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# A STUDY ON WORKING CAPITAL MANAGEMENT AND ITS EFFECT ON LIQUIDITY

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**Abstract** - This study focuses on evaluating the impact of working capital management on the liquidity position of firms and its overall influence on short-term financial stability. Working capital management is a crucial area of financial management that involves the efficient control and utilization of current assets and current liabilities. It mainly includes components such as cash, inventory, accounts receivable, and accounts payable, which directly affect a firm's operational efficiency and liquidity position.The main objective of this research is to analyze the relationship between working capital management and liquidity by using secondary data collected from the financial statements of selected companies over a specific time period. A quantitative research approach has been adopted to measure liquidity performance and assess how effectively firms manage their working capital. Various financial ratios such as current ratio, quick ratio, and other liquidity indicators are used to evaluate the efficiency of short-term fund management.The analysis reveals that effective working capital management plays a significant role in improving a firm's liquidity position and ensuring smooth business operations. Companies that maintain an optimal level of working capital are better equipped to meet their short-term obligations without financial pressure, thereby maintaining operational continuity and financial stability. Proper management of receivables ensures timely cash inflows, efficient inventory control reduces unnecessary holding costs, and effective management of payable supports better cash flow planning.

***Keyword*:** Working Capital Management , Financial Management , Current assets and Current liabilities , Accounts receivable, and Accounts payable , Cash Flow

## INTRODUCTION

Working capital management is a fundamental aspect of financial management that deals with the administration and control of a firm's short-term assets and liabilities. It ensures that a business has sufficient resources to carry out its daily operations efficiently while maintaining financial stability. The major components of working capital include cash, inventory, accounts receivable, and accounts payable. Proper management of these components is essential for maintaining smooth business operations and avoiding financial disruptions.Working capital is critical because it directly affects the operational efficiency and profitability of a firm. Efficient management ensures that sufficient cash is available for daily expenses, raw material purchases, salary payments, and other operational needs. At the same time, it helps in minimizing unnecessary investment in current assets, thereby improving overall financial performance.Liquidity refers to the ability of a firm to meet its short-term financial obligations as they become due. It is a key indicator of financial health and reflects the firm's ability to convert assets into cash quickly without affecting its value. A company with strong liquidity is more capable of handling unexpected expenses, maintaining creditworthiness, and ensuring uninterrupted operations. Poor liquidity, on the other hand, can lead to financial distress, delayed payments to suppliers, and loss of business credibility.The relationship between working capital management and liquidity is highly interdependent and requires careful balancing. Adequate working capital improves liquidity by ensuring sufficient funds are available to meet short-term obligations.

## STATEMENT OF THE PROBLEM

Many firms experience financial instability not because they are operating at a loss, but due to inefficient management of working capital. Working capital management plays a crucial role in ensuring the smooth functioning of day-to-day business activities, as it deals with the control of current assets such as cash, receivables, and inventory, along with current liabilities like payables and short-term obligations. When these components are not properly managed, it creates serious financial imbalances that directly affect liquidity and operational efficiency.

One of the major issues arises from poor management of receivables, where delays in collection of payments from customers reduce the availability of cash needed for routine operations. Similarly, ineffective inventory control leads to either excessive stock or insufficient stock. Excess inventory increases storage costs and locks up funds unnecessarily,

while shortage of inventory disrupts production and sales activities, ultimately affecting customer satisfaction. In addition, improper handling of payable can lead to loss of supplier trust or missed credit opportunities, which further weakens the firm's financial position.

## REVIEW OF LITERATURE

**1. Mehta (2023):**

Mehta (2023) analyzed the relationship between the cash conversion cycle and firm performance. The study found that a shorter CCC leads to quicker cash recovery, which improves liquidity and enhances returns. Firms with efficient working capital cycles were better positioned to reinvest funds and achieve higher profitability.

**2. Khan (2023):**

Khan (2023) focused on inventory management and its impact on liquidity. The study highlighted that poor inventory control results in excess stock, leading to blocked funds and increased holding costs. Efficient inventory management ensures optimal stock levels, reduces wastage, and improves overall operational efficiency.

