Effect of Working Capital Management On The Profitability of Women Owned Small And Medium Enterprises In Nyeri Town, Kenya

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ABSTRACT

Working Capital management is one crucial element used to analyze the performance of organizations in their daily operations by ensuring that there is a balance between profitability and liquidity. This research evaluates the effects of working capital management on the profitability of Small and Medium Enterprises. Specifically, the study looks at the effect of cash, accounts receivables, accounts payables management on the performance of women owned Small and Medium Enterprises in Nyeri Town, Kenya. The target population was 10 Women owned Small and Medium Enterprises registered by the County Government of Nyeri Kenya and had been in business for more than 5 years. Secondary data for a period of 5 years between 2018 and 2022 was collected and analyzed using a panel regression analysis model. The study results indicated that all the three variables under observation, that is cash accounts receivable and payables management had a negative and significant effect on profitability of Women Owned Small and Medium Enterprises in Nyeri County, Kenya. The study recommends that the Enterprises should reduce their average collection period in order to improve their profitability. Data collected showed that the average accounts receivables collection period in the period of 2018 to 2022 was 182.4715 days. Thus to boost profitability the study recommends the Women Owned Small and Medium Enterprises should reduce the account receivables collection period by using incentives to encourage the debtors to pay on time. The average accounts payables payment period was 79.9924 days which was quite high. A firm with a long account payment period frustrates the supplier from supplying any more goods or services to the firms. Thus, the accounts payable period needs to be maintained as low as possible and the firms need to pay any debts promptly if possible.

Keywords: Cash Management, Accounts Receivables Management and Accounts Payables Management.

I.0 INTRODUCTION

1.1 Background of the Study

Working Capital management is one crucial element used to analyze the performance of organizations in their daily operations by ensuring that there is a balance between profitability and liquidity (Muhammad, Zahid & Syed, 2014). According to Muhammad, Zahid & Syed, 2014, working capital management is the action and decisions that affect the effectiveness and size of working capital. Its aim is to ensure that there is an optimal balance of each of the components working capital which include inventory, cash, payables and receivables.

Working capital management ensures that an organization got sufficient cash flow that is required to meet its operating expenditure and short-term financial obligations. Some of the many businesses that operate in various sectors of an economy have optimal working capital levels that maximize the shareholders wealth (Rathiranee, 2017). According to Ramesh et al (2017), working capital management is a major financial function of management of any business that represents the finances that are invested to meet daily operations of any business. It is the difference between current assets and the current liabilities of any business. Current assets include cash in hand, cash at bank, marketable securities, trade & other receivables, and inventories. Current liabilities on the other hand include trade payables, short term payables, and accrued expenses.
In the current business environment that is characterized with stiff competition, it calls for efficient use of limited resources and that is why working capital management is very important.

Ahmet & Emin, (2012) concluded in their research that the way in which management of capital is done has a great contribution to the profitability of any business. When there is inefficient management of working capital in a business, it will lead to financial distress in an organization in addition to reduction in profitability. According to Tasie and Akinyomi, 2016, the amounts of capital invested are usually very high and therefore there is a need to ensure that the money is efficiently used to ensure profitability of any business. An optimal balance between the components of working capital is key role of the overall corporate strategy of any organization and it results in creation of value for money and gives an organization a competitive advantage in the market (Azhagaiah, & Muralidhara, 2017).

Working capital management has an effect on financial performance and the expected liquidity of an organization in a big way. Heavy working capital investment by an organization more that it is required results in a decline of profits that could be generated by such an investment of firm’s resources in long-term and fixed assets (Azhagaiah & Muralidharan, 2017). A research conducted by Ogbonnaya and Magadha (2016), to establish the effects of working capital management on the performance of Nigerian companies, it was established that financial performance of the manufacturing firms improved with how efficient working capital management is done.

