

# 1 Working Capital Management: Is It Really Affects the 2 Profitability ? Evidence from Pakistan

3 Dr. Asghar Ali<sup>1</sup>

4 <sup>1</sup> The University of Lahore

5 *Received: 13 June 2012 Accepted: 6 July 2012 Published: 18 July 2012*

6

---

## 7 **Abstract**

8 Firm's financial management policies compose of very important decisions including working  
9 capital management. Working Capital of a firm comprises on current assets. Current assets  
10 are cash and equivalents, accounts receivable, and inventory items of a firm. Working Capital  
11 Management is applying Investment and Financing Decisions to Current Assets. Most of the  
12 researchers found a positive impact of working capital management decisions on profitability  
13 of organizations. It directly affects the liquidity and profitability of the firm. In this research  
14 article, 15 research papers of different scholars have been studied and compared. The results  
15 showed impact of working capital on profitability and supported the hypotheses.

16

---

17 **Index terms**— Profitability, Working Capital, Total Assets.

## 18 **1 Introduction**

19 firm's financial management policies compose of very important decisions including working capital management  
20 (WCM). Working Capital of a firm comprises on current assets. Current assets are cash and equivalents, accounts  
21 receivable, and inventory items of a firm. The decisions made in respect of current assets are called working  
22 capital management. Most of the researchers found a positive impact of working capital management decisions  
23 on profitability of organizations. It directly and positively affects the profitability of the firms. In this article,  
24 total 15 companies are selected at random from Textile, Chemical and Engineering sector i.e. 5 from each sector.  
25 The results showed positive impact of WCM on profitability and supported the hypothesis.

## 26 **2 II.**

## 27 **3 Literature Review**

28 Semra Karacaer, Mehmet Aygün and Ayhan Kapusuzlu (2009) observed that, in terms of their revenues, the  
29 firms in the first group were very sensitive to changes in earning level and less sensitive to unexpected changes  
30 (positive/negative) in the working capital accruals; those in the second group were very sensitive to changes in  
31 earning level and less sensitive to unexpected changes (positive/negative) in the working capital accruals as well  
32 as firm size; and finally, Author ?: M. Phil Scholar, Lahore Business School, The University of Lahore. E-mail :  
33 asgharpk@hotmail.com Author ?: Assistant Professor, Lahore Business School, The University of Lahore. E-mail  
34 : atif\_hcc@hotmail.com those in the third group were very sensitive to changes in earning level and less sensitive  
35 to earnings level and firm size.

36 Vedavinayagam Ganesan (2007), found that the working capital management efficiency is negatively associated  
37 to the profitability and liquidity. When the working capital management efficiency is improved by decreasing  
38 days of working capital, there is improvement in profitability of the firms in telecommunication firms in terms of  
39 profit margin.

40 Patrick Buchmann and Udo Jung (2009), observed that applying best practices of working capital management  
41 also means applying value-oriented management of tradeoffs between NWC and fixed assets, and between NWC

### 3 LITERATURE REVIEW

---

42 and costs. The isolated treatment of individual levers has its boundaries and, therefore, all elements of tied-up  
43 capital across the balance sheet (fixed assets, inventories, receivables, payables, and cash) have to be considered  
44 as a whole.

45 Karamjeet Singh and Firew Chekol Asress (2010), concluded that firms which have adequate working capital  
46 in relation to their operational size are performed better than those firms which have less than the required  
47 working capital in relation to their operational size. If firms actual working capital is below the required working  
48 capital in relation to their operational size, firms are forced to produce below their optimal scale and this create  
49 problem to run day to day activities smoothly, so this lead firms to generate low return on their investment.

50 Corazon L. Magpayo (2011), highlighted the importance of working capital management and financial leverage  
51 on the firms' financial performance is emphasized in this study to bring attention of business leaders to the obvious  
52 but is often neglected. The next step is to look into the best practices of top performing companies. What working  
53 capital management strategies may be implemented to minimize investment in current assets, at the same time  
54 maximize use of financial leverage at the firm's acceptable financial risk appetite and concluded that aggressive  
55 working capital management policy reflected in low investments in current asset influences net income positively.

56 Afza, T. and MS Nasir (2007) found no significant relationship between working capital management policy  
57 and financial performance among the 208 public limited companies listed in the Karachi Stock Exchange. They  
58 measured aggressive working capital investment policy in terms of low level of investment in current assets as  
59 percentage of total assets. On the other side of the spectrum are companies with high investments in current  
60 assets vis-à-vis total assets, which they classified as advocating conservative working capital management policy.

61 Wajahat Ali and Syed Hammad Ul Hassan (2010) study of 37 listed companies in the OMX Stockholm Stock  
62 Exchange showed no significant relationship between profitability and working capital management policy when  
63 grouped as aggressive, defensive or conservative based on cash conversion cycle. The ratio of current asset to total  
64 assets of the observations in this study was another possible proxy variable for working capital management, but  
65 the data failed the tests of normality. Because of this limitation, dummy variables were used instead to capture  
66 the effect of working capital management policy on profitability.

