

Working Capital as a Panacea for Profitability of Companies: A Conceptual Paper

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Abstract

Profitability is the bedrock for the survival of organizations that are profit oriented. Organizations need to properly manage their components of working capital in order to be profitable. This paper through the review of literature explores the relationship between working capital management and profitability. The findings from the relevant literature suggest conflicting results on the impact of working capital management on the profitability of companies. Whereas the majority of the literature portrays a positive relationship, few others provide the opposite. Hence, the paper recommends more research into the area to further unearth the field.

Keywords: *Profitability, Working capital, Management, Companies*

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Background to the Study

Proliferations of business activities is essential for the well-being of nation. Private companies are set up with the motive of making profits. Profit is an excess of revenues over expenses for an activity over a period of time. Olaoye, Adekanbi and Oluwadare (2019) see profit as a process that signifies how working capital is successfully managed. The main goal of every organization is to maximize profit (Adamu, 2018). Choong (2011), states that Profitability is the most important block for assessing the efficiency of assets and success of the company for the continual operation in the long run. Profitability is the rate of return on investment. it is a primary goal of a company to make a profit, without it the panacea company could not survive in a foreseeable future (Husain & Alnefaee, 2016; Ponsian, Chrispina, Tago and Mkiibi, 2014; Khalid, Saif, Gondal and Sarfraz 2018). Profitability is the most important activity in the company, where a company is unable to earn a profit the business will collapse. While if a company is able to use the resources efficiently it will lead to profitability. (Philip, 2015).

Capital is an asset or money used or to be use in a productive way (Misbah, Anjum, Aqdas, Marwat & Muhammad 2015). Omo (2011) stated that Working Capital (WC) is an essential part of the investment in a company which is necessary for endless operation of cash used by the company for daily expenses. WC is a fund needed for the day to day operations of the company (Misbah et al. 2015). WC represents the available resources of a company that changes from one type of resources to another during day-to-day operation of the company (Omo, 2011). Saarani, and Shahadan, (2014), observe that a degree of an optimal working capital is when a balance between the risk and efficiency is reached, and to reduce the opportunity cost and carrying cost, a regular checking to keep appropriate level components of working capital. Every company must keep adequate working capital for running daily activities (Osundina, 2014).

Working capital management (WCM) is a management of short term liabilities and short term assets (Adamu, 2018). The main objective of working capital management is to maintain an optimal balance between each of the working capital components, such as receivables, inventory and payables- and using the cash efficiently for daily routine (Famil & Ali, 2016). Bagh, et al (2016), stated that important part is managing working capital since it influences both liquidity and profitability of the company. Mbawuni, Hawa, and Gyasi (2016), opined that a company have to keep optimum working capital for being in existence, appropriate management of working capital enabled company to grow, which would lead to owner's funds maximization. Effectiveness management of working capital resulted to a companies' profitability (Omo, 2011).

The significance of working capital management in enhancing a firm's profitability cannot be overemphasized. This emphasis is justified thus; First, the creation of stockholders' equity greatly depends on how efficiently and effectively a firm manages its working capital (Dong & Su, 2010). Second, given that “working capital management seeks to maintain an optimum balance of each working capital component thereby ensuring that firms operate with sufficient fund (cash flows) that will service their long-term debt and satisfy both maturing short-term obligations and upcoming operational expenses” (Qazi et al., 2011).

Working capital management is very important for the survival of a business. Companies have to manage the components of working capital, and by keeping an optimal level of working capital in order to maximize profit, which resulted in profitability. In view of the foregoing, this paper examines the relationship between working capital and profitability of companies from the review of literature in the subject area. Therefore, the paper is structured in four parts. Section one, reflecting current portion covers the introductory aspects. The second portion deals with the review of relevant literature. Related concepts are highlighted in this section. The third section dwells on the empirical review on the variables concerned. Lastly, a conclusion was drawn from the previous sections covered.

