ISSN: 2961-1989
Academia Research Journal (ARJ)
A Multidisciplinary Peer-Reviewed Research Journal, Indexed in NepJOL
Volume: 4 Issue: 2, Year 2025

Working Capital Management: A Review of Concepts and Empirical Evidence in the Nepalese Manufacturing Sector

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DOI: *https://doi.org/10.3126/academia.v4i2.82971*

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Article History: Received: Feb. 19, 2025 Revised: June 11, 2025 Received: July 6, 2025

Abstract

This study aims to critically examine the impact of working capital management on the profitability of selected manufacturing firms. Nepal. Using financial and statistical tools, including correlation and regression analysis, the research examines the liquidity position, working capital utilization, and the relationship between working capital and profitability for Unilever Nepal Ltd. (UNL), Dabur Nepal Ltd. (DNL), and Himalayan Distillery Ltd. (HDL) over five years (2019/20 to 2023/24). Key findings highlight certain companies which are struggling with ideal liquidity and are effectively managing working capital. It recommends that firms prioritize effective management of inventory, receivables, and payables to enhance their financial health.

Keywords: Working Capital, Management, Manufacturing Sector, HDL, UNL

Introduction

Working capital management is at the heart of financial health and smooth operation of any business, combining the planning and control of current assets and liabilities to mitigate the risk of failing to meet short-term obligations while avoiding excessive investment in these assets due to its direct impact on a firm's profitability, risk, and overall value. The ongoing hardships in financial markets are prompting many companies to prioritize working capital for liquidity. A company with sufficient liquidity can meet its debts promptly, reduce financial costs, and invest in profitable opportunities. Gosl-oriented working capital management is essential for the financial stability and efficient operation of any firm, which combines overseeing and controlling current assets and liabilities to minimize the risk of failing to meet short-term obligations while avoiding excessive investment in these assets. This management influences a company's overall value, risk, and profitability. It involves overseeing and controlling current assets and liabilities to minimize the risk of failing to meet short-term obligations while avoiding excessive investment in these assets. This management is important because it directly influences a company's overall value, risk, and profitability. Due to the vulnerability of financial markets in recent years, more businesses are focusing on their working capital to maintain liquidity. A liquid business may cut expenses, invest in lucrative ventures, and pay off debts on schedule.

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In addition to indicating a company's liquidity, operational efficiency, and /short-term financial performance, working capital is often defined as net working capital (current assets minus current liabilities). Positive working capital indicates potential for investment and growth, whereas a deficit may lead to difficulties in achieving growth, repaying debt, or even bankruptcy. Nepal has an economy which is historically been agricultural, and manufacturing companies are increasingly vital for economic development. However, Nepalese production companies face challenges such as fund shortages, uncontrolled working capital expansion, administrative negligence, and liquidity problems, often operating at a loss despite aggressive working capital management approaches. This puts a focus on the importance of effective working capital management for ensuring survival and competitiveness in the market.

One of the most important measures of a company's liquidity, operational effectiveness, and short-term financial health is working capital, which is commonly calculated as net working capital, i.e., current assets minus current liabilities. While a deficit might result in development challenges, debt repayment issues, or even bankruptcy, a positive working capital indicates the possibility of investment and expansion. Manufacturing businesses in Nepal are increasingly prioritizing economic growth, a shift that reflects the country's growing industrialization. Indeed, we believe in active working capital management strategies. However, many Nepalese manufacturing enterprises struggle with issues such as funding shortages, unchecked working capital expansion, administrative inefficiency, and liquidity issues, frequently operating at a loss. This highlights the importance of effective working capital management to a company's ability to survive and thrive in the marketplace. Working capital management (WCM) is the strategic process of overseeing and controlling a company's fast functioning assets and liabilities to ensure it has enough liquidity to meet its day-to-day operational expenses and short-term obligations, while simultaneously optimizing the use of its financial resources.

In a nutshell, its prime concern is to maximize profitability and maintain adequate liquidity. The primary goal of WCM is to ensure the smooth functioning of a business without facing cash flow interruptions or liquidity crises, thereby supporting sustainable growth.

