



## Policy Identification of the Working Capital Management of Medium-Sized Business

Christian Herdinata

*International Business Management Program,  
Faculty of Management and Business, Universitas Ciputra, Indonesia*

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### Abstract

*Enterprises use working capital to meet the needs of the organizations in order to perform operational activities. Hence, in order to produce optimal results, companies require sufficient working capital. Medium-scale industries have great potential in driving the economy through output and employment. As such, the purpose of this research is to analyze the working capital management policy of medium-sized business. This research employs literature study method by compiling relevant literature on the research problems. The data analysis process of this research is divided into three stages: (1) data reduction, which includes summarizing, classifying main points, focusing on important facts, and finding patterns; (2) data display, which includes data compilation and systematic data presentation; and (3) conclusion drawing and verification, which presents the research conclusions on the problem statements. Research findings suggest that working capital policy is dependant upon loan term and interest rate, which means that longer loan period leads to higher interest. Long-term loan of working capital requires debtors to pay bigger interest than short-term loan, because creditors must take into consideration the risks of uncertain future. Companies with short cash conversion cycle suggest fast retrieval of accounts receivable, good inventory management, and slower payment to supplier while maintaining corporate credibility.*

**Keywords:** Working capital management, Cash, Accounts receivable, Inventory

### 1. Introduction

Riyanto (1999:3) states that funds can be obtained from company owner and accounts payable. Therefore, corporate financing can come from both sources. The fund is prioritized as working capital. Brigham and Houston (2014) define working capital as the entire short-term assets or current assets, which include cash, tradeable stock, inventory, and accounts receivable. Companies use working capital to fulfill their business needs in order to conduct operational activities. Hence, without sufficient working capital, business activities cannot be performed optimally. This condition may disrupt, or even halt, operational activities. Working capital is crucial because every business activity begins with it. A mistake in financial decisions, either in fund search or use, may endanger the company's operational activities. Husnan (1998:550) claims that when the working capital's ability to achieve operational profit is better, the working capital management will also become more efficient.

Consequently, an efficient working capital management can enhance the company's chance of achieving target profit. The efficiency of working capital management is a reflection of the working capital's ability to produce operational profit. In other words, efficient working capital management is equal to operational profit. The purpose of this research is to identify the policy of working capital management in mid-scale business. The findings of this research are aimed at

helping mid-scale entrepreneurs in managing their working capital by considering the internal, external, supporting, and obstacle factors of working capital management.

## 2. Literature Review

### 2.1 Definition of Working Capital Management

Working capital can produce positive outcomes for the company. Therefore, it is important to manage the working capital within the framework of working capital management, as a part of financial management. Similarly, a clear explanation on working capital management is required to prevent management mistakes that may bring negative impacts to the company, such as disrupted operational activities and loss. Horne and Wachowicz (1997:214) define working capital management as the administration of current assets, and the funding required to support the current assets. In other words, working capital management can be defined as the management of current assets required by the enterprise to run its operational activities, and the management of the fund needed to manage the current assets.

As working capital is made of several components, the management of the components is automatically considered as part of the working capital management. The management of these components; such as cash, accounts receivable, and inventory, requires the consideration of turnover period and component content amount (Husnan, 1998). In conclusion, working capital management can be described as the process of managing each of the working capital components in order to produce positive outcome for the company. Turnover period is an important aspect in the management of working capital. For efficiency purpose, the company must ensure that the working capital turnover within a period does not take too long. The amount of working capital components will determine the amount of the company's current assets. Therefore, corporate decision on the amount of working capital will determine the amount of current assets.

### 2.2 Functions of Working Capital Management

Based on the definition of working capital management, it can be concluded that working capital plays a crucial role in any business. Weston and Bringham in Ahmad (1997:1-2) argue that the management of working capital is very important due to the following reasons: (1) Several studies indicated that most of the financial manager's time is spent on daily internal corporate activities as part of working capital management; (2) In reality, the average sum of current assets is more than half of the company's total assets with changeable tendency; (3) Sales growth rate has a direct and close relationship with the need for current assets funding; (4) Working capital management is significantly more crucial for small enterprises because: a) Although fixed assets investment can be reduced by rent or lease, it is impossible to ignore current assets, accounts receivable, or inventory, and b) The opportunity to enter long-term stock market for small enterprises is relatively small. Therefore, they must rely on business debt and short-term banking debt as capitals. The increase in debt will reduce the net working capital.

