



Received: 15-01-2025
Accepted: 25-02-2025

ISSN: 2583-049X

Examining Effects of Working Capital Management on Profitability: A Case Study of Small and Medium Enterprises in Mongu

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DOI: <https://doi.org/10.62225/2583049X.2025.5.2.3822>

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Abstract

This study focused on the examination of working capital management on profitability: A case study of small and medium enterprises in Mongu. Working capital management refers to a business process that aids companies make effective use of their current assets and optimize cash flow. The research objectives were: to assess the effects of working capital management on profitability of small and medium enterprises; to analyze the influence of financial planning on profitability, and to examine resource allocation on profitability in Mongu. The researcher used the questionnaire and interview design to collect primary data from the respondents. Questionnaires were distributed to a sample of 50 small and medium enterprises in Mongu district of western province and they all participated in the study. The findings showed that (96%) of SMEs that practiced financial planning on the business experienced favorable profits from their business' undertakings. The findings further showed that (60%) of small and medium enterprises had their source of capital from personal savings and contributions. The study examined the effects of working capital management on profitability in terms of

average collection period, average payment period, inventory turnover days and cash conversion cycle on profitability. It was found that (68%) of SMEs that had a shorter payback period of less than 30 days from their debtors realized good returns on their business. There was a significance relationship between Working Capital Management and profitability. It was also found that accessing funding by SMEs from Citizen Economic Empowerment Commission, Youth empowerment and women empowerment was not easy. The results showed that (2%) managed to access loans from CDF and youth empowerment. In conclusion, the study highlighted a positive relationship between working capital management and profitability among the sampled SMEs in Mongu. Most of the SMEs in Mongu used their own savings and contributions for capital financing. SMEs that planned for their business experienced good profits and growth of their businesses. None of SMEs on the sample benefited from CEEC fund, and only (2%) benefited from CDF and youth empowerment.

Keywords: Working Capital, Profitability, Liquidity, Leverage, Equity, Debt Capital

1. Introduction

1.1 Background

By definition, working capital or net working capital is the difference between current assets and current liabilities of a company. The relationship reflects the company's ability to pay short-term liabilities with short-term assets within a year. It is important to keep working capital at desired levels and this takes into consideration of the firm's size. Excess working capital leads to unnecessary accumulation of inventories causing losses and wastages. On the other hand, with the inadequate working capital, the firm may not be in a position to pay short-term liabilities.

According to Enestelle N. Zimba (2004), argued that the absence of sound policy on management of capital structure has had a negative impact on the performance of the Companies and the economy of Zambia.

The study was important because it enlightened shareholders on the effects of working capital and financial approaches on their firm's value which would eventually aid them make informed financing decisions that would enhance financial performance. It also provides financial managers with information that w help establish a financing policy suitable on their assets to maximize profitability.

The study is significant to academia because it will form a basis for future researchers by providing additional information to the topic. The study will further increase knowledge and information to the business fraternity. Furthermore, the researcher anticipated that the SMEs would be enlightened on the best ratios of working capital to be employed in their firms in order to maximize profits, experience growth and value of the company.

1.2 Statement of the problem

Past statistics shows that three out of five small and medium scale businesses fail within the first few months of operation (BoZ, 2016). One of the reasons is failure by management to manage working capital for the businesses and lack of information on how to access debts. Past studies have also given conflicting results on the relationship between working capital management and profitability of small and medium enterprises in Zambia. According to Olomi (2008) many small and medium enterprises failures have been attributed to the inability of business managers to plan and control properly the current assets and current liabilities of their firms. According to Pandey (2008) [24], excessive investment should be avoided as it impairs the firm's profitability. On the other hand, inadequate amount of working capital may expose the firm to insolvency. With the different results found by the previous studies conducted in the subject under study, we can easily see that there are still gaps that needs to be reduced if not closed.

1.3 Research objectives

The main purpose of the study is to empirically examine the effect of working capital management on profitability. The research objectives are:

1. To examine the effects of working capital management on profitability of SMEs in Mongu district;
2. To analyze the influence of financial planning on profitability among selected SMEs in Mongu.
3. To examine resource allocation on profitability in Mongu.

1.4 Research questions

Research questions were a reflection of the individual objective as stated above

1. What are the effects of working capital on profitability among small and medium enterprises in Mongu?
2. What influence does the financial planning have on profitability for small and medium enterprises in Mongu?
3. How does resource allocation affect profitability of small and medium enterprises in Mongu?