The strategic process of monitoring and managing a business's short-term assets and liabilities to ensure it has sufficient cash on hand to cover its short-term commitments and daily operating costs, while optimizing the use of its financial resources, is known as working capital management, or WCM. WCM's primary goal is to support sustainable growth.

The core requirements of working capital management are:
a. To manage the collected amount of money to cover daily expenses and, on the other hand, to minimize unused funds aimed to allocate for further investments; i.e., cash management.
b. To manage raw materials, work-in-progress, in order to complete goods effectively to meet demand while minimizing excessive holding costs is known as inventory management.

Problem Statement

Working capital management is a serious but challenging aspect of financial decision-making due to the unpredictable nature of cash flows and the need to maintain an optimal balance between excessive and inadequate levels of working capital. Both extremes are detrimental: excessive current assets tie up costlier long-term funds, while inadequate levels can lead to technical bankruptcy. Nepal's

public enterprises have struggled in managing working capital since their history. It often relies on external sources instead of utilizing its internal funds. The research aims to cover a few key questions such as: The liquidity position of selected companies. The status of working capital utilization in selected companies.

Objectives of the Study

The primary objectives of this study cover the working capital management of three companies, a) Unilever Nepal Ltd., b) Dabur Nepal Ltd., and c) Himalayan Distillery Ltd. The specific objectives are as follows:

To identify the liquidity position of selected companies.
To analyze the status of working capital utilization of selected companies.
To observe critically the relationality between working capital and the profitability of selected companies.

The Study Rationale

This study aims to benefit both academics and management in manufacturing companies. The insights gained will help managers and corporate leaders determine and manage working capital effectively. In particular, it will assist Unilever Nepal Ltd., Dabur Nepal, and Himalayan Distillery Limited in enhancing their working capital management practices.

Limitations of the Study

This study is subject to several limitations:

It covers only three Nepalese manufacturing companies: Unilever Nepal Limited, Dabur Nepal Limited, and Himalayan Distillery Limited.
The study relies solely on secondary data, without incorporating primary survey data.
The analysis is based on data from the last five years, specifically from 2019/20 to 2023/24.
A significant research and practice gap is found in the literature on working capital management within the Nepalese manufacturing context.

Literature Review

Conceptual Review

In order to run daily operations, such as purchasing raw materials, paying salaries, and managing other daily expenditures, a company needs a working capital management fund. Net-working capital, calculated as current assets minus current liabilities, measures a firm's ability to meet short-term financial obligations and mirrors working capital efficiency. It is considered the "lifeblood" of a company, supporting ongoing investments in current assets, addressing seasonal financing needs, sustaining growth, and enabling activities for business improvement and competitiveness.

Working Capital Management (WCM) includes all financial management aspects related to planning and controlling current assets and liabilities. Its efficiency is mainly for the success or failure of manufacturing firms, as it affects all functional areas and safeguards a smooth operation. Effective WCM aims to maximize the profitable use of liquid funds while maintaining sufficient liquidity for unexpected short-term expenditures.

Working Capital

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A Firm requires working capital for multiple and diverse purposes in order to resume smooth operations and achieve a profitable situation.
Transaction Motive: To conduct daily business actions like purchases and sales, ensuring a continuous flow of operations.
Precautionary Motive: To hold cash as a safety margin to be prepared against unforeseen events such as strikes, customer failures, or unexpected collection slowdowns.
Speculative Motive: To seize profitable opportunities such as purchasing raw materials at low prices, speculating on interest rates, or acquiring assets at advantageous prices.

