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The Profitability of Net Working Capital in company wealth: Special case for companies in Azerbaijan.

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ABSTRACT

This study investigates how working capital in the Azerbaijan impact companies profitability. A sample of five companies used, which are biggest petroleum exporting companies in the Azerbaijan. The working capital policies between companies are compared. This comparison examines whether companies profitability working capital are impacted. The results of this study show that working capital positively influence the profitability. For the working capital policy managing accounts receivables this is not the case. This is because during an every period accounts receivables have an optimistic effect on a firm's profitability of the next year. These results are on temporary basis. On the longstanding, benefits of aiding customers during crisis periods are likely to raise, because upcoming sales will still be there. In addition, the risks taken by these aiding firms are low and for big reputable firms it is comparatively inexpensive.

T A B L E O F C O N T E N T S

ACKNOWLEDGEMENT.....	2
ABSTRACT.....	3
TABLE OF CONTENTS.....	4
LIST OF TABLES.....	7
CHAPTER ONE.....	8
INTRODUCTION.....	8
1.1 Background of the Study.....	8
1.1.1 Determinants of Working Capital.....	9
1.1.2 Profitability.....	11
1.1.3 Determinants of Profitability.....	11
1.1.4 Working Capital Management and Profitability.....	13
1.1.5 Companies in Azerbaijan.....	14
1.2 Statement of the Problem.....	15
1.3 Objective of the Study.....	16
1.4 Significance of Study.....	16
LITERATURE REVIEW.....	18
1.5 Working Capital Management Policies.....	18
1.5.1 A Conservative Working Capital Policy.....	18

1.5.2 An Aggressive Working Capital Policy.....	18
1.5.3 A Moderate Working Capital Policy.....	19
1.6 Theories on Working Capital.....	19
1.6.1 The Operating Theory.....	19
1.6.2 The Cash Conversion Cycle Theory.....	20
1.6.3 The Net Trade Cycle Theory.....	20
1.7 Working Capital Financing Management and Profitability.....	21
1.8 Empirical Review.....	23
1.9 Summary.....	27
CHAPTER TWO.....	29
RESEARCH METHODOLOGY.....	29
2.1 Research Design.....	29
2.2 Population.....	29
2.3 Sample Design and Sample size.....	29
2.4 Data Collection.....	30
2.5 Data Analysis.....	30
DATA ANALYSIS AND INTERPRETATION OF THE RESULTS.....	33
2.6 Descriptive Statistics for Selected Measures of Working Capital Management and Profitability.....	33

2.6.1 Comparative means of various WCM ratios and NOP for each of the Companies.....	33
2.7 Comparative Means of Various WCM Ratios and NOP for the Years under Review.....	35
2.8 Correlation analysis.....	37
2.9 Regression analysis.....	38
CHAPTER THREE.....	41
DISCUSSIONS, CONCLUSIONS AND RECOMMENDATIONS	41
3.1 Discussions.....	41
3.2 Conclusions.....	44
3.3 Recommendation.....	44
3.4 Recommendations for further studies.....	44
3.5 Limitations of the study.....	44
References.....	46

LIST OF TABLES

Table 2.1 Descriptive Statistics.....	36
Table 2.2: Comparative means of various WCM ratios and NOP for each of the Companies.....	38
Table 2.3: Comparative Means of Various WCM Ratios and NOP for the Years under Review.....	40
Table 2.4: Correlation Analysis.....	41
Table 2.5: ModelSummary.....	43
Table 2.6 Coefficients.....	44

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Working capital management is a very significant factor of corporate finance since it conventional affects to the liquidity and profitability of the corporation. It deals with current assets and current liabilities. Working capital management is important due to many causes. For one item, the current assets of a characteristic industrial firm financial accounts for above half its entire assets. For a distribution business, they account for even extra. Extreme levels of current assets can simply result in a firm's understanding a substandard return on savings. Conversely, organizations with too few current assets may incur scarcities and problems in maintaining smooth processes (Horne, 2000). Efficient working capital management includes planning and monitoring current assets and current liabilities in a method that reduces the risk of inability to meets due short term obligations on one hand and escape excessive investment in these assets on the other hand (Eljelly, 2004).

