**	**Total Current Liabilities**	**$90,000**

You'll notice only the top part of the balance sheet which contains current assets and current liabilities is displayed.

This is where you'll obtain the numbers to include in your working capital calculation.

To calculate working capital based on the balance sheet above, you'll take your total current liabilities total and subtract them from your total current assets total.

$130,000 – $90,000 = $40,000

Based on the balance sheet numbers, the business has $40,000 in working capital that can be used to pay bills or invest in the business.

While knowing the total amount of working capital you have available may be helpful for some business owners, others may find it more useful to calculate the net working capital ratio.

Calculating the Net Working Capital Ratio

While the working capital formula simply subtracts current liabilities from current assets, the net working capital ratio divides current assets by current liabilities.

Let's complete the net working capital calculation using the same balance sheet numbers.

$130,000 / $90,000 = 1.44

Since a good ratio result runs between 1.2 to 2, as we'll explain shortly, 1.44 would be considered a good result, indicating that the business has enough working capital to cover any financial obligations, with some funds left over.

However, the results of any NWC calculation have to be put into context.

For example, if the previous year's NWC was 2.0, 1.44 would signal a decrease in NWC, which may be cause for concern.

When calculated alone, an NWC of 1.44 isn't cause for concern, but the ratio should be calculated regularly so businesses can spot trends, which can give you insight into the direction the business is headed.

What Do the Results Mean?

There are four possible results from calculating working capital and net working capital. Those results are:

- ### A Ratio Between 1.2 to 2.0

  A positive net working capital ratio of at least 1.2 indicates that your business can cover all of its short-term obligations with little left over to invest or use for business growth or development.

  It's recommended that a business have at least a 1.2 net working capital ratio for handling any future cash emergencies, with 2 considered ideal.

- ### A Ratio of Less Than 1

  If your net working capital ratio is less than 1, it means that your financial obligations currently outweigh your available assets.

  This can happen if you have an unexpected outlay of cash, but if your business operations are stable, it usually will increase in the coming months.

A Negative Net Working Capital Ratio

There may be times when your net working capital ratio is negative.

This can occur when a business makes a large purchase or investment in stocks, equipment, or machinery.

However, it can also be a reflection of poor accounts receivable collection practices.

- ### A Ratio of More Than 2

A higher ratio is not always better.

Many lenders and investors view a high net working capital ratio as a sign that a business is not investing enough cash back into the business.

When comparing your results, look for trends, and if you're comparing your results with other companies, make sure the comparison is with similar companies, since results can vary widely between industries.

What Are the Benefits of Managing Net Working Capital?

Managing net working capital offers plenty of benefits including the following:

Benefits of Managing Net Working Capital

Financial Health

Liquidity

Sustained Operations

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- ### Financial Health

  Managing your NWC provides you with the information you need to properly manage business finances.

  Understanding how cash flow, accounts receivable collection, and accounts payable payment terms can all impact net working capital allows you to make more informed business decisions, which typically results in an improved NWC ratio result.

- ### Liquidity

  All businesses aim to make a profit, but liquidity is equally as important as profit.

  Without the funds available to pay your short-term debts and cover any other operational expenses, earning a profit may not be enough to sustain your business in the long term.

- ### Sustained Operations

  Managing your net operating capital not only provides you with a way to gauge your short-term liquidity, but it provides a window into the future.

  For example, if your NWC is trending downward, you can take measures immediately to correct the trajectory before business operations are negatively impacted.

What Are the Limitations of Managing Net Working Capital?

The biggest limitation of managing net working capital is that it provides information on company finances in the short-term, but doesn’t speak to long-term financial health.

The other limitation is that all assets and liabilities are not created equal.

While cash is immediately available, accounts receivable rely on your customers paying on time, while the sale of securities can take considerable time depending on the current market.

Inventory is another asset that may not be as liquid as you'd like, and may not be the best source of cash should you need to pay short-term debt off quickly.

How Can You Increase Net Working Capital?

If your net working capital is not where you'd like it to be, there are ways to increase it.

