A Theoretical Review on the Relationship between Working Capital Management and Company's Performance

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Abstract: The purpose of this paper is to elaborate the relationship between working capital management (WCM) and company's performance as well as related determinant factors based on literature review. It aims to identify gaps in the current body of knowledge which justify future research directions. Working capital management has attracted serious research attention in the recent past, and has become a hot topic since the financial crisis of 2008. Working capital management is a topic that has been well-known in science as well as in business practice for a long time. At the same time, its presence in the literature is still comparatively low, concentrating on the analysis of the link between WCM and company's performance with the help of publicly available data and key ratios from the annual financial statements. Especially, in view of the growing volatility and uncertainties in the credit and financial markets that have been observed for a number of years and the corresponding increase in regulatory capital in the area of external capital raising, the company's focus increasingly shifts to internal liquidity generation from the operating business on the structure of working capital. However, in order to take account of this increased interest, a stronger focus on qualitative empirical investigations is necessary from a scientific point of view, which has so far only been sparsely represented in the literature. Besides this, the review of empirical studies explore the avenue for future and present research efforts related to the subject matter.

Keywords: working capital; management; performance; liquidity; company's value

JEL Classification: G3; G32; M41

1. Introduction

Working capital management amongst businesses (either large or small and medium scale) appears to have been relatively neglected despite the fact that a high proportion of failures in businesses is due to poor decisions concerning the working capital of enterprises (Tewolde, 2002). Management of working capital is an important component of corporate financial management because it directly affects the profitability of the firms. But what could working capital and working capital management mean?

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The term "working capital" originates from the field of corporate finance and was first mentioned at the beginning of the 20th century (Firth, 1976, p. 1; Smith, 1979, p. 1). It is not a new one, but very important topic in business economics. Its basic importance can be inferred from the following, nearly one hundred year old quotation from Lough: "Sufficient Working Capital must be provided in order to take care of the normal process of purchasing raw materials and supplies, turning out finished products, selling the products, and waiting for payments to be made. If the original estimates of working capital are insufficient, some emergency measures must be resorted to or the business will come to a dead stop" (Lough, 1917, p. 355). According to Bhattacharya (2009), the concept of working capital was first evolved by Karl Marx in 1914, though in a somewhat different form, and the term he used was "variable capital".

Since the explicit distinction of capital by Adam Smith into fixed and working capital over 300 years ago, economists have recognized the important role of working capital in the company. Dewing, one of the leading financial authors in the first half of the twentieth century, argues that "the differentiation between fixed and current capital is practically as old as corporation accounting among the Anglo-Saxon nations" (Dewing, 1953, p. 685). He refers explicitly to the balance sheet of the *Society of Mines Royal*, which in 1571, was already differed between "fixed capital" and "current capital". Despite this period, as in many terms of business management, a single definition has not been possible and there are semantic problems not only for the terms "working capital" and "management", but in particular with regard to the scope of working capital management. This led Dewing at an early stage to the following statement: "Furthermore, I believe, owing to the confusion of terms, the expression 'working capital' had better be omitted altogether" (Dewing, 1953, p. 689). Working capital is one of the most misunderstood terms in the terminology of accounting and it does not appear to be uniform today (Kulshreshtha & Jha, 2009, p. 82). The lack of clarity or misunderstandings regarding the application of working capital was justified by the fact that there is no corresponding classification of working capital in the balance sheet (Meyer, 2007, p. 22). A lack of unity and confusion about the understanding of working capital has led in the past to the fact that many authors have either completely neglected the concept and subject of working capital, or dealt with a low priority (Falope & Ajilore, 2009, pp. 73-74). This is all the more remarkable since a large share of past corporate insolvencies was caused by inadequate management of working capital (Rafuse, 1996, p. 59; Al-Shubiri, 2011, p. 41).