Majority of Small and Medium Enterprises have fewer than 10 employees but about 70 percent of the enterprises are run by one person. These enterprises operate at the bottom of the economy and about 53 percent of people who live below poverty line of one USD per day operate their businesses as SMEs (Kihonge, 2014). The importance of SMES cannot be underestimated. They are important in promoting the state of an economy (Subhan et al, 2013). Because of their importance, every nation both developed and developing ones are focusing on the advancement of SMEs. Subhan et al(2013) additionally contended that, SMES are considered as fundamental driver for advancement, reduction of poverty, social reconciliation and generation of employment. SMEs area might intensify the creation limit which has critical effect for the advancement of financial and social turn of events. Avendano (2013) argued that, SMEs are very key in developing nations and are cornerstones in the development of emerging economies.

In Kenya a micro enterprise has been defined as a registered enterprise with less than 10 employees (National SME Survey, 2016). Therefore, Self Help Groups can be categorized under the Micro Enterprises because they have less than 10 employees. There are a number of factors affecting the performance of SMEs. One of the factors these factors is finances. According to Levy (2015), finances are critical in determining how Small and Medium Enterprises are operated. Limited or lack of finances greatly deter the growth and development of SMES. Poor management of these firms also proven to be another major factor that hinder the financial performance of the SMEs.

1.2 Statement of the problem

There has been an increased growth of businesses in Kenya which has in turn led to an increase in number of enterprises owned by women. Small and Medium Enterprises sector plays a pivotal role economic development and reduction of poverty in Kenya. SMEs form the largest section of businesses in every economy and in a big way create job opportunities to people (Asquith et al, 1994). The Government of Kenya has been working hard to support the development of SMEs sector as a means to eradicate poverty, accelerate economic growth and encourage self-employment. It was reported that the majority upto about 60% of SMEs fail before they celebrate their fifth birthday (KNBS, 2007).Atrill (2006)found out that SMEs find it difficult to access finances from banks and other financial institutions due to lack of adequate working capital management skills.
According to a research done by Kiambi and Mwangi (2021), women owned SMEs in Nyeri County have been faced with a decline in net profits and an increased operating cost. They are faced with losses in businesses and decrease in total assets and preventing them from attaining optimal growth and exposing them to high risks. They added that financial performance among the women owned SMEs in Nyeri have decreased over time resulting into more 37% of them closing down between the year 2015 and 2019. Additionally, 45% of the existing ones were found to be making losses and were being in the verge of collapsing (International Finance Corporation, 2019).

The major challenge is the impacts of working capital management practices on the profitability of Small and Medium Enterprises. Majority of the SMEs are not able to balance between shortage and surplus of working capital. Others do not possess the working capital management skills and that is how they find themselves failing within their first months upon registration. Additionally, SMEs have been experiencing slow growth because they are unable to meet their day-to-day operating expenses.

They are also unable to venture new markets to carry out profitable businesses because they lack working capital as a result of poor working capital management. It is therefore imperative that this research finds out the effects of working capital management on the performance of women-owned SMEs and address the problem of failure of SMEs within their first few months of registration. The researcher will be much interested to focus on women-owned SMEs that have been registered by the County Government in Nyeri Town because of the high failure rate of these businesses and due to the fact that not many researchers have taking time to study the effect of working capital management on the performance of women-owned SMEs.

1.2 Objectives

i. To assess how cash management affects the profitability of the Women owned Small and Medium Enterprises.

ii. To determine how accounts receivables management affects the profitability of Women owned Small and Medium Enterprises.

iii. To determine how accounts payables management affects the profitability of Women owned Small and Medium Enterprises.

