Influence of Working Capital Management on the Financial Performance of Small Enterprises; a Survey of Nakuru County

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Abstract: Poor Working Capital Management (WCM) has been cited as the major causes of SME business failures and startups in the sector long lived shelf life. The Kenya National Bureau of Statistics (KNBS) in 2010 indicated that three out of five SMEs fail within the first few months of operations. In 2007, a Fina Bank report had indicated that SMEs exhibit both high birth rates and high death rates with 40% of the startups failing by year two and at least 60% failing by year four. The major cause of the failures of these SMEs both in the country and around the world is the poor working management. SME also lack proper debt collection procedures, such as prompt invoicing and sending out regular statements which tends to increases the risks of late payment and defaulting debtors. This study aims to examine the influence of cash management component of the working capital management on the financial performance of SMEs in Nakuru County. The study adopted a descriptive research design and the structured questionnaire for data collection. The data was analyzed using the SPSS version 21 to generate the descriptive and inferential statistics. The examination of whether the cash management had statistically significant impact on the financial performance of the SMEs was done using the linear correlation tests. The results indicated that the sufficiency of stocks as per customer’s demands, increased sales, bills payments on required timelines, adequate investment of excess cash, and preferential treatment from suppliers through cash discounts had means of 4.1136, 3.5000, 4.1591, 2.5341, and 3.8182 respectively. This implied that on average the respondents tended to agree in relations to all the cash management metrics except the aspect of investment of excess cash which had a mean of 2.5341 implying a tendency to be uncertain. On the other hand, sufficiency of stocks as per customer’s demands, increased sales, bills payments on required timelines, adequate investment of excess cash, and preferential treatment from suppliers through cash discounts had standard deviations of 0.65094, 0.99424, 0.72534, 0.98201, and 1.11979 respectively. This indicated that the responses for all the metrics were moderately distributed except for preferential treatment from suppliers through cash discounts which had a standard deviation of 1.11979 indicating lack of consensus. The relationship was found to be positive and statistically significant since r=0.497, p<0.05. The study recommends that in relations to the effects of the cash management on the financial performance of the SMEs, a particular emphasis should be placed on the firm getting preferential treatment from the suppliers through cash discounts.

Keywords: Financial Performance, Cash Management, Working Capital Management.

I. Introduction

The need for effecting working capital management is of critical and fundamental importance to any business (Kipkemoi, 2014). The effective working capital management assists the company in two different aspects that are profitability and solvency (Mandu, 2014). Solvency refers to the ability of the business to meet its obligations to lenders and creditors whenever their claims fall due in a prompt manner (Kiprotich, 2013). Business entities that have prudent working capital management means that they have smooth operations by meeting their obligations they fall due hence filling their sales orders on time (Irungu, 2012). Liquidity (solvency) means that the business maintains relatively large current assets holdings (Nyambiro, 2011). The other function of the working capital management is ensuring profitability of the business (Wambugu, 2013). High solvency implies that the firms are keeping a large amount of current assets holdings (Waithaka, 2012). This is money that could be otherwise be invested and can be considered the cost of solvency (Wambugu, 2013). Business must therefore maintain an optimal balance between current and fixed assets with a view of generating profitability (Okinyi, 2014). To achieve a high profitability, the firm may sacrifice the solvency and maintain a relatively low level of current assets but a greater risk of cash shortage and stock outs (Nyabenge, 2009).

Business must monitor their working capital with a view of ensuring that they have sufficient resources to continue their day-to-day operations (Runyora, 2012). In this context, Okinyi (2014) notes that most firms require certain levels of working capital to deal with variable and somewhat unpredictable financial inflows and outflows. There are certain business challenges that require higher working capital. These challenges include disconnected supply chains processes, excessive stocks caused by non-bridged interfaces, inadequate trade credit terms, and suboptimal loan decisions require higher working capital than necessary (Okungu, 2014). Since a higher working capital comes at an opportunity cost to profitability, the businesses must reduce the...
working capital in hand while confronting any challenges that may arise due to limited solvency (Owele, 2014). Therefore, the businesses will try to have less capital tied up in non-productive stocks, shorten the collection period for account receivables, and stretch cash payments for accounts payable as far as possible (Mwaniki, 2012). The ultimate aim of the working capital management is the minimization of the capital tied up in the company’s turnover process through reduction of the current assets and extending current liabilities (Wahogo, 2014). Companies invest in short-term assets, which are inventories, accounts receivables, cash and short-term securities which need to be managed (Luchinga, 2014).