The term "working capital" is often used as a generally accepted subject and collective term for short-term balance sheet items, which are attributable to current assets on the assets side and short-term liabilities on the liabilities side of the balance sheet (Brealey et al., 2011, p. 856). "Current assets include all those assets which are not classified as non-current assets and which are therefore expected to

be recognized within one year (or in the course of the normal business cycle) back into liquid funds". The main balance sheet items therefore include inventories, trade receivables, other receivables, down payments and cash and cash equivalents. The items are generally classified in the order of liquidity in the preparation of the balance sheet. Similar to the short-term investments on the assets side of the balance sheet, various short-term financing alternatives are available to companies. Short-term liabilities are defined as items that are settled within one year or during a business cycle. These mainly include short-term financial liabilities, short-term provisions and other short-term liabilities. In contrast to fixed capital or long-term assets, working capital is changed at a relatively fast rate. Within the scope of the normal business cycle, for example, the capital invested in inventories and receivables is again available to the company after the sale of inventories and the collection of receivables. In contrast, long-term assets usually require several years to amortize the initial investment (Moyer et al., 2009).

However, working capital does not refer to a general term as short-term operational asset and liability position, but "allows the liquidity ratio to provide information on the short-term financing behaviour of a company". For the concept of working capital used in finance and accounting area, there are often different definitions, both from the theoretical as well as the practical point of view, depending on which short-term balance items are ultimately taken into account (Schneider, 2002). In general terms, working capital can be divided into two concepts: *Gross Working Capital* and *Net Working Capital*. Gross Working Capital refers to current assets in the balance sheet and is considered by some authors to be synonym to Working Capital Ratio. In return, Net Working Capital is the surplus of the current assets over short-term liabilities. In Fig. 1 below is presented the concept of working capital in the balance sheet:

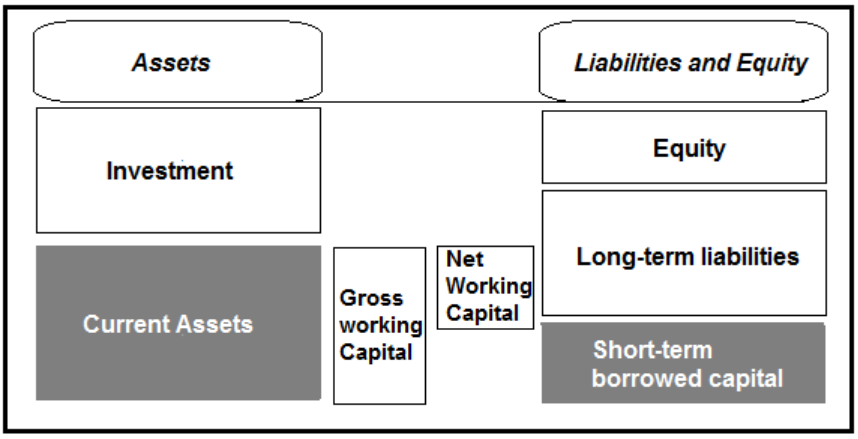

Figure 1. Working capital in the balance sheet
Source: (Meyer, 2007, p. 25)

The overwhelming number of authors understands working capital as the difference between current assets and short-term liabilities. This is based on the understanding that both active and passive positions of a short-term nature influence company's liquidity. In terms of liquidity, this difference is of great importance in the context of balance sheet analysis, since it allows a statement about the liquidity status of a company as a key ratio. This ratio is often referred to more precisely as *Net Working Capital*, in order to highlight the surplus of current assets via short-term liabilities. A *positive* Working Capital means that part of the current assets are financed on a long-term basis, while a *negative* Working Capital indicates a short-term financing of long-term or fixed assets (Spremann, 1996, p. 220). Working capital is therefore an absolute monetary amount. In addition to working capital as an absolute monetary amount, there is also the working capital ratio, which is the ratio of current assets over current liabilities. This ratio is identical to the third-degree liquidity:

WC Ratio = Current assets / Current liabilities = Third-degree liquidity

2. Concept of Working Capital Management

The ultimate goal of corporate finance is to make the available capital as profitable as possible. The funds made available appear as equity or borrowings on the liabilities side of the balance sheet and as investment or current assets on the assets side. Working capital is a term taken from corporate finance and is often used as a term for short-term balances (Meyer, 2007, p. 23).