Literature Review

2.1 Theoretical Framework

2.1.1 Financial Literacy Theory

The theory argues that the people with high financial literacy level might be dependent of two styles of thinking according to a theory known as dual- process theories namely; cognition and intuition. Financial literacy theory argues that a combination of entrepreneurs understanding of financial concepts and products and their confidence and ability to appreciate financial opportunities and risks help them to make informed decisions and choices to ensure that there is financial wellbeing of an organization (Chikati, 2009). The financial literacy theory underpins this research study on the basis that Small and Medium Enterprises are always likely to access different finances from banks and financial institutions more easily if they possess adequate information about the loans, if they are able to develop proper budgets and ensure that they have allocated funds to activities that are aimed at maximization of profits of the firms within the time period given to repay loans. It is also argued that lack of proper financial planning by business owners is a big challenge that contributes to poor performance of businesses.

2.1.2 Liquidity Theory

The proponent of Liquidity Theory is Jose (1996) who argues that liquidity as a function of current assets and current liabilities is an important determinant of working capital of the firm. It also indicated capability of a firm to meet its financial needs when they arise. The traditional measures of liquidity that include cash ratios, current ratios and acid-test ratios have been considered incompetent because they are balance-sheet based measures that are incapable to give an accurate and detailed information on the effectiveness of working capital. The formulas that are used to calculate the
liquidity ratios consider both the operating and liquid assets in common and that they are not meaningful in the determination of firm’s cash-flow (Richards & Laughlin, 1980). According to Boer (1999), it would be prudent to use ongoing liquidity measures as opposed the traditional liquidity measures in working capital management. Ongoing liquidity is the cash inflows and outflows within the firm as a result of production activities, products acquisition, payments, sales and collection processes taking place over time. Pinches (1992) argued that the ongoing liquidity of a firm will be more ideal to effectively evaluate the working capital of a firm because it is not only accurate but more appropriate as it uses cash conversion cycle as opposed to the traditional liquidity measures.

2.1.3 Free Cash Flow theory
This theory that was proposed by Jensen and Michael (1996) argues that the managers’ behaviors does not conform to profit optimization of a firm. Instead of managers investing on activities that may help in profits generation for the firm, the managers use the available excess cash flow to better their personal lives. Having a close check on the behavior of the management especially in relation to their expenditure is very important to the development and growth of any firm thereby resulting into generation of profit. Incurred an agency cost where close monitoring of the behavior of the management in terms of their expenditure, may help in the improvement of the management and the reduction of internal expenses. This is vital for the growth and development of the firm and leads to generation of cashflow for stakeholders.

The management uses investments to reduce the cashflows and also personal gains. The management with firms that have excess cashflows that are gained from the firms’ profitable investments are likely to be faced with temptation of wasting the cash flow through engaging with unprofitable investments. Instead of firms paying dividends to the shareholders, the managers use the free cash flows on investments that are geared at increasing the size of the firms (Davis et al, 1997). The agency hypothesis argues that firms that have excess free cash flow have greater chances growing beyond the expectations of the shareholders and wealth maximization. Any decision by the management that reduces expenditures and waste is appropriate for the shareholders of the firms. According to Jensen & Smith (1995), the management can introduce the repurchase of shares as a way of preventing the waste of surplus cashflow.

The free cash flow theory is an important theory that tries to elaborate the causal-effect relationship that exists between the firm’s profitability and the free cash flow. Managers may choose to spend the excess cash flow to better their personal lives instead of investing in profit generating ventures.

2.2 Conceptual Framework

<table>
<thead>
<tr>
<th>Cash management</th>
<th>Accounts Receivables Management</th>
<th>Accounts Payable Management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Conversion Cycle = Days Inventory Outstanding + Days Sales Outstanding) – Days Payable Outstanding</td>
<td>Accounts Receivable Turnover Ratio = Net Credit Sales / Average Accounts Receivable</td>
<td>Accounts Payable Turnover ratio= Net Credit Purchases / Average Accounts Payables</td>
</tr>
</tbody>
</table>

Profitability of Women owned SMEs (ROA)

