

## EFFECTS OF ACCOUNTS RECEIVABLE MANAGEMENT ON THE PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES (SMEs) INNIGERIA



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### Abstract

Accounts Receivable Management which is one of the components of Working capital management is expected to enhance the performance of enterprises and by extension, the share holder's value. The relation between Accounts Receivable Management and performance was investigated for a sample of 211 small and medium sized enterprises in Kaduna North and South Local Government Areas of Kaduna Nigeria for the period 2008-2012. The Accounts Receivable Management was used as the independent variable while Performance of SMEs was considered as the dependent variable. Correlation coefficients and regression analysis were used as measures of the relations. The Accounts Receivable Management showed significant positive relations with Performance of SMEs. The Regression results rejected the null hypothesis that Accounts Receivable Management does not affect the performance of SMEs. It (regression results) however, ensured the positive relation between Accounts Receivable Management and Performance measures of Small and Medium Enterprises (SMEs).

**Keywords:** *Account receivable management, Performance, SMEs*

### Background to the Study

Sales on credit are inevitable necessity in the business world today. No business can exist without selling the products on credit. According to Joshi, (2000) and Meyer et al (1992), noted that accounts receivables consist of the credit a business grants its customers when selling goods or services which take the form of either trade credit which the company extends to other companies or consumer credit, which the company extends to its ultimate consumers and so the effectiveness of company's credit policies can have a significant impact on its total performance.

Machiraju (2005) also argue that receivables arise out of delivery of goods or rendering of services on credit. Receivables represent claims against others for future receipt of money, goods or services whose value depends upon the volume of credit sales and the policy for collecting such credits. Joshi (2000) indicated that the primary objective of investment in trade debtor is to increase profit by expanding sales to attract new customers and retain old customers. By constantly increasing its sales and profit the business carves out a bigger niche in the market and elevates its status among competitors. Corporations can have a best possible amount of working capital that leads to their value maximization M. Deloof (2003). He further added that on the other hand, maintaining a huge inventory, readily granting credit to customers, and being willing to wait a longer time to receive payment may result in higher sales. In determining an optimal credit extension policy, Meyer et al (1992) observe that a company's financial managers must consider a number of major controllable variables that can be used to alter the level of receivables which include credit standards, credit terms and collection effort.

Horn (2000) averred that, credit standards are the criteria a company uses to screen applicants in order to determine which of its customers should be offered credit and how much. The process of setting credit standards allows the firms to exercise some degree of control over the "quality" of accounts accepted. The quality of credit extended to customers is a multidimensional concept involving the time a customer takes to repay credit obligation, given that it is repaid and the probability that a customer will fail to repay the credit extended to them. In establishing credit standards, Horn (2000), suggests a means of categorizing customers for the purpose of approving or refusing credit to them. This will enable the firm to avoid investigating the credit worthiness of customers who fall into the refused category. As a basis for credit extension to those who qualify, he suggests the comparison between the expected cost of credit extension and expected profit to be forgone in the absence of credit. A business should have a rational for collection of receivables. Collection policy can be tight policy which ensures better collection, fewer instances of bad debt but high collection costs. It may, however, antagonize the customers and some of them may switch to competitors. A liberal collection policy will have opposite effect Joshi (2000). Meyer et al (1992) also assert that the collection effort consist of the methods a business employs in attempting to collect payment of past-due accounts. Some commonly used methods include sending notice or letters informing the customers of the past-due status of the account and requesting payment, telephones and/or visiting the customers in an effort to obtain payment

employing a collection agency and taking legal action against the customers.

The literature related to credit policy is quite extensive. Srinivasan (1999) argued that it is essential for companies to spell out clearly and precisely the credit policy directions in writing in the general interest of the organization. The credit policy will be an adjunct to the company's marketing policy and should serve to reinforce such a policy. The decision made out of these options is based on the lowest cost. This technique is appropriate for a firm which relies to a larger extent on information obtained from experience with its own customers.