Meanwhile, Ahmad (1997) believes that the role of working capital management is based on its two functions, which are: (1) Supporting production activities and sales, acting as a bridge between inventory purchase expense and sales, and receiving payment; and (2) Closing fixed expense or funds with no direct relation to production or sales. Horne and Wachowicz (1997:215) also add that working capital management is the foundation of two important corporate decisions.

### 2.3 Classifications of Working Capital

Working capital normally uses several posts as the elements of the creation of corporate working capital. This permanent setting allows proper working capital management. Working capital is also essentially flexible, which means that it can be increased or decreased according to the company's needs. The biggest challenge is determining the amount of change required. In addition, each company may have different types of working capitals in accordance with their business field and

needs. Riyanto (1999:58) states that corporate working capital can be classified according to the company's needs for working capital, as follows:

**1. Permanent Working Capital:**

Permanent working capital is a compulsory working capital for any company to function well within one accounting period. This type of working capital can be categorized into two types, namely: (a) *Primary working capital*, which refers to the minimum amount of working capital required to ensure business sustainability; and (b) *Normal working capital*, which refers to the amount of working capital required to run production activities under normal capacity. There is no strict definition of 'normal capacity', as it depends on the company's condition.

**2. Variable Working Capital:**

Variable working capital refers to the amount of working capital required in a particular situation, which has changeable amount based on the situational change in one period. Variable working capital can be categorized into three types: (a) *Seasonal working capital*, which refers to the changing amount of working capital as a result the change in season; (b) *Cyclis working capital*, which refers to the changing amount of working capital as a result of the change in product demand; and (c) *Emergency working capital*, which refers to the changing amount of working capital as a result of unexpected incidents, such as fire, flood, earthquake, and labour strike.

#### 2.4 Calculations of Working Capital

Husnan (1998:544) mentions several methods that can be used to calculate working capital based on the viewpoints offered by the different definitions of working capital, as follows:

**1. Turnover Methods**

To estimate the working capital (current assets), a working capital turnover method is used. The turnover of the current asset components are calculated as follows:

- Inventory Turnover =  $\text{Inventory}/\text{Sales}$ :365
- Accounts Receivable Turnover =  $\text{Accounts Receivable}/\text{Sales}$ :365
- Days Payable Outstanding =  $\text{Accounts Payable}/\text{Cost of Goods Sold}$ :365

This method can determine the number of days required for each component to return to its initial sum. Thus, the bound period of fund in working capital is the sum of days in which the funds are bound. It also means that the working capital turnover is a 365-day Working Capital Turnover, which determines the number of times the working capital returns to cash within a year. This method also shows the turnover for each of the working capital components. This condition is better known as *cash cycle*; a term used to indicate the amount of time taken for the cash to be bound to the working capital before returning into cash.

**2. Fund Linkage Method**

This method recognizes two important matters: (a) The funds for the working capital may be (partially) provided by other parties in the form of spontaneous financing; and (b) The funds required to finance receivables should not include profit. The contrast in this method lies in the exclusion of profit in the accounts receivable. It means that the profit gained from the receivables can be omitted from the calculation of working capital.

**3. Cash Flow Method**

In essence, this method is similar to cash budgeting. The difference is that the cash flows taken into consideration are the cash flows which involve expenses or income from day-to-day operations. Items like fixed assets purchase or long-term debt payment are not included in the calculation. The amount of working capital required for a period can be seen from the deficit between the cash inflows and outflows. This method emphasizes on the cash element of the working capital calculation by considering only the cash inflows and outflows. The appropriateness of these methods varies between enterprises, as it depends largely on the needs of the company. Therefore, it is normal for companies to employ different methods in managing their working capitals. Nonetheless, all of the

methods refer to the corporate financing for daily operations. The variation lies with the different components used by each company.

### 3. Research Methods

This research employs literature study method by compiling relevant literature on the research problems. The subjects of the studied literature consist of medium-sized business entrepreneurs and practitioners who manage working capitals, and management consultants who have good understanding of working capital management. This research uses qualitative approach in its data analysis. According to Denzin and Lincoln (2009), qualitative research is a research study that employs scientific approach on the observed phenomena through various methods and data sources. Miles and Huberman (2014) mention three analysis techniques for qualitative data, which include: (1) data reduction, which includes summarizing, classifying main points, focusing on important facts, and finding patterns; (2) data display, which includes data compilation and systematic data presentation; and (3) conclusion drawing and verification, which presents the research conclusions on the problem statements. The core principle of qualitative data analysis technique is to analyze the research data and process them into systematic, organized, structured, and meaningful information.