Independent variables

Dependent variable

Figure 2.1: Conceptual Framework
2.3 Empirical Literature Review

Muturi (2015) conducted a research on the effect of cash conversion cycle on the profitability of tea factories in Meru. He analyzed data from the seven tea factories over a period of 5 years and found out that there was appositive relationship between the CCC and profitability of a firm. He claimed that profitability of a firm is negatively affected by the CCC. He later recommended that finance managers should shorten the net CCC in order to improve profitability of firms. Muneed & Kashif (2012) argued that CCC is one of the most useful measure of how effective a firm’s working capital management and especially cash management is done. The two researchers carried out a research to determine relationship between the CCC and the size and firm’s profitability. A significant negative correlation between CCC and firm’s profitability was established by the researcher. Profitability was in terms of returns on assets while the size of the firm was in terms of total assets. Divya et al (2017) conducted a research on how accounts receivables management affects the profitability of commercial vehicle industries in India and established a positive relationship between the profitability of a company and the debt turnover ratio. This implied that management of accounts receivables is supposed to be the key focus for the improvement of profitability of any business according to these researchers. (Ksenjia, 2015) conducted a research on how the profitability of a firm was affected by the management of accounts receivables in Serbia found out that in times of crisis accounts receivables are affected and therefore the amount of debt collected reduced and in return the profitability reduces. The conclusion of the study was that during the times of crisis, profitability of firms will change as a result of reduction in debt collections from the debtor of the firm. Abdullahi et al (2016) conducted a research to determine the effects of inventory management and trade receivables to the performance of SMEs in Malaysia. The study that was conducted on 66 SMEs and that was conducted for a period of 6 years from 2006 to 2012 indicated that there was a negative correlation between profitability of SMEs substitutes that include operating profits, Return On Equity (ROE) and the Return On Assets (ROA), inventory management and account receivables. The results implied firms’ profitability highly dependent on the effectiveness of management of working capital components.

Okpe and Nwakego (2015) argue that the firm’s credit policy and debt collection process has a great influence on how account receivables are managed. A credit policy stipulates the what is required to value customer’s worth while the collection process gives the guidelines for collection of the invoices that have been unpaid and that will reduce the customer delays in payment for goods and services and outstanding debts. In addition to this, (Sharma & Kumar, 2011) argued that there an excessive account receivable ratio has a negative effect on profitability of a firm. This is because when the firm is expected to pay the many debts, there may not be enough cash and this may result to difficulties in settling the firm’s short-term financial dues. Okpe and Nwakego (2015) in their study on effects of accounts receivable management on the profitability of paints and chemicals manufacturing firms, they found out that accounts receivables had a significant and positive effects on the profitability of the firm and the profitability ratio had a 1% significance level. This implied that as variables increase, the profitability ratio of the firm. The sales growth and debt ratio were found to have a non-significant and negative effect on firm’s profitability.

A research study on the how accounts receivable management affect the performance of SMEs in Somalia by Osman & Ayuma (2018) and that studied 102 SMEs concluded that cash flow management, inventory management, debt and credit policy management had a significant positive effect on the profitability of the SMEs at a significance level of 5%. A research conducted by Darush and Ohman (2016) found out that use of trade credit by SMEs greatly affected profitability of the SMEs both positively and negatively. The research indicated that the SMEs that had a lower accounts payable reported higher profitability. Additionally, the research also revealed an existence of a positive relationship between a firm’s profitability, size and level of the firm. It was argued that the long-term profitability of any firm is jeopardized when such a firm is heavily reliant on the account payables. Yazadanfar (2012) advises that having an efficient financing policy should be used to ensure that there is transparent trade credit. He argues that managers of any firm ought to use the trade agreements between the suppliers and the firm in order to control losses that are related to trade payables. A research that was conducted to establish the effects of working capital on the performance of SMEs in Vietnam by Doan et al (2016), indicated that working capital turnover and accounts receivables had a negative impact.
on the performance of the SMEs. It also revealed that there was a direct relationship between the profitability of the firm, inventory conversion period, accounts payable period, and accounts receivable period.

