

# Impact of Conservative Financing Policy on Profitability of Listed Companies at the Nairobi Securities Exchange, Kenya

Magadi S. Oloo<sup>1</sup>, Junge H. Bwire<sup>2</sup>, Nyang'au B. Onguso<sup>3</sup>

<sup>1</sup>School of Human Resource Development, Jomo Kenyatta University of Agriculture and Technology  
Nakuru Town Campus, P.O. Box 1063-20100, Nakuru- Kenya

<sup>2</sup>Faculty of Commerce, Department of Accounting Finance and Management Science, Egerton University  
Nakuru Town Campus College, P.O. Box 13357, Nakuru-Kenya

<sup>3</sup>School of Business, Department of Accounting and Finance, Kabarak University. Nakuru Town Campus  
P.O. Box Private Bag- 20157, Kabarak.

**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 impact of conservative 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 conservative policy on profitability is not explicit. This research therefore aimed to determine how conservative financing policy impacts on profitability of Kenyan Listed firms. The study employed a descriptive research design and survey research method. The population comprised of the financial managers of 38 companies listed at the Nairobi Securities 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 conservative financing policy had a positive effect on the profitability of listed firms. The study therefore recommends that Kenyan listed firms should embrace conservative financing policy in order to improve their profitability.*

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

## 1. Introduction

Conservative financing policy is a working capital financing policy that utilizes more long term funds to finance it working capital needs. A conservative financing plan relies heavily on long term financing such that a firm has less risk of facing the problem of shortage of funds. It is a component of working capital management which is one of the most important topics in corporate finance. It 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 [5]. The conservative policy is said to play a crucial role on the company's liquidity. 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 [11]. 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 [13].

Conservative financing policy depends more on long term funds. More long term funds are used particularly to finance fixed assets, permanent current assets and even part of the temporary current assets. The risk preference of management shall decide the approach; risk averse normally adopts the conservative 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 [4], [12], and [3]. 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. Objective of the Study

To establish the effect of conservative working capital policy on profitability of Kenyan listed companies.

### 4. Research Hypothesis

The study was guided by the following research hypothesis

**Ho:** There is no significant relationship between conservative 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 conservative working capital policy measured by total current assets to total assets ratio (TCA/TA)

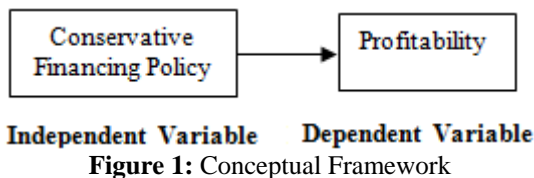


Figure 1: Conceptual Framework

### 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 researchers 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 were also 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 [14].

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 [14]

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 [14]

## 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 Conservative Working Capital Policy

A conservative policy is the opposite of aggressive policy [8]. An aggressive policy is where a firm depends more on short term funds for financing its working capital needs. In this case, a firm maintains a low level of short-term liabilities and a high level of current assets in the total assets. Findings suggest that Companies with a larger capacity to generate internal resources have higher current asset levels. This could be due to the lower cost of funds invested in working capital for these Companies generated by great cash flows. It was noted that Companies that have a more efficient working capital management registers an increase in operating cash flow [2]. Studies by [6] and [1] found that Companies with greater operating cash flows manage working capital more conservatively. In recent times, it is observed that making research about working capital management has spread to Asia and even Africa [8]. The author in his study further asserts that small and medium sized Companies from developing economies in Africa have not got any attention. Their working capital management is said to be very poor and probably not very well polished and as such it is questionable if it is an area interesting for research. It is also argued that researchers in developing economies make more studies from easy topics that someone has already studied as most profitability and working capital management relation studies come from those countries.

In their study of the public limited companies listed at Karachi Stock Exchange in Pakistan, for a period between 1998 and 2003, [10] sought to establish the relationship between conservative working capital policies for the aforementioned companies. The study found significant differences in their working capital investment and financing policies across different industries. The findings

further confirmed that these significant differences were remarkably stable over the study period.