How Can You Increase Net Working Capital

Selling Some Long-Term Assets for Cash

Refinance Short-Term Debt Into Long-Term Debt

Increase Inventory Turnover

Follow Up on Late Payments Promptly

Invest in Financial Software Automation

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1. **Consider Selling Some Long-Term Assets for Cash:** If you have equipment or machinery in good working shape, you may want to sell them while they're still in good condition.

   Any money received on the sale would boost your NWC since it's cash.

2. **Refinance Short-Term Debt Into Long-Term Debt:** Though you'll still be responsible for the current year's debt, moving the majority into long-term debt allows you to better focus on liquidity for the upcoming year, while also working to increase your assets in the upcoming years.

3. **Increase Inventory Turnover:** Increasing your sales can increase your net working capital.

   For example, if you have $25,000 worth of inventory on your balance sheet as a current asset, if you sell that inventory above cost at $30,000, you’ve just added $5,000 to your current assets, effectively increasing your net working capital.

   And if you have inventory that you’re not going to use, return it to your suppliers for cash, if possible. It may not necessarily increase your current asset total, but as cash, it becomes more liquid.

4. **Follow Up on Late Payments Promptly:** Again, while both cash and accounts receivable are considered current assets, cash in the bank is a more liquid asset than accounts receivable is, since you have no guarantee that your customers will pay you when they’re supposed to.

5. **Invest in Financial Software Automation:** Using multiple applications to manage your finances can produce mixed results.

   Using multiple systems also relies exclusively on manual data entry and paper processing, both of which contribute to errors.

   Instead, when you’re ready to invest for the long term, it’s a good idea to choose a robust procure-to-pay software solution like PLANERGY, that makes it much easier to manage net working capital by providing the following benefits:

   - A centralized way to obtain the data you need in real time to ensure that any financial calculations or ratios are based on accurate financial statements.

   - Better accounts payable management often results in increased working capital.

     While increasing or decreasing your accounts payable balance will have no impact on your net working capital, having favorable payment terms in place provides you with more cash on hand, increases your liquidity, and provides you with an opportunity to use the extra cash to grow the business.

- More efficient inventory management. Inventory management plays a large role in net working capital.

  Knowing how much inventory to order and when to order allows you to avoid ending up with a large amount of inventory items you're unable to move.

What Are the Best Practices for Managing Net Working Capital?

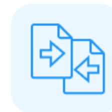
Following best practices helps ensure accuracy and provides you with the information you need to manage your business.

What Are the Best Practices for Managing Net Working Capital

Use Automation

Use Multiple Ratios

Pay Attention to Trends



Only Compare Results to Similar Businesses

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- ## Use Automation

  If your balance sheet isn't accurate, your net working capital ratio won't be either.

  Using an automated accounting software application provides you with a level of accuracy that you won't have if you're using manual processes.

Remember That Not All Assets and Liabilities Are Created Equal

Some assets and liabilities are more liquid than others.

For example, some people choose to exclude inventory from their NWC calculation because it may or may not be a truly liquid asset.

The same is true of accounts receivable balances.

While considered an asset, if a customer files for bankruptcy, a large chunk of your current assets total will be reduced.

- ## Use Multiple Ratios

Accounting ratios are extremely helpful individually, but using multiple ratios together is even more beneficial.

For example, when calculating net working capital, you may also want to calculate your current ratio or quick ratio for a more complete picture of your business's financial health.

- ## Pay Attention to Trends

Running any ratio a single time won't give any real insight.

Instead, be sure to regularly run ratios at their designated intervals and look for trends in the results.

- ## Only Compare Results to Similar Businesses

Comparing your NWC to other businesses can be helpful, but only if you're looking at similar businesses.

A manufacturing plant will not want to compare ratio results to those of a big box store.

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Calculating Net Working Capital Helps You Plan for the Future

Understanding and properly managing your company's net working capital can improve your company's ability to manage cash flow, easily cover debt, and have the funds left over to grow your business, now and for the foreseeable future.

What's your goal today?

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