INTI INTERNATIONAL UNIVERSITY

MASTER OF BUSINESS ADMINISTRATION

Effect of Working Capital Management on Firms'Profitability : Empirical Evidence from Malaysia

Author: Cheng MuiGek

Student No: I12001111

Supervisor: Ms Too Shaw Warn

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List of Abbreviations

- WCM (working capital management)
- NPM (net profit margin)
- CCC (cash conversion cycle)
- SG (sales growth)
- AR (Days of Accounts Receivable turnover or Receivables conversion period)
- AP (Days of Accounts Payable turnover or Payable deferral period)
- INV (Days of Inventory Turnovers or Inventory conversion period)
- SIZE (Size of firm by natural log of total assets)
- CR (Current Ratio)
- ROA (Return on Asset)
- ROE (Return on Equity)
- Anova (Analysis of Variance)
- LSD (Least Significant Difference)

CHAPTER 1

INTRODUCTION

1.1 Introduction

Chapter 1 provides a general overview of the research. It aims to give readers a general outline of the research from research background, problem statement, research objectives (both primary and secondary), significance of study and scope of study are described in this chapter.

1.2 Research background

Corporate finance theory can be discussed under three main areas: capital budgeting, capital structure and working capital management. Capital budgeting and capital structure decisions are related to financing and managing long-term investments and their returns. Working capital management is a very important component of corporate finance theory and deals with managing short-term financing and investment decisions of the firm. The corporate finance literature in the past has focused extensively on the study of long-term financial decisions, particularly investments, capital structure or company valuation decisions. However, working capital management also directly affects the liquidity of the company as it deals with the management of current assets and current liabilities that are essential for the smooth running of a business unit. Consequently, efficiency in working capital management is vital for any firm.

Working capital management is the process of managing activities and processes related to working capital. This level of management serves as a check and balances system to ensure that the amount of cash flowing into the business is enough to sustain the company's operations. This is an on-going process that must be evaluated using the current level of assets and liabilities. Working capital management may involve implementing short-term decisions that may or may not carry over from one earnings period to the next.

Working capital management involves the relationship between a firm's short-term assets and its short-term liabilities. The goal of working capital management is to ensure that a firm is able to continue its operations and that it has sufficient ability to satisfy both maturing short-term debt and upcoming operational expenses. The management of working capital involves managing inventories, accounts receivable and payable, and cash.

Working capital management is revolving around the company's current assets and current liabilities (Current asset is defined as asset which can readily converted to cash within a year during the normal course of business. Examples of current assets include cash on hand or at bank, inventories or stocks, accounts receivable or debtors and prepaid expenses; current liability is defined as obligations or debts which fall due within a year, such as short term debt, accounts payable or creditors.) In short, working capital management is about the company composition level of current assets versus current liabilities and "net working capital" is generally defined as the differences between current assets and current liabilities. Hence working capital management or policy is affecting the company's profitability or "bottom line" and ultimately the company shareholders wealth. (Gentry,1998). So in order to sustain long term growth, effective working capital policies are very vital to any company. If for example, a company short of working capital for it to expand in the area of production and marketing, it will result in loss in revenue and then eventually profit will be decreased as well. In order to remain liquidity (able to meet financial obligation when it falls due) working capital management is very crucial. Otherwise, events such as deteriorating company credit rating, potential forced liquidation of company assets and ultimately bankruptcy declaration will happen (Moyer et al., 2012)

If a firm maintain low level of current assets, it may incur fund shortage and business operation cannot be run smoothly. (Horne and Wachowicz, 2000). Efficient working capital management is fundamental part of any business operation. In other words, firm should maintain optimal working capital to maximize firm value (Afza and Nazir, 2007; Deloof, 2003) . Specifically, working capital management involves a trade-off between profitability and risk. In other words, corporate strategy that increase profitability will also increase risk and conversely, any corporate decision that decrease profitability will lead to risk reduction. (Arnold, 2012)

1.3 Problem statement

The working capital management is the most critical problem in financial management. Most of the time the financial executives are devoted towards managing the current assets and current liabilities which are the main constituents of working capital.

The aim of working capital management is to achieve balance between having sufficient working capital to ensure that the business is liquid but not too much that the level of working capital reduced profitability which means that maintaining the best composition of current assets and current liabilities. The management of working capital involves managing inventories, accounts receivable and payable, and cash. (Moyer et al., 2012). The goal of working capital management is to ensure that a firm is able to continue its operations and that it has sufficient ability to satisfy both maturing short-term debt and upcoming operational expenses.

The mismanagement of the working capital will lead to a loss of profit in the short run but it ultimately lead to downfall of an enterprise in the long run. An excessive investment in working capital will lower the rate of return while inadequate investment will hamper solvency position and growth thereby affecting the operation of the company. The adequacy of working capital together with efficient handling virtually determine the survival or demise of an enterprise.