**3. Patel and Shah (2023):**

Patel and Shah (2023) conducted a comprehensive review of working capital management practices in emerging markets. They proposed a structured framework for managing receivables, payables, and inventory effectively. The study emphasized that a systematic approach helps firms maintain liquidity, reduce financial risk, and enhance profitability.

**4. Patel (2022):**

Patel (2022) focused on small and medium-sized enterprises (SMEs) and highlighted the critical role of working capital management in sustaining their operations. The study found that SMEs, due to limited access to external financing, rely heavily on internal fund management. Efficient handling of working capital ensures adequate liquidity, reduces financial stress, and supports business growth in small firms.

**5. Gupta and Jain (2022):**

Gupta and Jain (2022) emphasized the importance of maintaining an optimal level of working capital. Their study pointed out that both excessive and insufficient working capital can negatively affect firm performance. While excess funds lead to idle resources and reduced profitability, insufficient funds result in liquidity shortages and operational inefficiencies. Therefore, achieving a balanced approach is essential for financial stability.

**6. Akbar et al. (2022):**

Akbar et al. (2022) explored the strategic dimensions of working capital management beyond its traditional scope. The study found that efficient working capital management not only improves short-term liquidity but also influences long-term investment and financing decisions. By optimizing working capital, firms can enhance their ability to invest in growth opportunities and maintain sustainable financial performance.

**7. Gautama and Neupane (2022):**

Gautama and Neupane (2022) investigated various internal and external factors affecting working capital management practices. Internal factors such as firm size, profitability, and operational efficiency were found to play a significant role, while external factors like GDP growth, inflation, and interest rates also influenced decision-making. The study concluded that firms must adapt their working capital strategies according to both organizational characteristics and macroeconomic conditions.

**8. Zheng, Zhou, and Iqbal (2022):**

Zheng, Zhou, and Iqbal (2022) examined working capital management in SMEs during the COVID-19 pandemic. Their findings highlighted the influence of managerial behavior, particularly overconfidence and risk perception, on financial decision-making. The study revealed that behavioral factors significantly affected how firms managed liquidity during crises, emphasizing the need for rational and data-driven financial strategies.

**9. Sharma (2021):**

Sharma (2021) analyzed the key components of working capital, namely inventory, accounts receivable, and accounts payable, and their impact on financial stability. The study highlighted that improper management of these components leads to operational disruptions and liquidity shortages. It concluded that maintaining an optimal balance among these elements ensures smooth day-to-day business operations, minimizes financial risk, and supports long-term sustainability.

**10. Reddy and Reddy (2021):**

Reddy and Reddy (2021) focused on receivables management and its role in reducing financial risk. Their study found that firms with strong credit policies and efficient collection procedures experience lower levels of bad debts. Faster recovery of outstanding dues enhances liquidity, enabling firms to meet short-term obligations without relying heavily on external financing sources.

**11. Kumar (2021):**

Kumar (2021) examined the efficiency of receivables management practices in firms and their impact on cash flow. The study demonstrated that prompt collection of receivables not only minimizes the risk of defaults but also ensures a steady inflow of cash. This, in turn, improves liquidity and allows firms to reinvest funds into productive activities, thereby enhancing financial performance.

**12. Singh and Kumar (2020):**

Singh and Kumar (2020) conducted an empirical study on manufacturing firms to examine the relationship between the cash conversion cycle (CCC) and profitability. Their findings

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revealed a significant negative association between the length of the CCC and firm profitability, indicating that firms with shorter operating cycles tend to perform better financially. The study emphasized that efficient management of inventory, receivables, and payables reduces the time gap between cash outflows and inflows.

## RESEARCH DESIGN

This study adopts a combination of descriptive and analytical research design to examine working capital management and its impact on liquidity. The descriptive approach is used to present the existing practices of the organization, particularly in managing inventory, receivables, and payable, thereby providing a clear understanding of day-to-day financial operations. The analytical design is employed to evaluate the relationship between working capital components, such as current assets and current liabilities, and liquidity indicators including the current ratio and quick ratio. This dual approach enables both systematic description and critical evaluation of financial data, facilitating meaningful interpretation without any experimental intervention. The study is based on both primary and secondary data, where primary data is collected directly from employees, finance managers, and accounts staff through a structured questionnaire, providing first-hand insights into financial practices. Secondary data is obtained from balance sheets, profit and loss accounts, financial reports, and internal records, as well as from academic journals, textbooks, and relevant online sources related to working capital management. The study covers a period of five years, ensuring a comprehensive analysis of financial performance over time. Analytical tools such as ratio analysis, trend analysis, and comparative analysis are used to interpret the data and draw meaningful conclusions regarding the relationship between working capital management and liquidity.