1.5 Theoretical/ Conceptual framework

According to Brigham, et al. (1999, Gitman, 1997), the theory of working capital management describes how working capital should be managed and demonstrates the benefits in terms of liquidity, solvency, efficiency, profitability, and shareholder wealth maximization which accrue to the company from appropriately managing working capital.

The concept of capital structure has many different views. According to Stephen, Westerfield, and Jordan (2003), the firm's capital structure is the combination of the use of debt and equity in a certain proportion to finance production and business activities of the enterprise.

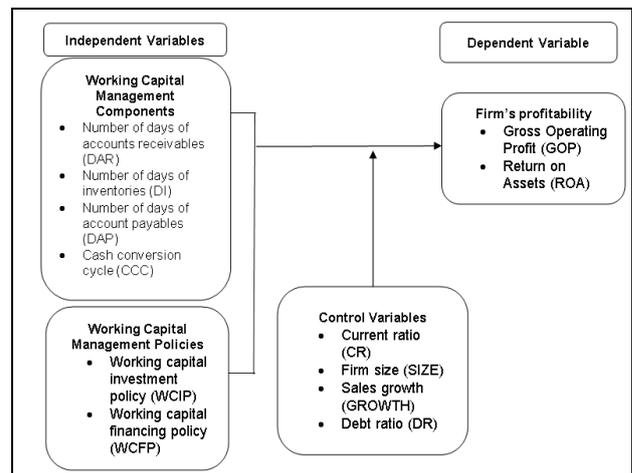


Fig 1: Conceptual framework

2. Literature Review

Smith (1973) argues that SME firms constitute the bulk of enterprises in all the economies in the world. However, the large numbers of business failures, especially SMEs have been attributed to the inability of financial managers to plan and control properly the current assets and current liabilities of their firms. With the increasing role of SMEs in the economy, elucidating how to develop them sustainably has received much attention from business managers and policymakers. Currently, one issue being debated is how the financial performance of SMEs is affected by the capital structure and their working capital management. This comes from the theoretical aspect that the effectiveness of financial management can be positively or negatively affected by the capital structure (Modigliani and Miller 1958; Fama and Miller 1972; Myers and Majluf 1984).

The effects of working capital on profitability of small and medium enterprises.

According to Ghosh (2004) working capital management is an important aspect of the short-term planning of the business. Changes in the business environment affects working capital therefore management efforts must be made at identifying such changes and efforts made consciously at curtailing them to ensure an efficient level of investment in working capital (Atrill, 2009). Unless the required working capital for a project is ascertained, investment decision cannot be said to be complete. The total amount of working capital needed by firms varies from period to period with regards to production.

Shin and Soenen (1998) studied at 58,985 firms over the period 1975-1994 and concluded that there is a significant relationship between the length of a firm's net trade cycle (NTC) and its profitability. They used NTC instead of CCC to measure WCM, because NTC is basically equal to the CCC where all its three components were expressed as a percentage of sales. In other words, it has a strong negative relationship between CCC and the profitability of a company. It means that the longer the NTC of a firm, the riskier it is for its profitability.

Samiloglu and Demirgunes (2008) analyzed the effect of working capital management on company profitability of a sample of companies consisting of Istanbul Stock Exchange (ISE) listed manufacturing companies for the period of 1998 to 2007. Making use of ROA as a measure of company profitability, they found a significantly negative effect of inventory holding period and accounts receivable period on

company profitability. Their conclusion was that the negative relationship between accounts receivable period and profitability may be due to the fact that customers want more time to assess the quality of products they buy from companies with declining profitability. However, there was no statistically significant relationship between ROA and cash conversion cycle.

Mukhopadhyay (2004) asserts that working capital is the most crucial factor for maintaining liquidity, survival, solvency and profitability of business. There is growing interest in the investigation of the relationship between working capital management (WCM) and Firm performance e.g. (Wang 2002; Deloof 2003; Garcia-Truel and Martinez Solano 2007; Raheman & Nasr 2007).

According to Pandey (2008) ^[24], excessive investment should be avoided as it impairs the firm's profitability. On the other hand, inadequate amount of working capital may expose the firm to insolvency. Whenever a need for working capital arises due to the increasing level of business activity, financing arrangements should be sought timely. Similarly, if surplus funds arise, they should be invested in short term securities.

