

**THE EFFECT OF WORKING CAPITAL MANAGEMENT
ON THE PERFORMANCE OF SMALL SCALE
ENTERPRISES IN UGANDA
A CASE STUDY
UGANDA INVESTMENT AUTHORITY**

BY

**BOSA JOHN
BBA/0283/41/DU**

**SUPERVISOR
MR. NALEELA KIZITO**

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ADMINISTRATION**

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DECLARATION

I Bosa John declare that this dissertation is my own original work and has not been presented to any university for a similar or any other degree award.



.....
BOSA JOHN

STUDENT

DATE: 30/08/06

APPROVAL

The undersigned approve that he has read and hereby recommend for acceptance by *Kampala International University* a research project entitled: *The effect of working capital management on the performance of small scale enterprises in Uganda*, in partial fulfillment of the requirements for the award of a Bachelor of Business Administration



.....
MR. NALEELA KIZITO

SUPERVISOR

DATE: 30/08/06

DEDICATION

To my family and true friends.

I dedicate my work to three people who have shaped and helped me to grow up intelligent and responsible man; my Dad MR. HAJJ. SERUNKUMA, my sister MRS. NABOSA FARIDAH and my friend MR. IGA YUSUF.

ACKNOWLEDGEMENT

Any one who has done research will agree with me that it is not an easy task. I extend *sincere regards to the people who have made it possible for me to come up with this beautiful work.*

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LIST OF ABBREVIATIONS

WCM	WORKING CAPITAL MANAGEMENT
SSEs	SMALL SCALE ENTERPRISES
WC	WORKING CAPITAL

ABSTRACT

The study investigated the effect of working capital management on performance of small scale enterprises in Uganda. It was undertaken by reviewing theoretical and empirical literature on working capital management (WCM) and performance of small enterprises. The study employed annual secondary data on Ugandan small scale enterprises (SSEs) covering the period 2002-2006.

Empirical findings indicated that many SSEs do not have in place proper (WCM) policies and as such their performance remains low. The study also showed that apart from WCM, taxation and interest rates affect the performance of SSEs in Uganda, i.e there is a negative correlation and interest rates on one hand and performance of SSEs on the other hand, accordingly, in the case of Uganda, there is a need to improve the performance of SSEs. For SSEs to achieve this there is need to implement proper WCM policies. Moreover, lending institutions need to introduce schemes that would enable SSEs to acquire funding at lower interest rates and lastly the present income tax system in Uganda should be made more responsible to small scale enterprises.

CHAPTER ONE

1.0 INTRODUCTION

1.1 Background to the study

The working capital decision has always been a key element in management of organizations. Working capital is the short term capacity that enables a business to operate the long term assets of the firm on a daily basis (Kakuru 2003). Gross working capital of business consists of short term assets like cash, balances expected from debtors, short term commercial paper, prepayments and inventory.

Small scale enterprises (SSEs) in Uganda are defined as those employing less than 50 employees and with an annual turnover of less than three hundred thousand dollars. Investment in working capital is not a matter of choice; it is some thing that must be undertaken in any business venture, whether big or small.

Small scale enterprise therefore need to determine appropriate levels of investment in *working capital and as such must decide how this investment should be financed*. Unfortunately, small scale enterprises have limited capital because they lack the necessary collateral to acquire funding from lending institutions.

Accordingly, these small scale enterprises can not afford to employ personnel with financial management capabilities (Kakuru 2003). This means that the key decisions like working capital investments are taken by the business owners themselves who in most cases lack the necessary skills and expertise in handling such issues.

1.2 Statement of the problem

Investment in working capital (WC) is inevitable. Accordingly many small scale enterprises have put in place elaborate policies of managing individual components of networking capital. However, a few studies on working capital management and *small scale enterprises performance that have been undertaken* show that despite the working capital management techniques their level of performance has continued to

be low (Byagaba 2003), this raises curiosity and hence the need to investigate the effect of working capital management on performance of small scale enterprises.

1.3 Objectives of the study

The broad objective (purpose) of the study was to establish the impact of working capital management (WCM) policies on performance of small scale enterprises.

The specific objectives were:

- i) To examine the performance level of small scale enterprises in Uganda.
- ii) To examine the working capital management policies used by the small scale enterprises.
- iii) To analyze the impact of working capital management policies on performance of small scale enterprises.
- iv) To identify other factors that affects the performance of small scale enterprises in Uganda.

1.4 Research Questions

The study was aimed at answering the following research questions.

- i) What is the performance level of small scale enterprises in Uganda?
- ii) How do these small scale enterprises manage their working capital?
- iii) What is the effect of working capital management policies on performance of small scale enterprises?
- iv) What other factors apart from working capital management affect the performance of small scale enterprises.