### 4. Discussion

#### 4.1 *The Internal and External Factors of Working Capital Management*

The internal and external factors of working capital management in medium-sized enterprises are, among others: (1) Company types or characteristics. The working capital of a service company, for instance, is relatively small compared to that of a manufacturing company, because service company does not require massive investments in cash, accounts receivable, or inventory. On the other hand, industrial companies demand substantial investments in current assets for day-to-day operations purpose; (2) The time needed to produce or obtain the goods to be sold and the unit price of the goods. A company's need for working capital is directly related to the time it takes to acquire the goods to be sold, as well as the amount of raw materials to be produced until the goods are sold. The longer the time required to produce or acquire the goods is, the bigger the working capital will be. Additionally, cost per unit also affects the size of the working capital; higher cost per unit means bigger working capital; (3) Terms of purchase of materials and goods. The terms of purchase set for the goods or the raw materials used to produce the goods significantly affect the amount of working capital required by the company. If the credit terms agreed at the time of purchase are profitable, only a small amount of cash needs to be invested in goods or materials inventory. On the other hand, if the payment for the purchased materials or goods must be completed in a short amount of time, the amount of cash required to finance the inventory will be bigger; (4) Terms of sale. Corporate policy of providing greater credit leniency to buyers will result in bigger investment of working capital in the accounts receivable component. To reduce the risk of uncollectible accounts, enterprises offer cash rebate to buyers in the hope of encouraging the buyers to pay off their debts during the rebate period; and (5) Inventory turnover rate. Higher inventory turnover rate equals lower amount of working capital. To achieve high turnover rate, organized and efficient planning and supervision are required. High turnover rate will also minimize the risk of loss caused by price deduction or the change in consumer taste, while allowing the company to save on storage costs.

#### 4.2 *The Supporting and Obstacle Factors of Working Capital Management*

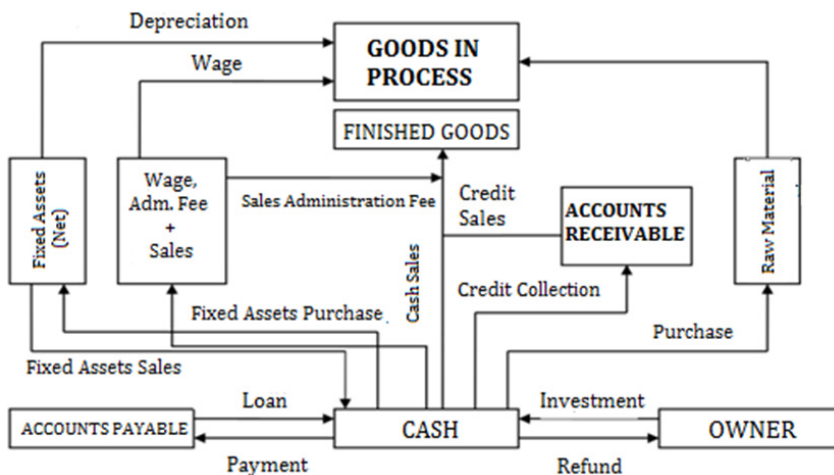
The supporting and obstacle factors of working capital management in medium-sized business are, among others: (1) Labour factor. The labour factor is a major factor in business success, because even the most advanced equipments require operators. However, workforce availability does not always guarantee smooth process. In fact, lazy and low-skilled workers will slow down the process;

(2) Marketing factor. The marketing factor plays an important role, because it determines the accuracy and timely flow of goods and services to consumers. Sales increase will boost cash flow, accounts receivable, and inventory, which will result in good financial performance; (3) Technology factor. The development of technology from time to time enables companies to create a good system for more effective and efficient work. It also allows companies to invent and produce high-tech goods. High technology also enables companies to monitor and evaluate their businesses; and (4) Government regulation factor. The success of a business is strongly influenced by government regulation. The facilities provided by the government, such as simplicity and flexibility in obtaining business license or applying for additional capital, contribute positively to the development of medium-sized enterprises.

### 4.3 Cash Management in Working Capital Management

Cash is a part of assets which has the highest level of liquidity, because it can be directly used to fulfill the financial obligations of the company. Corporations need cash in the form of working capital to finance their daily operational activities. The need for cash can be categorized into three types: (a) Transaction purpose, which refers to the use of cash to finance daily operational activities; (b) Anticipation purpose, which refers to the use of cash to anticipate intermittent and unpredictable cash inflows and outflows; and (c) Speculation purpose, which refers to the use of cash to respond to future possibilities.

