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Impact of working capital management on the profitability of smes through cash operation cycles in Kumasi

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A business ought to be able to breed an adequate amount of cash and cash equivalent to meet its short-term liabilities if it is to carry on and develop in business. For that reason, working capital management which helps an entity to, efficiently and effectively manage current assets and liabilities is a key factor in the company's long-term success; without working capital, the non- current assets will not function. The better the degree to which current assets exceed current liability, the more solvent or liquid a company is likely to be.

This paper observes the relationship between working capital management practices of small and medium enterprises (SMEs) and the performance and profitability of these businesses in the Kumasi Metropolis distinctively Asafo, to evaluate key ratios of industries of such working capital management policies in ensuring that current assets meets current liabilities, to assess the degree to which management of SMEs are dedicated to the effective and efficient management of working capital. The implication of the findings is that the government of Ghana should pursue policies aimed at encouraging training and improving the managerial skills of SME owner/managers as well as creating the enabling environment for the development of improved modern technologies to transform the business processes of these vital industries.

Keywords: small medium enterprises, working capital, profitability Ghana

1. Background of the study

An organization`s financial performance has usually been measured with its ability to gain surplus revenue over expenditure or profit for the period. In most performance standards, a successful organization is usually deemed as the one with the higher profit (or profit on capital employed ratio).

Simply generating profit cannot be the only motive for engaging in business activities as profit in itself does not guarantee the availability of liquid resources to finance further business operations. Considering that revenue and profits can be recognized as earned when cash has not yet been received, companies may record high profits and still have to contend with liquidity problems in the form of inability to provide cash and cash equivalents to finance operating activities. This has created the awareness of the need for organizations to adopt policies and programmed toward the management of their working capital since the organizations‟ success of both long and short term decisions depend on it.

Long-term investment and financing decisions give rise to future cash flow which, when discounted by an appropriate cost of capital, determine the market value of a company. However, such long-term decisions will only result in the expected benefits for a company if attention is also paid to short-term decisions regarding current assets and liabilities. Current assets and liabilities, that is, assets and liabilities with maturities of less than one year, need to be carefully managed (Watson–Head 2016).

Several indicators have shown that working capital management plays a pivotal role in keeping the wheels of a business enterprise running (Kishore 2008). By definition, working capital management refers to all management decisions and actions that influence the size and effectiveness of the working capital. It is that portion of a firm`s capital invested in short term or current assets to carry on its day to day operations smoothly (Kishore 2008). It emphasizes the management of currents assets, current liability and the relationships that exist between them. In other words, working capital management may be defined as the management of firm`s liquid assets that is cash, account receivable, market securities and inventories and its current liabilities such as accounts payable, outstanding expenses, short term borrowings among others (Chowdhury–Amin 2007). The requirement of working capital varies from firm to firm depending upon the nature of business, production policy, market conditions, seasonality of operations, conditions of supply etc. (Kishore 2008).

Working capital which considers the ability of an organization to meet its current liabilities (trade creditors, short term loan, expenses owing) with its current assets(cash, bank, debtors and stock) by measuring its liquidity in the form of current and acid test ratios will need to be managed for the success of the company.

To prevent liquidation or bankruptcy, most companies have taken various policies like just-in-time stock policies, investing surplus cash, credit control system, factoring, buffer stock and lead time policies, credit analysis system, invoice discounting, debtor collection system and others. Many of the recent cases of Small and Medium Scale Enterprises collapse might have been avoided if owners/managers had been in a position to interpret the early signs of collapse. Existing financial models provide some indication of how to avoid failure, but these need to be supplemented by a holistic, strategic management approach (Buttery–Shadur 1991).

The working capital cycle of a business can either gobble up more than its fair share of cash or it can be managed as an efficient cash flow system. If managed, it can become one of the company's most significant competitive advantages (Kaufman 2009).

This study therefore seeks to assess the impact of working capital on the profitability of Small and Medium Scale Enterprises within the Kumasi Metropolises by using Cash Operation Cycle. Working Capital Management is therefore necessary for the success of any organization and must not be underestimated in meeting long-term corporate goals.

2. Literature Review

This chapter discusses and reviews existing literature on the subject matter from a general perspective. A lot of studies have been conducted on the subject of working capital management and small and medium sized enterprises (SMEs) on the international as well as national levels but not necessary in the study area. Hence, the review of this subject is based on literature by both foreign researchers and local ones.

