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WORKING CAPITAL MANAGEMENT PRACTICES: A STUDY ON BUSINESS ENTERPRISES IN JIMMA TOWN, ETHIOPIA

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ABSTRACT

Working capital constitutes significant portion of firms' total assets. These include cash, Accounts receivables, Inventories etc. This study is aimed to assess the practices of working capital management in business enterprises in Jimma town, Ethiopia. Data were collected from 40 firms using questioner. The finding of the study showed that firms are weak in using scientific working capital management techniques and computerized record system. The researchers recommend that firms should think of hiring qualified personnel for the position of financial management in their firms.

Keywords: Accounts Receivable, Cash, Inventory, Working capital

INTRODUCTION

Business enterprises use working capital in their day to day operations. In broader sense, the phrase "working capital" refers to the gross working capital, which represents the amount of funds invested in current assets which includes cash, Receivables, Inventories etc. Financial managers should strive to maximize firms' value by managing these short term assets. This involves determining the optimal level of investment in short term assets. A firm needs sufficient level of current assets (Cash, Accounts Receivable, and Inventory) to ensure timely payment of current liabilities (accruals, accounts payable, and notes payable). Excessive investments in current assets may diminish profitability and lower firms' value (Baker and Powel, 2005).

In Ethiopian, the number and investment of business enterprises is growing since the coming of the Ethiopian People Revolutionary Democratic Front government in 1991 (Alemayehu & Tadele, 2004). Jimma town is one of the oldest and commercial centers found in Oromia regional state, Ethiopia. According to the census made in 2007, there are about 3,060 licensed business organizations in Jimma town. This number is increasing at alarming rate at the moment because of the favorable investment policy.

Despite the increase in number, business Enterprises in Ethiopia in general and in Jimma town in particular are currently being faced with many serious difficulties. These include shortage of capital, low productivity and competitiveness, lack of experience in terms of marketing, production, and financial management. Of these difficulties, lack of financing resources and lack of experience in financial management are currently the most serious issues. Inefficient financial management including working capital management may damage business enterprise's profitability (Gebrehiwot & Wolday, 2006).

Although these problems exist, to my knowledge, there has not been any research on working capital management practice conducted on business enterprises in Jimma town. Therefore, this study is aimed at investigating the working capital management practices of business enterprises in Jimma town. As a result of the increasingly important role and contribution of business enterprises as well as, the recent promotion and supporting policy in developing business enterprises, this research study is considered as a contribution to improvement of financial management practices of Business Enterprises in Ethiopia in general and Jimma town in particular.

RESEARCH PROBLEM AND OBJECTIVES

Management and control of working capital is one of the most effective measures of a company's financial health. It is common to assume that a firm's objective is to maximize shareholder value, and effective working capital management can contribute substantially towards this goal. Efficient working capital management can foresee and sometimes avoid potential financial difficulties. Poor working capital management can lead to financial distress, which increases the probability of bankruptcy. In the study conducted in Belgium, Deloof (2003) found out that the way working capital is managed will have a significant impact on the profitability of firms. Gill, et al (2010) also studied 88 American firms and found out statistically significant relationship between cash conversion cycle and profitability. In the recent study by Lakew and Rao (2013), efficiency in working capital management has a significant impact on firm's profitability.

Effective working capital management is very important. As a result, many financial managers spend long time managing current assets. For instance, according to Baker and Powel (2005), in USA manufacturing firms, current assets comprise about 40 percent of the total assets and skilful management of these short-term assets is critical for ensuring that the firms can meet their short-term maturing obligations and provide attractive return to its shareholders. In addition, working capital assets are the most manageable accounts and thus require frequent attention and oversight.

Managers need to understand how to develop effective working capital policies to ensure growth, profitability, and long-term success for their firms. Firms experiencing rapid growth may easily fall into a growth trap with insufficient levels of current assets to support increasingly higher levels of sales. In such cases, a firm may go broke while making a profit. Small but rapidly growing firms must pay particular attention to maintaining sufficient liquidity through their working capital policies and management (Baker and Powel, 2005).

In the case of Ethiopia, usually, the owners or general managers with the assistance of the accountant control financial matters of the companies. On the other hand, most owners or managers have no formal training in management skills, especially financial management. One reason for this is that, the concept of financial management has only been recognized in Ethiopia since the beginning of the 1960s, when the commercial code was introduced by the then imperial government. Hence, financial management is still one of the challenges of Business Enterprises in Ethiopia (Lakew & Rao, 2013).

