



DOES MANAGEMENT OF WORKING CAPITAL AFFECTS SMES FINANCIAL PERFORMANCE IN KADUNA METROPOLIS

By

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Abstract

Extant financial literature has focused more attention on the medium and long-term financial decisions of companies ignoring the importance of short-term decisions. This is more evident from SMEs manufacturing companies. Hence, lack of proper research study on the area gives a chance for Nigeria SMEs managers to have limited understanding on the link between WCM and SMEs financial performance. Thus, this study empirically determines the effect of working capital management on the financial performance of manufacturing SMEs in Kaduna metropolis, Nigeria. The study was conducted on a sample of 9 Kaduna SME's registered with Manufacturing Association of Nigeria (MAN) for a period of six years from 2015 to 2020 which led to a total of 54 firm-year observations. The data were collected from the annual reports and accounts of the sampled companies for the said period. Data were analyzed by means of descriptive statistics to provide summary statistics for the variables and correlation analysis was also carried out using Spearman Correlation technique for the correlation between the dependent and explanatory variables. Ordinary Least Square (OLS) regression was used in testing the study hypotheses using STATA software version 12.00. Findings from the analyses revealed mixed results, where cash management had a positive impact on profitability while account payable management had a negative impact on the profitability of the firms.

Key words: working capital management, profitability, SMEs

1. Introduction

The financial literature which have traditionally focused on the medium and long-term financial decisions have continuously re-evaluated the importance of short-term financial decisions, recognizing the importance of the later in the overall financial performance of the companies (Deloof, 2003; Howorth & Westhead, 2003; Filbeck & Krueger, 2005; Raheman & Nasr, 2007; Banos Caballero, Garcia-Teruel & Martinez-Solano, 2012). Accordingly, the focus on financial management which was earlier neglected has now become a necessity (Mielcarz, Osiichuk, & Wnuczak, 2018) and this has been true and important especially for small and medium scale enterprises (SMEs) whose survival and growth depend largely on short term financing models (Javid, 2014; Yazdanfar & Ohman, 2016). By their obvious nature, smaller firms have limited access to long term capital (Javid, 2014) which makes their dependence on short term credit such as trade credit inevitable (Yazdanfar & Ohman, 2016).



SMEs play a significant role in both developed and developing economies. Statistics has shown that SMEs contribute over 55% of gross domestic product (GDP) and over 65% of total employment in developed economies and it also play a significant role by contributing 60% of GDP and over 70% of total employment in developing economies (Small and Medium Enterprises Development Agency of Nigeria [SMEDAN], 2012). In Nigeria for example, SMEs contributed 48.47% to Nigeria's GDP in nominal terms and 7.27% to total export (SMEDAN, 2013). However, the contribution of SMEs to economic development in Nigeria is very low as compared to its contemporaries in Asia emerging economies such as China, Indonesia, Malaysia, India, and Singapore despite its resource endowment (SMEDAN/NBS, 2012; Sanusi, 2012). This may be due to insufficient funding, infrastructural facilities, poor financial management related to poor governance and working capital management (WCM) which result to low profitability, growth and failure of many SMEs (Okpara, 2011; Sunday, 2011; SMEDAN/NBS, 2012; Ademola et al., 2013).

SMEs in manufacturing sector ideally undertake the operation of WCM with the aim of maximizing the profit which is a form of measuring FP. To achieve the organization's objective of profit maximization, adequate liquidity is required to finance day to day activities of the firm. SMEs are required to maintain the liquidity for day-to-day operation to ensure their smooth running and to meet their obligation (Eljelly, 2004). The main objective of WCM is to maintain an optimal mix of inventories, receivables and payables (Bellouma, 2010). Indeed, a number of research works reveal the sensitivity of WCM to SMEs with substantial evidence highlighting poor WCM practices as a major cause of SMEs failure (Javid, 2014). The large number of failed SMEs has been as a result of inadequate plan and control by the financial manager towards the current assets and current liability (Javid, 2014). Kargar and Blumenthal (1994) showed that despite having healthy operations and profits, many enterprises fail owing to mismanagement of working capital, so it is a research theme that deserves increased investigation and especially for the SMEs as it is the wide belief that they are an essential element of a healthy and vibrant economy.