There are a lot of factors that are considered in relation to working capital management; Definition, Management of Inventories, Management of Debtors, Management of Cash, Management of Trade Payables, Objectives of Working Capital Management, Level of Working Capital, Short-term Finance, Financing Working Capital, Cash Operating Cycle and Overtrading.

But this paper seems to focus on the use of Cash Operation Cycle. The chapter also looked at Definition, Role and Impact, and Challenges of SMEs as well as SMEs and Working Capital Management.

3. Working Capital Management

Working Capital Management is the functional area of finance that covers all the current accounts of the firm. It is concerned with the adequacy of current assets as well as the level of risk posed by current liabilities. It is a discipline that seeks proper policies for managing current assets and liabilities and practical techniques for maximizing the benefit from managing working capital (Hampton 2007).

Further, Working capital management is our ability to effectively and efficiently control current assets and current liabilities in a manner that will provide a firm with maximum return on its assets and will minimize payment for its liabilities (Adelman–Marks 2007).

According to Baghiyan (2013), "proper selection and management of working capital management policies can create competitive advantage" and brings about improved management of companies. However, these ratios have to be constantly reevaluated for each industry and situation given uncertainties in the business environment caused by political instability, weakening law and order, wars, technological developments, monetary shortage, food and energy crises and high business operational costs (Baghiyan 2013, Satish 2014). Furthermore, Satish (2014) noted the lack of current theories, models, and survey based studies in the area of WCM.

Working capital management is the administration of the firm`s current assets namely; cash and marketable securities, receivables, and inventory and the financing (especially current liabilities) needed to support these current assets (Horne–Wachowicz 2008). Again, it refers to all management decisions and actions that influence the size and effectiveness of the working capital.

Watson and Head 2007 identified that the level of current assets is a key factor in a company‟s liquidity position. A company must have or be able to generate enough cash to meet its short- term needs if it is to continue in business. Therefore, working capital management is a key factor in the company‟s long-term success: without the „oil‟ of working capital, the „engine‟ of fixed assets will not function. The greater the extent to which current assets exceed current liabilities, the more solvent or liquid a company is likely to be, depending on the nature of its current assets.

Management of associated cash inflows and outflows is the basic aim of managing each of the components. Selected solutions must result in acceptable cash flows, and also produce a return in excess of costs (Thachappilly 2009).

The major elements of current assets are: Stocks, Trade Debtors and Cash (in hand and at bank) whereas the major elements of current liabilities are Trade creditors and Bank overdraft (Atrill 2000)

According to Vishnani and Shah (2007), a company`s inventory management policy, debtors‟ management policy and creditors‟ management policy play an important role in its profitability performance. Managers should give due attention towards policy formulation in this regard as well as implementation of such working capital policies. From their findings, they advised managers to see for themselves the practices followed by their peers in the area of working capital management. Corporate value is enhanced when return on capital employed (ROCE), a function of working capital management, exceeds cost of capital, a function of capital investment decisions.

4. Management of Inventories

Firms can produce or purchase raw materials, they can also produce to meet order or produce in block. The costs of holding inventories must be set against its benefits. Money tied up in inventories does not earn interest; storage and insurance must be paid for; and there a risk of spillage or obsolescence. Therefore, production managers need to strike a sensible balance between the benefits of holding inventories and the costs (Brealey et al. 2006).

Given the large variety of products that are manufactured and marketed, and hundreds of different raw materials used by a company, accurate forecasting of inventory is very important for effective working capital management. A wrong forecast can lead to piles of inventory, thus blocking unnecessary investment and increasing storage cost as well as the risk of damage associated with perishable items (Ahuja–Sweta 2007).

According to Watson and Head, 2016, the benefits of holding stock must be weighed against any costs incurred. They identified the costs which may be incurred for holding stock as holding costs, replacement costs, the cost of the stock itself and the opportunity cost of cash tied up in stock. The economic order quantity, buffer stocks and lead times or a just-in-time policy must be adopted for effective and efficient management of stock.

5. Management of Cash

Cash management, which is part of the wider task of treasury management, is considered with optimizing the amount of cash available, maximizing the interest earned by spare funds not required immediately and reducing losses caused by delays in the transmission of funds. Companies need to hold cash for transactions motive, precautionary motive and speculative motive.