On the other hand, most previous empirical evidences on working capital come from the developed countries. There is lack of evidence from developing countries like Ethiopia. This lack of empirical evidence from developing countries is the major gap in the knowledge of working capital management practices. Therefore, it is difficult to convince business practitioners of the need for changes in practices until evidence of working capital management practices and its potential benefits are provided. Therefore, the main objective of this study is to examine the working capital management practices of business enterprises in Jimma town, Ethiopia. Specifically, the study is designed to:

1. Describe the cash management practice of business enterprise in Jimma town
2. Assess the receivable management practice of business enterprises in Jimma town
3. Investigate the inventory management practice of business enterprises in Jimm town

LITERATURE REVIEW

There are two closely related concepts with regard to Working Capital Management. Gross working capital refers to a firm's short term assets used in operations, including cash, receivables, and inventory. On the other hand net working capital management is the management of the firm's short term assets and short term liabilities. Net working capital is short term assets minus short term liabilities. An effective working capital management policy requires that managers find appropriate investment levels of cash, receivables, and inventories and the appropriate level and mix of short-term financing (Baker and Powel, 2005).

In this study, the phrase "working capital" refers to only current assets of the firms which include Cash, Account Receivables and Inventories. A significant portion of many firms' capital is invested in current asset. Therefore, management's ability to manage efficiently the relative levels of the firm's cash, receivable and inventories directly affects the profitability. Efficient working capital management means minimizing the dollar invested in cash, accounts receivables and inventories per profit (Gitman, 1997). The following subsections review different literatures on how to manage these three components of working capital.

Cash Management

Cash includes all currency and demand deposit balance. It is the life blood of business firms. It is needed to acquire supplies, resources and other assets used in generating the products and services provided by the firm. It is also needed to pay wages and salaries to employees, tax to government, interest and principal to creditors and divided to shareholders. More fundamentally, cash is a medium of exchange that allows management to carry on the various activities of the business firms from day to day (Weston, Besley & Brigham, 1996).

According to Ross, et al (2001), the objectives of cash management are twofold. The first objectives of cash management are to meet the payment schedule. That is to have sufficient cash to meet the disbursement needs of a firm. The second objective is to minimize the cash balances a firm holds on. However, in minimizing the cash balance, two conflicting aspects have to be reconciled. A high level of cash on hand will ensure timely payment of obligation and will enable the firm to take advantages of opportunities. But it also implies that large funds will remain idle, as cash is a non earning asset and the firm will have to forgo profits. A low level of cash balance on the other hand may mean failure to meet payment schedules. Thus the goal of cash management is to minimize the amount of cash the firm must hold for use in conducting its normal activities, yet at the same time to have sufficient cash to take trade discount, to maintain credit rating, to meet unexpected cash needs, to prevent insolvency or bankruptcy arising out of the inability of a firm to meet its obligation (Ross, westerfield & Jordan, 2001).

According to Walson, et al(1996) cash management has taken an increasing importance in recent years for two reasons. First, there was an upward trend in interest rate that increased the opportunity cost of holding cash. Second technological development, particularly computerized electronic fund transfer mechanisms changed the way cash is managed. Financial managers, therefore have developed and refined techniques of cash collection and disbursement to try to optimize the availability of cash and to reduce the interest cost of borrowing from creditors (Weston, Besley & Brigham, 1996). Most cash management activities are performed jointly by the firm and its banks. According to Weston, et al (1996), effective cash management encompass proper management of cash inflow and outflow, which entail (1) synchronizing cash flow (2) using float (3) accelerating collection (4) slowing cash disbursement (5) getting available funds to where they are needed.

Receivable Management

Receivables are asset accounts representing amounts owed to the firm as a result of sales of goods or services in the ordinary course of the business. In developed countries, research indicated that the average account receivables accounts for 37% of the current assets and about 16% of the total assets (Gitman, 1997). The extension of credit to customers will enable firms to be competitive, attractive and retain customers and improve and maintain sales and profit.

Further, according to Gitamn (1997), account receivable management involves careful consideration of the following core aspects: (1) Formulating credit policy which is a set of decision that includes a firms credit terms, credit standards, collection procedures and discount offered (2) Executing the credit policy. Having established the term of sales to be offered, the firm must evaluate individual credit application and determine applicants' credit worthiness. In evaluating applicants, the 5c's (Character, Capacity, Capital, Collateral and Conditions) should be assessed properly (Gitman, 1997).

