

# Effect of Aggressive Financing Policy on Profitability of Listed Companies at the Nairobi Securities Exchange, Kenya

Magadi S. Oloo<sup>1</sup>, Muturi W. Mwangi<sup>2</sup>

<sup>1,2</sup>School of Human Resource Development, Jomo Kenyatta University of Agriculture and Technology, Kenya

**Abstract:** Working capital financing is one of the pertinent issues in working capital management; it impacts both on the liquidity and profitability of firms. The objective of this study was to determine the effect of aggressive financing policy on the profitability of Kenyan companies listed at the Nairobi Stock Exchange (NSE). Even though a number of studies about working capital have been carried out in Kenya, the impact of aggressive policy on profitability is not explicit. This research therefore aimed to determine how aggressive financing policy affects profitability of Kenyan Listed firms. The study employed descriptive research design and survey research method. The population comprised of the financial managers of 38 companies listed at the Nairobi stock Exchange. A census method was employed whereby the sample was equal to the target population. Both primary and secondary data was collected and processed using SPSS Version 21. According to the findings obtained from inferential statistics aggressive financing policy had a positive effect on the profitability of listed firms. The study therefore recommends that Kenyan listed firms should embrace aggressive financing policy in order to improve their profitability.

**Keywords:** Aggressive Financing Policy, Profitability, Working Capital Management, Corporate Finance and Liquidity.

## 1. Introduction

Aggressive financing policy is a working capital policy that utilizes more of short-term funds to finance its working capital requirements. Aggressive financing policy is a component of working capital management which is one of the most important topics in corporate finance. Working capital management involves the management of working capital components which includes inventories, accounts receivable, cash and cash equivalents and accounts payables. It also involves determining the optimal financing strategies or policies for financing working capital requirements or needs. The objective of working capital management is to maintain an optimum balance of each of the working capital components. The aggressive financing policy is said to play a crucial role on the company's liquidity and profitability [3]. On the other hand it is posited that a company has to determine the equilibrium between liquidity and profitability because increasing profits at the expense of liquidity of the firm can be harmful in terms of solvency and bankruptcy of the firm [12]. The ultimate objective of any firm is to maximize profits, but preserving liquidity is an important objective too. The problem is that increasing profits at the cost of liquidity can bring serious problems to the firm. Therefore there must be a tradeoff between these two objectives (liquidity and profitability.) Working capital management efficiency is vital especially for manufacturing firms where a major part of its assets is composed of current assets [15].

Aggressive financing policy depends more on short term funds. More short term funds are used particularly to finance variable or temporary current assets and even part of the permanent current assets. The risk preference of management shall decide the approach, risk seekers normally adopts the aggressive approach to financing their working capital requirements.

## 2. Statement of the Problem

Working capital management poses a serious challenge for financial managers all over the world. Various researchers have conducted studies in different countries on employing working capital in an optimal way in order to pursue profitability [12], [13], and [1]. The biggest problem faced by most financial managers is striking a balance between the working capital components in a manner that maximizes profits and at the same time minimizes risk for the firm. Over investing in working capital while it may reduce the firm's liquidity risk simultaneously reduces profits. On the other hand, under-investing in working capital while it may increase liquidity risk, it increases profits through reducing the cost of funds tied up in working capital components, that is, inventories and trade receivables. Therefore, too much capital reduces risk and return while too little capital increases risk and returns which puts managers in a dilemma.

For Kenyan firms, this is a problem too. It is noted that most Kenyan firms have large amounts invested in working capital [7]. By managing working capital efficiently, the firm's success can be regarded as guaranteed whereas inefficient management of capital can lead to complete fiasco for the firm. One of the most important aspects of working capital management is working capital financing policies. Even though previous studies have addressed working capital management, they have concentrated on the working capital components and their impact on profitability. Working capital financing policy has been largely ignored. In an attempt by financial managers to efficiently manage working capital, different financing policy can be adopted. The extent to which the companies listed at the Nairobi Securities Exchange (NSE) have adopted the different policy remains unclear. This is what the study sought to find out.

### 3. Objectives of the Study

The objective of the study was to establish how aggressive working capital policy affects profitability of Kenyan listed companies.