Small and Medium Enterprises (SMEs) must monitor their working capital levels as it has a direct impact on the financial performance of their business (Owele, 2014). This is because the working capital affects the SMEs liquidity and profitability. Efficient working capital management involves planning and controlling current assets and current liabilities in a manner that eliminates the risk of inability to meet due short term obligations on the one hand and avoid excessive investment in these assets on the other (Waithaka, 2012). Malombe (2010) argues that the working capital management is more important to the SMEs than the big firms because the SMEs often lack much investment in fixed assets but rather invests more in current assets. Therefore, the SMEs face the receivable collection problems and have challenges in financing their long-term financial commitments (Kiprotich, 2013). The WCM is thus far critical to the SMEs given the vulnerability of small firms to fluctuations in working capital since they cannot afford to starve of cash (Mugo, 2012). The SMEs have limited access to the long-term capital markets therefore tend to depend heavily on the owner financing, trade credit and short-term bank loans to finance their cash requirements, account receivables and inventory requirements (Kiarie, 2012). These sources of capital are more expensive and risky compared to equity financing hence making WCM are critical component of the SMEs (Omino, 2014).

II. Literature Review

Theoretical Review

The study utilized the tradeoff theory. The tradeoff theory suggests that business seek to maintain optimal level of liquidity to balance between the benefit and cost of holding cash (Kiprotich, 2013). The theory argues that the value of cash is neither destroyed nor created under ideal capital market assumptions (Maina, 2013). Firms may raise funds including capital market and liquidation of assets in several ways. The holding of sufficient cash levels means that the firms save transactional costs to raise funds and do not require liquidating any assets to make payments (Waithaka, 2012). The tradeoff theory suggests that the major concern of business is the effective management of the day-to-day operations in a smooth manner while increasing the shareholder’s profitability (Afza & Nazir, 2009). In this context, the businesses must manage their current assets and liabilities prudently. Minimization of funds tied in the current assets implies that the freed up funds can be invested hence improving financial performance of the business (Lazaridis & Tryfonidis, 2006). On the other hand, the capital invested in cash, trade receivables and inventories must be sufficient to prevent business having challenges with their daily operations (Samiloglu & Demirgunes, 2008). Therefore, Malombe (2010) emphasize that the trade-off between liquidity and profitability places a fundamental burden on the firm prudently manage its working capital.

Concept of Financial Performance

According to Kabethi (2013), the financial performance is the process of measuring the results of a firm's policies and operations in monetary terms. Machiuaka (2010) argues the analysis of financial performance reflects the financial position of the company, the level of the competitiveness in the same sector, and a thorough knowledge about the cost and profit centers within the firm. Financial performance may be defined as a general measure of a company’s overall financial health over a given period of time, and can be used to compare similar companies across the same industry or to compare industries or sectors in aggregation (Maymand, 2014). It may also be defined as the results of a company’s policies and operations in monetary terms (Wangu, 2011). The financial performance of an institution can also be defined as the ability of an institution to employ the available resources to increase shareholders’ wealth and generate sustainable profits to strengthen its capital base through retained earnings to ensure future profitability (Musomba, 2012). The traditional measurement of financial performance is the Return on Assets (ROA) that is the net income for the year divided by the total assets (Ogoye, 2013). The other measure is Return of Equity (ROE) that is the internal performance measure of shareholder’s value (Machiuaka, 2010). There are other measures used to test specific aspects of the financial performance such as liquidity ratios and profitability ratios. The liquidity measures the ability of the business to meet financial obligations as they come due, without disrupting the normal, ongoing operations of the business (Okinyi, 2014). The current and acid test ratio are fundamental measures of liquidity. The current ratio measures the relationship between total current firm assets and total current firm liabilities. The higher the ratio, the more liquid the farm is considered to be (Kipkemoi, 2014). Acid test ratio is a measure of the amount of funds available to purchase inputs and inventory items after the sale of current assets and
payment of all current firm liabilities (Maina, 2013). The profitability measures the extent of the business profit generation from different factors of production such as labour, management and capital (Mwaniki, 2012). The profitability analysis focuses on the relationship between revenues and expenses and on the level of profits relative to the size of investment in the business. Profit is the difference between revenue and expenses over a period of time.

