Advances in Economics, Business and Management Research, volume 135
3rd Asia Pacific International Conference of Management and Business Science (AICMBS 2019)

Integrated Corporate Governance Model Innovation for Working Capital Management

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ABSTRACT
Working capital management is a short-term investment decision funded by current liabilities consisting of interrelated components, namely: cash, receivables, securities and inventories, that have different agency relationships yet interrelated. Until recently corporate governance was not integrated, so it was not effective in increasing companies' liquidity and profitability. The purpose of this study is to develop an integrated corporate governance framework model innovation for working capital management. This research was conducted by reviewing articles related to corporate governance and working capital management, finding gaps among them, and identifying their limitations. The results show that the integrated corporate governance model innovation for working capital management is able to determine the composition of optimal working capital so as to increase liquidity, profitability, and reduce business risk. This research, theoretically, develops agency theory and good corporate governance model in managing working capital and, practically, provides information for managers and investors in short term investment decisions and financing decisions.

Keywords: *integrated corporate governance model innovation, working capital management, interrelated, profitability, business risk*

1. INTRODUCTION

Every company has a goal to increase its value through three financial decisions, namely: investment, financing and dividend decision. Investment decision consists of short-term investments, called working capital investments, and long-term investments, called fixed asset investments. Working capital must be managed effectively and efficiently because the amount of funds invested in working capital from the proportion of the company's total assets is very large [1]. In addition, the management of working capital greatly affects the level of liquidity and profitability of the company, so that in working capital management it is necessary to determine the composition of current assets that are funded by the optimal amount of current liability [3-5]. If the manager incorrectly manages the working capital, the company will have to face various risks such as losing customers and credit, paying high inventory storage costs, and damaging its inventory. Working capital management consists of all managerial decisions regarding all current assets and current debt, by determining the optimal amount of cash, receivables, securities, inventory and current liabilities, as well as the relationship between current assets and current debt [5-7].

Researches on the effect of working capital management on the efficiency and profitability of companies show inconsistent results. Sharma & Kumar [8] and Abuyazed [6] showed that working capital management has positive effects on profitability. However, Singh et al. [1], using a meta-analysis, found that working capital management has negative effects on profitability. In other words, a manager is not capable of managing working capital properly because the existing management of working capital cannot improve the company's liquidity and profitability.

Working capital management has high agency conflict potentials due to asymmetric information. Thus, corporate governance is necessary since it is a system, structure and mechanism to control and restrain the moral hazard behaviors of managers as agents so that the working capital management can increase profitability and reduce business risk. Several studies of corporate governance on working capital management show inconsistent results. Gill & Biger [9], Jamalinesari & Soheili [10] and Prasad, Sivasankaran, Saravanan, & Kannadhasan [11] found that corporate governance can increase the efficiency of working capital management. However, Fiador [7] found that corporate governance has negative effects on working capital management. Achchuthan & Kajananthan [12] explained that corporate governance influences current liabilities to total assets in working capital management. However, corporate governance does not affect the cash conversion cycle or the current assets to total assets. The results of the study conclude that the mechanism of corporate governance is not effective in monitoring, supervising and controlling the behavior of managers in managing working capital.

Research on corporate governance mechanisms in working capital management has been separated. In the management of cash in working capital management, poor corporate governance mechanism does not involve other components as they should have been in interconnected system. For example, if cash, which is prone to fraud, is managed using good corporate governance, the activities dealing with it will be able to be monitored, and eventually working capital management will be more effective [9]. However, in the real practice, the four components of working capital management (cash, receivables, securities, and inventories) have different but interrelated agency relationships, so corporate governance of the four components should be integrated. In addition, the corporate governance principles developed by the OECD were more general in nature, so they were not effective and could not increase liquidity, profitability or reduce business risk.

The research gap and such phenomenon encourage researchers to develop a framework of Integrated Corporate Governance Model Innovation for Working Capital Management. The novelty of this study is that the innovation of cash, receivables, securities and inventories frameworks is integrated in the management with good corporate governance.

The purpose of this study is to develop a framework of Integrated Corporate Governance Model Innovation for Working Capital Management and to increase liquidity and profitability, reduce business risk and improve business sustainability.

This research develops agency theory and good corporate governance models in managing working capital to increase liquidity and profitability, reduce business risk and improve business sustainability. Furthermore, this research provides suggestions for management in managing working capital and provides investors with benefit in that integrated corporate governance model innovation can increase returns and reduce business risk.

