Determinants of Working Capital Management Practices in Small and Medium Enterprises in Nairobi

Jean Paul Ndagijimana, MBA - Finance

Timothy C. Okech, PhD - Economics[1]

Abstract

Governments in collaboration with sectoral stakeholders have over the years continued to support small and medium enterprises (SMEs) as part of initiatives aimed at poverty alleviation, wealth and employment creation. In Kenya, the government of Kenya continues to strengthen the development of the sector including training in financial management. The purpose of this study was to investigate the factors affecting working capital management practice in small and medium enterprises in Nairobi, Kenya by specifically examining how the management of accounts receivables and payables, and the cash conversion cycles affect working capital management practice in these enterprises. Using descriptive research design, both primary and secondary data was collected from SMEs in Nairobi registered with the Federation of Small and Micro Enterprises and analysed to obtain both descriptive and inferential statistics. The study revealed positive significant relationship between accounts receivable, accounts payable and cash conversion, and working capital management practices in the enterprises. Similarly, a large majority reported acquiring in puts and selling output on credit with payments ranging from two weeks to even four months which however, affected the cash flow of the enterprises and consequently their ability to honor their financial obligations. Finally, a large majority obtained their finances from banks, micro-finance institutions, as well as shy-locks to boost their businesses unfortunately they ended up charging very high interests. In the end many enterprises could not repay the money on time while others could not afford to pay back thereby closing shop. It was recommended that SMEs need to balance between credit sales and cash sales so as to avoid running into a cash trap position; entrepreneurs need to be equipped with necessary financial management skills to effectively enhance their ability manage accounts payables and receivables efficiently to avoid the challenges that are likely to emanate from overreliance on debts. Necessary regulatory mechanisms need to be put in place governing credit facilities to ensure full disclosure of the information while at the same time cap interest chargeable.

Keywords: SMEs, Accounts payables, Accounts Receivables, Cash conversion Cycle, Working capital

1.0 Background and the context of the Problem

Over the years, small and medium enterprises (SMEs) development has emerged a major economic development and growth strategy aimed at in poverty alleviation, wealth and employment creation in many world economies. As a result, many governments world-wide with support from sectoral partners have continued to initiate programs earmarked towards the strengthening and development of the sector (Okech, 2006). Areas of support include management and technical training, extension services, provision of physical structures, provision of lack and utilities, marketing and credit facilities (Okech 2006; GoK, 2010). Aware of this, the Kenyan government has taken steps to develop a legal, and regulatory framework, markets and marketing, business linkages, the tax regime, skills and technology and financial services (GoK, 2005; GoK, 2010).

In Africa, about 25 percent of the people employed outside agriculture depend on this sector for their livelihood; improving the conditions for small business is thus seen as a solution to unemployment and poverty alleviation (Mead & Liedholm, 1998). According to Haftendorn and Salzano (2003), micro and small enterprise creation are routes that young people actively explore to ark their current and future economic needs. In Kenya, the sector contributed over 50% of new jobs created in 2005 and contributed estimated 18 per cent of GDP, up from 3 per cent in 2010 (GoK, 2012).

[1] Corresponding author

The Government of Kenya in Kenya's blue-print of 2010 acknowledged Kenya to move towards a newly-industrialized middle-income country capable of providing a high quality of life for all its citizens by the year 2030, SMEs need to be strengthened (GoK, 2010).

Despite the significant contribution and support earmarked towards the sector, SMEs are faced with the threat of failure with past statistics indicating that three out of five fail within the first few months (Sonia, 2009; Nzyoka, 2011). According to Sonia, working capital management accounts for most of the failures in these enterprises with management of both current assets and liabilities singled out. The need to main effective working capital management within small and medium enterprises remains pivotal to solvency and liquidity of SME's (Nzyoka, 2011). Nzyoka noted that majority of SMEs do not care about their working capital position, with many paying attention to their working capital position and credit management policy. Sunday (2011) supports Nzyoka by contenting that many SMEs do not care about their financial position, they only run business and they most focus on cash receipt and what their bank position.