Selling products and services on credit is useless unless there is proper collection effort. Collection policy refers to the process the firm follow to collect receivables. The collection policy may be termed as strict or lenient policy. A strict policy of collection will involve more efforts on collection. This policy will enable early collection of account receivables and will reduce bad debt loss. On the other hand, a lenient policy is a relaxed collection policy where no rigorous collection efforts are taken. This policy may increase the credit collection period and bring bad debt loss (Gitman, 1997).

Inventory Management

The term inventory refers to current assets which will be used in production process or held for sale in the future in the normal course of business operations. Inventory management is concerned with keeping enough inventory on hand to avoid running out of stock while at the same time maintaining a small enough inventory balance to allow for a reasonable return on investment. Proper inventory management is important to the financial health of the firm: being out of stock forces customers to turn to competitors or results in a loss of sales. Excessive level of inventory, however results in large inventory carrying costs, including the cost of capital tied up in inventory, warehouse fee and insurance etc (Weston, Besley & Brigham, 1996).

The ultimate goal of an inventory management program is to provide maximum customer service at a minimum cost. Effective inventory management requires effective techniques of inventory control. A proper inventory control not only helps in solving the acute problem of liquidity but also increase profits and causes substantial reduction in working capital requirement of a firm. Techniques that are commonly used in managing inventory are materials requirement planning (MRP) system, ABC system, the basic economic order quantity (EOQ) model, the Just in Time (JIT) system, and other Inventory management techniques (Weston, Besley & Brigham, 1996).

RESEARCH DESIGN AND METHODOLOGY

This research study is designed to describe the working capital management practices of Business organizations. Thus, “descriptive method” was viewed as an appropriate research type. Due to limitation of time and fund, the target population in this research is limited to business organizations in Jimma town, Ethiopia. Jimma town is selected for this study because of the following reasons. First Jimma is one of the biggest business centers in Ethiopia and a research conducted in Jimma can more or less represent the practice in the other parts of the country. Second Jimma is chosen by the researchers because of its proximity and convenience for data collection with the limited time and fund available and finally as the researchers are academic staffs at Jimma University, they are responsible to contribute their part in solving local problems.

The 1960 commercial code of Ethiopia (Art 63-73) states that any person or business organization carrying on trade shall keep books and accounts as are required in accordance with the business practices and regulations, having regard to the nature and importance of the trade carried on. Further, the Ethiopian Income tax proclamation No.286/2002 specifies that business organizations that earn annual turnover of more than Br. 100,000 are required to keep books of accounts. According to the data obtained from Jimma town revenue office, of the business organizations available in the town, only 135 business organizations have been keeping accounting records till July 7, 2011.

The target populations for the study are the whole 135 business organizations that keep book of accounts. Since large non respondents were expected at the beginning because of the confidentiality of the data sought, the whole target populations were considered for the study. As expected, only 40 usable questionnaires were returned back; which means a response rate of approximatly30%. These firms include 21 service giving, 14 trading and five manufacturing firms.

Selecting data collection technique is the next step after choosing type of research. In this study, survey technique was used. Survey was selected as a research technique in this study because it is useful to investigate and describe working capital management practices of various Business Enterprises when there is lack of sufficient secondary data (Zikummund, 2009).

A questionnaire was designed and directly delivered to Business Enterprises to collect primary data related to their working capital management practices. Content validity of the questionnaire was established by asking for assistance of three academic staffs to pass judgment on the suitability of the items chosen before conducting the survey. While collecting data, since most of the respondents did not have deep finance background, the data collectors had to explain most of the technical terms in order to obtain the appropriate response. During the visit of respondents, opportunity was taken to observe how things were done in the various enterprises and informal interviews were made with accountants and other relevant employees.

Descriptive statistics were used to investigate and describe characteristics of working capital management practices. Some of the descriptive statistical tools used in this study includes: frequency distributions, percentage distributions, tabulations and cross tabulations.

RESULT AND DISCUSSION

Cash Management Practice

Cash is said to be the life blood of business organizations. It needs strict control and good management practice. Cash budget is an extremely important cash management tool because it enables firms to plan ahead for their day to day cash needs. Another aspect of proper cash management is proper controlling of cash. One of the tools used for cash control is using bank account and computerized record keeping. The table below shows the frequency of preparing cash budget and cash controlling techniques.

Table 1. Cash Budget and Control

		Number	Percentage
a) Preparing Cash Budget	Never	9	22.5%
	Rarely	4	10%
	Sometimes	6	15%
	Often	6	15%
	Always	15	37.5%
	Total	40	100%
b) Using bank account	Never	0	0%
	Rarely	0	0%
	Sometimes	1	2.5%
	Often	10	25%
	Always	29	72.5%
	Total	40	100%

Table 1. Cash Budget and Control (Contd….)

