

Effects of Working Capital Management Practices on the Financial Performance of Tourist Hotels in Mombasa County, Kenya

Shadrack Mbithi¹, Dr. Jane Muiruri², Dr. William Kingi³

^{1,2,3} School of Business, Technical University of Mombasa, Mombasa, Kenya

Abstract: The study focused on the effects of working capital management (WCM) practices on the financial performance of tourist hotels based on the tourist hotels at the Kenyan coastal region. Systematic random sampling was applied to select a sample of 22 hotels from the total 44 as per the Ministry of Tourism. Questionnaires were used to collect primary data from the accountants and Managers of the hotels as they were well versed with the data required. The data collected was analysed using descriptive statistics to determine the mean, standard deviation, minimum and maximum of the various variables. Pearson correlation coefficient was also used to analyse the relationship between the dependent variable (financial performance) and the independent variable based on the inventory turnover days, number of days account receivables, number of days accounts payable and the cash conversion cycle. All the independent variables showed a negative correlation to the net operating profit, which meant that the days of converting inventory and receivables into cash together with paying creditors needed to be shortened for increased profits. The study strongly confirmed that the hotels best financial performance strongly relates to the efficient management of working capital components whereby the shareholders' value can be created through shortening of the cash conversion cycle. Therefore, the management should identify the hotel's unique working capital drivers and relevant risks and use them to develop their unique working capital management policies and practices that are in line with their business model and the overall hotel corporate strategy.

Keywords: Working Capital, Cash Conversion Cycle, Current Assets, Current Liabilities, Liquidity, Tourist Hotel.

I. INTRODUCTION

Over the years, poor management of working capital has been the main reason for business insolvency, bankruptcy and the ultimate failure. Working capital is the money needed to pay for the daily operations of the business, which is the difference between current assets and current liabilities. Atrill (2006) defines working capital as a net of the short-term assets that continuously flow into and out of the business that are important for daily operations. Mukhopadhyay (2004) terms working capital as the life giving force of any business venture and states that for continued business operations then the current assets (bank, cash, marketable securities, payment of advance taxes, debtors and inventories and short-term loans and advances) should be well financed.

Maintaining the working capital at an optimum is the main concern of working capital managers as a firm loses money in the form of interest on the blocked funds in case of holding excess working capital when there are inadequate opportunities. During periods of economic turbulence, the firms with reliable and efficient working capital management practices are able to survive (Reason, 2008). During periods of economic boom also, efficient management of working capital is important as it involves the management of both current assets and current liabilities (Emery, Finnerty & Stowe, 2004). According to Darun (2011), working capital management is not only important in cases of financial distress but can be managed in the most efficient way to increase a firm's profitability and a competitive edge over the others.

The processes of managing working capital involve significant decisions on various aspects- investment of available cash, managing accounts receivable, maintaining an absolute level of inventories and the management of accounts payables (Darun, 2011). Gitman (2009) notes the main goal of working capital management as striving to reach and maintain an optimized balance between the various components of working capital, as the success of a business, according to Filbeck and Krueger (2005), depends heavily on the ability of financial executives to manage receivables, payables and inventory in the most efficient way.

A number of studies on working capital have been carried out around the world but mostly in the developed western countries, with very little on firms in the developing countries (Quayyum, 2012). These include firms operating in African countries, which face unique challenges in their operations given the high political instability, insufficient financing and little or slow technological advancement among others (World Economic Forum, 2011).

Numerous theories have also been developed on working capital management including the Baumol cash management model (1952), Miller- Orr cash management model (1966) and the inventory management model. However, practitioners find these financial decision making techniques difficult to put into actual application due to their unrealistic assumptions including the ignorance of uncertainty in business operations and their complexity in explaining to decision makers (Trahan & Gitman, 1995).

Studies on working capital management on Kenyan firms especially in the service sector and in particular, the tourism industry that is core to the Kenyan economy, are not explicit. It is therefore, important to study the working capital management in the tourism industry in these developing economies given their uncertain business environment.

II. STATEMENT OF THE PROBLEM

The tourism industry operates on seasons (peak, shoulder and low) and is very sensitive to the environment especially on security concerns (Kuto & Groves, 2004). In Kenya, the tourism industry operates in a highly uncertain environment due to the increased political instability and terrorism incidences that have led to negative international press and travel advisories resulting in dwindling demands (Okumu, 2007). The tourism industry is highly capital intensive hence, the low demand has led to most tourist hotels cutting down on their services and eventually closing down due to the inability to manage their working capital optimally.

