CHAPTER I

INTRODUCTION

1.1 Background

In the world of business there is always increasing and decreasing of financial aspects and profitability. The economy is rapidly changing along with the technological changing and other factors. This changing will lead to more complex global competition that give managers more responsibility to conduct their activities. The managers who play significant role in the growth and survival of the company have task to make decisions that will affect the company regulation and profitability include the decision about working capital management.

Working capital is a prevalent metric for the efficiency, company's performance, short-term financial health and the position of the company that shows the result of the activities including cash conversion cycle, inventory turnover, accounts receivable turnover, current liabilities that is very important for the company whether to obtain the objectives or run the business well.

Keown et al (1998) stated that working capital is defined as the firm's total investment in current assets. In managing the firm's working capital, we are concerned with managing the firm's liquidity. This entails managing two related aspects of the firm's operations which are investment in current assets and use of short-term or current liabilities. Other things remaining the same, the greater the firm's investment in current assets, the greater its liquidity. As a means of increasing its liquidity, the firm may choose to invest additional funds in cash or marketable securities. Such action involves a trade-off, however, because such assets earn little or no retun. The firm thus finds that it can reduce its risk of illiquidity only by reducing its overall return on invested funds, and vice versa.

The risk-return trade-off involved in managing the firm's working capital involves a trade-off between the firm's liquidity and its profitability. By maintaining a large investment in current assets like cash and inventory, the firm reduces the chance of production stoppages and lost sales from inventory shortages and the inability to pay bills on time, which might in turn result in credit-rating problems. However, as the firm increases its investment in working capital, there is not a corresponding increase in its returns. This means that the firm's return on investment drops because profits are unchanged, while the investment in assets increases.

Based on the book by Keown et al (1998) concluded firstly, current assets are a major component of a firm's investments and can constitute as much as 70 percents of firm assets. Secondly, most firms maintain current ratios greater than 1, although this relationship varies both across industries and over time. Finally, long-term debt is frequently a less important source of financing than are current liabilities. So, it can conclude that working capital management is extremely important to the firm's financial well-being and deserves serious consideration.

Working capital is defined as the difference between current assets and current liabilities and is often used to measure a firm's liquidity level. The components of working capital are cash, accounts receivable, inventories, accounts payable, current debt, and the current portion of long-term debt (Mun and Jang, 2015).

Working capital management refers to the administration of all components of working capital cash, marketable securities, debtors (receivable) and stock (inventories) and creditors (payables). The financial manager must determine levels and composition of current assets. They must see that right sources are tapped to finance current assets, and that current liabilities are paid in time (Homework1.com).

There are many aspects of working capital management which make it an important function of the financial manager:

1. Time working capital management requires much of the financial manager's time
2. Investment working capital represents a large portion of the total investment in assets
3. Criticality working capital represents a large portion of the total investment in assets
4. Growth, the need for working capital is directly related to the firm's growth

Empirical observations show that the financial managers have to spend much of their time to the daily internal operations, relating to current assets and current liabilities of the firms. As the largest portion of the financial manager's valuable time is devoted to working capital problems, it is necessary to manage working capital in the best possible way to get the maximum benefit.

Investment in current represents a very significant portion of the total investment in assets. For example, in the case of the large and medium public limited companies in India, current employed.

Working capital management is critical for all firms, but particularly for small firms. A small firm may not have much investment in fixed assets, but it has to invest non-current assets. Small firms in India face a severe problem of collecting their debtors (receivables). Further, the role of current liabilities in financing current assets is far more significant in case of small firms, unlike large firms, they face difficulties in raising long-term finances.

There is a direct relationship between a firm's growth and its working capital needs. As sales grow, the firm needs to invest more in inventories and debtors. These needs become very frequent and fast when sales grow continuously. The financial manager should be aware of such needs and finance them quickly. Continuous growth in sales may also require additional investment in fixed assets.

It may, thus, be concluded that all precautions should be taken for the effective and efficient management of working capital. The finance manager should pay particular attention to the levels of current assets and the financing of current assets. To decide the levels and financing of current assets, the risk return implications must be evaluated (Homework1.com).

There is a strong 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).

As a result, firms can minimize risk and improve their overall performance if they can understand the role and determinants of working capital. Keeping an optimal balance among each of the working capital components is the main objective of working capital management. Business success heavily depends on the ability of the financial manager to effectively manage receivables, inventory, and payables. Firms are able to reduce financing costs and/or increase the funds available for expansion by minimizing the amount of funds tied up in current assets (Filbeck and Krueger, 2005).

Firms may have an optimal level of working capital that maximizes their values. Large inventory and a generous trade credit policy may lead to high sales. Larger inventory reduces the risk of stock-out. Trade credit may stimulate sales because it allows customers to assess product quality before paying. Another component of working capital is accounts payable. Delaying payments of suppliers allows a firm to assess the quality of the products bought, 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.

This research adopts previous research conducted by Raheman and Nasr (2007) which studied the effect of different variables of working capital management including the average collection period, inventory turnover in days, average payment period, cash conversion cycle, and current ratio on the net operating profitability of 94 Pakistani firms listed on Karachi Stock Exchange (KSE) for a period of 6 years from 1999-2004. The differences in this study from previous research are, in this study we investigate the effect of working capital management to corporate profitability in manufacturing companies sector foods and consumption goods listed on Indonesia Stock Exchange for a period of 5 years from 2011-2015.

Manufacturing companies sector foods and consumption goods are the companies that have large market and potential market that people always consumed the goods as basic needs. This sector plays a strong role in the economic and business because it is a large sector that can not be substituted and has high consumer, which will encourage the development of the industry and increase the values.

1.2 Problem Statements

Based on the background, the problem statements of this research are to evaluate:

1. How the effect of accounts receivable days toward profitability?
2. How the effect of inventory days toward profitability?
3. How the effect of accounts payable days toward profitability?

4. How the effect of cash conversion cycle toward profitability?
5. How the effect of net trade cycle toward profitability?

1.3 Research Objectives

The research focuses on evaluating the effect of working capital management to profitability, for sample of manufacturing companies sector foods and consumption goods listed on Indonesia Stock Exchange. The main objectives are:

1. To determine the effect of accounts receivable days toward profitability
2. To determine the effect of inventory days toward profitability
3. To determine the effect of accounts payable days toward profitability
4. To determine the effect of cash conversion cycle toward profitability
5. To determine the effect of net trade cycle toward profitability

1.4 Research Benefits

With the achievement of the objectives of the research that already described above, the results of this research are expected to provide the following objectives:

1. The research gives additional information about working capital management and its effect to profitability of manufacturing companies sector foods and consumption goods listed on Indonesia Stock Exchange period 2011-2015. This research also helps financial managers of manufacturing companies in making decisions in order to increase corporate profitability and encourage them in making proper decision.

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

1.5 Writing Systematics

In order to make it easier and moderate the forwarding of content, this research is divided into five chapters. The first chapter is introduction describes background, problem definition, research objectives, research benefits, and 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 calculate the 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, 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.