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Working Capital Management and Profitability of SMEs

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ABSTRACT

Working capital management—the management of a firm's short-term assets and liabilities, including cash, inventory, accounts receivable, and accounts payable—has long been recognized as a critical determinant of firm profitability, with particular significance for small and medium-sized enterprises (SMEs), for which working capital often constitutes a disproportionately large share of total assets and which typically face greater constraints in accessing external financing than larger firms. This conceptual paper examines the relationship between working capital management and the profitability of SMEs, synthesizing literature on the cash conversion cycle and its components, empirical evidence on the working capital-profitability relationship across developed and emerging economies, the role of financing constraints in shaping SME working capital practices, and the specific dynamics observed among SMEs in India, where a substantial formal credit gap continues to constrain working capital availability. The review finds that while a large body of empirical literature documents a negative relationship between the cash conversion cycle and profitability—suggesting that more efficient (shorter) cash conversion cycles are associated with higher profitability—more recent studies report non-linear and context-dependent relationships, with the optimal cash conversion cycle varying across firm size, sector, and economic conditions. The paper identifies gaps relating to the limited integration of financing constraints into working capital-profitability models for SMEs, the relative scarcity of research situated in developing economies, and the implications of digital lending and supply chain finance innovations for SME working capital management. Drawing on the Cash Conversion Cycle approach, the Trade-off Theory of liquidity and profitability, the Pecking Order Theory, and Agency Theory, the paper develops a theoretical lens for understanding how working capital management decisions translate into profitability outcomes for SMEs. The paper concludes with future research directions and discusses implications for SME managers, financial institutions, and policymakers.

Keywords: Working Capital Management; Profitability; SMEs; Cash Conversion Cycle; Liquidity; SME Financing

1. Introduction

Working capital management refers to the management of a firm's short-term assets and liabilities—principally cash, inventory, accounts receivable, and accounts payable—with the objective of ensuring that the firm has sufficient liquidity to meet its short-term obligations while minimizing the opportunity cost of funds tied up in current assets. The efficiency of working capital management is commonly measured using the cash conversion cycle, which represents the length of time between a firm's outlay of cash for raw materials and the collection of cash from the sale of finished goods, calculated as the sum of days inventory outstanding and days sales outstanding, less days payables outstanding (Richards & Laughlin, 1980).

Working capital management has long been recognized as a critical determinant of firm profitability and liquidity, with Shin and Soenen (1998) finding that efficient working capital management is an integral part of overall corporate strategy to create shareholder value. The relationship between working capital management and profitability has been examined across firms of varying sizes and in numerous national contexts, generating a substantial empirical literature.

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Small and medium-sized enterprises (SMEs) occupy a particularly important position in this literature for several reasons. First, working capital typically represents a much larger proportion of total assets for SMEs than for large firms, given that SMEs tend to hold relatively less in fixed assets and rely more heavily on short-term assets and liabilities to finance their operations. Second, SMEs generally face greater constraints in accessing external long-term financing than large firms, making efficient management of internally generated working capital particularly important to their survival and growth. Third, SMEs play an outsized role in employment and economic output in many economies—in India, for example, the micro, small, and medium enterprise (MSME) sector contributes approximately 30 percent of GDP and generates well over 100 million jobs, yet continues to face a substantial formal credit gap, estimated by a Reserve Bank of India expert committee at approximately ₹20–25 trillion (Reserve Bank of India, 2019).

Given the centrality of working capital to SME operations and the constraints SMEs face in accessing external financing, the relationship between working capital management and SME profitability has attracted growing academic attention, particularly following García-Teruel and Martínez-Solano's (2007) influential study of Spanish SMEs, which found that managers could create value by reducing inventories and the number of days accounts were outstanding, and that shortening the cash conversion cycle improved SME profitability.

However, the broader literature on working capital management and profitability presents a complex and at times contradictory picture. While numerous studies report a negative relationship between the cash conversion cycle and profitability—implying that firms benefit from minimizing the time capital is tied up in working capital—other studies report positive relationships, particularly with respect to certain components of the cash conversion cycle such as days inventory outstanding in developed-economy contexts, while more recent research suggests that the relationship between the cash conversion cycle and profitability may be non-linear, with an optimal or "target" cash conversion cycle that varies across firms and economic conditions.

