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The Role of Managing Flow of Working Capital on the Business Operations and Profitability

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Abstract –

Purpose – The operations of an organization are conducted through various sources of funding. The current research aims at the proper management of Working Capital in a business so that negative impact can be minimized and profitability is maximized. The management of the flow of Working Capital brings stability to business operations and success. The paper provides effective understanding about the implication of working capital on a business.

Research Methodology – The books and academic papers have been analyzed and reviewed to conduct secondary research so that potential information is gained on the research topic. The research majorly focuses on carrying out qualitative data through which relationship between working capital management and profits of the business is being analysed

Findings – In the concept of financial management, Working Capital plays an imperative role in managing day to day activities effectively. Capital management by the financial manager is directly linked to the increased profitability of the business. The Working Capital structure of an organization can be enhanced through a reduction in the overall inventory period and the accounts receivables.

Conclusion – The report provides an in-depth understanding of the positive and negative impacts of Working Capital management in a business. It is essential to depend on short term investment opportunities so that easy conversion of cash assures the necessary flow of capital. Highly liquid firms provide trade credits and easily eradicate the phase of the financial crisis.

Keywords – Financial Crisis, Working Capital (WC), Cash Conversion, Profitability, Trade Credits

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INTRODUCTION

Rationale: The reason behind the proper allocation of Working Capital is to meet the everyday obligation of the company and sufficiency in managing operations through the availability of funds. The WC in small business organizations is used to conduct three major activities of speculations, transactions and precautions. Paper is based on identifying the role of managing working capital and its impact on business profitability. The chosen topic is interesting as it provides effectiveness of managing flow of working capital and its relationship with the business operations.

Research questions:

- What is the relationship between management of working capital and firm's profit?
- How working capital impact on growth and development of SME?
- What are the suitable methods for calculating elements of the working capital?

OBJECTIVES OF RESEARCH

- To understand and analyse the relationship between management of working capital and profitability of the firm.
- To explore the role of working capital management in growth of SME.
- To find out relevant method for calculation of elements working capital to assess business profits.

RESEARCH METHODOLOGY

The study is conducted with the help of secondary sources and relationship between working capital and business profitability is being explored. For this study, secondary reports and other financial reports have been taken to analyse the effectiveness of the research method. Therefore, only reliable and authentic sources have been considered to complete the research paper.

WORKING CAPITAL MANAGEMENT AND RELATED CONCEPT

Working Capital management: As per Enqvist et al., the planning of Working Capital (WC) management is an appropriate strategy designed by the business financial managers to suggest proper monitoring and balance between the current assets and liabilities so that the ideal current ratio can be achieved. Enqvist et al. concluded that the reason behind the proper allocation of Working Capital is to meet the everyday obligation of the company and sufficiency in managing operations through the availability of funds. The formula for WC is the sum of current assets less current liabilities. Continuous monitoring of the company's assets and liabilities ensures tracking and comparing ratios to improve the positioning of the company [Enqvist, 2014].

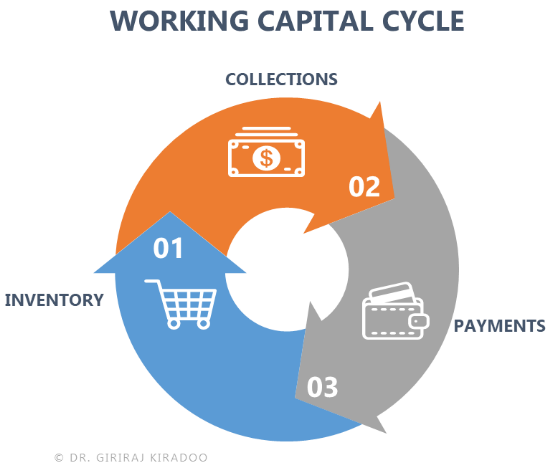

Figure 1: WC cycle

Financial crisis: The financial crisis is organization are defined as bad or negative situations where the financial managers are not able to meet their regular capital needs and fund the various business activities and operations. It is an unfavourable situation where the business loses a major part of their valuable assets and lacks the availability of proper investment to continue or manage business operations. Cowling et al., argued that the situation of financial crisis leads to a shortage of liquidity and a continuous fall in the value of organizational assets. These circumstances are a threat to business stability and effectiveness in the competitive market [Cowling, 2012].

