



Faculty of Economics and Business

**RELATIONSHIP BETWEEN WORKING CAPITAL
MANAGEMENT AND PROFITABILITY IN MALAYSIAN
COMPANIES**

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Bachelor of Finance with Honours

2015

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PROFITABILITY IN MALAYSIAN COMPANIES**

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This project is submitted in partial fulfillment of the requirement for the
degree of Bachelor of Finance with Honors

Faculty of Economics and Business
UNIVERSITI MALAYSIA SARAWAK

2015

Statement of Originality

The work described in this Final Year Project, entitled
**“Relationship between working capital management and
profitability in Malaysian companies”**
is to the best of the author’s knowledge that of the author except
where due reference is made.

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ABSTRAK

PENGURUSAN MODAL DAN KEUNTUNGAN DI SYARIKAT MALAYSIA

Oleh

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Pengurusan modal merupakan salah satu elemen yang penting dalam operasi harian syarikat. Pengurusan modal semakin diberi tumpuan oleh kebanyakan bidang akademik dan institusi kewangan baru-baru ini kerana panduan ini dapat membantu pengendali dalam membuat keputusan yang betul lalu dapat menambah nilai kepada syarikat. Kajian ini bertujuan untuk mengkaji kesan pengurusan modal atas prestasi kewangan di syarikat Malaysia. Selain itu, kajian ini juga bertujuan untuk mengkaji hubungan antara pengurusan modal dan keuntungan. Saiz sampel yang mengandungi 80 syarikat tersenarai dari 2009 hingga 2013 telah digunakan dalam kajian ini. Untuk mencapai tujuan kajian, *Pearson correlation coefficient*, analisis *panel data*, ujian *Breush* dan *Pagan Lagrangian Multiplier* dan ujian *Hausman* telah digunakan dalam analisis. Kajian ini mendapati bahawa hari akaun belum terima (ARD) dan kitaran penukaran tunai (CCC) mempunyai hubungan negatif yang ketara terhadap nisbah pulangan atas jumlah asset (ROTA). Jumlah hari inventori dan bilangan hari akaun yang perlu dibayar kesan yang tidak ketara atas prestasi kewangan.

ABSTRACT

RELATIONSHIP BETWEEN WORKING CAPITAL MANAGEMEMENT AND PROFITABILITY IN MALAYSIAN COMPANIES

By

Lee Meng Yee

Working capital management is a significant element in daily operation of a company. Working capital management had been a focus of various researchers and companies recently as it can be a guidance for financial manager in decision making so that every decision made can increase the value of the company. This study aim to investigate the effect of working capital management and profitability of Malaysian companies. In addition, this study also aim to investigate the relationship between working capital management and profitability. The sample size of this study is 80 listed companies from year 2009 until 2013. In order to fulfill the objective of this study, Pearson correlation coefficient, panel data analysis, Breusch test and Pagan Lagrangian Multiplier will be used. Based on the findings, there is a negative and significant relationship between number of days account receivable (ARD) and cash conversion cycle (CCC) with return on total assets (ROTA). However, number of days inventories (INV) and number of days account payable (AP) do not have significant relationship with return on total asset (ROTA).

ACKNOWLEDGEMENT

First of all, I wish to express great thanks to my final year project supervisor, Mr. Shaharudin Jakpar, who gives constructive advises, valuable comments and steady support throughout the period of this study. Without his supervision and guidance, my project would not have completed as desired.

Special thanks to my friends who always share their views and opinions with me during the process of this study. Their valuable views had helped and taught me a lot in the completion of this study.

Foremost, I would like to express my gratitude to my family who always show their encouragement, caring and love during the period of this study. Deeply thanks to them for being with me at all difficult time.

Finally, I thank those have not be referred above, but have contributed in one way or another to the successful completion of my project.