In terms of viability of the enterprises, Banos *et al* (2010) observed that efficiency in the management of working capital is critical. This Banos *et al* noted will enhance performance, sustainability and competitiveness of these enterprises. Accordingly, business viability relies to a greater extent on its ability to effectively manage receivables and payables and inventory. The goal according to Banos *et al* is to ensure that firms have sufficient ability to manage their financial obligation on time otherwise their cash flow position are likely to be affected negatively. Existence of mismatch between cash inflows and cash outflows in the operating activities in SMEs was also emphasized to negative affect their operations. To control these cash flows and thereby reduce the potential negative effects on profitability and risk, Ross *et al* (2005) noted that it is important that working capital management skills and process are embedded in the firms' management practices. Further, it was observed that SMEs experience volatility in cash flows which affect their liquidity and consequently their ability to meet short term financial obligations and hence collapse of many (Nzyoka, 2011; Pieterson, 2012). Pierterson (2012) attributed this to poor financial management, especially the working capital management.

The need to maintain effective working capital management within small and medium enterprises remains pivotal to solvency and liquidity of SMEs (Kehinde, 2010). Kehinde further noted that most SME's do not care about their working capital position, most have little regard for their working capital position and most do not even have standard credit policy. Many do not care about their financial position, they only run business, and they mostly focus on cash receipt and what their bank account position is. In the process a number have collapsed. The purpose of the study was thus to investigate the factors affecting working capital management practice in small and medium enterprises in Nairobi, Kenya by specifically examining how the management of accounts receivables and payables, and the cash conversion cycles affect working capital management practice in these enterprises.

2.0 Methodology

The target population comprised all SMEs in Nairobi and registered with the Federation of Small and Micro Enterprises from which a sample was drawn. Both primary and secondary data were collected to facilitate the realization of the study objectives. Whereas primary data was collected using structured questionnaire, secondary data was collected from the both published and unpublished reports ad studies relating to these enterprises. Data collected was analyzed to obtain both descriptive and inferential statistics. Reliability and Validity Tests were conducted after pilot testing the tools to respondents drawn from a few our SMEs not included in the sampling frame. The research instrument was thereafter modified on the basis of the pilot test before administering it to the study respondents. In order to ascertain the reliability of the research instrument, Cronbanch Alpha was used and the cut-off point of 0.538 was obtained indicating that the instruments were reliable and that the information to be obtained was valid. Additionally, a normality test was conducted to establish the normal distribution of the data. A Kolmogorov statistic showed no significance an indication that the data showed normal distribution.

2.1 Findings and Discussion

In this sub-section, results are presented starting with background information followed by findings based in terms of management of account receivables, account payables and cash conversion. Majority of the respondents were sole proprietors, followed by partnership, co-operatives and finally limited liability companies. In terms of the respondents' sex, there was gender balance in terms of ownership of business with half being male and the other half were female.

This is an indication that there is minimal gender parity in engagement of economic activities and that none of the sex has not been left behind in the quest for entrepreneurship in general and economic generation in particular.

Other notable findings in terms of background information were levels of education, marital status and basic management skills. Majority of the respondents' had primary education, followed by secondary level of education and lastly university education. These results could be an indicator that only a small segment of those with high level of education have ventured in small and micro enterprise businesses or that those with high levels of education perceive SMEs are risk ventures and therefore not keen in investing in them. Alternatively, this could be that education skills may not be necessary in operating SMEs or that most of those with low level of education have found this as opportunity for employment.

Majority of the respondents were found not to be keeping financial records, while only a few were keeping these records. Most of the entrepreneurs however only kept sales day books, while less than a quarter kept purchase day books, with an insignificant percentage preparing general ledgers and cash books. Preparation of these basic books is considered necessary since apart from providing an indication of the performance of the business, they also facilitate in tracking business transaction. As observed by Peel and Wilson (1996), small and medium enterprises should adopt formal working capital management routines in order to reduce the probability of business closure, as well as to enhance business performance and maintain a steady cash flow. Peel and Wilson emphasized that SME managers and entrepreneurs should understand the importance of working capital management for the liquidity, profitability and ultimately the survival of their company. Further, it was found that accounts receivable were not recorded which in the process affected follow-ups for payments on time.

In the study, many enterprises rarely maintained customer details and credit information; appropriate credit terms and billing cycle which affected timely collection of payments from the customers. As observed by Connolly (2013), developing and maintaining receivable schedules and regular review of receivables including customer statements and implement policies to ensure timely and efficient collection of outstanding accounts are necessary. This would in the process facilitate follow up as well as setting reminders to the customers. Inability to undertake this is bound to affect cash inflows and consequently ability to meet the business obligations when due. According to Sunday, best practice requires that receivables are stated at their net realizable value by reducing amount receivable by the amount it estimates it will not collect either by using percentage of sales on its income statement or by using the aging of the account receivable on the balance sheet.