One significant revelation by Western and Copeland (1989) in the management of accounts receivable is the consequence of persistent inflation on accounts receivable. In inflationary period, when interest rates are high and financing requirement becomes large, buyers may delay their payment beyond the normal credit period. These in turn cause the selling firm's investment in account receivables to rise, increasing their financing requirement. The outcome of such a situation is the important role credit and collection policies assume in the broad spectrum of receivable management. Provision of trade credit is normally used by businesses as a marketing strategy to expand or maintain sales Pandey, (2004). Efficient receivables management augmented by a shortened creditor's collection period, low levels of bad debts and a sound credit policy often improves the businesses' ability to attract new customers and accordingly increase financial performance hence the need for a sound credit policy that will ensure that SSEs' value is optimized Ross et al., (2008). Costs of cash discounts, losses of bad debts and costs of managing credit and credit collections constitute the carrying costs associated with granting a credit which increase when the amount of receivables granted are increased. Lost sales resulting from not granting credit constitute the opportunity cost which decrease when the amounts of receivables are increased.

Firms that are efficient in receivables management should determine their optimal credit which minimizes the total costs of granting credit (Ross et al., 2008). As observed by Michalski (2007) in his study, an increase in the level of accounts receivables in a firm increases both the net working capital and the costs of holding and managing accounts receivables and both lead to a decrease in the value of the firm. A study by Lazaridis and Dimitrios (2005) found out that firms who pursue increase in their accounts receivables to an optimal level increase their profitability resulting from increase sales and market share.

A study by Juan and Martinez (2002) emphasized that firms can create value by reducing their number of days of accounts receivable, thus confirmed the finding of Deloof (2003) who established that the length of receivables collection period has a negative effect on a firm's performance. A study by Sushma and Bhupesh (2007) also affirmed that, putting in place a sound credit policy ensures proper debt collection procedures and is pivotal in improving efficiency in receivables management hence the performance of firms.

## Literature Review

Lazaridis and Tryfonidis (2006) conducted a cross sectional study by using a sample of 131 firms listed on the Athens Stock Exchange for the period of 2001 - 2004 and found statistically significant relationship between profitability, measured through gross operating profit, and the cash conversion cycle and its components (accounts receivables, accounts payables, and inventory) found out that firms who pursue increase in their accounts receivables to an optimal level increase their profitability resulting from increase sales and market share.

Mathuva (2009) studied the impact of working capital management on the performance. He took almost 30 listed firms as a sample and all these companies were listed in Nairobi stock exchange and the data was taken from 1993 to 2008. There were certain findings of his research by analyzing the fixed effects regression models. Firstly, there is a negative relationship between the time when the cash is collected from the customers and the firm's productivity. This depicts, firms that are more profitable enjoys less time period for the collection of cash from the customers as compare to ones which are less profitable.

Deloof (2003) used a sample of 1009 large Belgian non-financial firms for a period of 1992-1996. He used correlation and regression analysis and found a significant negative relation between gross operating income and the collection period of accounts receivable, average days in inventories and accounts payable of Belgian firms. These results suggest that managers can create value for shareholders by reducing collection period of accounts receivable and average days in inventories to a reasonable minimum.

Another attempt to explore the relationship between the variables of Working Capital Management and Profitability was made by Haitham Nobanee and Maryam AlHajjar. Their analysis was based on a sample containing 2123 Japanese non-financial firms listed in the Tokyo Stock Exchange for the period from 1990 to 2004. The authors, after analyzing the results, suggested that Japanese firms should focus on shortening their Receivable Collection Period, Inventory Conversion Period and Cash Conversion Cycle to enhance profitability. Lengthening the Payable Deferral Period could also add to profitability, they argued. However, they deemed the over lengthening of the Payable Deferral Period to be equally risky as it could harm the firm's credibility and credit reputation in the long run.