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Chapter 1: Introduction

1.1 Introduction

Researchers had pay more attention on long-term financial decisions in the field of corporate finance such as investment decision making and company's capital structure than working capital management (WCM). However, working capital management decision or short-term financial decisions take up managers' lots of time and attention (Richard & Laughlin, 1980). In general, working capital management represents the time interval between a firm decide on purchasing inventory and the period of collection of cash, during firm's normal operation which involve all company's activities which related to customers, suppliers and products. But, in reality, manager of a firm assume that WCM only fund between short term assets and liabilities of a company.

The main goal of WCM is to improve financial performance while minimizing the risk associated with the reduction of the investment in current assets. In general, management of working capital aims to maintain optimum balance between each working capital components which are inventory, cash, account payables and account receivables which plays a fundamental role of the overall corporate strategy in creating value and a significant element of competitive advantage (Deloof, 2003). In addition, it also involves decision making on the amount of current assets and current liabilities which ensure that eliminates the risk in failing to meet due short-term obligations on one hand and eliminate surplus investment in these assets on the other hand (Eljelly, 2004). Therefore, working capital involve short-term financial management with

firm's strategic decision making which will affect firm's profitability, risk and its value.

In determining the firm's profitability, the finance manager need to manage the firm's current assets and current liabilities at an optimum which in short, emphasize on the firm's WCM (Gill, Biger & Mathur, 2010). Although the aspect of WCM on profitability is significant, there are limited studies conducted in Malaysia to observe this relationship. Therefore, this study aims on identify the relationship between WCM and profitability in Malaysia companies.

1.2 Background of the study

The fundamental of working capital management (WCM) is to ensure the in-flow is corresponding with the outflows. It emphasize on managing capital with the daily operational activities which include ensuring that cash in-flow (accounts receivable) is more than the cash out-flow (accounts payable). Or else, the company will face insolvency. In addition, working capital management (WCM) also take into account on the number of days inventories held, as if the days of holding inventories are too long, it means that there are surplus of inventory that you are unable to sell. Deficiency of inventories meaning there is insufficient of production and it failed to fulfill the demand. In addition, Lamberson (1995) mentioned that working capital management (WCM) is a significant aspect in a company's financial management. It is so significant that it will effects a company's profitability and risk. When managers make decision on investment, they will prior profit than other components.

Working capital management (WCM) involved in management of firm's payables, receivables and inventory with a goal which is to achieve a balance between risk and returns and thereby contribute positively to the profitability of a firm. Lamberson (1995) showed that working capital management (WCM) is an importance aspect in financial management of a company. Generally, most of the financial managers face difficulties in identifying the significant components of working capital management (WCM) that can enhance their company's profitability.

Working capital management (WCM) is an important factor in determining the maximization of firm values and wealth of shareholder, there are many various research study the relationship between working capital management (WCM) and

profitability of firm over the last two decades. However, the results of the studies are not consistent which conducted by different researcher and carried out separately. In addition, there is also deficiency of study conducted in Malaysia's companies about the relationship of working capital management (WCM) and profitability.

In this study, cash conversion cycle (CCC) which means the cash flow of a company in a duration is under the efficiency of working capital management (WCM) and other working capital management (WCM) components which are number of days inventories (INV), number of days accounts receivable (ARD), and number of days account payable (AP) are being analyzed by their effect on company's profitability, which is measured using return on total asset (ROTA).

In these recent years, financial market had become essential to Malaysia as it can boost Malaysia in overall economic growth. This study about Malaysia companies make distinctive with other study as the public traded companies in Malaysia might provide a different result compare to other country. Hence, this study which focus on only single country so that the working capital management can be analyzed in a more detail way.

1.3 Problem statement

The relationship between working capital management (WCM) and profitability is still ambiguous because different results are obtained in some relevant studies. There are numerous factors had being analyzed by different researchers as the factors of profitability of a company which also include working capital management. Previously, there are empirical studies finding whether the relationship between working capital management and profitability is having positive, negative or no significant relationship. Nevertheless, some relevant studies which produced different results will be included in literature review. These review show there is differences among these studies and hence, this issue need to be carried out by more researchers.