Working Capital Policy

Working capital policy dictates a firm's approach to the level of current assets and their financing. It comprises the current Assets Investment Policy:

Relaxed Policy: Involves holding large amounts of cash, marketable securities, and inventories, with liberal credit policies to customers. This leads to more extended inventory and cash conversion cycles, but lower expected returns with reduced risk.
Restricted Policy: Aims to hold minimum amounts of current assets to support sales. This policy involves a tight credit policy and carries the risk of losing sales.
Moderate Policy: Balances between relaxed and restricted policies, resulting in moderate risk and return.
Current Assets Financing Policy: Aggressive Policy: Finances fixed assets and part of permanent current assets with debt and longer-term equity, and temporary current assets with short-term liabilities. Firms are considered more aggressive if a portion of their fixed assets is also financed with current or short-term debt.
Conservative Policy: Finances all fixed assets, permanent current assets, and some temporary current assets with long-term capital, considered a very safe but less profitable approach.
Maturity Matching Policy: Aligns asset and liability maturities to minimize risk. For example, a 30-day inventory is financed by a 30-day loan. Long-term funds, and temporary ones with short-term capital back up permanent current assets.

Cash Conversion Cycle (CCC)

The Cash Conversion Cycle (CCC) calculates the period that starts from paying suppliers for materials by collecting cash from customers for credit sales. It demonstrates the longevity of a company's cash tied up in its operations.

The CCC is calculated as:
CCC = Operating Cycle – Accounts Payable Period
OR,
CCC = (Inventory Period + Accounts Receivable Period) - Accounts Payable Period.
A shorter CCC generally improves profitability by reducing the need for external financing and its associated costs.
Inventory Period (ICP): The time required to transform raw materials into finished goods for sale. It is calculated as:
ICP = 365 × Average Inventory / Annual Cost of Goods Sold.

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Accounts Receivable Period (RCP): The average time to collect accounts receivable after credit sales. Calculated as:
RCP = Receivables / (Sales / 360).
Accounts Payable Period (PCP): The average time a firm delays payment to suppliers for raw materials. Calculated as:
PCP = Payables / (Cost of goods sold / 360).

Factors Affecting Working Capital

Several factors influence a firm's working capital needs, which can change over time and vary across businesses. Key factors include:

Nature and Size of Business: Different industries have varying working capital requirements (e.g., manufacturing vs. public utilities).
Manufacturing Process and Length of Production Cycle: Longer production cycles tie up more funds in materials, labor, and overhead, increasing working capital needs.
Growth and Expansion of Business: Expanding enterprises generally require more working capital to support increased operations and fixed capital.
Rapidity of Turnover: A higher turnover rate (the speed at which working capital is recovered through sales) means less working capital is required.
Terms and Conditions of Purchase and Sales: Liberal credit terms from suppliers reduce working capital needs, while selling on credit increases working capital in receivables.
Seasonal Demand: Companies experiencing seasonal fluctuations may require additional working capital to purchase materials in large quantities during slower periods, thereby ensuring uninterrupted production.
Dividend Policy: Companies that retain a greater share of their earnings require less external working capital than those that distribute a considerable portion of their profits as dividends.
Operating Efficiency of the Firm: Efficient resource utilization and improved profitability can generate more internal funds for working capital.
Cash Conversion Cycle: A longer CCC indicates a greater need for working capital.
Production Policy: A steady production policy, even with seasonal demand, requires more working capital than producing only when goods are sold.
Access to Money Market: Good relationships with banks and financial institutions can minimize working capital needs by facilitating easier access to loans.
Transport and Communication Facilities: Effective facilities reduce the time for material procurement and finished goods distribution, thereby reducing working capital requirements.

Recent studies have explored working capital management and its impact on profitability. Shin and Soenen (1998) emphasized the importance of efficient working capital management in creating shareholder value. A balanced relationship is required between a firm's profitability and net trade cycle. Moss and Stine (1993) observed that larger firms usually have shorter cash conversion cycles, highlighting that conventional liquidity ratios may not fully capture a company's cash situation, as funds can be tied up in working capital.

Terruel and Solano (2002) provided empirical evidence that reducing accounts receivable and inventory days, as well as shortening the cash conversion cycle, can improve the profitability of small and medium-sized Spanish firms. Lazaridis and Tryfonidis (2006) reevaluate the relationship between

WCM and profitable companies on the Athens Stock Exchange, utilizing the cash conversion cycle as a measure of efficiency and gross operating profit as a determinant of profitability.

