CHAPTER 1
INTRODUCTION

1.1 Background

The financial crisis that occurred in United States in 2008 quickly evolved into a global financial crisis. The crisis did not only happen in the stock market and the American financial sector, but has spread to Europe, Asia, and Australia. Almost countries in the world are affected by that, it is no exception of Indonesia. The global financial crisis was impacting the Indonesia stock market. Indeks Harga Saham Gabungan (IHSG) in Indonesia Stock Exchange fell sharply to a level of 1,400 – 1,500 compared to the peak at level of 2,800 by the end of year 2007 (news.okezone.com, Thursday October 23rd 2008).

One of the sectors that affected by the global financial crisis is manufacturing sectors. Based on the data of Badan Pusat Statistik (BPS), national manufacturing industry in the fourth quarter of 2008 grew 2.06% when compared to the same quarter in 2007. However, when compared with the third quarter of 2008, the manufacturing industry would grow minus of 2.76%. Various ways have been done by the government to enhance the growth of the manufacturing industry, including the issuance of Presidential Instruction No. 2 of 2009 concerning P3DN that is Peningkatan Penggunaan Produk Dalam Negeri. However, no significant impact on the growth of the industry. Therefore, the growth of the manufacturing industry is expected to grow only 2% in the days to come. Seeing this condition, it is important to analyze how the performance of companies in the manufacturing industry, particularly in managing the working capital.

In the face of crisis, most companies do the rescue act by adding working capital from a variety of sources both internal and external to improve the financial performance of the company. Working capital is the crucial problems for the company because of the current state of good working capital management is closely related to firms performance in term of profitability. In manufacturing companies, the majority of its assets are current assets, thus the amount of investment in working capital becomes large enough, it needs to be managed properly.

The requirements of working capital depend on the period of the operating cycle. Operating cycle ranging from cash outflow and ended up being the cash inflow routinely and repeatedly. The longer of the period, mean that the more working capital needs. Operating cycle of manufacturing company is longer than the trading company, because the company is only trading cash conversion directly from the finished goods ready for trading. While the operating cycle of manufacturing companies ranging from cash and raw materials and then work in process, finished goods, receivables, and back into cash.

Actually, working capital is known as life giving force for any economic unit and its management is considered among the most important function of corporate management. Every organization whether profit oriented or not, irrespective of size and nature of business, requires necessary amount of working capital. It is a very important component of corporate finance because it directly affects the liquidity and profitability of the company. It deals with current assets and current liabilities. Working capital management is important due to many reasons. For one thing, the current assets of a typical manufacturing firm accounts for over half of its total assets. For distribution company, they account for even more. Excessive levels of current assets can easily result in a firm's realizing a substandard return on investment. However firms with too few current assets may incur shortages and difficulties in maintaining smooth operations (Horne and Wachowicz, 2008).

Working capital management is a very sensitive area in the field of financial management. It involves the decision of the amount and composition of current assets and the financing of the assets. Current assets include all those assets that in the normal course of business return to the form of cash whithin a short period of time, ordinarily whithin a year and such temporary investment as may be readily converted into cash upon need. The working capital management of a firm in part affects its profitability. Working capital management plays in important role of overall corporate strategy in order to create shareholder value. It is also involves planning and controlling current assets and current liabilities in a manner that eliminates the risk of inability to meet due short-term obligations on the one hand and avoid excessive investment in these assets on the other hand (Eljelly, 2004).

As a result, firms can minimize risk and improve their overall performance if they can understand the role and determinants of working capital. Keeping an optimal balance among each of the working capital components is the main objective of working capital management. Business success heavily depends on the ability of the financial manager to effectively managed receivables, inventory, and payables (Filbeck and Krueger, 2005). The companies can decrease their financing costs and raise the funds available for expansion projects by minimizing the amount of investment tied up in current assets.

The ultimate objective of any company is to maximize the profit. But, preserving liquidity of the company 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 trade off between these two objectives of the firms. One objectives should not be at cost of the other because both have their importance. If the firms don't care about profit, the firm can not survive for a longer period. On the other hand, if the firms do not care about liquidity, the firm may face the problem of insolvency or bankruptcy. For these reasons working capital management should be given proper consideration and will ultimately affect the profitability of the firm.

