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Working Capital Management Policies for Managers to Improve Profitability

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Abstract

Efficient working capital management is a requisite and is crucial for small firms' profitability. The main reason for most SMEs' failure is the incompetence of their managers to appropriately control and plan their current liabilities and current assets (Smith, 1973). Keeping in view the SMEs' difficulties in proper working capital management and the significance of working capital management in profitability, survival and growth of SMEs, this research aims to analyse the association between individual working capital components, corporate governance characteristics and alternate proxies of profitability in SMEs. The study has significance for managers in planning and managing working capital in such a way that they can increase their profitability.

Introduction

Working capital is considered the most vital element for the smooth functioning of firms as it represents those funds used to carry routine operations of the business (Tauringana and Afrifa, 2013; Pais and Gama, 2015). It implies that the more the business's working capital, the stronger its liquidity position will be. Working capital management is critical in all forms of business as it affects the firms' liquidity, risks, and profitability (Deloof, 2003). There is always a trade-off between liquidity and profitability in companies. Holding too many funds in working capital leads to opportunity cost, and keeping working capital less can lead to obstacles and hampering of day-to-day operations. A firm needs to find an ideal level of working capital for balancing the profitability and liquidity of the firm. Aggressiveness in trade credit and investing in inventory could influence corporate profitability in a negative manner (Garcia-Teruel & Martinez-Solano, 2007). So, it is vital to understand the association among different working capital components. It will be very useful in devising appropriate policies for the smooth and profitable running of the companies if the actual relationship between working capital components and profitability is clear. This paper examines the relationship between the working capital component and proxies of profitability of SMEs (Small and Medium Enterprises) listed in the US NASDAQ.

The profitability of all types of businesses depends on proficient working capital management in the businesses (Aleef, 2011). Working capital policies have become relevant in the present economic downturn and its implications on companies (Enqvist et al., 2011). Efficient working capital management entails upholding optimal capital components to meet operating expenses and short-term obligations on time. An extensively utilised measure of working capital management is the net trade cycle, and it can be expressed by three main components, i.e. receivable, payable and inventory, and as a percentage of sales. The net trade cycle specifies the company's total daily sales financing the working capital.

It has been highlighted by quite a few studies that working capital management is a vital factor determining companies' profitability, especially SMEs (Peel et al., 2000). Working capital management is of high significance for SMEs due to several reasons. One of the reasons is SMEs' difficulty raising short-term funds due to the impression of SMEs as a high-risk investment by investors (Padachi et al., 2011). Another reason for the difficulty in raising funds for SMEs could be their lack of expertise in the management of accounting systems, maintaining appropriate records, insufficient financial statements, or improper business reports, making it challenging for investors to analyse their creditworthiness and viability. So, SMEs have to depend more on credit provided by suppliers as the main basis of credit. The dependency of SMEs on short term sources of funds makes effective management of working capital for them all the more significant for their growth and survival (Padachi 2006). It has also been observed that SMEs always have to maintain higher liquidity due to their high dependence on working capital as the source of funding, and liquidity is always linked with profitability (Gill et al., 2010). The high investment of SMEs in current assets also calls for efficient working capital management.

SMEs do not have the expertise or skilled managers to plan and manage financial resources, especially working capital. This lack of proper planning and management of working capital is often the reason for their failure (Smith 1973, Padachi 2006). So, the management of SMEs needs to devote more time to the management of working capital for sustainability and profitability. The listing of SMEs on stock exchanges is expected to resolve SMEs' financial crises and issues. But there is no evidence about the same. It is not supported by proper evidence that SMEs' inclusion does any good for their survival and growth. This is one of the motivations for analysing the relationship between working capital component and proxies of profitability of SMEs listed in the NASDAQ in the US.

Literature Review

Inventory Management and Profitability

Inventory management is critical for maintaining firms' profits (Tinghbani, 2015; Koumanakos, 2008). Firms need not maintain inventory in perfect conditions, as in that scenario, firms can produce the exact number of products to fulfil the demand in the market (Mathuva, 2013). But the markets are imperfect, so the firms must maintain inventory to face many uncertainties in the market. The inventory management strategy chosen by a firm has a direct/indirect impact on its profitability and risks (Tinghabani, 2015; Afrifa, 2013). Nazir and Afza (2009) argued that an aggressive inventory strategy might enhance the firm's profitability by decreasing various inventory carrying costs. This is supported by the theory of Just-In-Time (JIT) in inventory management, which points that holding excess inventory leads to wastage of resources and does not lead to any value addition to the product (Bhattacharya, 2008).

