

THE RELATIVE IMPORTANCE OF WORKING CAPITAL MANAGEMENT AND ITS COMPONENTS TO SMES' PROFITABILITY

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Abstract

The focal point of extant research is the importance of working capital management (WCM), measured by cash conversion cycle (CCC), and all its components (inventory, accounts receivables and accounts payables) on the profitability of predominantly large firms (Deloof, 2003; Padachi, 2006; Garcia-Teruel and Martinez-Solano, 2007; Banos-Caballero et al., 2010).

Such research has been carried out on the implicit assumption that large firms have the necessary resources (e.g. financial, technology and personnel) to manage all components of working capital. Literature on SMEs, however, suggests that such firms have limited resources compared to their large firm counterparts that may prevent them from managing all components of working capital. For example, research has found that SMEs are poorly managed due to the lack of management competence of their owner-managers (Gockel and Akoena, 2002; Pansiri and Temtime, 2008). The Small Business Research Centre (1992) also found management skills to be one of the barriers to SMEs' growth.

The nature of the relationship between WCM and profitability depends on the strategy that the firm decides to pursue (Weinraub and Visscher, 1998; Garcia-Teruel and Martinez-Solano, 2007; Nazir and Afza, 2009). A firm can also adopt a conservative strategy to WCM which advocates an increase in investment in working capital. This strategy is adopted with the view of stimulating sales by increasing both inventories and receivables in order to increase profitability. An increase in inventories can prevent production disruptions (Garcia-Teruel and Martinez-Solano, 2007).

The relationship between WCM measured by the CCC and profitability was found to be negative and significant by Raheman et al. (2010), Hayajneh and Yassine (2011) and Karaduman et al. (2011), consistent with the aggressive strategy of WCM. However, a positive and significant relationship was reported by Raheman and Nasr (2007), Mathuva (2010), Nobanee and Alhajjar (2009) and Stephen and Elvis (2011), which supports the conservative strategy of WCM.

Key words: Relative importance; Working capital management; Profitability; Small to medium-sized enterprises; Working capital; Profit