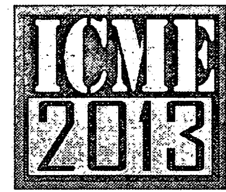

WORKING CAPITAL MANAGEMENT PRACTICES IN SRI LANKAN SMALL FIRMS: AN ORGANİZATIONAL LEANING PERSPECTIVE

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Abstract

The efficient management of working capital is crucial for small firms to ensure their prosperity and the survival. This paper aims to identify the working capital management practices in small firms. The study uses qualitative research approach by selecting five manufacturing firms with assistance of in-depth semi-structured interview. The data analysis utilized a set of qualitative techniques such as content analysis, pattern matching and explanation building techniques. The results show that working capital decisions of the small firms are heavily based on owner managers past experience, advices of specialists and shared norms and practices within the business sector. No specific methods based on calculating cost benefits of the decisions were found. The lack of awareness and knowledge about the importance of managing cash flows and liquidity and record keeping were further identified as some of weaknesses in the working capital process of the selected firms. In light of the findings of the study, it is recommended among other things that, they should avoid mixing business transactions with other transactions. The findings, further stress that neediness of establishing proper network between business firms and other helping and assisting organization to improve owner manager's experience and access to information sources.

Keywords: Organizational learning; Owner managers; Working capital

1. Introduction

Small firms are recognized and acknowledged worldwide as vital and significant contributors to economical development in both of developed and developing countries. The limited resource based and the huge competition in the market emprises the neediness of managing their resources effectively and efficiency for the survival and taking competitive advantages in the market. In this regard, financial management plays a vital role and its involves a wide spectrum of a firm's financial decision and broadly covers areas such determining the sources of finance, investment decisions and working capital management. With limited access to the long term capital markets, tendency to rely more heavily on owner financing, trade credit and short term loans to financing their needed investment in cash, account receivables and inventory, working capital management, among the functions of financial management, is crucial for small firms.

Despite the importance of financial inadequate working, capital decisions and accounting information have been referenced consistently as causes of small firm failure (Libaert, 1998). According to Dodge et al (1994) the most

important internal problems identified for small firms relate to inadequate capital, cash flow problem and inventory control. Berryman (1983) has also indicated the poor and careless financial management is a major cause for small business failure. Likewise, research has pointed to the relative volatility of the small firms when compared with large firms, due to volatile cash and profit positions, a reliance on short term debt financing and poorer liquidity (Walker and Petty, 1978). Similarly, Ekanem (2010) has reported that the most internal problems identified by small firms relate to cash flow management and inventory control.

The studies on financial management primarily have been tending to mostly focused in large firm. This nature of studies concentration of small firms is scanty. Therefore, study aims to understand how working capital decisions are made in small firms and to identify the problems which face with regards to taking such decisions and how to help them improve on their business.

2. Literature Review

Working capital refers to that part of the firm's capital which is required for financing short term or current assets such as cash, debtors and inventories. Working capital is also known as revolving or circulating capital or short term capital. A firm is required to maintain a balance between liquidity and profitability while conducting its day to day operations. Liquidity is a precondition to ensure that firms are able to meet its short term obligations and its continued flow can be generated from a profitable venture. The maintaining of proper and adequate working capital is necessary to smooth function of business firms. As circulation of blood is essential for in human body to the life the flow of funds is extremely essential to well function of business firms. The success of a firm, particular to a small, eventually dealt on its ability to generate cash receipt in excess of disbursements. The cash flow problem of small firms is worsen due to poor financial control in particular the lack of planning cash requirements (Jarvis et al, 1996). The proper planning and management of working capital is importance to the financial health of business of all sizes. For the proper function of a business firm, the twin objectives of profitability and liquidity must be matched and one should not impinge on the other for long. Investment on current assets is inevitable to ensure delivering of goods and services to the ultimate customers and a proper management of same should give the desired impact on either profitability or liquidity. The resource blocked at different stage of supply chain will extend the cash operation cycle. Further, it may adversely affect the profitability since the cost tied up in working capital exceed the benefits of holding more inventory and granting trade credit to customers.