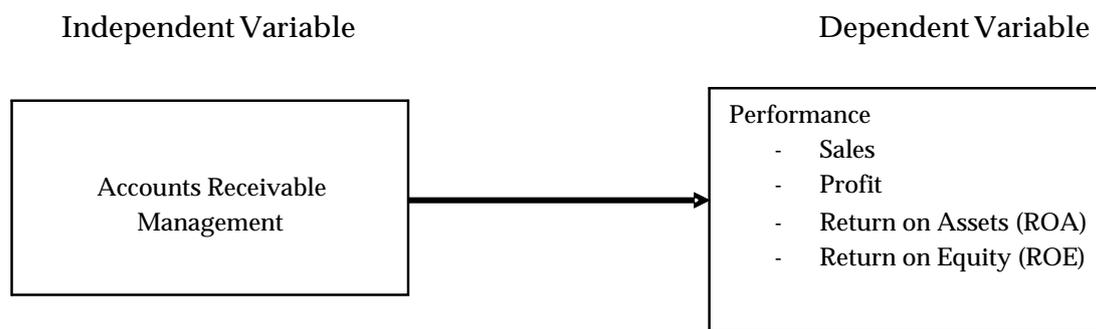
Christopher and Kamalavalli investigated the influence of the management of working capital on the profitability of Indian Corporate Hospitals by taking a sample of 14 out of the fifty one listed corporate hospitals in India using panel data analysis for the period 1996-97 to 2005-06. The results of their analysis depicted that Inventory Turnover ratio, Debtors Turnover ratio and Working Capital Turnover were positively related with the Return on Investment, a variable used for the measurement of a firm's profitability.

Padachi (2006) uses a set of 58 small manufacturing firms in Mauritius with 340 firm-year observations from 1998 to 2003. The study confirms that firms with more receivables and higher levels of inventory are less profitable. The author conducts a comparative analysis of five major industry groups, and asserts that working capital has a negative correlation

with ROA. The study concludes that the efficient management of working capital increases profitability.

### Conceptual Framework

Accounts Payable Management has been identified as independent variable while performance which include (profitability, growth in sales, return on assets and return on equity) of the small and medium enterprises (SMEs) was the dependent variable. A good accounts payable management indicates proper working capital management also, meaning that an optimum accounts payable management finally leads to higher performance in small and medium enterprises.



### Methodology

The research used both qualitative and quantitative tools for analyzing data. In effect the research was carried out by employing data collection techniques including questioners and interviews as advocated by Curran and Blackburn (2001) where they averred that a single study may use qualitative and quantitative techniques and procedures as well as primary and secondary data. The data were analyzed using descriptive statistics: weighted average and mean. Regression Analysis which indicate the impact of Accounts Payable Management on Performance and Correlation analysis which shows the relationship between the variables (accounts payable management and performance) were also used.

Performance model adopted for this were as summarized below:-

$FP = \beta_0 + \beta_{1RM} + e$  where  $\beta_0$  and  $\beta_{1RM}$  are coefficient and  $e$ =Error Variable.  $RM$ =Receivable Management  $P$ =Performance

### Results and Discussions

Table 4.5 shows that 32.4% of the respondents stated that they monitor the period within which investment of receivable remains while 67.6% stated that they do not monitor the period of the investment in accounts receivable. This is not surprising though considering the finding from the responses received on the policy and optimum questions which could be attributed to non credit sales by majority of SMEs and thus, supporting the view expressed by Finau (2011) that credit sales can create cash flow problems because they delay the receipt of cash the business needs to meet its financial obligations. All credit customers who pay late or do not pay at all only exacerbate the problem. Reduction in

money tied up in receivables, by reducing credit to customers result in their patronizing the firm's competitors. Cost of firm's investments in receivables is the interest that would have been earned if customers had paid up quickly or interest paid on finance borrowed to acquire the current assets. The firm also forgoes interest of investing such in marketable securities Nwidobie (2012).

Table 1.1 Descriptive analyses of the items in the questionnaire

Item	No		Yes		Average	Average response
	F	%	F	%		
Does your firm have account receivable management policy?	111	59.8	75	40.2	.4020	No
Is the periodicity of account receivable being monitored?	126	67.6	60	32.4	.3235	No
Is optimum account receivable management being achieved?	111	59.8	75	40.2	.4020	No

Sections 1.1 to 1.3 present findings on each of the specific question which was used in obtaining information on this variable.

#### Accounts Receivable Management Policy

Kelly & McGowen, (2010); Lo, Yeung, & Cheng, (2009); Zietlow et al., (2007) averred that the main objective of Account receivables management is to minimize the time-lapse between completion of sales and receipt of payment. In order to significantly increase sales for a business, the customers should be given credit transaction policy. At the same time, the cash budget must show that credit sales create trenced cash flow otherwise it would create cash flow problems if they delay the receipt of cash to meet its financial obligations.