Independent studies of the profit and loss accounts and balance sheets of large companies in the U.S. and Europe have shown that they hold an average of a quarter more cash in working capital than is required. Such an unnecessarily high level of liquidity is often associated with particularly high levels of receivables, unnecessary levels of inventory, higher operating costs or debt, which are often accompanied by inadequate implementation of strategic initiatives. As a result, there are bigger losses in the generation of potential cash flows, profits or distributions for shareholders, as well as an increased vulnerability to possible takeovers. Against this background, the need for an effective and optimized working capital management becomes more and more obvious, which in the past was at the lower end of the entrepreneurial priorities list. Not only large, but especially medium-sized companies have recognized the contribution that working capital optimization can make in this context an integrated and enhanced cost management.

This has been confirmed by the events on the capital markets in recent years as well as the regulatory requirements, such as those arising from the Basel II guidelines for banks and their borrowers. These have partly led to a rise in the risk

of acquisitions in financial markets by way of credit downgrades, thus making the generation of cash from their own (operational) power an increasingly important source of liquidity for a company's continued existence.

Unfortunately, the context of working capital management is still being viewed narrowly by many companies and is usually defined by a simple economic equation: current assets minus short-term liabilities. Such a treatment often creates a sort of casuistic problem solving, which is characterized by the fact that companies temporarily delay payments to suppliers or exert more pressure on customers for faster payment performance. If these efforts can also reduce the bound cash in the short term, however, the advantages may soon be as the suppliers usually adjust their terms and conditions accordingly and often alienate customers.

In the development of the normal business, managers have the task to decide what will be the perfect capital structure that will better fit in the company's needs. Managers tend to underestimate the working capital management and commonly look on long term perspective, focusing on long-term investments. The short-term financial management had been forgotten or avoided by managers, but recent studies (Al-Shubiri, 2011; Falope & Ajilore, 2009; Garcia-Teruel & Martinez-Solano, 2007) have been proving the importance of the management between current assets and current liabilities. When financial needs arise, claiming for long-term debt is preferable instead of changing the cash management policies in companies. For several years, working capital management was neglected because of the excessive efforts required to change short-term policies comparing with increased profit (Darun, 2008).

There are several authors (Weinraub & Visscher, 1998; Schaeffer, 2002; Meyer, 2007) supporting the importance of working capital management referring to the importance of the management of the short-term needs and the importance of the financial slack for companies. When working capital needs are positive, it is a necessary investment in working capital and the managers will have to secure funds and cover the increased capital costs. If the working capital needs are negative, then firms are getting credit from the suppliers.

Since the financial crisis of 2008, firms have witnessed a deteriorating environment where managers were forced to take rigid measures, cutting costs and delaying investments in order to respond to the decrease in demand and the consequent reduction in production. At this level, cash and working capital were under higher monitoring and control. Working capital management has been changing and common policies and usual trends had to be adapted to the new economic conditions. Due to rapid changes in economy, firms are reacting and working capital management is one of the most important issues to be dealt with.

Working capital management also became an important topic because firms have been exploring different ways to finance their activities since in the past years the

cost of long-term debt increased and the new costs levels were difficult to afford. Therefore, "working capital management is relevant in the way it influences the firm's profitability and risk" (Smith, 1980).

2.1. Components of Working Capital Management

The main components of working capital management are inventories, receivables, cash and cash equivalents and current liabilities such as payables and short-term debt. All these components have a monetary and a temporal aspect to consider. The summary of all temporal components is referred to as "Working Capital Cycle". The goal of working capital management is to optimize the investment volume and investment duration, which usually means a minimization of working capital and a shortening of the recovery process. Fig. 2 below presents the concept of Working Capital Cycle:

