Effects of Working Capital Management on Firm Profitability in Merchandise Companies in Mogadishu, Somalia

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ABSTRACT

The purpose of the study was to establish the effects of working capital management on firm profitability in the merchandise firms in Mogadishu, Somalia. The overall results indicated that there was a significant linear relationship between averages collection period, inventory management, cash conversion cycle and firm profitability of merchandise firms in Mogadishu. But there was insignificant relationship between average payment period and the firm profitability. The conclusions were based on the objectives of the study that working capital management components had a significantly and positively influence on firm profitability of merchandise firms.

Keywords- Working capital management, inventory, conversion cycle

1.1 INTRODUCTION

Working capital management (WCM) is essential to survive because of its effects on a firm's profitability and risk, and consequently its value. WCM is the investment in current assets and current liabilities which are liquidated in a year or less and is very crucial for a firm's day-to-day operations (Baveld M. B., February 2012). It is the ability to control effectively and efficiently the current assets and current liabilities in a manner that provides the firm with maximum return on its assets and minimizes payments for its liabilities (Jagongo, December 2013).

Decisions relating to working capital and short-term financing are referred to as working capital management. It involves managing relationships between a firm's short-term assets and its short-term liabilities. Its goal is to ensure that a firm is able to continue its operations and that it has sufficient cash flow to satisfy both maturing and short-term debts, and upcoming operational expenses. Working capital decisions are reversible and based on cash flows and profitability. Measurement of a firm's cash flow is by the cash conversion cycle, the net of days from the outlay of cash for raw materials, to receiving payments from customers. This metric makes explicit the inter-relatedness of decisions relating to inventories, accounts receivables and payable, and cash. This effectively corresponds to the time that the firm's cash tied up in operations and unavailable for other activities (Barine, 2012).

1.2 Statement of the problem

One of the main purposes of any firm is to maximize the profit. But, maintaining liquidity of the firm also is an important objective. The problem is that at the cost of liquidity can bring serious problems to firm. Thus, strategy of firm must be a balance between these two objectives of the firms. Because the importance of profit and liquidity are the same so, one objective should not be at the cost of the other. If firm ignores about profit, firm cannot survive for a longer period.

Conversely, if firm does not care about liquidity, firm may face the problem of insolvency and bankruptcy (Davoudi, Jan 2013,). This study sought to establish the affect of working capital management on the profitability in merchandise companies in Somalia. Information gathered and the recommendations will help to create a more complete and efficient sustainability and, therefore, optimize the economic as well as social benefits of the merchandise companies to the country.

1.3 General objective

To investigate the effects of working capital management on firm profitability in Mogadishu, Somalia.

1.4 Theoretical Frame work

This study reviews the theory of working capital management, Fisher's separation theorem and the cash conversion cycle approach as the underlying theories to explain the concept of working capital management.

1.4.1 Theory of Working Capital Management

The theory of working capital management emanated from Sagan (1955) and the theory provides the basis for working capital management research. The theory of working capital management emphasizes the need for management of working capital accounts and warns that it could vitally affect the health of the company. Sagan (1955) pointed out the money manager's operations are primarily in the area of cash flows generated in the course of business transactions. However, the money manager must be familiar with what is being done with the control of inventories, receivables and payables because all these accounts affect cash position. Thus, Sagan (1955) advocated that the management of accounts receivable, accounts payable, inventories and cash is vital for the operational functions of a firm. Further, the theory of working capital management argues that the major task of a money manager is to provide funds as and when needed and to invest temporarily surplus funds as profitably as possible in view of his particular requirements of safety and liquidity of funds by examining the risk and return of various investment opportunities. Thus, a money manager should take his decisions on the basis of cash budget and total current assets position rather than on the basis of traditional working capital ratios (all, dec, 2015).

1.4.2 Fisher's separation theorem

In order to avoid confusion, a short introduction to Fisher's separation theorem is in place. According to Hochstein (2001), the idea of the Fisher separation theorem is: "Given perfect and complete financial capital markets, the production decision (investment) is seen as governed solely by an objective market criterion (maximizing wealth), with no regard to the individual's subjective preferences that enter into the consumption decision."