A company's value cannot be exploited in the end unless it continues the short-run. Companies fail most often since they are weak to meet their working capital needs; as a result, sound working capital management is a necessary for firm actuality (Deloof, 2003).

The crucial part in working capital financing is essential in maintaining its liquidity in regular process to ensure its level running and meet its duty (Eljelly, 2004).

To this point, this is not a modest assignment since executives must confirm that business procedure is running in effective and profitable way. There are the capacities of disparity of current asset and current liability for the period of this procedure. If this

happens and firm's supervisor cannot deal with it properly then it will affect firm's growth and profitability. This will extra lead to financial suffering and lastly firms can go bust.

Working capital management is important since of its possessions on the firm's profitability and risk, and so its value (Smith. 1980). Certainly, working capital investment contains a tradeoff between profitability and risk. Decisions that incline to growth profitability incline to rise risk, and, on the other hand, decisions that focus on risk reduction will incline to decrease potential profitability. Gitman (1994) claimed that the cash conversion cycle was a key factor in working capital management. Actually, decisions about how much to exploit in the customer and inventory financial records, and how much credit to obtain from providers, are reflected in the firm's cash conversion cycle, which means the average number of days between the date when the firm must stand paying its providers and the time when it starts to gather payments from its clients. Former studies have used links based on the cash conversion cycle to analyze whether shortening this cycle has positive or negative possessions on the firm's profitability.

1.1.1 Determinants of Working Capital

The factors of working capital are objects that have a straight impact on the quantity invested in current assets and current liabilities. Directors like to keep a near watch over these features, since working capital can captivate a large part of the funding that a business has at its discarding. Therefore, directors are always annoying to regulate the manner in which processes are running in order to cut back on the working capital investment. There are amounts of determinants of working capital, which contain the following:

Credit policy - If a business proposals easy credit rapports to its customers, the company is capitalizing in accounts receivable that may be unresolved for a long time. This investment can be edited by constriction the credit policy, but responsibility so may energy away some customers.

Growth rate - If a business is rising at a rapid degree, it is probable increasing its investments in receivables and inventory. If profits are very high, it is improbable that the object can make sufficient cash to pay for these receivables and inventory, resultant in a steady rise in working capital. Contrariwise, if a business is decreasing, its working capital requirements will similarly drop, which turns off excess cash.

Payables payment terms. If a business can transfer longer payment terms with its dealers, it can decrease the amount of investment desirable in working capital, fundamentally by obtaining an allowed loan from its dealers. Contrariwise, short payment terms decrease this basis of cash, which growths the working capital balance.

Production process flow. If a business evaluates its production wants, what it productions will possible vary slightly from actual demand, resulting in an excess amount of inventory on hand. Equally, a just-in-time scheme produces goods only to demand, so the investment in inventory is abridged.

Seasonality. If a business sells greatest of its goods at one time of the year, it may essential to build its inventory asset in development of the selling season. This investment in inventory can be edited by subcontracting work or paying actively to production goods at the last minute.

There are no definite set of rules or formulations to control the working capital necessities of firms. A big number of factors, each having different significance effects working capital needs of firms. The following is the description of factors that generally influence the working capital requirements of firms (Musayev, 2008).

Nature of business: Working capital requirements of a firm are principally influenced by decess nature of the business. In replication, trading and financial firms have a very small savings in fixed assets but necessitate a large sum of money to be capitalized in working capital. In contrast, public benefits have a very limited requirement for working capital and have to capitalize plentifully in fixed assets (Tagiyev, 2002).

Sales and demand situations: There is a link between volume of sales and the working capital needs of an organization. However, it is problematic to precisely control the link between volume of sales and working capital needs. In preparation, current assets will have to be employed in advance growth takes place. It is consequently, necessary to make advance preparation of working capital for expanding firm on an incessant basis (Peel and Wilson, 1996).

