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Relationship between Working Capital Management and Profitability

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ABSTRACT

This research highlighted a number of hazards or events that might affect the MMG Hospital's capacity to accomplish effective working capital management in Oriental Mindoro, Philippines. Using a descriptive research design, MMG Hospital's total income and receivable increased continually in the succeeding periods. Average collection may exceed 45 days if not effectively monitored. Despite an increase in sales, MMG Hospital has managed its inventory more successfully than the previous year by paying particular attention to the timing and volume of its acquisitions. The cash conversion cycle at MMG Hospital is strongly tied to its operating cycle and inversely related to the number of days before payment to suppliers. Every increase in debt diminishes profitability due to interest payments.Annual financial statement analysis should be done and reported to the Board of Directors. The findings of the inquiry should form the basis of the study. This plan should focus management's attention on inventory management, cash management, accounts receivable and payable management, and other related tasks.

Keywords: Working Capital Management, Profitablity, Risks, Strategies And Decisions

Introduction

Working capital is as important to the functioning of a business as blood is to the operation of the body. The firm cannot survive in the absence of either blood or working money. Working capital, like blood in the human body, is the amount of money that a firm has available to satisfy its day-to-day operating requirements. It circulates in the business in this manner.Working capital is regarded as the lifeblood of every firm. If properly managed and maintained, company prospers and thrives; otherwise, it leads to financial misery, illness, and other forms of operational difficulties. Companies do not cease to exist because of being exhausted their earning potential.

To carry out its goal and adapt to new problems and opportunities, every organization need operating cash. Companies must adapt to macroeconomic variables such as economic activity, interest rate fluctuations, stock market values, and regulatory changes, over which they have limited influence. Working capital performance is critical to a company's capacity to react in a difficult environment since it is independent of macroeconomic conditions while remaining firmly under an organization's control.

The type of working capital required by a firm varies according to its nature. Organizational requirements and situations differ as well. In many circumstances, current liabilities may be subtracted from current assets to determine the amount of working capital required. Organizations are continuously looking for strategies to increase their working capital in order to stay solvent. To lessen the burden of borrowing, every firm must effectively manage its working capital. Not just small firms, but also huge enterprises, require good working capital management to provide a higher return on investment. Thus, working capital ensures that business operations function smoothly. As a result, efficient working capital management is an important subject throughout the business cycle.

The main consideration in working capital management decision are cash flow and liquidity of which cash flow is probably the most important. Management uses a combination of policies and techniques for the management of working capital. These policies aim at managing the current assets and the short-term financing, such that cash flows and return are acceptable.

Therefore, the goal of working capital management is to ensure that the firm can operate, and that it has sufficient cash flow to service long-term debt and to satisfy both maturing short-debt and upcoming operational expenses. In so doing, firm value is enhanced when, and if, the return on capital exceeds the cost of capital.

Efficiency in working capital management is as vital for a business as it directly affect liquidity and profitability of any firm. No firm can endure without liquidity. Profitability is the rate of return of company's investment. An unwarranted high investment in current assets would reduce this rate of return. Working capital management has thus, become a basic and broad aspect of adjudicating the performance of a corporate entity. It is, therefore, essential to maintain an adequate degree of liquidity for smooth running of business operation. While excessive level of working capital can easily result in a substandard return on assets; inconsiderable amount of it may incur shortages and difficulties in maintaining day-to-day operations.

The Higgins Sustainable Growth Model depicts the firm's balance sheet as an investment choice, liabilities, and owner's equity, referred to as the firm's financing decision, and assets must equal liabilities plus owner's equity. If the corporation want to boost sales. This shows the cost of new assets required to support rising sales. Because the corporation will not be selling shares through assumption, the cash needed to pay for this asset growth must come from retained earnings and increased liabilities. As equity rises, liabilities can grow proportionally without affecting capital growth. The pace at which assets grow is determined by the rate at which equity grows. And, because it is assumed that management would not sell any shares, equity increase indicates profit. of the company. Hence, the amount of profit increases in the level of investment in assets and vice versa (Higgins 2001).

An increase in assets can be an increase of the current assets or an increase in long-term assets. A company invests in long-term assets to provide products and services. On the other hand, it maintains short term assets short term assets to support the productivity of the long-term assets. long term assets are subjected to Investments in analytical techniques such as net present value (NPV), internal rate of return (IRR), is payback period and others. A long-term asset acquired once a choice is made, and finances are available. The utilization or use of assets must be maximized to increase profitability. This involves proper utilization or profitability salesmix strategies leading to working capital management. The amount of long-term assets appearing on the balance sheet remains fairly constant year after year unless a company makes a strategic change such as mergers, acquisitions, divestment, product differentiation, sales or customer increases which need further capacity expansion.