This paper undertakes a conceptual review of the relationship between working capital management and SME profitability. The paper does not report primary empirical findings but instead synthesizes existing literature, identifies gaps, develops a theoretical framework, and proposes directions for future research. The remainder of the paper proceeds as follows. Section 2 reviews the literature on working capital management and profitability, organized around the conceptualization of working capital management and the cash conversion cycle, empirical evidence from large firms and SMEs, the role of individual working capital components, evidence from developing and emerging economies, SME financing constraints, and the specific context of SMEs in India. Section 3 identifies research gaps, and Section 4 outlines the paper's objectives. Section 5 develops a theoretical framework drawing on the Cash Conversion Cycle approach, the Trade-off Theory of liquidity and profitability, the Pecking Order Theory, and Agency Theory. Section 6 proposes future research directions, Section 7 discusses theoretical, practical, and policy implications, and Section 8 concludes the paper.

2. Review of Literature

2.1 Conceptualizing Working Capital Management and the Cash Conversion Cycle

Working capital management encompasses decisions relating to the level and composition of a firm's current assets—cash, marketable securities, accounts receivable, and inventory—and how these assets are financed through current liabilities, principally accounts payable and short-term borrowings. The cash conversion cycle, introduced by Richards and Laughlin (1980), provides a widely used dynamic measure of working capital management efficiency, capturing the net time interval between cash outflows for inputs and cash inflows from sales, calculated as the sum of the inventory conversion period and the receivables collection period, less the payables deferral period.

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A shorter cash conversion cycle generally indicates more efficient working capital management, as it implies that a firm converts its investments in inventory and receivables back into cash more quickly, reducing the need for external financing to support operations. However, the literature also recognizes that working capital management involves an inherent trade-off between liquidity and profitability: holding higher levels of inventory and extending more generous credit terms to customers may support sales and reduce stock-out and customer-loss costs, but ties up capital that could otherwise be invested productively or used to reduce financing costs (Smith, 1980).

2.2 Working Capital Management and Firm Profitability: Evidence from Large Firms

Early large-sample studies established the empirical foundation for the working capital management-profitability relationship. Shin and Soenen (1998), using a large sample of listed American firms over the period 1975–1994, found a strong negative relationship between the cash conversion cycle and corporate profitability, suggesting that managers could create shareholder value by reducing the cash conversion cycle to a reasonable minimum. Deloof (2003), examining a sample of large Belgian firms, similarly found that working capital management significantly affects firm profitability, with a negative relationship between gross operating income and the number of days accounts receivable, inventories, and accounts payable.

Subsequent studies extending this line of research to other national contexts have generally confirmed a negative relationship between the cash conversion cycle and profitability, although the relative importance of individual components of the cash conversion cycle—inventory, receivables, and payables—has been found to vary across countries and industry sectors. More recent research comparing developed and emerging economies finds that while the cash conversion cycle is generally inversely related to firm performance in both contexts, the relationship between individual components and performance differs: firms in developed economies tend to exhibit higher performance with longer days inventory on hand, whereas firms in emerging economies tend to exhibit lower performance with longer inventory, receivables, and payables periods.

2.3 Working Capital Management and SME Profitability

García-Teruel and Martínez-Solano (2007) provided the first large-scale evidence on the working capital management-profitability relationship specifically for SMEs, examining a panel of 8,872 small and medium-sized Spanish firms over the period 1996–2002. Their results, robust to tests for endogeneity, demonstrated that SME managers could create value by reducing inventories and the number of days accounts were outstanding, and that shortening the cash conversion cycle improved SME profitability as measured by return on assets. The study also found evidence that SMEs adjust toward a target cash conversion cycle over time, suggesting that working capital management decisions reflect deliberate strategic choices rather than purely passive outcomes of operational constraints.

Padachi (2006), examining a sample of Mauritian small manufacturing firms, similarly found that working capital management practices significantly influence SME performance, with high investment in inventories and receivables associated with lower profitability. Pais and Gama (2015), examining Portuguese SMEs, found broadly consistent evidence of a negative relationship between the cash conversion cycle and SME profitability, while also highlighting the role of firm-specific factors such as size, age, and sector in moderating this relationship.

More recent research has begun to identify non-linear relationships between working capital management and SME profitability. Braimah et al. (2021), examining a panel of 366 Ghanaian SMEs over a ten-year period, found a positive relationship between the trade payables period and profitability, a negative association between the inventory conversion period and cash conversion cycle and profitability, and, notably, an inverted U-shaped relationship between the trade receivables collection period and profitability—indicating that an optimal receivables collection

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period exists that maximizes SME profitability, with both excessively short and excessively long collection periods associated with lower profitability.

2.4 Components of Working Capital: Receivables, Inventory, and Payables Management

The literature has examined the individual components of the cash conversion cycle—accounts receivable, inventory, and accounts payable—both individually and in combination. Accounts receivable management, or trade credit extended to customers, has been identified as a key component of working capital with direct implications for profitability, cash flows, and customer relationships, with effective receivables management considered vital to balancing sales growth against the costs of extending credit and the risk of bad debts.

