Working Capital

Subjects: Economics

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The simplest net working capital can be defined as the difference between the value of current assets and short-term liabilities together with other short-term accruals. It is equivalent to the part of the current assets financed with equity, provisions for liabilities, long-term liabilities, and the remaining part of accruals. Therefore, it is the capital that finances only that part of the current assets that are not financed with short-term liabilities. This amount is financed with fixed capital. Summing up, net working capital is the fixed capital that finances the company's current assets.

Keywords: working capital ; strategy ; financial liquidity ; financial security

There are many definitions of net working capital in the literature. It is often referred to as working capital, net working capital (NWC), or circulating capital. In the literature, the concept of working capital is most often considered in net or gross terms [1][2][3]. On the other hand, gross working capital are current assets used in the normal operating cycle [3][4][5][6][7].

The term "working capital" is derived from an old Yankee travelling merchant who loaded goods onto his cart and was on the way to sell them. These commodities were referred to as "working capital" as he had to circulate them in order to make a profit. The cart and horse were his fixed assets [4]. The merchant owned the cart and the horse, so they were financed with equity. However, he had to borrow funds to buy the goods that he wanted to sell. These were called working-capital loans and had to be paid off after each trip to prove the merchant's creditworthiness. When the merchant was able to pay off the loan, the bank was willing to give him another [3][4]. The example of this definition clearly shows that working-capital management includes a number of key elements related to company finances, i.e., short-term receivables, inventories, cash, and short-term liabilities.

Authors usually present current assets and liabilities as two basic elements that influence the level of net working capital. Apart from current assets and current liabilities, profits that generate sales revenue are the third most important element that significantly influences the level of net working capital. Several studies showed that the length of the production process and other technological characteristics are important determinants of working-capital demand [8][9].

However, current assets are the most relevant areas that affect the level of working capital. The entire current asset management process generally focuses on two elements, i.e., inventories and receivables from customers. Inventories are the component of current assets that generates high costs. By analyzing small and medium-sized enterprises in this area, one can find many places where unnecessary costs are incurred. Therefore, in order to create an optimal working-capital management strategy, it is necessary to introduce various methods, inventory-management tools derived from logistics, which optimize the level of inventories and the costs of their management.

In turn, receivables from customers are a component that directly impacts creating a policy of managing liabilities towards suppliers. Establishing a receivables-management strategy very often determines the policy of managing liabilities towards suppliers.

Decisions made by managers in the area of current assets should aim at determining the appropriate levels and structure of individual elements that make up the current assets [5]. Inventories and short-term receivables are such elements of current assets in the case that the selection of an appropriate management strategy determines the level of costs incurred by an enterprise. Is it high or low cost? The prerequisite for effective management in this place is a continuous control of the risks associated with holding assets [10].

The second area that strongly influences working capital is the management of current liabilities. Managing this area mainly involves managing liabilities towards suppliers whose share in the structure of short-term liabilities is generally very high.

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