Table 4.9 shows that 40.2% of the respondents have Account Receivable Management policy while 59.8% said they do not have the policy in place. The finding suggest that the SMEs averagely have the account receivable management policy and does not fully represent the view of Nwidobie (2011) that, debtor management identifies appropriate credit policy i.e. credit terms which will attract customers, such that any impact on cash flows and the cash conversion cycle will be offset by increased revenue and hence return on capital. It is however in agreement with the empirical finding of Nyabwanga et al (2012), which revealed that selling products on credit was averagely practiced for SSEs in Kisii South District which also suggest that the low use of credit sales can be attributed to lack of sound credit policies since majority (56 SSEs representing 60% of all SSEs) seem not to set credit guidelines for their credit customers.

#### Monitoring Account Receivable Period

Brealey and Myers (1996) argued that, investment in account receivable is determined by the firm's credit policy therefore, the longer the credit period given to a customer, the higher will be its investments in accounts receivables.

Table 4.9 shows that 32.4% of the respondents stated that they monitor the period within which investment of receivable remains while 67.6% stated that they do not monitor the period of the investment in accounts receivable. This is not surprising though considering the finding from the responses received on the policy and optimum questions which could be attributed to non credit sales by majority of SMEs and thus, supporting the view expressed by Finau (2011) that credit sales can create cash flow problems because they delay the receipt of cash the business needs to meet its financial obligations. All credit customers who pay late or do not pay at all only exacerbate the problem.

Reduction in money tied up in receivables, by reducing credit to customers result in their patronizing the firm's competitors. Cost of firm's investments in receivables is the interest that would have been earned if customers had paid up quickly or interest paid on finance borrowed to acquire the current assets. The firm also forgoes interest of investing such in marketable securities Nwidobie (2012)

Whether Optimality being Achieved.

Investments in customer credit in the form of accounts receivables and inventories of goods or materials are long-term resource commitments. Minimization of these investments relative to the level and pattern of a firm's operation is crucial in the total management of operating funds. Similarly, extending normal credit to marginal customers need to be carefully assessed in terms of risk of delayed payments or default, compared with contribution from sales gained.

Table 1.1 showed that 40.2% of respondents stated that they achieved optimum management of their accounts receivable while 59.8% stated a no answer to the question and this could be attributed to the reasons adduced in the questions posed in the policy and monitoring section of this variable. The findings here is in contrast to the views expressed by Pandey (2004) that provision of trade credit is normally used by business as a marketing strategy to expand or maintain sales.

The finding is also in contrast to the views of Ross et al. (2008) that efficient receivables augmented by a shortened creditors collection period, low levels of bad debts and a sound credit policy often improves the businesses ability to attract new customers and accordingly increase financial performance hence the need for a sound credit policy that will ensure that SSEs value is optimized. It is also at variance with the empirical study of the fortune 500s financial management practices, conducted by Gilbert and Reichert (1995) in which they found that account receivable management models are used in 59% of these firms to improve WCM projects.

Regression analysis for Accounts Receivable Management

Regression Analysis was carried out on Accounts Receivable Management via hypothesis 4 below to determine whether the independent variable can be relied on in explaining the change in the dependent variable, performance of Small and Medium Enterprise (SMEs) in Nigeria.

Hypothesis 4: the null hypothesis that working capital management (Accounts receivable) does not have a significant effect on the performance of Small and Medium Enterprises in Nigeria is tested at 5% level of significant using linear regression analysis

Table 4.12: Table of regression analysis

Model	Coefficients <sup>a</sup>				T	Sig.
	Unstandardized Coefficients		Standardized Coefficients			
	B	Std. Error	Beta			
	(Constant)	82.306	4.790		17.182	.000
1	Account Receivable Management	19.397	9.089	.209	2.134	.035

a. Dependent Variable: Performance of SME,  $R^2 = .044$ ,  $R = 0.210$

$$Y = 82.306 + 19.397 * x$$

The above analysis shows that the value of the correlation  $R = 0.210$ , implying that there is 21% linear relationship between the working capital (account receivable) management and performance of SME, the p-value (0.035) of the slope of the regression model is less than 0.05 we therefore reject  $H_0$  and conclude that working capital management (account receivable) have a significant effect on the performance of Small and Medium Enterprises in Nigeria. The value of R-square (0.044) implies that 4.4% of the performance of SMEs in Nigeria is determined by the working capital management (accounts receivable) and that accounts receivable management can explain up to 4.4% of the change in performance.

