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Exploring the Relationship between Working Capital Management, Liquidity, and Financial Performance within the Context of Kenyan SME's

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Abstract

The concept of working capital revolves around the effective administration of short-term assets and liabilities within an organization, with the ultimate goal of augmenting profitability and safeguarding against potential insolvency scenarios. In this scholarly article, we undertake a thorough evaluation of the intricate relationship between working capital management, liquidity, and financial performance within the context of Kenya, with a particular focus on small and medium enterprises. Our analysis primarily relies on an exhaustive review of pertinent academic literature that delves into the subject matter at hand. A noteworthy observation that emerged from this investigation was the realization that inadequate working capital management has the potential to precipitate the downfall of even the most prosperous corporations. The majority of the scrutinized literature unequivocally posits that a strong correlation exists between working capital management and profitability. Moreover, it is imperative to acknowledge the pivotal role played by liquidity, firm size, leverage, and various other financial ratios, as these factors constitute integral components of the overarching framework of working capital management.

Keywords: Working capital management, Liquidity, Financial performance, profitability, SME's

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1. Introduction

Working capital is concerned with the management of the current assets and current liabilities of an organization. It can be defined as assets that, during the course of business operations, can easily be converted into cash within a period

of one year without suffering an attenuation in value or interruption of the operations (Delima, 2020). The main objective of working capital management is to provide assurance to companies about their going concern in terms of their daily operations and meeting their commitments as and when they arise (Ndagijimana, 2014).

Analytically, it has been understood that excessive availability or lack of current assets in a company is not a problem as long as there is adequate planning and control of working capital. Most firm directors usually involve financial experts with the knowledge and professionalism to determine the efficient working capital requirements for their companies (Nyeadi, Sare, & Aawaar, 2018). Over the years, the aim of working capital management has had to be reevaluated in the present narrative. As a result, if the old model perspective regarded working capital solely as “a positive component of the balance sheet”, later, the modern view considered working capital a “drag on financial performance” (Botoc & Anton, 2017).

Being a vital component of corporate governance, working capital administration considerably mirrors the operation magnitude of the whole initiative, basically representing the foundation of the endurance and growth of firms (Han, 2021). According to Han (2021), effective working capital management can benefit from increased earnings as a risk mitigation measure while at the same time upholding the solvency expectations of firms.

More research needs to be conducted in regard to working capital management and, to a greater extent, the determinant factors effects on financial performance since they are of high concern to legislators, intellectuals, and industry owners due to the sensitivity of this phenomenon (Botoc & Anton, 2017). In addition, Botoc and Anton (2017) note that speeding up industry operations has a tendency to expand the quantity of working capital, that is, produce extra financial limitations for upcoming ventures. If these modern ventures are funded through leverage, this will cause an increasing leverage ratio and, consequently, a rise in financial hazards. Besides that, in the course of a depression or in a continually rising price of commodities scenario, working capital has a contradictory tendency to grow (Botoc & Anton, 2017).

Finance theory specifies the sound working capital management can impact financial performance and therefore financial stability of various enterprises (Murigu, 2019). With the ravaging Covid- 19 pandemic, the fact to place in is serious lens is that in eras of financial distress, some of the suitable resolutions to emancipate from financial difficulties is to make proper choices concerning working capital management strategies (Zimon & Tarighi, 2021). In the modern dynamic and fluctuating global economy, Zimon and Tarighi, (2021) notes that the choices on working capital management policies are some of the imperative responsibilities for company managers since they can perform a significant part in refining the financial state of firms in periods of distress. Decreasing the quantities of resources bound up in working capital, companies can increase its reserves for other useful purposes and long-term investments (Botoc & Anton, 2017). Futher, Botoc and Anton, (2017) found out that joint venture capital is the basis on which useful working capital management

promotes higher firm operations. Furthermore, Botoc and Anton, (2017) emphasized that effective working capital management may contribute to a new source of profitability on funds within the company, which consequently would be invested in a higher productive venture and portfolios to maximize the shareholders' funds, the main objective of the company.