Concept of Small and Medium Enterprises

There is no single definition of the Small and Medium Enterprises (SMES) across the world. In this context, Abera (2012) notes that this is because of the variance in the criteria of categorizing affirm as a SME among different institutions and country depending on the country’s level of development. However, even within the same country there may be differing definitions due to changes in price levels, advances in technology amongst other considerations (Kizaka, Kobia, & Katwalo, 2013). Kiveu (2010) argues that the SMES are classified by the number employees employed in the business. In this context, the SMES are defined as non-primary enterprises (excluding Agricultural production, animal husbandry, fishing, hunting, gathering and forestry) that employ 5-99 fulltime employees (Kiveu, 2010). The Micro, Small and Medium Enterprises (MSME) Act of 2012 formally defined the SMES for usage in the Kenyan context. The micro enterprises have been defined as those employing less than 10 workers with annual turnovers of less than KES 500,000 and capital formation of less than KES 5 million for services or less than KES 10 million for enterprises doing manufacturing (Ong’olo & Awino, 2013). Small enterprises are defined as those that employ between 10 and 50 workers with annual turnovers between KES 500,000 and KES 5 million and capital formation between KES 5 million and KES 20 million for services or between KES 5 million and KES 50 million for enterprises doing manufacturing (Ong’olo & Awino, 2013).

Working Capital Management (WCM)

According to Mitau (2013), working capital management is the management of the short-term investment and financing of a company. Chepkania (2014) defines the Working Capital Management (WCM) as a process that involves planning and controlling current assets and liabilities in a manner that eliminates the risk of inability to meet short-term obligations and avoid excessive investment in these assets. Luchinga (2014) defines WCM as the process of maintaining an optimal balance between each of the working capital components, that is, cash, receivables, inventory and payables. On the other hand, Apuoy (2010) defined working capital management also called net working capital as current assets less current liabilities. The current assets are divided into cash and cash equivalents, short-term investments, trade and other receivables, prepaid expenses, inventories and work-in-progress (Wambugu, 2013). On the other hand, the current liabilities are divided in trade payables, short-term debt and accrued liabilities (Mugo, 2012). According to Kipkemoi (2014), the components of the working capital management includes cash and marketable securities, account receivables, inventories, and accounts payable. Effective working capital management consists of applying the methods, which remove the risk and lack of ability in paying short-term commitments in one side, and prevent over investment in these assets in the other side by planning and controlling current assets and liabilities (Runyora, 2012).

Impact of Cash Management on Financial Performance

The management of the cash utilization is a critical component of the working capital management. According to Nyabenge (2009), the cash management is the process of planning and controlling cash flows into and out of the business, cash flows within the business, and cash balances held by a business at a point in time. On the other hand, Kiprotitch (2013) defines the cash management as the collection, concentration and disbursement of cash. The companies need to ensure the delivery of goods or services to the customer and must therefore have investments in current assets (Luchinga, 2014). However, there is a fundamental need to manage the current assets with a view of having the desired impact on either profitability or liquidity (Malombe, 2010). The blocking of resources at different supply chain stages results in prolonged cash operating cycle hence a probability of increased profitability due to increased sales (Awuor, 2014). However, this may affect the profitability if the costs tied up in working capital exceed the benefits of holding more inventories and/or granting more trade credit to customers (Apuoyo, 2010).

Cash is a critical current asset since it is the basic input for business operations and it is the ultimate output of the business activities (Kiprotitch, 2013). The cash consists of the currency, demand deposit and time deposits (Nyambiro, 2011). The main sources of cash in a business are the accounts payable and equity (Runyora, 2012). The account payable refers to the money the firm owes it suppliers or trade credit the customer gets from the supplier of goods or services (Okinyi, 2014). On the other hand, the equity is defined as the owner’s claim against business entity, which keeps on changing, and the amount payable is determined upon the firm’s liquidation (Nyandemo, 2012). There is need for prudent management of the cash because cash shortage
disrupts the business operations while excess cash means existence of idle money that do not contribute to the firm’s profitability (Kiarie, 2012). One way of dealing with excess cash is using marketable securities which contribute to the profitability of the business (Mitau, 2013). The marketable securities also referred as near cash items or bank time deposit notes are characterized by their ability to be readily converted to cash (Nyabenge, 2009). Therefore, the ultimate aim of cash management is the managing of cash flows into and out of the firm, cash flows within the firm, and cash balances held by the firm at a point of time by financing deficit or investing surplus cash (Mwaniki, 2012). The ultimate aim of cash management is maintenance of adequate control over cash position to keep the firm liquid and to use excess cash in some profitable way (Owele & Lilian, 2014). The standard measure of cash management is Cash Conversion Cycle (CCC) which refers to the time period from buying raw material, converting to finished goods, sales products, and collecting account receivables (Wahogo, 2014). CCC is calculated as ACP + ICP – APP.