Although cash can be held for each of the reasons identified, it may not always be necessary to hold cash for these purposes. The decision as to how much a particular business should hold is influenced by the nature of the business, the opportunity cost of holding cash, the level of inflation, the availability of near- liquid assets, the availability of borrowing, the cost of borrowing, the economic conditions and the relationship with suppliers. According to Watson and Head (2016) and Atrill (2000) companies need to determine the optimum cash levels, solve cash flow problems, prepare cash budgets and manage cash flows by the use of cash flow forecast.

A cash flow forecast is a detailed forecast of cash inflows and outflows incorporating both revenue and capital items. A cash flow forecast is thus a statement in which estimated future cash receipts and payments are tabulated in such a way as to show the forecast cash balance of a business at defined intervals. A cash flow forecast shows the cash effect of all plans made within the flow of forecastary processes and also gives management an indication of potential problems that could arise and allows them the opportunity to take action to avoid such problems. A cash flow forecast can show four positions: short-term surplus, short-term deficits, long-term surplus and long-term deficits. The optimal cash holding levels can be calculated from formal models, such as the Baumol model and the Miller- Orr model (ACCA 2009).

6. Objectives of Working Capital Management

Working capital management is highly important in firms as it is used to generate further returns for the stakeholders. When working capital is managed improperly, allocating more than enough of it will render management non-efficient and reduce the benefits of short term investments. On the other hand, if working capital is too low, the company may miss a lot of profitable investment opportunities or suffer short term liquidity crisis, leading to degradation of company credit, as it cannot respond effectively to temporary capital requirements (Afza–Nazir 2008).

According to Gitman (2009) the objective of Working Capital Management (WCM) is to minimise the Cash Conversion Cycle (CCC) the amount of capital tied up in the firm's current assets. It focuses on controlling account receivables and their collection process, and managing the investment in inventory. Working capital management is vital for all business survival, sustainability and its direct impact on performance.

The two main objectives of working capital are to increase the profitability of a company and to ensure that it has sufficient liquidity to meet short term obligations as they fall due and so continue in business (Pass–Pike 1984).

Maintaining adequate working capital is not just important in the short term but adequate liquidity is needed to ensure the survival of the business in the long term. An excessively conservative approach to working capital management resulting in high level of cash holding will harm profit because the opportunity to make a return on the assets tied up as cash will have been missed. The two main objectives will often conflict as liquid assets give the lowest returns (ACCA 2009).

Profitability is related to the goal of shareholder wealth maximization, so investments in current assets should be made only if an acceptable return is obtained while liquidity is needed for a company to continue in business, a company may choose to hold more cash than is needed for operational or transaction needs, for example for precautionary and speculative reasons (Watson–Head 2007).

7. Level of Working Capital

There are three levels of working capital management; aggressive, conservative and moderate policy. A company‟s working capital policy can be characterized as aggressive, moderate or conservative only by comparing them with the working capital policies of similar companies.

An aggressive policy is where a company chooses to operate with lower levels of stock, debtors and cash as well as delaying payment to suppliers for a given level of activity or sales. This policy increases profitability since less cash will be tied up in current assets but will also increase risks since the possibility of cash shortages or stock outs is increased. A conservative policy is associated with maintaining a larger cash balance, offering more generous credit terms to customers and holding higher levels of stock. Suppliers are paid promptly to ensure their goodwill. Such a policy lowers risk of financial or stock problems but at the expense of reducing profitability. A moderate policy will tread a middle path between the aggressive and conservative approaches (ACCA 2009, Watson–Head 2007)

8. Cash Operating Cycle

The cash operating cycle is the period of time which elapses between the point at which cash begins to be expended on the production of a product and the collection of cash from a purchaser (ACCA 2009).

Figure 1 The Firm's Operating Cycle and Its Impact on the Firm's Balance Sheet

Source: http://www.drawpack.com

When managing cash it is important to be aware of the operating cash cycle of the business. The payment for goods acquired on credit occurs sometime after the goods have been purchased and, therefore, no immediate cash outflow arises from the purchase. Similarly, cash receipts from debtors will occur sometime after the sale is made and so there will be no immediate cash inflow as a result of the sale. The operating cash cycle is important because it has a significant influence on the financing requirements of the business. The longer the cash cycles the greater the financing requirements of the business and the greater the financial risks. For this reason, a business is likely to want to reduce the operating cash cycle to a minimum (Atrill 2000).