1.2. Problem Statement

Working capital management is critical in unindustrialized economies, where the volatile conditions in the commercial sector and the unforeseen factors related to the economic situation can lead to severe general price instability (Boisjolya, Conine, & Donald, 2020). In the case of Kenyan economic background, SMEs face substantial challenges in as far as acquiring the credit facilities, which are strongly placed on the banking system, and also in outsourcing the sources required to finance their investments in their businesses. The problems faced by small marketers are even more patent in the manufacturing sector, especially at this point where businesses tend to have a greater requisite for capital (Sensini, 2020).

Working capital management has for a long time played a leading role in enabling the success of companies in recent decades. Working capital management gained momentum as a result of the global financial crisis and the downfall of several major corporations, such as “Lehman Brothers, Worldcom, Enron, and Bear Stearns” (Terreno, Peréz, & Sattler, 2020). Generally, neoliberalism and rapid technological evolution lead to high competition among business enterprises.

Working capital management therefore becomes critical for the achievement of day-to-day business operations. Effective working capital management is also important since it is associated with the firm's financial performance. Maintaining adequate financial resources is key at any moment for businesses (Kulo, Joshua, & Obeng, 2020). The working capital management concept, being a process of regulating short-term resources, is worth being analyzed. WCM also manages liquidity by ensuring that it's maintained at a reasonable level so as to achieve firm profitability.

2. Methodology

Working capital, which refers to the amount of current assets a business has to cover its operating expenses, is widely recognized as an indispensable component in effectively managing a company's financial health, particularly when assessing its solvency. Consequently, the primary goal of this research endeavor was to undertake a comprehensive examination and critical evaluation of the existing body of literature pertaining to the management of working capital, as well as the interrelated concepts of liquidity and financial

performance. In order to achieve this objective, the study adopted a methodology that involved the utilization of either derived or compiled data. By employing this approach, the researchers were able to conduct a thorough analysis of the relevant academic sources and publications, thereby facilitating a comprehensive and systematic review of the subject matter. As a result, this paper ultimately serves as a desk review as well as literature review, with the ultimate purpose of drawing well-founded conclusions and insights based on the observations extracted from the extensive literature review process.

3. Literature review

According to the perspective of the factors determining working capital management, the firm's categorical approach and the external economic atmosphere will equally influence a company's overall plan for working capital management. Various firms may adopt enhancement techniques and still face unstable conditions; therefore, the firm should always employ a working capital that resonates well with its mode of procedures (Han, 2021).

As a result of the vibrant continuing argument between theory and practice pertaining to the correlation between working capital and profitability, Botoc and Anton (2017) found that the outcomes are pertinent for both researchers and specialists. The outcomes, to some extent, strengthen the contemporary point of view of working capital and may perhaps support the rationales for potential theories and research in the future.

3.1. Cash Conversion Cycle (CCC)

Cash conversion cycle (CCC) is an important technique used to estimate the level of efficiency of working capital management. The cash conversion cycle can be defined as the duration from the time of purchases of raw materials and/or goods until the time accounts receivable are realized. (Delima, 2020) observed that CCC had a negative correlation with profitability. He further stated that working capital management has a significant impact on the profitability of listed companies in Sri Lanka. In his study, the components of working capital management (WCM) included the number of account receivable days, the number of inventory days, and the number of inventory days. The findings by Delima (2020) were similar to another study by Elangkumaran and Nimalathanasan (2016), who observed that WCM had a significant impact on the profitability of listed manufacturing companies in Sri Lanka. The study was also based on the principles of the CCC.

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Various past analyses have recorded an inverse correlation between working capital management and company profitability (Botoc & Anton, 2017). In his formative paper, Deloof (2003) evaluated an example of huge Belgian non-financial firms involving the era 1992–1996 and noticed an inverse linear relationship between cash conversion cycle (CCC) and operational performance determined by aggregate working revenue (Botoc & Anton, 2017), in which a negative relationship between working capital management and profitability is partly established for listed firms from the CESEE region.