## DATA ANALYSIS AND INTERPRETATION

The analysis of financial data over the three-year period reveals that the company is in a recovery phase, but the improvement is uneven and not structurally strong yet. While there is clear progress in profitability, operational efficiency, and asset utilization, the core financial foundation still shows weaknesses. Liquidity management is inconsistent, cash reserves are critically low, and dependence on debt financing remains high. These factors indicate that although the company is growing, it is doing so with underlying financial risk. The improvement seen in later years is real, but it is not fully stable or sustainable unless key issues like cash flow management, cost control, and capital structure are addressed systematically.

### 1. LIQUIDITY POSITION

Current ratio remained above 1 but showed a declining trend → indicates unstable liquidity.

Quick ratio dropped below 1 → high dependence on inventory.

Cash ratio extremely low → poor immediate liquidity and weak cash management.

Net working capital fluctuated sharply → inconsistent working capital control.

| YEARS | CURRENT ASSETS (INR Hund.) | CURRENT LIABILITIES (INR Hund.) | RATIO |
|---|---|---|---|
| **2020-2021** | 6,53,289 | 4,09,205 | 1.596 |
| **2021-2022** | 6,45,792 | 6,15,951 | 1.048 |
| **2022-2023** | 6,69,287 | 6,07,685 | 1.101 |

### 2. CAPITAL STRUCTURE

Equity ratio below 50% → weak ownership base.

Debt ratio increased significantly → rising financial risk.

Debt-to-equity ratio exceeded 2 → excessive reliance on borrowed funds.

| YEARS | SH. EQUITY (INR Hund.) | NET ASSETS (INR Hund.) | RATIO | % |
|---|---|---|---|---|
| 2020-2021 | 2,53,114 | 11,11,928 | 0.228 | 22.76% |
| 2021-2022 | 2,68,554 | 11,02,711 | 0.244 | 24.35% |
| 2022-2023 | 3,15,469 | 12,87,473 | 0.245 | 24.50% |

### 3. PROFITABILITY

Net profit improved from loss to positive → recovery phase.

Gross profit ratio declined initially → poor cost control.

Operating profit improved but slightly declined later → rising expenses.

Overall profitability improving but still not strong.

| YEARS | GROSS PROFIT (INR Hund.) | SALES (INR Hund.) | RATIO (%) |
|---|---|---|---|
| 2020-2021 | 2,23,246 | 5,55,284 | 40.15% |
| 2021-2022 | 3,26,822 | 12,13,089 | 26.87% |
| 2022-2023 | 5,85,388 | 19,94,106 | 29.35% |

**4. LEVERAGE ANALYSIS**

Financial leverage high initially → high debt burden.

Operating leverage increased later → higher business risk.

Shift from financial risk to operational risk observed.

| PARTICULARS | AMOUNT (INR) |
|---|---|
| Sales | 10,92,400 |
| Less: Variable Cost | 1,04,464 |
| Contribution | 11,96,864 |
| Less: Fixed Cost | 4,37,700 |
| EBIT | 7,59,164 |
| Less: Interest | 2,82,564 |
| EBT | 4,76,600 |
| Less: Tax | 1,37,800 |
| **EAT** | 3,38,800 |

**5. COVERAGE POSITION**

Interest coverage ratio improved significantly → better debt servicing ability.

Final year shows financially safer position compared to initial year.

| YEARS | EBIT (INR Hund.) | INTEREST (INR Hund.) | RATIO |
|---|---|---|---|
| 2020-2021 | (5,559) | 35,709 | -0.156 |
| 2021-2022 | 60,278 | 33,470 | 1.801 |
| 2022-2023 | 89,234 | 29,414 | 3.034 |

**6. EFFICIENCY (TURNOVER RATIOS)**

Total asset turnover increased → better utilization of assets.