Literature Review

i. The Concept of Profit

Profit is a basic plan of organization to carryout designed policies and activities to achieved objectives (Olaoye, et al. 2019). The main goal of every organization is to maximize profit (Adamu, 2018). Profit maximization is the main goal of any organization (Puspa, 2019). Profit is money earned in trade or business after the expenses costs (Cambridge Advance Learners Dictionary, 2019). According to Egvide (as cited in osundina, 2014), profit is the surplus of income generated by a firm over cost that generated within accounting period. 2014). According to Collins Dictionary (2010), defines profit as an amount of money to be gain when more paid on cost or a monetary gain derived from a transaction. Thus Profit is a difference between the purchase price and the costs price, or it is the difference between the revenues and expenses over a period of time.

ii. Profitability

Profitability is the most important block for assessing the efficiency of assets and success of the company for the continual operation in the long run (Choong, 2011). Philip (2015), see profitability as the most important activity in the company, and if a company is unable to earn a profit the business will collapse, if the resources used efficiently it will lead to profitability. according to Uguru, Chukwu and Elom (2018), Profitability is a company's determination and depend on how working capital managed. By reviewing the literature profit maximization is the most important objective and the main goal of every company to be achieve, also profitability is the primary goal of a company, without it the company could not survive in a long run. Where a company should earn a profit to survive over a long period of time. Profitability is the amount of money charge or paid on investment return. Company would be assessing based on how their resources are managed efficiently, effectively in order to earn a profit which would leads to profitability.

iii. Working Capital

Working capital (WC) is basically the needed part of asset by a company in current operations (Omo, 2011; Osundina, 2014; Akindele & Odusina, 2015). Hadri, and Ahmad (2018), state that working capital is the complete funding by the company in current assets within accounting year. WC is the excess of current assets over current liabilities (Almazari, 2013; Agbi & Yusuf 2017; & James et al nd). Acceptable WC enhances the operational performance of a company thereby assuring it survival while its inadequacy can harm the continual

existence of it. (Okoye, Olayinka, Modebe, & Achugamonu, et al 2015) working capital can damage the survival and growth of the company (Mathuva, 2010). Without proper working capital it is not easy to run the activities of a company in a smooth way. (Ponsian, et al. et al 2014; Bagh et al. 2016; & Sadaf, 2016), observed that Companies have to keep an optimal level of working capital that will increases their value. (Almazari 2013; & Osundina 2014). Having adequate working capital level is essential and serves in adding value to the company in the form of risk reduction and performance improvement (Akindele & Odusina, 2015).

Gross Working Capital is the investment in current assets (Akindele & Odusina, 2015; Husain & Alnefaee, 2016; Ahm Yeaseen, Mohammad, Sabiha, & Kaysher 2018). Where Net Working Capital is the difference between current assets and current liabilities (Akindele & Odusina, 2015; Husain & Alnefaee, 2016; Ahm Yeaseen, Mohammad, Sabiha, & Kaysher 2018). A Positive Working Capital demonstrates the capability of the company to settle its short term obligations as at when due (Kioko, & Sitienei 2015). While Negative Working Capital signifies the inability of a company to settle its short term obligations (Kioko, & Sitienei 2015). It was also witnessed that the performance could increase by increasing the effectiveness of the working capital (Karaduman, Akbas, Caliskan, & Durer, 2011).