Inventory management decisions involve a trade-off between the benefits of holding larger inventories—reducing supply costs, hedging against price fluctuations, avoiding production interruptions, and minimizing stock-out related losses—and the costs of holding inventory, including storage, insurance, obsolescence, and the opportunity cost of capital tied up in inventory. Accounts payable management, or the use of trade credit from suppliers, represents a relatively low-cost source of short-term financing for many SMEs, particularly those with limited access to formal credit; however, excessive reliance on trade payables can also signal financial distress and may damage supplier relationships if payment terms are not honoured.

2.5 Working Capital Management in Developing and Emerging Economies

While much of the foundational literature on working capital management and profitability draws on samples from developed economies, a growing body of research examines this relationship in developing and emerging economy contexts, where firms often operate in environments characterized by less developed financial markets, higher costs of external finance, and greater macroeconomic volatility. Raheman and Nasr (2007), examining a sample of Pakistani firms, found a strong negative relationship between the cash conversion cycle and profitability, consistent with findings from developed economies, while also highlighting the particular importance of working capital management in environments where access to external financing is constrained.

Studies comparing developed and emerging economies suggest that the components of the cash conversion cycle may have different implications for profitability depending on the broader institutional and financial market context, with longer collection and payment periods in emerging economies sometimes associated with lower performance, potentially reflecting weaker contract enforcement, higher costs of extending trade credit, and greater working capital financing constraints in these contexts.

2.6 SME Financing Constraints and Working Capital

A distinguishing feature of SMEs relative to large firms is their relatively limited access to external financing, particularly long-term debt and equity capital, which increases their reliance on internally generated funds and short-term financing, including trade credit, for working capital purposes. This financing constraint has direct implications for working capital management: SMEs facing binding financing constraints may be forced to maintain higher levels of trade payables (relying on supplier credit) and may have less flexibility to extend generous trade credit terms to customers, even where doing so might support sales growth.

The literature on SME financing constraints suggests that working capital management decisions for SMEs cannot be fully understood in isolation from the broader financing environment in which SMEs operate, including the availability and cost of bank credit, the development of alternative financing mechanisms such as supply chain finance and invoice discounting, and macroeconomic and regulatory factors that influence the overall credit environment for SMEs.

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2.7 Working Capital Management and SMEs in the Indian Context

India provides a particularly relevant context for examining working capital management and SME profitability, given both the scale and economic importance of the MSME sector and the persistent financing constraints SMEs face. The MSME sector in India contributes approximately 30 percent of GDP and generates more than 100 million jobs, yet a Reserve Bank of India expert committee estimated the sector's formal credit gap at approximately ₹20–25 trillion (Reserve Bank of India, 2019), with the working capital gap—the difference between current assets and current liabilities excluding short-term bank borrowings—found to have widened consistently in recent years, driven in part by payment delays and, during the transition to the Goods and Services Tax regime, by increased working capital requirements associated with changes in tax compliance and input credit mechanisms.

In response to these challenges, Indian policymakers have introduced several measures aimed at improving SME access to working capital finance, including revised priority sector lending guidelines that mandate specific lending targets for the MSME sector, regulatory norms requiring banks to compute working capital requirements for micro and small enterprises as a minimum percentage of projected annual turnover for certain borrowal limits, and the operationalization of the Trade Receivables Discounting System to address the problem of delayed payments to MSMEs by enabling the discounting of trade receivables. Despite these measures, evidence suggests that formal credit penetration among Indian MSMEs remains low, particularly among micro enterprises, with a significant share of MSME financing continuing to be sourced informally. These dynamics make India a valuable setting for research examining how working capital management practices interact with financing constraints to influence SME profitability in a large emerging economy.

3. Research Gaps

Based on the foregoing review of literature, the following gaps emerge as priorities for further investigation:

1. Limited research integrates SME financing constraints directly into working capital management-profitability models, despite evidence that financing constraints fundamentally shape SME working capital decisions.
2. The emerging evidence of non-linear relationships between individual cash conversion cycle components and SME profitability warrants further investigation to establish whether optimal or “target” levels of working capital vary systematically across firm size, sector, and economic context.
3. Research on working capital management and SME profitability remains comparatively limited in developing and emerging economies relative to developed economies, despite the larger role of SMEs in employment and output in many developing economies.
4. Limited research examines the implications of digital lending, supply chain finance, and invoice discounting platforms—which directly target SME working capital financing—for the working capital management practices and profitability of SMEs.
5. There is limited longitudinal research examining how SME working capital management practices and their relationship with profitability evolve over the SME life cycle, from start-up through growth and maturity stages.
6. The implications of macroeconomic shocks and regulatory changes—such as tax reforms or payment regulation changes—for SME working capital requirements and the working capital management-profitability relationship remain underexplored.

