

The Tacticality of Working Capital

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Abstract

In today's dynamic and competitive business landscape, the effective management of working capital has emerged as a critical factor for the success and sustainability of organizations. Literature review has shown that working capital management can be an effective survival tool in a tough macroeconomic environment where businesses can enhance their ability to meet short-term obligations, improve cash flow, and ultimately achieve long-term success. As businesses strive to maintain financial stability and optimize operational efficiency, tactical working capital management has taken center stage. This research sheds light on the importance of working capital management and how it affects companies. The study goes on to demonstrate that working capital management may influence the performance of a firm and therefore its strategic management can enhance business sustainability.

Keywords: working capital management, cash conversion cycle, current ratio, current assets, current liabilities, inventory management

Introduction

Working capital management strategies can be categorized into three groups: operational working capital, fixed assets, and profitability (Talonpoika et al., 2016). The operational working capital strategies include reducing the cycle time of inventories, accounts receivables, and accounts payables. The fixed assets strategies include reducing the percentage of fixed assets and the average depreciation period. The profitability strategies include increasing the return on investment and the earnings before interest, taxes, depreciation, and amortization. The cash conversion cycle (CCC) is one of the most crucial indicators of how successfully a business manages its working capital. It calculates how long it takes a business to turn its inventory investments into cash flows from sales. According to Zeidan and Shapir (2017), a shorter CCC is associated with improved firm performance. A shorter CCC indicates that a firm can sell its inventory more quickly and collect cash from customers, leading to increased liquidity and reduced financing needs. This, in turn, can enhance the firm's profitability and return on assets. Moreover, a shorter CCC allows a company to allocate its resources more effectively, as it minimizes the time and cost associated with holding excessive levels of inventory. By optimizing the CCC, firms can enhance their operational efficiency and financial performance, ultimately contributing to their long-term competitiveness in the marketplace. In a tough macroeconomic environment management of working capital can enhance sustainability and provide funds for operations without the need for costly external financing.

Strategic working capital management is a crucial aspect of financial management for organizations, as it plays a significant role in enhancing their financial performance and overall competitiveness. According to Nobanee and Dilshad (2021), effective working capital management involves the appropriate management of current assets and liabilities to ensure optimal resource utilization and adequate liquidity levels. By adopting a strategic approach to working capital management, organizations can effectively balance the trade-off between profitability and liquidity. This involves implementing tactics to minimize the level of working capital while maximizing the efficiency of its utilization. Moreover, effective working capital management enables organizations to meet their short-term obligations, invest in growth opportunities, and reduce the cost of funding. Thus, it is imperative for organizations to develop and implement comprehensive strategies for working capital management to achieve sustainable financial performance and maintain a competitive advantage in the market (Nobanee & Dilshad, 2021). Cooper (1984) highlighted the need for multinational firms to consider the effect of foreign exchange risk when managing working capital.

Multinationals may employ operational hedging techniques involving managing working capital items such as inventory levels, credit policy, local borrowing, and opportunity costs to reduce the impact of foreign exchange risk on the firm's profitability, net cash flows, and market value. Therefore, firms irrespective of characteristics should consider strategic management of working capital to reap inherent benefits.

Methodology

The study adopts a desk review of the existing literature.

Literature Review

Working capital management has received less attention in the literature compared to long-term financing as the decisions occur frequently thus the individual impact is insignificant, and the decisions are reversible (Pratap Singh & Kumar, 2014). However, the financial crisis of 2008 awakened interest in short-term financing to address the financial health of firms through the balance between current assets and current liabilities. Working capital management literature focuses mostly on working capital management approaches and their impact on performance. Challenges observed include a lack of systematic theory development, the dominance of empirical literature, and a lack of sufficient country comparisons (Pratap Singh & Kumar, 2014). By applying the generalized approach of moment system estimation to dynamic panel data, Nobanee et al. (2011) investigated the relationship between the cash conversion cycle and profitability for companies in Japan across various industries and size ranges. The study discovered a strong and negative correlation between the cash conversion cycle and the profitability of Japanese businesses. The inverse relationship implies that higher profitability is associated with a shorter cash conversion cycle and lower profitability with a longer cash conversion cycle. The results of the study also showed that the cash conversion cycle of the retail/wholesale industry was shorter than that of manufacturing industries. However, the study did not find any significant difference in the relationship between the cash conversion cycle and profitability among different industries. For businesses across all sizes and sectors, it was also discovered that there is a negative and substantial correlation between the cash conversion cycle and profitability.

Additionally, Jabbouri et al. (2023) examined the effects of macroeconomic and firm-specific variables on working capital management for emerging markets companies in the Middle East and North Africa (MENA) area. In addition to offering guidance on how managers might implement effective procedures and determine the ideal working capital levels, the study sought to define the factors that influence working capital management. Based on a panel data analysis utilizing the Generalized Method of Moments technique covering 687 companies listed between 2004 and 2009 in 11 MENA markets, the study was conducted. According to the study, profitable businesses with significant operating cash flows tended to use cautious working capital management strategies. The study showed that rapidly growing businesses, heavily leveraged businesses, and organizations with large fixed asset investments are more likely to use aggressive working capital approaches because they have a higher demand for liquidity. Similarly, large businesses adopted an aggressive working capital management strategy by using their negotiating leverage over suppliers and customers. Ultimately, the research showed that when businesses were influenced by external macroeconomic pressures that also had an impact on their stakeholders, the ability to decide how to handle their working capital was restricted. The research findings underscored the need to enhance working capital management strategies in developing economies, particularly in cases when companies hold surplus cash reserves, leading to inefficient resource allocation and underinvestment in the economy. The study admitted its shortcomings, including its inability to identify significant qualitative variables and the impact of crisis times on working capital choices.

