

# A Study on Liquidity Position of Selected Firm

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## ABSTRACT

This study looks at the relationship between corporate performance and working capital management for a sample of UK non-financial businesses. Unlike earlier research, the results present compelling evidence for an inverted U-shaped relationship between working capital investment and firm performance, suggesting that there is a working capital investment threshold that maximizes a firm's value while balancing costs and benefits. According to the findings, managers should steer clear of detrimental effects on business performance that could result from lost sales and lost discounts for early payments or additional financing costs. The paper also analyses whether the optimal working capital level is sensitive to alternative measures of financial constraints. The findings show that this optimum is lower for firms more likely to be financially constrained.

**Keywords** Management accounting · Working capital management · Cash conversion cycle · Profitability

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## INTRODUCTON

A crucial component of financial management, working capital management is concerned with managing a business's short-term assets and obligations in order to maintain both operational effectiveness and financial stability. Maintaining liquidity, maximizing profitability, and guaranteeing the seamless operation of daily business operations are all made possible by it. Working capital refers to the money needed to support current assets like cash, inventories, and accounts receivable while balancing them against current obligations like short-term debts and accounts payable. A business that practices effective working capital management avoids overinvesting in non-productive assets while maintaining enough resources to pay its immediate responsibilities.

In the current dynamic and competitive business world, it is more crucial than ever for firms to manage their working capital effectively. Business failure, decreased profitability, and liquidity issues can result from poor working capital management. On the other hand, an effective working capital plan can boost profitability, improve cash flow, and provide you a competitive advantage. This study investigates the working capital management concepts, methods, and difficulties. Key elements including inventory control, accounts payable, accounts receivable, and cash flow optimization are examined, and their effects on an organization's overall financial health are analyzed. The goal is to find best practices and tactics that can assist companies in striking the ideal balance between profitability and liquidity. Through examining these facets, the research seeks to shed light on the ways in which efficient working capital management can support the long-term viability and expansion of a firm. It is essential to break down working capital into its component parts in order to examine the causal relationship between working capital management and business performance. This is the structure of the rest of the paper. A summary of popular techniques for assessing working capital management is provided in Section 2. In Section 3, the most recent empirical study on working capital management's impact on profitability and its limitations is presented.

### Definition and measurement of working capital management

According to Hall and Haley (1991), p. 621, working capital management is commonly described as the "management of a company's current assets and current liability." When current assets and current liabilities are subtracted, net working capital is the result. Both theory and practice emphasize the key components of current liabilities and assets. According to Deloof (2003), accounts payable are especially pertinent to current liabilities, whereas inventories and accounts receivable usually make up a significant share of current assets.

It is believed that the other components of current assets and current liabilities are a component of financial decision-making and have no direct connection to the operational success of the company (Hawawini et al. 1986). Although this is the prevailing perspective, some authors argue that "it makes little sense [...] to actively manage a net difference between current assets and current liabilities, particularly when that difference is continually changing" (Van Horne and Wachowicz 2005, p. 202), so they do not include current liabilities in working capital and instead use a gross working capital approach.

The majority of pertinent studies incorporate accounts payable into their separate analyses, thus for the purposes of this brief survey article, we adopt the prevailing perspective and treat it as a component of working capital. Because current liabilities are causally related to both the existence of inventory and the eventual conversion of inventories into accounts payable, utilizing net working capital rather than gross working capital has the primary benefit. As a result, looking solely at net working capital would ignore how accounts payable offsets the need for working capital financing. Fig. 1 illustrates the cash conversion cycle (CCC) time, a standard metric for working capital management. CCC is derived from the operational cycle, which is the sum of days sales inventory (DSI) and days sales outstanding (DSO) and reflects the interval between resource purchases and incoming sales payments (Richards and Laughlin 1980). Nonetheless, the operational cycle employs a gross working capital strategy, ignoring the fact that payments and delivery of acquired resources typically fail. According to Jose et al. (1996), CCC, which was initially put forth by Gitman (1974), is therefore thought to be a more suitable stand-in for working capital management.

## EMPIRICAL RESEARCH

**Empirical investigation findings** The relationship between working capital management and firm profitability is the subject of a sizable number of empirical studies. The results of a thorough literature review that used keywords to find studies emphasizing the connection between working capital management and firm profitability are shown in lists the primary findings and salient features of the research in chronological order.

Regarding the features of the literature review study, the relationship between profitability and working capital management is investigated for a wide variety of nations. More recent research comes from European and Asian nations, however the earliest investigations were conducted in the United States. All of the other studies use panel data with time spans spanning from 4 to 20 years, including Meyer and Lüdtke (2006), who only use data for 2003 in their analysis. In order to conduct an empirical investigation of the correlation between working capital management and profitability, researchers must create proxies for both concepts.