9. Overtrading

Overtrading (also called undercapitalization) occurs if a company is trying to support too large a volume a trade from too small a working capital base. Overtrading can arise in the early years of a new business if it starts off with insufficient capital (Watson–Head 2007). Overtrading happens when a business tries to do too much too quickly with too little long-term capital, so that it is trying to support too large a volume of trade with the capital resources at its disposal. Even if an overtrading business operates at a profit, it could easily run into serious trouble because it is short of money. Symptoms of overtrading are rapid increase in turnover, rapid increase in volume of current assets, small increase in proprietors‟ capital and some debt ratios and liquidity ratios alter dramatically (ACCA 2009).

According to Atrill (2000), overtrading usually reflects a poor level of financial control over the business. It results in liquidity problems such as exceeding borrowing limits, slow repayment of lenders and creditors, and so on. It can also result in suppliers withholding supplies, thereby making it difficult to meet customer needs. A business may collapse because it cannot meet its maturing obligations.

10. The Concept of Small and Medium Scale Enterprises (SMEs) Introduced

The term SME covers a assorted group of businesses in a developing economy, ranging from a single artisan working in a small shop making handicrafts for a village market to sophisticated engineering firms selling in overseas markets (Reuber–Fischer 2003).

There are various criteria to distinguish an SME from a large firm. According to (Wignaraja 2003) three possible criteria are: the number of employees, the value of sales and the value of production equipment. Each of these can be useful depending on the purpose at hand. Although the definition varies between developing countries, SMEs are commonly defined by employment because it is readily available. Setting a cut-off point between an SME and a large firm is difficult and can vary depending on the level of development, the structure of an economy, sectoral characteristics and the nature of given production technologies. Ultimately, it becomes a matter of judgment as to what is appropriate to the specific context.

According to Hussain (2000) SMEs have been defined according to size, turnover, activity, ownership and legal status. There is, however, an emerging consensus that size (i.e., number of employees) may be the most appropriate defining characteristic, given the heterogeneity of enterprises operating in this sector. SMEs may, therefore, be defined as firms employing less than 100 employees while entities with less than ten employees are categorized as micro-enterprises (MEs).

Although this sector has not been largely enumerated, available estimates suggest that SMEs account for roughly 60 percent of the workforce and 25 percent of industrial output in value terms in Africa. Wynarczyk et al (1993) identified the other characteristics of the small firm than size. They argued that there are three ways of differentiating between small and large firms. The small firm has to deal with:

(a) Uncertainty associated with being a price taker;
(b) Limited customer and product base;
(c) Uncertainty associated with greater diversity of objectives as compared with large firms.

11. SMEs Internationally Defined

UNIDO (1983) considers the number of employees as the sole yardstick for determining an SME. According to their definition for developing countries, medium firms are firms with an employee size between the range of 20 and 99. Small firms, on the other hand, covers firms with employee size of between 5 and 19 while micro firms employ less than 5 workers (Elaian 1996).

The USAID, on the other hand, did not consider fixed assets in their definition. In the 1990s, they described Small and Medium Scale Enterprises as firms with less than 50 employees and at least half the output sold (Kayanula–Quartey 2000).

The European Commission in 2005 in their definition qualifies enterprises as micro, small and medium-sized enterprises (SMEs) if they fulfill the criteria laid in Table 1. In addition to the staff headcount ceiling, an enterprise qualifis as an SME if it meets either the turnover ceiling or the balance sheet ceiling, but not necessarily both.

Table 1 European Commission's definition of SMEs

Enterprise category	Headcount	Turnover	Balance sheet total
medium-sized	< 250	≤ € 50 million	≤ € 43 million
Small	< 50	≤ € 10 million	≤ € 10 million
Micro	< 10	≤ € 2 million	≤ € 2 million

Source: European Commission (2005)

The Bolton Committee in 1971 employed different definitions of the small firm to different sectors as given in Table

Table 2 Bolton Committee's definition of SMEs

Sector	Definitions
Manufacturing	200 employees or less
Construction	25 employees or less
Mining & Quarrying	25 employees or less
Retailing	Turnover of 50,000 pounds or less
Miscellaneous	Turnover of 50,000 pounds or less
Services	Turnover of 50,000 pounds or less
Motor Trades	Turnover of 100,000 pounds or less
Wholesale Trades	Turnover of 200,000 pounds or less
Road Transport	Five Vehicles or less
Catering	All excluding multiples and Brewery- managed houses

Source: The Bolton Committee (1971)

The best description of the key characteristics of a small firm remains that used by the Bolton Committee in its 1971 Report on Small Firms in the table above. This stated that a small firm is an independent business, managed by its owner or part-owners and having a small market share.