For strategic reasons, management may adopt an aggressive policy of holding less investment in short term assets or large volume of short term liabilities. On the opposite, management may decide to opt for a more liberal approach of holding a huge amount of investment in working capital (Altaf & Shah, 2018). Irrespective of the policy adopted, there are associated cost and benefit attached, hence managers who are astute in choosing an optimal working capital level tend to create value for the firm (Gorondutse et al., 2017).

Despite the importance and numerous studies on WCM and SMEs financial performance, such studies in Nigeria are scanty and literature available focuses on the WCM and performance of large firms as opposed to SMEs performance (Idowu, & Ogundipe, 2012; Raji, & Sadiq, 2014). Lukkari (2011) in his review literature study identified that most studies in the literature were done on the developed economies but no evidence has identified on the developing countries, especially for micro and small label companies, this is more evident for Nigerian SMEs. Moreover, similar study has not been conducted in Kaduna metropolis. Hence, lack of proper research study on the area gives a chance for Nigeria SMEs managers to have limited awareness in understanding the link between WCM and SMEs financial performance. Keeping the above problem in mind, the study will examine the effect of WCM on financial performance of SMEs in Kaduna metropolis, Nigeria.

2. Literature Review

Financial Performance

Financial performance (FP) is one of the most important objectives of financial management because one goal of financial management is to maximize the owner's wealth (McMahon, 2011). FP may be defined as a general measure of a company's overall financial health over a given period of time, and can be used to compare similar companies across the same industry or to compare industries or sectors in aggregation (Maymand, 2014). The financial performance of an institution can also be seen as the ability of an institution to employ the available resources to increase shareholders' value and generate sustainable profits to strengthen its capital base through retained earnings to ensure future profitability (Musomba, 2012). According to Kabethi (2013), the financial performance is the process of measuring the results of a firm's policies and operations in monetary terms.

Working Capital Management (WCM)

Working capital is the amount of funds that a company needs to finance its day-to-day operations in order to ensure smooth operations (Nwankwo & Osho 2010). The importance of efficient WCM is inevitable because it is attached to liquidity, survival, solvency and profitability of firms (Javid, 2014). According to Eljelly (2014) WCM is the most important area for comparison of liquidity and profitability among firms. There has been and there is still growing interest in the investigation of WCM and performance of firms (Javid, 2014). If WCM is not given due consideration, firms are likely to fail and face bankruptcy (Javid, 2014).

Components of Working Capital Management

Cash Management Practice (CMP)

Cash management involves the management of cash flow into and out of the firm; cash flow within the firm; and cash balances held by the firm at a point in time by financing deficit or investing surplus cash (Pandey, 2009). Cash management system normally depend on the firm's product, organization structure, competition, culture, and options available (Raheman, 2008). CMP could either be that of aggressive or conservative strategy. Aggressive CMP policy involves the pursuit of shorter trade receivables and inventory holding while depending heavily on shorter term financing from trade creditors through longer trade payables. On the other extreme, a more conservative strategy involves holding large volume of debtors and inventories while relying less on the short credit financing, in other words, this policy is a clear reflection of the use of longer trade credit receivable days, shorter trade credit payable days and longer inventory holding.