Studies in Nepal have made significant contributions to this field. Shrestha (2004) found that Nepalese manufacturing companies suffer a significant loss due to administrative negligence and a lack of specific working capital policies, concluding that while profitability is positive, it is not satisfactory. Yadav (2016) researched working capital management of listed hotels in Nepal, finding that some firms had excess current assets and identified varying financing policies among them. The study also found negative relationships between current assets and liabilities and net working capital, with positive relationships between receivables and net sales. Sharma (2017) observed a negative relationship between the cash conversion cycle and profitability in Nepalese manufacturing firms, but a positive relationship between gross operating income and accounts payable/inventory days, and a negative relationship with accounts receivable days. The study also highlighted that Nepalese firms often lack formal working capital policies.

Deloof's (2003) research on the relationships between working capital management and corporate profitability in Belgian non-financial firms. The study revealed a noticeable negative relationship between gross operating income and the days of accounts receivable, inventories, and accounts payable. It suggested that managers could enhance profitability by reducing accounts receivable and inventory days, and noted that less profitable firms tended to delay bill payments. Sharma (2003), in a study of Nepalese manufacturing companies, concludes that many suffered significant losses due to administrative negligence, unnecessary inventory blockage, or the imbalance of specific working capital strategies. The study has identified several notable issues, including unfavorable liquidity, profitability, and turnover positions, characterized by prolonged inventory and receivable conversion periods, as well as exceptionally high payable periods, resulting in negative cash conversion cycles that are detrimental to long-term sustainability.

Methodology

This study employs a descriptive research methodology, utilizing both financial and statistical tools for analysis. The financial data for the study was collected as secondary data from the annual reports of Unilever Nepal Ltd. (UNL), Dabur Nepal Ltd. (DNL), and Himalayan Distillery Ltd. (HDL) for five years, from 2019/20 to 2023/24.

Variables

The dependent variable, Return on Assets (ROA), was chosen as a measure of firm profitability; the calculation is net profit after tax divided by total assets.
Independent Variables (WCM Efficiency Proxies): Cash Conversion Cycle (CCC), Inventory Conversion Period (ICP), Receivable Conversion Period (RCP), and Payable Conversion Period (PCP) were found to be the most effective in measuring the efficiency of working capital management.
Control variables here cover current ratio (CR), Sales Growth (SG), and the Ratio of Current Liabilities to Total Assets Growth (AG). These are firm characteristics that may alter profitability.

Data Analysis

Descriptive statistics (percentage, mean, median, standard deviation, maximum, and minimum) were used to summarize and describe the characteristics of the dataset. To analyze the data set,

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statistical tools (specifically Pearson Correlation Analysis) calculate two variables which interprets data dispersion variability via standard deviation and coefficient.

Results and Discussion

Liquidity Position

The liquidity position of all three selected companies (UNL, DNL, and HDL) was found to be unsatisfactory based on an analysis of the Current Ratio (CR), which fell below the standard level, indicating a negative impact on working capital. For instance, UNL, being a manufacturing company, requires an efficient liquidity position, but its current ratio was lower than the standard.

Working Capital Utilization

The study indicated that working capital has not been fully utilized in the selected companies, and it needs to be arranged to generate maximum turnover. HDL, for example, exhibited the lowest Net Working Capital Turnover Ratio (NWCTR), with high fluctuations, indicating a poor financial position. The study also found liquidity issues because of the low working capital.

Profitability Position

Net Profit Margin (NPM): UNL demonstrated an increasing trend in its net profit margin, averaging 23% on sales. In contrast, DNL and HDL had fluctuating profit margins, averaging 6% and 9% respectively.

Return on Assets (ROA): The companies- UNL, DNL, and HDL hold an average ROA of 43%, 9%, and 20%, respectively. While UNL's ROA showed a decreasing trend over the five years, it still achieved a high average of 43%, indicating excellent returns on total assets. DNL consistently showed the lowest average return (9%). Whereas, HDL's ROA fluctuated on 20% average. UNL asset utilization is superior to that of DNL and HDL. The coefficient of variation for ROA indicates low variation for UNL (31.53%) compared to DNL (38.82%) and HDL (41.61%), implying higher stability in UNL's returns.

