

Impact of Working Capital Management on Profitability: An Assessment

M.S. Herath and K.M.M.C.B Kulathunga
Uva Wellassa University, Badulla, Sri Lanka

Introduction

Working capital management (WCM) means planning and controlling current assets and current liabilities to eliminate the risk of inability to meet short term obligation on one hand and avoid excessive investment in current assets on the other hand (Eljelly, 2004). Working capital management is an important part of financial management decisions of the firms.

This study contributes to the literature by examining the impact of Working Capital Management on the profitability. The study also sheds light on the relationship of working capital components with profitability.

The research carried out by MTI Consulting on the Challenges of Sri Lankan Corporate Finance reveals that 68% of the respondents had reported that they have been impacted by longer cash generation cycles. It means that there is an unnecessary tie up of capital in working capital. Most firms have invested large amount of cash in working capital and a considerable amount of short term payables have used as a source of finance (Deloof 2003). Moreover, according to the rel/cfo Asia survey (2006) which was carried out to evaluate the Asian working capital improvements based on over 725 Asian companies, the Asian companies have unnecessarily tied up in working capital.

Many research articles have found that, the managers spend a considerable time on day-today working capital decisions since current assets are short-lived investments and hence, continuously convert into other asset types (Rao, 1989).

Therefore, it is important to assess whether the time spend on managing working capital is effective or not. Thus, the primary objective of this study was to identify the relationship between working capital management and profitability. The secondary objective of this study was to evaluate the effect of different components of working capital management on profitability.

Methodology

A sample of 38 companies listed in Colombo stock exchange was considered based on market capitalization. Although there are 20 sectors in the Colombo stock exchange, 18 sectors were considered initially by eliminating Banking, Finance and Insurance sector and services sector. Since, maintaining a balance between liquidity and profitability is considered as the major business activity in financial institutions, Banking, Finance and Insurance sector was eliminated from the study. Hence, 38 companies were drawn to the sample from 5 sectors based on the number of companies listed under the particular category.

Data gathering was based on annual reports of the companies. In order to analyze the data descriptive statistics, correlation analysis and regression analysis were used. Independent variable is recognized as the Cash Conversion Cycle (CCC) while Gross profit (GP) has been used as the dependent variable. In addition, debt ratio, sales and sales growth have been used as controllable variables.

Results and discussion

Results revealed that, in all five sectors, companies were keeping stocks on hand averagely 86 days before selling them. Companies in all five sectors had taken in average 53 days to collect receivables. As far as accounts payable are concerned, average accounts payable period was 80 days. CCC was averagely 60 days in all sectors and it can be deviated by 118 days. Maximum days taken by companies to convert resource inputs into cash flows were 576 days while a minimum negative CCC can be seen.

According to the correlation analysis, it was identified that there are statistically significant moderately negative correlations between inventory conversion period (-0.507) and receivables collection period (-0.506) and gross operating profit. In addition, it was found that there is a statistically significant moderately positive (0.584) correlation between number of days accounts payable and the gross operating profitability. This emphasizes that the more profitable firms wait longer to pay their bills.

Further, it has identified that there is a statistically significant strongly positive correlation between CCC and gross operating profit. Accordingly, result supports the expectation that CCC is associated with higher profitability.

The adjusted R-Square of the regression analysis is 63.6% and which emphasizes that the model is fitted well as 63.6% of the total variation of gross operating profit is jointly explained by cash conversion cycle, debt ratio, sales growth and amount of sales.

According to the regression analysis, the regression equation shows a negative relationship between cash conversion cycle and profitability and that is consistent with the view that a reduction in the cash conversion cycle generates more profits for a company. However, the regression analysis performed to identify the relationship between different components of working capital management and profitability shows that there is a statistically significant positive relationship between accounts payable period and profitability while there is no statistically significant relationship between inventory turnover period and accounts receivable period and profitability.

Conclusions

Working capital management is an important part of financial management decision of a firm. The ability of the firm to continuously operate in longer period depends on how they deal with investment in working capital management.

The significant negative relationship found between working capital management and profitability demonstrates that the increase or decrease in the cash conversion cycle would significantly affect the profitability of the firm. Therefore, effective working capital management practices have to be conducted in order to achieve a higher profitability. So as to have an effective working capital management, it is essential to manage the three components of working capital management effectively.

Furthermore, it can be concluded that in the settlement of accounts, extended credit periods from suppliers, reduced collection period from customers and short term oriented stock maintaining policy are associated with an increase in the firm's profitability.

References

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