Accounts Receivable Management Practice (ARMP)

ARMP measures the level of investments firms make in trade receivables (Martinez-Sola, Garcia-Teruel, & Martinez-Solano, 2014). The effectiveness of firm's credit policies can have a significant impact on its total performance. Alternatively, firms may offer a longer or shorter period; technically termed as conservative or aggressive policies (Altaf & Shah, 2018). It has been argued that, offering a longer trade receivables period enhance profitability by affording the firm the opportunity to attract especially financial constraints customers (Abuhommous, 2017) and helps in improving a long-term customer relationship (Banos-Caballero, Garcia-Teruel & Martinez-Solano, 2014). However, others argued that, decision on trade credit elongation may result in higher cost arising from both real and opportunity cost (Dary & James, 2019). Extending trade credit to customers also lends the firm to higher risk of payment default which could result to illiquidity, financial distress and bankruptcy (Dary & James, 2019).



Inventory Management Practice (IMP)

Inventory has been defined in many ways. For example, Falope and Ajilore, (2009) state that inventory comprise the various raw materials, work in progress as well as the finished product held by the firm at any point in time. An inventory system is the set of policies and controls that monitor levels of inventory and determine what levels should be maintained, when stocks should be replenished, and how large orders should be. Some authors are on the believe that large inventories help to avoid stocks out to ensure uninterrupted production (Banos-Caballero, 2012). Large inventory also helps to promptly and consistently deliver on customers' orders, which also helps enhances customer relations, sales performance and corporate profitability (Banos-Caballero, 2012; Mathuva, 2013). Additionally, firms stand a chance to enjoy the cost advantage, such as benefitting from quantity discounts by resorting to large inventory purchase. However, other authors believe that holding large inventories hurts profitability of the firm. For example, holding large inventories are associated with high cost of storage e.g. high insurance, heating/cooling as well as personnel and other administrative costs (Banos-Caballero, 2012). Similarly, there is also danger of material spoilage and stocks obsolescence leading to persistent stock write-downs.

Accounts Payable Management Practice (APMP)

Trade payables period measures the number of days a firm is allowed to delay payment for goods and services offered by its suppliers. A firm will always wish to tie up as little cash as possible in disbursement. The idea in these systems is to have no more than the minimum amount necessary to pay bills on deposit in the Bank (Ross, 2008). Studies in the financial literature and theory established that firm's AP policies affect its profitability (Yazdanfar & Ohman, 2016). Several research work reveal a positive relationship between trade payables and corporate profitability. For example, it has been argued that delaying payment to creditors provides cheap alternative sources of short term finance to the firm (Yazdanfar & Ohman, 2016). Thus, the amount delayed could be invested by the firm into alternative short term viable investments. Consequently, this could lead to increased profitability. However, other scholars reveal a negative correlation between trade credit and firm profitability. For example, Giannetti et al., (2011) state that delayed payment to suppliers may attract interest on overdue debts. There is also likelihood of the firm forgoing the cost advantage that could have been enjoyed through cash discounts from early payments. Moreover, excessive delay in payment may pose doubts on the firm's creditworthiness which could lead the firm to lose out favorable credit terms from existing and potential suppliers.

Empirical Review and Hypothesis Formulation

Empirical studies that have explored WCM and profitability nexus have had a remarkable development in the last twenty years (Sensini, 2020; Prasad et al., 2019; Chalmers, 2020). This is evidenced by the numerous literature produced in this important area. A number of studies have established a positive link between WCM and firms' FP. For example, Javid (2014) using 54 samples SMEs listed on Karachi stock exchange discovered that SMEs with shorter inventory holding period, shorter accounts receivable period and shorter accounts payable period are more profitable and create value. Afeef (2011) investigate the effect of WCM on FP of 40 SMEs listed on KSE. Findings suggested that indicators of WCM had impact on FP of the samples firms. Afrifa, (2013) analyze the relative importance of various components of WCM on a sample of 133 SMEs in the UK. They show that the management of accounts payable and accounts receivable is particularly important for profitability of SMEs.