1.5 Scope of the study

The scope was longitudinal, covering the period 2002-2006, the justification for choosing this period was that the required information pertaining to this period was readily available. Geographically, the study was restricted to small scale enterprises in Kampala central.

1.6 Significance of the study

Besides helping the researcher to ascertain issues related to working capital enterprise, the study was also expected to identify policies that can be adopted to boost the performance of small scale enterprises in Uganda.

1.7 Organization of the study

The study was divided into five chapters. Chapter 2 explores the related literature on working capital management and performance of small scale enterprises, chapter 3 outlines the methodology that has been used in investigating the relationship between working capital management and performance of small scale enterprises, chapter 4 presents the findings and policy implications, chapter 5 presents the summary, conclusion and recommendation of the study.

CHAPTER TWO

LITERATURE REVIEW

2.0 Introduction

The main purpose of this chapter is to present some general consensus on the theoretical underpinnings and previous empirical studies on the impact of working capital management on performance of small scale enterprises. In this respect, the chapter provides an empirical platform for use in the investigation of how working capital management impacts on performance of small scale enterprises in Uganda.

2.1 Working capital

Working capital typically means the firm's holdings of current, or short – term, assets *such as cash, receivables, inventory, and marketable securities*. Much academic literature is directed toward gross working capital, i.e. total current or circulating assets. These items are referred to as circulating assets because of their cyclical nature. *In a retail establishment, cash is initially once the receivables are collected, they become cash – part of which is reinvested in additional inventory and part (i.e...., the amount above cost) going to profit or cash throw – off.*

Corporate executives devote a considerable amount of attention to the management of working capital. An examination of the proper components of working capital is helpful because of the preoccupation of management with the proper combination of assets and acquired funds, concerted efforts are made to ensure the ability of the firm to meet the short – term obligations. The management must be concerned with proper financial structure, these and other funds must be raised judiciously. The chapter provides a theoretical framework in the risk/return trade – off of various approaches, applied in the firm's working capital management.

Interpretations of working capital

There are two possible interpretation working capital concepts:

- (a) Balance Sheet Concept
- (b) Operating Cycle Concept

It goes without saying that the pattern of management will be very largely influenced by the approach taken in defining it. Therefore the two concepts are discussed

separately in a nutshell.

(a) Balance sheet concept

There are two interpretations of work capital under the balance sheet concept. It is represented by the excess of current assets over current liabilities and is the amount normally available to finance current operations. But, some – times working capital is also used as a synonym for gross or total current assets. In that case, the excess of current assets over liabilities is called the net working capital or net current assets. Economists like Mead, Malott, Baker and Field support the latter view of working capital. They feel that current assets should be considered as working capital as the whole of it helps to earn profits; and the management is more concerned with the total current assets as they constitute the total funds available for operational purposes. On the other hand, economists like Lincoln and Saliers up hold the former view. They argue that (a) in the long run what matters is the surplus of current assets over current liabilities (b) it is this concept which helps creditors and investors to judge the financial soundness of the enterprise; (c) what can always be relied upon to meet the contingencies, is the excess of current assets over the current liabilities since this amount is not to be returned; and (d) this definition helps to find out the correct financial position of companies having the same amount of current assets. Institute of chartered accountants of India, while suggesting a vertical form of balance sheet, also endorsed the former view of working capital when it described net current assets as the difference between current assets and current liabilities.

The conventional definition of working capital in terms of the difference between the current assets and the current liabilities some what confusing. Working capital is really what a part of long term finance is locked in and used for supporting current activities. Consequently, the larger the amount of working capital so derived, greater the proportion of long – term capital sources siphoned off to short-term activities. It is difficult to say whether this is right or wrong. Apparently, when firms are warned about tight working capital situation, the logic of the above definition would perhaps indicate diversion of long-term finances for short-term purposes. For, if short-term bank loans were procured to bring in cash, under the conventional method, working capital would evidently remain unchanged. Liquidation of debtors and inventory into cash would also keep the level of working capital unchanged. Similarly, a relatively large amount of working capital according to this definition may produce a false sense

of security at a time when cash resources may be negligible, or when these may be provided increasing by long-term fund sources in the absence of adequate profits. Again, under the conventional method, cash enters into the computation of working capital, but it may have been more appropriate to exclude cash from such calculations because one compares cash requirements with current assets less current liabilities. The implication of this in conventional working capital computations is that during the financial period current assets get converted into cash which, after paying off the current liabilities, can be used to meet other operational expenses. The paradox, however, is that such current assets as are relied upon to yield cash must themselves to be supported by long-term funds until they are converted into cash.