III. Objective of the Study
To examine the impact of cash management on financial performance of SMEs in Nakuru County

IV. Research Question
What is the impact of cash management on financial performance of SMEs in Nakuru County?

V. Methodology
The descriptive design was appropriate for this study as the researcher attempted to find out the relation between WCM and financial performance without manipulating any of the variables. The researcher was interested in making observations on the status of the relationship as it is on the ground. The target population of this study was SMEs within Nakuru County. According to Kariuki (2013), there are about 20,355 registered SMEs within Nakuru County which were used as the target population for this study. The formula to scientifically derive the sample from the target population is illustrated hereunder.

\[
n = \frac{NC^2}{C^2 + (N-1)e^2}
\]

Where
- \(n\) = sample size
- \(N\) = size of target population
- \(C\) = coefficient of variation (0.5)
- \(e\) = error margin (0.05)

Substituting these values in the equation, estimated sample size \(n\) were:

\[
n = \frac{20,355(0.5)^2}{(0.5^2 + (20,355-1)0.05^2)} \approx 99.51 \text{ that is } 100 \text{ respondents}
\]

The study used 100 respondents as the sample size.

The study used the stratified proportionate random sampling techniques proportionate sampling design in which the sampling fraction was the same for each of the seven strata. According to Matama (2008), the stratified proportionate random sampling technique produce estimates of overall population parameters with greater precision and ensures a more representative sample is derived from a relatively homogeneous population. Stratification aims to reduce standard error by providing some control over variance.

<table>
<thead>
<tr>
<th>SME Category</th>
<th>Population Size</th>
<th>% Constitution</th>
<th>Sample Numbers</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Trade, Wholesale, Retail, Stores, Personal Services</td>
<td>15,349</td>
<td>75.41%</td>
<td>75</td>
</tr>
<tr>
<td>Transport, Storage, and Communication</td>
<td>338</td>
<td>1.66%</td>
<td>2</td>
</tr>
<tr>
<td>Agriculture, Forestry, and Exploitation of Natural Minerals</td>
<td>479</td>
<td>2.35%</td>
<td>2</td>
</tr>
<tr>
<td>Accommodation and Catering</td>
<td>1,530</td>
<td>7.52%</td>
<td>8</td>
</tr>
<tr>
<td>Professional and Technical Services</td>
<td>565</td>
<td>2.78%</td>
<td>3</td>
</tr>
<tr>
<td>Private Education, Health, and Entertainment Services</td>
<td>438</td>
<td>2.15%</td>
<td>2</td>
</tr>
<tr>
<td>Industrial Plants, Factories, Workshops, Contractors</td>
<td>1,656</td>
<td>8.14%</td>
<td>8</td>
</tr>
<tr>
<td>Total</td>
<td>20,355</td>
<td>100%</td>
<td>100</td>
</tr>
</tbody>
</table>

A hundred questionnaires were distributed corresponding to the sample size of the study. Out of the 100 questionnaires distributed, 10 questionnaires were not returned therefore 90 questionnaires were returned making a response rate of 90%. This was deemed sufficient for the study. On the other hand, two questionnaires were disqualified due to having identifiers.
VI. Findings And Discussions

The impact of cash management on financial performance of SMEs in Nakuru County was examined using the following questions:
1. My cash management practices enable the business to have sufficient stocks as per customers’ demands
2. The cash management in my firm enables the business to have increased sales
3. The cash management in my firm enables payments of my bills on required time
4. The cash management in my firm ensures that any excess cash is adequately invested
5. The cash management in my firm enables me to get preferential treatment from my suppliers through cash discounts

The likert scale of Strongly Agree (SA), Agree (A), Uncertain (U), Disagree (D), and Strongly Disagree (SD) was used. The impact of the cash management on the financial performance was examined using five metrics that is sufficiency of stocks as per customer’s demands, increased sales, bills payments on required timelines, adequate investment of excess cash, and preferential treatment from suppliers through cash discounts. The frequency distributions for sufficiency of stocks as per customer’s demands were 27.3% (SA), 56.8% (A), 15.9% (U), 0.0% (D), and 0.0% (SD). In relations to the increased sales as a result of cash management, the results were 19.3% (SA), 28.4% (A), 35.2% (U), 17.0% (D), and 0.0% (SD). The results for bills payments on required timelines were 35.2% (SA), 45.5% (A), 19.3% (U), 0.0% (D), and 0.0% (SD). On the other hand, the results for adequate investment of excess cash were 0.0% (SA), 15.9% (A), 40.9% (U), 23.9% (D), and 19.3% (SD). Finally, the results for preferential treatment from suppliers through cash discounts were 38.6% (SA), 20.5% (A), 25.0% (U), 15.9% (D), and 0.0% (SD).

