

CHAPTER I

INTRODUCTION

1.1 Research Background

Working capital management related to the management of current assets and current liabilities. Working capital management is considered very important in the sustainability process of production or operation activities of the company. If the working capital cannot be fulfilled, then the production process in danger. Indeed, this can be overcome by borrowing capital to banks or other financial institutions. But that would automatically increase the liquidity risks faced by the company. Therefore working capital management is very important to prevent this from happening in the future.

Optimal working capital levels are determined largely by management of current assets and current liabilities. It requires continuous monitoring to maintain proper levels in the various components of working capital. Especially for manufacturing companies current assets amount covers more than half of total assets. First, the management of current assets where within the post contained the company's assets that could be used in the operating activities of the company. Cash account is included in current assets; where cash is used by companies to finance the operating activities of the company include the purchases of raw materials and maintenance supplies. Later, accounts receivable is a tool used by the company to increase the number of sales. The company carries out the policy of giving credit to the consumer to achieve sales targets and ultimately to meet the profitability targets that have been set.

There are some amounts of inventories needed by company for the sustainability of the production process or as a “buffer” in case a significant increase of demand. Inventory is one part of the working capital (Subramanyam and Wild, 2010). Inventory is one part of current assets which have fairly large quantity and are in need of special attention. Most companies maintain inventory levels at a certain level. This happens because the company wanted to have enough supplies so that the sale of the company can continue to run. If the supply is not enough, they can lead to a decrease in sales volume below the level that can be achieved (Subramanyam and Wild, 2010).

Company manages the inventory as well as possible so that the company's sales activities can be running well. Excessive investment in inventory resulted in accruing various costs such as storage costs, insurance costs, tax costs, the cost of obsolescence and physical damage to the inventory itself (Subramanyam and Wild, 2010). When these costs have a large enough portion then these costs will reduce profitability. Excessive investment in inventory also identifies that there is a problem in the management of inventory. There is a possibility that the products the company is not sold, so the supply is piling up. No behavior can identify items that policies concerning the sale should be corrected so that the inventory can be sold by the company.

In the management of current liabilities, this post cannot be separated from trade payable undertaken by the company. There are several motives of a company to do so. First, these companies do not have sufficient cash to make purchases. Second, the company has sufficient cash but it was allocated to finance other operating activities and make a credit purchase for raw material. Third, the company is looking for the benefit from the credit purchase policy from producers (Hanafi, 2009).

The main indicator of working capital management, commonly used in studies is the cash conversion cycle (cash conversion cycle). In this study, the cash conversion cycle and its components are used as a basis for assessing the efficiency of working capital management to determine its relevance in achieving the objectives of profitability.

Working capital management will indirectly affect the level of corporate profitability. As described above, any measures taken by the company will have an impact on the level of sales and eventually also affect the value of companies that are affected by the amount of net profit.

The company's ability to generate profits by using all its resources referred to profitability. Munawir (2010) mentions the profitability as company's ability to generate profits within a certain time that can be measured by the success of the company and the company's ability to manage its assets. It is this ability which became one of the factors that may affect investor consideration in deciding where he should be investing. Profitability also showed the effectiveness and efficiency of companies in utilizing its resources. The higher the level of productivity of a company the better performance is.

Profitability and liquidity are two important and major aspects of corporate business life (Vataliya, 2009). The problem is that increasing profits at the cost of liquidity can bring serious problems to the firm. Therefore, there must be a trade-off between these two objectives (liquidity and profitability) of firms. One objective should not be at the cost of the other because both have their own importance. If firms do not care about profit, they cannot survive for a longer period. In other round, if firms do not care about liquidity, they may face the problem of insolvency or bankruptcy. For these

reasons managers of firms should give proper consideration for working capital management as it does ultimately affect the profitability of firms. As a result company can achieve maximum profitability and can maintain adequate liquidity with the help of efficient and effective management of working capital.