Current liabilities and assets: Current liabilities and assets are the valuable fundamentals of profit account of a business. Current assets refer to those assets that have the ability to convert itself into cash within a specified period of 12 months or less [Saleem, 2011]. On the other hand, current liabilities are the obligations of payment on business that can be dispensed within a time of less than one year. Kontu, Eleonora in his study identified the list of current assets involves cash in hand, bills receivables, pre-paid expenses, and inventory. The current liabilities include short term bank loans, trade creditors, outstanding expenses and bills payable. These are the short term liabilities and assets of a business that serve regular business needs. The current assets are also termed as floating assets [Kontu, 2012].

Balances between current assets and liabilities: The accounting practices and principles state that the ideal ratio is 2:1, which is interpreted as current assets of a company is double the total current liabilities. It means that if the total current asset if £80,000, then the liabilities shall be £40,000. This is known as an ideal ratio and the required standard by companies. Dong et.al concluded that ideal ratio indicates the soundness of the financial situation of a business and that the financial manager has enough WC to meet the daily requirements of expenses. The managers are satisfied with the performance of business operations and are able to meet its obligations of current liabilities in the concerned time frame [Dong, 2010].

ROLE OF WC IN THE GROWTH AND DEVELOPMENT OF SME

Growth of SME: As per Sunday, Kehinde James, there are various sources of earnings in the business, and the proper management of revenues adds on to the effectiveness of business operations. In small business organizations the proper organizing of the WC cycle plays a critical role in managing business funding and daily expenses. The bank loan is a major source of funding WC in the SME’s. These organizations require a structured cash flow management so that the small business owners can look for growth opportunities [Sunday, 2011].

Improving WC management : There are various techniques that can be used to manage daily working needs. The organizations follow the concept of JIT so that no cash is unnecessarily blocked in purchasing stock of goods. There are alternate sources of short funding that can be used to meet the daily needs of the organization. Hofmann believed that the suppliers must be provided with timely payment through money rotation by collecting from the creditors [Hofmann, 2010].

THE LINK AMONG CASH CONVERSION CYCLE IN BUSINESS AND PROFIT INDEX OF ORGANIZATIONS

Cash conversion cycle: The cash conversion cycle is stated as the time and process involved in the conversion of current assets such as trade receivables and stock into cash by the exchange.

Yazdanfar stated that the organizations are advised to minimize the time involved in the conversion of receivables into cash so that proper flow of cash can be maintained. The cash conversion cycle is improved through proper methods of collection from customers, improved communication with the debtors, and ensuring proper collection methods [Yazdanfar, 2014].

Importance of WC management: The efficiency in the managing of WC flow is highly beneficial to the positive financial health of the organization. It creates a good reputation in the market and is able to attract customers. Sharma et al., concluded that the effective management of WC ensures a balance amid profitability, stability and growth. It provides liquidity to the assets of the organization that supports in meeting regular business expenditures [Sharma, 2011]. This reflects the fact that the organization is able to repay its debts in an effective manner. The sufficiency of cash flow supports effective business operations and profitability.

THE NEGATIVE EFFECT OF IMPROPER MANAGEMENT OF WC IN AN ORGANIZATION

Low Liquidity: Low liquidity means the cash or capital that is equipped in non-liquid assets. Low liquidity or tight liquidity occurs when the interest rate of the loan is high, and a different loan makes it very expensive. If the firm is having tight liquidity, then it will face difficulties with the wages, bills, and other expenses [Ben-Caleb, 2013]. The regular expenses will also be affected in case of liquidity. The employees will be resenting working without pay and will also develop the habit of cutting clients who are not paying the bills on time. Low liquidity occurs when the negative economic shocks or cyclical changes occur in the economy. One of the major causes behind low liquidity is poor cash management and control with cash flow. Apart from it increased tax rates, interest rate, financial risk and others.