Cash Conversion Cycle (CCC)

The average Inventory Conversion Period (ICP) for UNL, DNL, and HDL was 95, 123, and 87.6 days, respectively. The Receivable Collection Period (RCP) was 37.2, 61.4, and 19.2 days, respectively. HDL exhibited comparatively lower ICP and RCP, suggesting a satisfactory conversion of inventory to sales and faster receivable collection than the other two companies. The study covers 128 days for UNL, 75 days for DNL, and 36.2 days for HDL for the average Payable Deferral. Based on the delayed payments to creditors, UNL had the highest PCP as long as its credit reputation is not harmed. The average CCC for UNL, DNL, and HDL was 4.2, 109.4, and 70.4 days, respectively. HDL's longer PDP, coupled with shorter ICP and PCP, is generally favorable but could lead to higher impact from trade creditors due to delayed obligations.

Correlation Analysis

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For UNL, the correlation analysis revealed a negative relationship between ROA and Net Profit Margin (NPM), Current Ratio (CR), Inventory Conversion Period (ICP), Receivable Conversion Period (RCP), and Payable Conversion Period (PCP). The above calculations conclude that customer/supplier payments on due dates may decrease company profitability.

Crucially, a strong positive relationship was observed between ROA and the Cash Conversion Cycle (CCC) for UNL, with a coefficient of 0.44. This indicates that an increase in CCC has a significant positive impact on UNL's return on assets. A positive correlation is seen in the results between ROA and Assets Growth (AG), and a negative correlation with Sales Growth (SG), suggesting that increased sales may lead to increased profit. Unlike an aggressive financing policy, it may result in negative returns.

Conclusion and Recommendations

Conclusion

In conclusion, the study uncovers the working capital management of three Nepalese manufacturing companies: UNL, DNL, and HDL. It is essential to manage working capital effectively. It is crucial for a firm's growth, liquidity, and optimal leverage. The empirical analysis, using Return on Assets as a measure of profitability, revealed that the liquidity position of all sample companies reflects an unsatisfactory position, unlike HDL, which shows the highest turnover ratio. UNL demonstrated the highest ROA and NPM, and also performs better operationally compared to DNL and HDL. The correlation results highlighted a significant positive impact of the cycle of cash conversion on return on assets in Nepalese manufacturing companies. It indeed suggests that increasing the CCC proportionally leads to increased profitability.

Recommendations

The following recommendations are proposed to enhance working capital management based on the analysis above.

Improve Liquidity Position: All selected companies should strive to improve their liquidity, as the current ratio is below the standard level. UNL, in particular, should maintain standard current and quick ratios for optimum solvency.

Optimize Working Capital Utilization: Companies should actively utilize their working capital to generate maximum turnover and maintain a sound turnover position. HDL, which has a negative net working capital, needs to maintain an optimal size of investment in current assets and liabilities and regularly monitor its working capital.

Effective Cash Management: Companies should adopt a proper managerial policy for cash and bank balances, as holding excessive cash provides no return.

Shorten Operating Cycles: Firms should aim to reduce the period between purchasing goods and making transactions to suppliers to enhance profitability. Companies should reduce the time it takes to transform raw materials into finished products, enabling faster sales.

Effective Inventory Management: Effective inventory management, crucial to companies, involves implementing effective sales plans to increase marketability and reduce overstocking. Attention should be paid to capacity utilization, carrying costs, ordering costs, and lead times. A sound storekeeping system, better materials handling, and timely inspection are also essential.

Manage Cash Conversion Cycle: Companies should manage their Inventory Conversion Period (ICP), Receivable Collection Period (RCP), and Payable Deferral Period (PCP) by applying suitable credit policies, especially for HDL, which has a negative cash conversion cycle due to poor collection and payable policies. Both excessively long and negative cash conversion cycles are detrimental to a company's financial health.

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