International Journal of Research Publication and Reviews

Journal homepage: www.ijrpr.com ISSN 2582-7421

Working Capital Management and its Impact on Profitability.

Arun Kumar H P

SRN: PES1PG22MB495
PES University

ABSTRACT:

The research mainly talks about how working capital management impacts on profitability of the companies. Here, we are considering certain companies to prove the statement. Some analytical tools like correlation and regressions are performed. This result determines the cash conversion cycle to that of return on assets and provides the correlation between them. Also, it gives the significance level which means the increase in the cash conversion cycle results in a decrease in return on assets. In addition to that, it also explains the parameters involved in the cash conversion cycle. It includes the inventory conversion period creator's conversion period and debtor conversion period. These parameters provide specific data that helps to determine the cash conversion cycle which is basically the cash involved from the purchase of raw materials to the cash received through sales. This cycle provides suitable insights about the cash and gives a better idea of days inventory to hold which impacts directly on the profits of the company.

KEYWORDS: Working capital management (WCM), Return on assets (ROA), Inventory conversion period (ICP), Debtor's conversion period (DCP), Creditor's conversion period (CCP), Cash conversion cycle (CCC),

INTRODUCTION:

We know that working capital management is one of the important elements that determine the company's ability to meet its short-term obligation, this ability determines the company's financial status in the market. Working capital consists of all the current assets. Majorly cash is one of the important elements that play a vital role in working capital management. Basically, if the working capital is at the optimal level, it always provides a good valve to the company. On the other hand, a company that contains a large inventory and enormous trade credit policies always helps the company to increase sales. This large inventory reduces the risk of a shortage of stock. and trade credit also increases sales where customers can buy products without paying immediately. Hence all these elements play an important role in making major decisions in working Capital Management.

Working Capital Management ensures an optimum level of cash flow to meet short-term debt obligations and operating expenses. This provides the relationship between short-term liabilities and assets. We can say the main goal of WCM is to maintain sufficient cash to meet all the short-term debts and to manage operating expenses.

Working Capital Management includes the current assets like accounts receivable, payable, cash, and inventories. Taking the necessary steps in all these areas results in an excellent decision the improve profits. And we are considering to make major decisions in working capital. Ration analysis like working capital ratio, collection ratio, and inventory ratio. This ratio identifies the key areas where a company should focus on managing its inventory, cash, and accounts payable and receivable. efficient working capital management also helps reduce the cost of capital. Basically, working capital is meant for short-term obligations, If a company maintains excess of it will help reduce the dependency on an external source of finance which results in reducing the cost of capital.

Furthermore, we can say that effective working capital management is one of the crucial concepts that determines the company's profitability. It mainly impacts various companies' operations Improving operational efficiency. Better working capital management also ensures a better cash flow, reduces the burden on borrowing finance, and balances Current liabilities. It has the ability to tackle opportunities and uncertainties during the tough period. in this highly competitive business world, the Significance of working capital should not be neglectable at all. finally, we can say that a company's financial health and long-term profitability always depend on working capital management.

LITERATURE REVIEW:

Guthman and Dougall (1948) define working capital mean the excess of current assets over current liabilities. He explains with an example by determining the current assets like cash, accounts receivables, and inventories. Current liability is like accounts payable, and taxes, wages, and salaries. He explains the concept of working capital with the accountant. And states networking capital is always distinct from that of gross working capital.

Micheal (1997) that firms will choose low yields on dividends and low asset volatility over a wider range of firm assets. In accordance with Kesseven (2006), there is a substantial correlation between profitability and WCM, and excessive spending in investors and debtors is linked to less wealthy profitability. The relationship between an indicator of the cash conversion cycle and business profitability was examined by Shin & Soenen (1998). They discover a substantial negative association for a sizable sample of listed American corporations over the 1975–1994 period. This finding suggests that managers might increase shareholder value by keeping the cash conversion cycle at a manageable level.

The goal of WC planning for businesses is to maximize the quantity and length of what they invest in WC, which frequently translates to lowering investment levels and speeding up the recovery phase (Nuhiu and Dermaku, 2017). To gauge the effectiveness of WCM, Richards and Laughlin (1980) advise using the operational cycle concept. They define the cash conversion cycle, or CCC, as the sum of the period during which inventory is converted and the receivables conversion period less the payment deferral period. They calculate the CCC as the amount of time between the acquisition of resources and the cash received. CCC has been frequently utilized as a gauge of WCM effectiveness.

The notion of the operating cash cycle has been expanded by Talonpoika et al. (2014) by including the payment in advance as an operational component of the current liabilities. By including the cycle time of payments in advance to the conventional metric of CCC, they created a modified CCC. They have empirically demonstrated that the WCM efficiency as measured by CCC and modified CCC may dramatically vary depending on the number of advance payments that companies get.

OBJECTIVE OF THE STUDY:

- Determining the relationship between the working capital management and the profitability.
- Factors affecting the profitability of the company.
- Analyzing the importance of working capital management.

RESEARCH METHODOLOGY:

Research methodology mainly talks about the methods that are used in the research paper.

HYPOTHESES:

H(a) -ICP impacting on ROA

H(b) -DCP impacting on ROA

H(c)- CCP impacting on ROA

METHODS AND MATERIAL:

Here the analysis is divided into two sections. The first section talks about the source of data and the second section talks about Statistical tools that are used in hypothesis testing.

