
EFFECT OF FINANCIAL MANAGEMENT PRACTICES AND CHARACTERISTICS ON PROFITABILITY: A STUDY ON BUSINESS ENTERPRISES IN MUMBAI CITY, INDIA

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ABSTRACT

This study investigated the effect of financial management practices and financial characteristics on profitability of business enterprises in Mumbai city. Both primary and secondary data were collected from 37 business enterprises in Mumbai city. Analysis of the collected data provided that; profitability was significantly affected by efficiency in financial management practices such as accounting, reporting, & analysis, working capital management, fixed asset management and financial planning and financial characteristics such as current ratio and debt ratio. Therefore, in order to increase profitability, the researchers recommend that business enterprises should continuously improve their financial management practices and financial characteristics.

Keywords: Business Enterprises, Financial Management Practices, Financial Characteristics, Profitability

INTRODUCTION

Financial management is one of the several functional areas of management but it is the center to the success of any business. Inefficient financial management, combined with the uncertainty of the business environment often led Business Enterprises to serious problems. According to Kawame (2010), careless financial management practices are the main cause of failure for business enterprises in Ghana. Regardless of whether an owner-manager or hired manager, if the financial decisions are wrong, profitability of the company will be adversely affected. Consequently, a business organization's profitability could be damaged because of inefficient financial management. Business Enterprises have often failed due to lack of knowledge of efficient financial management. Moreover, the uncertainty of the business environment causes Business Enterprises to rely excessively on equity and maintain high liquidity and these financial characteristics affect profitability

Since the Ethiopian People Revolutionary Democratic Front (EPRDF) led government introduced a series of economic reforms in 1992, the private sector in Ethiopia has rapidly grown in terms of the number of businesses, capital and employees. The number of private businesses and limited companies had quickly risen and the majorities are micro, small and medium enterprises. These business Enterprises have contributed considerably to growing GDP and creating jobs for labor-age people (Alemayehu&Tadele, 2004). Jimma town is one of the oldest and commercial centers found in oromia regional state, Ethiopia. According to the census made in 2007, there are about 3,060 licensed business organizations in Jimma town. Now days this number is increasing at an accelerated rate (Ministry of Trade and Industry, 1997). Although their number is increasing, inefficient financial management practices are assumed to prevail in business organizations found in Jimma town. To my knowledge, there has not been any research on financial management practice conducted on business enterprises in Jimma town. This

research paper is aimed at investigating the effect of financial management practice and financial characteristics on the profitability of the business organizations.

RESEARCH PROBLEM AND OBJECTIVES

Most previous researchers have concentrated on examining, investigating and describing the behavior of Business Enterprises in practicing financial management. Their findings are mainly related to exploring and describing the behavior of business enterprises towards financial management practices and characteristics. Although they provided much descriptive and empirical evidence on financial management practices, it appears that there are still some gaps in the literature which need to be addressed. First, most empirical evidences came from the developed economies such as the United States of America. There seems to be a lack of evidence from less developed countries like Ethiopia. Second, most previous researchers focus on investigating and describing financial management practices. There has been little research examining the effect of financial management practices on profitability (McMahon, et al. 1993)

This lack of empirical evidence from less developed economies and the lack of examination of the effect of financial management practices and financial characteristics on profitability are major gaps in the knowledge of financial management. Therefore, it is difficult to convince business practitioners of the need for changes in practices until evidence of the effects of financial management practices and characteristics on profitability are provided and the relationship between the two variables is proved. Based on previous research findings and recognition of these gaps, a study of the

effect of financial management on profitability is justified and the effect of financial management practices and financial characteristics should be developed and tested by using empirical data from less developed economies (kieu,2004)

The case of Ethiopia is very serious. Most Business Enterprises have not appointed financial managers to be in charge of financial management of the company. Usually, the owners or general managers with the assistance of the accountant control financial matters of the company. On the other hand, most owners or managers have no formal training in management skills, especially financial management. Moreover, the concepts of financial management have also only been recognized in Ethiopia since the beginning of the 1960s