### 4. Research Hypothesis

The study was guided by the following research hypothesis

**Ho:** There is no relationship between aggressive working capital policy and profitability of Kenyan listed companies.

### 5. Conceptual Framework

The conceptual framework illustrates how the independent variable relates to the dependent variable. The dependent variable of the study is profitability measured by gross operating profit (GOP) while the independent variable is the aggressive working capital policy measured by total current liabilities to total assets ratio (TCL/TA)

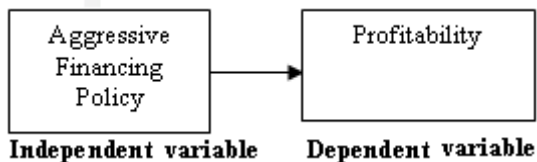


Figure 1: Conceptual Framework

### 6. Literature Review

This chapter presents a review of both the theoretical and empirical literature on working capital management with a specific interest in working capital financing. The theoretical framework encapsulates the reviewed theories which will form the basis of the study. The empirical studies were reviewed in line with the study objectives and were conceptualized into a framework

#### 6.1. Theoretical Literature Review

In this section, theories touching on working capital management and financing were delved into. This enabled the researcher to have a more informed approach to the study. In particular, the researcher looked into the theories of working capital. These are basically divided into two: Walker's approach, and Trade-off approach. The approaches to financing working capital will also be reviewed.

##### 6.1.1 Walkers approach

This theory advocates that a firm's profitability is determined in part by the way its working capital is managed. When working capital is varied relative to sales without a corresponding change in production, the profit position is affected. If the flow of funds created by the movement of working capital is interrupted, the turnover of working capital is decreased as is the rate of return on investments. In this regard, Walker has laid down the following four principles with respect to working capital investment [16].

The first principle is concerned with the relationship between the levels of working capital and sales. This principle states that if working capital is varied relative to

sales, the amount of risk that the firm assumes is also varied and the opportunity for gain or loss is increased. This implies that a definite relationship exists between the degree of risk that management assumes and the rate of return. The more the risk that a firm assumes, the greater is the opportunity for gain or loss [16].

The second principle states that capital should be invested in each component of working capital as long as the equity position of the firm increases. This principle is based on the concept that each shilling invested in fixed assets or working capital should contribute to the net worth of the firm. The third principle advocates that the type of capital used to finance working capital directly affects the amount of risk that the firm assumes as well as the opportunity for gain or loss and the cost of capital. It is indisputable that different types capital posses varying degrees of risk. Investors relate the price for which they are willing to sell their capital to this risk. They may charge less for debt than equity since debt capital possesses less risk.

Thus risk is related to the return. Higher risk may imply a higher return too. Unlike rate of return, cost of capital moves inversely with risk. As additional debt capital is employed by management cost of capital declines. This relationship prevails until the firm's optimum capital structure is achieved. The fourth and final principle argues that the greater the disparity between the maturities of a firm's short term debt instruments and its flow of internally generated funds, the greater the risk and vice versa. The principle is based on the analogy that the use of debt is recommended and the amount to be used is determined by the level of risk the management wishes to assume.

##### 6.1.2. Trade-off Approach

It is evident from the study of Walker's principles that working capital decisions involve a trade off between risk and return. The same is sought to be further examined in this section. All decisions of a financial manager are assumed to be geared to maximisation of shareholders wealth, and working capital decisions no exception. Accordingly risk and return trade off characterises each working capital decision. There are two types of risks inherent in working capital management, namely liquidity risk and opportunity loss risk. Liquidity risk is the non availability of cash to pay a liability that falls due. Even though it may happen only on certain days, it can cause not only loss of reputation but also make the work condition unfavourable for getting the best terms on transactions with trade creditors.

The other risk involved in working capital management is the risk of opportunity loss, that is the risk of having too little inventory to maintain production and sales or the risk of not granting adequate credit for realising achievable level of sales. In other words it is the risk of not being able to produce more or sell more or both, and therefore not being able to earn a potential profit because there are not enough funds to support higher inventory and book debts. Thus it would not be out of place to mention that it is only theoretical that current assets could all take zero levels. Indeed it is neither practical nor advisable in practice; all current assets take positive values because firms seek to reduce working capital risk [16].

## 6.2 Empirical Literature

In this section, the researcher reviewed empirical studies touching on the effects of working capital financing on profitability of listed companies that had been conducted. The review looks into the pertinent studies carried out globally, regionally and in Kenya respectively. The studies were reviewed in tandem with the study variable which captures the study objective.