DATA SOURCE;

For analysis testing the data is collected from the secondary source from the various financial reports of that particular company.

STATISTICAL TECHNIQUES:

The main statistical tools like correlation and regression are used to analyze the data. Here the entire study is done on the system itself. Some other tools are also used to provide efficiency of a company in working capital management and the ratios like inventory, debtor, and creditor conversion ratios are used to determine the best possible result.

WORKING CAPITAL AND PROFITABILITY RATIOS:

TYPE OF RATIO	***EXPLANATION***	***FORMULA***
Inventory turnover (ICP)	**Time taken to convert inventory into cash**	**Average stock /cost of goods sold*365**
Debtor's conversion period (DCP)	**Time taken to convert cash into receivables.**	**Average debtors/net credit sales*365**
Creditor's conversion period (CCP)	**Time taken to convert creditors into payment**	**Average creditors/cost of goods sold*365**
Cash conversion cycle (CCC)	**Time taken from cash involved in the purchase of raw material to cash received from the sale of goods**	**CCP=ICP+DCP-CCP**
Return on assets (ROA)	**Defines the relationship between sales and total assets**	**Net sales /total assets*100**

METHODOLOGY:

We can say that ROA is always depending on CCC which is a cash conversion cycle that includes ICP, DCP, and CCP. The following formula determines the impact of working capital on profitability.

- **ROA =f (ICP, DCP, CCP, CCC) is the equation 1**
- **ROA=β0+β1+β2(DCP)+β3(CCP)+β4(CCC)+e is equation 2**

Here, ROA is the return on assets

ICP inventory conversion period,

DCP debtors' conversion period

CCC is a cash conversion cycle.

E is an error.

Based on the equation we can say ICP, TCP, and CCP are dependent variables and ROA is an independent variable.

RELATIONSHIP BETWEEN THE WORKING CAPITAL MANAGEMENT AND ITS IMPACT ON PROFITABILITY:

As you mentioned in the above statement profitability always depends on working capital management, working capital parameters like ICP, DCP, CCP, and CCC have a relationship with profitability. To test this relation, we are performing correlation analysis and the result will be provided below.

Correction matrix

VARIABLE	**CCC**	**ICP**	**DCP**	**CCP**
ROA	-0.127	-0.5	-0.192	0.004
ICP			0.244	-0.127
DCP				0.276

Here, correlation significance is at a 0.05 level

The above correlation matrix determines the correlation between the variables. Here CCA and ROA have a negative correlation which means the correlation value is - 0.127. The significance level is 5%. This determines that cash conversion cycle increases result in a decrease in ROA (return on asset).

WORKING CAPITAL MANAGEMENT IMPACTING PROFITABILITY:

To prove the above statement, we are performing multiple regression analyses. The below table determines the impact on profitability.

MODEL	R	R square	ADJUSTED R square
1	**0.612**	**0.375**	**-1.501**

a. predictors(independent) are ICP, DCP, CCP, and CCC.

The above table represents the values of R, R Square and adjusted R Square, here R Square is the return on assets (ROA)0.37, which explains 37.5% of independent variables (WCM which includes ICP, DCP, CCP, AND CCC).

FACTORS IMPACTING OF WORKING CAPITAL MANAGEMENT ON PROFITABILITY:

- Level of working capital:

A company that has high working capital can meet its debt obligations instantly this gives confidence to the company about its efficient management. However high working capital also leads to wastage of resources. The optimum level of working capital is what the company actually needs to get sufficient profits.

- Composition of working capital:

A working capital contains different parameters which directly impact the profitability of the company. Here the parameters include the cash, inventory, debtors, creators Etc all these parameters play an important role in determining the efficient working capital management that leads to higher profit.

- Length of operating cycle:

We all know that the operating cycle begins with the purchase of materials to the cash receipt from sales. The shorter the process the higher the profits. Hence the company always focuses on reducing the operating cycle that determines the profitability of the company.

- Efficiency of working capital:

We can say good efficient working capital management is highly positively correlated with profitability. High working capital management determines the higher profit. hence the optimum level of working capital is an essential aspect of profit.

CONCLUSION:

The primary goal of the study is to determine how working capital management affects businesses' profitability. ROA is a metric used to assess profitability. The variables' correlation coefficients. CCC and ROA have a negative correlation with a value of -0.127, which is extremely significant at the 1% level of significance. This relationship indicates that ROA declines as CCC rises. Additionally, ICP is quite important at the 1% level. It shows that ROA will rise -0.065 levels with an increase in ICP level. Additionally, the p-value for the cash conversions cycle parameter is 0.006 and the coefficient is negative at -0.0503. At a 1% level of significance, H(a) is accepted.

REFERENCES

Deloof, M., & Jeger, M.(1996). Trade Credit, Product Quality and Intragroup Trade: Some European Evidence, Financial Management, 25(3), 945-968.

Gole, V.L.(1959). The Management of Working Capital, Australian Accountant, 229-250. Guthman, H.G. & Dougall, H.E.(1948). Corporate Financial Policy,2nd ed, Prentice-Hall. Inc, New York.

James C.V.(2000). Financial Management Policy, 11th ed.

Michael, P.R.(1997) Dynamic Optimal Risk Management and Dividend Policy under optimal Capital Structure and Maturity: Management Accounting Research, Vol. 102, pp. 32- 39.