Cash flow consists of cash inflows and cash outflows. It can also be further categorized as continuous and intermittent cash flows. Examples of continuous cash inflows are cash product sales and receivable receipts, while the examples for intermittent cash inflows are the income obtained from the involvement of company owners, shares sales, bank loan, and unused fixed assets sales. On the other hand, examples of continuous cash outflows include cash for raw materials purchase and employee salary. Meanwhile, examples of intermittent cash outflows are expenditures for dividend payments, interest, debt installment payment for the repurchase of shares, and fixed asset purchase. The cash flow process of a company can be seen in Figure 1 below.



**Figure 1.** Cash Flow Process

The total sum of cash can be associated with cash sales. The comparison between cash sales and the average sum of cash indicates the level of cash turnover. Faster turnover means more efficient cash use by the company. It is also important to maintain cash adequacy, or 'safety cash balance', which refers to the minimum amount of cash that the company must keep to fulfill its financial

obligations at any time. The factors affecting the amount of cash are: (1) the balanced amounts of cash inflows and cash outflows; (2) the deviation from the estimated cash flow; and (3) good relationships with the banking sector.

#### *4.4 Accounts Receivable Management in Working Capital Management*

Accounts receivable management for working capital management can be influenced by the following factors: (1) Credit sales volume. Greater credit proportion from total sales will increase the investment in accounts receivable. Bigger amount of accounts receivable may comprise higher risk, but also bigger profit; (2) Credit sales payment terms. Credit sales payment terms can be strict or lenient. If the company implements strict payment terms, it means the company prioritizes credit safety over profit. Examples of strict terms are short payment deadline and heavy imposition of interest for late payment of receivables. Longer credit payment deadline may result in bigger amount of corporate investment in receivables; (3) Credit limit terms. It is within the company's authority to set credit limits for its customers. Higher credit limit for each customer means bigger investment in receivables. Similar implication applies to credit provision policy. More selective credit provision policy will result in smaller amount of investment in receivables; (4) Accounts receivable collection policy. The company may set active or passive accounts receivable collection policies. Companies with active accounts receivable collection policies are entitled to bigger fund in financing the collection process than those with passive policies; (5) Customer payment methods. Some customers take advantage of cash rebate offers to pay their debts while others decline the opportunity. Their decision is based on their assessment of the more profitable option between the two alternatives. If the majority of the customers make their payment during the cash rebate period, the investment in receivables will be released in a shorter amount of time. In other words, the investment in accounts receivable will be smaller.

#### *4.5 Inventory Management in Working Capital Management*

There are different types of inventory in a company, depending on the type of business. It means that the types of inventory in a manufacturing company are different from the inventory of a trading or service company. Trading companies normally do not have too many inventory types. Rather, they keep a considerably large amount of items for each type. The same applies to service companies, which have significantly fewer inventory types than manufacturing companies. Manufacturing companies create products through a series of process, from the provision of raw materials to the finished goods. Kasmir (2013:267) believes that manufacturing companies, in particular, have at least three types of inventory: (1) Raw material, which refers to the materials used in the first production process. The results of this process can take the forms of intermediate or finished goods; (2) Goods in process, which refer to the processed raw materials; and (3) Finished goods, which refer to goods that have passed the previous process, and are ready to be sold to the market or consumer.

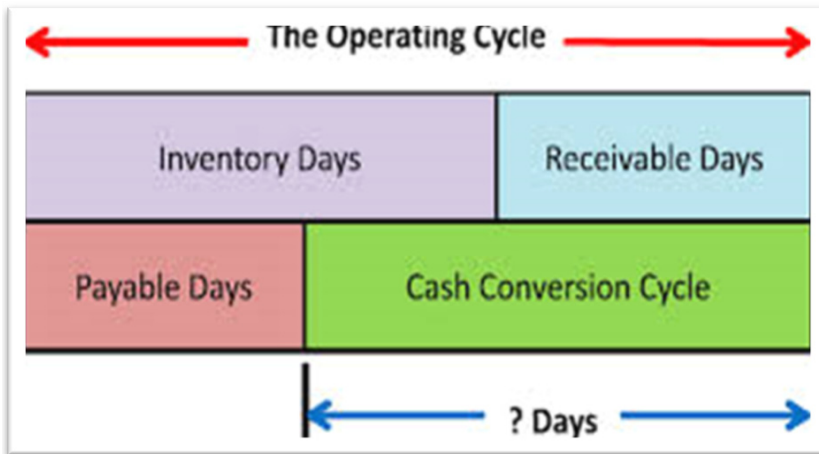
Inventory costs consist of, among others: (1) Holding or carrying costs, which refer to the costs incurred in inventory keeping. Holding costs hinge on the quantity of goods stored; (2) Ordering or procurement costs, which refer to the costs that come as a result of the company's need for inventory; and (3) Stock-out or shortage costs, which refer to the costs caused by the exhaustion of inventory. It is difficult to measure stock-out costs, because they also affect customer satisfaction and company credibility. Therefore, inventory management must consider the following key aspects: (1) Inventory availability must suit the company's needs to prevent stock exhaustion and increasing demands; and (2) Poor inventory quality, such as product defect, will bring loss to the company.