As seen in Table 1, the majority of research use a form of return-to-capital ratio as the dependent variable in order to gauge profitability. More precisely, the majority of studies employ gross operating income (GOI) or return on assets (ROA), which are calculated by dividing total non-financial assets by sales less cost of products sold (Deloof 2003). One Every profitability metric has pros and cons. All things considered, such a measure ought to meet two requirements: It must, first and foremost, be a legitimate operationalization of the profitability model. Second, it must be possible to calculate the measure with just historical data.

Regarding the first requirement, not every measure employed in earlier research is a good operationalization. The nominator, or output, and the denominator, or input, are conceptually different. The majority of research employs a prior interest measure for the numerator (e.g. Jose et al. 1996). Since long-term obligations are typically used to finance at least some of working capital, interest paid on these liabilities is not included in the profitability metric. Some studies utilize sales as the denominator (Shin and Soenen, 1998), while others use total assets less financial asset investments (Deloof, 2003).

Since the latter metric is impacted by depreciations, profitability rises over time, *ceteris paribus*. The fact that accounting measurements are susceptible to earnings management is a broader problem. Thus, using company value or changes in firm value could be an alternate proxy. The studies' profitability measurements all readily satisfy the second condition, or computability.

### Caveats of prior research

At least three significant limitations apply to previous research's effort to show a negative correlation between CCC and profitability. First off, as illustrates, working capital management is often operationalized using a single variable (CCC or NTC). However, CCC is actually an aggregate measure of its three components. As a result, studies showing a favorable correlation between CCC and profitability can only hypothesize about how strongly each of the three factors influences business profitability.

Second, as mentioned in the introduction, a number of conflicting impacts combine to produce the overall impact of working capital management and its constituent parts on firm profitability. Given an ideal working capital level, it is reasonable to assume that a decrease in working capital will even lower business profitability (Baños-Caballero et al. 2012). However, the empirical research uses linear models, implying that the dependent and independent variables have a linear relationship. Third, it is important to exercise caution when interpreting a strong correlation between working capital management and business profitability in terms of causality. According to Trochim (2000), establishing a causal relationship necessitates (1) a correlation between cause and effect, (2) ruling out alternative explanations, and (3) the cause's temporal primacy.

The reason for this is that theoretical reasoning not only anticipates that tighter working capital management will increase company profitability (Baños-Caballero et al. 2012), but it also anticipates that working capital management

will have an impact on profitability (Baños-Caballero et al. 2010; Howorth and Westhead 2003). According to Deloof (2003) and García-Teruel and Martínez-Solano (2010), less profitable businesses are incentivized to extend their payment terms in order to support sales or to wait longer to pay their bills. More current research takes these three primary cautions into account to varying degrees. In the Specifically, working capital management and profitability for each of the three components are examined independently in these studies (caveat 1). Deloof (2003), García-Teruel and Martínez-Solano (2007), Rahman and Nasr (2007), Karaduman et al. (2010), and Enqvist et al. (2012) note that both inventories, as measured by DSI, and accounts receivable, as proxied by DSO, have a significantly negative correlation with firm profitability when it comes to current assets. Meyer and Lüdtke 2006; Wöhrmann et al. 2006; Lazaridis and Tryfonidis 2006) and other investigations support similar findings.

García-Teruel and Martínez-Solano (2007) consider the critical aspect of causality when using instrumental variables for working capital management. In detail, these authors deploy the first lag of the working capital management proxies to study the causal relationship.

## CONCLUSION

Effective management of working capital is crucial to a company's success. Although it is easy to determine the short-term liquidity implications, it is yet unknown how working capital management affects business profitability. In this brief overview article, the results of empirical research examining the relationship between working capital and business profitability are organized and integrated. The profitability of businesses is generally positively impacted by stricter working capital management, according to empirical research. However, this general finding is limited by three significant caveats.

Initially, it is crucial to examine the distinct impacts of the three components of working capital: payables, inventory, and receivables. The literature study demonstrates that the total outcome is only influenced by the advantages of stricter inventory and accounts receivable management. Therefore, it is less persuasive or even deceptive to analyze the impact of working capital management on profitability using general proxies like CCC or NTC. Second, theoretical considerations indicate that working capital management and business profitability have a non-linear, concave relationship.

With the exception of Baños-Caballero et al. (2012), however, every empirical research uses models for linear regression. Given that Baños-Caballero et al. (2012) do show a concave association, it is crucial to keep in mind that stricter working capital management may only have a limited positive impact on company profitability.

Identifying the levels of the working capital components that maximize firm profitability and firm value demands a comprehensive approach that better integrates the claims of suppliers and customers. In addition to analysing the connection between working capital management and profitability, qualitative research may be useful in advising businesses on how to lower the CCC. To help businesses determine which working capital instruments to use when, it seems beneficial to create a hierarchy of these instruments, such as inventory management and factoring.

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