The transactional cost motive of inventory implies that firms hold a high inventory level to fulfil the anticipated demand of the commodity or services in the market (Tinghbani, 2015). It is believed that firms maintain inventory for demonstration or display purposes as some consumers like to see and inspect the product before buying it. The availability of samples of products for examination by customers can lead to higher profits. By ordering in bulk, the firm can get a quantity discount and save on transportation costs and ordering costs (Afrifa, 2013). Companies should use methods for ordering an optimal inventory level like economic order quantity (EOQ) (Afrifa, 2013).

Accounts Receivables and Profitability

Short term credit provided by a firm to its different customers is termed as accounts receivables. The aggressive receivable policy pertains to a decrease in the period of accounts receivable, which leads to an increase in the company's cash flow and thus an increase in profitability (Tinghabani, 2015). This increase in profitability can save the firm from bankruptcy by making sure that payments are made on time (Couderc, 2006). The cash saved can be used to create a buffer and be used in financial distress (Arena and Julio, 2010). The firm's profitability is increased by a decrease in accounts receivable period by a decrease in the transactional cost of bill payment (Bhattacharya, 2008). Bhattacharya (2008) concluded that the firms could use trade receivable policy as a cost-reducing strategy to increase profitability. Firms can use trade credit for price-cutting at times of reckless fluctuations in demand; when sales increase, they tend to

tighten their trade receivables (Bhattacharya, 2008). Conservative receivable policy pertains to an increase in accounts receivable period, which increases the working capital investment (Tinghabani, 2015). Emery (1987) argues that firms attempt to increase their profitability by stretching trade credit by achieving improved operational flexibility. Smith (1987) stated that consumers could get an exchange facility by getting the required time to examine the quality of the product before making any purchase if the delayed payment option is available to them. This is also beneficial by decreasing the information irregularity between the seller and the buyer. A consumer has to pay less if provided with extended trade credit than those with shorter payment tenure (Garcia-Teruel and Martínez-Solano, 2010).

Accounts Payable and Profitability

The short-term credit provided by suppliers to the firm is termed accounts payable. It is an essential short-term source of finance for most businesses (Tinghabani, 2015; Garcia Teruel & Martinez-Solano, 2010; Wilner, 2000). Peterson and Rajan (1997) highlighted that the most important and sole source of finance for many companies, i.e. almost 35%, is trade payables. Garcia-Teruel and Martinez Solano (2010) revealed that in medium-sized firms in the UK, almost 41% of the total credit and 20% of their liabilities are represented by trade payables. Marinez-Sola et al. (2013) emphasised that the firms adopt optimal accounts payable policy due to market imperfections. By having lengthy periods of payment, the firm can utilise funds for their working capital needs and thus can maximise their profits (Mathuva, 2010). The cash saved by a lengthy payment period could be utilised for investment in accounts receivable and in days of inventory, thus reducing transactional costs of bills payment and consequently improving profitability.

As per financial distress theory, firms facing financial distress have issues in the timely fulfilment of credit policies due to their weak finances (Tinghabani, 2015). Financially distressed suppliers can use accounts payable as an opportunity to enhance profitability (Wilner, 2000). Furthermore, an increase in production requires extending the payment period without bank loans (Bougheas et al., 2009). For higher production, costs associated with production will also increase, which implies that the firms resort to lengthy payment periods (Tinghabani, 2015). For financing the production, thus longer payment period acts as an alternate resource (Ferrando and Mulier, 2013).

Liquidity and Profitability

A company's liquidity is a vital factor that affects its profitability (Appuhami, 2008). Both profitability and liquidity are the main aims of firms, and it is very difficult to choose one over the other as it can lead to multiple issues in the firm (Kargar & Bluementhal, 1994). If a firm has adequate liquidly, it can maximise its sales by extending credit to its customers (Ng and Baek, 2007). By providing credit to customers, the customers buy more of the firm's product, enhancing the firm's profitability (Garcia-Teruel & Martinez-Solano, 2010; Gill et al., 2010). Boermans and Wiilbrands (2011) contended that a firm's liquidity level has a high impact on its profitability as having liquidity ensures that all short-term liabilities are fulfilled on time, and the firm can opt for profitable projects and when they are available. Moreover, a company can avoid taking external finance, which turns to be costly if the firm has good liquidity. In his study, Lartey et al. (2013) stated that many liquid assets negatively impact firms profitability as it results in the opportunity cost of not investing cash in profitable options.