Most previous studies focus on developed market (Shin and Soenon, 1998; Deloof, 2003). Thus investigating this issue could provide additional insights and perhaps different evidence on the working capital management in emerging capital market. This will surely enrich the finance literature on this issue. Additionally, the results of this study would provide firm managers better insights on how to create efficient working capital management that have ability to maximize firm's value. As a result, it will build up confidence in investor to invest in that firm. Further, the confidence of investors to invest in Malaysia will influence the growth of economic. The results of this study would also assist policy-makers to implement new sets of policies regarding the working capital market in Malaysia to ensure continuous economic growth.

1.4 Research objective

1.4.1 Primary

The primary objective is to study the effect of working capital management on firms' profitability

1.4.2 Secondary

Whereas the secondary objective is to study the exact relationship between the five components of working capital management and firms' profitability namely as follow:

Objective 1 : The objective of this study is to examine the relationship between cash conversion cycle and firms' profitability

Objective 2 : The objective of this study is to examine the relationship between inventory turnover and firms' profitability

Objective 3 : The objective of this study is to examine the relationship between receivables turnover and firms' profitability

Objective 4 : The objective of this study is to examine the relationship between payables turnover and firms' profitability

Objective 5 : The objective of this study is to examine the relationship between current ratio and firms' profitability

1.5 Significance of the study

This research will help other researchers and company's management team in understanding the impact of WCM on firm's profitability. The importance of the working capital stems from the fact that working capital level has an impact on the firm profitability and risk level that the firm can carry, which in turn has an effect on the value of the firm, (Smith, 1980). The management of working capital is considered as one of the most important strategy that the firm should take into consideration, and that firms should maintain adequate level of the working capital to meet its current obligations. The finding will also help government (Central Bank) to formulate monetary and fiscal policies in relation to public listed companies, for example bank loan application regulations or terms or conditions. The benefits accrued to industry include better management of working capital policies in the companies and this enable management team to safeguard the interest of all stakeholders ranging from shareholders, employees, creditors, potential investors, consumers, customers, government bodies and also bankers. Moreover, better managed companies will build up investors' confidence and as a result will boost Malaysia economic growth as well.

1.6 Scope of the study

This study is focused on 70 randomly selected public-listed companies in Bursa Malaysia and analysing their financial data or ratio. The financial data of each firm was collected from DataStream database public website and internet published reports. The analysis period is from 2010 to 2011. Financial (banking) sector is excluded from this sample due to the nature of their business. Its nature is provide banking services which do not have stock or inventory in operation.Then inventory conversion period is one of the major explainary variables. Firms that have missing value for selected variable which are used in this study also will be excluded from this sample. Quantitative research approach is used in the study. Furthermore SPSS software version 20 is used for the analysis with specific focus on multiple and linear regression. The research is focused on Public Listed companies in Malaysia and will not covered SME , NPO, or Private Limited Companies.

1.7 Organisation of the study

As shown in figure 1, this research paper consist of 5 chapters, namely:-

Figure 1 : Outline of study

Chapter 1

- Chapter 1 provides a general overview of the research. It aims to give readers a general outline of the research from research background, problem statement, research objectives (both primary and secondary), significance of study and scope of study are described in this chapter.

Chapter2

- This chapter presents the overview of prior studies which are relevant to the research topic "the Effect of Working Capital Management on Firm Profitability : Empirical Evidence from Malaysia"

Chapter 3

- This chapter explains the research methodology of this study, which includes types of research, measuring instruments, validity and reliability tests, study population, unit of analysis, sample selection, sampling techniques, data collection and analysis methods are all discussed in this chapter.

Chapter 4

- This chapter starts with the descriptive analysis of the sample data, which will summarize both the dependent and independent variables. Then it will follow by the summary and results of correlation analysis and multiple regression analysis, whereby the effects of each explanatory variables on the net profit margin (the dependent variable) will be estimated

Chapter 5

- After analyzing the data, conclusion will be presented in this chapter. Then followed by recommendation, limitation of study, future studies and finally personal reflection

Chapter 2

Literature Review

2.1 Introduction

This chapter presents the overview of prior studies which are relevant to the research topic "the Effect of Working Capital Management on Firm Profitability : Empirical Evidence from Malaysia"

2.2 Working Capital Management

Various studies have analysed the relationship of working capital management and firm profitability in various markets. The results are quite mixed, but a majority of studies conclude a negative relationship between WCM and firm profitability. The studies reviewed have used various variables to analyse the relationship, with different methodology such as linear regression and panel data regression. In this section, we have presented the chronology of major studies related to our study in order to assess and identify the research gap.

Soenen (1993) investigated the relationship between the net trade cycle as a measure of working capital and return on investment in US firms. The results of the study indicated a negative relationship between the duration of net trade cycle and return on assets (ROA). Furthermore, this relationship between net trade cycle and return on assets was found to be differ across industries, depending on the type of industry. A significant relationship for about half of the industries studied indicated that results might vary from industry to industry. To support the results of Soenen (1993) on a large sample and with a long time period, Jose et al. (1996) examined the relationship between profitability measures and management of ongoing liquidity needs for a large cross section of firms over a 20-year period. They tested the long run equilibrium relationship between the cash conversion cycle and alternative measures of profitability, using both non-parametric and regression analysis. The