Nyamao (2012) explore the WCM practices of SMEs in Kenya using a sample of 113 SMEs. Result concluded that WCM practices are low amongst SMEs as majority had not adopted formal WCM routines. Pieterston (2012) explore the WCM practices of SMEs in the Western Region of Ghana. The author reveal that a well designed and implemented WCM is expected to contribute positively to the creation of firms' values. Raji and Sadiq, (2014) examined the impact of WCM on SMEs FP in Nigeria. Using 28 SME firms discovered a mixed effect of WCM on performance. It was concluded that account payables period, CCC, and net trading cycle has positive effect on performance. Account receivables period and inventories turnover in days has negative relationship with performance. Adediran, Samson, Josia, Yemisi and Imuzeze (2012) investigate the impact of WCM on the FP of 30 SMEs in Nigeria. The result demonstrate that managers can create value by reducing their firm's number of days of account receivable and inventories. Equally, shortening the CCC also improve the firm's profitability. Oroka and Othuke (2013) determine the WCM practices required by SMEs for effective operation in Nigeria. Using a sample of 1110 SMEs in Delta state. The findings obtained include among others; SMEs in Delta State highly require both long-term and short-term sources in financing their working capital. Thus, the following hypothesis is formulated:

H_{01} : There is no significant relationship between CMP and profitability of SMEs

H_{02} : There is no significant relationship between ARMP and profitability of SMEs

H_{03} : There is no significant relationship between IMP and profitability of SMEs.

H_{04} : There is no significant relationship between APMP and profitability of SMEs

3. Research Methodology

The study used an ex-post facto research design. The quantitative research approach was employed to arrive at the conclusions where correlation analysis was used to identify the nature of the relationship of the variables. Regression analysis were used to find out the extent of the effect of WCM variables on profitability. The population of the study comprised of 33 SMEs registered with Manufacturers Association of Nigeria (MAN, 2018) in Kaduna. The study consists of 9 purposively selected SMEs from the total population of SMEs registered with MAN. The size of the sample used for the study was dependent on the availability of complete financial data of SME's in the source document published by the Federal Inland Revenue Service (FIRS, 2020). STATA version 12 was used to conduct the analysis.

Measurement of Variables

Table 3.1: Measurement of Variables

S/N	Variables	Measurement
1	Financial Performance (Dependent Variable)	Profit After Tax/ Equity
2	Cash management	Inventory Turnover Days + Average Collection Period – Average Payment Period
3	Account receivables	Debtors/Sales $\times$ 365
4	Inventory management	Inventory/Cost of Goods Sold $\times$ 365
5	Accounts payable	Creditors/ Cost of Goods Sold $\times$ 365
6	Liquidity (Control)	Current Assets/ Current Liabilities
7	Tangibility (Control)	Fixed Assets/ Total Assets
8	Sales growth (Control)	(Sales ₁ - Sales ₀) / Sales ₀
9	Efficiency (Control)	Sales/ Total Assets

Source: Generated by the Researcher

4. Results and Discussion

Descriptive Statistics

Table 4.1: Descriptive Statistics of the Dependent, Independent and Control Variables

Variables	Obs	Mean	Std. Dev.	Min	Max
FP	54	-0.0489314	.7044223	-3.510373	1.645988
CM	54	1573.258	10967.11	-1257.958	80651.52
PM	54	415.9397	1660.796	0	10758.57
LQ	54	1.07419	.477885	.3453537	3.081263
TA	54	.4551712	.204533	.1235201	.8977166
SG	54	1.654902	12.09077	-.9475891	88.83194
EFF	54	1.093834	.7206269	.0020585	2.521739

Source: Generated by the researcher from Annual Reports of the sampled Companies, using STATA (version 12.00)

From Table 4.1, the mean total FP score for the companies shows an average value of -0.0489314. This means that sample companies have an average FP of about 5%. This shows an element of low level of FP in the companies, with a minimum disclosure level of -3.510373 and maximum compliance level of 1.645988. The standard deviation of .7044223 (i.e about 70%) indicates that there is a significant variation in FP among the companies during the period of the study. The mean proportion of cash management of the companies has a mean average of 1573 days. This means that the companies have a longer CCC, with a minimum level of 1258 days and maximum level of 80652 days. The standard deviation is 10967 days. This suggests a high level of dispersion in the cash management among the companies. However, the mean average of payable management is 416 days indicating that the average payment period by the companies is 415 days with a minimum of 0 and maximum of 10759 days. This indicates that there is delay in payment period by the companies. The standard deviation was 1660.796; this shows a significant variation in payment period among the companies.