Table 2; Frequency Distribution of Cash Management

<table>
<thead>
<tr>
<th>STATEMENT</th>
<th>SA</th>
<th>A</th>
<th>U</th>
<th>D</th>
<th>SD</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>My cash management practices enable the business to have sufficient stocks as per customers’ demands</td>
<td>27.3</td>
<td>56.8</td>
<td>15.9</td>
<td>0.0</td>
<td>0.0</td>
<td>100%</td>
</tr>
<tr>
<td>The cash management in my firm enables the business to have increased sales</td>
<td>19.3</td>
<td>28.4</td>
<td>35.2</td>
<td>17.0</td>
<td>0.0</td>
<td>100%</td>
</tr>
<tr>
<td>The cash management in my firm enables payments of my bills on required time</td>
<td>35.2</td>
<td>45.5</td>
<td>19.3</td>
<td>0.0</td>
<td>0.0</td>
<td>100%</td>
</tr>
<tr>
<td>The cash management in my firm ensures that any excess cash is adequately invested</td>
<td>0.0</td>
<td>15.9</td>
<td>40.9</td>
<td>23.9</td>
<td>19.3</td>
<td>100%</td>
</tr>
<tr>
<td>The cash management in my firm enables me to get preferential treatment from my suppliers through cash discounts</td>
<td>38.6</td>
<td>20.5</td>
<td>25.0</td>
<td>15.9</td>
<td>0.0</td>
<td>100%</td>
</tr>
</tbody>
</table>

The means and the standard deviations of cash management were undertaken. The sufficiency of stocks as per customer’s demands, increased sales, bills payments on required timelines, adequate investment of excess cash, and preferential treatment from suppliers through cash discounts had means of 4.1136, 3.5000, 4.1591, 2.5341, and 3.8182 respectively. This implied that on average the respondents tended to agree in relations to all the cash management metrics except the aspect of investment of excess cash which had a mean of 2.5341 implying a tendency to be uncertain. On the other hand, sufficiency of stocks as per customer’s demands, increased sales, bills payments on required timelines, adequate investment of excess cash, and preferential treatment from suppliers through cash discounts had standard deviations of 0.65094, 0.99424, 0.72534, 0.98201, and 1.11979 respectively. This indicated that the responses for all the metrics were moderately distributed except for preferential treatment from suppliers through cash discounts which had a standard deviation of 1.11979 indicating lack of consensus.

Table 3; Means and Standard Deviation of Cash Management

<table>
<thead>
<tr>
<th>STATEMENT</th>
<th>N</th>
<th>Mean</th>
<th>Std. Dev</th>
</tr>
</thead>
<tbody>
<tr>
<td>My cash management practices enable the business to have sufficient stocks as per customers’ demands</td>
<td>88</td>
<td>4.1136</td>
<td>.65094</td>
</tr>
<tr>
<td>The cash management in my firm enables the business to have increased sales</td>
<td>88</td>
<td>3.5000</td>
<td>.99424</td>
</tr>
<tr>
<td>The cash management in my firm enables payments of my bills on required time</td>
<td>88</td>
<td>4.1591</td>
<td>.72534</td>
</tr>
<tr>
<td>The cash management in my firm ensures that any excess cash is adequately invested</td>
<td>88</td>
<td>2.5341</td>
<td>.98201</td>
</tr>
<tr>
<td>The cash management in my firm enables me to get preferential treatment from my suppliers through cash discounts</td>
<td>88</td>
<td>3.8182</td>
<td>1.11979</td>
</tr>
</tbody>
</table>

VII. Conclusion

The examination of whether the cash management had statistically significant impact on the financial performance of the SMEs was done using the linear correlation tests. The relationship was found to be positive and statistically significant since r=0.497, p<0.05.
the suppliers through cash discounts.

Influence of Working Capital Management on the Financial Performance of the SMEs, a particular emphasis should be placed on the firm getting preferential treatment from the suppliers through cash discounts.

VIII. Recommendations

The study recommends that in relations to the effects of the cash management on the financial performance of the SMEs, a particular emphasis should be placed on the firm getting preferential treatment from the suppliers through cash discounts.

References


Table 4: Linear Correlation Between Cash Management and Financial Performance

<table>
<thead>
<tr>
<th>Cash Management</th>
<th>Pearson Correlation</th>
<th>Sig. (2-tailed)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>.497</td>
<td>.000</td>
</tr>
<tr>
<td>N</td>
<td>88</td>
<td></td>
</tr>
</tbody>
</table>

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