At least three points seem to emerge from the above. First, the balance sheet *definition of working capital is perhaps not so meaningful, except as an indication of the firm's current solvency in repaying its creditors.* Secondly, when firms speak of shortage of working capital, they in fact possibly imply scarcity of cash resources. Thirdly, *in funds flow analysis an increase in working capital, as conventionally defined, represents employment or application of funds.*

(b) Operating cycle concept

A company's operating cycle typically consist of three primary activities: purchasing resources, producing the product, and distributing (selling) the product. These activities create funds flows that are both unsynchronized and uncertain. They are unsynchronized because cash disbursements (for example, payments for resource purchases) usually take place before cash receipts (for example, collection of receivables).

Importance of working capital

To produce the best possible returns, firms should keep no unproductive assets and should finance with the cheapest available sources of funds. Why? In general, it is often advantageous for the firm to invest in short – term assets and to finance with short – term liabilities.

In a “perfect” world, there would be no necessity for working capital assets and liabilities. In such a world, there would be no uncertainty, no transaction costs,

information search costs, scheduling costs, or production and technology constraints. The unit cost of producing goods would not vary with the amount produced. Firms would borrow and lend at the same interest rate. Capital, labour, and product markets would reflect all available information and would be perfectly competitive. In such a world, it can be shown that there would be no advantage for firms to invest or finance in the short term.

But the world in which real firms function is not perfect. It is characterized by the firm's considerable uncertainty regarding the demand, market price, quality, and availability of its own products and those of suppliers. There are transaction costs for purchasing or selling goods or securities. Information is costly to obtain, and the firm is faced with limits on the production capacity and technology that it can employ. There are fixed as well as variable costs associated with producing goods for sale, and there are spread between the borrowing and lending rates for investments and financings of equal risk. Information is not equally distributed and may not be fully reflected in the prices in product and labour markets, and these markets may not perfectly be competitive.

These real – world circumstances introduce problems with which the firm must deal. *While the firm has many strategies available to address these circumstances, strategies that utilize investment or financing with working capital accounts often offer a substantial advantage over other techniques.*

Wood Frank (1996) working capital is the excess of current assets over amounts of current liabilities of a business.

Working capital is the short term capacity that enables the business to operate the long term assets of the firm on a daily basis (Kakuru 2003) working capital are funds available for carrying on activities of a business after an allowance is made for bills that have to be paid within the year.

Investment in working capital is not a matter of choice; it is some thing that must be undertaken in any business venture. The question that faces the financial manager as far as investing in working capital is concerned is not whether to invest in short term assets as this is inevitable (Kakuru 2003).

The need for working capital to run the day today business activities cannot be over emphasized; we will hardly find a business which does not require any amount of working capital (Pandey 1999).

Even profitable companies fail if they have inadequate cash flows. Liabilities are settled with cash and not profits (ACCA student accountant 2000).

The components of working capital are cash debtors and inventory, cash includes cash in hand and bank deposits not specifically earmarked for any purpose and cash equivalents which are readily available for meeting payment obligations (Rao 1994) stock (inventory) may be of raw materials of finished goods which have emerged from a manufacturing process or of items for resale in the case of retail or wholesale business (Brockington 1993). Debtors (trade credit). When a firm sells its products or services and does not receive cash for it immediately the firm is said to have granted trade credit to customers. Trade credit creates receivables or book debts which the firm is expected to collect in the near future (Chad wick 1995).

Concepts of working capital

There two concepts of working namely gross working capital and net working capital.

- (i) **Gross working capital.** It is also called simply working capital. It refers to the total of all the current assets of the firm, current assets are the assets which are meant to be converted into cash with in a year or an operating cycle. Stock of raw materials, stock of semi-finished goods, stocks of finished goods, trade debtors, bills receivable, prepaid expenses, cash at bank and cash in hand are examples of current assets.
- (ii) **Net working capital.** For financing current assets, long term funds as well as short term funds are used. Short term funds are provided by current liabilities such as claims of out siders which are expected to mature for payment within a year. Trade creditors, bills payable and outstanding expenses are examples of current liabilities. Net working capital refers to the excess of current assets over current liabilities.

From the point of view of the period for which working capital is required, it can be divided into two categories namely.

- (i) **Permanent working capital.** It refers to that minimum amount of investment in current assets that has always to be true. It is the working capital required to carry out the minimum level of activities of the business.

It is also called core working capital, regular working capital or fixed working capital.

- (ii) **Temporary working capital.** It refers to that part of total working capital which is required by a firm over and above permanent working. It is required because the actual level of activities of the business most of the time exceeds the minimum level of activities. As the level of business activities fluctuates the volume of temporary working capital also may keep fluctuating.

The Webster's dictionary defines a debtor as one owing money to another. The financing policies of working capital are aggressive, conservative and moderate working capital policy (Puxty 1999).