### 6.2.1 Aggressive Working Capital Policy

The aggressive policy is said to be maintaining a high short-term liabilities level and a low level of current assets compared to the total assets. It is further argued [8] that this leads to high income since net working capital level is negative but high risks because the firm has more short-term liabilities than assets (current ratio is poor). The relationship between profitability and aggressive working capital management in the United States companies has been examined [8]. With the cash conversion cycle as a measure for working capital they found a significant negative relationship between cash conversion cycle and profitability. More precisely, they found that a shorter cash conversion cycle leads to a higher profitability.

Moreover, the relationship between efficient working capital management and a firm's profitability using net-trade cycle as a measure of working capital management is looked into [14]. The relationship was examined using correlation and regression analysis by different industries. They used a sample of 58,985 firms, years covering a period 1975 to 1994, in all cases the authors found a strong negative relationship between the length of a firm's net-trade cycle and its profitability, also a shorter net-trade cycle was associated with higher risk-adjusted stock returns. One of the policies that a firm may adopt is aggressive working capital investment (asset management) policy with a low level of current assets as a percentage of total assets.

Aggressive working capital financing [15] employs high level of current liabilities as a percentage of total liabilities. The scholar further posits that excessive levels of current assets may have a negative effect on the firm's profitability whereas a low-level of current assets may lead to lower level of liquidity and stock-outs resulting in difficulties in maintaining smooth operations. Moreover, aggressive working capital financing policy that utilizes higher levels of normally lower cost short-term debt increases the risk of a short-term liquidity problem. A survey of 88 firms between 2005 and 2007 in the United States has been carried out [4]. Their sample was a random sample to be representative to the population. Their research has been controlled by sales, financial debt ratio and fixed financial asset ratio.

With their regression analysis they found that the relationship between cash conversion cycle and profitability is positive which contradicts to most literature. The relationship between accounts receivable and profitability is negative. For the relationship between accounts payable and inventory no statistical evidence has been found due to poor results. It is argued that smaller firms have more aggressive working capital policies than big firms [5]. A study was carried out to investigate the relationship between the aggressive working capital policies for the industrial groups

and companies listed at Karachi Stock Exchange in Pakistan for the period 1998 to 2003 [10]. It was found that the aggressive investment working capital policies were accompanied by aggressive working capital financing. Ordinal least square regression analysis found a negative relationship between the profitability measures of the firms under study and the degree of aggressiveness of working capital investment and financing policies.

According to another study on manufacturing private limited companies in Addis Ababa, Ethiopia, it was established that the lower the amount of the investment in current assets, the more aggressive is the firm in working capital investment [9]. In contrast to current liability to total asset ratio, the higher the value of current liabilities to total ratio, the more aggressive is the firm in financing its working capital requirements.

A survey of working capital management policies among public companies in Kenya was conducted [11]. The study sought to establish the current working policies in public companies that follow different working capital policies report significantly different profit levels. It was noted that the commonly practiced working capital management policy among the companies in Kenya is the aggressive policy and that there were no significant differences in return on equity among companies that practice different working capital management policies.

## 7. Research Methodology

The study used descriptive research design and survey method. The population of the study comprised of companies listed at the Nairobi securities Exchange. There were 62 listed companies out of which 38 comprised the target population. The 24 other companies were excluded from the study due to the nature of their operations which do not involve working capital items. A census approach was used where the sample comprised 38 respondents that is the finance managers of the 38 companies selected for the study. Structured questionnaires were administered to the respondents to collect the primary data while the secondary data was obtained from the financial statements of the selected companies provided to the Capital Markets Authority Kenya website ([www.cma.or.ke](http://www.cma.or.ke)). The research instruments were pre tested. A pilot test was conducted on 4 respondents who were selected randomly from the target population. The researcher used the Cronbach's alpha to test the reliability of the instruments

### 7.1 Data Processing and Analysis

The impact of aggressive working capital financing policy on the profitability of the listed companies was evaluated by applying a simple regression analysis. The profitability variable (GOP) and Aggressive financing policy (AFP) was regressed using the SPSS software. The following regression equation was run to estimate the impact of working capital financing policies on the profitability

$$GOP_t = \beta_0 + \beta_1 AFP + \varepsilon$$

Where:

AFP = Aggressive Financing Policy as Measured by the ratio of Total current liabilities to total assets (TCL/TA)

$\epsilon$  = the error term of the model

### 7.2 Research Findings

The researcher had issued 34 questionnaires to the sampled respondents out of which 30 were filled and returned. This represents 88.2% response rate which was deemed sufficient for the study.