The working capital management (WCM) is one of the components in financial management of a companies, various researchers had conduct empirical research on the relationship between working capital management (WCM) and profitability of companies (Deloof, 2003; Lazaridis & Tryfonidis, 2006). However, topics about working capital management (WCM) has not been studied thoroughly by researchers if compare with other component in corporate finance studies such as capital budgeting and capital structure because working capital management (WCM) is perceived as short term investing and financing (Zariyawati, Taufiq, Annuar & Sazali, 2010). Working capital management (WCM) is short-term financial management and it is categorized as less significant to company. Furthermore, researchers always overlooked it and give more attention on other components in corporate finance and investment regardless of WCM which actually consume extensive time of financial managers (Nasruddin, 2006).

Based on the findings by various researcher, the findings are varies. Despite that numerous studies had being conducted regarding the relationship between working capital management and profitability, the findings shows different results and different researchers apply various approach and methodology in determining working capital management (WCM), for example, current ratio (Nor Edi Azhar & Noriza, 2010) and cash conversion cycle (Padachi, 2006). In addition, there is lack of study in the relationship of working capital management and profitability in companies especially in Malaysia context.

Hence, in trying to close the knowledge gap, this research will investigate the relationship between working capital management (WCM) and profitability of companies listed in Bursa Malaysia.

To close the knowledge gap on the impact of working capital management (WCM) on profitability of listed companies and its results are expected to contribute to the existing literature on working capital management (WCM) and profitability. The problem statement would be what is the relationship between working capital management and profitability of companies listed in Bursa Malaysia during the period 2009-2013?

1.4 Objective of study

This study attempt to close the knowledge gap of working capital management (WCM) by focusing in Malaysia listed companies. Based on the problem statement, the objective of this studies are:

1.4.1 General Objective

The general objective of this study is to determine the effect of working capital management (WCM) on companies' profitability in Malaysia listed companies. That is to analyze the effect of components in working capital management (WCM) (cash conversion cycle, numbers of days inventory, numbers of days account receivable and numbers of days account payable) and return on total asset.

1.4.2 Specific Objective

The specific objectives of this study are:

- i) To identify the relationship between working capital management (WCM) and profitability.
- ii) To identify whether working capital management (WCM) contribute to the company's profitability.

1.5 Theoretical Framework

According to Majeed, Makki, Saleem and Azzi (2013), working capital management (WCM) is being categorized into two group, static WCM and dynamic WCM. Static method is based on the ratio of liquidity such as ratio of liquidity such as working capital, current ratio and quick ratio reflected on balance sheet. On the other hand, static method refer to the operations of a firm. The measurement used in dynamic method is CCC which is from obtaining raw materials after payment until cash collection.