#### *4.6 Working Capital Management Policy*

Working capital policy is associated with loan term and interest rate. Longer loan age equals to higher interest rate. Long-term loans for working capital affect the loanees, because they must pay

higher interest than short-term loans. This condition is a result of the risks of uncertain future, which propel loaners to add the risks to the equation. Working capitals that come from long-term loans have higher liquidity level and smaller failure risk in meeting the obligation deadlines. Companies generally use long-term loan to meet their working capital needs. Such companies adhere to a conservative working capital policy. Another working capital policy is associated with assets. Current assets should be financed with current liabilities, while fixed assets should be financed with long-term debt and equity. This type of working capital policy is called aggressive policy. The risk of aggressive policy is great, because companies must be able to fulfill all due obligations using their current assets. The majority of companies that employ this policy experience failure, because it is difficult to turn some current assets into cash, particularly intermediate goods inventory and goods in process inventory.

In general, there are three types of working capital policy: (1) Aggressive policy, which refers to the use of short-term debt as working capital; (2) Moderate policy, in which fifty percent of the working capital is short-term debt, and the other half long-term debt; and (3) Conservative policy, which refers to the use of long-term debt as working capital. Corporate strategy for effective and efficient working capital management can be seen from the shortened cash conversion cycle. Companies with short cash conversion cycle indicate fast retrieval of accounts receivable, good inventory management, and slower payment to supplier while maintaining corporate credibility. This condition will result in profitability and optimal liquidity. Deloof (2003); Eljelly (2004); Lazaridis & Tryfonidis (2006); and Raheman & Nasr (2007) all suggest that cash conversion cycle negatively influences company profitability. Cash conversion cycle consists of three components, namely account payable deferral period, accounts receivable conversion period, and inventory conversion period. Companies can shorten the cash conversion cycle by accelerating the accounts receivable conversion period and inventory conversion period, while simultaneously slowing down the account payable deferral period. The cash conversion cycle can be seen in Figure 2 below.



**Figure 2.** Cash Conversion Cycle (CCC)

The following are strategies that can be used to shorten the cash conversion cycle: (1) The extension of accounts payable payment. However, companies are expected to withhold their debt payment without damaging their reputation and credibility. This means that the debt payment postponement should not exceed the payment deadline set by the creditor. By postponing their debt payment, companies can utilize the fund for other purposes or short-term investments with high liquidity to bring in revenues; (2) Inventory management. From the perspective of financial management, inventory will result in cost. Hence, if the company invests too much in inventory, the high opportunity cost will burden the company. Good inventory management accelerates the

inventory turnover by speeding up the process of converting raw materials into finished goods. The finished goods will then shorten the inventory conversion period. When the age of inventory is short, the company can use the fund for more profitable investments and increase their profitability; (3) The acceleration of accounts receivable collection. Accounts receivable is formed when the company makes credit sales. Companies investing in large amount of receivables risk bad debt and opportunity cost. Therefore, they must consider these aspects, in addition to sales improvement, in granting accounts receivable. Leniency in credit terms should only be allowed when the benefits from sales increase are greater than bad debt and opportunity costs. In brief, faster accounts receivable collection will result in positive impact on profitability. Therefore, in order to accelerate the collection process, companies should use the retrieved money for other investments.

## 5. Conclusions

The conclusions of this research, which analyzes the working capital management policy for mid-scale business in Surabaya, can be described as follows:

- (1) Working capital policy is based on loan terms and interest rate, which means longer loan age will result in higher interest. Long-term loan of working capital requires loanees to pay bigger interest than short-term loan, because loaners must take into consideration the risks of uncertain future.
- (2) In general, most corporations have three types of working capital policy: (1) Aggressive policy, which means that the entire working capital is covered by short-term debt; (2) Moderate policy, which means that half of the working capital consists of short-term debt, and the other half long-term debt; and (3) Conservative policy, which means the entire working capital is covered by long-term debt.
- (3) Corporate strategy for effective and efficient working capital management can be seen from the shortened *cash conversion cycle*. Companies with short cash conversion cycle indicate fast retrieval of accounts receivable, good inventory management, and slower payment to supplier while maintaining corporate credibility.

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