Using ordinary least squares, fixed effects, and two-stage least squares estimation models, Mathuva (2014) looked at the factors influencing the cash conversion cycle (CCC) in Kenyan listed non-financial enterprises from 1993 to 2008. The study found that non-financial firms listed on the Nairobi Securities Exchange maintained a target CCC and adjusted to it moderately. The study also found that inflation positively and significantly affected the CCC. The study did not find the firm size to be a key determinant of the CCC among listed non-financial firms in Kenya. Additionally, Sardo and Serrasqueiro (2022) examined the determinants of working capital in manufacturing small and medium enterprises (SMEs), with a focus on the

impact of the probability of financial distress on working capital. The study analyzed the relationship from a sample of Portuguese manufacturing SMEs for the period between 2011 and 2017, using a dynamic panel data model. The study concluded that there was a negative relationship between size and working capital, suggesting that larger firms held lower levels of working capital than their smaller counterparts. The results also showed that age, cash flow, long-term debt, and working capital in the previous period had a positive impact on working capital in the current period. Additionally, the findings revealed that SMEs facing a high likelihood of financial distress tended to increase their investment in working capital, possibly to reduce their exposure to financial distress risk.

Furthermore, Kabuye et al. (2019) investigated the relationship between internal control systems, working capital management, and financial performance of supermarkets in Uganda through a survey. The study found that working capital management was a significant predictor of financial performance in supermarkets in Uganda. However, internal control systems did not significantly predict financial performance. The results implied that once organizations have appropriate working capital management, they are also likely to have adequate internal control systems that enhance financial performance. Wasiuzzaman (2015) conducted a study to examine how Malaysian firms' value was affected by their working capital investments. The findings revealed that improvements in working capital efficiency can lead to higher firm value, but this relationship was influenced by a firm's financial constraints. The study also found that investors preferred firms that followed a more restrictive working capital policy and associated a higher value to firms with lower investments in net working capital. Furthermore, Abuzayed (2012) looked at the relationship between working capital management and profitability for companies that were listed between 2000 and 2008 on the Amman Stock Exchange. According to the study, companies with effective working capital management outperformed those with ineffective working capital management in terms of profitability and market value. Moreover, the market and accounting performance of businesses are greatly impacted by the elements of working capital management.

In a study to examine the impact of the 2008 global financial crisis on working capital management practices in Australia and behavioral biases exhibited by working capital managers Ramia et al. (2014) conducted a survey of listed firms. According to the findings, over half of the respondents changed how they managed their working capital during the financial crisis. They reduced inventory levels while maintaining cash levels as there was a widespread decrease in the supply of loans, and institutions' creditworthiness became increasingly significant. Furthermore, the results demonstrated that behavioral biases, including overconfidence, were displayed by Australian working capital managers. In an effort to maintain liquidity, firms tended to reduce expenditure and inventory to preserve cash while attempting to reduce debt. Firms also focused on risk control and on shortening the cash conversion cycle.

A sample of businesses located throughout a few Asian nations was used by Singhania and Mehta (2017) to evaluate the effect of working capital management on businesses' profitability. Working capital management and profitability were found to have a non-linear connection. The profitability of listed manufacturing enterprises in Ghana was investigated by Amponsah-Kwatiah and Asiamah (2021) through panel regression analysis in connection to working capital management. As per the study's findings, manufacturing firms' profitability was contingent upon their capacity to manage their working capital effectively. Leverage was found to have a negative impact on return on equity (ROE) and return on assets (ROA), while inventory management, accounts payable, receivables, cash conversion cycle, current ratio, and company size had favorable effects.

Furthermore, Akbar et al. (2022) investigated the influence of working capital policy on both the investment and financing activities of Pakistani firms and explored a possible link between the working capital management practices and the long-term capital structure of firms. The study found that there were significant inefficiencies in the working capital management practices across firms. It was detrimental to a company's capacity to undertake long-term capital expenditures when too much money was locked up in working capital compared to the industry. Moreover, Le (2019) investigated how working capital management affected risk, profitability, and firm valuation in Vietnamese enterprises. Net working capital was found to have a highly negative relationship with risk, profitability, and company valuation. According

to the findings, corporate managers must choose between controlling risk and maximizing profitability when it comes to working capital management.

Conclusion

In conclusion, effective strategic working capital management is a vital component of financial stability and operational efficiency for businesses in today's dynamic business landscape. This paper has highlighted the significance of strategic working capital management and its impact on organizations. By employing appropriate strategies and best practices, businesses can optimize their utilization of resources, maintain adequate liquidity levels, and strike a balance between profitability and liquidity. Furthermore, effective working capital management allows organizations to meet their short-term obligations, invest in growth opportunities, and reduce funding costs. Therefore, it is crucial for businesses to develop and implement comprehensive strategies for working capital management to achieve sustainable financial performance and gain a competitive edge in the marketplace.

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