		Number	Percentage
c) Preparing Bank Reconciliation	Never	1	2.5%
	Rarely	0	0%
	Sometimes	4	10%
	Often	10	25%
	Always	25	62.5%
	Total	40	100%
d) Using computer in cash Management	Never	7	17.5%
	Rarely	8	20%
	Sometimes	10	25%
	Often	10	25%
	Always	5	12.5%
	Total	40	100%

As can be seen in table 1 above, only 37.5% of the firms always prepare cash budget. The remaining majority of firms will not prepare cash budget regularly. From table 2c, it also looks that firms under study are strong in using bank account and periodic preparation of bank reconciliation. One of the reasons for this might be the availability of many public and private banks in the town. However, the majority of the respondents are not using computer in managing their cash. If cash is not properly managed, frequent surpluses and shortage may occur. Table 2 below summarizes the response with regard to occurrence of surplus cash and how they invest this surplus cash.

Table 2. Occurrence of Surplus Cash and its Investment

		Number	Percentage
a) Occurrence of surplus cash	Never	16	40%
	Rarely	9	22.5%
	Sometimes	15	37.5%
	Often	0	0%
	Always	0	0%
	Total	40	100%
b) Investment Opportunity	Deposit in bank	10	62.5%
	Government t- bill	0	0%
	Other Businesses	3	18.75%
	Paying liability	3	18.75%
	Total	16	100%

As can be seen from the table 2 above, the majority of the respondents never or rarely faced surplus cash. Those which have experienced surplus cash in their day to day operation will deposit in bank until the cash is required for use in their current account. Some proportions of the respondents invest the idle cash on other businesses and use it to pay their debt. None of the respondents will invest the surplus cash on the weekly Ethiopian government Treasury bill, the only available short term money market in Ethiopia. In the contrary, respondents were also asked whether they have encountered any cash shortage and how they finance the shortage. The result is summarized below.

Table 3. Occurring of Cash Shortage and its Method of Financing

		Number	Percentage
a) Occurring of Cash Shortage	Never	15	37.5%
	Rarely	9	22.5%
	Sometimes	10	25%
	Often	6	15%
	Always	0	0%
	Total	40	100%
b) Method of Financing	Borrowing from bank	19	76%
	Borrowing from creditors	2	8%
	Borrowing from friends	1	4%
	Delaying payment	3	12%
	Total	25	100%

As shown in the table 3 above, 62.5% of the respondents have faced some sort of cash shortage in their life. Only 37.5% of the respondents have never faced any cash shortage at all. About 76% of the respondents will finance their cash shortage by borrowing from a bank. Other alternative mechanisms applied by some of the respondents include delaying cash payment (12%), borrowing from other creditors (8%) and borrowing from friends (4%).

Accounts Receivable Management

The account receivable management practice of the firms under study is discussed as follows. First, respondents were asked whether they make sales on credit and have appropriate credit policy. The response to this question is presented in table 4 below.

Table 4. Sales on credit and Credit policy

		Number	Percentage
a) Sells on credit	Never	8	20%
	Rarely	10	25%
	Sometimes	16	40%
	Often	4	10%
	Always	2	5%
	Total	40	100%
b) Set up credit policy	Never	13	40.63%
	Rarely	2	6.25%
	Sometimes	8	25%
	Often	7	21.8%
	Always	2	6.25%
	Total	32	100%

Table 4 demonstrates that the majority of the respondents do not make credit sales regularly. Of those that make credit sales, only some will setup a sort of credit policy. Respondents were also asked the percentage of credit sales to total sales. Almost all of them responded that their credit sale is less than 20% of their total sales. Proper record keeping is a very important tool in managing receivables. Table 5 below summarizes receivables record keeping practice of the responding firms.

Table 5: Record Keeping for Receivables

		Number	Percentage
a) Record kept	Subsidiary record	6	18.75%
	General record	6	18.75%
	Both together	20	62.50%
	Total	32	100%
b) Use of Computer	Never	12	37.5%
	Rarely	5	15.63%
	Sometimes	6	18.75%
	Often	6	18.75%
	Always	3	9.40%
	Total	32	100%

From table 5 above, it can be seen that the majority (62.50%) of the firms keep both subsidiary and general accounts receivable ledgers and the majorities of the firms does not use computer in their receivable management. Frequent follow up and having appropriate collection policy is very important in managing receivables. Table 6 below presents the actual practice of the firms under study.