Sen and Oruc (2009) investigated the relationship between efficiency level of working capital management and ROA of companies trading on the Istanbul Stock Exchange (ISE). Exploiting a total of 49 production companies for the period between 1993 and 2007, they concluded that there existed a negative relationship between inventory holding period, accounts receivable period, cash conversion cycle and ROA. However, the association between accounts payable period and ROA was found to be significantly positive.

According to Raheman and Nasr (2007), argues that working capital management directly affects the profitability and liquidity of firms. The profitability liquidity tradeoff is important because, if working capital management is not given due considerations then the firms are likely to fail and face bankruptcy (Kargar and Bluementhal, 1994).

The influence of financial planning on profitability of small and medium enterprises

Padachi (2006) concluded that excellent working capital control and policy affect the formulation of a company's value. This conclusion came from the investigation of the working capital control policy objectives and its relation to companies' achievement and profitability. This was done by applying statistical methods using the return on total assets ratio. The results show that focusing heavily on investments in high capital causes low profitability ratios. Muhammad et al. (2016) added that firms can use working capital management, which is one of the essential determinants to influence their profitability. The result reveals that there is an association between working capital elements and profitability.

Mathuva, (2010) studied the influence of working capital management components on corporate profitability by using a sample of 30 companies listed on the Nairobi Stock Exchange (NSE) from 1993 to 2008. He used Pearson and Spearman's correlations, the Pooled Ordinary Least Square (OLS), and the fixed effects regression models to conduct data analysis. The findings of his study were that there is a highly significant negative relationship between accounts collection period and profitability. In regard to the relationship between profitability and the inventory conversion period or the average payment period, the results were positive and significant.

Muchina (2009) carried out a study on influence of working capital management policies on firm's profitability in Kenya by analyzing affixed panel of 232 firms. The study found that SMEs in Kenya follow conservative working capital management policy and they needed to concentrate and improve on their collection and payment policy. The effective policies must be formulated for the individual components of working capital.

Mwololo (2011) maintains that due to lack of professionalism and skills in management practices, SMEs are faced with a challenge of managing their working capital that may subsequently affect their performance. Few small business entrepreneurs handle their jobs with high sense of professional carefulness and expertise. Often, they rely on their experience. They learn through mistakes but this exposes them to unnecessary risks.

Samiloglo and Demirgunes (2008) examined the relationship between working capital components and profitability. They concluded accounts collection periods and inventory conversion periods are negatively related with the profitability while accounts payable period are positively related with profitability.

WCM is one of the management concepts that focus on finding the optimum level of cash, inventory and debtors, also financing this level at the lowest possible cost through current liabilities to meet the company's daily needs (Brigham and Houston, 2009). Companies have to know how to manage current assets and liabilities; there is a difference in managing each of its key elements, where appropriate management of each element affects the profitability of companies (Ehrhardt and Brigham, 2011).

Finance managers have to take various types of financial decisions like investment decision, finance decision, liquidity decision and dividend decision, in different time. In every area of financial management, the finance manager is always faced with the dilemma of liquidity and profitability. He/she has to strike a balance between the two (Eljelly, 2004). Liquidity means the firm has to have adequate cash to pay bills as and when they fall due, and it also have sufficient cash reserves to meet emergencies and unforeseen demands, in all time. On the other hand, Profitability goal requires that funds of a firm should be utilized as to yield the highest return. Hence, liquidity and profitability are conflicting decisions, when one increases the other decreases. More liquidity results in less profitability and vice versa. This conflict finance manager has to face as all the financial decisions involve both liquidity and profitability.

Maness (1994) argues that liquidity is affected by cash, credit, inventory, and accounts payable that form part of the overall cash flow of a business. A business that considers decreasing its levels of cash by carrying too many inventories or providing too much credit endangers its liquidity (Cooper, et al. 1998, Gitman, 1997, Dierks and Patel, 1997, Peel and Wilson, 1996, Moss and Stine, 1993, Hill and Sartoris, 1992, Martin, et al. 1991, Asch and Kaye, 1989, Kamath, 1989, Madura and Veit, 1988). Declining levels of liquidity, unless remedied, may result in insolvency and eventually bankruptcy as the business's liabilities exceed its assets (Cooper, et al. 1998, Gitman, 1997).