Gitman (2006) defines working capital as current assets which represent the portion of investment that circulates from one from to another in the ordinary conduct of business.

According to Concordia (2007),working capital management is the management of short-term assets and liabilities in furtherance of the firm’s goals. This function is performed in the formation of firms in the administration of their investment opportunities, in the management of their continuing projects, and in reorganization or liquidation. It is vital for firm success and especially to its survival.

Though Medical Mission Group Hospital and Health Services Cooperative of Oriental Mindoro (MMGHHSCOM) is a cooperative, profitability, growth and long-term viability. Profits are being used to improve its operation and to invest in resources or ventures that will bring additional profits and value to the firm. Since MMGHHSCOM is dependent on its profit in terms of funding ang operation and additional ventures, it is vital to the study the role of working capital management policies on profitability of the firm to ensure efficient and effective operation.

This study identifies some risk or events that may endanger achieving an effective working capital management of MMG Hospital. Risk is related to identifies threats for example: the threat of losing money. Any event that may endanger achieving an objective partly or completely is identified as risk. When either source or problem is known, the events that a source may trigger or the events that can lead to a problem can be investigated. Risk reduction measures involve methods that reduce the severity of the loss or the likelihood of the loss from occurring.

Methods

The study employed a descriptive research design to examine MMG Hospital's working capital management in Oriental Mindoro, Philippines. It entailed examining the components of working capital management in terms of cash flows and measuring MMG Hospital's profitability. To measure the variables using its operational definition, formulas and trend analysis utilizing time-series analysis were applied.

This is also quantitative research aimed at determining the impact of working management as the independent variable and profitability as the dependent variable. Using the operational definition of the variables, the influence of independent variables with the dependent variable was determined.

The study was conducted in MMG Hospital. Its working capital management component was identified, and its profitability was measured using its operational definition. The analysis for working management and profitability covered the calendar years. Analysis of the responsiveness of profitability with working capital management was done to identify the relationship and to test the hypothesis.

The relevant data needed in the study are all quantitative. These data were gathered from financial statements for calendar years. These financial statements are balance sheet and income statement. Data for working capital management and profitability as operationally defined are all accounting data that were taken from the financial statements.

Audited financial statements that include balance sheets and income statements were the sources of all relevant data for the study. Financial statements were secured from the Cooperative Development Authority. Relevant data from the statements were selected and were entered in the computer using Microsoft Excel for tabulation and processing of the raw data.

Relevant data based on the operational definition of working capital management and profitability that came from the balance sheet were total assets, total debt, and the components of current assets. Relevant data from the income statement were revenues and net surplus.

The data collected were examined, categorized, tabulated, recombined, and concretized into the evidence required for answering the research problems. Relevant data were computed using the operational definition of working capital management as the independent variable and profitability as the dependent variable.

To determine the status of the working capital management of MMG Hospital for the calendar years, include in the definition of terms. Relative changes on accounts receivable period, inventory period, cash conversation cycle, firm size, firm growth (in sale), leverage and fixed financial assets were determined.

To determine the profitability performance of MMG Hospital over the ten-year period under study, trend analysis was used. This showed the increases and decreases of profitability as operationally defined. A measure of profitability for analysis is the Return on Assets (ROA) ratio.

The Pearson Product- Moment Correlation Coefficient was to be used investigate the effects of accounts receivables period, inventory period, cash conversation cycle, firm size, firm growth, leverage and fixed financial assets of firm profitability.

Results and Discussion

MMG Hospital is also affected by some non-PhilHealth patients who are discharged with unpaid balances. Collection from these patients is sometimes guaranteed by the hospital personnel or members-doctors; however, there is also a possibility that these accounts will not be collected. Increases to this type of receivable will add to the increase in the average collection period.

The average collection period of MMG Hospital is acceptable considering the processing period of 30 days. The hospital was able to maintain 45 days average collection period despite large increases in receivable. The number of personnel in the Medicare Section has been increased to cope with the volume of transactions. However, this effort means additional expenses in terms of salaries, employees' benefits and overtime pay. And to monitor this collection period, the accounting department is required to prepare a monthly Aging Schedule of Receivable both for Phil health and non-PhilHealth.

Significant decline in days' inventory equivalent to 34 days is attributable to improved inventory management and significant increase in sales or revenues as revealed by substantial increase in daily production value. The Medical Director was able to implement policies concerning the timing and volume of purchases that resulted to lower inventory days.

MMG Hospital has an effective inventory management as they are able to maintain their days' inventory to 60 days inspite of a very significant increase in hospital's operation.