Table 6. Follow up and Review of Receivables and Uncollectable

		Number	Percentage
a) Follow up Receivables	Never	4	12.5%
	Rarely	1	3.13%
	Sometimes	5	15.63%
	Often	7	21.82%
	Always	15	46.88%
	Total	32	100%
b) Review uncollectable	Never	4	12.5%
	Rarely	2	6.25%
	Sometimes	4	12.5%
	Often	6	18.75%
	Always	16	50%
	Total	32	100%
c) Percentage of Uncollectable	Less than 5%	24	75%
	B/n 5% -10%	6	18.75%
	B/n 10%-20%	2	6.25%
	Greater than 20%	0	0%
	Total	32	100%

In reviewing receivable levels and uncollectable, a relatively high percentage (about 80%) in the sample review their receivable levels and bad debt though the frequency vary. In addition, about 94% of the responding firms indicated that their bad debts have not exceeded 10% of sales. This implies that the firms are relatively good in getting receivables collected back.

Inventory Management Practice

For inventory management practices, only trading and manufacturing firms are considered (a total of 19 firms), because service giving businesses do not have inventory held for sales purpose. Of course, service giving business have supplies inventory which they consume in the provision of service, however, the management of supplies is somehow different from management of inventory held for sales and used in the production process. Respondents were asked about, frequency of determining inventory level & inventory budgeting practice. The table below summarizes the result of the survey.

Table 7. Inventory level and Inventory Budget

		Number	Percentage
a) Review inventory level	Never	0	0%
	Rarely	0	0%
	Sometimes	2	10.52%
	Often	4	21.1%
	Always	13	68.42%
	Total	19	100%
b) Prepare inventory Budget	Never	1	5.26%
	Rarely	1	5.26%
	Sometimes	1	5.26%
	Often	8	42.1%
	Always	8	42.1%
	Total	19	100%

As shown in table 7 above, the majority of the firms (68.42%) review their inventory level always. In addition about 84% of the firms often or always prepares inventory budget. Further; respondents were asked how they determine inventory level and the result of the survey is presented in the subsequent table.

Table 8. Method of Determining Inventory Level

		Number	Percentage
a) Inventory level determination	Based on theory of inventory	1	5.26%
	Based on historical data	9	47.36%
	Based on experience	9	47.36%
	Total	19	100%

Table 8. Method of Determining Inventory Level (Contd.…)

		Number	Percentage
b) Inventory model application	Never	15	78.95%
	Rarely	2	10.52%
	Sometimes	2	10.52%
	Often	0	0%
	Always	0	0%
	Total	19	100%

As can be seen from the above table 8, above 94% of the respondents determine inventory level using historical and past experience. Further, almost all of the respondents do not use inventory management models such as economic order quantity (EOQ), Reorder point (ROP) and Just in Time (JIT). This implies that the firms lack the awareness of scientific inventory management techniques. This might be because of lack of knowledge of the techniques or not understanding their benefits. Inventory control is one aspect of inventory management. In this regard, respondents were asked their inventory control practice and the result is presented in the table below.

Table 9. Inventory Record System and Inventory Count

		Number	Percentage
a) Inventory record system	Perpetual system	8	42.1%
	Periodic system	8	57.9%
	Total	19	100%
b) Utilization of computer In inventory mgt	Never	5	26.31%
	Rarely	4	21.1%
	Sometimes	5	26.31%
	Often	4	21.1%
	Always	1	5.26%
	Total	19	100%
c) Make Inventory Count Annually	Never	0	0%
	Rarely	0	0%
	Sometimes	1	5.26%
	Often	3	15.8%
	Always	15	78.9%
	Total	19	100%

From the above table 9, it can be seen that the majority of the firms use periodic record system. For retail enterprises, perpetual system should be supported by computer. However, as shown in the above table 9, only some of the firms make use of computer in inventory management. Further, 78.9% of the respondents always make inventory count annually.

CONCLUSION AND RECOMMENDATION

Sound working capital management is essential to the success of businesses. Successfully managing current assets is important in new as well as expanding business. So time should be taken to develop and implement proper working capital management practices that ensure success of business enterprises. From the descriptive analysis part of the study, it can be seen that there are problems in working capital management practice of the firms' that needs to be improved. First, most of the working capital management practices are performed based on experience and intuition instead of scientific management techniques. Second, most of the working capital management practices are not supported by computerized system which will have a negative impact on the accuracy and timely processing of information used in managing the business and finally business enterprises are found to be poor in credit sales which have an impact on their revenue. The researchers recommend that firms should think of hiring qualified personnel acquainted with scientific working capital management techniques and computer application for the position of financial management in their firms.

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