Poor Working Capital Management Remain Major Cause of Business Failure

Tesleem Adelodun Alade
Nikoy Nigeria Limited, Nigeria

DOI: https://dx.doi.org/10.47772/IJRISS.2024.801081
Received: 27 December 2023; Revised: 06 January 2024; Accepted: 11 January 2024; Published: 06 February 2024

ABSTRACT

Businesses must manage their working capital well since it affects their resilience and profitability. Liquidity and profitability must be balanced. Sustaining sufficient operating capital guarantees operational stability and on-time payment of debts. Shortening the cash conversion cycle and increasing efficiency maximizes cash flow. This approach provides advantageous lending terms and increases credibility with stakeholders. Conversely, poor working capital management can lead to cash flow issues, increased costs, and missed opportunities. Overtrading brought on by low liquidity might jeopardize financial stability. To secure a business's long-term success in the face of changeable market conditions, regular assessments and adaptable plans are essential. Thus, this study focuses on the effects of poor working capital management resulting to business failure.

Poor Working Capital Management Remain Major Cause of Business Failure

Working capital management is a crucial factor that forecasts businesses' success rate, profitability, and value. The main goal of businesses is maximizing their profitability while also maintaining business liquidity. However, businesses that focus on increasing their profitability at the expense of business liquidity face serious problems. Hence, businesses must balance their thirst and hunger for profitability and liquidity (Hawley et al., 2022). Because of the reasons highlighted above, working capital management ought to be an essential parameter for businesses as it ultimately affects a business's profitability or its subsequent failure. The article will discuss the importance of working capital to businesses and why poor working management of enterprises is a leading cause of business failures.

LITERATURE REVIEW

Business gains immensely from the management of working capital. Efficiency in managing businesses' working capital plays a critical role in the corporate business strategy with the end goal of creating shareholder value (Boisjoly *et al.,* 2020). How businesses manage their working capital significantly impacts their liquidity and profitability. A study by Boisjoly *et al.,* (2020) found that liquidity and profitability have similar importance, and businesses should strive to balance the two. The authors further state that the management of business working capital involves maintaining a balance of the current assets and liabilities for the business to meet its obligation in the short-term and prevent itself from accumulating excessive existing assets and investments. Within businesses working capital is a critical issue and financial managers find it challenging to identify necessary working capital drivers (Boisjoly *et al.,* 2020). Working capital management entails striking the right balance among working capital components.

Business success depends on the financial capability of effectively managing the business' receivables and payables. As a result, business financial departments spend much time trying to bring current assets and liabilities to optimal levels. However, in their study, the authors found that in most of the 130 organizations they investigated, optimal working capital levels strike the right balance between efficiency and risks.

Working capital management measurement is done by using the cycle of cash conversion. The principle of the cash conversion cycle is that longer time lags mean the working capital investment is significant (Boisjoly *et al.,* 2020). The importance of working capital to businesses is enormous, and it cannot be ignored; it is essential in helping management look for solutions that create value for the business's stakeholders within emerging markets. Businesses are expected to meet their financial obligations with a good current ratio. According to Atseye *et al.,* (2015), most finance department in every business recognize working capital as essential, hence adopt the necessary ways of managing capital.

Businesses that understand the role of working capital benefit from minimized risks; businesses' working capital is arrived at by comparing current liabilities and assets. It helps ensure enterprises have enough cash flows to ensure continued business operations and minimize the risks of paying short-term liabilities (Atseye et al., 2015). Working capital helps in meeting business financial obligations. Working capital ensures that business operations continue and that cash flow is sufficient to meet the business debts and expenses in the short term. Finally, it provides businesses with the liquidity needed for businesses' efficient operations.

Working capital management is critical to businesses' survival. Proper working capital management is essential for maintaining the running of a business in all aspects (Abuzayed, 2012). Working capital facilitates the business's survival in diverse mechanisms. First, working capital investment is hinged on large parts of total assets; hence the amount invested must be utilized efficiently. Second, working capital management affects businesses' liquidity and profitability (Mandipa & Sibindi, 2022). Working capital balances profitability and liquidity while observing the businesses' day-to-day operations. Businesses must arrange funds that meet their daily operations requirements apart from fixed assets.

