



# Working Capital Management Practices and Financial Performance in Kenya

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**Abstract:** *Gross working capital and net working capital are the two components that can be used to establish the working capital concept. Between current liabilities and current assets, there is a difference called net working capital. Accounts receivable, cash, and inventory are examples of current assets because they are easily convertible into cash; on the other hand, current liabilities are those that are owed to the company right away, such as accounts payable, bills payable, and other financial instruments. This paper appraises the interactions between working capital management in terms of cash, inventories, receivables, and payables management in relation to financial performance. The study also highlights two theories relating to working capital management: the liquidity preference theory and the cash conversion cycle. The study concludes that different working capital components have varying effects on the financial performance of manufacturing enterprises. Some studies reveal a favorable association between the components of working capital, whereas others reveal a detrimental relationship.*

**Keywords:** Financial Performance, working capital management, Receivables and payables management, Cash management, inventory management

## 1. Introduction

The working capital concept can be defined using two aspects, namely, gross working capital and net working capital. Net working capital is defined as the difference between current liabilities and current assets. Current assets are assets that can easily be converted into cash, and they include accounts receivable, cash, and inventory, whereas current liabilities refer to claims against the business by outsiders and include accounts payable, bills payable, and other financial instruments. Net working capital is also a measure of liquidity, that is, how easy it is for a business to honor its financial obligations as and when they fall due. Gross working capital is basically defined as the amount of money a firm has invested in current assets. Financial managers frequently struggle to make proper turnover decisions for organizations with working capital in order to achieve targeted profits. When an organization's long-term financial projections are strong, it usually has trouble managing its working capital (Ha, Thahn, & Hang, 2016).

According to [Matinovicova and Motlicek](#) (2014), financial managers must treat working capital management (WCM) with a lot of concern, irrespective of the organization's size or sector they belong to, because it greatly affects the performance of a firm. The determinants of working capital include the nature of the business, the operation cycle (cash conversion cycle), credit policy, availability of raw materials, and price fluctuation, among other factors. The main aim of working capital management is to ensure continuity in the operation of a business and have sufficient cash flow to meet both long-term debts and short-term obligations as well as daily operating expenses.

Efficient management of working capital has a direct influence on the firm's financial performance, and firms should have a shorter cash conversion cycle with a shorter number of days as their policy to attain their profitability index. Inventory as a component of working capital in manufacturing firms is divided into three main types: work in progress, raw materials, and finished goods. Thus, inventory levels of manufacturing firms should be maintained at an optimal level to ensure minimum financing costs, which will improve their financial performance. Manufacturing firms are among the key segments in the Kenyan economy that lead to sustainable annual growth in Gross Domestic Product (GDP). There are also some factors that contribute to a firm's inability to meet its obligations as they fall due, such as blacklisting by suppliers and labor strikes. Manufacturing companies also use advanced technology to make the process more efficient and cost effective.

## 2. Theories

This section highlights the various theories relating to working capital management and financial performance in Kenya.

### **Keynesian Liquidity Preference Theory**

According to Keynes (1936), he focused on the quantity of the supply of money, liquidity preferences, and interest rates. The theory explains why organizations and individuals have three main motives or purposes for holding money rather than investing in securities bearing interest. The theory argues that cash is required for precautionary, transactional, and speculative motives.

The precautionary motive implies that money is required to take care of unforeseen opportunities and contingencies, and this helps organizations in times of crisis and emergencies, therefore explaining the liquidity preference theory for retaining money. The transactional motive refers to holding money to meet an organization's day-to-day expenses, and short-term obligations of the company are met by using liquid money; thus, the amount of income should be directly proportional to the amount of liquidity. The speculative motive, on the other hand, addresses the need for money to take advantage of future investment opportunities. Precautionary and transaction motives are primarily influenced by income rather than interest rate, which makes them interest-inelastic. Therefore, as income decreases, cash reserves for precautionary and transactional purposes decrease, and vice versa. The speculative motive, on the other hand, is interest elastic because it is dependent on interest rates.