The study revealed that accounts receivable management affected working capital management practice in these enterprises as evidenced by over seventy percent of the respondents who indicated that lack requisite inventory management tools that could be essential in the reduction of pile up of raw materials. A similar percentage singled out lack of skills in keeping necessary records as well as stock taking as a key factors contributing towards the situation. This finding was supported by regression results that showed a positive relationship between accounts receivables and working capital management practice in SMEs. The study further revealed that accounts payable management affect working capital management in small and medium enterprises in Nairobi since more than half of the enterprises had adopted a negotiated credit purchases ranging from two-weeks to four months. This was supported by the regression results that showed a positive significant relationship between accounts payable management and working capital management.

In the same regard, the study established that trade receivables a rose from a variety of transactions including verbal promises to pay at a latter date. Examples of these included interest receivable, loans to officers, advances to employees, deposit to cover potential damages or loss, deposit as a guarantee of performance or payment, dividends receivables, claims against insurance companies, government bodies for tax refunds, creditors for returned, damaged or lost goods, customers for returnable items such as crates or containers, among others. The findings support a research carried out by Kehinde in 2011 on effective working capital management in small and medium scale enterprises which revealed that most SME suffer from the problem of paying all bills from cash earnings.

Kehinde observed that for most SME's the production and sales cycle is shorter than the average time of accounts payable, creating a scenario where trade debt builds up in an ever increasing manner until a point where the SME cannot pay debts in due date, and eventually collapses (Kehinde, 2011). This kind of practices, may not be sustained for long and if not checked on time affect the smooth operations of the enterprises.

The findings are an indication that management of payables is an important factor in an SME's working capital management, and a key indicator of overall operational effectiveness. For instance if it is too high, the SME may find themselves in operational inefficiencies in meeting short-term obligations such as payment of bills, leading to costly penalties in the medium and long run. In the process, maintaining business trusts with creditors is eroded.

Finally it was revealed that cash conversion cycle management affect working capital management in small and medium enterprises in Nairobi. Additionally majority of the SMEs were seen to have gotten their finances from banks, friends, micro financing institutions as well as shy locks who unfortunately were charging very high interest with a number of clauses not revealed at the time of advancing the financing support. This according to the respondents affected them negatively in the process due to high interest rates charged. Similarly, majority were operating without bank accounts and that many a times the cash was kept in cash tills, while a few others spent the proceeds on family obligations without necessarily accounting for it.

3.0 Conclusion and Way Forward

3.1 Conclusion

The study concludes that accounts receivable management affect working capital management practice in small and medium enterprises in Nairobi. It evident that SMEs still face the challenge of lacking requisite inventory management tools that could be essential in the reduction of pile up of raw materials in addition to inability to undertake stock taking to inform stock movements. From the regression results, it is inferred that accounts payable management affect working capital management in small and medium enterprises in Nairobi. Additionally many enterprises allowed credit period ranging from two weeks to one month with poor records on due dates for payment of various business obligations. This was supported by positive and significant relationship between accounts payables and working capital management.

Finally, it was established that majority of the SMEs sought financial support from various sources including micro finance institutions, banks and shy-locks that however were charging high interest and many a times did not disclose all the information regarding the transactions. In the end, many SMEs were negatively affected. Again this is a point of weak working capital management practices in these enterprises. Also, it was revealed that only a few SMEs had separate accounts for business and their own individual accounts with many spending the same from the business on personal needs while at the same time many simply kept the money in tills a reflection of weak and prudent financial management.

3.2 Way Forward

In lieu of the findings, various recommendations are made. First, SMEs need to be cautious about their accounts receivables position given that if this is not properly managed, there is likelihood that it will dwindle their performance. Thus, the entrepreneurs need to be trained on financial management skills including book keeping stock taking and inventory management. Basic information technology skills are also considered important to facilitate inventory management, billing of account while ensuring effective management of customers' records. The study acknowledges the important role played by accounts payable in working capital management practice and as such the study recommends the need for SMEs to put in place tools to effectively manage accounts payables so as to enhance the efficiency off the business process and to avoid the challenges that are likely to emanate from overreliance on debts.

Cash management has been established to be key in working capital management practices. Thus it is recommended that SMEs should adopt the culture of standard liquidity position so as to reduce the risk of inability to meet financial obligations when they are due in order to maintain business trust with credit providers. Additionally, the government needs to initiate and implement necessary rules and regulation governing provision of financial support targeting SMEs especially on areas of disclosure of information to clients. This way, SMEs will be cautioned against cost of credit due clauses need disclosed at the time of provision of credit to the enterprises.