In manufacturing companies, working capital is expected to affect the company's profitability. It can be seen from the operating activities of companies started from capital investment to supplies the raw materials of its products and their receivables and pay for the debts of the company. The manufacturing company is a company that produces the needs of society in Indonesia both as an industry that produces goods to satisfy basic needs also generates additional needs. Inventory is an asset to manufacturing company, since the inventory is a major source of income in these types of companies. Manufacturing companies must store enough supplies to meet the needs of its customers. Failure on this account would be bad if it was not considered seriously, because it can result in loss of sales / revenue so as to reduce the company's operating profit.

This research adopts previous research conducted by Akoto, Vitor, & Angmor (2013) who studied the effect of working capital management on profitability in the manufacturing industry listed in Ghanaian Stock Exchange 2005-2009 consist of the dependent variable is the return on equity to measure profitability, independent variables; number of days accounts receivable, number of days accounts payable, cash conversion cycle, & current ratio. And the control variable is the size of the company and current assets turnover. Prior research done by Falope and Ajilore (2009) found a significant negative relationship between net operating profitability and the average

collection period, inventory turnover in days, average payment period and cash conversion cycle for a sample of fifty Nigerian firms listed on the Nigerian Stock Exchange. Furthermore, the study found no significant variations in the effects of working capital management between large and small firms. An important lesson therefore is that, prudent working capital management is critical for the profitability of firms of all sizes.

From previous study can be seen that the research about working capital management and its impact towards profitability and liquidity had given an inconsistent result. Regarding this inconsistencies between previous study, the researcher wants to reconduct the research using different variables and object.

In this study, the selected industries as an object of research are the manufacturing industry. Because the industry is consider ideal in working capital management. In manufacturing companies, it can be seen from the operating cycle that involves investment in inventories and receivables and make the payments on their debts. In connection with the days of outstanding inventory (DOI), the study was conducted in industries associated with supplies. In particular, the manufacturing industry associated with supplies. Based on the above mentioned argumentation, this study observed the effect of working capital to profitability of manufacturing company in Indonesia.

1.2 Research Questions

This study wants to analyze the influence of working capital on profitability in the manufacturing industry in Indonesia in 2010-2014.

The following research questions are posed:

- 1) What is the effect of *number of days accounts receivable* towards profitability of manufacturing company in Indonesia?
- 2) What is the effect of *number of days accounts payable* towards profitability of manufacturing company in Indonesia?
- 3) What is effect of the level of *cash conversion cycle* towards profitability of manufacturing company in Indonesia?
- 4) What is the effect of the *level of current ratio* towards profitability of manufacturing company in Indonesia?
- 5) What is the effect of *firm size* to profitability towards profitability of manufacturing company in Indonesia?
- 6) What is the effect of *current assets turnover* towards profitability of manufacturing company in Indonesia?

1.3 Research Objectives

This research was conducted with the following objectives:

- 1) To determine the effect of *number of days accounts receivable* towards profitability of manufacturing company listed in Indonesia Stock Exchange 2010-2014.

- 2) To determine the effect of *number of days accounts payable* towards profitability of manufacturing company listed in Indonesia Stock Exchange 2010-2014..
- 3) To determine the effect of the level of *cash conversion cycle* towards profitability of manufacturing company listed in Indonesia Stock Exchange 2010-2014.
- 4) To determine the effect of the *level of* current ratio towards profitability of manufacturing company listed in Indonesia Stock Exchange 2010-2014.
- 5) To determine the effect of *firm size* to profitability towards profitability of manufacturing company listed in Indonesia Stock Exchange 2010-2014.
- 6) To determine the effect of *current assets turnover* towards profitability of manufacturing company listed in Indonesia Stock Exchange 2010-2014.

1.4 Research Benefits

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

- a. For companies
To raise awareness of all activities undertaken by the company, in particular from the results of this study can be used as a reference to know the impact of working capital management towards profitability.
- b. For the development of science
To added the literature on research about the importance of working capital management within company.
- c. For academics

It can provide information as input to add insight and guidance in order to conduct further research.

1.5 Writing Systematics

The writing systematic of the research comprise five parts. 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, previous research, conceptual framework, and hypothesis. Third chapter describe about research methodology including types and sources of research, population and sample, data collection methods, variables and measurements, and data analysis techniques. Chapter four is results and discussion, this chapter contains the 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.