Fixed asset turnover improved steadily → efficient use of infrastructure.

| YEAR | TIME HOUR RATE | UNIT RATE |
|---|---|---|
| 2020-2021 | **-0.102** | **-2.18** |
| 2021-2022 | **0.092** | **1.157** |
| 2022-2023 | **1.00** | **15.26** |

## RESULTS AND DISCUSSION

The findings of the study indicate that working capital management has a significant influence on the liquidity position of the firm. The analysis of financial data reveals noticeable fluctuations in liquidity ratios, reflecting inconsistencies in the management of short-term assets and liabilities.The current ratio demonstrates that the firm is generally capable of meeting its short-term obligations; however, variations across the study period suggest periods of both surplus and inadequate working capital. This indicates the absence of a stable working capital policy. Similarly, the quick ratio highlights that the firm's immediate liquidity position is moderate, with certain periods showing potential liquidity pressure due to reliance on inventory.Further analysis shows that inventory management plays a crucial role in determining liquidity. Higher inventory levels during specific periods resulted in the locking up of funds, thereby reducing the availability of liquid assets. Conversely, improved inventory turnover in other periods contributed to better cash flow and enhanced liquidity.The study of accounts receivable reveals that extended credit periods and delayed collections adversely affect liquidity. A higher receivables turnover period indicates inefficient credit management, leading to a slowdown in cash inflows. This weakens the firm's ability to meet its short-term liabilities on time.In

contrast, the management of accounts payable suggests that the firm occasionally relies on delayed payments to suppliers as a short-term liquidity strategy. While this approach provides temporary relief, it may negatively impact supplier relationships and operational continuity if sustained over tim a lack of optimal balance between liquidity and profitability. In certain periods, excess working capital indicates inefficient utilization of resources, while in others, aggressive management practices expose the firm to liquidity risks.

## LIMITATIONS OF THE STUDY

The study has several limitations that must be acknowledged while interpreting the findings. Firstly, it is confined to a limited time period, which restricts its ability to capture long-term trends or cyclical fluctuations in working capital and liquidity. The analysis relies primarily on secondary data such as financial statements, which may be incomplete, outdated, or lacking detailed disclosures, thereby affecting the depth and accuracy of the study. In cases where the research is focused on a single company, the findings become company-specific and cannot be generalized to other firms or industries. Moreover, financial statements are prepared based on accounting principles and may not reflect the actual cash position or real-time liquidity, leading to possible distortions in analysis.Another key limitation is the exclusion of external factors such as economic conditions, inflation, market demand, and government policies, all of which significantly influence liquidity but are not fully incorporated into the study. The research also considers only limited variables, mainly focusing on working capital components like inventory, receivables, and payables, while ignoring other financial indicators that may impact liquidity. There is also a possibility of data manipulation or window dressing in financial reports, which can reduce the reliability of the results. Additionally, the lack of primary data, such as insights from management or employees, limits the understanding of practical challenges in working capital management. The use of simplified analytical tools, including basic ratios like the current ratio and quick ratio, further restricts the ability to capture the full complexity of liquidity management.

## CONCLUSION

The study concludes that working capital management has a direct and significant impact on the liquidity position of the firm. Efficient management of current assets and current liabilities is essential for maintaining an adequate level of liquidity and ensuring smooth business operations.The analysis reveals that improper control over key components such as inventory, receivables, and payable leads to fluctuations in liquidity. Excess investment in inventory results in blockage of funds, while delays in receivables collection weaken cash inflows. On the other hand, strategic management of payable can temporarily support liquidity but may create long-term operational risks if not handled carefully.The findings indicate that the firm does not consistently maintain an optimal balance between liquidity and profitability. Periods of high liquidity suggest under utilization of resources, whereas low liquidity reflects inefficiencies in working capital management. This imbalance highlights the need for a more structured and consistent working capital policy.the study emphasizes that effective working capital management is not just about maintaining liquidity but also about optimizing resource utilization. Firms must adopt efficient credit policies, improve inventory control, and ensure timely collection of receivables to strengthen their financial position.maintaining an optimal level of working capital is crucial for sustaining liquidity, improving operational efficiency, and enhancing the overall financial performance of the firm.

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