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Research Journal of Finance and Accounting
ISSN 2222-1697 (Paper) ISSN 2222-2847 (Online)
Vol 3, No.11, 2012
www.iiste.org

Determinants of Inventory Managements as a Component of Working Capital in Ensuring Corporate Profitability-A Conceptual Approach

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Abstract

Sufficient and effective management of working capital has always been associated with the financial health of all business. It is regarded as an integral part of corporate strategy aimed at maximizing corporate profit. Inventory management which is an integral part of the working capital management is viewed as a fundamental catalyst of ensuring corporate profitability. The study intends to explore conceptually the inventory management options in ensuring corporate profitability.

Keywords: working capital, inventory management, and profitability

Introduction

Working capital refers to the firm`s investment in short-term assets (Olufemi et al). It is regarded as the difference between the current assets and the current liabilities or in other words as net assets. Padachi (2006) opined that management of working capital is important in ensuring the financial health of all businesses. This could be viewed in the fact that most often the amount invested in the fact that most often the amount invested in working capital are high in proportion to total assets employee this and therefore justifies why it should be utilized efficiently. Equally the manner in which working capital is managed directly affects the liquidity and profitability of the corporate firm and consequently its net worth. (Smith 1980)

Efficient working capital management therefore, tries to maintain a balance liquidity and profitability within the realm of business operations. The impact of efficiency of working capital management corporate profitability have been a central focus of most empirical research for quite number of years. (Shin & Soenan, 1998; Deloof 2003; Lazandis & tryfonidis, 2006: filbeck & Krueger, 2005).

Working capital management encompasses planning and controlling current assets and current liabilities. In such a way that the risk of failure to meet the due short term obligations is reduced if not completely eliminated on the one hand and avoiding excessive investment in the assets on the other (ejelly, 2004).

Lamberson (1995) described that studies on working capital management has ultimately become one of the most important issues in an organization, this is simply characterized by the inability of most financial managers to identify the important drives of working capital and what is supposed to be its optimum level. Therefore, companies can reduce the risk, and increase their performance if they properly understand the importance and determinants of working capital.

A company may decide on an aggressive working capital management policy with a minimum current asset level as a percentage of total current liabilities relative to percentage of total assets, or conversely use in the form of high level current liabilities relative to percentage of total liabilities in financing decisions (Afza and Nazir, 2009). Therefore drawing from the above analogy, it is clear that maintaining an optimal balance among all the components of working capital management. Business Success therefore heavily depends on the ability of the financial managers to effectively manage receivables, inventory and payables (filbeck & Krueger, 2005).

The most populous measure of working capital management is the cash conversion cycle, it is expressed as the total days of sales outstanding (average collection period) and days of sales. In inventory minus days of outstanding payables (keown et al, 2003). The much longer the time lag, the larger the investment in working capital. When the cash conversion cycle tends to be longer, the more likely the tendency to increase in profitability, because that may lead to higher sales. Conversely, corporate profitability might also decrease with the cash conversion cycle, especially when the costs of higher investment in working capital is higher and it rises faster than the benefits of

holding more inventories and it rises faster than the benefits of holding more inventories and trade credit to customers (Deloof, 2003).

In addition to all that have been discussed so far, working capital management plays a vital role in the area of managerial enterprise, it may determine the success or failure of firms, it equally affects its profitability.

Literature Review

Various previous researches discussed extensively on the relationship between working capital management and profitability of firm related to different environments. Shin and Soeren (1998) used a sample of 58,985 firm`s years covering the period 1975-1994 in order to investigate the relationship between the net-trade cycle that was used to measure efficiency of working capital management and corporate profitability. The study found a strong negative relationship between the length of firm`s net-trade cycle and its profitability.

Deloof (2003) used a sample of 1,009 large Belgian non-financial firms for the 1992-1996 periods to investigate. The relationship between working capital management and corporate profitability. The result indicated a negative relationship between profitability that was measured by Gross Operating Income and the cash conversion cycle, number of days accounts receivable, inventories. According to his suggestion, manager may tend to increase profitability by reducing the number of days account receivable and inventories, according to his analogy, less profitable firms wait longer to pay theirs.

Lazaridis and Tryfomidis (2006) used a sample of 131 listed companies in the Alliens stock exchange for the period 2001-2004 to investigate the relationship between working capital management working capital management and corporate profitability. The results revealed that there was a statistical significance between profitability which was measured through gross operating profit and cash conversion cycle. In their final submission, they maintain that the managers could create value for shareholders by handling correctly the cash conversion cycle and keeping each different component to an optimum level.

Raheman and Nasr (2007) studied the effects of various components working capital management on net operating profitability. They selected a sample of 94 Pakistani firms listed on Karachi stock exchange for a period of six years from 1999-2004. A negative relationship was established, between the components of working capital management as average collection period, inventory turn-over in days, cash conversion cycle and the profitability. Equally among their findings was establishing a positive relationship between the firm`s size measured by natural algorithm of sales and profitability.