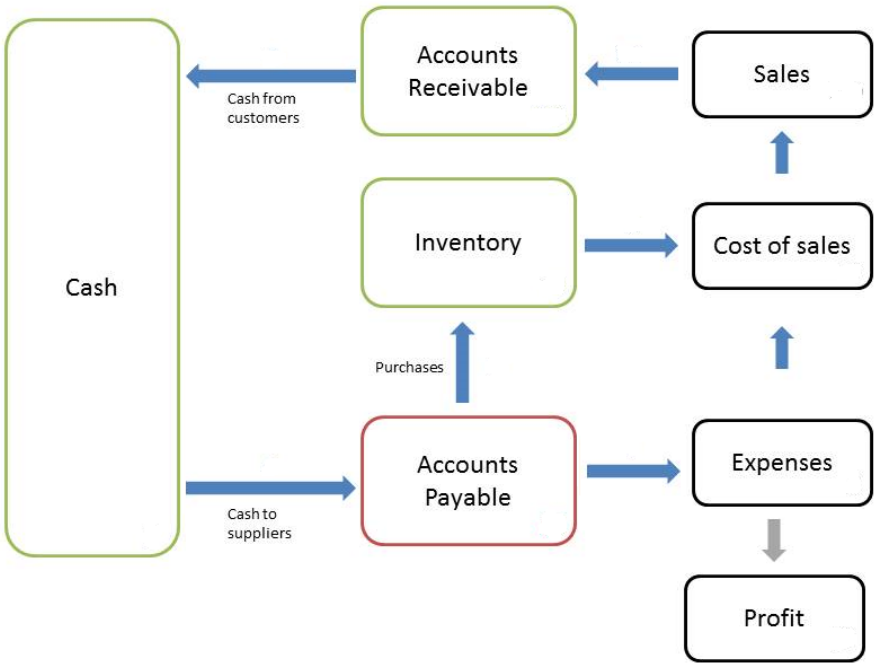

Figure 2. Working Capital Cycle

Source: Retrieved from: http://www.planprojections.com. Copyright 2014 by Plan Projections

The working capital cycle includes three core processes: On the revenue side Receivables management, also referred to as *"Order-to-Cash"*. On the output side Debt management, referred to as *"Purchase-to-Pay"*, and Inventory management, referred to as *"Forecast-to-Fulfill"*.

Accounts Receivable

The delays between sales and the correspondent cash-inflow originate from accounts receivable. Accounts receivable stands for the amount the consumers have to pay to the firm on a current basis and are related with the operating activities. A higher ratio of accounts receivable means higher short-term loan given by the firm to the customers.

Companies which facilitate trade credit to customers have more number of days of accounts receivable, meaning higher investment in working capital, but companies which receive the payments from the customers close to the moment on which they deliver the product/service, have less cash invested in working capital. Commonly, the level of investment in working capital depends on the type of strategy of the firms which is driven by the advantages and disadvantages of the cash tied up to the receivables.

Inventory

Inventories are goods or materials waiting to be sold and to be converted into cash in short run. More investment in inventories means more cash tied up waiting to generate returns. Inventory management deals with a variety of risks which can increase costs and impact on the short-term management. The relevant costs are commonly classified as physical storage costs and inventory management costs.

Inventory management costs can also be related to coordination and control, and may include costs related to theft, depletion and shrinkage of goods, order size, length of the production process and credit availability from the suppliers.

Inventory increases lead to higher number of days of inventory. Normally, companies try to mitigate as much as possible the cash tied up in inventories but sometimes, as part of the business, companies have a lot of cash invested in inventories since the product need to mature long periods to be finished and ready to be sold.

Accounts Payable

Accounts payable stand for an obligation to pay in a short-term period. Normally, it is referred to transactions to suppliers in the operational activities which were not already paid. They correspond to the amount due to suppliers starting from the moment the company receives the goods/services and ending in the exact moment the company pays for these goods/services.

The number of days of accounts payable (DAP) will increase as debt to suppliers increases. Since companies can get cheap financing by delaying payments, they can engage in deliberately delaying the payment to suppliers as much as they can, using this financial opportunity to invest the cash in other activities and get higher returns.

2.2. Working Capital Management Policies

Working Capital Management policies have direct impact on the supply chain and on the relations between the firms, suppliers and customers. Therefore, managers have to be aware of the impact of such policies in firm's profitability. Both strategies are commonly used in order to satisfy the conditions of the business between the firm, the buyers and suppliers. In what is related with these policies, Garcia & Martinez (2006) explains two major strategies of working capital management, "the aggressive and conservative policies differ in the balance between weight of current assets and short-term liabilities". Weinraub & Visscher (1998) goes in line with Garcia & Martinez (2006) defining the strategies by concluding that "an aggressive asset management results in capital being minimized in current assets versus long-term investments."