2. RESEARCH METHOD

This research was conducted by reviewing articles related to working capital management with efficiency and profitability and those related to corporate governance in working capital management to find gaps between them and to find their limitations. The results of the analysis are then used as the basis for developing a new framework for integrated corporate governance model innovation to reduce agency conflict in working capital management, for determining the optimal amount of working capital to increase liquidity and profitability and reduce business risk.

3. RESULTS AND DISCUSSION

3.1 Working Capital Management as an Interrelated System

Working capital management was first developed by Nadiri in 1969. Since that year researchers have developed their concept to determine the optimal cash level. Working capital management consists of all management decisions related to all current assets and current debt through the determination of optimal amount of cash, receivables, securities, inventory and current liabilities, as well as relationship between current assets and current debt [6, 7]. Working capital management is related to the decisions regarding the composition of current assets and current debt that can increase company profitability [2, 5]. The four components in working capital management which are funded by current liabilities are interrelated and are an inseparable unit. This means that the components influence and interrelate with one another. For example, good management of receivables will affect the amount of cash available, so that cash with an optimal amount will facilitate the company in providing inventory.

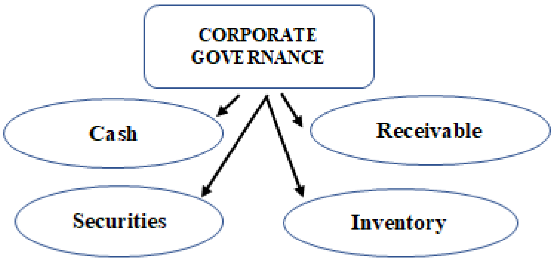
3.2 Corporate Governance for Working Capital Management

There is no single definition of corporate governance that can be applied to all situations, countries, and institutions [13]. Corporate governance has a significant role in controlling working capital management by conveying policies so that shareholders can get maximum returns from their invested capital. The results might be generalized to manufacturing industry [9]. Corporate governance in working capital management is a system, structure and mechanism to control and restrain the moral hazard behavior of managers or creditors as agents. In addition, it also determines the optimal working capital composition and decide whether liquidity and profitability can be increased. Drobetz & Grüninger [14], Gill, Biger, & Mathur [15] and Gill and Shah [16] showed the impact of CEO duality and board size as corporate governance on cash holdings. Furthermore, they showed that corporate governance affects the efficiency of working capital management. However, Fiador [7] found that corporate governance has a negative influence on working capital management, indicating that corporate governance in working capital management is not effective in increasing company liquidity and profitability.

3.3 Proposed Framework of Integrated Corporate Governance Model Innovation for Working Capital Management

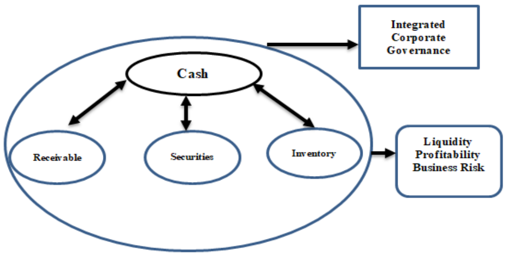
Working capital management has a high potential for agency conflict, ranging from cash, receivables, securities and inventory. The conflict arises because of asymmetric information, so corporate governance mechanism is needed. The existing corporate governance mechanisms are not able to improve the efficiency and effectiveness of working capital management (Fig. 1). Fig. 1 shows that the components of working capital in corporate governance (cash, receivables, securities and inventories) are implemented separately and not integrated. In the previous corporate governance model, the principles of corporate governance developed by OECD are general in nature and analyzed individually related to the working capital management components. It also means that corporate governance in working capital (Fig. 1) is ineffective, unable to increase liquidity and profitability, and unable to reduce business risk.