Aggressive working capital policy

An aggressive manager will finance all the assets through short term financing. Due to the low cost of financing, the firm may earn profits. However, this approval will lead to the exposure to risk of illiquidity i.e. failure to meet its financial obligations when they fall due.

Conservative working capital policy

A conservative manager is most likely to finance the company's current assets with equity and long term debt.

And this approach tends to reduce the average cost of long term sources of funds tend to be higher than the short term source of funds.

The alternative is less risky because there are less chances of a company failing to meet its maturity obligations.

Moderate working capital policy

Management here will finance part of the permanent current assets with long term sources of finance. Fluctuating current assets and the remaining parts of the permanent current assets are financed with short term sources of funds. This leads to less expected returns and lower risks than in aggressive and conservative policies respectively.

2.2 Determinants of levels of working capital requirements.

Firms differ in their requirements of working capital (Pandey 1999) the following factors determine the working capital requirements.

Nature of business

Companies that have high inventory turns and do business on a cash basis e.g. a grocery store need very little working capital. These types of business raise money every time they open their doors, then turn around and plough that money back into inventory to increase sales.

Sales growth

Working capital needs of a firm increase as its sales grow. It is difficult to precisely determine the relationship between volume of sales and working capital needs.

In practice, current assets will have to be employed before growth takes place. Its therefore necessary to make advance planning of working capital for a growing firm on a continuous basis (Pandey 1999)

Risk and profitability

The greater the ability of a firm to borrow on short notice, the less it needs to operate for a margin of safety (Kakuru 2003)

Price level changes

If a firm can revise their product prices with increasing price levels, then they will need less investment on working capital (Van Horne 1992).

Stability of sales and revenue

If revenues are stable and can be predicted then there is no need for keeping substantial amounts of surplus working capital (Kakuru 2003)

Size of the business. The larger the size of the business, the greater will be working capital requirements of the firm as more funds will be locked up in the inventories and receivables to meet the demands of bigger size of the business.

Manufacturing cycle. Manufacturing cycle refers to the time span between the purchase of raw materials and their conversion into finished goods by means of manufacturing process. Funds remain tied up in semi finished goods during the manufacturing process, for example, a distillery requires heavy investment in inventories because it has an ageing process. On the other hand, in a bakery, raw

materials are soon converted into finished goods and not much funds are locked up in inventories.

Production policy. In certain enterprises there are wide seasonal changes in demand for the product manufactured by the firm. In such case, if the firm adopts a steady production policy inventories of finished goods will accumulate during the off – season periods requiring a higher amount of working capital. If the firm opts to vary its production schedules in accordance with changing demand. There may be serious production problems during the slack season, the firm will have to maintain its working force and fixed assets without adequate production and sale during the peak period, it will have to operate at a full capacity.

Business cycles. There are business cycles resulting in marked variations in business conditions. *There is an up ward swing of business conditions leading to a boom* when the business activities are at their peak. It is followed by down ward phase called recession when a business activities decline the down ward phase ends in a *depression, during recovery, the working capital requirements increase while during the stock period, the working capital requirement decrease.*

Conditions of supply raw material. In an enterprise where raw material is available only in a particular season and the firm has to buy raw material in bulk for production of finished goods, the working capital requirements will be more. When in cases where the supply of raw material is unpredictable, the firm may have to accumulate stock raw material requiring more working capital.

Terms of credit to customers. The terms of credit granted to customers normally *depend upon the norms followed in the small scale enterprises in which the firm is engages* but the firm has some flexibility within the norms. Ideally, the firm should use discretion in granting credit to its customer's different terms of credit should be *offered to different types of customers. A liberal credit worthiness of the customers* will land the firm in trouble and the requirements of working capital will also unnecessarily increase.

Credit from suppliers. If the firm is able to procure liberal terms of credit from suppliers of raw material, its net working capital will be reduced.

Stock turn over ratio. Stock turn over ratio refers to the speed with which finished goods are converted into sales. If a firm has a high stock turn over ratio as in the case of a bakery its working capital requirements will be less on the other hand. If a firm has a low stock turn over ratio as in the case of Fancy Jewellery shop, its working capital requirements will be high.

Price level changes. Price level changes also affect the working capital requirements in times of rising prices, a firm will require a larger amount of working capital to maintain the same quantity of inventory and credit sales. But the effect will be different for different firms. If the firm increases the price of its products promptly, the requirements of working capital will not be high.

Income tax. Out of the profits, income tax has to be paid. Mostly advance payment of income tax has to be made on the estimated income of the current year. The management has no discretion in the matter. If level of income tax is increased by the government, the working capital requirement will increase.

Operating efficiency. The working capital requirement can be reduced by *management by means of operating efficiency*. Management can ensure the efficient utilization of resources by minimizing wastages improving coordination's and accelerating the pace of cash cycle.

