Historical Perspectives on Working-Capital Management: A Thorough Literature Review

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Abstract: Working capital management has impacts on the liquidity and profitability of firms; it is, in fact, the determinant of overall financial health. This literature review synthesizes key findings from studies conducted up to 2016 to give a comprehensive understanding of the theoretical and empirical developments in this area of study. The review canvases several dimensions of WCM, including its components, determinants, and effects on firm performance, all of which give insights into the practices and strategies that have shaped contemporary approaches toward working capital management.

Keywords: working capital management, liquidity, profitability, cash flow, financial performance

I. INTRODUCTION

Working capital management is the management of short-term assets and liabilities to attain operational efficiency and financial stability of the firm. Effective WCM enables firms to balance between liquidity and profitability, thus ensuring that firms can meet short-term obligations while maximizing returns. Working capital has changed a lot over the years and reflected developments in the financial theory and practice.

Working capital typically consists of cash, receivables, inventory, and payables. Efficient management of the constituents of working capital ensures that firms are able to finance their operating activities without suffering from liquidity constraints. Poor working capital management results in financial distress, while efficient working capital management contributes to profitability and firm value maximization.

The importance of WCM lies in the effect it has on the general financial health of the firm and the generation of positive cash flows. In this respect, firms with efficient WCM practices are not often confronted with economic downturns, are better positioned to exploit investment opportunities, and ensure healthy relationships with suppliers and customers. More specifically, this literature review will enable the exploration of seminal works or influential studies in WCM, underlining major themes, methodologies, and findings that have contributed to its evolution as a field.

II. COMPONENTS OF WORKING CAPITAL MANAGEMENT

Cash Management

Cash management is that part or module of WCM that deals with the planning and monitoring of cash flows in a manner so that liquidity and other operational efficiencies are ensured. The principal objective of cash management is to maintain such level or amount of cash that weighs or balances the cost of holding cash against the benefits derived from liquidity.

It was Baumol in 1952 who introduced the transactions demand for cash model, which provided a framework on how to determine an optimal cash balance by contrasting the costs of holding cash with the opportunity cost from not holding other non-cash assets. Miller and Orr in 1966 provided another model for managing the cash balances in firms, whereby a stochastic approach will help firms set upper and lower limits in holding their cash and achieve an optimum practice in cash management.

Further research was conducted based on these basic models, taking into account the implications of cash management in numerous contexts. For instance, Kim, Mauer, and Sherman (1998) examined the determinants of corporate liquidity, trying to explain the contribution of market conditions and firm-specific characteristics in determining the cash management policy.

Management of Receivables

This means that the accounts receivables management function is a core necessity of a company in maintaining liquidity and reducing bad debt risks. Effective receivables management will ensure timely collection of payments from customers; such amounts collected will support cash flow for operational efficiency in the firm.

DeLoof, 2003, documented that there is a negative relation between the average collection period and the profitability of Belgian firms. This implies that a firm with a short average collection period tends to have better financial health. García-Teruel and Martínez-Solano, 2007, centred this analysis on SMEs and concluded that good management of receivables is associated with high levels of profitability.

Furthermore, Pike and Cheng assessed in 2001 how credit management policies played their role in influencing receivables management practices. They found that firms with well-defined credit policies and robust credit management systems are more likely to realize efficient receivables management, which again enhances overall financial performance.

Inventory Management

This involves the management of the inventory to levels that can sufficiently meet demand without incurring too many holding costs.' This statement dictates the importance of the methods of inventory management, where firms are supposed to keep enough stock to meet their customers' demands while at the same time avoiding storage and other inventory costs incurred.

The model of the economic order quantity, developed by Harris in 1913, is a basic model that outlines how to find the optimum order quantity which minimizes the total inventory costs, composed of ordering and holding costs. Since then, this model has been heavily adopted into many industries and researched for a variety of ways in which it could further be developed to bring improved inventory management practices.

The Just-In-Time inventory system, brought into the forefront in the 1970s by Toyota, revolutionized inventory management by emphasizing the reduction of the levels of inventory and synchronizing production based on demand. JIT works on the concept of minimizing waste through efficiency by producing goods only when required. This has been reiterated in studies by Schonberger, 1982, and Fullerton and McWatters, 2001, who have identified its benefits for reducing inventory costs and improving operational efficiency.

Payables Management

Accounts payable management is oriented to optimize the period of payment to suppliers for better cash flows. Effective management of payables means, in essence, negotiating the best possible terms of payment with suppliers, availing of early payment discounts on offers from suppliers, and maintaining good relations with suppliers.