Businesses' internal resources are mainly insufficient to meet the business needs, and owners cannot mobilize financial resources from personal resources. Therefore, business resources require financing from borrowed funds while keeping in check the businesses' short and long-term requirements (Atseye et al., 2015).

Sufficient working capital is crucial in ensuring the survival of businesses. Therefore, working capital management is essential to businesses. Furthermore, with businesses not possessing many fixed assets, the businesses must invest in current assets (Abuzayed, 2012). Working capital in business refers to the investment, financing, and control of current assets within the approved regulatory frameworks. It plays a crucial role in the survival of a business, and effective management of working capital is vital for ensuring the success of businesses.

In businesses, the finance department should be specialized, requiring individuals with professional qualifications and experience. Estimating a business's working capital involves forecasting, as there are often significant changes due to new developments (Atseye et al., 2015). Effective management of operational capital ensures that businesses can generate funds from their internal operations. Therefore, businesses require management to maintain the necessary working capital accounts. Keeping the working capital accounts is essential to the businesses. Moreover, investment in current assets depicts a company's investment as stipulated by Atseye et al., (2015). The investments made by enterprises in existing assets and liabilities should be structured in case of changes in the sales levels of the businesses.

Working capital management significantly influences businesses; hence, financial managers must spend a substantial portion of time managing businesses' current assets and liabilities (Mandipa & Sibindi, 2022). It is done through making arrangements for short-term financing, credit terms negotiations, and cash movement control.

Mandipa & Sibindi, (2022) also found that inefficient working capital management leads to business enterprises' downfall. Therefore, businesses are required to have a balanced position of working capital. A balanced working capital ensures businesses have adequate working capital to ensure smooth operations

(Atseye et al., 2015). Inconsistent working capital has a negative effect from the business's point of view. Uneven working capital affects the business's profitability and production interruptions (Atseye et al., 2015). Management of working capital helps ensure that the working capital available to businesses is not too little or too large.

Despite the benefits of businesses implementing effective working capital management practices, it is important to recognize that poor management of working capital is often responsible for business failures. While there have been some improvements in working capital management among businesses globally, research shows that these improvements have been limited (Jana, 2018). International organizations have established standards to govern working capital management in businesses. Unfortunately, many businesses have not taken working capital management seriously, which has contributed to the failures they experience.

Poor governance leads to ineffective management of working capital. In business organizations, incompetent managers struggle with multiple responsibilities: keeping stakeholders motivated, maintaining balanced budgets, and enhancing revenue streams and employee performance. These problems accumulate and often result in business failures.

METHODOLOGY

This study adopts a qualitative research design approach through analyzing non-numerical data, while understanding the different concepts and opinions of authors. The researcher utilizes case studies from a comprehensive examination of different groups and businesses that failed due to poor working capital management. The researcher further utilized the grounded theory model in developing new theories on this subject.

ANALYSIS AND DISCUSSION

It is critical first to discuss the consequences of poor working management on businesses to address the effect of poor working capital management. The results of poor working management include; first, poor working management affects businesses' profitability levels. Jana (2018) states that working capital management is integral to the business as it affects profitability and liquidity levels. Second, most businesses do not understand working capital management, and most fail to realize that balancing current assets and liabilities is critical. Poor working capital management means businesses fail to observe short-term assets and liabilities, which is crucial to business profitability (Jana, 2018). Third, Jana (2018) states that business management has responsibility for businesses' profits and losses. Fourth, most management often neglects to ensure that businesses maintain optimal liquidity. This lack of attention leads to excess liquidity being idle and not adding any value. Jana (2018), in his study, states that reduced business liquidity will prevent the businesses from meeting their financial obligations creating financial distress.

Working capital aims to maintain the right balance between business liabilities and assets in the short term. With proper management, businesses have the liquidity that helps them meet their maturing liabilities. For businesses, the good management allows managers to find and identify working capital drivers and working capital levels. Such is different from businesses with poor leadership. Businesses with poor management face reduced profit margins as the working capital management system is flawed, affecting the businesses' profitability and liquidity (Jana, 2018). The authors found that organizations with poor management recorded a decrease in gross profit from 10% to 1% as the businesses cannot control current assets and liabilities in a way that reduces inability risks (Tan, 2016). As a result, such firms cannot meet their short-term obligations and suffer from disproportionate asset investments.