Much of the previous studies on working capital management have concentrated on the manufacturing industries in the trade sector (Filbeck, Krueger & Preece, 2007; García-Teruel & Martínez-Solano, 2007; Lazaridis & Tryfonidis, 2006; Azam & Haider, 2011; Quayyum, 2012). To date, little focus has been given to the management of working capital in the service sector and in particular, the tourism industry. Consequently, working capital management advice to the service sector has been monotonous in its prescription of trade sector solutions. To further compound the issue, many of these studies assume that trade sector praxis can be applied to the service sector though contemporary academic opinion suggests that this assumption is fundamentally flawed as it is now widely accepted that the service sector is subject to different operational dynamics to the trade sector (Kato, 2010).

Even with such uncertainty, the tourism industry players continue employing the same working capital management practices used in the other more certain and stable industries. This has led to overtrading and the subsequent poor performance of the tourist subsectors. To maintain a competitive edge or even sustain operations in such an uncertain economic environment, the working capital should be managed in the most prudent manner. This study therefore, sought to gain an empirical insight into the various working capital management practices used in the tourism industry, with special reference to tourist hotels in Mombasa County with the aim of determining best practices in uncertain business environments.

Objectives of the Study:

The overall objective of the study was to determine the effects of working capital management practices on the financial performance of tourist hotels in Mombasa County.

Specific Objectives:

1. To determine the effect of cash on the financial performance of tourist hotels in Mombasa County.
2. To determine the effect of inventory on the financial performance of tourist hotels in Mombasa County.

3. To determine the effect of accounts receivable on the financial performance of tourist hotels in Mombasa County.
4. To determine the effect of accounts payable on the financial performance of tourist hotels in Mombasa County.

III. LITERATURE REVIEW

This study was based on the existing relevant literature on working capital management. Darun (2011) sought to examine the working capital management practices at an organizational perspective focusing on the determinants of the various practices employed in managing working capital based on multiple case studies of five Malaysian companies that were listed on the main board of Bursa Malaysia. Semi structured interviews were used to collect data from key informants that represented the managers of the various components of working capital. The research found out that the working capital management practices employed in various firms depended on various determinants including perceived environmental uncertainty, budgetary control, organizational structure, interdependency and information technology, and organizational culture.

Apuoyo (2010) embarked on a study to find the relationship between the policies that companies used and their effect on profitability. The study was based on fifty-five companies quoted at the Nairobi Stock Exchange (NSE) in Kenya as at 31st December, 2009. The companies were classified based on the NSE sector categorization proportionate random stratified sampling was used. Relevant data was collected from the sampled companies' audited financial reports for the five years since 2005 to 2009. The data was analyzed to find out the annual working capital policy for each firm that were then classified into aggressive, conservative and moderate policies. The relationship between the working capital policies and return on total assets (ROTA), which was the measure of profitability, were determined using simple regression. The study found out that the firm's profitability increases with the firm's gross working capital efficiency, size and less aggressiveness in asset management. Contrary to conventional theory that a conservative working capital policy sacrifices profits at the expense of liquidity the study revealed a positive relationship between conservative working capital policy and firms profitability. Significant differences in working capital policies between the five sector classifications were also realized.

There are several theories that relate to the management of working capital especially in firms operating in highly volatile business environments like the Kenyan tourism sector. These include the pecking order theory, agency theory and the configuration theory.

A. Pecking Order Theory:

The Pecking Order Theory is based on information asymmetry where the firm's managers are seen to possess more knowledge on the firm's value than the potential investors are. It states that firms prefer internal financing and the use of debt to common stock in case of the need for external funds (Myers & Majluf, 1984). Internally generated funds are assumed to have no transaction costs and the use of debt signals positive information while the use of ordinary shares signals negative firm information (Correa, Basso & Nakamura, 2007). The pecking order theory explains the maintenance of high levels of cash reserves and most liquid assets that ensure obligations are met as they arise and avoid the use of external funds (Chen, 2004). By using a conservative financing strategy, a firm gets easy access to credit and is seen as safe by potential investors. According to the pecking order theory, firms should use an aggressive working capital policy by maintaining a lower level of current assets and higher supplier financing. This ensures a high level of internal funds to finance the firm's operations without the issuing of debt or equity. The pecking order theory is relevant in the management of working capital of firms operating in highly uncertain environments, as the managers responsible should be able to trade-off between the conservative and aggressive financing strategies to optimize a firm's performance.

