

**THE EFFECTS OF WORKING CAPITAL MANAGEMENT ON SMEs
PROFITABILITY IN MALAYSIA**

BY

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ABSTRACT

This study investigates the effect of working capital management on SMEs profitability in Malaysia using a sample of 66 SME manufacturing firms covering from 2006 until 2012. *Ordinary least square (OLS)* regression is used to estimate the relationship between the independent and dependent variables. The results show that, there is negative relationship between working capital management measures i.e. days account receivables (DAR), inventory turnover in days (ITID), and cash conversion cycle (CCC) and SMEs profitability proxies i.e. return on assets (ROA) and return on equity (ROE) except for net operating profit (NOP) which is having positive effect with CCC. Furthermore, the study shows that there is positive relationship between days account payables (DAP) and SMEs profitability measured by (ROA and ROE) but having a negative relation with NOP. The results imply that Profitability of SME manufacturing firms depends upon effective working capital management. Therefore, this study suggests that SME manufacturing companies can improve their profitability by managing working capital properly.

KEY WORDS: Working capital, working capital management, manufacturing Sector, Malaysia, SMEs, profitability.

ABSTRAK

Kajian ini mengkaji kesan pengurusan modal kerja ke atas keuntungan perusahaan kecil dan sederhana (PKS) di Malaysia dengan menggunakan sampel 66 firma pembuatan PKS meliputi dari tahun 2006 sehingga 2012. Teknik regresi *Ordinary Least Squares (OLS)* digunakan untuk menganggarkan hubungan di antara pembolehubah bebas dan bersandar. Hasil kajian menunjukkan bahawa, terdapat hubungan negatif di antara komponen kerja modal iaitu hari akaun belum terima (DAR), hari pusing ganti inventori (ITID), dan kitaran penukaran tunai (CCC) dengan keuntungan PKS yang diukur menggunakan pulangan atas aset (ROA) dan pulangan ke atas ekuiti (ROE), kecuali keuntungan operasi bersih (NOP) yang mempunyai kesan positif dengan CCC. Di samping itu, hasil kajian menunjukkan bahawa terdapat hubungan yang positif di antara hari akaun pembiutang (DAP) dengan ROA dan ROE, tetapi di sebaliknya, DAP mempunyai hubungan yang negatif dengan NOP. Ini menunjukkan bahawa keuntungan firma pembuatan PKS bergantung kepada pengurusan modal kerja yang berkesan. Oleh itu, kajian ini mencadangkan bahawa syarikat-syarikat pembuatan PKS boleh meningkatkan keuntungan mereka dengan mengurus modal kerja dengan betul.

PERKATAAN PENTING: Modal kerja, pengurusan modal kerja, pembuatan Sektor, Malaysia, PKS, keuntungan.

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CHAPTER 1

INTRODUCTION

1.1 Background of Study

Working capital deals with the financial health of a company and it also plays important role in maximizing the shareholders wealth, hence, every company needs to sustain the balance between liquidity and profitability. Liquidity is a requirement to ensure that the firm is able to meet its short-term obligations (Deloof, 2003; Padachi, 2006). Working capital comprises the most liquid assets and it can be defined as the difference between current assets and current liabilities (Paramasivan and Subramanian 2009). Thus, the relationship between current assets and current liabilities are the main theme of the theory of working capital management.

Talat and Nazir (2011) & Smith (1980) highlight that short-term assets and liabilities are important components of net working capital and therefore needs to be carefully analysed, since they play a key role for firm's profitability, risk, as well as its value. Indeed, companies might have an optimal level of working capital that counterbalances the costs and advantage of holding working capital and also maximizes their profitability or value (Afza & Nazir, 2007; Deloof, 2003).

According to Padachi (2006), company has efficient working capital when their current assets are higher than its current liabilities. This explains that the company is able to continue its operations and also has sufficient fund to fulfil its short-term obligations and upcoming operational expenses (in other word, the notion of working capital management explains how companies' manage their current assets and current liabilities to improve both liquidity and profitability). A proper management of working capital encourages a company's well-being in the market and also helps

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