A study that was carried out by Jyoti & Uday (2017) to determine the impact of account receivable and payables on the performance of Indian telecommunication industry found out that there existed a negative relationship between Return On Asset and average debt collection period but the relationship between the Return On Asset and average payment period was a positive one. There was an inverse relationship between changes in accounts payables and the profitability of the firm (Ani et al, 2013). They argued that inverse relationship between the profitability of a firm and accounts payables goes contrary to the theory that supports the extension of payment terms in order to manage working capital and liquidity improvement.

3. Research Methodology

Descriptive survey was employed in this study as it aims at collecting data in a systematic way on the characteristic features and facts of a given population by selecting samples for analysis and discovers occurrences. The study population chosen by the researcher comprises 10 major sectors of Women SMEs within Nyeri Town and have been registered by the County Government of Nyeri. For this study, the researcher carried out a census instead of sampling from the population. This helped in ensuring that all the characteristics of the population will be captured and no member of the population will be left out. The researcher used secondary data from the listed Women –owned SMEs and will seek to obtain financial statements and reports of the women owned SMEs. This research used Panel Data Regression model to analyze data. The choice of the model is determined by the fact this model is used to predict the value of one variable depending on the value of other variables in different periods. In this case, the performance of SMEs is determined by independent variable that include cash management, accounts receivable management and the accounts payables management (Charles, & Benson 2023).

Model
The model will be as follows:

\[ Y_{it} = \beta_0 + \beta_1X_{1it} + \beta_2X_{2it} + \beta_3X_{3it} + \epsilon_{it} \]

Where:
\[ Y_{it} = \text{Profitability} \]
\[ X_1 = \text{Cash Conversion Cycle} \]
\[ X_2 = \text{Accounts Receivables Management} \]
\[ X_3 = \text{Accounts Payables Management} \]

4. Research Findings and Discussion

4.1 Correlation Analysis
Correlation analysis illustrates the relationship between research variables. The relationship between accounts receivables, accounts payables, cash management and profitability is depicted in Table 1

Table 4.1: Correlation Matrix

<table>
<thead>
<tr>
<th>Variables</th>
<th>Profitability</th>
<th>Accounts Receivable Collection Period</th>
<th>Accounts Payables Payment Period</th>
<th>Cash management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profitability</td>
<td>1.0000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts Receivables</td>
<td>-0.0317</td>
<td>1.0000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts Payables</td>
<td>-0.0553</td>
<td>0.1277</td>
<td>1.0000</td>
<td></td>
</tr>
<tr>
<td>Cash management</td>
<td>-0.0626</td>
<td>0.0428</td>
<td>0.3674</td>
<td>1.0000</td>
</tr>
</tbody>
</table>
The results presented in Table 4.6 show that the accounts receivables is negatively associated with profitability ($r = -0.0311$). The study also found that the accounts payables is negatively correlated with profitability ($r = -0.0553$). The study results further illustrated that the cash management is negatively associated with profitability ($r = 0.0626$).

The results concur with the findings of Muscettola (2018), Sheikh, & Oluoch, (2023), who established that the average receivables had a significantly negative relationship with profitability. Besides; Ksenija (2017) revealed there is a negative relationship between accounts receivables and return on asset. Eneje et al., (2016) found that the cash management is negatively related to profitability. Moreover, Gill, Biger and Mathur (2016) and Mathuva (2014) revealed a negative relationship between inventory turnover and financial performance.