Delima (2020), who examined the effects of WCM on the profitability of Sri Lankan listed firms, In addition, we observed a significant negative correlation between “net operating profitability and the average collection period, inventory turnover in days, and average CCC.” The debt ratio is insignificantly positively related to profitability. In a study by Althaqafi (2020) on the effects of WCM on a firm's profitability, they established that a significant negative relationship exists between profitability, the number of accounts receivable components, and the cash conversion cycle. However, an insignificant positive correlation was observed with inventory and accounts payable. Other significant control variables observed were financial leverage, sales growth, current ratio, and firm size, which had an effect on the business's profitability. The WCM-profitability relationship might depend on the firm's WCM strategy. According to Altawalbeh M.A.F. (2020), a firm that adopts aggressive WCM approaches “usually has a negative relationship between components of WCM and profitability and should expect profitability to be positively related.”

3.2. Liquidity

Liquidity is one of the key elements of working capital management. Liquidity is basically measured using the current ratio and the quick (or acid test) ratio. The current ratio is determined by dividing current assets by current liabilities, while the quick ratio is obtained by dividing current assets net of inventories by current liabilities. Under normal circumstances, a current ratio of 2:1 and a quick

ratio of 1:1 are considered to be the standard to indicate the sound liquidity position of a firm. A study by Khan (2016) observed that small manufacturing enterprises operate below the stated standards, therefore bearing a higher risk of facing liquidity and solvency challenges.

It is critical for an organization to maintain a balance between liquidity and profitability while conducting its day-to-day operations. Failure to maintain such a balance leads to the risk of insolvency. "Risk can be minimized by maintaining a higher level of current assets or working capital." Further, firms that "adequately plan their cash and inventory have fewer problems of control than those that operate without effective policies in these areas" (Khan, 2016).

From the previous studies, it is evident that strategic management of working capital, encompassing sound decision-making, proactive control of current asset movements, an effective Cash Conversion Cycle (CCC), and timely settlements of current liability obligations as and when they fall due, leads to stability in operations, predictability in earnings, and mitigation of insolvency risks.

3.3. Working Capital Management and financial performance

The noticeable narrative is that companies don't establish the factual worth of appropriate administration of working capital and, in such a regard, stress more on non-current investment decisions (Islam & Nazneen, 2013). Financial managers in various firms need to be well conversant with the factors determining working capital management and thereby base their decisions on consideration of such factors in a deliberate attempt to achieve an optimal level of working capital.

To achieve a sound working capital management strategy, it is essential to determine the critical mechanisms influencing WCM and enhancing the increase in earnings (Bashir et al., 2018). However, the analysis and subsequent determination of such parameters that would curtail risks and foster profitability have been a thorn in the flesh of many firms, necessitating some to turn to the adoption of sensitivity analysis techniques, and to a certain degree, small and medium enterprises (SMEs) are settling on a trial-and-error method attributed to a lack or expensive cost of consultation from professional financial experts. Sensitivity analysis adopts a special and effective method that, in contemporary global business, makes it possible to determine the impacts on an undertaking as well as detect variations in several factors, thus aiding in defining the aspects reflected as the main determination for the system (Iqbal, Hussain, Khaliq, & Tabassum, 2020).

It has been established that under an optimal level of working capital, it is said that there exists effective management of working capital in the company, insinuating

the possibility of a positive correlation between working capital and the profitability of the firm (Islam & Nazneen, 2013).

The problem lies in the overall objective of a firm, which is the maximization of shareholder wealth. Since WCM is the key determinant of the company's profitability, balancing and maintaining it at an optimal level is usually the greatest undoing of many firms. That notwithstanding, it should be noted that a firm's profitability does not necessarily become a yardstick to measure the efficiency of WCM and conclusively presume that the firm is operating at the optimal working capital level.