According to another study on manufacturing private limited companies in Addis Ababa, Ethiopia, it was found that on average, these companies were highly conservative in managing their current assets [9]. The study further noted that the lower the value of current asset to total asset ratio, the more conservative is the firm in financing its working capital through current liability.

## 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 Conservative financing policy (CFP) was regressed using the SPSS software. The following regression equation was run to estimate the impact of working capital financing policies on the profitability

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

Where:

CFP= Conservative Financing Policy as Measured by the ratio of Total Current Assets to Total Assets (TCA/TA)

$\varepsilon$  = 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. Conservative Financing Policy (CFP)

Lastly, the study sought to describe the various issues related to CFP and also the sources of funds for conservative financing. Table 1 illustrates the findings regarding the

issues touching on CFP while Table 2 indicates the analytical results on sources of funds for CFP.

**Table 1:** Issues related to Conservative Financing Policy

	Min	Max	Mean	Std. Dev.
Preference of Equity Financing	3	3	3	0
Effect of CFP on Cost of Funds	2	3	2.78	0.441
Current Assets Investment Level	2	3	2.67	0.5
Effect of CFP on Level of Risk	2	3	2.56	0.527
Support of CFP on Sales and Production	2	3	2.11	0.333
Preference of Short-term Debt	2	2	2	0
Preference of Long-term Debt	1	1	1	0

All respondents were of the opinion that preference for equity financing was high (mean = 3.00; std. deviation = 0.000), preference of short-term debt was moderate (mean = 2.00; std. deviation = 0.000), and preference of long-term debt was low (mean = 1.00; std. deviation = 0.000) in companies that have adopted CFP. This financing policy was further argued to moderately (mean = 2.11) support sales and production. Moreover, on average, respondents argued that current asset investment level was high, and the effect of the policy on both the risk level and cost of funds was also high. The three issues returned means inclined towards 3.00 (high). These findings are in agreement with the theory which states that a conservative policy is inclined towards using more of long term funds in financing its working capital. Generally however it was noted in the findings that most Kenyan Companies have low levels of long term debt finance.

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

	Min	Max	Mean	Std. Dev.
Temporary Current Assets	2	3	2.78	.441
Permanent Current Assets	2	2	2.00	.000
Fixed Assets	2	2	2.00	.000

The researchers used a scale of 1 to 3 where 1 represented short term funds, 2 represented equity and 3 represented long term funds. The companies that have embraced the conservative financing policy, according to all the respondents, as indicated by Table 2, used equity financing to fund both their permanent current assets and fixed assets (mean = 2.00; std. deviation = 0.000). On the other hand, temporary current assets were believed to be financed, on average, through long-term debt (mean ≈ 3.00).

**7.2.2 Effect of CFP on Profitability of Listed Companies**

The researchers wanted to find out how profitability of listed companies is affected by such companies adopting conservative financing policy. The policy was represented by the ratio of Total Current Assets (TCA) and Total Assets respectively, that is:

$$CFP = TCA / TA.$$

Profitability (GOP) was regressed against CFP and the results of the regression analysis are shown in Table 3. The findings as summarized by the regression model indicate that profitability is positively affected by conservative financing policy ( $\alpha = 0.05$ ). The level of significance of the model is p-value = 0.024. This meant that the more a company embraces the CFP, the more profitable it is likely

to be. On the other hand, the less the firm stresses on CFP, the less profitable it is bound to be.

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

Coefficients					
Model	Unstandardized Coefficients			t	Sig.
	B	Std. Error			
1	(Constant)	0.163	0.029	5.609	0
	TCA / TA	0.134	0.056	2.393	0.024
Dependent Variable: Gross Operating Profit					

$$\text{Profitability} = 0.163 + 0.134 \text{ CFP}$$

**Table 4:** ANOVA Model Summary for CFP

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.412 <sup>a</sup>	0.17	0.14	0.0657528

a. Predictors: (Constant), Total Current Asset / Total Asset

The findings in Table 4 show that there is a relationship between CFP and profitability of listed companies ( $r^2 = 0.170$ ). This implies that the third hypothesis ( $H_{03}$ : There is no relationship between conservative working capital policy and profitability of listed Companies) was also rejected. The finding of this study, however, contradicts the findings of Nazr and Afza (2007). The difference in findings could be due to the reason that the studies adopted different measures of profitability.