The Bolton Report also adopted a number of different statistical definitions. It recognised that size is relevant to sector - i.e. a firm of a given size could be small in relation to one sector where the market is large and there are many competitors; whereas a firm of similar proportions could be considered large in another sector with fewer players and/or generally smaller firms within it.

Similarly, it recognized that it may be more appropriate to define size by the number of employees in some sectors but more appropriate to use turnover in others. Across government, it is most usual to measure size according to numbers of full-time employees or their equivalent.

Table 3 Other SME Definitions Used by Multilateral Institutions

Institution	Maximum number of Employees	Maximum Revenue or Turnover ($)	Maximum Assets ($)
World Bank	300	15,000,000	15,000,000
MIF-IADB	100	3000,000	None
African Development Bank	50	None	None
Asian Development Bank	No official definition. Uses only definitions of individual national governments		
UNDP	200	None	None

Source: Gibson, T. – van der Vaart, H. J. (2008) Definitions by other multilateral organizations are given in Table 3.

12. Ghanaian Definitions of SMEs

In Ghana, SMEs have been defined by various institutions.
The National Board for Small Scale Industries (NBSSI) classifies SMEs into:

- Micro Enterprises; Enterprises employing up to 5 employees with fixed assets not exceeding $10,000
- Small Enterprises; Employing between 6 and 29 employees with fixed assets of up to $100,000
- Medium Enterprises; Employing between 30 and 99 employees with fixed assets of up to $1,000,000.

The Ghana Statistical Service (GSS) considers firms with less than 10 employees as Small Scale Enterprises and their counterparts with more than 10 employees as Medium and Large-Sized Enterprises. Ironically, The GSS in its national accounts considered companies with up to 9 employees as Small and Medium Enterprises. The Ghana Enterprise Development Commission (GEDC) on the other hand uses a 10 million Cedis upper limit definition for plant and machinery (Kayanula–Quartey 2000).

Steel and Webster (1990) and Osei et al. (1993) in defining Small Scale Enterprises in Ghana used an employment cut off point of 30 employees to indicate Small Scale Enterprises. The latter however dis-aggregated small scale enterprises into three categories:

- Micro -employing less than 6 people;
- Very small, those employing 6–9 people;
- Small -between 10 and 29 employees

Financial accounting and control systems are very important for small businesses, especially at the start-up and development stages when SMEs" needs for investment and working capital are greatest. However, these are also the times when institutional credit is comparatively much more difficult to obtain by them.

13. Challenges Faced by SMEs

The success or failure of new business is often dependent on overcoming a series of potential barriers, such as securing financial backing, adequate and appropriate guidance and training (Fielden et al. 2000). UNCTAD (2001) recognized that many financial institutions in developed and developing countries find it difficult to serve small and medium-sized enterprises (SMEs) because of high perceived risk and high transaction costs and lack of experienced personnel and appropriate corporate structures, which bias them against SMEs.

Bharadwaj (2009) identified three main challenges that need to be addressed by SMEs: penetrate the market, access finance, skilled power and infrastructure and lastly influence the external environment and check unfair trade practices and illegal dealings. Despite the important role of SMEs in the economy, their growth is often constrained by the lack of capital, among other impediments such as regulatory red tape. Their small size, lack of credit ratings and the generally underdeveloped capital markets in the region deny SMEs access to bond and equity financing. Banks are also reluctant to lend to SMEs or charge them a high interest rate, since SMEs usually do not have strong credit history and cannot provide substantial collateral (Pang 2008).

In Ghana, the challenges of SMEs have been identified as input constraints, inadequate finance, limited skilled labour, poor equipment and technology, poor market for produce and legal constraints (Kayanula–Quartey 2000).

I also see the current major challenge to the SME`s as lack of quality working capital management because the past and present governments have implemented various policies to revamp the private sector with special attention to SME` seen as the drivers of economic growth and poverty reduction. The National Board for Small Scale Industries (NBSSI), the Business Advisory Center and the Ministry of Trade and Industry Private Sector development and the Presidential Special initiatives were consequently established to provide special advice and support to SMEs to enable them identify the growth opportunities available to them and measures they can take to expand their business. But the problem for most is their ability to manage the working capital very well because most of the owners finds it difficult to employ a qualify accountant to help them making financial decisions such cash operation circle, inventory management, debtors management etc.