Investment in the era of financial instabilities can prove lucrative due to the provision of more profit-making avenues against substantial risk; moreover, companies can maximize profitability by growing their portion of the market (Zimon & Tarighi, 2021). In their study, they established that a substantial decline in investment in times of financial distress is not the consequence of a deficiency of invention and ingenuity in the industry but instead of the deficiency of credit provision by financial organizations to firms.

Firms that adopt highly ambitious working capital policies tend to concentrate on working capital management, which tends to increase trade margins and profitability. Once the optimum point is achieved, extra investments in working capital can lead to shortfalls in profits (Botoc & Anton, 2017).

3.4. SMES and Kenyan Perspective

The backbone of any country's economy is primarily supported by SMEs. Due to its significant impact on both social and economic development, the micro- and medium-sized business precinct is well recognized across the globe. For instance, the Garissa SMEs recorded a decline in net income for the period 2016–2020, with a declining growth of ROA of 12.5% in 2016 to below 8.3% in 2020 (Ahmed & Mwangi, 2021).

Ostensibly, the challenges plaguing firms in their resolve to create an appropriate equilibrium between surplus and shortage of working capital and the deficiency of suitable WCM undertakings ultimately affect the earning capacity of the firm (Mbathi, Mwambia, & Makena, 2021). Handling the working capital efficiently promotes the earnings of an enterprise; hence, the CCC and its determinants, specifically inventory days, sales unpaid, and account payables' payment period, were linked with the company's financial performance as the main contributor to the research gap (Murigu, 2019).

Imperatively, working capital is essential in any firm since it sustains the capacity of the firm's liquidity, expands the company's probabilities of existence in an extreme rivalrous setting, promises the creditworthiness of the enterprise, and

fosters an increase in earnings (Mbathi, Mwambia, & Makena, 2021). Murigu (2019) found out that the association that occurs between the financial performance of the firm and debtor variations in an era of financial predicament is in such a manner that various companies must not sustain their debtors accounts at a minimum amount so as to adventure profitability during the era of crisis.

A business concern cannot operate efficiently without proper management of short-term resources such as receivables, cash, payables, and inventory in order to honor its financial obligations when they fall due. Scrupulous management of receivables' collection period is quite important and ought to be prudently controlled. Ahmed and Mwangi (2021) established that the financial performance of organizations is positively correlated to accounts receivable. They concluded that business managers should craft good credit plans in order to improve monitoring of receivables' balances to ensure better financial performance (Ahmed & Mwangi, 2021).

Working capital management policies as employed by Kenyan firms play a key role. For instance, a cash management policy helps a business lessen or circumvent liquidity risks and increases the firm's production and investment income. Inventory management policies play a major role in reducing the costs associated with inventories, which in turn improves their financial performance. The receivables management policy also helps businesses grow their revenue turnover and reduce their borrowing costs. Payables management policy also enables a firm to increase production and avoid liquidity risks (Kiptoo, 2017). In order for Kenyan firms to enjoy long-term survival in business, it is critical for them to manage working capital effectively. The manner in which short-term assets and liabilities are managed will have a direct effect on the supermarkets' profit and balanced liquidity (Ngari & Kamau, 2021).

3.5. Derived conceptual framework

A comprehensive and thorough examination and evaluation of the various scholarly works and publications that were reviewed in the process has resulted in the development and formulation of the conceptual framework, which is visually represented as figure 1. This framework serves as a visual representation that effectively demonstrates and showcases the interconnectedness and interdependence between the management of working capital, the concept of liquidity, and the overall financial performance of an organization.

