CHAPTER I

INTRODUCTION

1.1 Background

On the financial crisis, the world has drawn attention and shocking after the big companies such Enron and WorldCom that collapse in 2001 and 2002. Also, the same thing happened on General Motors, Lehman Brothers, and Bear Stearns. This happened because lack of control of the company include the importance of management of organizational resources expecially the management of working capital. Working capital describes about the capital available to meet day-to-day operations of the company. Working capital management is about how well the company manage their financial resources, creating values, reducing the days-in-inventory period, the debtors collection period, creditors payment period and indicated to the reduction in the cash conversion cycle associated with the company's profitability.

In order to improve the financial performance, the company undertake actions that can save the company from financial crisis, both from external and internal sources in working capital. Working capital is a major problem for the company because if a state of their own working capital management is good then it will be closely linked to the company's performance in term of profitability. Working capital management is vital for manufacturing firms because the important part of the assets is the current assets. The amount of investment in the company is large enough. Because of that, the company needs to have a well managed of working capital.

Working capital management needed to manage the company's current assets and current liabilities to meet the requirements of the expenditure in daily business. The requirements depend on the operating cycle period of the company, that is start from cash outflow and ended up being the cash inflow routinely then it will goes repeatedly. The more of working capital needs, the period will be longer.

In manufacturing company, the operating cycle will start from cash and raw materials and then work in process, finished goods, receivables, and back into cash. It is important for the company to plan adequate funds and the planning process for the acquisition also the use of short-term assets and liabilities. Available funds necessary to carry out continuous operation of a company. Because of that, working capital management determines policy of the firm in planning for its current assets and liabilities holdings in financing its routine operations. It became an organization's resources and requires proper planning and well manage because it has an important role in achieving profitability and overall performance of the entity. According to Jeng-Ren, et., al (2006), A well managed working capital promotes a company’s well being on the market in terms of liquidity and it also acts in favor for the growth of shareholders value (Makori, 2013). Current assets will affect the liquidity and profitability of the company directly. According to Kargar and Bluementhal (1994), The liquidity tradeoff is important because if working capital management is not given due considerations then the firms are likely to fail and face bankruptcy.

At the time in making liquidity and profitability comparisons among companies, working capital management is needed to make decisions that will be seen from the amount and composition of current assets and the financing assets. the greater relative proportion of liquid assets, the risk of running out of cash will be lower, all other things being equal. All of the components of working capital such as receivables, inventory and payable also use the cash efficiently in order maintaining its optimum balance to realize the maximum possible revenues and also minimize the working capital requirements and also have a significant impact on the success of the business and on profitability as well.

A key factor in the working capital management is the cash conversion cycle (Deloof, 2003). Cash conversion cycle is defined as the time lag between the purchasing of raw materials or rendering of services and the collection of cash from the sale of goods or services rendered. The longer the lag, the greater the investment in working capital, and thus the financing needs of the firm will be greater. Interest expense will be also higher, which leads to higher default risk and lower profitability (Charitou, et al., 2010).

Deloof (2003) explained that the longer the time span between the expenditure incurred in the purchase of raw materials or machandise and the collection of sales proceeds, the larger the investment in working capital. A long conversion cycle will lead to higher sales volume and therefore increase profits but will also decrease profits when the cost of investment in working capital rises faster than the benefits of holding more inventories and or granting more trade credits to buyers.

The main purposes of the company are to maintain liquidity, viability, solvency and profitability of the business. However, the increase in profits at the cost of liquidity can be a serious problem for the company. If the company do not care about liquidity, it will result bankruptcy. According to Padachi (2006), Liquidity is a precondition to ensure that firms are able to meet its short-term obligations and its continued flow can be guaranteed from a profitable venture. The importance of cash as an indicator of continuing financial health should not be surprising in view of its crucial role within the business. This requires that business must be run both efficiently and profitably. In the process, an asset-liability mismatch may occur which may increase firm’s profitability in the short run but at a risk of its insolvency. On the other hand, too much focus on liquidity will be at the expense of profitability and begin their working capital sections with a discussion of the risk and return tradeoffs inherent in alternative working capital policies.

Thus, the manager of a business entity is in a dilemma of achieving desired tradeoff between liquidity and profitability in order to maximize the value of a firm. So, There is a strong linear relationship between profitability of the firm and its working capital efficiency. Proper Working capital management ensures that the company increased its profitability. 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 (Agha, et.al., 2014). So, working capital management must be efficient and effective because efficient management of working capital became an important part of the overall corporate strategy in order to create shareholder value which would have a significant impact on liquidity and profitability. Efficient working capital management will also increase company's free cash flow and increases the firms’ growth opportunities.

The company should be able to manage their fund source, increase their productivity and also efficiency of the use of capital for the development of the company. The planning and control of the company's working capital management should be in a proper way because it has the significant effect for the company's operations in daily activities that will also generate to company's revenue to be earned. From the explanation above, working capital management has the effects on the company's profitability also it is important for the investor in making decisions whether they should invest or not.

This research adopts previous research conducted by Alipour (2011) who studied the relationship between working capital management and profitability. It does affect the working capital management on the profitability that listed in Tehran stock exchange from 2001-2006 in Iran. Gross Operation Profit is as the dependent variable and Average collection period, Inventory turnover in Days, Average payment period also Cash conversion cycle are as the independent variables. Control variables are also used to control the dependent and independent variables in this research, those are liquidity, size of the firms, financial assets ratio and leverage for Tehran stock exchange in Iran.

The difference with the previous study is the previous research took the sample of data on 1063 companies of Iran on the Tehran stock exchange for the 6 years period from 2001-2006. But, this study investigates the relation between working capital management and profitability for a sample of 101 companies in Manufacturing companies listed in Indonesia Stock Exchange from 2012-2014 in order trying to prove the effectiveness of working capital management and the effect of the different components on profitability in Indonesia. Also, determines how much the influence on each of the variables on the working capital management to the profitability in Indonesia.

1.2 Problem Statements

This research wants to find out about the relationship between working capital management and profitability and how effective it is to company profitability in Indonesia, especially in manufacturing companies. The problem statement of the research is:

"How the relationship between effective working capital management and profitability on manufacturing companies during 2012-2014?"

1.3 The Research Objectives

1. To establish the relationship between effective working capital management and profitability on manufacturing companies during the year investigation
2. To find out the effect of different components of cash conversion cycle on the profitability of the manufacturing companies during the year investigation
3. To draw a conclusion about the relationship between working capital management to the profitability

1.4 The benefit of research

1. To give the contribution to the users of financial statements to understand how the effect of working capital management to profitability.

2. Increase the knowledge of the management regarding to the influence of working capital management to profitability, which is expected to help the management in working capital management to maximize profitability.
3. Provide references for further research that are interested in studying the effects of working capital management on profitability.

1.5 Writing Systematic

The writing systematic of the research divided into five parts. The first chapter is introduction that describes background, problem statements, research objectives, research benefit, and writing systematic. The second chapter is about literature review, includes theories that relevant to study conducted. This chapter explains about 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 describes 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.