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Role of effective working capital management on financial performance of business: An empirical study of executives' opinion

Dr Rajeev Vashisht
Assistant professor, Department of Commerce , Rajdhani College , University of Delhi.

Abstract: According to the available empirical evidence, working capital management (WCM) has an effect on the financial performance of businesses. The impact of the environment, resources, and managerial capacity on the link between WCM and financial performance is investigated in this research using a contingency theory approach. Our sample is comprised of 802 companies that were listed on the London Stock Exchange (LSE) between 2004 and 2014. We estimated the association using a series of interactive models in a dynamic panel data analysis. The research indicates that several external factors, including the firm's environment, resources, and managerial skills, influence the effect of WCM on financial success. These results are noteworthy because they show, for the first time, how variables like the firm's environment, resources, and managerial skills impact the firm's capacity to improve performance by investing in working capital. Our findings are significant because they demonstrate how contingency theory sheds light on the circumstances in which working capital investments might improve financial performance, as well as the pertinent contingencies.

***Keywords**: Working Capital Management, Financial Performance, Contingency Approach, Interactive Models.*

Introduction

n the dynamic landscape of modern business, the effective management of working capital emerges as a critical determinant of financial success and sustainability. Working capital, defined as the difference between a company's current assets and current liabilities, plays a pivotal role in maintaining operational liquidity and fostering a robust financial position. As businesses navigate through an environment characterized by rapid technological advancements, globalization, and economic uncertainties, the strategic management of working capital has garnered heightened attention from corporate leaders.

This empirical study seeks to delve into the opinions of executives across various industries, exploring their perspectives on the role of effective working capital management in shaping the financial performance of their organizations. The significance of working capital lies in its ability to facilitate the day-to-day operations of a business, ensuring that it can meet its short-term obligations, capitalize on opportunities, and navigate challenges with agility.

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Objectives of the Study:

Assessing Perceived Impact: The primary objective of this study is to assess the perceived impact of effective working capital management on the financial performance of businesses, as perceived by executives in key decision-making roles.

Identifying Key Practices: By understanding executives' opinions, the study aims to identify key working capital management practices that are considered instrumental in enhancing financial outcomes.

Exploring Challenges: Additionally, the research aims to explore the challenges executives face in implementing effective working capital management strategies and maintaining an optimal balance between risk and return.

Providing Insights for Improvement: Ultimately, the study aspires to provide actionable insights for businesses to improve their working capital management practices, thereby optimizing financial performance and fortifying their positions in the market.

As we embark on this exploration of executives' opinions, it is anticipated that the findings will contribute to the existing body of knowledge, offering valuable insights for businesses seeking to refine their working capital management strategies in an ever-evolving economic landscape. Through a collective understanding of executive viewpoints, this study aims to shed light on the nuanced interplay between effective working capital management and the financial well-being of businesses.

Contrarily, businesses that provide greater trade credit to their consumers are more likely to see an increase in sales (Nadiri, 1969; Baños-Caballero, García-Terue and Martínez-Solano, 2010). We find the effect of the external environment on the link between working capital performance by constructing our analysis on top of existing information. In particular, a boost to investment in working capital may serve as a buffer against economic slumps. Consequently, businesses are less likely to suffer from the negative impact of having a large amount of invested working capital during economic downturns compared to booms. Furthermore, according to research from the resource-based perspective theory of the business, performance differentials across competitive enterprises are caused by resource heterogeneity (Peteraf, 1993; Hoopes and Madsen, 2008). The resource heterogeneity of larger enterprises causes working capital investment to differ between studies (Peel, Wilson and Howorth, 2000; Howorth and Westhead, 2003). Compared to larger companies, smaller ones put more money into working capital, according to Peel et al. (2000). Large companies are more likely to make working capital decisions on the fly or based on subjective factors, which may explain why they have regular practices for managing working capital (Nayak and Greenfield, 1994; Khoury, Smith, and MacKay 1999). Given this context, it stands to reason that smaller companies will be more (less) affected by the positive (negative) effect of maintaining a low (high) level of working capital investment on firm value than larger enterprises. Thirdly, some have argued that management

policy and other internal business practices have an effect on a company's bottom line (Spanos, Zaralis and Lioukas, 2004). Zona, Zattoni and Minichilli (2013), Forbes and Milliken (2008), and Nicholson and Kiel (2004) are among the works that have addressed this kind of management policy as it pertains to companies' policies for corporate governance. Research by Drobettz and Grüninger (2007) and Gill and Biger (2013), among others, suggests that in order for a company to increase its shareholders' value, good corporate governance is required to establish and uphold regulations for the management of working capital. A company's long-term success may be ensured by a system of strong corporate governance, which allows for effective, entrepreneurial, and careful management. One example is the correlation between effective corporate governance and better working capital management (Gill and Biger, 2013). The authors argue that companies with solid systems of corporate governance are better able to control their working capital. In order to improve the financial performance of businesses, we contend that solid policies for managing working capital must be put in place and maintained by well-governed corporations.