Solvency and Profitability

Goyal (2013) studied public sector banks in India to investigate the influence of financial structure ratios on profitability. A direct relationship was found between profitability ratios and short-term debt. In another study, Nirajini and Priya (2013) examined the selected companies in Sri Lanka to find the relationship between financial performance and capital structure. It was found in the study that financial performance was positively related to capital structure. Ebrati et al. (2013) found that earning per share and return on assets were negatively associated with the capital structure of the companies. In a similar study, Saeedi and Mahmoodi (2011) used the data of 320 companies in Tehran for seven years to investigate the association between profitability and solvency. For the study, three financial structure ratios (short-term debt, total debt, and long-term debt) were used as dependent variables; four financial performance ratios were used (return on assets, Tobin's Q, return on equity, and earning per share) as independent variables. It was established in the study that a positive association exists between capital structure and Tobin's Q and earning per share. A negative association was found between return on investment and capital structure.

CEO Age and Profitability

Age of CEO is also studied as a factor influencing profitability by many researchers. In recent research by Diks (2016) a negative relationship between age of CEO and profitability of the firm has been reported. This was inconsistent with the research of Hambrick and Mason (1984) where a negative association was found between profitability and CEO age. It has been observed that CEOs are comparatively older than other managers. It can be argued that older CEOs have more expertise and knowledge. But they take more time in taking decision and are averse to projects having risk (Diks, 2016). Hambrick and Mason (1984) debated that no new ideas are bought by older CEOs as they have a conservative outlook. They further added that older CEOs attain a status quo and develop a comfort level and do not like any changes to be made. Chown (1960) explained that older CEOs do not come up with new ideas as they do not think of new ideas. Child (1974) stressed that younger CEOs bring growth and new ideas in the organisation. MacCrimmon and Wehrung (1986) highlighted that with the age of managers their risk-taking ability decreases. The managers lose their optimism and start preferring risk free projects more. However, this is supported by the Stewardship Theory that sees a strong relationship between CEO and the success of the firm. They all want companies to maximise on profitability.

CEO Tenure and Profitability

The time a CEO has been in charge of the position is referred to as CEO tenure. It is a significant component of the corporate system which influences the profitability of the firm (Miller and Shamise, 2001). CEO tenure is vital factor for executive leadership and performance in an organisation. It is believed that CEOs can start building their self-empire if they remain at CEO position for a longer time. It may be because after remaining in the position and company for a longer time, the CEO becomes more relaxed and may spend the knowledge gained and power vested in him to further self-interest at the cost of profitability of the firm (Tingbani, 2015). This is also supported by Agency Theory. Companies having long tenure tend to have access control on the board which might result in taking up costly projects by the firms and thus resulting in a negative impact on the profit of the firm.

Shen (2003) found that long-tenured CEOs strived hard for the position and the years of their experience adds to their skills and efficiency. This increased skills and efficiency have positive impact on profitability of the firm. Kyereboah Coleman (2007) also suggested that CEOs with lengthy tenure are motivated to increase profits of the company as they like to see positive outcomes of their decisions. Lengthy tenured CEOs also helps in decreasing monitoring cost as they need to be monitored initially until the time they gain confidence and trust of management. This leads to high monitoring costs for new CEOs. But the contrary conclusion was given by Shen and Cannella (2002) where they contended that new CEOs tend to be more careful as they know they are being watched. They further argued that new CEOs have better performance as they perform under the fear of being laid down and it helps in improving the profitability of the firm.

Bergh (2001) found a significant and positive association between profitability and CEO tenure. But some researchers (Allgood and Farrell, 2003; Hill and Phan, 1991) argued that if a CEO retains the post for long then they will bargain for higher remuneration and it will impact the profitability of the firm. It was proved by Hermalin and Weisback (1998) in their study that CEOs that remain in the position for long develop dominating power over the board. It was also concluded in the same study that with length CEOs tenure the independence of also diminishes. CEOs that remain in the position for a long period tend to influence the selection of other board members (Zajac and Westphal, 1996). This leads to the selection of those directors who are the CEOs favourites and the ones who will further their interests, and this will eventually lead to decline in profitability of the firm due to vested interests of the CEO. Long tenured CEOs also gain trust of managers, and they are less monitored and it may negatively influence the profitability of the firm (Coles et al., 2008). Empirical evidence was provided by various studies to show the negative influence of the CEO tenure on the firm performance (Farooque et al., 2007; Hambrick et al., 1993)

Methodology

The approach for this research is deductive. Adopting a deductive approach signifies that the focus of the study is on using data to test the specific theories. This research is descriptive and explanatory to answer the research questions effectively. The secondary data is used for the study; it was collected from sample US SME companies listed on the NASDAQ. The required data was collected for six years, i.e. 2014 - 2019. The data was collected from financial reports on Bloomberg, NASDAQ stock exchange, Market Watch's, and selected companies' websites.

