CHAPTER I

INTRODUCTION

1.1 Research Background

The world economy is rapidly changing. Rapid technological changes along with the increasing global competition give managers more responsibility for conducting their activities. One of the most controversial management decisions is profit and working capital management which plays a significant role in the growth and survival of profit. The issue of decision making can be seen in all areas of finance, and working capital management is not an exception.

Working capital is a prevalent metric for the efficiency, liquidity and overall health of a company. It is a reflection of the results of various company activities, including revenue collection, debt management, inventory management and payments to suppliers. This is because it includes inventory, accounts payable and receivable, cash, and portions of debt due within the period of a year and other short-term accounts.

A firm may exist without making profits but cannot survive without liquidity. The function of working capital management organization is similar that of heart in a human body. Also it is an important function of financial management. The financial manager must determine the satisfactory level of working capital funds and also the optimum mix of current assets and current liabilities. Financial managers must ensure that the appropriate sources of funds are used to finance working capital and should also see that short term obligation of the business are met well in time.

Working capital management (WCM) refers to all management decisions and actions that ordinarily influence the size and effectiveness of the working capital (Kaur, 2010). Management strategy focuses on maintaining efficient levels of current assets and current liabilities, this ensures that the company has sufficient cash flow to meet short-term obligations.

There is a strong linear relationship between profitability of the firm and its working capital efficiency. The ability of the company to earn profit can be referred to as the profitability of that company. Profit is determined by deducting expenses from the revenue incurred in generating that revenue. The amount of profit can be a good measure of the performance of a company, so we can use profitability as a measure of the financial performance of a company, as well as, profitability is the promise for a company to remain a going concern in business world. Proper optimization of working capital balance means minimizing the working capital requirement and realizing maximum possible revenues. Proper working capital management ensures that the company increased its profitability. (Ganesan, 2007).

Effective working capital management is very important due to its significant effect on profitability of company and thus the existence of company in the market. If a firm minimizes its investment in current assets, the resulting funds can be invested in value creating profitable projects, so it can increase the firm's growth opportunities and shareholders return. However, management can also face liquidity problems due to under investment in working capital. The ability of financial manager to effectively and efficiently manage their receivables, inventories, and payables has a significant impact on the success of the business and on profitability as well. Dilemma in working capital management is to achieve desired tradeoff between liquidity and profitability (Smith, 1980; Raheman & Nasr, 2007).

Financial executives have to make different decisions about the level of these components in order to get the best results. The dynamic nature of short-term business emporium, the daily need to substituting current assets, and liquidation current liabilities help to clarify the importance of working capital management and financial executive duties. The direct effect of working capital management on profitability and liquidity position of firms also refers the importance of working capital management (Nobanee, Abdullatif, & Al Hajjar, 2011). Firms may face to bankruptcy if they select and use improper working capital strategies, even though they experience positive profitability.(Samiloglo & Demirgunes, 2008).

Companies can minimize risk and improve the overall performance by understanding the role and drivers of working capital. A firm may adopt an aggressive working capital management policy with a low level of current assets as percentage of total assets or it may also be used for the financing decisions of the firm in the form of high level of current liabilities as percentage of total liabilities. Excessive levels of current assets may have a negative effect on the firm's profitability whereas a low level of current assets may lead to lower level of liquidity and stock-outs resulting in difficulties in maintaining smooth operations (Bhattacharya, 1997; and Van Horne and Wachowicz, 2004). A firm can be very profitable if it can translate cash from operations within the same operating cycle, otherwise the firm would need to borrow to support its continued working capital needs. Thus, the twin objectives of profitability must be synchronized (Brigham and Houston, 2004).

A popular measure of working capital management (WCM) is cash conversion cycle, i.e. the time lag between the expenditure for the purchases of raw materials and the collection of sales of finished goods. NTC is basically equal to the CCC whereby all three components are expressed as a percentage of sales. The Net trade cycle (NTC) actually indicates the number of day's sales the company has to finance its working capital under ceteris paribus conditions. The NTC is also closely related to the issue of firm valuation and creation of shareholder value. The shorter the NTC, the higher the present value of the net cash flow generated by the assets and thus, the higher the value of the firm for its shareholders. Thus, firms try to keep an optimal level of working capital that maximizes their value (Afza and Nazir 2007). Likewise, the shorter the NTC, the more efficient the firm is in managing its working capital, the lower the need for external financing and the higher its financial performance in order to anticipate an inverse relationship between the firm's NTC and its profitability. Another component of working capital is accounts payable. Delaying payments to suppliers allows a firm to assess the quality of bought products, and can be an inexpensive and flexible source of financing for the firm. On the other hand, late payment of invoices can be very costly if the firm is offered a discount for early payment.