67 Garcia-Teruel and Martinez-Solano (2007) affirmed in their study the importance of working capital management to corporate profitability especially among small and medium enterprises by providing empirical evidence  
68 on the effects of working capital management on the profitability of 8,872 small and medium-sized Spanish firms.  
70 They demonstrated in their study how managers can improve profitability by shortening the cash conversion  
71 cycle through inventory reduction and reduction in the outstanding number of days receivables.

72 Kesseven Padachi (2006) the different analyses have identified critical management practices and are expected  
73 to assist managers in identifying areas where they might improve the financial performance of their operation. The  
74 results have provided owner-managers with information regarding the basic financial management practices used  
75 by their peers and their peers attitudes toward these practices. The working capital needs of an organization  
76 change over time as does its internal cash generation rate. As such, the small firms should ensure a good  
77 synchronization of its assets and liabilities.

78 Deloof (2003) have found a strong significant relationship between the measures of Working Capital  
79 Management and corporate profitability. Their findings suggest that managers can increase profitability by  
80 reducing the number of day's accounts receivable and inventories. This is particularly important for small  
81 growing firms who need to finance increasing amounts of debtors.

82 Raheman A., Afza T, Qayyum A, Bodla M.A (2010) the Cash Conversion Cycle and Net Trade Cycle offer easy  
83 and useful way to check working capital management efficiency. For value creation of shareholders, firms must try  
84 to keep these numbers of days to minimum level. ??fza and Nazir (2007) investigated the relationship between  
85 aggressive and conservative working capital policies for a large sample of 205 firms in 17 sectors listed on Karachi  
86 Stock Exchange during 1998-2005. They found a negative relationship between the profitability measures of  
87 firms and degree of aggressiveness of working capital investment and financing policies. ??azaridis and Tryfonidis  
88 (2006) investigated the relationship of corporate profitability and working capital management for firms listed  
89 at Athens Stock Exchange. They reported that there is statistically significant relationship between profitability  
90 measured by gross operating profit and the Cash Conversion Cycle. Furthermore, Managers can create profit  
91 by correctly handling the individual components of working capital to an optimal level. Amarjit Gill, Nahum  
92 Biger, Neil Mathur (2010) the finding indicates that slow collection of accounts receivables is correlated with  
93 low profitability. Managers can improve profitability by reducing the credit period granted to their customers.  
94 Regarding the average days of accounts payable previous studies reported negative correlation of this variable  
95 and the profitability of the firm. They found no statistically significant relationship between these variables.

96 B.A Ranjith Appuhami (2008) On the basis of the findings of the research, it can be concluded that the  
97 listed companies in Thailand change their working capital management policies based on many factors, such  
98 as capital expenditure, operating cash flow, sales growth, etc. Thus, I can recommend that firms operating in  
99 other countries consider the pattern of capital expenditure in managing working capital. Especially, the findings  
100 suggest that companies manage working capital efficiently when companies have growth opportunities so that  
101 they can meet required capital expenditure to expand their business.

---

102 **4 III.**

103 **5 Research Objectives**

104 The objectives of this research article are:

105 ? To find the affect of working capital on profitability of firms. ? To find the affect of total assets on  
106 profitability of firms. ? To find the affect of working capital on total assets of firms.

107 IV.

108 **6 Hypothesis Development**

109 The following hypotheses are developed: H1 = There is positive impact of working capital management on  
110 profitability of firm. H2 = There is positive impact of total assets on profitability of firm. Results mentioned in  
111 model 2 above showing positive impact of total assets on profitability of the firms. Total asset shows the strong  
112 financial position of the firms. Firms having much total assets also have choices for making better financial  
113 decisions which increase the profitability of the firms. Results mentioned in model 3 above showing positive  
114 impact of working capital on total assets of the firms. Firms with sufficient amount of working capital have  
115 enough total assets. The firms having better working capital have enough total assets which affects the increase  
116 in ratio of profitability of firms.

117 VII.

118 **7 Conclusion**

119 The study showed a positive impact of working capital management on profitability, working capital on total  
120 assets and impact of total assets on profitability of 15 companies of 3 different sectors of Pakistan. Considering the  
121 results it is evident that efficient management of working capital can lead a firm towards profitability. The firms  
122 should improve their receivables and other currents assets components for sufficient working capital. Efficient  
123 management of inventories enhances the profitability of firms. It is concluded that firms with higher working  
124 capital have higher ratio of profitability and firms with higher total assets also have higher ratio of profitability.  
125 The firms having sufficient working capital also have enough total assets. So it is observed that firms having  
126 sufficient proportion of working capital have positive effect on total assets and profitability of the firms.