Resource allocation of small and medium enterprises

Sources of working capital are many and include family loans, owners' equity, share capital, loans from friends,

leasing, supplier advances, and hire purchasing and bank loans. Bank loan is the most common source of finance for SMEs in Kenya. According to Reuvid (2006), bank financing normally includes term loans, overdrafts and asset finance. Moreover, according to Hisrich (2004), another common bank finance facility is credit line financing, which is the major form of working capital financing and is popular with SMEs. According to Agyei-Mensah (2012), access to finance continues to be a major challenge to SMEs in other African countries like Ghana.

Khazi (2006) demonstrates the relationship between sources of funds and effective management of working capital by discussing the effect of excess and shortage of funds to the performance of the SMEs. Holding excess funds means that there is an opportunity cost in form of returns that the business foregoes. On the other hand, shortage of funds will disrupt the firm's operations. Such a situation requires that organizations design and implement appropriate funds management system to ensure that the best return is derived from every single coin held by the business at any time. The management of small-scale and medium-size businesses should establish and strengthen the internal controls over funds and other resources to reduce mismanagement and misappropriations (Berger & Udell, 2006).

Griffiths (2003) asserts that SMEs always face competition in accessing finance and markets. A number of survey-level studies have found that SMEs face greater obstacles than large firms both in terms of accessing capital finance and the underlying cost of credit (Leo, 2011). With poor technology, competition for markets and inadequate equity finance, SMEs cannot expand to serve global markets or even establish business linkages with larger firms. Moreover, they cannot acquire credit ratings that satisfy investors (Kumar, Krishna, Raghuram, et al, 1999; Park, 2006). Kasekende & Opondo (2003) maintains that SMEs are typically required to demonstrate that they have sufficient equity to contribute to their businesses, which many small business owners usually lack. However, bigger, older, and foreign companies have a much easier time accessing external debt for expansion and development of their businesses (Leo, 2011). Capital structure plays a vital role in company's financial performance provided it is utilized efficiently and in an effective manner at its optimal level. However, the question of what constitute an optimal capital structure remains unclear and the most controversial issue in the finance circles (Kajola, 2010).

Park (2006) argues that SMEs financing is provided primarily by banks with loans being backed by credit guarantees or collaterals. SMEs continue to face challenges like scarcity of collateral to secure bank loans. There is evidence that inadequate collateral continues to cripple the financial needs of these SMEs (Apire 2003; Griffiths, 2003; UNEP, 2007). This does not mean that SMEs do not secure loans from banks. In fact, financial analysts like Kasekende & Opondo (2003) explain that some SMEs get loans from financial institutions. However, they reveal that when banks lend to SMEs, they tend to charge them a commission for assuming risk and apply tougher screening measures, which raises costs for SMEs.

According to African Development Bank (2013), 70% of the SMEs in East Africa "die" within the first 2 years of their

establishment due to financing-related reasons and inadequacy in the basics of enterprise management. This is in line with the Kenya National Bureau of Statistics (2016) which posits that about 46% of the SMEs surveyed ceased operations within the first year of establishment. In Uganda, studies indicate that only 30% of the small businesses that start survive up to the 3rd year of their establishment (Abaho, Aarakit, Ntayi & Kisubi, 2017). Whereas the business failure problem is partly attributed to limited business management skills, lack of access to formal credit, and limited government support (Turyahikayo, 2015; Wang, 2016), it has been reported that over 80% of the SMEs investors in Africa prefer internally generated funds to finance their investments which makes the formal lenders shy away from engaging with them because of the perceived high financial risk (United Nations Development Programme, 2015; Olawale, & Garwe, 2010). However, the extent to which preference to internally generated funds, alongside other components of capital structure contribute to SMEs' failure remains unclear.

3. Research Methodology

The researcher used the survey which had 50 questionnaires distributed to SMEs in Mongu and interview design to reach out to the respondents. A detailed descriptive population of the SMEs were those already established and registered with Patents and Companies Registration Agency (PACRA). Convenience sampling technique was applied to draw the sample of SMEs within Mongu town that the researcher could easily reach to collect the required data. A sample of 50 small and medium enterprises was used to conduct the research. Both primary and secondary data were collected, primary data was collected by the use of a questionnaire and interviews. Data collected were both quantitative and qualitative in nature and was analyzed by the aid of excel and Statistical Package for Social Sciences (SPSS). Triangulation of the study was not done due to limited resources and time on the part of the researcher. The researcher faced some challenges in terms of transportation costs especially that the government revised fuel prices on a monthly basis. The costs were incurred during questionnaire printing, distribution to the respondents and also during collection of answered questionnaires.