Furthermore, Liquidity (LQ) has a mean average value of 1.07419. The full sample has indicated that most of the companies are liquid while others have less liquidity. The mean value is 1.07419; the standard deviation is 0.477885, this signifies a significant dispersion in liquidity ratio among the companies of about 48%. The companies have a minimum of 0.3453537 and maximum of 3.081263 liquidity levels. The mean average of tangibility (TA) is .4551712. This means that the companies have an average tangibility ratio of about 46%. It shows a significant level of tangibility among the companies. The minimum and maximum levels of tangibility among the companies are approximately 12% and 90% respectively. The standard deviation is 20% which indicates an insignificant variation in liquidity among the sampled companies. Sales growth (SG) has a mean average value of 1.654902. This has indicated that most of the companies experience growth in sales. The mean value is 1.654902; the

standard deviation is 12.09077, this signifies a significant dispersion in sales growth among the companies. The companies have a minimum of -.9475891 and maximum of 88.83194 sales growth levels. The mean average of Efficiency (EFF) is 1.093834. This means that companies have average efficiency levels of 1.093834. It shows a significant level of efficiency among the companies. The minimum and maximum levels of efficiency among the companies are approximately .0020585 and 2.52173 respectively. The standard deviation is 72% which indicates a significant variation in efficiency levels among the companies.

Correlation Matrix

Table 4.2: Correlation Matrix of the Dependent, Independent and Control Variables

Variables	FP	CM	PM	LQ	TA	SG	EFF
FP	1.0000						
CM	-0.0876	1.0000					
PM	0.0586	-0.5057	1.0000				
LQ	0.1549	0.0876	0.0491	1.0000			
TA	-0.1787	0.2774	-0.4876	-0.2800	1.0000		
SG	0.4552	-0.1308	0.0979	0.0717	-0.0042	1.0000	
EFF	0.2930	-0.4830	-0.1770	-0.0212	-0.2675	0.1633	1.0000

Source: Generated by the researcher from Annual Reports and Accounts of the sampled Companies, using STATA (version 12.00)

The correlation results presented above indicate strong negative relationship between CM and FP of the companies with a coefficient value of -0.0876. However, strong and positive relationship exists between PM and FP with a coefficient of 0.0586. A weak positive relationship exists between LQ and FP with a coefficient of 0.1549. Moreover, a weak and positive relationship exists between SG and FP with a coefficient of 0.4552. Finally, a weak and positive relationship exists between EFF and FP with a coefficient of 0.2930. The correlation result however, shows that the independent variables themselves were found to be insignificantly related except for LQ which is positively and strongly related with CM and PM respectively. Also, strong and positive relationship exists between SG with PM and LQ respectively. Moreover, a weak negative relationship exists between SG and TA. Finally, a weak and negative relationship exists between EFF and LQ.

Regression Results

Table 4.3: OLS (Robust)Regression Result

FM	Coefficient	Std Error	T-Statistics	P-Value
CM	.0000278	3.43e-06	8.13	0.000
PM	-.0002095	.0000479	-4.37	0.000
LQ	.1706108	.2178578	0.78	0.437
TA	-.2413671	.3713644	-0.65	0.519
SG	.0214485	.1554026	7.50	0.000
EFF	.2668072	.4380625	1.72	0.093
R ²	0.3177			
Adj. R ²	0.2306			
F	3.65			
Sig	0.0047			

Source: Generated by the researcher from Annual Reports of the sampled Companies (2010-2015), using STATA (version 12.00).

