

EFFECT OF WORKING CAPITAL MANAGEMENT ON FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN KENYA

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Abstract: This study determined the effect of working capital management on performance of Small and Medium Enterprises in Kenya. Specifically, the study determined the effect of optimum inventory management on financial performance; determined the effect of cash conversion cycle on performance in Kenya; and determined the effect of debts management on performance. The study used descriptive research design. A population of 70 respondents was drawn from the industry. Data was collected through questionnaires and interviews. Collected data was analyzed using multiple regression analysis. Inferential statistics was used to determine the relationship between variables. The study revealed that there was a positive significant effect of working capital management on financial performance of SMEs in Kenya. This study is important for the policy makers to come up with the strategies on how to better manage working capital in SMEs in Kenya.

Keywords: Inventory Management; Cash Conversion Cycle; Debts Management; Financial Performance.

1. INTRODUCTION

Background to the study

Working capital is the difference between a company's current assets and its current liabilities on its balance sheet. It reflects the liquid resources available to a business to run its day-to-day operations, and it's an indicator of a company's short-term financial health. Current assets constitute cash, receivables and inventory and are managed closely on a daily basis for a whole financial year whereby the mix must be optimal. Current liabilities are defined as claims against the business by third parties such as suppliers of goods, services and lenders of short term cash and other financial instruments. Proper turnover decision making for any organization with a working capital to realize targeted profit is usually a challenge to financial managers. An organization with a strong projection of finance in the long run will have problems in managing the working capital (Ha, Thanh & Hang 2016)

Motlicek and Matinovicova (2014) argues that working capital management is very important for any organization irrespective of their size or the sector they belong to. Working capital consists of inventories, receivables and current financial assets. Working capital management affects significantly the performance of an organization and the managers must treat it with a lot of concern. Nandon (2017) argues that working capital management is very crucial component in financial performance of an organization. Working capital management entails on how an organization can manage its current assets and current liabilities efficiently that will lead to better performance.

Stubely and Laporsek (2016) assert that short term assets and short term liabilities are very important the organizations balance sheet. The firm must be able to exploit market opportunities and add equity capital value. Short term assets and short term liabilities produce holdings and financial costs. The correct working capital must maximize revenue or profits and minimize cost at agreed rate.

Haro and Omar (2017) argue that cash is one of the important aspect in current asset from the point of acquisition of the resources to the point of marketing. It is important for the financial managers to balance cash inflow and cash outflow. The reason for holding cash ranges from precautionary purpose, transaction motive to speculative motives. They argued that inventory composes of raw material, work in progress, finished goods and consumables. The composition of inventories among the Small and Medium Enterprises depend on the business being undertaken. They define inventories as a cost that cannot be avoided at all cost irrespective of the business being undertaken. Inventory management entails maintaining smooth flow of the materials from production to sales.

Usman, Shaikh and Khan (2017) looks at working capital as a representation of 30% to 40% of enterprise overall investment. The major objective of working capital is to guarantee an enterprise that is capable of meeting its obligation at a given period of time. However, working capital mismanagement may lead to serious losses in the organization. Wambugu (2013) argues that firms that employ workers between 5 and 99 are referred to as small and medium enterprises SMEs. In Kenya SMEs is growing at a high rate because of accessibility of loans, availability of grants, and increased level of exportation, subsidies and increase in domestic demand for the locally produced goods and services. However, lack of proper knowledge on working capital management practice among Small Medium Enterprises SMEs among the managers poses a threat on the survival of Small and Medium Enterprise.

Nandon (2017) argued that there are many Small and Medium Enterprises that are not very in managing working capital despite the existence of high investment in current asset. This is one of the major reasons of the failure of Small and Medium Enterprises. Wambugu (2013) argues that most of the SMEs operate without credit control departments which contribute to the failure of SMEs in countries like Kenya. SMEs lack proper and systematic debt collection procedures which avenue of bad debts. Several studies have shown that SMEs with poor working capital management leads to failure of such businesses. On the other hand, SMEs that have good and organized working capital management have better performance. Good performance of SMEs can be realized in terms of; Returns on Investment (ROI), Return on Assets (ROA), Returns on Equity (ROE) and growth of the business in terms of size (Motlicek and Matinovicova 2014)

Statement of The Problem

The Kenyan Government has a vision 2030. It has come up with different strategies in order to achieve this vision. One of the strategy is empowering SMEs through accessible loans and business subsidies. SMEs have contributed a lot to the Gross Domestic Product (GDP), employment opportunities and reduction of poverty levels. Despite the significant contribution of SMEs recent studies shows that 60% of the SMEs fail within the first few months (Wambugu 2013). It is hard for SMEs to access loans from financial institutions because they lack proper working capital management. Most of the SMEs fail to balance between working capital surplus and working capital shortages. This is as a result of poor working capital management. Nunow (2016) conducted a research on the effect of working capital management on profitability of SMEs Nairobi, Kenya. Poor Working capital management makes the SMEs to fail in exploiting new markets. This means that Working Capital decisions are very crucial on performance of any organization. Up to now there have been studies on the effect of Working Capital management and performance of SMEs with different results. Some have shown positive correlation between Working Capital and performance of SMEs. Similarly, Kinyanjui, Kiragu and Kamau (2017) conducted a research on cash management practices on financial performance of SMEs in Nyeri town, Kenya. Some studies have shown negative correlation between Working Capital and the performance of SMEs. It is on these contradicting results that provides a basis of this study. This study determines the effect of working capital management on financial performance in Kenya.