The p-value (0.035) of the slope of the regression model is less than 0.05 we therefore reject  $H_0$  and conclude that working capital management (Accounts Receivable) have a significant effect on the performance of Small and Medium Enterprises in Nigeria. This also means that at 5% level of significance or 95% level of confidence, Receivable Management plays a significant role in the performance of Small and Medium Enterprises in Nigeria and that the model is statistically significant in explaining the change in the dependent variable (performance) considering that the *P-value* is less than .05 at the 95% level of confidence.

The above finding concurred with the views of Joshi (2000) who indicated that the primary objective of investment in trade debtor is to increase profit by expanding sales to attract new customers and retain old customers and so, by constantly increasing its sales and profit the business carves out a bigger niche in the market and elevates its status among competitors. This view is supported by Deloof (2000) who averred that, Corporations can have a best possible amount of working capital that leads to their value maximization. Deloof (2003) further added that, maintaining a huge inventory, readily granting credit to customers, and being willing to wait a longer time to receive payment

may result in higher sales.

The findings are further supported by the views of Pandey, (2004) Ross et al., (2008) who posits that, provision of trade credit is normally used by businesses as a marketing strategy to expand or maintain sales and efficient receivables management augmented by a shortened creditor's collection period, low levels of bad debts and a sound credit policy often improves the businesses' ability to attract new customers and accordingly increase financial performance hence the need for a sound credit policy that will ensure that SSEs' value is optimized and that lost sales resulting from not granting credit constitutes the opportunity cost which decreases when the amount of receivable are increased and further stating that firms that are efficient in receivables management should determine their optimal credit which minimizes the total costs of granting credit. An empirical study by Lazaridis and Dimitrios (2005); Juan and Martinez (2002) Sushma and Bhupesh (2007) who found out that firms who pursue increase in their accounts receivables to an optimal level increase their profitability resulting from increase sales and market share, that firms can create value by reducing their number of days of accounts receivable and that, putting in place a sound credit policy ensures proper debt collection procedures and is pivotal in improving efficiency in receivables management hence the performance which all showed the significance of accounts receivable to performance are in agreement with the findings of this study.

The findings also concurred with study of Lazaridis and Tryfonidis (2006) who conducted a cross sectional study by using a sample of 131 firms listed on the Athens Stock Exchange for the period of 2001 - 2004 and found statistically significant relationship between profitability, measured through gross operating profit, and working capital and its components (accounts receivables, accounts payables, and inventory) found out that firms who pursue increase in their accounts receivables to an optimal level increase their profitability resulting from increase sales and market share and that of Mathuva (2009) on a sample of 30 firms listed in Nairobi stock exchange on data taken from 1993 to 2008 which depicts that, firms that are more profitable enjoys less time period for the collection of cash from the customers as compared to ones which are less profitable.

The finding however, negates that of Deloof (2003) who used a sample of 1009 large Belgian non-financial firms for a period of 1992-1996. He used correlation and regression analysis and found a significant negative relation between gross operating income and the collection period of accounts receivable, average days in inventories and accounts payable of Belgian firms suggesting that managers can create value for shareholders by reducing collection period of accounts receivable and average days in inventories to a reasonable minimum. Considering the value of R-square (0.044) which implies that 4.4% of the performance of SMEs in Nigeria is determined by the working capital management (accounts receivable), this study, therefore, established that there is need to implement sound accounts receivable management policies and monitoring system by managers of SMEs in Nigeria so as to achieve optimum results.

## Summary

The study of this component of working capital revealed that less than 50% of the respondents which is 40.2% and 32.4% for accounts receivable policy and accounts receivable monitoring respectively stated the yes answer while 40.2% answered yes to achieving optimum level of managing accounts receivable indicating that only few of the SMEs monitor the management of their accounts receivables which falls in line with the empirical evidence of Nyabwaga et al (2012), which revealed that selling products on credit was averagely practiced for SSEs in Kisii South District which also suggest that the low use of credit sales can be attributed to the lack of sound credit policies since majority (56 SSEs representing 60% of all SSEs) seem not to set credit guidelines for their credit customers.

The study revealed from the analyzed data, a 21% linear relationship between the working capital (account receivable) management and performance of SMEs, with the value of R-square (0.044) implies that 4.4% of the performance of SMEs in Nigeria is determined by the working capital management (accounts receivable) also suggesting that cash management can explain up to 4.4% of the change in performance of SMEs in Nigeria.