The motives mentioned in the theory are applicable to manufacturing firms, which must maintain a particular margin of working capital to cater to them. According to the transaction motive, manufacturing firms should keep money on hand to cover expenses such as employee remuneration and raw material purchases, among other things. For precautionary reasons, manufacturing firms should hold some money to make payments on urgent bills to avoid the penalties that may accrue. A manufacturing firm can invest in government bonds being issued to earn interest on maturity, and this can only happen when the firm holds money for speculative purposes.

### **Cash Conversion Cycle Theory**

The cash conversion cycle (CCC) is the time it takes an organization to convert its resources into cash. It can also be defined as the period between cash collection and cash disbursement (Sadia, 2018). This theory states that when all factors are held constant, the organization's profitability and liquidity will increase when the cash conversion cycle is short, thus ensuring efficient working capital (Gitman, 1991). The organization can slow down payments made by suppliers but speed up customer payments in order to keep the CCC shorter. The liquidity of a firm can be a function of its CCC. The liquidity position of an entity is affected by the levels of receivables, inventory, and payables.

When a company's manufacturing process is lengthy, it can keep more cash in inventory. Accounts receivable grow in tandem with the time it takes for customers to pay their bills. The net working capital will be reduced by accounts payables when inventories are not paid on time, and this reduces cash held since there is no cash outlay. This theory helps in the management of the CA of the firm, and its creditworthiness can be defined. There would be greater liquidity when the CCC is shorter, and this gives the firm an opportunity to obtain discounts during cash purchases and a lesser borrowing due to effective WCM. When the CCC is extended, the firm's need for cash grows. Manufacturing firms can maintain proper WC levels when they use this theory to obtain a balance between the collections period and the receivables period; this ensures that the business remains a going concern while also maximizing shareholder wealth.

## **3. Working Capital Management**

### **Cash Management**

Cash management is an important constituent of working capital because companies cannot always rely on customers to pay their suppliers and meet other operating expenses. The motivations for companies holding cash include precautionary, speculative, and transactional motives. Managers may hold on to cash to meet the frequent payment needs due to instability in the market or when the business activities are unpredictable (Gakondi & Muturi, 2019). For a firm to meet its liquidity needs, it should do an analysis of the cash conversion cycle to gain more explicit insight on managing

cash as a component of WC. A shorter cash conversion cycle will enable the firm to generate maximum profits by utilizing the resources vested in the business.

### **Inventory Management**

Inventory can be defined as goods that have not been taken into the production process to be converted into an end product. The minimization of inventory as a WC component is ideal; however, it can only be offset by the economic order quantity (EOQ) available from suppliers (Cinnamon & Helweg-Larsen, 2010). Financial managers find inventory management a more challenging task; for them to reduce costs and shorten the cash conversion cycle, it implies that inventory should be minimized as much as possible. The firm may increase the possibility of running short of finished goods during high demand or of the inventory needed in production when raw materials are minimized down to a level close to zero. Maness and Zietlow, (2005) states that such a situation may be costly for any firm because they would lose more revenue. The firm can use a just-in-time strategic approach for efficient management of inventory to help keep it at a lower level. This approach aims to make orders for inventory, production, and delivery just in time when they are required and not before.

### **Management of Account Receivable**

Ejike and Agha, (2018) suggest that accounts receivable are current assets owed to the firm as a result of the sale of goods and services on credit in the ordinary course of business. Financial managers should determine an efficient policy that controls credit sales and the costs associated with them. Managers should carefully consider the cost and benefits of different policies before establishing receivables policies (Ogbuji & Ogunyomi, 2014). The financial managers should investigate different forecasts and possibilities that affect the profits of the firm in the future. The cost of funds tied up in bad debt losses, collection costs, receivables, and cash discounts lost should be compared with sales losses and additional sales as a result of each policy proposed. Firms are sometimes willing to accept losses on increased sales in order to profit if a new policy is implemented. Firms can have a greater share of a previously closed market when they adopt a certain credit policy.