B. Agency Theory:

Jensen and Meckling (1976) advanced the agency theory, which explains the relationships and contracts that exist in a firm among the various stakeholders like shareholders (principals) and the managers (agents). Despite the stipulated shareholder objectives that managers are supposed to meet, they are not able to achieve them due to non-rational opportunistic behavior of the managers leads to agency conflicts or problems (Jensen, 1994). To minimize agency problems the principals incur agency cost that is defined as the monitoring expenses incurred by the principal, bonding expenses and the resultant loss due to the separation of control and ownership (Jensen & Meckling, 1976). The agency theory is important in the management of firms' finances as it depends on the ability and ethics of the managers responsible for running the organization. It is crucial in the management of working capital especially in firms operating

in highly unstable and uncertain environments like the Kenyan tourism sector as high agency costs are incurred in ensuring the success and sustainability of the hotels.

C. Configurational Theory:

The Configurational theory is an advancement of the contingency theory that proposes that the performance of a firm depends on the fit of organizational design and environment (Shortell, 1977). The contingency theory advances that various aspects of technologies, environments and structures interact to determine the performance level of an organization (Vorhies & Morgan, 2003). However, the configurational theory goes further on to state that the environment and organizational fit should not be limited to structural perceptions like centralization but should extend to abstract situational aspects like technological uncertainty and firm size (Meyer, Tsui, & Hinings, 1993). According to the contingency theory, the effectiveness or ineffectiveness of a firm depends on the match of mismatch of an organizational structure against its external contingency factors (Donaldson, 1982). These external factors include demographic trends, economic conditions, legal/ political factors, industry structure variables and demographic trends (Hofer, 1975). External factors are prone to rapid changes hence managers should align the firm to the arising situations to maximize their output (Hofer, 1975). In managing working capital, the configurational theory states that an organization's aspects should be aligned to its contextual variables like the industry structure, economic situation, demand behavior and supplier variables (Faden, 2014). To achieve organizational performance then the various internal variables of working capital should be matched with arising contextual variables, as an optimization of these aspects will lead to the attainment of maximum firm performance as the configurational theory postulates (Faden, 2014). With working capital being a major driver of organizational performance, it is important for the firms' managers to be able to align the various internal working capital variables to the changing environmental aspects especially in firms operating in highly volatile environments like the Kenyan tourism sector if a firm is to survive during the low demand periods.

IV. METHODOLOGY

The study adopted a descriptive survey research as it enables the identification and classification of the elements or characteristics of the subject. According to Cooper and Schindler (2003), a descriptive study attempts to describe or define a subject, often by creating a profile of a group of problems, people, or events, through the collection of data and tabulation of the frequencies on research variables or their interaction. The target population in this study consisted of the tourist class hotels in Mombasa County. There were forty-four tourist hotels in Mombasa County as at 2013 as per The Ministry of Tourism database. The study used a target sample of 22 hotels that represent 50% of the target population in collecting primary data. Systematic random sampling was used to determine the sample size of the study units (tourist hotels) from the total population. Purposive sampling was used to specifically select respondents from the finance or administration department of the hotels selected. This mainly focused on the financial managers or administrator charged with the duty of managing the hotel's finances especially the day-to-day operating funds. Descriptive statistical techniques including Minimum, Maximum, Mean and Standard Deviation were used to analyze data. The association between the dependent variable and the independent variables were determined by the use of the Pearson correlation coefficient that determines a linear relationship between two variables.

V. RESULTS AND DISCUSSION

The overall response rate was 19 out of 22 questionnaires giving a response rate of 86.4 percent. The total number of usable responses was 18, which gave a usable response rate of 81.8 percent. This response rate was adequately sufficient as it conformed to the stipulation that a response rate of 50 percent is adequate for analysis and reporting; a rate of 60 percent is good and a response rate of 70 percent and over is excellent (Mugenda, *et al.*, 2003).

Working Capital Management:

Most of the respondents (77.8 percent) admit that the management of working capital is very important to the hotel while 22.2 percent rate it as just important with none classifying it as non-important. The hotels that practiced an aggressive working capital financing policy were a majority at 50 percent, followed by moderate policy at 27.8 percent while the least, 22.2 percent had a conservative policy. With an aggressive policy, it indicated that the hotel maintained low levels of net current assets to the total assets while a conservative policy indicated the holding of quite a large proportion of net current assets (Apuoyo, 2010). This implies that in case of sudden changes in demand and supply then the hotels operating an aggressive policy will be at a higher risk.