#### 7.2.1. Aggressive Financing Policy (AFP)

The researcher intended to describe the issues touching on AFP and the sources of funds for AFP. The findings of the analysis are presented in Tables 1 and 2

**Table 1:** Issues Touching on Aggressive Financing Policy

	Min	Max	Mean	Std. Deviation
Current Assets Investment Level	1	3	2.12	0.719
Effect of AFP on Cost of Funds	1	3	2	0.73
Effect of AFP on Level of Risk	1	3	2.31	0.602
Support of AFP on Sales and Production	1	3	2.25	0.577
Preference of Short-term Debt	1	3	2.25	0.577
Preference of Long-term Debt	1	2	1.13	0.342
Preference of Equity Financing	2	3	2.94	0.25

The findings in Table 1 are in line with a 3-point scale (1: low, 2: Moderate, and 3: High). Current assets investment level, effects of AFP on cost of funds and level of risk, support of AFP to sales and production, and preference of short-term debt returned mean tending to 2.00 (moderate). This implies that on average these issues were viewed by the respondents to be moderate. However, preference of long-term debt was argued to be a low (mean = 1.13) and on the other hand, preference of equity financing in AFP was averagely high (mean = 2.94). Therefore, it can be posited that firms that have adopted AFP highly prefer equity financing.

**Table 2:** Sources of Funds for Aggressive Financing Policy

	Min	Max	Mean	Std. Deviation
Fixed Assets	2	2	2	0
Permanent Current Assets	2	3	2.31	0.479
Temporary Current Assets	3	3	3	0

According to the findings shown in Table 2, all respondents were of the opinion that sources of funds for financing fixed assets in companies that have embraced AFP were equity (mean = 2.00; std. deviation = 0.000). On the other hand, temporary current assets were funded through short-term debt according to all the respondents (mean = 3.00; std. deviation = 0.000). Permanent current assets were averagely believed to be financed through equity (mean  $\approx$  2.00).

#### 7.2.2 Effect of AFP on Profitability of Listed Companies

With a view of determining whether or not AFP affects profitability of listed companies, TCL/TA was regressed against GOP. AFP was represented by TCL/TA where TCL and TA represent Total Current Liabilities and Total Assets respectively. Table 3 shows the results of the analysis.

**Table 3:** Effect of AFP on Profitability of Listed Companies

		Coefficients			
Model		Unstandardized Coefficients		t	Sig.
		B	Std. Error		
1	(Constant)	0.174	0.028	6.271	0
	TCL / TA	0.182	0.088	2.062	0.049

**Profitability = 0.174 + 0.182 AFP**

The results indicate that AFP significantly (p-value = 0.049) affects profitability of listed companies ( $\alpha = 0.05$ ). The results further show that AFP has a positive effect on profitability. This is interpreted to mean that the more aggressive financing there is in a company the higher the chances of enhancing its profitability. Similarly, reducing aggressive financing would lower the firm's profitability. The findings led to the rejection of the second hypothesis ( $H_0$ : There is no relationship between aggressive working capital policy and profitability of listed firms).

This finding is similar to the findings of a study carried out on manufacturing firms in Addis Ababa, Ethiopia that established that aggressive working capital financing policy has a positive effect on firm's profitability [9]. It is, however, contrary to the findings of yet another study which found that there exist a negative relationship between profitability measures of firms and the degree of aggressiveness on working capital financing policy [10]. The difference in the findings could be attributed to the different measures of the profitability used in the studies. The latter study used return on assets (ROA) as their measure of profitability while this study used gross operating profit (GOP) as profitability measure.

### 8. Summary, Conclusions and Recommendations

The researcher summarized the findings in line with the variables and objective of the study. This was followed by drawing of relevant conclusions. Lastly, recommendations for pertinent actions were suggested.