2.3 Management of cash resources

Cash refers to money in the form of bills or debtors ([www.C fee.org/en/glossary](http://www.Cfee.org/en/glossary))

Cash resources are very vital in any firm acquired through the medium of cash. The need for cash resources can be explained by the classical motives holding cash in the firm. These are the transaction, precautionary and speculation motive (Kakuru 2003). The issue at hand in a firm is not whether to maintain cash but rather the level of cash to keep in the firm. Excessive cash balances are not ideal because they make the firm forego potential return. Inadequate cash balances are not ideal either as they imply that the business may be illiquid with the attendant implications.

A trade off between liquidity and profitability is required so as to have optimal cash balances (Rao 1994)

A proper cash management policy should be adopted to be able to determine optimal cash balances. Such a policy should spell out.

- How to manage cash in flows
- How to manage cash outflows
- How to manage surplus cash balance.

A business will either have a surplus when cash receipts exceed disbursement and a deficit when the disbursements exceed the receipts. In order to synchronize the two so as to have a zero net balance, the financial manager should design measures aimed at accelerating cash receipts and delaying payments.

Cash receipts may be accelerated through offering cash discounts, offering cash incentives and ensuring efficiency of the internal process of preparing and dispatching customers. Invoices, payments can be delayed by exploring credit stretching possibilities, centralizing payments and paying through the bank so as to take advantage of the processing time.

Despite efforts to match cash inflows and outflows, the firm will always find itself with balances representing idle resources and should be invested to earn a return. In investing these resources however, the manager should consider safety, marketability and profitability of the investment, cash planning should also be undertaken to manage deficit cash balances thus

- The firm should anticipate future cash needs over a definite period of time.
- The firm anticipates its cash sources over the same period.
- The firm then determines periodic cash balances and plans for them.

2.4 Management of debtors

Accounts receivable are created when credit is offered to a firm's customers who can not make immediate payment. Firm sells on credit to beat competition, to push weak products on the market and also to help build a long term relationship with their clients.

Costs associated with investing in debtors include opportunity costs administered costs, collection costs and bad debt losses. At low levels of credit, the firm is

emphasizing liquidity at the expense of profitability at high levels of credit, the firm is emphasizing profitability at the expense of liquidity since these two positions are in conflict, then it is necessary to obtain a level of credit that optimizes the two objectives of liquidity and profitability.

A credit management policy should thus be designed to minimize the costs associated with credit while maximizing the benefits from it.

A credit policy should be based on credit standards, credit terms and collection procedure.

Credit standards; Credit clients should be screened and they should meet the specified criteria before credit is advanced the standards can be set basing on character, condition collateral security, capacity and capital.

Credit terms: These are stipulations under which firms sell on credit to its customers they include the credit period and cash discounts cash discounts are a reduction in amounts to be paid to induce customers to repay their obligations within a specified period of time which is less than the normal credit period.

Credit period is the length of time for which credit is extended to customers.

Collection procedures: These are procedures used to collect cash from debtors once credit has been extended to them. A firm should design collection procedure that will accelerate receipts from debtors without damaging relationships with them.

Credit evaluation: At the end of the day, the firm should evaluate the benefits from trade credit in relation to the costs.

Approaches like ratio analysis, credit scoring and cost benefit analysis can help in this effect.

2.5 Management of inventory

Inventory management is concerned with keeping enough product on hand to avoid *running out while at the same time maintaining a small enough inventory balance to allow for a reasonable return on investment.* Proper inventory management is important to the financial health of the corporation; being out of stock forces *customers to turn to competitors or results in a loss of sales.*

Excessive level of inventory, however, results in large inventory carrying costs,

including the cost of the capital tied up inventory warehouse fees, insurance e.t.c. The objective of the chapter is to examine the impact of inventory on the financial decision-making.

Functions of inventory

The functions of the turn firm, such as the purchase of raw materials, processing, and having finished goods available for sale, have a sequential, physical dependency. Maintenance of inventories allows the firm to decouple these functions so that each can be planned, scheduled, and operated independently. For retail firms, inventory provides customers with selection choices and decouples the purchasing function from the selling function.

Types of inventory

Raw materials

An inventory of raw material allows separation of production scheduling from arrival of basic inputs to the production process. Factors affecting the amount of the raw materials inventory include proximity to the supplier, relationship with the supplier, predictability of the production process, lead time required to place an order, and transportability and perishability of materials.

Work-in-process

An inventory of partially completed units allows the separation of different phases of the production process. The amount of work-in-process inventory is in part a function of the type of product, the measurement period, and the nature of the production process. For example, a firm with a very short production process, such as a bakery, may have a work-in-process inventory during the day: kneaded dough that is rising before being baked. However, this work-in-process inventory will not be carried overnight.