It is an accepted fact that the industrial prosperity and success are linked directly or indirectly with efficient management of working capital but a developing industry generally faces the problem of either inefficient utilization of resources which are available to them, or scarcity of adequate resources among all the resources, one of the scarcest productive resources is capital, and capital plays the most pivotal role in overall corporate management of an industry Thus, management of working capital in a balanced and efficient manner can lead to the survival of the industry and it also further helps in protecting the purchasing power of assets and maximizing the return on investment.

This research adopts previous research conducted by Shubita (2013) who studied the relationship between working capital management and profitability and introduces empirical evidence about working capital management. It effects to the profitability of Industrial Jordanian companies listed in Amman Stock Exchange 2004-2011 consist of dependent variable is ROA (Return on Assets), independent variable are average collection period, inventory turnover in days, average payment period and net trade cycle on the return of assets for Jordanian companies.

The difference with previous studies is previous research employed data on 39 companies of Industrial Jordanian companies for the 8 years period from 2004-2011. But, in this study we investigate the relation between working capital management and corporate profitability for a sample of 28 companies in Sector basic industry and chemical listed in Indonesia Stock Exchange for the 2010-2014 periods.

Basic industry and chemical company are comprised of companies that produce raw materials which will be processed into finished goods. Basic industry and chemical company are chosen because it has high consumer, which will encourage the development of this industry. With high consumer, it will be able to increase the value of the company. The industry has a big opportunity in the global competition for being able to meet consumer tastes. In addition, the industry has also become a factor supporting the national industry because of the high investment and domestic consumption.

1.2 Problem Statement

Based on the background, the problem statement of this research is *Does working capital management affect profitability of Basic Industry and Chemical companies listed in Indonesia Stock Exchange?*

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1.3 Research Objectives

Based on the problem statement that already made and identified, so the objectives of the research are:

1. To determine the effect of *accounts receivable days* towards profitability of Basic Industry and Chemical Company listed on the Indonesia Stock Exchange 2010-2014.
2. To determine the effect of *inventory days* towards profitability of Basic Industry and Chemical Company listed on the Indonesia Stock Exchange 2010-2014.
3. To determine the effect of *accounts payable days* towards profitability of Basic Industry and Chemical Company listed on the Indonesia Stock Exchange 2010-2014.
4. To determine the effect of *net trade cycle* towards profitability of Basic Industry and Chemical Company listed on the Indonesia Stock Exchange 2010-2014.

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5. To analyze the effect of *sales growth* towards profitability of Basic Industry and Chemical Company listed on the Indonesia Stock Exchange 2010-2014.
6. To analyze the effect of *debt ratio* towards profitability of Basic Industry and Chemical Company listed on the Indonesia Stock Exchange 2010-2014.

1.4 Research Benefits

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After knowing the background, problem identification, research scope and purpose of this study, the authors have several benefits including:

1. This research gives additional information to existing literature concerning working capital management particularly for the case of Indonesian basic industry and chemical firms listed in Indonesia Stock Exchange. Moreover, this study helps financial executives of manufacturing firms to ensure they made right decisions regarding working capital management in order to increase corporate profitability and enhance the value of the shareholder.

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2. This research is expected to contribute in the form of empirical evidence to the theory of financial management related to the effect of working capital management on profitability and contributions to any interested parties to conduct further research on the subject of working capital.

1.5 Writing Systematics

In order to make it easier and make moderate the forwarding of content, this research is divided into five chapters. The first chapter is introduction describes background, problem definition, research objective, research benefit, and also writing systematic. The second chapter is about literature review, includes theories that relevant to study conducted. This chapter explain the meaning and function of working capital, components to calculate the working capital management, meaning and the way to calculating of profitability, liquidity, previous research, conceptual framework, and hypothesis.

Third chapter describe about research methodology including research design, population, data collection methods, variables identification, data analysis techniques and hypothesis testing. Chapter four is results and discussion, this chapter contains the overview of research sample, analysis of the data and the interpretation of the test results and a discussion of the research that has been done. The last chapter is closing that includes the conclusion of a series of discussion, limitations and constraints in the research as well as suggestions in the research and suggestions should be submitted either to the subject of research as well as for further research.

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