References

Abel, K. (2008).Financial Management for Decision Makers .London: Pearson Education Ltd.

Abor, J. and Quartey, P. (2010) Issues in SME Development in Ghana and South Africa. International Research Journal of Finance and Economics, issue 39.

Anand, G. (2012). Working Capital Management of Corporate firms in India, Business Journal.

Appuhami, B.A.R. (2008). The impact of firm's capital expenditure on working capital management: An empirical study across industry in Thailand, International Management review, vol.4, No. 1, p 11 – 24

Banos, M. B. (2010). Impact of Working Capital Management on the Profitability of Public Listed Firms in the Netherlands during the Financial. Journal of Finance

Baveld, M. B. (2012), Impact of Working Capital Management on the Profitability of Journal of Finance. vol.5 No. 1, p 20-27

Bowen M, Morara M, Mureithi S (2009). Management of business challenges among small and micro enterprises in Nairobi-Kenya, Retrieved from http://www.kcajournals.com. KCA J. Bus. Manag., 2:1.

Chandra,P.(2008). Financial Management:TheoryandPractice.NewDelhi:Tata McGraw Hill Education Private Ltd.

Connolly, T. (2013) A look at the cash conversion cycle. http://Investopedia.com

Falope OI, Ajilore OT. (2009). "Working capital management and corporate profitability: evidence from panel data analysis of selected quoted companies in Nigeria". Research Journal of Business Management, 3: 73-84

Garcia-Teruel, P.J & Martinez-Solano, P (2010). Determinants of Trade Credit International journal of management finance, vol 3 no.2

Gitman L. (2005). Principles of Managerial Finance (11th Edition). New York: Addison Wesley Publishers.

G.O.K (2010). Kenya Vision 2030; The Popular Version, Nairobi: Government Printer.

G.O.K (2012). Kenya Vision 2030; the Popular Version, Nairobi: Government Printer.

Hill, MD., Kelly, G.W. & Highfield, M.J. (2010). Net Operating Working Capital Behaviour: A First Look, Financial Management, Vol.39, No.2, p783-805

JICA, Japan International Cooperation Agency (2008) SME toolbox: Total know-how for growing a small business in Ghana, Accra

Khan, M.Y.and Jain P.J. (2007). Financial Management. Tax, Problems and Cases.5th ed, Tata, McGrawHill Publishing Company Limited.

Mathuva D. (2009). The influence of working capital management components on corporate profitability: a survey on Kenyan listed firms.Research Journal of Business Management, 3: 1-11.

Nazir, M.S & Afza, T. (2008). Factors determining working capital requirements. Proceedings of ASBBS, Vol. 15, N0.1, p293-301

Peterson, A. (2012).Working Capital management practices of SME in Ghana: Kwame Nkrumah University

Peel, M and Wilson, K. (1996). Assessing Growth of MSEs in Africa. A new Dimension. Strategic Management Journal , 565-586.

Reeve, M. James, Warren, S Carl and Duchac, E. Jonathan (2009) Principles of financial and managerial accounting, 11th edition, South Western

Richards,V.D.and Laughhlin E. L.A cash Conversion Cycle Approach to Liquidity Analysis-Financial Management, (spring1980)pp.28-32

Ross, S.A., R.W. Westerfield and B.D. Jordan, (2005). Fundamentals of Corporate Finance. 6th Edn. McGraw-Hill Irwin Publications, New York, ISBN: 0-07-246974-9, pp: 167

Sushma, F and Bhupess, K. (2007). A Cash Conversion Cycle Approachto Liquidity Analysis, FinancialManagement9, 1, 32-38.

Sonia, P., (2009). Inventory and Working Capital Management: An Empirical Analysis. The IUP Journal of Accounting Research and udit Practices, IUP Publications, vol.0 (2),

Sunday, J. (2011). Business Finance, Theory and Practice 5th ed, University of Plymouth Business School. Financial Times Pitman Publishing.

Tagoe, N. Anawa-Armahand Nyarko, E.(2008) SME Access To Bank Finance In An Emerging Economy: The Role Of Information Management Practices. International Journal of Financial Services Management, Vol.3, No. 2 pp.148- 170.

Ternel, P (2007). Effects of working capital management on SME profitability. www. emelardinsight.com/1743/html.

Zariyawati et al (2009). Efficiency of Working Capital and Corporate Profitability, Financial Practice and Education 8 (2), 37-45