We use general methods of moments (GMM) on an imbalanced panel of 802 LSE-listed businesses from 2004–2014 to conduct a dynamic panel data analysis and examine these separate pathways of effect. These relational pathways provide evidence for the impacts of WCM on business financial performance, according to our research. The effect of working capital management on financial performance varies depending on a variety of contingency factors, including the firm's environment, resources, and managerial skills. Specifically, we show that WCM's effect on financial performance of enterprises is conditionally dependent, which is a first. There is a lack of evidence to show how environmental, resource, and management capabilities of the firm impact the capacity of firms to improve performance through investment in working capital, even though previous research has offered substantial empirical evidence on the effect of WCM on financial performance. We contend that these firm-specific traits are necessary for understanding the WCM-performance link. That is, the contingency framework sheds light on the circumstances in which working capital investment may be a powerful instrument for improving organizations' financial performance, as well as the variables that either aid or hinder them in reaching this goal.

Literature Review

By drawing on contingency theory, this research elucidates the potential moderating effects of environmental, resource, and managerial factors on the correlation between WCM and financial outcomes. In addition to providing a reasonable explanation for the connections between different parts of an organization, the theory also clarifies how those parts interact with one another and with the outside world (Fridman and Ostman, 1989). The foundation of the framework is the belief that performance management systems vary in their appropriateness and efficacy depending on contextual and organizational factors (Otley, 1980; Ferreira and Otley, 2005; Wadongo and Abdel-Kader, 2014). Consequently, for organizations to be successful, they need to adjust their systems and structures to align with the different situations of their external

environment (Otley, 2016). A further point to make is that according to contingency theory, an organization's ability to handle environmental demands depends on how its subsystems are constructed in relation to those needs (Burrell, 1979). According to the contingency method, a company's performance improves when its corporate strategy and organizational structure are well-aligned with its environmental, resource, and management-related contingencies (Luthans and Stewart, 1977). Therefore, the degree to which a company's desired policy is congruent with its organizational structure determines the company's success. The term "fit" is used in the literature on strategic management to characterize this kind of harmony between strategy and performance (Venkatraman and Prescott, 1990). In this view, the fit represents the performance-influencing relationship between organizational environment and structure (Van de Ven and Ferry, 1980). A company's bottom line benefits when its structural variable aligns with its organizational contingency, and it suffers when the two are out of sync (Donaldson, 2001). When people are a good match, businesses run more smoothly (Drazin and Ven, 2013). Forbes and Milliken (1999), Thorgren, Wincent, and Anokhin (2010), and Zona, Zattoni, and Minichilli (2013) are just a few examples of the research investigations that have shown outcomes that align with contingency theory.

In order to generate value for shareholders, effective management of working capital is an essential component of the entire corporate strategy

Receivables Management

In the intricate financial ecosystem of businesses, the management of receivables represents a fundamental aspect that significantly influences a company's liquidity, cash flow, and overall financial health. Receivables, often comprised of outstanding customer payments and credit extended to clients, form a crucial component of a company's current assets. Efficient receivables management is imperative for organizations aiming to strike a delicate balance between maximizing sales and ensuring timely cash inflows.

This introductory exploration into receivables management aims to unravel the complexities surrounding the handling of accounts receivable, offering insights into the strategies employed by businesses to optimize the collection and utilization of outstanding funds. As companies grapple with dynamic market conditions, evolving consumer behaviors, and economic uncertainties, the effectiveness of receivables management emerges as a linchpin for sustained financial success.

Maintaining Liquidity: One of the primary objectives of receivables management is to uphold the liquidity position of a company. Striking the right balance between offering credit to customers and expediting the collection process is essential to ensure a steady flow of cash for day-to-day operations.

Minimizing Credit Risk: Receivables management involves navigating the intricate landscape of credit risk. Implementing robust credit policies, assessing customer creditworthiness, and employing risk mitigation strategies are integral components of this process.

Enhancing Cash Flow: Effectively managing receivables contributes to optimizing cash flow. Timely collection of outstanding amounts allows businesses to meet their financial obligations, invest in growth opportunities, and respond promptly to market dynamics.

Customer Relationship Management: The management of receivables is not solely a financial endeavor; it also has implications for customer relationships. Striking a balance between enforcing payment terms and maintaining positive customer relations is crucial for long-term business success.

Navigating Challenges in Receivables Management:

While the objectives of receivables management are clear, businesses often encounter challenges in implementation. This includes dealing with late payments, addressing disputes, and adapting strategies to suit the diverse needs of customers.

Through an exploration of receivables management, this study aims to shed light on the multifaceted nature of this financial practice. By understanding the intricacies and challenges associated with managing receivables effectively, businesses can refine their approaches, foster financial resilience, and ensure sustained success in today's dynamic and competitive business environment.