#### 8.1. Summary

Most of the listed companies were found to have adopted aggressive financing policy (AFP). Current assets investment level, effects of AFP on cost of funds and level of risk, support of AFP to sales and production, and preference of short-term debt were viewed by the respondents to be "moderate". However, preference of long-term debt was argued to be low. Preference for equity financing in AFP was averagely high. It was as such asserted that firms that have adopted AFP highly prefer equity financing. In financing fixed assets and permanent current assets, companies that have adopted this policy relied on equity financing. On the other hand, temporary current assets were funded through short-term debt. This policy was noted to have a significant and positive effect on listed company's profitability.

#### 8.2. Conclusions

It was inferred that most of the listed companies have adopted aggressive financing policy. It was also concluded that firms that have adopted AFP highly prefer equity financing especially in financing fixed assets and permanent

current assets. They only relied on short-term debt to finance temporary current assets. It was further concluded that this policy impacted positively and significantly on profitability of listed companies.

### 8.3. Recommendations

Companies are recommended to embrace aggressive financing policy as way of increasing their profitability and those that have already adopted the policy should enhance their equity financing.

### References

- [1] Deloof, M. (2003). Does Working Capital Management affects Profitability of Belgian firms? *Journal of Business Finance and Accounting*, 30(3&4), 573-587.
- [2] Dong, H. & Su, J. (2010). The Relationship between Working Capital and Profitability, A case study of Vietnam firms. *International Research Journal of Finance and Economics*, 49, 59-67.
- [3] Filbeck, G. & Krueger, T. (2005). An Analysis of Working Capital Management results across Industries. *Mid American Journal of Business*, 20(2), 11-20.
- [4] Gill, A., Biger, N., & Mathur, N. (2010). The Relationship between Working Capital Management and Profitability, Evidence from United States. 20(10), 1-9.
- [5] Hill, D., Wayne, K., & Highfield, J. (2010). Net Operating Working Capital behaviour: A first Look. *Financial Management Summer*, 783-805.
- [6] Jose, L., Lancaster, C., & Stevens, J. (1996). Corporate Returns and Cash Conversion Cycle. *Journal of Economics and Finance*, 20(1), 33-36.
- [7] Kithii, J. (2008). Relationship between Working Capital Management and Profitability of Listed firms in the Nairobi Securities Exchange. Retrieved from University of Nairobi website: <http://www.uonbi.erepository>
- [8] Lukkari, E. (2011). Working Capital Management: A bibliometric Study. A Master's thesis, Lappeenranta University of Technology.
- [9] Mohammed, N. (2011). Effect of Working Capital policies Management on firms profitability, Evidence from Manufacturing Private Ltd in Addis Ababa, Ethiopia. *Journal of Finance*, 66-75.
- [10] Nazr, M. & Afza, T. (2009). Impact of Aggressive Working Capital Management Policy on Firms Profitability. *The IUP Journal of Applied Finance*, 15(8), 19-30.
- [11] Nyakundi, M. (2003). A Survey of Working Capital Management Policies used in Kenya Public Companies. Retrieved from University of Nairobi: <http://www.uonbi.erepository>
- [12] Raheman, A. & Nasr, M. (2007). Working Capital Management and Profitability, A case study of of Pakistani Firms. *International Review of Business Papers*, 3(2), 275-296.
- [13] Shaskia, G. (2012). The Effects of Working Capital Management on Profitability of Dutch Listed firms. *International Journal of Business Management*, 5, 45-60.
- [14] Shin, H. & Soenen, L. (1998). Efficiency of Working Capital Management and Corporate Profitability. *Financial Practice and Education*, 8(2), 37-45.

[15] Van Horne, J. & Warchorwiz, M. (2000). *Fundamentals of Financial Management* (11th ed.). New Jersey: Prentice Hall Inc.

[16] Walker, E. (1964). Towards a theory of Working Capital. *The Engineering Economist*, 9, 21-35.

### Author Profile



**Magadi S. Oloo** has done B.Com (Finance option) Kabarak University, MBA, Finance option (JKUAT), CPA and CSIA both Professional courses Examined by Kenya Accountants and Secretaries National Examination Board. (KASNEB). He is currently working at Bright Star Institute of Business Studies as lecturer. He previously worked as a lecturer at MIS College of Accountancy and Information Technology, Achievers School of Professional Studies and Flamingo College of Accountancy.