The OLS regression results reveal the cumulative R² of 0.3177 which is the multiple regression coefficients of determination gives the proportion or percentage of the total variation in the dependent variable explained by the WCM variables jointly. It shows that 32% changes in performance were caused by the combined effect of both the independent variables and the control variables. While the remaining 68% variation in performance was caused by other factors not included in the model. The F-value of 3.65 and P-value of 0.0047 signifies that the model is statistically fit and significant at 1% level of significant. The regression results as shown in table 4.3 indicate that CM was found to be positive and statistically significant in relationship with FP at 1% level of significant. This means that a change in CM will cause a significant change in FP of the sampled companies. This finding is in line with the findings of Raji and Sadiq, (2014) CCC has positive effect on FP. The results also indicate that PM was found to be negative and statistically significant in relationship with FP at 1% level of significance. This means that a change in PM will lead to a significant change in FP of the companies. This finding contradict with the findings of Raji and Sadiq, (2014), who concluded that AP period has positive effect on FP.

Test of Hypotheses

Initially, four research hypotheses are formulated to test the effect of WCM on FP of SMEs in Kaduna, Nigeria. However, two research hypotheses were excluded in the regression model due to multicollinearity. Therefore, two hypotheses were tested in this study. The decision was based on the significance of P-Values. In testing the hypotheses, this study adopts the 1% level of significance as it is commonly used in social science research. To determine if the hypotheses can be accepted or rejected at 1% level of significance, the $P > |t|$ value would be compared with 0.01 in the regression as well as correlation matrix, the null hypotheses would be accepted if the $P > |t|$ value is less than or equal to 0.01, and rejected otherwise.

Hypotheses 1:

Ho1: There is no significant relationship between CMP and profitability of SMEs. Table 4.3 shows the P- value of 0.000. This signifies that CMP has positive significant effect on profitability of SMEs in Kaduna metropolis. Consequently, the null hypothesis that cash management practice has no significant effect on profitability of SMEs is rejected.

Hypothesis 2:

Ho2: There is no significant relationship between APM practice and profitability of SMEs. Table 4.3 shows the P- value of 0.000. This signifies that APM has negative significant effect on profitability of SMEs. Consequently, the null hypothesis that accounts payable management practice has no significant effect on profitability of SMEs is also rejected.

5. Conclusion

The regression analysis results of the study indicate that CMP has positive and significant effect on FP. APM is adequate enough to influence the FP of the sampled SMEs. These are confirmed by the significant relationship between CM, PM and FP of the sampled SMEs.

6. Recommendations

The following recommendations are made based on the findings of the study. Management of the SMEs should ensure as much as possible that: The SMEs should try and maintain an optimum period of settling their suppliers in order to avoid negative effect on the company's profitability. The management of the SMEs should develop aggressive policies to decrease CCC, since this will increase profitability, and this is a criterion for assessing the performance of the management in achieving optimal working capital and liquidity. Management of the SMEs should plan and control the liquidity ratio in a manner that eliminates the risk of inability to meet short-term obligations as it affects its profitability. The management of the SMEs should as much as possible decrease the amount of fixed assets in favor of current assets because the higher the ratio of fixed assets to total assets, the lower the profitability of the firms as reported by the regression results. The management of the SMEs should set up a strong sales representative that will help achieve its sales target as it strongly affects its FP.

Suggestions for Further Research

This study investigates the effect of WCM on the FP of SMEs. It is believed to have paved way for further research. The study only made use of two WCM proxies (CMP and APM). Thus, the study suggests to future researchers in this area to incorporate other working capital variables such as ARM, IMP. In addition, the study made use of (ROE) to proxy FP. The study therefore, suggests that further studies in

this area should make use of other FP measurement such as return on asset (ROA), net profit margin etc. Future research should also investigate generalization of the findings beyond the manufacturing SMEs, other sectors like banking, telecommunication that must have in one way or the other use working capital variables.

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