Companies may have an optimal level of working capital that maximizes their value. Large inventory and a generous trade credit policy may lead to high sales. Larger inventory reduces the risk of a stock-out. Trade credit may stimulate sales because it allows customers to assess product quality before paying. Another component of working capital is accounts payable, delaying payments to suppliers allows a firm to assess the quality of bought products, and can be an inexpensive and flexible source of financing for the firm. On the other hand, late payment of invoices can be very costly if the firm is offered a discount for early payment.

A popular measure of Working Capital Management (WCM) is the Cash Coversion Cycle, it is the time lag between the expenditure for the purchases of raw materials and the collection of sales of finished goods. The longer this time lag, the larger the investment in working capital (Deloof, 2003). A longer Cash

Conversion Cycle might increase profitability because it leads to higher sales. However, corporate profitability might also decrease with the Cash Conversion Cycle, if the cost of higher invesment in working capital rise faster than the benefits of holding more inventories and granting more trade credit to customers.

With reference to the research of Raheman, et.al (2010) and Raheman and Nasr (2007), the study willing examine the effect of changes in working capital to changes in the profitability of the manufacturing companies listed on Indonesia Stock Exchange. The differences in the study with previous research is, research of Raheman, et.al (2010) focused on evaluating the impact of working capital management and the performance in terms of profitability, by using 204 sample of firms in the research period of 1998 until 2007. The research of Raheman and Nasr (2009) focused on working capital management and its effects on profitability of 94 Pakistani firms in the research period of 1999 until 2004. Whereas the study is evaluating the impact of working capital management and profitability in manufacturing companies listed on Indonesia Stock Exchange in the period of year 2007 until 2011. During that period, the economic condition of Indonesia affected by the global financial crisis in 2008 which led to a large company stocks declined significantly even eliminated from the listing in the stock exchange.

1.2 Problem Statement

The problem of the research is to examine "how the relationship between working capital management and profitability of manufacturing companies in Indonesia?"

1.3 Objectives of Research

The research focused on evaluating the impact of working capital management on profitability, for sample of manufacturing companies listed on Indonesian Stock Exchange. The main objectives are:

1. To establish a relationship between efficient working capital management and profitability

2. To find out the effects of different components of working capital management on profitability
3. To see the investing and financing policies of working capital in the relationship to the profitability
4. To establish a relationship between liquidity of firms and profitability
5. To find out the relationship between profitability and leverage of firms
6. To find out the relationship between profitability and size of firms
7. To find out the relationship between financial debt used by the company and its profitability
8. To find out the relationship between investment growth opportunities and profitability
9. To draw the conclusion about relationship of working capital management and profitability over a period of 5 years for manufacturing companies on Indonesia Stock Exchange

1.4 Benefits of Research

With the achievement of the objectives of research that has been described above, the results of this research are expected to provide the following benefits:

1. For author, the research can add to knowledge about the topic under study. As well as add insight into the corporation mainly on working capital management and its relation to the profitability
2. For investors and corporation, it can contribute in prediction and decision making related to the firm profitability and Working Capital Management
3. For academic, adding a reference of empirical evidence and knowledge about the influence of Working Capital Management to the level of profitability at manufacturing firms that have *go public* on the Stock Exchange

1.5 Writing Systematic

The writing systematic of the research comprise five parts. The first chapter is introduction describes background, problem definition, research objectives, research benefits, and also writing systematic. The second chapter is about literature review, includes theories that relevant to study conducted. The chapter explain the meaning and function of working capital, components to calculate the working capital management, meaning and the way to calculating of profitability, previous research, conceptual framework, and hypothesis.

Third chapter describes about research methodology including types and sources of research, population and sample, data collection methods, variables and measurements, and data analysis techniques. Chapter four is results and discussion, the chapter contains the analysis of the data and the interpretation of the test results and a discussion of the research that has been done. The last chapter is conclusion that includes the conclusion of a series of discussion, limitations and constraints in the research as well as suggestions in the research and suggestions should be submitted either to the subject of research as well as for further research.