A very favorable cash conversion cycle is revealed by a shorter operating cycle of 105 days and longer payable of 59 days which leads to only 46 days cash conversion cycle. This means that working capital of MMG is tied-up with receivables and inventories for a total of 105 days.

The company manages to obtain a good relationship with its suppliers, as they allow the hospital to extend payment stretched to 55 days and 59 days. This is caused by the increase in amount and volume of transaction with the suppliers that can be traced from the amount of medicine sales.

All of these indicate that MMG is enjoying good and relaxed credit terms from its suppliers. This further implies that MMG Hospital has a good credit reputation in the community.

MMG Hospital's resources have grown so fast over the ten-year period. This further implies that management has focused on capital investing decisions during the last five years of operation rather than current assets. This is an aggressive investing decision aimed to achieve high profitability by making large investments in fixed assets such as building construction and modern hospital and medical equipment and minimizing investment in current assets.

MMG Hospital has the capacity to provide services that are comparable with the medical services being provided in the National Capital Region. This also implies that management and employees are working together to continuously improve the quality of their services. Furthermore, MMG Hospital is working toward to be among the ten (10) prominent health care institutions in the MIMAROPA Region, Philippines.

Low leverage ratio can be attributed to the strategic decision of the company for continuous capital build-up of member through additional investments and moratorium for withdrawal of interest in share capital and patronage refund. These actions lead to a favorable leverage ratio on the viewpoint of the creditor. This implies that they still have the capacity to borrow money when need arises because creditors are protected from losses.

Insignificant investment in fixed financial assets such as stocks and bonds can be traced also to the given explanation that in developing countries like the Philippines, larger cash balances compensate for the limited availability of marketable securities or fixed financial assets. This means that in developed financial markets, more securities are kept instead of cash because a wide range of readily marketable securities are available. This implies that MMG Hospital has limited access to the financial market.The decline in ROA ratio need not be interpreted as times having been caused by idle assets. There are investments that cause an immediate increase in sales. An example is more liberal credit terms that increase accounts receivable and sales and consequently the net income. However, a major expansion in fixed assets takes a few years to implement. The anticipated revenue increase from such expansion may not happen until later which means that ROA ratio of MMG Hospital will improve upon full utilization of its resources in the succeeding years.

Based on the Pearson Product Moment Correlation Coefficient Test, only leverage variable has significant relationship with profitability. The other variables include the correlation analysis have no statistically significant effects on firm profitability.

Leverage shows a negative correlation with profitability which means that any increase in debt causes profitability to fall. This can be traced from the fact that company pays finance cost or interest for using the funds of external creditors and this interest is expense on the viewpoint of the company and to be deducted from the operating income to arrive at the net income or net surplus in the case of cooperative.

This implies that MMG Hospital's loan from Land Bank of the Philippines significantly affects the financial performance because of the interest expense. However, this that does not mean that the company should not borrow funds from an external creditor, but if the return of investment is higher than the finance cost or interest rates, it is feasible touse the external funds for capital expenditures or expansion. The significant relationship of leverage to profitability means that if MMG Hospital does not pay interest for the loan they would earn in a higher net surplus or income.

Total revenue of MMG Hospital will consistently grow in the next periods and so with receivable, however, there is the risk that average collection will exceed to 45 days if not properly monitored.MMG Hospital has managed its inventory effective compared to the previous year despite of increase in sales through proper observance of timing and volume of its purchases.The cash conversion cycle of MMG Hospital is directly dependent on its operating cycle and inversely affected by the number of days before payment to suppliers.Any increase in debt causes profitability to fall because of the interest expense.MMG Hospital's loan from Land Bank of the Philippines significant effect on the profitability. The other variables included in the correlation analysis have no statistically significant effects on firm profitability.

Financial statement analysis using the variables in this study must be done annuallyand to be presented to the Boardof Director. Results of this study will be used as the benchmark in the analysis. This strategy will lead management to identify areas of foci such as inventory management, cash management, accounts receivable and payable management.Construct additional rooms to avoid referring patients to another hospital caused by not enough rooms.The financial manager should prepare cost-benefit analysis to determine which of the suggested investments will add value to the business.Tomaximize the sales potential of the cooperative, MMG Hospital could create linkages with other businesses in the province such as corporations, school, government offices or associations to provide regular check-up with their employees or members. They should encourage resident physicians of schools and other big corporations to become members of the cooperative. Offering patronage refund to patients is also good promotional activity.Excess funds of the cooperative not intended for capital investments may possibly use for payment of loan from Land Bank to minimize finance cost. This strategy will lead to a better profitability performance position and debt capacity.

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