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4. Objectives

Drawing on the research gaps identified above, this paper is guided by the following objectives:

7. To examine the conceptualization of working capital management and the cash conversion cycle and their relevance to SME operations.
8. To analyze the empirical relationship between working capital management and profitability among SMEs, drawing on evidence from developed and developing economies.
9. To examine the role of individual working capital components—accounts receivable, inventory, and accounts payable—in shaping SME profitability.
10. To explore the relationship between SME financing constraints and working capital management practices.
11. To examine the dynamics of working capital management and SME profitability in the Indian context, including the role of the formal credit gap and related policy measures.
12. To identify gaps in the existing literature and propose directions for future research on working capital management and SME profitability.

5. Theoretical Background

5.1 Cash Conversion Cycle Approach

The cash conversion cycle approach, introduced by Richards and Laughlin (1980), provides the foundational theoretical lens for analyzing working capital management efficiency. The framework conceptualizes working capital management as a dynamic process in which cash flows through successive stages of the operating cycle—from the purchase of raw materials and payment to suppliers, through production and the holding of inventory, to the sale of goods and collection of receivables from customers. The cash conversion cycle approach provides the conceptual basis for the widely used empirical measure of working capital management efficiency employed throughout the literature reviewed in this paper, and underpins the general expectation that shorter cash conversion cycles are associated with more efficient use of capital and, consequently, higher profitability.

5.2 Trade-off Theory of Liquidity and Profitability

The trade-off theory of working capital management, articulated by Smith (1980), proposes that firms face an inherent trade-off between liquidity and profitability in their working capital decisions. Holding higher levels of liquid current assets—cash, receivables, and inventory—reduces the risk of financial distress and supports operational flexibility and sales, but represents an opportunity cost relative to investing those funds in higher-return assets or using them to reduce financing costs. Conversely, minimizing working capital investment may improve short-term profitability but increases the risk of stock-outs, lost sales due to restrictive credit policies, and liquidity shortfalls. This trade-off is particularly salient for SMEs, which typically have less access to external financing to address unexpected liquidity shortfalls and therefore may need to maintain higher precautionary levels of working capital relative to larger firms, even at some cost to short-term profitability.

5.3 Pecking Order Theory

The Pecking Order Theory, developed by Myers and Majluf (1984), proposes that firms prefer to finance their operations and investments using internally generated funds first, followed by debt, and resort to external equity financing only as a last resort, reflecting the costs associated with information asymmetry between firm managers and external investors. Applied to SME working capital management, the Pecking Order Theory helps explain why SMEs—which typically face particularly acute information asymmetries with external financiers—tend to rely heavily on

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internally generated funds and trade credit from suppliers (accounts payable) for working capital financing, and why efficient management of internally generated working capital is especially important for SMEs relative to larger firms with greater access to external capital markets.

5.4 Agency Theory

Agency Theory, articulated by Jensen and Meckling (1976), examines the relationships between principals (owners) and agents (managers) and the costs that arise when the interests of agents diverge from those of principals. Within the context of working capital management, Agency Theory provides a lens for understanding potential conflicts between the incentives of SME owner-managers—who, in many SMEs, are the same individuals—and other stakeholders such as lenders and trade creditors. For example, owner-managers may have incentives to extend generous trade credit to customers to support sales growth, even where doing so increases the firm's exposure to bad debts or liquidity risk, particularly if the costs of such risk are not fully internalized by the decision-maker. Agency Theory also provides a basis for understanding the monitoring role that lenders and trade creditors play in constraining SME working capital decisions, for example through covenants or credit terms that limit the levels of receivables or inventory an SME can maintain.

Together, these four theoretical perspectives—the Cash Conversion Cycle approach, the Trade-off Theory of liquidity and profitability, the Pecking Order Theory, and Agency Theory—provide a multi-dimensional framework for understanding how working capital management decisions are made by SMEs and how these decisions translate into profitability outcomes, encompassing operational, financial, and governance dimensions.

6. Future Research Directions

First, future research could develop and test integrated models that combine working capital management variables with direct measures of SME financing constraints—such as access to bank credit, reliance on informal financing, or participation in supply chain finance programmes—to better understand how financing constraints moderate the working capital management-profitability relationship.