Finished goods

An inventory of finished goods allows separation of production from selling. With a stock of finished merchandise on hand, a firm can fill orders as they are received rather than depend upon the completion of production to satisfy customer's demands.

Cash and marketable securities

Cash and marketable securities can be thought of as an inventory of liquidity that

allows separation of collection from disbursement. Without this liquidity inventory, payment of bills would be tied to collection of accounts, in some cases, with payment delayed until accounts receivable are collected.

Motives for holding inventory

Economists have established three motives for holding inventories: a transactions motive, a precautionary motive, and a speculative motive. In addition, there may be a contractual reason for holding some inventories.

Transactions motive

The transactions motive for holding inventory is to satisfy the expected level of activities of the firm. For example, a pizza restaurant receiving its next materials consignment on Monday starts the weekend with enough flour, salt, tomato sauce, sausage and anchovies to make the number of pizzas anticipated to be ordered over the weekend.

Precautionary motive

The precautionary motive to provide a cushion in case the actual level of activity is different than anticipated. Again, using a pizza restaurant as an example, in addition to holding enough inventory to make the expected number of pizzas over the weekend, the restaurant may hold additional suppliers as a precaution against demand being different than anticipated. If demand exceed expectations (either in total or for a particular ingredient), sales will probably either be lost or if made, less profitable. It is doubtful that many customers will accept a pie topped with anchovies and pineapple as a substitute simply because the restaurant has run out of sausage and pepperoni.

Speculative motive

The speculative motive for holding inventory might entice a firm to purchase a larger quantity of materials than normal in anticipation of making abnormal profits. Advance purchase of raw materials in inflationary times is one form of speculative behavior. A second reason for speculative inventory purchases may involve an anticipated change in a product.

Contractual requirements

Occasionally it may be necessary to carry a certain level of inventory to meet contractual obligations.

Inventories include raw materials (inputs), work in progress and finished products. Keeping inventory is unavoidable, the issue is for managers to determine how much inventory to keep and when the firm should get this inventory cost associated with inventory include acquisition costs, carrying costs and opportunity costs.

Ordering (acquisition) cost: these are costs incurred in order to get the inventories into the firm, they include administration costs telephone charges transportation and inspection costs.

Carrying costs, these costs are incurred as a result of keeping inventory on a firm's premises. They include storage costs, pilferage, insurance, lighting and deterioration and evaporation costs.

Economic order quantity model (EOQ)

This model seeks to minimize costs of inventory while the same time maximizing benefits associated with inventory. This model works at the assumption that.

- Total annual demand is known.
- Ordering costs per order are known and are constant.
- Carrying costs per order are known and are constant.
- When inventory is depleted, placement is instantaneous.

At EOQ total costs are at the minimum

$$TC = TOC + TCC$$

$$\frac{\sqrt{2AO}}{C}$$

Where A=annual demand.

O= order costs.

C= carrying costs.

The EOQ model is widely written about in management accounting books, journals and magazines. It determines the optimal number of units to buy at any one time by

taking into account such factors as the costs of storing materials and the costs ordering materials the application of the EOQ model is relatively straight forward.

We do not need to discuss the assumptions in any great detail since they are built into the EOQ formula. However, any one who challenges the assumptions must remodel the formula (in the case of just – in – time purchasing and procurement procedures) This model needs to be remodeled to fit those particular circumstances.

At the same time we can set the EOQ within fairly well – defined limits, we can do the same for the other aspect of inventories: re order, maximum and minimum inventory levels.

Re-order level

Is defined as a quantity of materials fixed in advance at which inventory levels should be re -ordered (CIMA 1991).

Maximum usage X maximum re-order period

Maximum inventory level

Re-order level – minimum usage X minimum re-order period + EOQ

Minimum inventory level

The minimum inventory level is the level of inventories below which we should not allow inventory levels to fall, the reason for having a minimum inventory is to prevent the organization experiencing stock outs that is, the position of having no inventories of the relevant material at all. The danger with a stock out is that production or operations could be severely curtailed, or even halted together, at the great cost to the organization.

The formula that sets minimum inventory levels is.

Re-order level - (average usage X average Re-order period)

2.6 Performance

Performance as defined by the Webster dictionary is the effectiveness and efficiency of a firm in achieving corporate objectives.

Financial performance indicators

Financial performance indicators in the form of ratios cover a number of concepts and are grouped as profitability, liquidity, financial structure and investment /share holder ratio.

Liquidity ratio

$$\text{Current ratio} = \frac{\text{Current asset}}{\text{Current liabilities}}$$

The ratio measures the liquidity position of the firm. A ratio of 2:1 is good although it can be argued that, the best ratio is the one which takes into account the nature of the business and the conditions in which it is operating.