Research Objectives

This study was guided by the following research questions;

1. To determine the effect of optimum inventory management on financial performance in Kenya
2. To determine the effect of cash conversion cycle on financial performance in Kenya
3. To determine the effect of debts management on financial performance in Kenya

Research Hypothesis

H01 There is no significant effect of inventory management on financial performance in Kenya

H02 There is no significant effect of cash conversion cycle on financial performance in Kenya

H03 There is no significant effect of debts management on financial performance in Kenya

Significance of the study

The policymaker especially the Ministry of Finance will use these findings to make appropriate policy on investment strategies on small and medium enterprises in Kenya. SME businesses will benefit with improved working capital management and financial performance.

2. RESEARCH METHODOLOGY

Research Design

The study adopted a descriptive survey research design by making careful descriptions of phenomena. The descriptive design is appropriate in discovering the relationships between variables and the degree to which the variables relate to one another. It is also appropriate because the respondents are in position to give their views. It also allowed the researcher to access more information. Descriptive research design is appropriate because it aims establishing causes of low performance of Commercial

SMEs in Kisumu town despite the existence of Working Capital Management; optimum inventory management, cash management, Debt management. This study employed both quantitative and qualitative in order to get in depth information. Multiple correlations will be used to determine the relationship between working capital management and performance of Commercial SMEs.

Target Population

SMEs operating in Kenya's towns were the target population. To determine the effect of working capital management on financial performance of SMEs.

Sampling Procedure and sample size

Stratified random sampling was used in this study where stratification was done by town they trade from. The town used as strata to ensure that the results are proportional and representative of the whole population. The study used Yamen (1967) simplified method to calculate the sample size. The number of responses needs to be acquired using the equation.

Description of research instrument

The research instruments used in this study will be questionnaires. The questionnaires was designed using closed and open-ended question. This type of research gathered data of a large sample. Questionnaires administered to owners of the business enterprise. Questionnaire were more preferred by respondents for anonymity drop and pick questionnaires will ensure that the researcher does not disrupt the respondent working schedule.

Data collection methods

Collected data was both primary and secondary data. Primary and secondary data were collected from the respondents. Data was collected through questionnaires and interviews from the respondents. These data collection instruments were appropriate for the study because it allows the researcher to get opinion from the large respondents thus making it easier to determine the relationship between the variables.

Data Analysis

Quantitative data was analyzed using multiple regression analysis using Statistical Package for Social Science (SPSS). Inferential statistics was used to determine the rate of performance of SMEs. Qualitative data was reviewed using content analysis.

3. RESULTS AND DISCUSSIONS

Presentation of findings

Age of Respondent

The study established that the 7.1% of respondents are aged below 30 years, those aged between 31-40 years were 12.9%, those aged between 41-50 years were the majority at 61.4% whereby 18.6% of the respondents were above 50 years of age as illustrated in Table 1.

Table 1: Year of existence of organization

	Frequency Y	Percent	Valid percent	Cumulative Percent
<30 years	5	7.1	7.1	7.1
31-40 years	9	12.9	12.9	20
41-50 years	43	61.4	61.4	81.4
>50 years	13	18.6	18.6	100
Total	70	100	100	

Level of education of respondents

In regard to the level of education of the respondents, 30% indicated University while those who attained tertiary qualification accounted for 37.1% and formed majority of respondents for this study. Respondents who hold primary school qualification accounted for 25.7%, and those with no education level were 7.1% and were the least group in the study as indicated in Table 1 below.

Table 2: level of education of respondent

	Frequency	Percent	Valid percent	Cumulative Percent
None	5	7.1	7.1	7.1
Primary	18	25.1	25.1	32.9
Tertiary	26	37.1	37.1	70
University	21	30	30	100
Total	70	100	100	

Experience in management of working capital

Also, the study sought to establish the officers' previous experience in experience in management of working capital. From the scores, out of the 70 participants, 15.7% indicated less than 5 years, 10% indicated 6-10 years. Traders who have 11-15 years' prior exposure accounted for 15.7. On other hand those with over 16 years' experience were 58.6 5 % as shown in table 3

Table 3: Experience in management of working capital

		Frequency	Percent	Valid percent	Cumulative percent
valid	<5 years	11	15.7	15.7	15.7
	6-10 years	2	10	10	25.7
	11-15 years	11	15.7	15.7	41.4
	>16 years	41	58.6	58.6	100
	Total	70	100	100	

What Sector does the SME serve in kisii County?