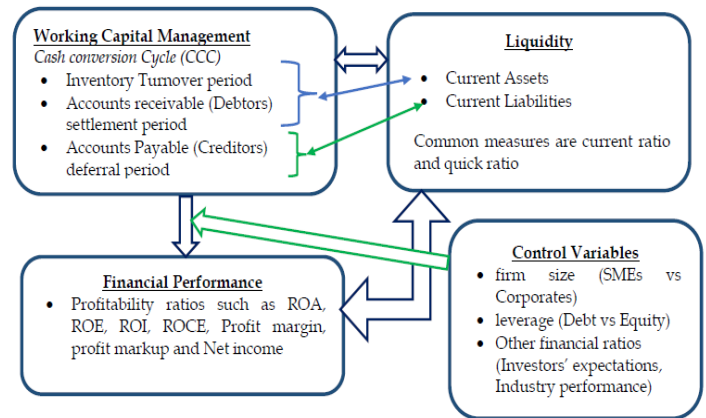


Figure 1: Relationship between variables

Figure 1 provides a visual representation that visually presents and illustrates the complex and intricate interplay and interaction among the key financial components within a business ecosystem. At the very core and heart of this interplay lies the concept and practice of working capital management, which is essentially and essentially the management and administration of the company's current assets and liabilities in a way that optimizes and maximizes the generation and flow of cash. This management is embodied and encapsulated by the Cash Conversion Cycle (CCC), which is a measure and indicator of the time and duration it takes for the various assets and liabilities of the company to be converted and transformed into cash flows. The CCC incorporates and includes several sub-components and elements, including the period and duration of Inventory Turnover, which essentially indicates and measures how quickly and promptly the company is able to sell its inventory and replenish it; the period of settlement and collection of Accounts Receivable, which measures and gauges the time and duration it takes for the company to collect and receive payments from its customers; and the period of deferral and postponement of Accounts Payable, which denotes and signifies the duration and length of time that the company takes and needs to pay its creditors.

One key and significant aspect and dimension that is closely and intimately linked and connected to working capital management is liquidity, which is fundamentally and essentially a measure and reflection of the company's ability and capacity to meet and fulfill its short-term obligations and commitments and responsibilities using and utilizing its current assets in comparison and relation to its current liabilities. Liquidity is a crucial and vital factor and consideration as it determines and influences the company's ability and capability to operate and function smoothly and efficiently on a day-to-day basis. Furthermore, financial performance is another crucial and critical aspect and indicator that serves as a barometer and gauge of the company's overall efficiency and profitability. It encompasses and encompasses a wide range and variety of

financial ratios and metrics, such as return on assets (ROA), return on equity (ROE), return on investment (ROI), return on capital employed (ROCE), profit margin, profit margin, and net income. Each of these ratios and metrics offers and provides unique and distinct insights and perspectives into different facets and dimensions of the company's financial health and efficiency.

However, it is important and essential to note and recognize that these dynamics and interactions are not existing and occurring in isolation and seclusion; rather, they are significantly and significantly influenced and impacted by two major and substantial factors and variables: firm size and leverage. The distinction and differentiation between small and medium-sized enterprises (SMEs) and corporations have profound and substantial effects and implications on various operational and financial aspects and elements, which in turn have a direct and indirect impact on the strategies and resources that are available and accessible for managing and administering working capital, liquidity, and financial performance. Additionally, leverage, which refers to the utilization and employment of debt financing, plays and exerts a significant and considerable role and influence in shaping and influencing these relationships and connections. The presence and use of leverage has the power and ability to shape and mold the risk profiles and outcomes and results that are associated and linked with working capital management, liquidity, and financial performance.

In conclusion and summary, Figure 1 serves as an illustrative and representational depiction and portrayal of a highly complex and intricate network and web of relationships and connections, where working capital management, liquidity, and financial performance are intricately and intimately linked and interconnected, and are also significantly and substantially influenced and affected by firm size and leverage. It is crucial and imperative for businesses and organizations to fully and comprehensively understand and comprehend these connections and relationships in order to make well-informed and informed decisions and choices and to effectively and efficiently navigate and maneuver the complexities and intricacies of financial management.

4. Summary, Conclusions and Recommendations

Due to the contemporary COVID-19 pandemic, SMEs in Kenya resorted to a more conventional and less aggressive WCM strategy, which jeopardized not only their going concern but also the stability of their operations (Zimon & Tarighi, 2021). That notwithstanding, with the new normal and the slow but steady sprouting of new SMEs and the sustainability of existing ones, there is a need for more research on strategies to achieve WCM optimization.