**8. Summary, Conclusions and Recommendations**

**8.1 Summary**

Respondents were in absolute agreement that preference of equity financing by Companies that have adopted CFP was “high” and their preferences for short-term debt and long-term debt were “moderate” and “low” respectively. This financing policy was further argued to moderately support sales and production. Moreover, on average, respondents argued that current asset investment level was high, and the effect of the policy on both the risk level and cost of funds was also high. The companies that have embraced the conservative financing policy used equity financing to fund both their permanent current assets and fixed assets. Temporary current assets were believed to be financed, on average, through long-term debt. Lastly, CFP was established to have a positive effect on profitability of listed companies.

**8.2 Conclusions**

The first inference to be drawn was that Companies that have adopted this policy had a high preference for equity financing especially in funding both their permanent current assets and fixed assets. Such companies had very low preference for long-term debt financing. It was also concluded that current investments level and the effect the effect of CFP on both risk and cost of funds were high. Finally, CFP was established to have a positive effect on profitability of listed companies.

### 8.3 Recommendation

It is recommended that companies which have embraced conservative financing policy should also increase their equity financing of both their permanent current assets and fixed assets.

### References

- [1] Banos-Cabalaro, S., Garcia-Teruel, P., and Martinez-Solano, P. (2010). Working Capital Management in SME's. Accounting and Finance Journal, 50(3), 511-527.
- [2] Chiou, J. and Cheng, L. (2006). The determinants of Working Capital Management. The Journal of American Academy of Business, 10(1), 149-155
- [3] Deloof, M. (2003). Does Working Capital Management affects Profitability of Belgian Companies? Journal, 573-587.
- [4] Dong, H. and Su, J. (2010). The Relationship between Working Capital and Profitability, A case study of Vietnam Companies. International Research Journal of Finance and Economics, 49, 59-67.
- [5] Filbeck, G. and Krueger, T. (2005). An Analysis of Working Capital Management results across Industries. Mid American Journal of Business, 20(2), 11-20.
- [6] Hill, D., Wayne, K., & Highfield, J. (2010). Net Operating Working Capital behaviour: A first Look. Financial Management Summer, 783-805.
- [7] Kithii, J. (2008). Relationship between Working Capital Management and Profitability of Listed Companies 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 Companies profitability, Evidence from Manufacturing Private Ltd in Addis Ababa, Ethiopia. Journal of Finance, 66-75..
- [10] Nazr, M. and Afza, T. (2009). Impact of Aggressive Working Capital Management Policy on Companies Profitability. The IUP Journal of Applied Finance, 15(8), 19-30.
- [11] Raheman, A. and Nasr, M. (2007). Working Capital Management and Profitability, A case study of Pakistani Companies. International Review of Business Papers, 3(2), 275-296.
- [12] Shaskia, G. (2012). The Effects of Working Capital Management on Profitability of Dutch Listed Companies. International Journal of Business Management, 5, 45-60.
- [13] Van Horne, J. and Warchorwiz, M. (2000). Fundamentals of Financial Management (11<sup>th</sup> ed.). New Jersey: Prentice Hall Inc.
- [14] 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



**Junge H. Bwire** has done Masters of Business Administration (MBA), Accounting (Egerton University), BBA, Accounting and Finance Major and HRM minor (KEMU), CPA (K) (KASNEB) and Diploma in technical education (KTTC). Currently he is teaching at Nakuru Boys High school and also a part time lecturer in Accounting and Finance disciplines in the following Universities: Mt. Kenya University, Kenya Methodist University, JKUAT, Laikipia University. He previously worked as a principal and lecturer at Compliance College of Professional Studies



**Nyangau B. Onguso** is a graduate of Kabarak University with Masters of Business Administration (MBA) Finance option and a Bachelor of commerce (B.com) Accounting option with Second Class Upper Division, Kabarak University. Currently he is a part time Lecturer in Accounting and Finance Courses with Kabarak University, Laikipia University and Egerton University. He is also undertaking a Certified Public Accountants (CPA) professional course examined by Kenya Accountants and Secretaries National Examinations Board (KASNEB)