Also, with poor working capital management, businesses found it difficult to locate major working capital drivers and optimal working capital levels. As a result, such enterprises fail to meet their fast-maturing financial obligations leading to decreased business liquidity. Good working capital management strives to ensure businesses can continue operations with sufficient cash flows to meet debts and operational expenses (Tan, 2016). However, companies that suffer from poor working capital management fail to continue their operations as their inadequate cash flows hinder the businesses' ability to honor debts and operational expenses.

Poor working capital management leads to business failure, creating low employee morale and reducing productivity. Low morale within the business makes room for employees to complain and fail to complete tasks allocated to them, and employees suffer low motivation (Seth *et al.,* 2021). Poor working capital management means businesses suffer from failure because they failed to meet their financial obligation. Finally, poor capital management leads to a situation where the operations of the businesses are severely affected because of insufficient cash flow problems that lead to a rise in business debts and operational expenses (Seth *et al.,* 2021). High debts and expenses mean that the business cannot serve its purpose hence closure is the last result.

Poor management affects business observance of working capital account levels. The responsibility of the business finance department is specialized, requiring the person to have specific qualifications and experiences (Atseye et al., 2015). The management is tasked with estimating the business working capital. However, assessing working capital requires regular forecasting and updating records. A business with good management benefits from improvement in fund generation from the internal business operations; however, businesses that suffer from poor management will suffer from an inaccurate forecast of working capital records by the business finance management and its fund generation from its internal business operationswill reduce.

IMPLICATIONS

It is difficult to fail to recognize the positive impact of working capital on the success of businesses in terms of profitability and value. Poor working capital management harms businesses. Businesses with adequate working capital enjoyed the benefits of achieved corporate strategy and enhanced shareholder value; It is evident that at certain levels of working capital, the value of businesses is maximized (Alvarez *et al.*, 2021). The main goal of businesses is maximizing their profitability while also maintaining business liquidity.

CONCLUSION

The management of business working capital involves maintaining a balance of the current assets and liabilities, which helps eliminate the inability risk for the business to meet its obligation in the short-term and prevent itself from accumulating excessive existing assets and investments. Within businesses working capital is a critical issue and financial managers find it challenging to identify necessary working capital drivers. Both liquidity and profitability have similar importance, and businesses should strive to ensure they balance the two.

A business that does not consider the liquidity aspect faces insolvency prospects. Finally, poor management has an impact on business enterprises' overall operations. Within business enterprises, incompetent managers face the enormous task of keeping business stakeholders motivated, balancing the business budgets, and increasing revenue channels and employee performance levels.

REFERENCES

1. Abuzayed, B. (2012). Working capital management and firms' performance in emerging markets: The case of Jordan. International Journal of Managerial Finance, 8(2), 155–18.

https://doi.org/10.1108/17439131211216620

2. Alvarez, T., Sensini, L., & Vazquez, M. (2021). Working capital management and profitability: Evidence from an emergent economy. International Journal of Advances in Management and Economics, 11(1), 32-39.
3. Atseye, F. A., Ugwu, J. I., & Takon, S. M. (2015). Determinants of working capital management. *International Journal of Economics, Commerce and Management*, *3*(2), 1-11.
4. Boisjoly, R. P., Conine Jr, T. E., & McDonald IV, M. B. (2020). Working capital management: Financial and valuation impacts. Journal of Business Research, 108, 1-8.
5. Jana, D. (2018). Impact of working capital management on profitability of the selected listed FMCG companies in India. *International Research Journal of Business Studies*, *11*(1), 21-30.
6. Hawley, J et al., (2022). The importance of working capital management. https://www.investopedia.com/ask/answers/100715/why-working-capital-management-important-company.asp
7. Mandipa, G., & Sibindi, A. B. (2022). Financial performance and working capital management practices in the retail sector: Empirical evidence from South Africa. Risks, 10(3), 1–17. https://doi.org/10.3390/risks10030063
8. Seth, H., Chadha, S., & Sharma, S. (2021). Benchmarking the efficiency model for working capital management: data envelopment analysis approach. International Journal of Productivity and Performance Management, 70(7), 1528-1560.
9. Tan, Y. (2016). The impacts of risk and competition on bank profitability in China. Journal of International Financial Markets, Institutions Money, 40, 85–110. https://doi.org/10.1016/j.intfin.2015.09.003