Profitability ratios

These ratios indicate the ability of the firm to earn a return; this return is normally a margin either of sales, a proportion of capital invested or proportion of asset used.

$$\text{Net profit margin} = \frac{\text{Earning after tax}}{\text{Total sales}}$$

The higher the ratio the better the performance

Investment ratios

These show the evaluation of the firm in the capital market; they show the value the market attaches to shares of the firm.

$$\text{Earning per share (EPS)} = \frac{\text{Earning after tax}}{\text{No. of shares.}}$$

Earning per share measures profit after tax and preference divided per equity share it serves the same purpose as is served by return on equity capital reveals profit on total of paid up equity share capital, earnings per share is another version of return on equity.

$$\text{Earning per share} =$$

$$\frac{\text{Net profit after tax - preference dividend - corporate dividend tax on preference dividend}}{\text{Number of equity shares.}}$$

The higher the ratio, the higher the performance, a more detailed trend of ratios given for over a period can clearly bring out the firm position.

2.7 Other factors affecting performance.

Several other factors affect the performance of small scale enterprises. They include: Taxation, interest rates, among others

Taxation: Taxes are compulsory payments by persons to the state. Firms pay taxes as proportion of their incomes. The higher the tax obligation, the poorer will be the performance since a substantial amount of funds that would otherwise be ploughed back into the business will be lost in taxes.

Interest rates: These are rates at which firms borrow money from the lending institutions. A high interest rates retards performance as the firm will spend a lot of money in serving the debt extended.

2.8 Empirical evidence

The relationship between working capital management and performance of small scale enterprises in general and whether proper working capital management improves the performance of small scale enterprises is a controversial question of recent , *researchers have heatedly debated on what empirical evidence holds .*

A study was conducted by a Swedish working group in 1987 and further developed in 1992 into “emerging issues in working capital management”. The group studied 50 *Swedish companies selected at random. Ratios were used to measure performance/ profitability.* The group found out that performance was relatively high in those firms which implemented working capital management policies.

In 2002 Moses Keizimbira Nareeba studied *inventory management and profitability* of medical stores. Stratified sampling was used to select 30 respondents from management and workers of national medical stores profitability was analyzed by *looking at the purchase procedures.*

CHAPTER THREE

METHODOLOGY

3.0 Introduction

This chapter discussed the methodology which was used in investigating the effect of working capital management policies on performance of small scale enterprises. The chapter gives the model specifications, variable definition and measurement, data analysis and techniques, data type and source as well as limitations to the study.

3.1.1 Model specifications

The model that was applied in this study follows from the model specifications of Keizembira (2002) Byagaba (2003) and Tumusiime (2003) accordingly, *performance of small scale enterprise was assumed to depend on working capital management taxation and interest rates symbolically*

$$P=F(K,T,I, e_i)$$

Where $P=$ Performance of small scale enterprises

$K=$ Working Capital Management

$T=$ Taxation

$I =$ Interest rates

$E_i =$ Other factors not modeled

For empirical analysis equation (i) was transformed as $p=d_0 + d_1k + d_2 + d_3I + e_1\ldots$

3.1.2 Variable definition and measurement

Performance: is the effectiveness and efficiency of a firm in achieving corporate objectives.

Performance in this study it was measured by profitability. This is because information on profitability was more readily available than information on losses.

Working capital management

Refers to policies and procedures undertaken by a firm to manage its cash, debtors and inventory, working capital management was measured by the economic order

quantity for inventory , credit policy for debtors and cash management policies in the case of cash.

Taxation

Taxes are compulsory non quid pro quo payments from persons to the government. The study considered income tax.

Interest rates

The study considered lending rates.

3.1.3 Data analysis and techniques

The data was analyzed by comparing and contrasting the theoretical and empirical literature on the subject of working capital management on the performance of small scale enterprises.

3.1.4 Data type and sources

The study employed annual secondary data on Uganda small scale enterprises covering the period 2002-2006. Major sources of these variables included Bank of Uganda Quarterly Review reports, Uganda Bureau of Statistics and Uganda Investment Authority.

3.1.5 Data collection methods

The data was gathered through reading, analyzing and recording data from various journals, text books, unpublished reports and internet websites.

Questionnaires

The researcher used questionnaires to get some data; the researcher got in touch with the officials of the Uganda Investment Authority and to some customers who provided relevant information.

Interviews

The researcher used interviews to acquire the information from respondents, clear questions was asked to respective respondents.

3.1.6 Data presentation

Data and information was presented according to the research questions.

3.1.7 Limitations of the study

The researcher encountered a couple of set backs during the data collection phase of the study, some of these set backs were:

Large volumes of information existed on the researchers study topic. Sorting out the relevant information was tedious.