The conservative approach requires cash to be tied up in current assets increasing the opportunity cost. This approach implies that the company's financing is going to be done at a relatively higher cost but at a lower risk. This decrease in profitability is done to avoid the risk of being faced with liquidity problem, which could result from a payment request from the suppliers. This method implies a structure of capital where current assets are mainly financed with long-term liabilities.

The aggressive approach requires a different balance-sheet structure. In this method "the company finances all of its fixed assets with long-term capital but part of its permanent current assets with short-term credit" (Van Horne & Wachowicz, 1980). Under this policy, the firm has low or no long-term capital invested in current assets.

Comparing the two strategies, the aggressive approach requires lower working capital investment and expects higher profitability with a higher risk implied. "A company that uses more short-term source of finance and less long-term source of finance will incur less costs but with a corresponding high risk. This has the effect of increasing its profitability but with a potential risk of facing liquidity problem, should such short-term source of finance be withdrawn or renewed on unfavourable terms" (Al-Shubiri, 2011).

3. An Integrated Approach to Working Capital Management

The solution to the long-term and reduction of the operating capital bound to the company is a holistic approach and fixes the optimization of working capital management on three basic business processes running within the company: *Order-to-Cash*, *Purchase-to-Pay* and *Forecast-to-Fulfill* (Meyer, 2007).

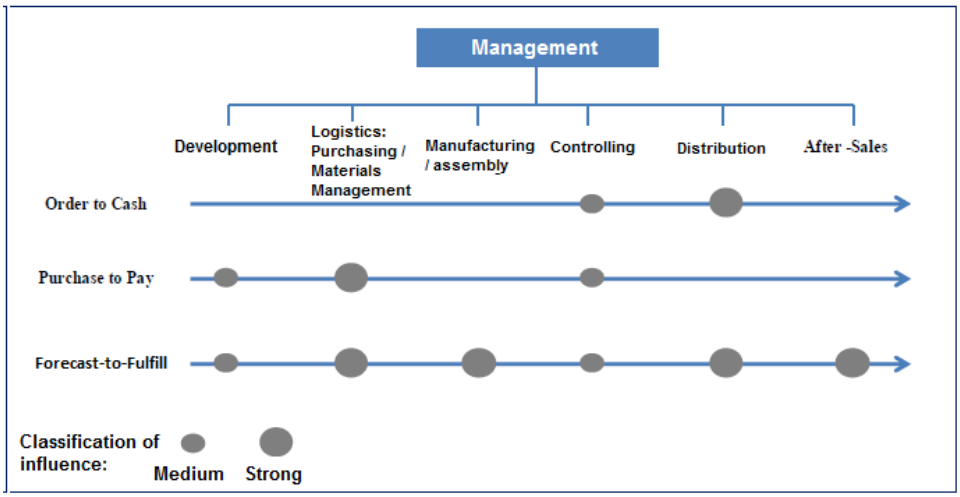

Figure 3. Process responsibility for working capital management

Source: (Klepzig, 2008, p. 29)

In addition to the large number of process managers involved (see Fig. 3), the competing objectives are more difficult for a holistic working capital management. The figure shows that sales are the main responsibility for the "Order-to-Cash" process. Controlling has a supporting function by measuring and controlling the performance of receivables. The "Purchase-to-Pay" process is characterized above all by purchasing, while the controlling function also has a supporting function. The "Forecast-to-Fulfill" is characterized by a large number of involved process partners. Purchasing and materials management are responsible for the storage of raw materials and supplies. Through the production/assembly, inventories of work in progress are affected before the finished products and spare parts are controlled by the sales department as well as after-sales (Klepzig, 2008).