The sample of SMEs (Small Caps) included in the study are from non-financial sectors. The Sector/industry type of 200 small-cap firms data collected but only 183 small caps data qualified included in the study are from these sectors: Industrials, Consumer Cyclical, Basic Materials, Technology, Consumer Defensive, Real Estate/Construction, Health Care, and Communication Services.

In the current case, the dependent variables are the alternative proxies of the profitability of small US firms. The alternative proxies of the profitability used in the current case are Revenue and Cost of Goods Sold (COGS). The independent variables taken for the current study are as follows: Days Receivable, Days Inventory, Days Payable, Liquidity Ratio, and Leverage Ratio.

Table 1: Working capital components & Corporate Governance characteristics and their equations

Individual Components of Working Capital	**Formula**
Days receivable	*Receivables/(sales/365)*
Days inventory	*Inventories/(sales/365)*
Days payable	*Payables/(sales/365)*
Corporate Governance Characteristics	
CEO Age	
CEO Tenure	
Board Size	
Company Age	
Additional Financial Variables	
Liquidity ratio	*Liquid assets/ Current liabilities*
Leverage ratio	*Total company debt/shareholder's equity*

Based on the above variables following two different models were tested.
In the first model, the dependent variable were COGS, whereas, in the second model, revenue was the dependent variable.

$$COGS = \beta 0 + \beta 1 \text{ Days Receivable} + \beta 2 \text{ Days Inventory} + \beta 3 \text{ Days Payable} + \beta 8 \text{ Liq Ratio} + \beta 9 \text{ Lev Ratio} + \mu$$

$$Revenue = \beta 0 + \beta 1 \text{ Days Receivable} + \beta 2 \text{ Days Inventory} + \beta 3 \text{ Days Payable} + \beta 8 \text{ Liq Ratio} + \beta 9 \text{ Lev Ratio} + \mu$$

Analysis

Correlation Analysis

Pearson's correlation analysis was done to find an association between different variables in the study. The results of Pearson's correlation analysis are given in Table 2. As observed from Table 2, liquidity ratio, days receivable, and days inventory were

negatively correlated to firms' revenue, but the relationship was found to be not significant. It was also noted from Table 2 that liquidity ratio, days receivable, days payable, and days inventory were found to be negatively correlated to the cost of goods sold (COGS) of firms and leverage was positively correlated with the cost of goods sold (COGS), but the relationship was not significant. The Leverage Ratio (LeR) was positive and significantly correlated to firms' revenue.

Table 2: Correlation Analysis

Correlations

		Rev	COGS	DR	DI	DP	CEOA	CEOT	BS	CA	LiR	LeR
Rev	Pearson Correlation	1	.211**	-.021	-.067	-.087	.035	-.069	.072	.068	-.040	.177*
	Sig. (2-tailed)		.004	.774	.367	.241	.636	.357	.332	.364	.593	.017
COGS	Pearson Correlation	.211**	1	-.013	-.064	-.072	.028	.096	-.058	-.005	-.086	.034
	Sig. (2-tailed)	.004		.862	.388	.331	.706	.197	.436	.941	.250	.643
DR	Pearson Correlation	-.021	-.013	1	-.019	-.022	-.067	-.077	.091	-.061	.006	.005
	Sig. (2-tailed)	.774	.862		.794	.770	.370	.299	.223	.411	.931	.950
DI	Pearson Correlation	-.067	-.064	-.019	1	.728**	.028	.069	.076	-.040	.116	.029
	Sig. (2-tailed)	.367	.388	.794		.000	.709	.354	.309	.593	.118	.695
DP	Pearson Correlation	-.087	-.072	-.022	.728**	1	.095	.076	-.106	-.125	-.009	-.057
	Sig. (2-tailed)	.241	.331	.770	.000		.203	.308	.153	.093	.902	.440
LiR	Pearson Correlation	-.040	-.086	.006	.116	-.009	.086	.019	.029	-.065	1	-.044
	Sig. (2-tailed)	.593	.250	.931	.118	.902	.248	.797	.693	.385		.555
LeR	Pearson Correlation	.177*	.034	.005	.029	-.057	-.172*	-.077	.099	-.121	-.044	1
	Sig. (2-tailed)	.017	.643	.950	.695	.440	.020	.299	.182	.103	.555	

**. Correlation is significant at the 0.01 level (2-tailed).

*. Correlation is significant at the 0.05 level (2-tailed).