Time constraint: the time at the researcher disposal was limited.

CHAPTER FOUR

4.0. Findings and policy implications

The study investigated the impact of working capital management on performance of small scale enterprises in Uganda. The small scale enterprises performance specification considered several variables: working capital management, taxation, and interest rates. *The chapter presents the findings which were got from both primary and secondary sources. Personal survey, questionnaires, interviews and observation were used to obtain the findings.*

4.1. Main findings

Uganda Investment Authority is located on Plot 28 Kampala Road mandated by an act of parliament purposely to promote and facilitate investment.

Uganda Investment Authority promotes Uganda as an investment authority, promotes Uganda as an investment location for investors, assisting investors in seeking joint venture partners and funding, providing first hand information on investment opportunities in Uganda, helping investors to secure secondary licenses and approvals as well as reviewing and making policy recommendations to government about working capital management on the performance of small scale enterprises.

Performance refers to efficiency and effectiveness in achieving corporate objectives. For many SSEs, performance is depicted by profitability. An enterprise is said to be performing well if and when the said firm's profitability increases at an increasing rate. Empirical literature shows that performance of many SSEs depends on WCM, taxation and level of interest rates.

Proper WCM improves the performance of SSEs, high taxes are a disincentive to profitability and high interest rates reduce profitability.

Working capital management: Both empirical and theoretical literature on WCM shows that the major components of working capital (WC) that SSEs have to manage are: cash, debtors and inventory.

Many SSEs do not have in elaborate policies of managing the different components of WC, and this has impacted negatively on their performance.

Debtors: Many SSEs do not set credit standards. They do not look into prospective credit clients' character, condition and capital. To them collateral security is all that matters. Many SSEs have lost large sums of money in this way as many of their debtors do not pay back.

These SSEs also use aggressive methods to collect payment from their debtors. This damages relationships with their clients who will then take their business dealings elsewhere. This robs the firm of customers and therefore impacts negatively on performance.

Moreover many SSEs offer very long credit periods. This leaves a lot of funds tied up in debt for a long time. The firm foregoes a return on these funds and thus profitability reduces.

Inventory: Inventory management techniques are non-existent in many SSEs. No clear model is followed in determining how much inventory to keep in the firm and when to purchase such inventory. As a result, carrying costs and ordering costs are always at their maximum. The overall effect of this is an increase in total operating costs and thus less profitability.

Cash: The cash management policies in many SSEs are needed. Many of the firms are not in the habit of making payments through the bank. Suppliers and employees are paid by cash. A lot of money is misappropriated this way, and also the firm can take advantage of the processing time that would otherwise arise if such payments were made through the bank.

Taxation: SSEs have an obligation to pay taxes to the government. The study considered income taxes. These taxes impact on the firm's performance because they are levied directly on incomes.

The present income tax system in Uganda does not favour SSEs. The firms are required to pay corporation tax just like big firms. At present the rate is 30% of net profit.

This rate, many SSEs argue, is very high especially for beginning firms. This retards growth, as a considerable portion of funds that would otherwise be ploughed back into

business go into payment of taxes. Moreover the study showed that many SSEs are not conversant with the computation of corporation tax payable.

These firms just submit income statements to the revenue authorities. They do not know about allowable expenses and capital deductions. This way the firms in actual sense pay more taxes than they would actually be liable to pay if the income tax returns were filed by a knowledgeable person.

Also SSEs with an annual turnover below 50 millions are taxed using the presumptive method. A firm here pay 1% of gross turnover as corporation tax. SSEs however have criticized this mode of taxation. A firm's turnover, they argue, in most cases is not representative of its proceeds. To tax one on one's turnover is anticipating profits which may not even accrue. The overall effect of the taxes is to increase input costs. SSEs retaliate by demand for many of their products is elastic.

Interest rates: Lending rates in Uganda are relatively high. The annual rate for commercial banks is 21% on average. This high cost of debt financing has greatly reduced the profitability of small scale enterprises because a big part of the firm's proceeds goes into servicing the debt.

Moreover many of the SSEs have refrained from using debt finance, owing to the high rate. In this case, the firms rely on their meager internally generated funds for growth. The end result has been slow growth and profitability.

4.2. Policy implications arising from findings

In Uganda there is need to improve the performance of small scale enterprises.

To achieve this, the following should be implemented;

Proper policies should be implemented to manage the different components of *working capital i.e cash, debtors and inventory.*

Cash: SSEs should develop a habit of making payments through the bank. This will eliminate misappropriation of funds and moreover the firms will take advantage of the processing time.

Debtors: SSEs should look into a prospective credit client's condition, capital character. This will minimize bad debt losses.