Analysis of data in this study also showed the p-value (0.035) of the slope of the regression model is less than 0.05 indicating that working capital management (Accounts Receivable) has a significant effect on the performance of Small and Medium Enterprises in Nigeria and that at 5% level of significance or 95% level of confidence, Receivable Management plays a significant role in the performance of Small and Medium Enterprises also implying that the model is statistically significant in explaining the change in the dependent variable (performance), and this concurred with an empirical study by Lazaridis and Tryfonidis (2006); who found statistically significant relationship between profitability, measured through gross operating profit, and the cash conversion cycle and accounts payables, among other components of working capital management. Considering the value of R-square (0.044) which implies that 4.4% of the performance of SMEs in Nigeria is determined by the working capital management (accounts receivable), this study, therefore, established that there is need to implement sound accounts receivable management so as to achieve optimum results.

## Conclusion

Sales on credit are inevitable necessity in the business world today as most of the transactions are done on credit. Accounts receivables consist of the credit a business grants its customers when selling goods or services which take the form of either trade credit which the company extends to other companies or consumer credit, which the company extends to its ultimate consumers and so the effectiveness of company's credit policies can have a significant impact on its total performance. The primary objective of investment in trade debtor is to increase profit by expanding sales to attract new customers and retain old customers. By constantly increasing its sales and profit the business carves out a bigger niche in the market and elevates its status among competitors. In determining an optimal credit extension scholars have argued that,

company's financial managers must consider a number of major controllable variables that can be used to alter the level of receivables which include credit standards, credit terms and collection effort. Credit standards are the criteria a company uses to screen applicants in order to determine which of its customers should be offered credit and how much. The process of setting credit standards allows the firms to exercise some degree of control over the "quality" of accounts accepted. The quality of credit extended to customers is a multidimensional concept involving the time a customer takes to repay credit obligation, given that it is repaid and the probability that a customer will fail to repay the credit extended to them.

A business should have a rational for collection of receivables. Collection policy can be tight policy which ensures better collection, fewer instances of bad debt but high collection costs. It may, however, antagonize the customers and some of them may switch to competitors. A liberal collection policy will have opposite effect. The collection effort consist of the methods a business employs in attempting to collect payment of past-due accounts. The literature related to credit policy is quite extensive. It is essential that companies spell out clearly and precisely the credit policy directions in writing in the general interest of the organization. Provision of trade credit is normally used by businesses as a marketing strategy to expand or maintain sales. Efficient receivables management augmented by a shortened creditor's collection period, low levels of bad debts and a sound credit policy often improves the businesses' ability to attract new customers and accordingly increase financial performance hence the need for a sound credit policy that will ensure that MSEs' value is optimized. Lost sales resulting from not granting credit constitute the opportunity cost which decrease when the amounts of receivables are increased. Firms that are efficient in receivables management should determine their optimal credit which minimizes the total costs of granting credit. An increase in the level of accounts receivables in a firm increases both the net working capital and the costs of holding and managing accounts receivables and both lead to a decrease in the value of the firm. Firms who pursue increase in their accounts receivables to an optimal level increase their profitability resulting from increase sales and market share.

### Recommendations

Analysis of the results of this study shows that not a majority of the respondents which represents 40.2 and 32.4% for accounts receivable policy and accounts receivable monitoring respectively stated the yes answer while 40.2% answered yes to achieving optimum level of managing accounts payable indicating that only few of the SMEs monitor the management of their accounts receivables. With regression and correlation analysis showing  $R = 0.210$  or 21% p-value (0.035) of the slope of the regression model is less than 0.05 and R-square (0.044) even though positive is not that very encouraging.

In view of the above factors therefore, more of SMEs are encouraged to set up account receivable policies, and monitor same for more positive results. This can be done by instituting more and elaborate credit terms, establishing credit standards and deciding upon appropriate collection policies. Under the collections process accounts receivable

should be followed up promptly and regularly. Alternative payment options are recommended to be simple and costless such as issuing of cheques or electronic funds and adoption of the aggressive policy of debtors' collection process to also include the five main credits selection techniques as standards for both small and medium enterprises such as character, capacity, capital, collateral and conditions of debtors as suggested by Gitman (2009).

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