Assignment - 9

Why are we exclude cash while calculating working capital?

Cash is typically excluded from the calculation of working capital in certain contexts, particularly in more advanced financial analysis because cash is indeed a current asset its doesn't directly contribute to a company's operational efficiency or its ability to generate revenue from core business activities. Here's a more detailed explanation

Focus on operational efficiency:

Working capital measure that efficiency with which a company manages its short-term assets and liabilities tied to its day-to-day operation. Including cash, especially excess cash that it not immediately needed for operation could distort the actual working capital requirement of the business.

For example: Excess cash sitting idle in a bank account details sales how will the company is managing receivable, inventory or payable which are more closely tied to operational performance.

Cash is often a Residual Balance.

Cash can accumulate for various reasons (e.g. financial activities, asset sale) and it may not be related to how well the company is managing its working capital cycle. So including cash may give an inflated view of liquidity without showing how efficiently the company is running its core operations.

Excluding cash helps focus the analysis on receivables, payables and inventory, which directly reflect the working capital needs to support the business.

Better understanding of operating liquidity

When we exclude cash, the resulting calculation (called non-cash working capital) provides a clearer view of the operational liquidity of the company. This means the analysis focus on how well the company can meet its short-term obligation from sales and operations without relying on excess cash reserves.

Cash flow Vs working capital.

Cash is better analyzed in terms of cash flow (such as in a cash flow statement) rather than in working capital. The cash conversion cycle (CCC) (how long it takes to convert working capital into cash) is a better metric for understanding how cash is generated from operations rather than simply including cash in the working capital.

Example:

If a company has \$5,00,000 is current assets (Including \$1,00,000 in cash) and \$3,00,000 in current liabilities its working capital (using traditional formula) would be

=> Working capital = current assets − Current liabilities.

= \$5,00,000 − \$3,0000

= \$2,00,000

=> Non-cash working capital } = (\$5,00,000 − \$1,00,000) − \$3,00,000

= \$1,00,000.