The research method may be incomplete and may not fully and comprehensively assess the effects of working capital management on the profitability of SMEs. Another obvious limitation would be time period to conduct the research which was almost six months or so.

Respondents were treated with respect and courtesy. The researcher adopted a strategy of 'Informed consent' with the aim of research being made clear to all participants. Individual respondents were assured of confidentiality and anonymity.

4. Results / Findings

4.1 Presentation of research findings

Fig 2 below shows that data collected from respondents comprised of 31 (62%) males and 19 (38%) females. In other words, 31 respondents were male SMEs while 19 were female SMEs which made the sample for this study.

Gender

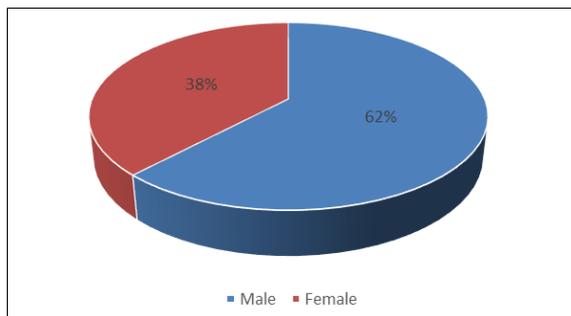


Fig 2: Gender composition of respondent

Fig 3 illustrates that 20 (40%) of the respondents were between 30 to 39 years old, 13 (26%) were between 40 – 49 years old, 11 (22%) were between the ages of 20 – 29 years, 5 (10%) were between 50 – 59 years and only 1 (2%) was above 60 years old.

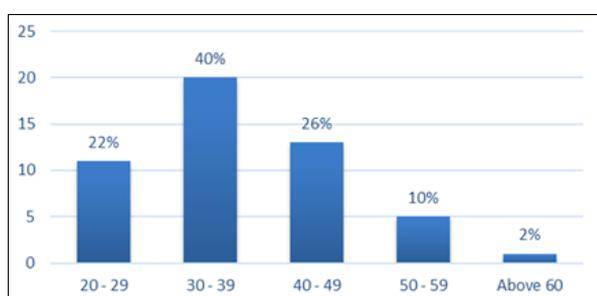


Fig 3: Age range of respondents

Fig 4 illustrate that there were 68% respondents that had debtor’s payback period of within 30 days, 22% responded that debtors took less or equal to 60 days to pay back and 10% took 90 days to pay for goods obtained on credit.



Fig 4: Debtors period to pay back

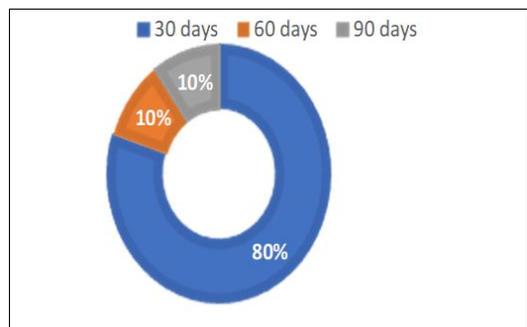


Fig 5: Creditors period to pay back

Fig 5 above shows that out of fifty respondents, 40 (80%) of SMEs paid for goods and services to the suppliers within 30

days, 5 (10%) paid after 60 days and 5 (10%) paid for goods and services after 90 days. We can easily mention that most of the SMEs in Mongu prefer their goods and services to be paid within a month. Few customers paid back for the goods after one month. This promoted the quick cash conversion cycle unlike the two- and three-month period.