Financial Performance:

The study measured financial performance of the hotels based on various working capital management metrics including the receivables collection period, creditors’ payment period, inventory turnover period, cash conversion period and the net operating profit. The study used the hotel’s annual financial details as provided to measure the variables as follows:

No. of Days Accounts Receivable (ACR) = (Accounts Receivables/Sales) x 365

No. of Days Accounts Payable (ACP) = (Accounts Payables/Cost of Goods Sold) x 365

No. of Days Inventory (ICP) = (Inventory/Cost of Goods Sold) x 365

Cash Conversion Cycle (CCC) = (No. of Days A/R + No. of Days Inventory) – No. of Days A/P

Net operating Profit (NOP) = (Operating Income + depreciation) / (Total Assets - Financial Assets)

Descriptive Statistics:

TABLE I: DESCRIPTIVE STATISTICS (N=18)

	ACR	ACP	ICP	CCC	NOP
Mean	46.39	31.61	21.39	37.83	0.1382
Median	42	30	20	37.5	0.1326
Maximum	81	62	35	56	0.1916
Minimum	28	14	7	17	0.1015
Std. Deviation	61.44	44	34.27	11.82	0.0267

Correlation Analysis:

The relationship between the various components of working capital and the tourist hotels’ profitability was measured using the Pearson’s Correlation analysis as provided in table 4.7 below.

TABLE II: PEARSON CORRELATION COEFFICIENT

Correlations					
	NOP	ARC	ACP	ICP	CCC
NOP	1	-0.682466	-0.6635778	-0.7027287	-0.8338
ARC		1	0.91591105	0.62096272	0.76093
ACP			1	0.64444482	0.65342
ICP				1	0.8061
CCC					1
**	Correlation is significant at the 0.01 level (2-tailed).				

As indicated in table 4.7, there is a strong negative correlation of – 0.6825 between the hotels’ net operating profit and the number of days accounts receivable. This implies that an increase in the average collection period will influence net operating profits negatively, hence for the hotels to make profits they should collect their receivables in the shortest time possible by sticking to their policies and avoiding any postponements. The number of days accounts payable is also strongly negatively correlated (- 0.6636) to the net operating which implies that for the hotels to make profits they should pay their bills in shorter periods also. This can be supported by the fact that a delay in servicing bills attracts other costs like fines and bad relations between the hotels and their creditors. The number of days it takes to sell inventory is also very strongly negatively correlated to the net operating profit (- 0.7027) which implies that hotel profitability will be negatively affected if the inventory turnover period increases hence the tourist hotels should strive to dispose their inventory in the shortest time possible. The cash conversion cycle which is an aggregate of the three variables is also negatively correlated to the net operating profit (-0. 8338). This implies that efficient management of working capital is crucial for increased hotel profitability. The results confirm previous studies that posit that a firm’s profitability is increased through a short conversion period between production and sale of products. These findings are in line with previous studies on the relationship between working capital and firm profitability (Ray, 2012; Deloof, 2003).

VI. CONCLUSION

The research found a strong negative relationship between the hotels net operating profit and the various measures of working capital management including the number of days accounts receivable, number of days accounts payable, the inventory turnover period and the cash conversion cycle. The findings imply that the shorter the accounts receivable, accounts payable, inventory turnover and cash conversion cycle period the higher the net operating profit in the hotels. The management should therefore identify the hotel's unique working capital drivers and relevant risks and use them to develop their unique working capital management policies and practices that are in line with their business model and the overall hotel corporate strategy.

The hotels should not focus on speeding up collection periods and delaying payments to creditors as the study showed that these two need to be shortened for any financial gain. Delaying payments may create bad relations between the hotel and their suppliers while 'unprofessional' collection procedures may lead to loss of some customers that hurt the hotel's performance hence excellent and professional customer relations should be followed in these activities. The hotels should also avoid the typical business cliché of just stocking items and waiting for customers to come. Operating in their very sensitive and uncertain environment the hotels should manage their inventory more on demands of the customer than their sales projections. Lastly the hotels would benefit from the use of enabling technology to increase working capital management efficiency and other organisational activities. This would help in more accurate forecasting but will need executive level support especially at their commencement because introduction of new technology has its shortcomings.

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