LITERATURE REVIEW

Specific Areas of Financial Management Practices

Most authors and researchers approach the specific areas of financial management in different ways depending upon their emphasis. Walker and Petty as cited by kieu (2004) defined the main areas of financial management including financial planning (cash planning, fixed asset planning, profit planning), investment decision-making, working capital management (cash, receivable and inventory management) and sources of financing (shortterm and long-term financing, intermediate financing and going public). A study made in Malaysia by Mohd, et al (2010) identified the components of financial management as financial planning and control, financial accounting, financial analysis, management accounting, capital budgeting and working capital management. Chung & Chuang (2010) classified financial management practice

in to the following five specific areas: Capital structure management, working capital management, financial reporting and analysis, capital budgeting and accounting information system. Generally, from the above and other literatures, it is possible to identify four major areas of financial management practices

1. Financial Accounting, Reporting and Analysis: these include the nature and purpose of financial records, bookkeeping, cost accounting, and use of computers in financial record keeping, the nature, frequency and purpose of financial reporting, auditing, analysis and interpretation of financial performance.

2. Working Capital Management: Working capital management involves managing the level and financing of the firm's investment in current assets, which includes cash, marketable securities, accounts receivable and inventory. It is a strategy focusing on maintaining efficient levels of both components of working capital, current assets and current liabilities, in respect to each other.

3. Capital budgeting (Fixed asset) Management: Unlike working capital decision, capital budgeting decision commits funds for a long term capital projects or fixed assets which have an impact on the company's strategic position.

4. Financial Planning and Control (Management Accounting): this includes financial objectives and targets, cost-volume-profit analysis, pricing, short term financial budgeting and control, and management of responsibility centers.

Effect of Financial Management Practices on Profitability

The effect of financial management practice on profitability was found to be positive. Paramasivan, et al (2009) argued that financial management helps to improve the profitability position of business organizations with the help

of strong financial control devices such as budgetary control, ratio analysis and CVP analysis. McMohon & Holmes (1991) pointed out that financial managers are crucial to the profitability, survival and well being of small business enterprises. In his study on small business in Vietnam, Kieu (2004) found out that efficiency in financial management practices such as accounting information system, financial reporting and analysis, working capital management, fixed asset management and financial planning and good performance in financial characteristics such as liquidity and business activity has a positive impact on profitability. In addition, the study conducted by Chung & Chuang (2010) also reveals efficiency in capital structure management, working capital management, financial reporting and analysis; capital budgeting and accounting information system has a positive impact on profitability of business organizations.

Effect of Efficiency in Accounting, Reporting and Analysis Practice

Tourna and Germanos (2000) studied about the role of accounting information on business strategy formulation in Greece. The study found out that, the use of accounting information system helped owners or managers to design and implement a strategic plan that will enable their business profitable in the long run. Kieu (2004) also found out that efficiency in accounting information system and financial reporting and analysis enhanced profitability. The efficiency of business organizations in this case was approximated by the on time and accurate recording and summarizing of business transactions, the frequency of preparing financial report and financial analysis, the degree of computerization of the accounting information system (kieu, 2004). In addition, different accounting and financial management books also confirm that good accounting,

reporting and financial analysis practice enhance performance by helping decision makers design and implement wise and strategic decisions. From this, it is possible to formulate the following hypothesis

Hypothesis 1: Efficiency in financial accounting, Reporting and analysis practices have a positive effect on profitability

Effect of Working Capital Management on Profitability

In the study conducted in Belgium, DeLoof (2003) found out that the way working capital is managed will have a significant impact on the profitability of a firm. Padachi (2006) investigated the relationship between profitability measured by return on assets and working capital management by taking 58 firms in Mauritius using panel data analysis for the period 1998 -2003. The regression result showed that high investment in inventories and receivables is associated with low profitability. Gill, et al (2010) also studied 88 American firms and found out statistical significant relationship between cash conversion cycle and profitability. From this, the following hypothesis can be formulated.