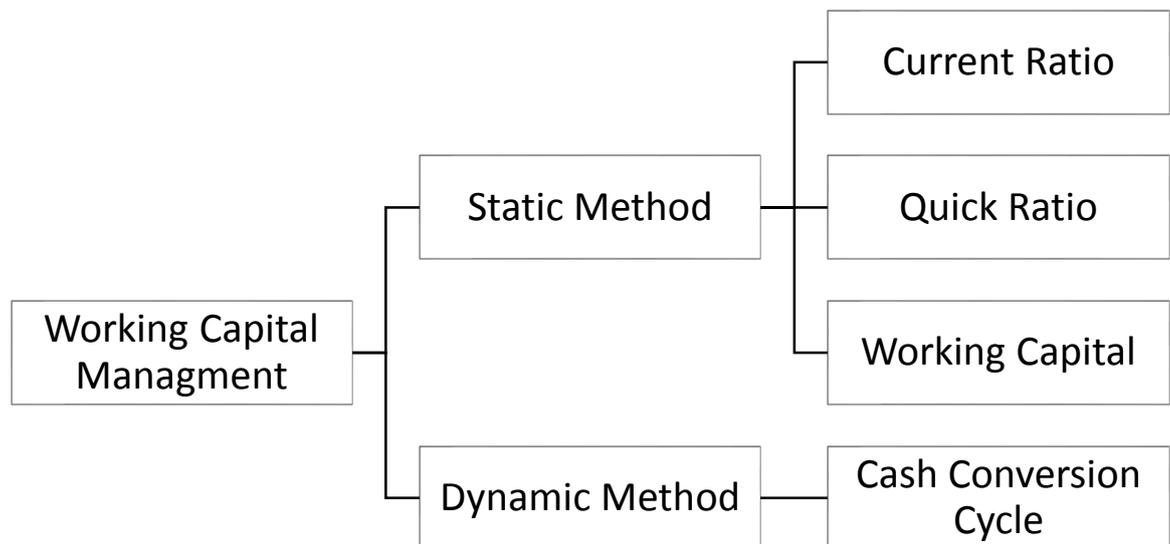


Figure 1: Summary of Theoretical Framework

Source: Moss & Stine ,1993; Lancaster, Stevens & Jennings, 1999.

1.5.1 Static Working Capital Management

Static approach of working capital management reveal the nature of balance sheet which included assets, liabilities and shareholder's equity in financial statement (Majeed et al., 2013). The main component of static method

is current ratio which reflect the level of liquidity of a firm. However, it is hard to analyze a company based on current ratio. In addition, there are a few setback about static working capital. The static view of data reflect in balance sheet fail to show the dynamic view of working capital management which is significant in decision making process. Furthermore, current ratio and quick ratio are inefficient due to its nature which is static in unable to predict future liquidity and cash flow. In this research, static approach of working capital will not be the focus.

1.5.2 Dynamic Working Capital Management

Due to the weakness of static approach of working capital, a few researchers had introduce an alternative in measuring working capital using more relevant approach which is dynamic. It focus more on the cash cycle that involve both balance sheet and profit and loss statement which is from the dynamic view of liquidity measures of a firm (Eljelly, 2004).

In 1974, Gitman had developed cash conversion cycle (CCC) model which determine the time period took for a company to receive cash from obtaining raw materials in days. Hence, the longer the time period of CCC, the more working capital is required. The focus of working capital management (WCM) is to control the account receivables and collection procedure and afterward, inventory investment management.

Cash conversion cycle is indeed a significant component in a company because it allows the company to monitor whether they are in need of liquidity improvement and how efficient is the company react to shortage of liquidity.

Although cash conversion cycle is a short-term view of managing a company's working capital, a firm might face bankruptcy if their liquidity do not meet their debt on time.

1.6 Significance of study

This study will determine the impact of working capital management (WCM) on companies' profitability in Malaysia listed companies. The significance of this study is to enable financial managers to decrease the risk of default especially during financial crisis because working capital management (WCM) has effect on profitability of a company.

Besides that, different components in working capital management (WCM) will contribute impact on profitability of a company. Thus, this research is conducted to give clearer understanding on the contribution of working capital management on profitability. Furthermore, this research will benefit various financial managers and professional as a recommendation in related field.

In addition, company in Malaysia will get to recognize their position in profitability through the study of working capital management (WCM). The research conducted will provide additional information and references for relevant research in the future. It aimed to contribute on the literature on working capital management (WCM) particularly in Malaysia.

1.7 Scope of the study

This research concentrate on Malaysia listed companies under Bursa Malaysia from year 2009 to 2013 for five years.

1.8 Organization of the study

This research examining the relationship between working capital management (WCM) and profitability.

In chapter one, introduction of the research which include background, problem statement, theoretical framework, objectives, significance and scope of the study are included. Next, for chapter two, discussion on different views of previous relevant studies will be developed. In chapter three, the study will emphasize on data and methodology. In chapter four, the study will include empirical result and discussion. And at last, which is chapter five, conclusion and recommendation for the whole study will be included.

Chapter 2: Literature Review

2.1 Introduction

The aim of this chapter is to review previous research regarding working capital management on the aspect of theory and empirical. The reviews discussed under this chapter would be used to construct the most suitable methodology for this research. Furthermore, results from previous studies are significant to support the findings that relevant to working capital management (WCM).