### **Management of Account Receivable Payables**

Accounts payable result from a business entity's credit supply of raw materials and services. For effective management of this liability, financial managers should consider the payment time of accounts payable. The payment time should be prolonged as long as possible to maximize suppliers' financing in order to convert purchased inventory into products to be sold (Maness & Zietlow, 2005). The managers should not be persuaded by the discounts offered by the supplier, as this may be tempting to ensure they pay their debt before the maturity date. Maness and Zietlow, (2015) argues

that beneficial discounts should have higher rates than interest rates the firm pays for credit supplies over the discount period. The firm should pay their payables on due dates within the credit period when discounts are not offered, and unless the firm has financial difficulties, payment of accounts payables after the due date should be avoided as it may attract a penalty.

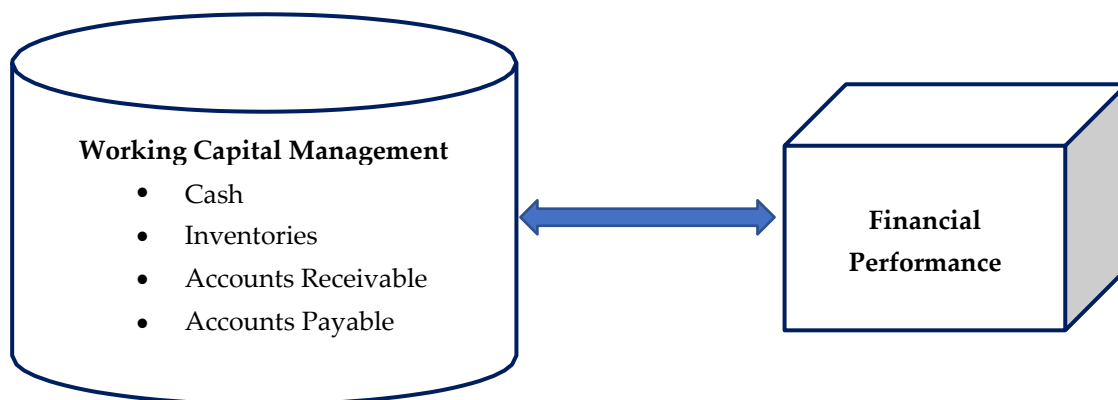


Figure 1: Working capital management and Financial Performance

#### 4. Financial Performance

WCM decisions have a greater impact on determining the financial performance of a firm. Efficient management of WC can be achieved by establishing an appropriate payment period, proper credit policies, inventory turnover levels, and CCC management at large (Krueger & Filbeck, 2005). The firm can minimize risks and cost by ensuring efficient WCM decisions are made, and this results in an increase in revenue and more cash trapped in the operating cycle for a shorter time, hence financial performance. Debt financing is also used by businesses to fund their expansion and operations, resulting in improved financial performance and higher investment returns.

#### 5. Conclusion

Working capital management shows how productivity and liquidity factors interact in a business. A company's current ratio will rise when its current assets are high, improving the firm's financial performance. On the other hand, a company's rate of return will rise when its current liabilities fall. Additionally, a company cannot function effectively without proper management of temporary assets, such as the average collection period, inventory turn, and net operating cycle, in order to implement its investment commission when they become past due (Chasha, Kavele, & Kamau, 2022).

The ideas taken into consideration for the study show that various WC components have varying effects on the financial performance of manufacturing enterprises. Some research reveal a favorable association between the components of WC, whereas others reveal a detrimental

relationship. Since most research has been done on manufacturing listed firms at Nairobi Stock Exchange Market, the purpose of this study was to ascertain the relationship between financial performance of manufacturing firms and WCM. To determine the links between working capital and a company's financial success, numerous research like the ones mentioned above have been carried out. The majority of research, however, use the company's valuation as the dependent variable.

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