Hypothesis 2: Efficiency in working capital management practice has a positive effect on profitability

Effect of Capital Budgeting (Fixed Asset management) on Profitability

Capital budgeting decisions are critical to the success of any firm. Brigham & Ehrhardt (2008) argued that capital budgeting decision is vital to a firm's financial well being and are among the most important decisions that owners or managers of a firm must make. Their rationale for that belief is that capital budgeting decision often involves significant capital outlay to acquire fixed assets. Additionally, the

acquisition of these assets often comes with long lasting and recurring financial obligation. Furthermore, efficient utilization and control and management of acquired fixed assets are also equally important. Appropriate acquisition process, proper record keeping , periodically evaluating the efficiency of the fixed asset, regular repair and maintenance and proper disposal of fixed assets will enhance the performance of firms. In a study conducted in South Africa, Olawale, et al (2010) found out that the use of sophisticated investment appraisal techniques such as NPV and IRR methods have a positive impact on the profitability of firms. From this the third hypothesis will be formulated as follows
Hypothesis 3: Efficiency in fixed asset management (Capital budgeting) practice has a positive effect on profitability
Effect of Financial Planning on Profitability Companies typically prepare a wide array of plans and budgets. Some of which include sales plan, production plan, cost plan and expense budget and budgeted income statement and balance sheet. These budgets are very important to anticipate the future in advance. This will in turn help to minimize risks and because of the tradeoff between risk and return, profitability increases. Therefore, preparing detailed financial plan or budgets will have a positive effect on profitability of the firm (Horngreen , Datar& Foster , 2006). From the above discussion, the following hypothesis can be formulated
Hypothesis 4: Efficiency in financial planning (short term budgeting) practices has a positive effect on profitability
Effect of Financial Characteristics on Profitability Liquidity measured by current ratio, leverage measured by debt ratio and business activity measured by total asset turnover ratio are the three independent financial characteristics used in this study. Liquidity measured using current ratio refers to the relative proportion of current

assets such as cash, receivables and inventories as compared to current liabilities. The greater the relative proportion of liquid assets, the less risk of running out of cash and profitability decrease, since these liquid assets become idle and do not earn any revenue. On the other hand, when liquidity of a firm is low, the risk is very high and profitability will increase because of the tradeoff between risk and profitability (Higgins, 1995). In physics, a lever is advice to increase force. In business financial leverage measured by Debt ratio is a device used to increase owners return (Brigham & Ehrhardt, 2008). Higgins (1995) argued that the impact of financial leverage on return on equity depends on the size of return on investment and the after tax interest rate. Financial leverage measured by debt tototal asset increases return on equity, when return on investment is greater than the after tax interest rate. When the return on investment is less than the after tax interest, increase in leverage reduces the return on equity. Therefore, leverage improves financial performance when things are going well but worsens performance when things are going poorly (Uwalomwa and Uadiale ,2012) Many people believe that assets are good things: the more the better. The reality is just the opposite. Unless a company is about to go out of business, its value is in the income stream it generates and its assets are simply a necessary means to this end. In dead, the best possible company would be the one that produces income without any asset. Other things constant, financial performance improves as asset turnover rise (Higgins, 1995). From the above discussion, the following three hypotheses can be formulated. Hypothesis 5: Profitability of business organizations is negatively related to the current ratio

Hypothesis 6: Profitability of business organizations is positively/negatively related to the debt ratio.

Hypothesis 7: Profitability of business organizations' is positively related to the total asset turnover ratio The effect of these seven independent variables on profitability can be summarized.

CONCLUSION AND FUTURE RESEARCH

In conclusion, the empirical finding implies that factors of financial management are good tools for improving enterprise's profitability. This finding leads to the conclusion that the efficiency of financial management practices and characteristics can bring about higher profitability. Therefore, business organizations can improve profitability by raising the efficiency of financial management practices and characteristics. Sound financial management is essential to the success of businesses organizations. Successfully managing financial resources is important in new as well as expanding business. So time should be taken to develop and implement financial management practices that ensure success of business enterprises. In addition, a more comprehensive survey throughout the country was suggested as a future study area to come up with country level conclusion.

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