iv. Working Capital Management

Working capital management (WCM) is the administration of current assets and current liabilities, (Tirngo, 2013; Owolabi & Alayemi, nd), WCM is a short term investments and financing in current assets and current liabilities collectively (Mathuva, 2010). The management of working capital is concerned with managing the different elements of current assets (inventories, debtors/receivables, cash/bank, short-term investments, prepaid expenses) and current liabilities (creditors/payables, provision for tax, other provisions against the liabilities payable within a period of one year) (Osundina, 2014; Akindele & Odusina, 2015). For a company to be efficient, it must keep its working capital at optimum level. It must neither have excess nor shortage (Osundina, 2014; Akindele & Odusina, 2015). Management of Working Capital directly effects the liquidity and profitability of the company (Almazari, 2013; & Tirngo, 2013). Omo (2011), proved that the main aim of Working capital management is to sustain a reasonable level of cash inflows and cash outflows, that will create tradeoff between each element of working capital (Bagh et, al. 2016). Without maintaining the balance between the element it is impossible for the company to operate in appropriate way. The effective management of working capital operation of a company in a smooth way is described as significant as well as most valuable factor Bagh et, al. 2016).

Empirical Review

Amarjit et al (2010), investigated the relationship between working capital management and profitability. of 88 American firms listed on New York Stock Exchange for 3years from 2005 to 2007, and found a statistically significant relationship between the cash conversion cycle and profitability. Almazari, (2013), Examine the Relationship between Working Capital Management and Profitability on Saudi cement companies for 2008 2012, and establishes a significant negative relationship with PAY, CCC, INV, Mathuva (2010), examined the

influence of working capital management on corporate profitability on 30 firms listed on Nairobi Stock Exchange (NSE) for 1993-2008 which shows a significant negative relationship between ACP and profitability, while positive relationship with ITD, APP and profitability.

Napompech (2012), studied the influence of working capital management upon corporate profitability using 255 companies listed on the European Stock Exchange for a 3 years 2007 to 2009. relationship between OP, ITP, RTO, AP shows no any effect on profitability. Ponsian et al. (2014), examine the statistical significance between company's working capital management and profitability using three manufacturing companies listed on the Dar es Salam Stock Exchange (DSE) from 2002 to 2011, found a positive relationship between CCC, APP and profitability, negative relationship between liquidity ACP, ITD and profitability, a highly significant negative relationship between average collection period and profitability. Raheman, Afza, Qayyum and Bodla (2010), analyzed the impact of working capital management on firm's performance for 1998 to 2007, results indicate that CCC, NTC, ITD significantly affects the performance of the firms.

While financial leverage, sales growth and firm size significant effects profitability. Husain & Alnefae (2016), examined the statistical significance of the impact of working capital management on profitability of listed agriculture and food companies of Saudi Arabia, for 6 years from 2009-2014 GOP, ACP, APP, ITD and CCC revealed that there is no significant impact on profitability. There is a negative relationship between GOP with APP, ITD and CCC. At the same found a positive relationship between GOP and APC. Misbah et al (2015), conducted a study and shows that DAR, DI, DAP, CCC and CR are highly significant and negatively affected to the profitability. Mbawuni et al. (2016), examined the impact of working capital management (WCM) on profitability for six-years from 2008-2013, the results show a favorable net working capital for the firms and a favorable networking capital to total assets ratio. ADP drives the firm's profitability, CCC, ADI, and ADR did not have significant relationship with profitability. Tirngo (2013) examines the impact of working capital management on performance of Ethiopian MSEs, which established a strong positive relationship between DAP on ROA. Where, DAR, DIT and CCC have a significant negative impact on ROA.

Conclusion

There is no doubt that the ultimate objective of any firm is to maximize profit. By reviewing the literatures of working capital management and profitability. Some of the findings were made invariably, where some revealed a positive result with profitability while some a negative result. Due to different environments and methodology. The company can create value by reducing inventories to a reasonable level since the profitability increases as ITD decreases. When the ITD increases, storage costs will increase for keeping the inventory. And when ACP reduces, profitability of the companies will be increases, as ACP increases, bad debt also increases which results to reduction in profitability. By increasing APP will give additional profitability. Effective and efficient utilization of the resources of the company through increasing the cash conversion cycle. In so doing, the profitability of the company is expected to increase, for proper managing their cash, accounts receivables, inventories, and account payable. In order to manage working capital efficiently, company has to be aware of how long it takes them, on average, to convert their goods and services into cash.

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