With regards to accounts payable, it does not consume resource and is often used for short term financing. Even though extending of settlement for accounts payable helps to reduce cash flow cycle, it has an implicit cost where discount is offered for early settlement of invoices. Studies conducted on working capital stress the neediness of proper and efficient management of working capital in small firms. According to Berry (1983), small firms have not developed their financial management practices to the great extent and concluded that owner managers of those firms should be made aware of the importance and benefits that can accumulate from improved financial management practice. Peel et al (2000) found that small firms tend to have a relatively high proportion of current assets, less liquidity, exhibit unstable cash flows and a high dependence on short term debt. A study conducted by Narasimhan and Murty (2001) stress on the need for many industries to improve their return on capital invested by focusing on some critical areas such as cost attainment, reduce investment in working capital and improving working capital efficiency.

3. Study Design and Methods

This study is concerned with the working capital practices in small firms. The small firms are different from large firms in various perspective and they operate with less capital, less managerial resources and little market share when compared to the large firms. The studies to date concerned with working capital practices have been heavily conducted with objective and qualitative data and measures. However, the lack of proper financial record keeping and unavailability of objective data relating to finical aspects of small firms limit the usage of qualitative approach in this type of study. Further, Stockport and Kakabadse (1999) acknowledged the use of grounded data in studies focusing on entrepreneurship. Therefore, a qualitative methodology was used in this study in order to capture the practices used by small business owners for managing their working capital. According to Eisenhardt (as cited in Ekanem, 2010), there is no clear cut method to decide number of firms to be used in this type of qualitative study and he proposes a number between 4 and 10 for better results. However 4 and 10 cases are too extreme where with fewer than 4 cases it is often difficult to generate genaralizable results and with more than ten cases it quickly becomes difficult to cope with the complexity and volume of the data. Thus, the investigation was conducted with in depth analysis of working capital practices in five small firms. The use of this method was helped to understand the behavior of small firms and answer the basic questions relating to the working capital managing process. The case study firms consist of five small firms with two from printing industry, two from food processing and one from construction sector. The study was conducted with planed and semi structured interviews followed by a detailed interview plan with owner managers of the selected firms. Special attention was given for the inventory control, credit management and debtor control. The data gathered during the interviews were analyzed with assist of qualitative techniques such as content analysis, pattern matching and explanation building techniques (Ekanem, 2007).

4. Results and Discussion

In the initial stage of the interview, most of the owner managers were reluctant to discuss about the financial and cash flow position of their firms. However, after few time and proper understanding the purpose of the study they were willing to discuss more about their financial matter and ways of making decision regarding inventory, debtors and credit management as well as the problems encounter in managing working capital. With respect to inventory decision, firm1 revealed that decisions of inventory are mostly influenced by past experience and pre-established time frame. The owner of company 1 further, described that;

"Our inventory decisions are mostly taken by my own experience and judgment. Most of time, I work with known suppliers and have built good and better relationship with them. So, I have not faced more difficulties regarding inventory control of my firm".

The similar practices were identified in firm 2 and firm 5 regarding inventory control. However, owner manager of firm 3 revealed that he has experienced inventory shortages in a number of occasions and has replaced trouble making suppliers with new suppliers. Accordingly, firm 3 and firm 4 have a bit different practices from the other firms. Apart from the experience and judgment, these two firms tent to use other parties experience and recommendations in case of inventory decisions. Specially, firm 4 uses views of experienced employees in the firm in addition to the owner manager's experience and opinion. For example, the owner manager of firm 4 described the situation as follows:

"I used to reserve a lot of inventory to avoid unnecessary shortage. However, after realizing the problems in investing more on inventory by the explanation of one of my experienced employee I used to maintain optimum inventory within the firm".

In the interviews, a variety of questions used to identify the credit granting process and debt collection methods of the selected firm. Results shows that no specific policy was used by selected firms with relating to sales on credit. All the firms have similar practices and tend to make decisions on past experience, judgment and gut feeling. According to the owner manager of firm 3;

"Most of our sales are on credit and I make decisions regarding credit granting and debt collection on my experience and judgment. Most often, as we deal with regular customers and it is not a hard matter me to make decision on credit sales. Further, new customers coming with the recommendation and introduction of existing customers also helps me to make our decisions with less effort. These practices help us to minimize the bad debt allocation".

With regards to the debt collection period, all owner managers did not have knowledge about the industry norms. According to their responses, the debt collection period depends on the customers' past payment history. As per the owner manager of firm 2;

"The Debt collection period from my customers depends on their past payment behavior and I allow generally one month or up to two months as debt collection period, I phone up debtors a few days after the expiration of the debt collection period".