Insufficient business inventory: As per Gill et.al, insufficient business inventory reflects the lack of possibilities for buying the stocks. It is essential for the business, particularly who deals in product selling because, in the lack of sufficient inventory, the selling of the buying will be majorly affected. As per Gill et al., the working cash flow is in a low amount, the inventory can't be replenished that will accordingly impact the business segments. Insufficient business inventory impacts business segments such as client satisfaction and the sales of the products [Gill, 2010]. If the business inventory is not sufficient, then the service-based industries will also have to hold their capital, or they will be bound to operate with the low cash flow. Inventory management let the firm maintains the consistent cycle of supply and demand. In the case of improper inventory management, the business will fail to meet business objectives.

Bankruptcy and penalties: When the outputs from the business process are not capable enough for refuelling its process or if it is unable to pay bills, debts, interest then it will be resulting in the bankruptcy accordingly. If the firm has sufficient assets, then too it will need to clear the debts by selling and declaring the bankruptcy. It may need to sell its stocks for the debts. On the other hand, Ramiah et al., states that penalties are in many terms such as if the expenses are more than the WC, the firms may face the failure in repaying its mortgage payments, bills, credit bills, and other expenses. The lenders or the seller who has given you the money will be asking for the penalties accordingly ad it may also stop their services with the clients [Ramiah, 2014].

Negative impact on the reputation: Negative impact on a business reputation occurs if the proper management lacks with different aspects. The negative impacts can also impact the employees hiring, and the employees turn over will be increased accordingly [Bhattacharya, 2014]. The investors may need to have the timely payment if the firm fails to deliver it on time the trust will be broken, and it will negatively impact the business process. The brand reputation is built on the basis of promises related to the payments majorly that also creates an impression and reputation to the society consumers [Rodriguez, 2010].

FORMULA INVOLVED IN CALCULATING ELEMENTS OF WC

Current asset and current liabilities: The formula of calculating current asset and liabilities of an organization is as presented.

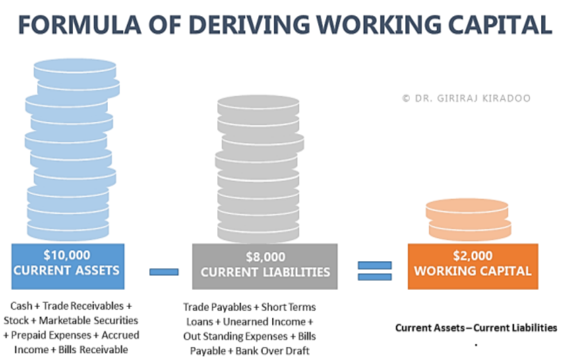

Figure 2: Formula of deriving data

A positive figure of the WC denotes the efficient and sound financial position of an organization and high ability to meet its debt payment requirements. This figure is calculated to find the balance of cash flow in the organization that can be invested in operating activities to maximize growth opportunities and business success [Ali, 2011].

RESULTS

The reason behind the proper allocation of Working Capital is to meet the everyday obligation of the company and sufficiency in managing operations through the availability of funds. The paper finds that management of working capital will lead to increase the value for its shareholders and provide effective return in the form of profits of the business. Sustainable competitive and proper management of finances can be observed by proper calculations of profits and growth can be observed over suitable time.

CONCLUSION

Business Finance is an important and interesting topic of study as it provides the right financial position of an organization that supports managing stability and growth. WC is the regular requirement of liquidity in organizations to fund its day to day operations in an effective manner. The financial manager takes proper care in rotating the WC so that assets can be used to pay back its liabilities. Management of WC flow provides various benefits to business functioning and business. The business can be made highly profitable through the application of approaches to WC management.

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