Singh and Pandy (2008) studied the relationship between working capital management`s components on profitability of Hindalco Industries Limited for period covering 1990 to 2007. The findings of the study indicated that, there was a statistical significance between the current ration, liquidity ratio, receivable turnover ratio, and total assets ratio to profitability.

Conclusively, Afza and Nasir (2009) used a sample of 204 non-financial firms listed on Karachi Stock Exchange (KSE) for the period 1998-2005 to investigate the relationship between working capital management policies and firm`s profitability.

The results of findings signified a negative relationship between the profitability of firms and the degree of aggressiveness of working capital investment and financing policies.

Inventory management

Mostly in manufacturing companies, inventory usually include supplies, raw materials, work-in-process and finished goods. All these forms of inventory needs to be financed and their efficient management can increase firm`s profitability. (Stanley and Geoffrey, 1997). An optimum inventory level depends on sales, so sales must be forecasted before target inventories can be established. Moreover, because errors in setting inventory levels lead to loss of sales or excessive carrying costs, inventory management is quite important.

Therefore, firms use sophisticated computer systems to monitor their inventory holdings (Brigham and Houston, 2007). Although inventory management may be considered as outside the main stream of finance, it is however, necessary to emphasize it`s important and potential effects to corporate profitability of manufacturing companies.

Inventories are lists of stock-raw materials, work-in-progress or finished goods waiting to be consumed in either production or to be sold. Inventory is a very important variable because it reflects the average number of days of stock held by the firm. Longer storage times represent a greater investment in inventory for a particular level of operations (Olufemi & Olubanjo, 2009).

Inventories represent the second largest asset category for manufacturing companies, next only to plant and equipment 15 to 30 percent. Given substantial investment to inventories, the importance of inventing management cannot be overemphasized prasana (2000).

Two major intrigues arises whenever, we tend to discuss or inventing management, they are, what should be the size of the order? And what level should the order is placed? Those two questions are best answered through the Economic Ordering Quantity model (EOQ) (prasana 2000).

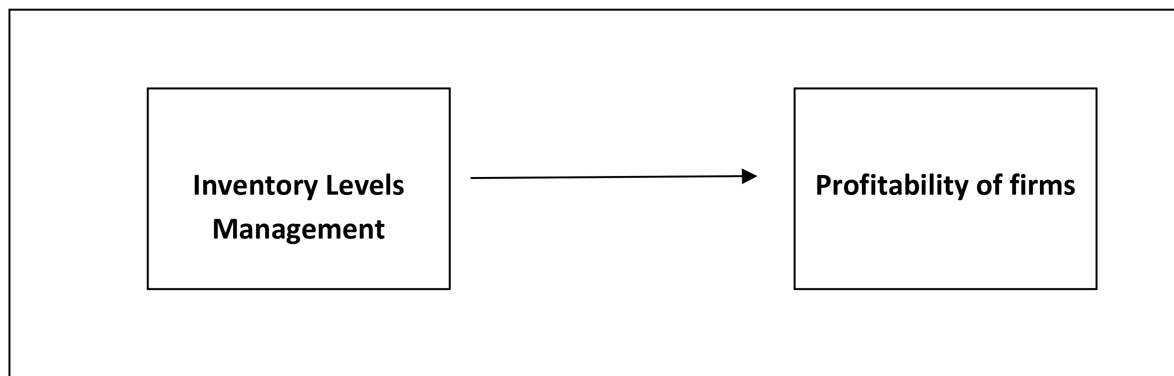
Singh (2000) found that, the size of inventory directly affects working capital and its management. He suggested that inventory was major component of working capital, and needed to be carefully controlled.

Profitability

Earning a profit is the fruit of a business, it indicates how well a business or company is performing. It measures the success of a business (Prasana 2002). A company or business may not be performing in some important aspects but once it generates other inadequacies are ignored.

Profitability reflects the final result of business operations. There are two types of profitability ratios: Profit margin ratios and rate of return ratios. A profit margin ratio shows the relationship between profit and sales. The two popular profit margin ratios are gross profit margin ratios and net profit margin ratios. Rate of return ratios reflects the relationship between profit and investment. The important rate of return measures are return on total assets, earning power and return on equity (Prasana 2000).

Research Framework



The research framework depicts the relationship between inventory level management and profitability of firms with inventory levels management as an independent variable while the profitability of firms as dependent variable in a simple linear relationship.

CONCLUSION

It could be deduced from the discussion so far that importance of inventory management, which is a component of working capital management cannot be overemphasized. Efficient and effective management of inventories ensures business survival and maximization of profit which is the cardinal aim of every firm. More so an efficient management of working capital through proper and timely inventory management ensures a balance between profitability and liquidity trade-offs.

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