When taking into account all three components of working capital management, it becomes clear that the driving forces of working capital performance are more operational than financial. This is clearly illustrated by the example of a company that has problems with the collection of claims. Even if this problem could be traced back to unsuccessful staff, a lot of other causes could be blamed. A supplier might, for example, supply the company with faulty components that have an impact on the quality of the company's products, which will annoy customers and cause them to withhold payments. Perhaps the salesperson has promised unpaid longer terms of payment, without, however, communicating to the responsible finance department. Or the dispatch department does not keep the dates so that the customers receive the deliveries late. If these transactions are not recorded in the books accordingly, corrective measure purchases, which are restricted to the debt collection department, are likely to create the desired remedy.

Another example shows the influence of different departments in the company on the expression of common control parameters such as Days Sales Outstanding (DSO). Often, the sales figures measured by the DSO show a significantly higher value than would allow the average payment periods granted to customers. This is often the responsibility of the finance and accounting department as a supposedly responsible payment processing center. However, it is not uncommon that only a fraction of the measured overhang times really have their origin in finance and accounting department. In addition to this, not infrequent periods of delay outside the area of responsibility and the scope of finance and accounting are caused by price fixing errors, unclearly agreed payment periods, product complaints and subsequent discounts, credit notes and unpaid partial payments or invoices or confirmations not submitted internally, all lead to retroactive and time-consuming accounting and coordination problems in finance and accounting.

This is where the integrated working capital management begins, in which it incorporates the entire value chain of the company into consideration by means of the main processes described above, thus capturing and integrally optimizing cross-functional relationships and dependencies. It follows immediately that such an approach generates added value for all stakeholders involved in the company. An integrated working capital management gives the company the possibility of higher operating speed in the processes, lower error of the fault and ultimately to higher profit margins and thus to an increased company value. In addition, the balance sheet ratios will improve, in particular with regard to cash flow and liquidity.

3.1. Organizational Principles of an Integrated Working Capital Management

Although some companies complain that the optimization of their working capital management disrupts or even interrupts customer processes, the opposite is true in practice. By eliminating the reasons for delayed customer payments, a working capital initiative actually improves customer service and, in principle, makes the customer more likely to buy more from the company. Similarly, the timely payment of invoices will make the supplier more likely to do business with the company. This is ultimately reflected in price fixing, the terms of sale and the services offered. All this also contributes to the satisfaction of the operations managers.

Although it is possible to achieve benefits by improving any aspect of working capital management, the main advantage is the measures and initiatives that affect all three of the previously categorized main processes. This is partly reflected in the fact that the main cause of all problems is easily outside the area in which it becomes visible. The immediate consequence is often that improvements in one area contribute to improvements in another.

The measures for optimizing working capital management usually start with the determination of the potential for improvement by analysing the company's

existing balance sheet and profit and loss account and by measuring its working capital performance. A measurement based on a comparison of individual subsidiaries or branches can be helpful in larger companies if the corresponding comparative data are available (Schaeffer, 2002, p. 85). In this way, an improvement potential for the entire company can be quantified in the internal (benchmarking) comparison based on the performance of the most powerful company or business unit.

Once the potential for improvement is identified, the manager responsible for the optimization of the working capital management must work closely with the other managers, customers and suppliers of the company in order to raise the potential and then develop a reliable implementation program. This manager is often the CFO. The CFO plays an important role in this process because it not only traditionally preserves the company's metrics, but also, as a rule, the only senior executive who has a complete overview of the company' s processes and not just the view of a functional area or a business unit. In addition, the CFO is almost always involved in strategic decisions as it has to provide funding to support this decision and in many cases articulates the logic of this decision to investors.

3.2. Successful Practices of an Integrated Working Capital Management

Although the challenges for optimal working capital management vary according to the company, the experience shows that there are cross-sector best practices that can be used on the basis of three key business processes running within the company: Order-to-Cash, Purchase-to-Pay and Forecast-to-Fulfill.