14. SMEs and Working Capital Management

Adequate working capital and working capital management are critical in the survival and success of Small and Medium-Sized Enterprises (SMEs). Most owners/ managers have experienced at some point in the life of their enterprises the impact of lost sales and business opportunities due to the inability to purchase stock; or having to juggle payments between supplies or long delays in collecting receivables and finding the right balance between sales and credit to customers (CBSL 2007).

Managers of SMEs can create value by reducing their inventories and the number of days for which their accounts are outstanding. Moreover, shortening the cash conversion cycle also improves the firm's profitability (Garcia-Teruel–Martinez-Solano 2007).

According to Uyar (2009), there is a significant negative correlation between the Cash Conversion Cycle (CCC) and the firm size in terms of both net sales and total assets. This means the larger the firm size, the shorter the CCC or the smaller the firm size, the longer the CCC. This finding indicates that the smaller firms should look for ways to shorten their CCC by shortening inventory period and accounts receivable period, lengthening accounts payable period.

As pointed out by most authors, the general characteristics of SMEs make it difficult for them to employ the required skilled personnel needed for the effective and efficient management of working capital. In addition to this, most SMEs have no working capital policies and therefore usually go out of business due to lack of funds to run the day-to-day activities of the business.

As pointed out by Parker et al, 1995 Access to finance remained a dominant constraint to small scale enterprises in Ghana. In their survey, credit constraints pertaining to working capital and raw materials were cited by respondents (small business owners). Owners of failed businesses often point to shortages of working capital as the prime cause of business failure (Brough 1970, Hall–Young 1991, Hall 1992).

This failure can be attributed to the fact that most businesses fail to efficiently implement good working capital policies. This is evident in the research conducted by Prasad 2001 on the working capital management in paper industry. His sample consisted of 21 paper mills from large, medium and small scale for a period of 10 years. He reported that the chief executives properly recognised the role of efficient use of working capital in liquidity and profitability, but in practice they could not achieve it. The study also revealed that fifty percent of the executives followed budgetary method in planning working capital and working capital management was inefficient due to sub-optimum utilisation of working capital.

According to UNCTAD (2001) SMEs in India receive assistance from The Small Industries Development Bank of India (SIDBI) through direct financing which includes loans to finance their working capital. Venture Capital is another important source of Finance for SMEs. Most entrepreneurs (SMEs in Ghana) see the establishment of the venture capital industry as the solution to their financial difficulties; however they would want the venture capital firms to relax their criteria and conditions a little bit so that more of the SMEs can benefit from this source of finance. It also came up that, venture capital accounts for only a small part of SME financing (fewer than 2%) concentrated in certain industries (Poku–Frimpong 2009).

In Ghana, projects currently on-going for the MSME sector include the Financial Sector Improvement Project, Financial Sector Strategic Plan (FINSSP), the Rural Financial Services Project (RFSP), the United Nations Development Programme (UNDP) Microfinance Project, the Social Investment Fund (SIF), the Community Based Rural Development Programme (CBRDP), Rural Enterprise Project (REP), and Agricultural Services Investment Project (ASSIP). A recent impact assessment of MSME financing programs that have been implemented across the country suggests that significant challenges remain in ensuring the effectiveness of MSME programs.

The study found that access to finance and low cash flow was a significant problem for MSMEs (Asiama–Osei 2007).

15. Small Medium Enterprise Profitability

Profitability is the primary goal of all business ventures, without profitability the business will not survive in the long run. Profitability is measured with an income statement (or profit and loss statement). This is essentially a listing of income and expenses during a period of time (usually a year) for the entire business. Profitability can be interpreted as a ratio, which expresses the rate of the profit amount benchmarked against some point of reference in percent. As decision tools profitability ratios can be used to assess the financial health of a business. Profitability can be defined as either accounting profit or economic profit.

Accounting profit (or net income) is the difference between the revenues and expenses of a company in a given period presented by the income statement. Accounting profit can give a view of the viability of the business. Although one year of losses may not permanently harm the business, consecutive years of losses (or net income insufficient to cover living expenditures) may jeopardize the viability of business.