Management practices of creditors concern, the owner manager of firm 2 said that he makes decisions on the credit payment to creditors based on the past experiences and comments from the experienced employees of his firm. According to him;

"In the beginning stage of my firm, I have a tendency to take cash discount by means early payments to my creditors. I did not analysis the impact of early payment until my accountant explained the benefits of late payment. Now, I hold on to my credit until the last moment for payment without damaging my credit period allowed by my creditors".

Similarly, the owner manager of firm 3 has tent to take advice from experienced employees in his firm in making decisions regarding firm's creditors apart from his experience and judgment. However, the owner manager of firm 5 has experiences on facing liquidity crisis in his firm in early stage of the business. With time being and through experience, he has realized the significance of proper management of firm creditors. The above evidences show that the owner managers of selected firms make decisions regarding working capital by using their own knowledge, past experiences, and knowledge assimilating from other parties. This ability of the owner manager to learn from previous experiences, decisions, mistakes and from others within their networks is crucial for survival and take competitive advantage in the market. This learning entails not only reacting or adapting to the environment in order to cope with it and survival but it also entails generative learning, which represents the capacity to create and bring forward experience, rather than wait for it (Gibb, 1997). According to Polanyi (1967), organizational learning in small firms can take form of tacit knowledge and formal knowledge. Tacit knowledge, which is implicit and not codified, can provide a forum for knowledge creation and greater effectiveness. Organizational learning in small firms has been found to enhance financial and knowledge performance.

Van Gelderen et al (2005) study on the relationship between organizational learning and small business performance and found a correlation between the ability to learn and the achievement of goals set by the entrepreneurs. Similarly, Michna (2007) concluded that protective processes based on double loop learning will be crucial result in organizational changes. Organizational learning process can broadly identified in two categories as open loop learning and closed loop learning. Open loop learning takes place when the situation is outside the boundaries of what owner manager's experience can cope with. It also occurs when the owner

manager asks about the reasons why certain things are done. It implies courage to revise or even question the existing practice, with the possible outcome of changing the strategy that has been used by the organization (Michna, 2007). Open loop learning entails the decision maker stepping outside his or her existing terms of reference to assimilate knowledge that is potentially transferable to the situation currently faced, drawing on personal experience judge to be relevant and the experience and knowledge of others. Burgoyne and Hodgson (1983) describe this learning process as gradually eroding one belief and building another with a gradual accumulation of evidence and experience. The evidences from selected firms show that some of owner managers had changed their some of practices after realizing the impact of those practices learning from other parties. On the other hand, critical incidents play a vital role in the learning process. Deakings et al (2002), argue that critical events could change behavior leading to a change in management practices through the accumulation of learned experience. Furthermore, the case study findings show that the owner managers had the courage to depart from the standard practices by making decision on their past experience and advices taken from others. The Owner managers were also able to build good relationship with external parties. This nature of relationship is necessary in the learning process because they can build up trust and interdependency with these parties by turning intermittent business relationships into ongoing relationships, enhancing understanding and interaction (Gibb, 1997).

On the other hand, close loop learning arises from a situation which is similar to what has been dealt with in the past. It is almost duplication and routine (Cope, 2005). It depicts a process of learning a determined way of doing the work without questioning the rules, goals or plans (Michna, 2007). With regards to the case study firms, close looped learning was most evident when firms were deciding credit to customers. For the example, the firm 2 and 4 revealed that the decision to give credit depends on whether the customer is an established one or new one.

5. Conclusion

The aim of this paper was to identify the working capital management practices in small firms. The results revealed that small firms use different approaches in managing their working capital rather based on established rational and formal methods. In fact, leaning through past experience, critical incidents and other parties were found as significant sources in their learning process which plays significant influence on the decision regarding working capital. These findings support the literature regarding organizational learning and its vital role on way of firm success. Further, study shows that the successful small firm uses networking activities to obtain key information that facilitates the development of trust, rapport, tacit knowledge and learning. Accordingly, it is suggested that owner managers should strength their involvement in learning process through past experience and building network with other significant parties. At the same time, policy makers need to facilitate networking opportunities where owner managers can interact with external parties such as accountant, bankers, larger firms and other significant parties. Finally, this study concludes that there is a pressing need for further empirical investigation to be undertaken in small firm financial management by giving special attention to working capital aspect using large sample and quantitative measures.

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