Figure 1. Non-integrated corporate governance model for working capital management



However, Fig. 2 shows the integrated corporate governance model for working capital management. The management, which includes management of cash, accounts receivables, securities, and inventories, is an interrelated system; each component has a different agency relationship (Fig. 2). For example, in cash management (a), agency relationship exists between the company as the agent and the investor/creditor as the principal. Too large cash (idle cash) is highly potential for agency conflict. Conversely, too little cash causes difficulties in paying current liabilities and financing sudden demand. In the management of receivables (b), agency relationship exists between company as a creditor and consumers as debtors. Too high value of receivables is not good because a large sum of company's cash stops at a number of receivables. This will certainly hinder the company's ability to meet sudden demands, to pay employees, and to expand. Regarding securities management (c), securities such as stocks, bonds, and mutual funds may lead to agency relationships between the company as investor (principal) and other companies as managers (agents). In inventory management (d), agency relationship exists between the company as the agent and suppliers as the principal. Too much inventory will make a company prone to paying costs for damaged goods and maintaining them, as well as paying the cost of using cash inefficiently. Thus, in order to increase liquidity and profitability and reduce business risk, the four components of current assets financed by current debt must be managed properly with an optimal composition. The quality of corporate governance implementation in one component will affect the performance of other components, so corporate governance must be integrated (Fig. 2).

Figure 2. Integrated corporate governance model innovation for working capital management



3.4 The Principles of Integrated Corporate Governance Model Innovation

The principles of integrated corporate governance model innovation differ from the principles of the previous corporate governance. In the previous corporate governance model, the principles of corporate governance developed by OECD are general in nature and analyzed individually related to the working capital management component. The principles of Integrated Corporate Governance Model Innovation are as follows. (a) Fairness. According to this principle, corporate governance framework must protect and be fair to all working capital management stakeholders, i.e. managers, debtors, creditors, investors, and other relevant stakeholders, in an integrated manner. (b) Responsibility. According to this principle, corporate governance framework must be able to fulfill the rights of all stakeholders related to working capital management as determined by law and to encourage active cooperation to realize liquidity and profitability and to reduce business risk. (c) Transparency. According to this principle, corporate governance framework must be able to provide transparency to relevant stakeholders regarding business processes, governance, and financial condition related to cash, receivables, securities and inventory management in an accurate, fast, timely and integrated manner. (d) Accountability. According to this principle, corporate governance framework must have clear strategic guidelines, monitoring, evaluation and accountability mechanisms for managing the working capital in an integrated manner for the stakeholders.

3.5 The Mechanism of Integrated Corporate Governance Model Innovation on Working Capital Management

There are two mechanisms in the Integrated Corporate Governance Model Innovation: internal and external mechanisms. The two are interrelated in that well-run internal mechanism enhances the quality of the external mechanism [17]. The internal mechanism of integrated corporate governance is an integrated system, structure and regulation that prevents and controls moral hazard behavior in working capital management. The external mechanism of integrated corporate governance is an integrated monitoring and supervision carried out by external parties: regulators and investors.

3.6 The Implementation of Integrated Corporate Governance Model Innovation on Working Capital Management

The implementation of integrated corporate governance model innovation on working capital management consists of planning, organizing, actuating, evaluating and controlling. The organization of such processes is expected o produce a more effective and efficient working capital management and bring up an optimal working capital composition. The explanation is as follows. (a) Planning is determining the desired amount of consumer demand, level of liquidity and profitability, and predicted business risk. b) Organizing determines the amount and quality of human resources to be used in managing working capital in an integrated manner, analyzes credit sales, organizes the level of accounts receivable turnover and optimal inventory levels. c). Implementation requires leadership roles, commitment from all parties in the company, culture and an adequate budget. d). Monitoring and Evaluating must be done periodically and in integrated manner so that they are useful in changing or improving working capital management for efficient and effective practice and minimum business risk.

4. CONCLUSION AND FUTURE RESEARCH

Working capital management is a short-term investment decision funded by current liabilities which consists of cash, receivables, securities and inventory. Corporate governance in the previous working capital was not integrated, so it was not effective in increasing the company's liquidity and profitability. However, in this new model, because working capital management has a high potential for conflict and has a different agency relationship in the management of cash, accounts receivables, securities and inventory, the components are interrelated. Therefore, integrated corporate governance model innovation on working capital management is needed to determine the optimal working capital composition, increase liquidity and profitability, and reduce business risk. This article is still in the form of a framework of integrated corporate governance innovation model in working capital management, so future researches should test the model. Furthermore, in current digital era, this research needs to be developed with ICT-based integrated corporate governance so that working capital management becomes more effective, efficient, and more transparent. Finally, this article only integrates corporate governance in working capital management as a short-term investment, so future research can be developed by integrating all components in the overall balance sheet.

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