Besides, the study inquired on whether what Sector the SME serves in kisii County. From the respondents' responses out of the 70 participants, 17.1% were in production sector, 31.4% were in trade whereas 51.4 % were in other sectors especially the service sector as summarized in table 4

Table 4: what sector does smes serve in kisii county?

		Frequency	Percent	Valid percent	Cumulative percent
valid	producer	12	17.1	17.1	17.1
	trader	22	31.4	31.4	48.6
	Other specify	36	51.4	51.4	100
	total	70	100	100	

Which Capital Management Components does your firm apply?

Besides, the study inquired on which Capital Management Components does apply to respondents firm. From the respondents' responses out of the 70 participants, 11.4% were involved in inventory, 42.9% were in cash management whereas 45.7 % were in other debtors management as summarized in table 5.

Table 5: Which capital management component does your firm apply?

		Frequency	Percent	Valid percent	Cumulative percent
valid	Optimum inventory management	8	11.4	11.4	11.4
valid	Cash management	30	42.9	42.9	54.3
valid	Debt management	32	45.7	45.7	100
valid	total	70	100	100	

Discussion of findings

Analysis of variance (ANOVA) is an analysis tool used in statistics that splits an observed aggregate variability found inside a data set into two parts: systematic factors and random factors. In this study ANOVA was used to determine the influence that independent variables have on the dependent variable in a regression study. For the regression model yielded a sum of squares of 10.205 and a residual of 3.450 whereas the mean square was 3.402 and 3 degrees of freedom.

ANOVA

model		Sum of square	Df	Mean square	F	sig
	regression	10.205	3	3.402	65.079	.000
	residual	3.450	66	.052		
	total	13.655	69			

a dependent variable: performance

b Predictors, conversion, debt management, cash management

Regression analysis

The data was analyzed using linear regression analysis to establish the extent to which the three variables affect performance of commercial SMEs in kisii Kenya. The summary model with a regression of 0.864a, an R square of 0.747, adjusted R square of 0.736 with a standard error of estimate of 0.22863.

Model summary

Model 1	R	R square	Adjusted R square	Std error of the estimate
1	.864	.747	.736	.22963

a Predictors, conversion, debt management, cash management

Interpretation of findings

The regression coefficients revealed that significance of 0.000, 0.000 and 0.000 for X1, X2 and X3 respectively indicating that the variables are significant and affect the performance of an organization. The standardized beta coefficients yielded 0.584, 0.538 and 0.383 for Inventory management, Debt management and Cash conversion respectively.

Coefficient

model		Unstandardized Coefficient		Standardized Coefficient	t	sig
		B	Std error	Beta		
1	Constant	1.403	.140		10.031	.000
	Inventory	.199	.024	.584	8.266	.000
	Debt management	.201	.030	.538	6.599	.000
	Cash conversion	.159	.031	.031	5.118	.000

A. Dependent variable: performance

4. SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

Summary of Findings

The summarized results on account management (days of sales outstanding) were that there was an insignificant effect of ROA. Therefore, changes in DSO would have no effect on SMEs' performance. In the study, it was observed that inventory management negatively influences the financial performance of SMEs. According to the study, creditor management has a significant positive influence on the financial performance of SMEs. In addition, the study revealed that increasing the number of days payment overdue has a positive influence on ROA in SMEs. If a discount is offered for early payment, the opportunity cost of holding considerable amounts of account payable may be damaging to the company.

The results also indicate that cash management significantly affects positive change financial performance (cash conversion cycle on SMEs performance). Cash conversion cycle changes in days positively affected the return on assets. It was established that CCC was also determined by the other three independent variables.

Conclusions

In conclusion, from the study there is a positive correlation between the working capital management and performance of small and medium enterprises. These working capital management include; optimum inventory management, cash conversion cycles and debtors management.

Recommendations

The study recommends SMEs owners should develop a policy on credit collection detailing the policies and practices to be followed by the organization. This policy should allow a combination of multiple collection techniques to be used concurrently to ensure that the organization not only reduces losses from bad debt but also increases its cash flow by shortening the average collection period. To enhance their accounts receivables and remove bad debts while boosting sales and inventory turnover, SME owners should rigorously follow up on debts, assess consumers before providing debts, give incentives for early debt payments, and build a solid debt management strategy.

SMEs may generally keep the standard payment interval longer than the average collection period to limit receivables payments for short-term needs, lowering finance expenses. The cash conversion cycle is determined by cash managers' ability to manage inventory.

Areas for Further Research

This study concentrated on SMEs and given the overall number of registered SMEs in Kisii, Kenya, the study's target population is limited, and the findings cannot be extended to all SMEs in the country. The amount of time covered was also reduced, making it suitable for an above five years period. The main goal of the study was to see how WCM affected the financial performance of SMEs in the County of kisii. More studies may also be conducted to find out how the working capital components can be handled and how this affects the overall aims of Kenyan companies.

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