### Panel Regression Analysis

The results of panel regression analysis are illustrated in Table 4.7

#### Table 4.2: Panel Regression Analysis

| Variables        | Coef.  | Robust Std. Err. | z      | P>|z| |
|------------------|--------|------------------|--------|------|
| Cash management  | -0.0623| 0.0264           | 2.3600 | 0.0180 |
| Accounts receivables | -0.1299| 0.0541           | 2.4000 | 0.0160 |
| Accounts payables | -0.0843| 0.0315           | 2.6800 | 0.0070 |
| _constant        | 0.0457 | 0.0408           | 1.1200 | 0.2630 |

$R$ squared $= 0.6529$

$ROA = 0.0457 - 0.0623 \cdot X_{it} - 0.1299 \cdot X_{it} - 0.0843 \cdot X_{it}$

The results presented in Table 4.2 shows that cash management, account receivables and accounts payment explain 65.29% of the variations in the profitability (return on assets). The study sought to carry out panel regression analysis to establish the relationship between accounts receivables and profitability. The study illustrated that the accounts receivables is negatively and significantly related to return on assets ($\beta = -0.1299$, $p = 0.0160$). This was supported by a calculated t-statistic of 2.4000 that is larger than the critical t-statistic of 1.96. This implied a decrease in the accounts receivables one unit would lead to a rise in the return on assets by 0.1299 units, while other factors are held constant.

The results concur with the findings of Muscettola (2018), who established that the average receivables had a significantly negative relationship with profitability. Besides; Ksenija (2017) revealed there is a negative relationship between accounts receivables and return on asset. The study illustrated that the accounts payables explain 19.99% of the variations in the profitability (return on assets). The study found that the accounts payables is negatively and significantly related to return on assets ($\beta = -0.0843$, $p = 0.0070$). This was supported by a calculated t-statistic of 2.6800 that is larger than the critical t-statistic of 1.96. This implied an increase in the accounts payable by one unit would lead to a decrease in the return on assets by 0.0843 units, while other factors are held unchanged.

The study also sought to carry out panel regression analysis to establish the relationship between accounts payables and profitability. The study found that the accounts payables is negatively and significantly related to return on assets ($\beta = -0.0623$, $p = 0.0180$). This was supported by a calculated t-statistic of 2.3600 that is larger than the critical t-statistic of 1.96. This signified a decrease in the accounts payables one unit would lead to a rise in the return on assets by 0.0623 units, while other factors are held unchanged. The results are in agreement with the findings of Agyemang and Asiedu (2017), who established there is a negative relationship between accounts payable and profitability. In addition, more research by (Chemngorem, & Njeru, 2023, Ray, 2016; Mekonnen, 2015; Deloof, 2009; Reheman & Nasr, 2012; Vural, Sökmen and Çetenak, 2016; Saghir, Hashmi and Hussain, 2015; Reheman et al., 2014) suggested a negative relationship between APPP and the firm profitability. Additionally, the study sought to carry out panel regression analysis to establish the relationship between inventory turnover and financial performance. The study noted that the cash management inventory is negatively and significantly related to return on assets ($\beta = -0.0623$, $p = 0.0180$). This was supported by a calculated t-statistic of 2.3600 that is larger than the critical t-statistic of 1.96. This signified a decrease in the cash management one unit would lead to a rise in the return on assets by 0.0623 units, while other factors are held constant.

The results agree with the findings of Eneje et al., (2016), who found that the Cash management is negatively related to profitability. Moreover, Gill, Biger and Mathur (2016) and Mathuva (2014) revealed a negative relationship...
between Cash management and profitability. Generally, accounts payables was the most significant variable as it has the lowest p value of 0.0070 while the Cash management was least significant variable as it has the highest p value of 0.0180.

5. CONCLUSION

The study concluded that cash management had a negative but significant effect on profitability of women owned small and medium enterprises. A longer cash conversion cycle may improve profitability in firms as it may lead to higher sales. But profitability may also decrease in the case where the cost of investment in working capital exceeds the benefits of holding large inventories. The study also concluded that accounts receivable management had a negative but significant effect on profitability of women owned small and medium enterprises. This implies that shorter average collection period will have an effect of increasing available cash for investment and consequent financial performance. The study finally concluded that accounts receivable management had a negative but significant effect on profitability of women owned small and medium enterprises. This implies that the study has indicated an inverse relationship between average payables period and return on asset.

REFERENCES