127 **8 Bibliography**



Figure 1: Working

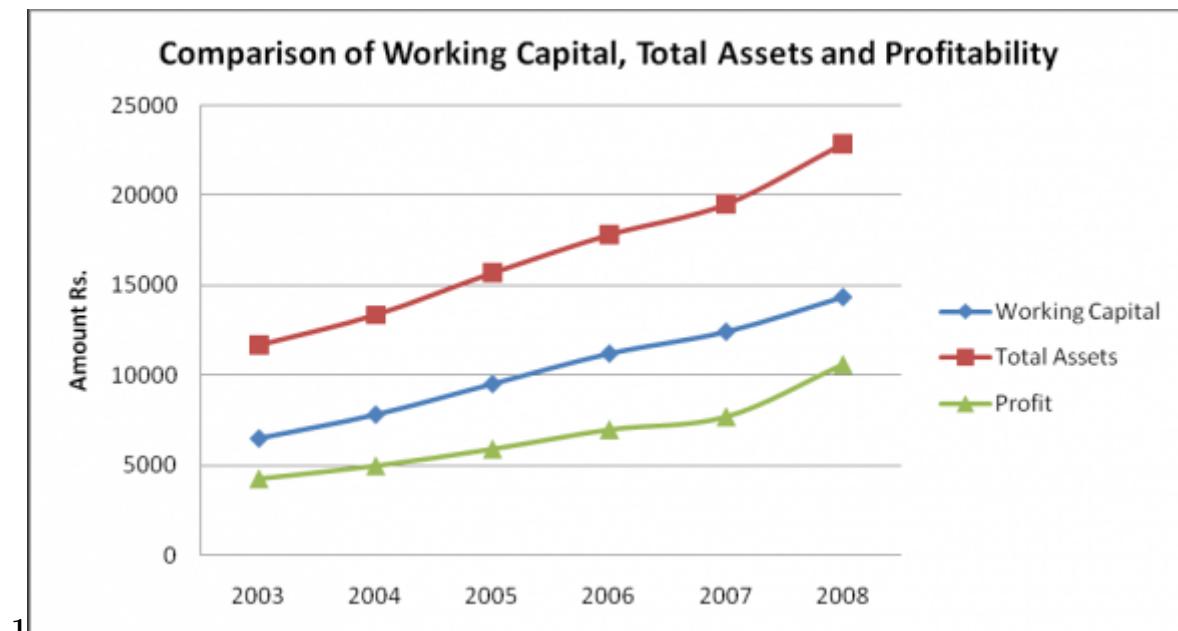


Figure 2: Figure 1 :

- 
- 129 [Ganesan ()] 'An analysis of working capital management efficiency in Telecommunication equipment industry'.  
130 V Ganesan . *Rivier Academic Journal* 2007. 3 (2) .
- 131 [Asress ()] 'Determining working capital solvency level and its effect on profitability in 6. Deloof'. K S Asress  
132 D. . *Journal of Business Finance and Accounting* 2010. 2003. 30 (3 & 4) p. . (Does Working Capital  
133 Management affect Profitability of Belgian Firms?)
- 134 [Magpayo ()] *Effect of Working Capital Management and Financial Leverage on Financial Performance of*  
135 *Philippine Firms*, C L Magpayo . 2011.
- 136 [García-Teruel ()] 'Effects of working capital management on SME profitability'. Pedro Juan García-Teruel , PM  
137 , .-S . *International Journal of Managerial Finance* 2007. 3 (2) p. .
- 138 [Afza ()] 'Is it better to be aggressive or conservative in managing working capital?'. T Afza . *Journal of Quality*  
139 *and Technology Management* 2007. 3 (2) p. .
- 140 [Jung ()] P B Jung . *Best-Practice Working Capital Management: Techniques for Optimizing Inventories,*  
141 *Receivables, and Payables*, 2009.
- 142 [Hassan ()] *Relationship between profitability and working capital policy of Swedish companies* . Essays.se, W A  
143 Hassan . 2010. Retrieved from Swedish University Essays
- 144 [Lazaridis ()] 'Relationship between Working Capital Management and Profitability of Listed Companies in the  
145 Athens Stock Exchange'. I A Lazaridis . *Journal of Financial Management and Analysis* 2006. 19 (1) p. .
- 146 [Appuhami ()] 'The Impact of Firms' Capital Expenditure on Working Capital Management: An Empirical  
147 Study across Industries in Thailand'. B R Appuhami . *International Management Review* 2008. 4 (1) .
- 148 [Gill ()] 'The Relationship Between Working Capital Management And Profitability: Evidence From The United  
149 States'. Amarjit Gill , NB . *Business and Economics Journal* 2010. 2010 p. 10.
- 150 [Padachi ()] 'Trends in Working Capital Management and its Impact on Firms' Performance: An Analysis of  
151 Mauritian Small Manufacturing Firms'. K Padachi . *International Review of Business Research Papers* 2006.  
152 (2) p. .
- 153 [Raheman ()] 'Working Capital Management and Corporate Performance of Manufacturing Sector in Pakistan'.  
154 A Raheman , AT . *International Research Journal of Finance and Economics* 2010.
- 155 [Afza ()] 'Working Capital Management Policies of Firms: Empirical Evidence from Pakistan'. T Afza .  
156 *Conference Proceedings of 9th South Asian Management Forum (SAMF)*, (Dhaka, Bangladesh) February  
157 24-25, 2007. North South University.