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The significance of working capital management in determining firm profitability: Evidence from developing economies in Africa

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ABSTRACT

Purpose: The purpose of this study is to examine the relationship between working capital efficiency and corporate profitability and in particular, to determine their significance across countries with differential industrial levels.
Design: The paper adopts a quantitative approach using balanced panel data of manufacturing firms in Egypt, Kenya, Nigeria and South Africa. We accessed financial statements of manufacturing firms from the Orbis database for the period 2005–2009. The database is known to be reliable and has universal acceptability.
Findings: The study reveals that there is a strong negative relationship between profitability, measured through net operating profit, and cash conversion cycles across different industrialisation typologies. The negative association implies that, when the cash conversion cycle increases, the profitability of the firm declines.
Practical implications: Managers can create positive value for shareholders by reducing the days customers settle their accounts, ensuring that they sell off their inventories as quickly as possible and delaying the payments to their suppliers, as long as this does not affect their credit rating.
Originality: To the best of our knowledge, this is the first paper to provide a fresh perspective on how working capital management influences profitability across Africa within different typologies.
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1. Introduction

The importance of working capital has been investigated from different perspectives in previous studies. For instance, there are those which have investigated the impact of optimal inventory management and those which have examined the best way of managing accounts receivable in order to maximise profitability. Recently Haq et al. (2011) noted that working capital management directly affects the profitability of a firm. This implies that working capital management is one of the fundamental decisions that a finance manager makes.

The objective of working capital management is to ensure that the firm is able to meet its operating expenses and also remain in a position to pay short-term obligations as and when they fall due. The mismanagement of working capital may lead to a liquidity crisis and a reduction in profitability, hence affecting the ability of the firm to continue to operate as a going concern.

Firms manage working capital using three approaches: conservative, aggressive and moderate. The conservative approach is where a firm tends to use mostly long-term sources of finance for its operations and use short-term sources in urgent circumstances. On the other hand, the aggressive approach is having fewer current assets – for example, cash, inventories and trade receivables in proportion of total assets. This may lead to illiquidity (Van Horne and Wachowicz, 2004). A moderate approach trends between the aggressive and conservative approaches. A moderate approach makes a distinction between fluctuating current assets and permanent current assets with the suggestion that short-term sources of finance should be used to finance fluctuating current assets. Likewise, long-term source of finance should be used to finance permanent current assets.

However, it is important to note that working capital management policies need to consider the nature of the company because different businesses will have different working capital requirements. For instance, manufacturing firms need to invest heavily in spare parts and components, while food retailers will need to have large inventories of goods for resale but will have few trade receivables. Nevertheless, firms may focus on increasing sales by offering trade credit to their customers. While this may increase the stock turnover, it may lead to cash flow problems because some accounts receivables may take a longer time to be settled. On the other hand, while there is an increase in credit sales, a firm may also be required to finance its operations through credit and hence an increase in accounts payable. Having sufficient inventory ensures that a firm does not run out of stock. However, this may lead to incurring extra cost of storage and also some inventory going bad or getting stolen. In addition, apart from tying capital in terms of excess inventories, if a firm takes a longer time to pay its creditors, then its credit rating may be affected and the suppliers may withhold their goods. Therefore it is important that accounts payable, accounts receivable and inventory turnover are maintained at a certain level which may be enhanced by efficient monitoring.

In this context, it is implied that working capital management plays a significant role in the overall corporate strategy of maximising shareholders' value. Maximising shareholders' value encompasses determining the composition and the level of current assets and the level and sources of short-term finance (Nwankwo and Osho, 2010). In addition, Alshubiri (2011) notes that, during unexpected economic changes, firms that efficiently manage their working capital are likely to react quickly. This requires that firms constantly monitor the level of inventories, accounts receivable and payable.

Therefore the objective of this paper is to examine the impact of accounts receivable, inventories days, accounts payable and cash conversion cycles on net operating profit of a firm. We used, firm size, gross domestic product growth and size of the board of directors as control variables. The rest of this paper is structured as: Section 2 reviews the previous literature, Section 3 examines the data and the methodology for the current research, Section 4 presents results from the data analysis, Section 5 in on the multiple regression analysis results, and Section 6 concludes.

2. Literature review

The most popular way of measuring working capital is the cash conversion cycle (CCC). The CCC is the number of days between the expenditure of the firm's cash for the purchase of raw materials to produce the goods (products) for sale, and the collection of cash from the sale of the finished product (Sathyamoorthi and Wally-Dima, 2008). Efficient cash management by the firm may increase the

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