Chapter 13
The Effect of Working Capital Management on Firm's Profitability:
Evidence from Istanbul Stock Exchange

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ABSTRACT

Working capital management is an extremely essential issue for the healthy conduct of the sustainability of a business. The active and day-to-day nature of the short term business emporium, the ongoing necessity to substitute current assets and in the meantime to liquidate current liabilities clearly demonstrates the significance of working capital management and therefore the essential duty the financial executives carry. While an optimal strategy of working capital management is expected to positively contribute not only to the profitability of a firm but also its value; there is a trade-off between the liquidity level the firm is carrying and its profitability. The direct effect of working capital management on profitability and liquidity of firms clearly demonstrates the significance working capital management has in a firm and consequently the objective of this chapter is to find whether or not working capital management, i.e. cash conversion cycle has an effect on profitability for the publicly listed companies in Turkey using panel regression analysis.

INTRODUCTION

Working capital management, which consists of current assets and current liabilities management, carries utmost importance in the financial management decisions of firms and is the main function of financial managers in all corporations. The main component of working capital is related to accounts receivables, inventories and accounts payables. The dynamic nature of short term business emporium, the daily need of substituting current assets and liquidating current liabilities help to clarify the importance of working capital management and financial executive duties (Mansoori & Muhammad, 2012).

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An optimal working capital management is expected to contribute positively to the creation of firm value. With the ultimate aim of reaching optimal working capital management, the trade-off between liquidity and profitability should be controlled by the firm manager. Working capital management is the lifeblood of businesses and every manager's primary task is to help keep it flowing and to use the cash flow to generate profits. Working capital in business is considered as lifeblood in human body (Reddy & Patkar, 2004).

Based on risk-return trade-off, there are three procedures about working capital management; including aggressive, conservative and moderate working capital strategies (Weinraub & Visscher, 1998). Aggressive working capital policy mentions to maintain the lower amount of working capital elements, which is accompanied with high risk of liquidity and high return on working capital investment. On the other hand, conservative working capital management strategy states to maintain higher volume of the working capital requirements, which results in lower liquidity risk and lower return on working capital investment. In line with the above, the moderate strategy is in between the two working capital policies and explains keeping working capital elements in such volume that is accompanied with average risk and return.

In a nutshell, the effective working capital management is very important because it affects the performance and liquidity of the firms (Taleb, Zoued, & Shubiri, 2010). The efficient management of working capital is a fundamental part of the overall corporate strategy to create shareholders' value (Nazir & Afza, 2008). Therefore firms try to keep an optimal level of working capital that maximizes their value (Deloof, 2003).

In line with the fact that working capital management constitutes a major part of executive manager's attention and time; there is a deserved attention to working capital management in the finance literature; which will be discussed in detail in the next section. In line with this fact, the purpose of this study is to investigate the relationship between working capital management measured by CCC and firm profitability while at the same time taking into consideration other factors that will have an impact on firm profitability for the companies listed at Borsa Istanbul for the time period between 2009 and 2012; firms being categorized in two broad sectors: manufacturing and non-manufacturing.

The rest of the paper is organized as follows: While a background on the subject will be provided in the next section; the data and sample utilized in this study will be discussed, following which the methodology employed and the results will be presented. The conclusions of this paper may be found in the final section.

BACKGROUND

Both the studies conducted for the Turkish market, as well as the studies conducted for the other markets in the world indicate that there is a significant negative relationship between working capital management often measured in terms of cash conversion cycle and firm performance measured in terms of profitability measures. One of the important papers supporting this conclusion is written by Shin and Soenen in 1998, who studied the relationship between working capital management and profitability of firms, using Net Trade Cycle (NTC) instead of Cash Conversion Cycle to measure working capital management. The difference is that components of CCC are expressed as a percentage of sales in NTC. This study found a strong negative relationship between NTC and corporate profitability for a large sample of listed American firms for the periods between 1975 and 1994.

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