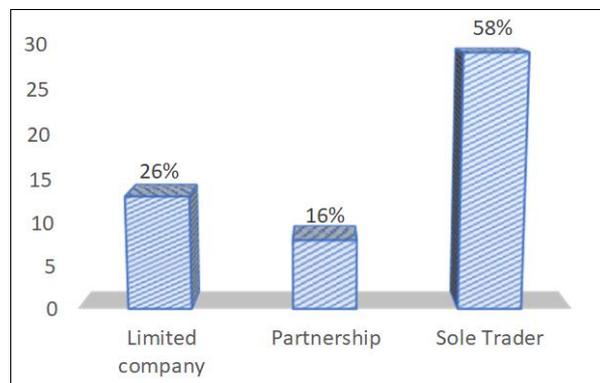


Fig 6: Ownership structure of SMEs

Fig 6 above shows that 13 (26%) of the respondents were running limited companies, 8 (16%) were in partnership business while 29 (58%) were sole traders. As earlier mentioned, SMEs in Mongu mostly depend on their own savings and contributions from family and friends to start and manage their businesses. The businesses were registered with PACRA in terms of either names and or limited company. From the results, we can easily deduce that the majority were sole traders with 58% ownership.

Table 1: Source of Capital for small and medium enterprises

| Sources of capital | | |
|------------------------------|-----------|------------|
| | Frequency | Percentage |
| Bank loans | 1 | 2% |
| Financial institutions loans | 2 | 4% |
| CEEC | 0 | 0% |
| CDF & Youth empowerment | 1 | 2% |
| Savings & contributions | 30 | 60% |
| Family & friends | 16 | 32% |
| Total | 50 | 100% |

The table above shows that 60% of SMEs use their own sources of fund to finance their business activities. This was followed by 32% of respondents who got capital for their businesses from relatives and family members. The other groups were those that obtained capital from financial institutions 4%, Commercial banks 2%, or CDF and Youth empowerment (2%). From the results, we can see that most of the SMEs do not benefit from government grants offered through Citizen Economic Empowerment Commission (CEEC) and youth empowerment. This also shows that the government, commercial Banks and financial institutions are doing very little on funding the SME’s in Mongu.

It was clear from the results that many businesses in Mongu were registered with PACRA. The only challenge was lack of support due to limited sources of capital available. Despite having constituency development fund and Citizen Economic Empowerment Commission fund available, few or no SMEs had access to such funds due to conditions attached to them. Capital finance has been a challenge for SMEs in Mongu and Zambia at large despite having many commercial banks, finance institutions and already

mentioned government agencies. Business men and women end up borrowing funds from unregistered money lenders (locally called “kaloba”) who charge abnormal interests for the loans, burdening the SMEs the more. The authorities have given a deaf ear to this growing exploitative business in Mongu despite them knowing individuals involved in it.

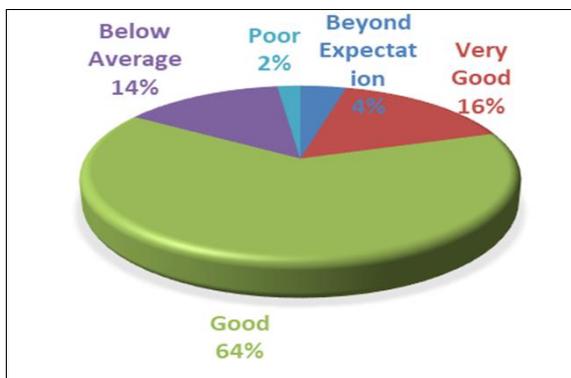


Fig 7: Performance of businesses of the SMEs

The results in Fig 7 shows that 4% respondents had their businesses performing beyond expectation, 16% of the respondents had their businesses performance very good. Then 64% of the respondents’ businesses performed good or on average, while 14% performed below average and 2% performed poorly.

Generally speaking, the results in Table 1 above suggest that business performance for the small and medium enterprises in Mongu was at an average because it was represented by 64% good or average performance.

Based on this study, the results on Fig 8 below show that 19 of the respondents were those with experience from 6 – 10 years in business which represented 38% in total compared to those with experience from 1 – 5 years which was 15 (30%). From the findings 9 (18%) of respondents had business experience of between 11 to 15 years, then 5 (10%) had experience of 16 to 20 years, while 1 (2%) had experience of 21 to 25 years. Only 1 (2%) of the respondents had business experience of more than 26 years and also who make very big contribution in economic and social development in Mongu.