Multiple regression analysis to find the relationship between the revenue of firms and working capital components

Firms' revenue was dependent variable and Days Receivable, Days Inventory, Days Payable, Liquidity Ratio, and Leverage Ratio as independent variables in the multiple regression analysis.

Table 3: Regression coefficients for revenue and working capital components and corporate factors

Model		Unstandardised Coefficients		Standardised Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-47502.672	26085.357		-1.821	.070
	DR	-1.330	3.873	-.025	-.343	.732
	DI	-12.005	44.739	-.030	-.268	.789
	DP	-14.616	39.109	-.043	-.374	.709
	LiR	-622.748	1174.853	-.040	-.530	.597
	LeR	5196.315	1972.100	.200	2.635	.009

Model: Adjusted R2=.027; F-test=1.553; p=.133

Table 4: Regression coefficients for COGS and working capital components, and corporate factors

Coefficients						
Model		Unstandardised Coefficients		Standardised Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	6347.616	5507.037		1.153	.251
	DR	-.043	.818	-.004	-.052	.959
	DI	.668	9.445	.008	.071	.944
	DP	-6.681	8.256	-.095	-.809	.420
	LiR	-274.419	248.030	-.086	-1.106	.270
	LeR	154.926	416.342	.029	.372	.710
a. Dependent Variable: COGS						

Model: Adjusted R2=.020; F-test=.598; p=.798

The results of Multiple linear regression revealed a weak prediction of 2.7% of changes in revenue of firms. It was found that CEO Age and Leverage ratio have a positive and significant relationship with the revenue of firms, whereas CEO tenure has a negative and significant relationship with the revenue of firms. On the other hand, no significant relationship was found between the Revenue of firms and Days Receivable, Days Inventory, Days Payable, Board Size, Company Age, and Liquidity ratio.

Multiple regression analysis was used to find the relationship between COGS (Cost of Goods Sold) of firms and individual components of working capital and corporate factors. The results of Multiple linear regression revealed a weak 2.0% change in firms' COGS. It was found in the study there was no significant relationship between COGS of firms and Days Receivable, Days Payable, Days Inventory, Company Age, Liquidity Ratio, Leverage Ratio, Board Size, CEO Age, or CEO tenure.

Recommendations of the Study

Based on the results, the following recommendations are put forward for Small firms and Investors in the US. The study results suggest that there is no impact of individual components of working capital on alternate proxies of profitability observed in the study. Furthermore, there was a significant impact of small firms' profitability from corporate characteristics such as CEO Age, CEO Tenure, and Leverage Ratio as confirmed in the study. Hence it can be said that Corporate Governance Characteristics such as:
CEO Age - has an impact on firms' profitability. CEO age would be of great importance in firms' selecting the right CEO.
CEO Tenure - refers to the amount of time a CEO has been in charge of the job and should be carefully evaluated since it has an impact on a company's profitability. Manager's age and tenure have an impact on the revenue/profitability of firms.

- Corporate Characteristics are subjective, unconscious, pre-rational impulses herd determine Alternate Proxies of Small US firms Profitability.
- Alternate Proxies of Small US firms profitability adhere to an organising principle at the aggregate level.
- Alternate Proxies of Small US firms are probabilistically predictable.
- Individual Components of Working Capital Management are not the right predictors of Alternate Proxies of Small US Firms rather, Composite Components of Working Capital Management could be used in the following studies to investigate the relationship with Alternate Proxies of Small US firms profitability.
- Leverage Ratio or Solvency and Capital structure affect a firm's profitability. So, firms should focus on maintaining the right balance of debt and equity.

The findings are in agreement with Tingbani (2015) confirming that profitability of these firms was moderated by corporate governance characteristics. Tingbani (2015) concluded that firms can maximise the benefits and minimize the cost of investment in working capital by aligning their working capital management policies with their internal resources, environment through management decisions, and actions as postulated in the contingency framework, as any misalignment could significantly affect the firm's performance. However, Socionomic theory of finance played a big role in corporate governance characteristics. It was during the 2016 elections and based on findings this also confirms that social election mood could have motivated the social actions of corporate governance characteristics on the profitability of firms.

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