3.2.1. Order-to-Cash

It is no secret that dissatisfied customers tie up their supplier cash by creating high levels of receivables that lead to an accumulation of overdue receivables and are finally debited. In order to prevent this process, credit risk methods must be reviewed in order to ensure that they comply with the Company's strategic objectives and adequately manage the risk of receivables. It is necessary to minimize the offered payment periods to the extent strictly necessary from a sales strategy perspective, whereby the sales department must be brought into the boat and additionally motivated by incentive mechanisms. In parallel, billing systems must be simplified as far as possible in order to prevent payment delays. The traditional argument in this context that costly solutions, if at all only with main customers are economic, is increasingly weakened by emerging and uncomplicated handling of electronic billing solutions. It should in any case be ensured that the dispatch of goods or the provision of services automatically trigger the billing process. Ideally, load-in writing procedures are ideal whenever they are used and enforceable. An important aspect of optimization also affects the dunning procedure. A standardized and comprehensive dunning process with strict dunning periods and sanctioning mechanisms is the prerequisite for a reduction in sales and

the associated so-called DSO (Days Sales Outstanding). Additional systematic methods for resolving disputes are offered by additional optimization potential, which assigns the competences to certain individuals and which transfers the responsibility to employees of the company at a higher level whenever the issues of concern escalate or remain unsolved. This is accompanied by the need for a regular review of reasons for disputes, as well as a sustained pursuit and continuous elimination of them to prevent repetition.

3.2.2. Purchase-to-Pay

With regard to the ordering and payment processes, it should be noted that the arbitrary holding of invoices until they are overdue is not a long-term solution for optimizing working capital management. Suppliers will pay attention to the higher costs to be taken into account in their pricing and performance, as well. On the other hand, the combination of expenditure among a few suppliers as well as a differentiation and categorization of the latter in terms of the effect of their potential business at risk and profit positions offer better solutions. Focusing on optimizing business relationships with suppliers that are either a high risk or have a significant impact on profit is required. Optimization should be in the form of providing free access to information between companies and suppliers (for example, automatic, revolving and direct forwarding of demand forecasts to the supplier), developing joint processes, and sharing efficiencies. At the same time, automation of procurement processes with suppliers is either a low risk or has a negligible effect on profit. An adjustment of the supplier portfolio is particularly useful with regard to those suppliers which are a high risk of fulfilment but have little effect on the profit. Agreements with regard to more advantageous payment periods in the context of customer-specific contracts are particularly suitable for suppliers or products with a high turnover, since both the profit effect as well as the negotiating position are good. A further option concerns the establishment of internal controls to prevent payments before the agreed payment periods and thus to fully utilize the payment periods.

3.2.3. Forecast-to-Fulfill

In the context of planning, production, inventory holding and delivery, the supply chain management, today's technology makes it possible to develop forecasts with the help of information about the company as a whole, the conflicting objectives of storage costs, customer service, operating costs and product range. This is particularly difficult in industrial branches with constantly changing technology, i.e. industries in which overnight aging products have a massively negative impact on poor management of the supply chain management. The best practice and methodology is to require companies to check the quantities in time, in order to avoid the unnecessary purchase or production of additional goods. For the same reason, methods and procedures have to be developed to ensure that the inventories

can be easily located. In addition, a differentiated inventory strategy is essential for the various goods, depending on how quickly goods can be replaced and how important they are to the production processes.

4. Concluding Remarks

An integrated, cross-functional working capital management must be supported by a stringent and revolving planning and controlling process ranging from conceptual orientation to strategic and operational control, to a successful and sustainable instrument of cost and liquidity optimization for the management of a company. The primary goal of working capital management in a company is to manage short-term funds required for the day to day business activities. The company requires effective working capital management policy for smooth, uninterrupted production and sales activity. The company should closely manage its level of working capital components so as to increase its profitability. Strict policies should be put in place when considering the type of people to offer credit services. Also sound collection policies should be put in place so that the company does not lose its revenue to consumers who do not pay for the services used or experience high level of bad debts. Payment to suppliers needs to be done as late as possible so that cash is used for other purposes in the company to generate more revenues. Inventory should only be purchased as and when it is required so that carrying costs and holding costs are kept at their minimum level. Good relationships with suppliers should be put in place so that the company will not run a risk of running out of stock and failing to get the required inventory which will result in tarnishing of the image of the company, and also lose of sales. An optimal incentive system from the point of view of working capital management is based on the margin contribution after incoming payments and the range of receivables. Increased knowledge about working capital management in sales promotes the asymmetrical distribution of information, thus becoming a decisive competitive advantage and thus contributing to profitability and safety of the company's liquidity.

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