Second, further research is needed to establish whether non-linear relationships between cash conversion cycle components and profitability, as found in some recent studies, generalize across other national contexts and SME populations, and to identify the firm-specific and contextual factors that determine the “optimal” level of working capital for SMEs of different sizes, sectors, and growth stages.

Third, research comparing working capital management practices and their relationship with profitability across a broader range of developing and emerging economies would help establish whether findings from individual country studies reflect broader patterns relevant to SMEs operating in similar institutional and financial market contexts.

Fourth, given the rapid growth of digital lending platforms, supply chain finance, and invoice discounting mechanisms targeted at SMEs, research is needed to examine how access to these innovations affects SME working capital management practices and, in turn, profitability outcomes.

Fifth, longitudinal research tracking SME working capital management practices and profitability across different stages of the firm life cycle—from start-up through growth, maturity, and potential decline—would help clarify how the working capital management-profitability relationship evolves as SMEs mature and as their financing options and operational complexity change.

Finally, research examining the effects of macroeconomic shocks and regulatory changes—such as tax reforms, changes in payment regulations, or credit policy interventions—on SME working capital requirements and the

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working capital management-profitability relationship would provide valuable evidence for policymakers seeking to design interventions that support SME liquidity and profitability during periods of economic disruption.

7. Implications

7.1 Theoretical Implications

This review contributes to the theoretical understanding of working capital management and SME profitability by integrating the Cash Conversion Cycle approach, the Trade-off Theory of liquidity and profitability, the Pecking Order Theory, and Agency Theory into a multi-dimensional framework specific to the SME context. Future theoretical development could extend this framework to more explicitly incorporate the role of external financing environment factors—such as the availability of supply chain finance and digital lending—as moderating variables in the relationship between working capital management and SME profitability, an aspect not fully addressed by frameworks developed primarily with reference to large firms operating in well-developed financial markets.

7.2 Practical and Managerial Implications

For SME owners and managers, this review suggests that working capital management represents an important and largely controllable lever for influencing profitability, even in the absence of significant new capital investment. Specifically, the literature suggests that SME managers may benefit from monitoring and seeking to optimize—rather than simply minimize—their cash conversion cycle, recognizing that excessively restrictive credit and inventory policies may harm sales and customer relationships, while excessively generous policies tie up capital and increase financing costs. For financial institutions and supply chain finance providers, this review highlights the potential value of working capital-focused financial products—such as invoice discounting, inventory financing, and trade credit insurance—in addressing a key constraint faced by SME clients.

7.3 Policy and Regulatory Implications

For policymakers, this review underscores the importance of measures that address the working capital financing constraints faced by SMEs, particularly in developing economies such as India where a substantial formal credit gap persists. Measures such as regulatory working capital norms for micro and small enterprises, mechanisms to address delayed payments such as the Trade Receivables Discounting System, and priority sector lending requirements represent important steps toward addressing SME working capital constraints; however, the persistence of a substantial credit gap suggests that further policy attention may be warranted, including continued support for digital lending innovations and alternative credit assessment mechanisms that can extend formal working capital financing to a larger share of the SME sector, particularly micro enterprises that remain largely excluded from formal credit channels.

8. Conclusion

Working capital management represents a critical determinant of SME profitability, given the disproportionately large share of total assets that working capital typically represents for SMEs and the financing constraints SMEs face in accessing external capital. This conceptual review has synthesized literature examining the conceptualization of working capital management and the cash conversion cycle, empirical evidence on the working capital management-profitability relationship from large firms and SMEs across developed and developing economies, the role of individual working capital components, the relationship between SME financing constraints and working capital management, and the specific dynamics observed among SMEs in India.

The review identified important gaps in the existing literature, particularly concerning the integration of financing constraints into working capital management-profitability models, the generalizability of recently identified non-linear relationships between working capital components and profitability, the relative scarcity of evidence from

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developing economies, and the implications of digital lending and supply chain finance innovations for SME working capital management. Drawing on the Cash Conversion Cycle approach, the Trade-off Theory of liquidity and profitability, the Pecking Order Theory, and Agency Theory, the paper has proposed a multi-dimensional theoretical framework for understanding how working capital management decisions translate into profitability outcomes for SMEs.

The implications of this review extend to SME managers, financial institutions, and policymakers. As SMEs continue to play a central role in employment and economic output in both developed and developing economies, including in India where the MSME sector contributes approximately 30 percent of GDP, ensuring that SMEs have both the knowledge and the financing access necessary to manage working capital efficiently represents an important contributor to SME profitability and, by extension, to broader economic development. Addressing the gaps identified in this review through future research will be essential to developing evidence-based guidance for SME managers and policymakers seeking to strengthen the financial performance and resilience of the SME sector.

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