1.5 Review of Study Variables

1.5..1 Average collection period

The average number of day's accounts receivable or averages collection period is used as a measure of accounts receivable policy. It represents the average number of days that the company uses to collect payments from its customer. This metric is received by dividing the sum of the opening and ending balance of account receivables with two and divide this with the net sales and then multiply the outcome with the average number of days in a year.

1.5.2 Inventory management

Inventory management is the process of supplying the assets in the inventories, processing, planning the process of delivering the finished goods to customers, organizing, conducting and controlling. According to these definitions, inventory management deals with the issues as procurement, transporting, producing, storing, and delivering. This process is realized in three stages according to different stages of product flow, these are, pre-production, during production and post- production.

1.5.3 Average Payment Period

Average payment period can be defined as the average length of time between the purchase of materials and labor and the payment of cash for them. Account payables plays a critical role in managing working capital because delaying bill payments is one of the tools for management to have access to an inexpensive source of financing. However, the opportunity cost of keeping high account payables may hurt the business if an early payment discount is offered (Ntui Ponsian, 2014).

1.5.4 Cash Conversion Cycle

The long run survival can only be possible through efficient management of cash conversion cycle including receivable collection period, inventory conversion period and payable deferral period. The efficient use of funds along with efficient operations management is the critical area of financial affairs of a firm (Muhammad Yasir, 2014).

1.5.5 Firm Profitability

Both liquidity and profitability are the core concern of the company's management.Also, profitability is expected to have significant impact on company's cash conversion cycle. Cash conversion cycle might have both positive and negative effect on the company profitability, for instance, while a company with long cash conversion cycle high cost of investment in working capital might decrease profitability as well. (Panbunyuen, 2010).

1.6 RESEARCH FINDINGS AND DISCUSSION

1.6.1 Average collection period on firm profitability

The study sought to investigate the effects of average collection period on firm profitability. Most of the respondents agreed that the average collection period is the length of time required to convert the firm's receivables into cash sale as shown by a mean of 2.72. The respondents agreed that averages collection period represents the average number of days that the company uses to collect payments from its customer, reporting a mean of 2.64.

1.6.2 Inventory management on firm profitability

The study sought to investigate the effects of inventory management on firm profitability.Most of the respondents agreed that lower inventory cost is a definite advantage for the company that effectively controls its inventory as shown by a mean of 2.43. The respondents agreed that effective inventory control reduces the costs because it reduces the total amount of inventory required to manage the business, reporting a mean of 2.47.

1.6.3 Average payment period on firm profitability

The study sought to investigate the effects of average payment period on firm profitability. Most of the respondents agreed that average payment period relates the length of time between the purchase of materials and labor and the payment of cash for them as shown by a mean of 2.47. The respondents agreed that account payable plays a critical role in managing working capital, reporting a mean of 2.34. The respondents agreed that the more number of day's accounts payable is considered better for shorter cash conversion period, reported a mean of 2.36.

1.6.4 Cash conversion cycle on firm profitability

The study sought to investigate the effects of cash conversion cycle on firm profitability. The respondents agreed that the cash Conversion Cycle measures the assessing how well or poor a company is managing its working capital as shown by a mean of 2.32. The respondents agreed that account payable plays a critical role in managing working capital, reporting a mean of 2.34. The respondents agreed that the more number of day's accounts payable is considered better for shorter cash conversion period, reported a mean of 2.36.

1.6.5 Firm profitability

A number of questions were asked to respondents to determine how firm's profitability will be as working capital management components change in Mogadishu. Respondents agreed that the profitability ratio measures profit generated from the business and is measured in percentage terms obtaining a mean of 2.68. The respondent agreed that high percentage of profitability plays a vital role to bring external finance in the business obtaining a mean of 2.53. The respondent agreed that optimal working capital management is expected to contribute positively to the creation of firm value obtaining a mean of 2.32.

1.7 Summary of Findings

The general objective of this study was to investigate the effects of working capital management on firm profitability of merchandise firms in Mogadishu with specific focus of textile firms, food staff firms and spare parts firms in Mogadishu, Somalia. Specifically, this study investigated the effects of average collection period, inventory management, average payment period and cash conversion cycle on firm profitability of merchandise firms in Mogadishu. The study employed a survey research design in data collection.

1.8 Conclusions

The conclusions were based on the objectives of the study that working capital management components had a significant influence on firm profitability in merchandise firms in Mogadishu-Somalia. The results established that working capital management components were found to significantly and positively influence firm profitability.

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