The concept of Economic profit based on the following logical consequences: in addition to deducting business expenses, opportunity costs are also deducted when computing economic profit. Profitability is one of the most important objectives of financial management because one goal of financial management is to maximize the owner`s wealth (McMahon 1995). Growth, profitability, cash flow for short-term are important for the survival of enterprises, while all these may at times be critical performance goals for organizations, the drive for profitability may be most important in smaller owner-operated firms.

Three important ratios of profitability are return on sales (ROS), return on assets (ROA) and return on equity (ROE). Return on sales: is computed by dividing profits by total operating revenue. Return on assets: is the ratio of income to average total assets. Return on equity: is defined as net income divided by average stockholders‟ equity.

16. Impact of Working capital management on Profitability

First, it considers the most recent pool of literature related to WCM. Second, unlike Singh and Kumar (2014), this study does not aim to analyze only the existing literature on certain themes such as impact of WC on profitability of the firms. Rather, its purpose is to take a complete stock of literature, classify them on different themes, and then identify some future scopes of research

Until recently, the main advances in financial research in business were in the fields of long-term investment and financial decision-making. Short-term financing received less attention, probably because of its small impact on organization (Singh–Kumar 2014). Things seem to have changed significantly, however, since the drop in corporate performance during the financial crisis starting in 2007. Whereas in the earlier research on WC focused on analyzing how it was managed in different types of company and environment (Belt–Smith 1991, Kim et al. 1992), today, the emphasis is on how WCM can issue capital for more deliberate objectives, reduce financial costs and improve profitability

According to the definition of Weston and Brigham (2005), "Working Capital refers to a firm`s investment in short-term assets, cash, short-term securities, accounts receivables and inventories". Working capital management is important because of its effects on the firm`s profitability and risk, and consequently its value (Smith 1980). On the one hand, maintaining high inventory levels reduces the cost of possible interruptions in the production process or of loss of business due to the scarcity of products, reduces supply costs, and protects against price fluctuations, among other advantages.

Decisions about how much to invest in the customer and inventory accounts, and how much credit to accept from suppliers, are reflected in the firm`s cash conversion cycle, which represents the average number of days between the date when the firm must start paying its suppliers and the date when it begins to collect payments from its customers. Some previous studies have used this measure to analyze whether shortening the cash conversion cycle has positive or negative effects on the firm‟s profitability. Specifically, Shin and Soenen (1998) analyze the relation between the cash conversion cycle and profitability for a sample of firms listed on the US stock exchange during the period 1974–1994. Their results show that reducing the cash conversion cycle to a reasonable extent increases firms‟ profitability.

Deloof (2003) analyzes a sample of large Belgian firms during the period 1992–1996. His results confirm that Belgian firms can improve their profitability by reducing the number of day accounts receivable are outstanding and reducing inventories. Moreover, he finds that less profitable firms wait longer to pay their bills. Most of these companies‟ assets are in the form of current assets. Also, current liabilities are one of their main sources of external finance in view of their difficulties in obtaining funding in the long-term capital markets (Rajan–Petersen 1997) and the financing constraints that they face (Fazzari–Petersen 1993).

It was found out that small and medium-sized US firms use vendor financing when they have run out of debt. Thus, efficient working capital management is particularly important for smaller companies (Peel–Wilson 1996). A part from that, Teruel and Solano (2007), also find a significant negative relation between an SME‟s profitability and the number of days accounts receivable and days of inventory. We cannot, however, confirm that the number of accounts payable affects an SME‟s return on assets, as this relation loses significance when we control for possible problems.

Finally, SMEs have to be concerned with quality working capital management because they can also create value by reducing their cash conversion cycle to a minimum, as far as that is reasonable.

17. Conclusion

Businesses do not survive just because they make profits but also their ability to remain solvent plays a vital role in their sustainability. In other words, a business might report high accounting profits but face liquidity problems. Quality working capital management that considers how an entity ensures that enough cash and cash equivalents are available to meet short term debts needs not be overemphasized in achieving organizational success. Most business failures have been as a result of poor working capital management.

It is no doubt that effective working capital management is essential to the success of every business. It plays an important role in maximizing shareholder wealth and increasing return from investments. SMEs can as a means of effectively managing working capital adopt tighter credit control, better methods of inventory management such as EOQ and also negotiate for better creditor days. Government agencies and bodies such as NBSSI could further enhance this course by devoting much attention to education and training on working capital management.

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