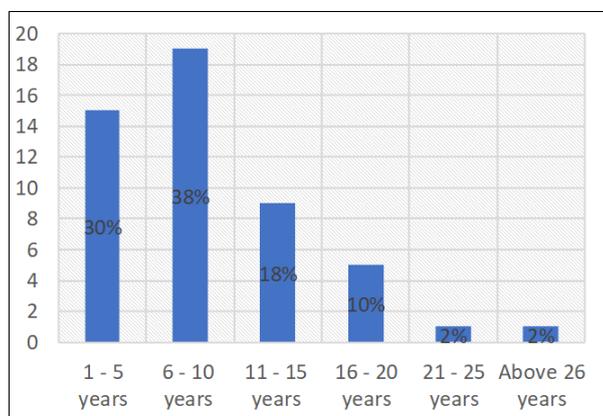


Fig 8: Business experience by the small and medium enterprises

4.2 Discussion

Small and medium enterprises in Mongu solely depend on their own savings and contributions from family members and friends for start-up capital and management of their

businesses. Profits from the business operations were mostly ploughed back into business for continuity and growth. Due to limited sources of finance, the performance of SMEs in Mongu was at an average because they could not engage in diversification nor grow their businesses.

The findings showed that SMEs that practiced financial planning on the business such as working capital management, budgeting, forecasting and record keeping, experienced favorable profits from their businesses. The majority of the respondents were literate as they attained either secondary or tertiary education.

The study examined the effects of working capital management on profitability in terms of average collection period, average payment period, inventory turnover days and cash conversion cycle on profitability. There was a significance relationship between Working Capital Management and profitability.

The results shows that the government of the Republic of Zambia through the leadership of his excellency the president Mr. Hakainde Hichilema, offered a conducive environment for doing business in Mongu. Businesses go about smoothly daily without interruptions nor rage from political cadres as it was the case during the previous government.

The researcher observed that the small and medium enterprises in Mongu encountered many challenges to access funding for their business. It was very difficult to access government loans or grants. Business owners depended on relatives and their savings for start-ups. Despite the government coming up with good policies and a ministry for small and medium enterprises, access to government loans and grants through established agencies and commissions has been difficult.

The results showed that there was too much exploitation among SMEs that resorted to borrowing money from local money lenders (kaloba) who charged exorbitantly on the interest.

4.3 Conclusions

In conclusion, the study showed that firms that practised financial planning and budgeting, experienced profitability on their investment compared to those who did not.

Businesses that had enough liquidity, experienced fast growth and profitability because they had solvency and managed to pay for any short-term and long term liabilities. Profitability for firms that depended on relatives for start-ups did not perform to their expectation because of lack of solvency which limited them to grow their businesses.

Working capital management has an impact on business performance and profitability. Working capital management requires the management of the most liquid resources of a firm with a view to maintain the firm’s liquidity, enhance profitability and promote business growth. Working capital management concentrates on the management of inventories, cash and cash equivalents, accounts receivable and accounts payables. Prudent management of these assets is critical to the success of small and medium enterprises in Mongu. The use of either long- or short-term financing to fund working capital requirement has a different impact on profitability of firms.

The management of inventories is aimed at determining the optimal level of stocks an organization should hold. It ensures that the organization is holding the right quantity of inventories at the right time and in the right location. Proper

management of inventories is meant to check on costs associated with holding incorrect quantity of stocks which includes damages to stocks, high capital tied up in stocks, stock holding costs and lost goodwill and profitability associated with being out of stocks.

The management of cash on the other hand is aimed at determining the optimal level of cash an organization should hold so that it can meet its day-to-day operating expenses, meet its short-term financial obligations, ensure that funds are available to ensure investments in expansion projects and that excess cash balances not immediately required for use are invested in income generating activities i.e., money market instruments.

The study provides useful information to state institutions and regulators who seek to see financial success and survival of SMEs. Working capital management policies of SMES should be enhanced to achieve such objectives. This is particularly important as the government seeks to champion its private sector-led economic growth agenda with emphasis on SMEs.

5. Acknowledgments

I would like to thank my heavenly father who gave me the strength to start and complete my study I want to thank the following persons for their respective contributions to this dissertation: Mr. Marvin Kabubi, my supervisor at the University of Information and Communications, for his support and guidance throughout this study. I also acknowledge my wife Phallen Kalima, my daughters Prudence Zimba, Faith Zimba, Malumbo Zimba and my son Niza Zimba.

Thank you for the unwavering support.

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