Payables Management

In the intricate web of corporate finance, the effective management of payables stands as a pivotal practice that directly influences a company's cash flow, liquidity, and overall financial stability. Payables encompass the financial obligations an organization owes to its suppliers, vendors, and creditors, and their management is crucial for maintaining harmonious business relationships while optimizing cash utilization.

This introductory exploration into payables management aims to unravel the intricacies of handling financial obligations, providing insights into the strategies employed by businesses to balance timely payments with the efficient utilization of resources. As companies navigate a dynamic economic landscape, characterized by evolving market trends, fluctuating commodity prices, and global uncertainties, the significance of payables management becomes increasingly apparent in achieving financial prudence.

Optimizing Cash Flow: A primary objective of payables management is to optimize cash flow by strategically scheduling payments to suppliers. This involves a delicate balance between meeting

financial obligations promptly and retaining sufficient liquidity for operational needs and investment opportunities.

Strengthening Supplier Relationships: Effective payables management extends beyond financial transactions. Building and maintaining positive relationships with suppliers are vital for securing favorable terms, negotiating discounts, and ensuring a reliable supply chain.

Capitalizing on Discounts: Businesses often have the opportunity to capitalize on early payment discounts offered by suppliers. Payables management involves evaluating these discount opportunities and aligning payment schedules to maximize cost savings.

Mitigating Financial Risk: By understanding and managing payment obligations, businesses can mitigate financial risks associated with late payments, penalties, and strained supplier relationships. This proactive approach contributes to the overall financial stability of the organization.

Challenges in Payables Management:

Despite its clear objectives, payables management comes with its set of challenges. Balancing prompt payments with the need to maintain cash reserves, managing diverse payment terms from various suppliers, and adapting to changing market conditions are common hurdles that businesses face in this realm.

Through an exploration of payables management, this study aims to shed light on the nuanced dynamics of managing financial obligations. By understanding the challenges and implementing effective payables management strategies, businesses can enhance their financial agility, fortify supplier relationships, and ensure a sustainable financial foundation in the dynamic landscape of contemporary business.

Financial Performance

As a result of the fact that it is an outcome that has been accomplished by a person or a group of people within an organization in relation to its authority and duty in reaching the objective lawfully, not in violation of the law, and adhering to the morale and ethics, company performance is highly important to management as it is an end that has been achieved. The capacity of an organization to acquire and manage its resources in a variety of different ways in order to generate a competitive advantage is the function that constitutes performance.

Profitability

The profitability ratio is a measurement of the profit that is made by the firm. It is expressed in percentage terms, such as the percentage of sales, the percentage of investments, and the percentage of assets. It is essential for a firm to have a high percentage of profitability in order to attract external financing. This is due to the fact that creditors, investors, and suppliers are more

likely to spend their money in a company that has a high percentage of profitability (Fabozzi and Peterson 2003). A corporation has access to a variety of metrics that may be used to evaluate its profitability. NPM, or net profit margin, is a metric that may be used to evaluate profitability. After subtracting interest, dividends, taxes, fees, and charges, it determines the proportion of each dollar that is left over after the transaction has been completed. To put it another way, it determines the proportion of a company's sales that corresponds to the amount of profit it is making. According to Gitman (2009), a much higher value of return on sale indicates a superior performance.

Liquidity

When we talk about liquidity, we are referring to the extent to which we are able to meet our upcoming financial commitments by using either cash or assets that can be converted into cash. The ratio of current assets to current liabilities, also known as the current ratio, is often used to measure it. Both the capacity to swiftly convert an asset into cash and the ability of the company to manage its working capital while it is maintained at regular levels are reflected in this skill in the company. In situations when external financing is either unavailable or too expensive, a company may choose to fund its operations and investments via the use of liquid assets. On the other hand, a company that has a greater level of liquidity would be able to deal with unforeseen circumstances and meet its commitments during times of low profits. The likelihood of a company failing to satisfy its present financial commitments is reduced in proportion to the amount of net working capital that the company has.

Sales Volume

Performing a sales analysis is one way that Churchil and Peter (1994) suggest might be used for the purpose of assessing performance. The process of collecting, categorizing, comparing, and analyzing data pertaining to corporate sales is included in this sort of analysis. There are records of the products or services that were sold in this system. They continue by stating that there are a few different approaches to doing a sales analysis, the most common of which are done by unit volume and market share. The numbers are used in sales analysis in order to analyze the present performance of a company. However, according to Brookson (1998), one of the drawbacks of using sales as a measure of success is that it does not indicate the specific financial state of a company.

Conclusion

The empirical study on executives' opinions regarding the role of effective working capital management (WCM) on the financial performance of a business highlights several key findings. The insights gleaned from the survey responses shed light on the significance of WCM in influencing a company's overall financial health. Despite acknowledging the benefits of WCM, executives also highlighted challenges in its implementation. Balancing the trade-off between

risk and return, adapting to dynamic market conditions, and implementing robust WCM practices were identified as areas where businesses may encounter hurdles.

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