Deloof, 2003, and Lazaridis and Tryfonidis, 2006, worked on the relation of accounts payable management to the performance of the firm. They really found out that although it is right that increasing payment terms does bring about a benefit of liquidity, it also has some sorts of implications for the relationships with their suppliers and the pricing policy thereof. Their findings suggest that firms have to take into account countervailing benefits from extended payment terms and possible costs related to strained relationships with suppliers.

Later research in the year 1999 by Ng, Smith, and Smith, focused on the problem of trade credit dynamics between firms and suppliers. This work established that trust and collaboration are necessary for managing accounts payable effectively. Literature shows that the ability of a firm to build strategic relations with its suppliers is a prerequisite to maximizing payables management practices.

III. WORKING CAPITAL MANAGEMENT DETERMINANTS

Characteristics of Firm

Research shows that firm size, growth opportunities, and industry characteristics significantly influence WCM practices. Normally, larger firms have more resources and more bargaining power to enable them to be more sophisticated in their WCM strategies. In addition, companies experiencing considerable growth opportunities may use more aggressive WCM practices to finance this expansion and meet new market opportunities.

Chiou et al. (2006) found that WCM practices of larger firms with more growth opportunities are more efficient. Specifically, their results show that firm size and growth prospects are critical factors when designing WCM strategies where larger firms can take advantage of economies of scale, as well as greater access to capital markets.

Economic Conditions

Interest rates, the volatility of markets—these are just some of the many economic conditions that bear on WCM decisions. One may expect firms to take more conservative WCM during times of economic uncertainty to safeguard liquidity and control financial risks. In contrast, it could be assumed that during stable economic times, firms would favor more aggressive WCM strategies to maximize profitability.

Hill et al. 2010; Baños-Caballero et al. 2014 focused their study on the influence of macroeconomic variables on working capital requirements and strategies. Their study showed that firms change their WCM practices when there are changes in economic conditions, thus showing the dynamic nature of working capital management.

Managerial Practices

This alone does not delimit its boundary, and it extends to managerial practice and corporate governance. Accordingly, effective structures of corporate governance can improve WCM practices by bringing in transparency, accountability, and strategic decision-making. Firms with robust governance frameworks are more likely to implement efficient WCM strategies that align with their overall financial goals.

Kieschnick et al. (2006) found that firms with superior corporate governance structures are associated with more efficient WCM practices. The study concluded that sound governance reduces agency problems by aligning management and shareholders' interests with improved WCM outcomes.

IV. THE EFFECTS OF WORKING CAPITAL MANAGEMENT ON FIRM PERFORMANCE

Profitability

The second line of literature has clearly and unequivocally established a link between WCM and firm profitability. Efficient WCM practices enhance profitability by reducing financing costs, optimally using assets, and improving operational efficiency. The converse also holds: poor WCM definitely contributes to erosion of profitability through additional costs and limitation of possibilities for gaining financial flexibility.

Basically, Shin and Soenen, 1998; Deloof, 2003 showed that shorter cash conversion cycles are associated with higher profitability, meaning efficient WCM results in improved financial performance. Their study demonstrated that firms can potentially improve their profitability by simply managing working capital in ways that reduce the length of time it takes to convert working capital into cash.

Liquidity

Efficient WCM practices ensure that firms maintain appropriate liquidity to satisfy the short-term obligations. Proper working capital conditions will avoid a liquidity crisis and help firms run their operational functioning with ease. Firms that have efficient WCM practices face less problem in dealing with sudden cash flow disruptions and servicing their financial commitments.

In contrast, Smith in 1980 and Eljelly in 2004 paid high regard to sustaining the optimum level for working capital so as to avert a liquidity crisis. These studies sought to establish the need for the firms to strike a balance between holding appropriate liquid assets while minimizing the costs related to excess liquidity.

Risk Management

WCM is also critical in risk management. Effective WCM practices may help reduce financial risks by ensuring that the firms possess sufficient liquidity to face STOB, thus avoiding their financial distress. Besides, efficient WCM can also improve the firm's responsiveness to economic fluctuations and market uncertainties.

According to Hill, Kelly, and Highfield (2010), firms with the best WCM practices seem to be in a better position to deal with financial risks when compared to those during times of economic turmoil. Their findings suggest that firms with more efficient WCM strategies are able to sail through uncertain economic conditions much more easily, thereby facing the least possibility of experiencing financial distress.

V. CONCLUSION

The literature on working capital management suggests that it is an extremely critical factor for the maintenance of financial health and operational efficiency of a firm. Research up to 2016 contributed tremendously to laying a base for the present practice and strategies that business units follow today in WCM, elaborating the components, their determinants, and impacts. Effective WCM remains a mainstay of striking a fine balance between liquidity and profitability that enables firms to face the complexities of the financial landscape.

VI. REFERENCES

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