WCM strategy has been emphasized by various scholars in their literature reviews and empirical studies as the key

determinant of a firm's liquidity and, to a great extent, its financial performance (Ngari & Kamau, 2021).

Working capital is a function of liquidity and profitability. Ideally, the working capital ratio, as a measure of current assets over current liabilities, is recommended to be between 1.5 and 2, according to financial experts. This literally depicts working capital as having a positive correlation with the current assets and a negative correlation with the current liabilities. However, a balance between the parameters needs to be achieved at the ideal ratio, as recommended.

Understanding the cash conversion cycle (CCC) helps organizations executives manage resources more prudently, therefore enhancing the firm's financial performance. The firm should therefore ensure that the inventory turnover exists to improve the net profit of the SMEs, whereas the creditors and debtors' eras must take the edge off to diminish the liability and ensure that there is advancement liquid in the daily operations of a business, leading to a significant impact on working capital. It was further observed that the liquidity of a firm rises when the business is in a position to finance its debtors through increasing stock measures to meet the required firm satisfactions. Therefore, well-managed working capital of a company can lead to effective financial performance of a firm, enhance profitability, which helps to accomplish liquidity (Kulo, Joshua, & Obeng, 2020), and thus establish a positive relationship between the working capital (average collection periods, average payment period, and cash conversion cycle) and the firm's net profit.

Further study reveals that working capital management demonstrates the effects of liquidity components and productivity in a firm. Whereby, when the company's current assets are high, there will be an increase in the current ratio, thus boosting the firm's financial performance, while on the other hand, when there is a decrease in its current liabilities, the rate of return increases. In addition, a firm cannot work well in the absence of appropriate management of temporary assets such as the average collection period, inventory turn, and net operating cycle so as to implement its investment commission when they go overdue. Therefore, the study established a negative correlation between the average collection period, inventory turn, net operating cycle, and firm cost effectiveness.

Another key consideration is the working capital turnover ratio, which depicts the relationship between liquidity and financial performance by measuring the extent to which a firm converts every shilling worth of working capital into sales (Warrad, 2013). The working capital turnover ratio can be determined by dividing sales by the average working capital. A high working capital turnover ratio indicates efficiency in the WCM since it contributes to boosting sales, leading to an increase in profitability; however, the turnover ratio should not be extremely high to the extent that the firm faces the risk of being rendered

insolvent.

Achieving and maintaining an optimal level of working capital is the ultimate indicator of a successful enterprise. At this point, the firm strikes a balance between liquidity and profitability, proving that there is a significant relationship between WCM and liquidity and profitability.

The correlation between WCM, liquidity, and profitability is significant, and its impact on the overall performance of the firm cannot be wished away. For a firm to maximize shareholder wealth, it needs to focus on investments that yield maximum returns at the minimum cost possible without compromising the value of the business. Profits from the financial performance statements are always considered a measure of performance, but WCM is often overlooked. Nevertheless, just like a car engine that needs maintenance, regular service, and replacement of worn-out parts, WCM is pivotal in driving the operation of the business, and profitability is only a comparison of the

distance covered by the car.

In the attempt to justify the effect of working capital management on firm productivity, past research papers used control variables mainly firm size, prospect expansion, debt ratio, and other financial ratios, where much of the previous papers found a negative relationship between leverage and firm revenue earnings (Botoc & Anton, 2017).

Working capital, which refers to the amount of money a business has available to cover its day-to-day operations and expenses, is considered to be a crucial element in the management of a business. It plays a significant role in ensuring that the business functions smoothly and effectively. The effective management of working capital entails various important factors such as moderation, coordination, efficiency, and optimization. These factors are essential in achieving the desired outcomes and acting as the driving force towards the ultimate goal of the overall financial performance objective.

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