Technology and manufacturing police: The manufacture process has a lot of influence on the working capital requirement. The industrial cycle includes of the purchase and the use of raw resources and the fabrication of finished goods. The longer the industrial cycle, the large will be the company's working capital requirements (Whites, 1992).

Credit policy of the firm: The credit policy of the company affects the working capital by inducing the level of debtors. The credit terms to be granted to the clients may be contingent upon the norm of the corporate to which the firm belongs. However,

a firm has the suppleness of shaping its credit policy inside the perpetual of industry norms and observes (Maharramov, 2003).

Operating efficiency: This relays to the optimum use of resources at minimum expenses. The firm will be effectively causal in keeping the working capital investment at a lesser level if it is effectual in controlling operating costs and using current assets (Viler, 2000).

Price level changes: Price is pertinent to purchase of material, packing of finished goods and final sales. The increasing changes in price level make purposes of financial manager challenging. Management should forestall the effects of price level alterations on working capital requirements of the firm. Mostly, increasing price level will require a firm to sustain higher amount of working capital. Matching levels of current assets will need increased savings when prices are increasing (Smith. 1080).

Credit granted by providers: The working capital requirements of a company are also pretentious by credit terms granted via its creditors. A company will need fewer working capital if generous credit terms are obtainable to it. Likewise, the availability of credit from banks also effects the working capital needs of the company. A company that can get bank credit simply on favorable circumstances will operate with fewer working capital than a company without such capacity (Gitman, 1994).

1.1.2 Profitability

Profitability is one of four structure blocks for examining financial statements and company presentation as a whole. The other three are efficiency, solvency, and market prospects. Investors, creditors, and managers use these important concepts to

examine how well a company is doing and the potential it could have if actions were managed correctly.

The two main aspects of profitability are revenues and expenses. Revenues are the business income. This is the quantity of money earned from customers by selling goods or providing services. Making income is not open, however. Industries must use their properties in order to crop these products and deliver these services.

Resources, like cash, are used to pay for expenditures like employee payroll, rent, utilities, and other supplies in the production procedure. Profitability appearances at the link between the revenues and expenses to realize how well a company is acting and the potential growing a company might have.

The key objective of every firm is exploiting profits but preservative liquidity of the firm is an important objective too. The challenging is that increasing revenues at the cost of liquidity carry serious difficulties to the firm. Therefore, there must be a compromise between these two objects of the firms. One object should not be at the cost of the other subsequently both have their significance. If we do not maintenance about profits we cannot endure in the end, on the other hand, if we do not care about liquidness, we may face problems of failure or bankruptcy. For this object, working capital management should be given good consideration and will eventually affect the profitability of the companies.

1.1.3 Determinants of Profitability

Maximizing profits is said to be the impartial of all firms. Certainly, it is not always simple for the management to find out which are the correct decisions that

would exploit them. For instance, short-run profits can be simply pumped up by escaping maintenance, optional costs, investments, that though are necessary of on-going affordability, more above what maximizes the "above all profits" is not necessary what permits to attain the maximum of "profitability".

In truth, firms do have profits goals, and sometimes they pay managers for attainment them, but the goals of firms are comprehensive than profits alone. Proceeding with other factors of profits, rising prices of competitors, better sales circumstances and skills, a higher above all price level allow for higher prices of the measured firm's products, thus rise nominal profits to the extent that costs are inelastic, i.e. they rise less than regularly to revenues. Cost structure and its over-all elasticity to production level is thus significant to profits. Economies of scale growth profits more than proportionately when sales grow. Conversely, a slump with falling sales levels will hit profits predominantly hard in businesses where there are economies of scales and high fixed costs. Rising wages conventional reduce profits. If, though, on a macro-economic level, these wages will be spent on local goods, higher consumption will increase business revenues, partly counteracting the previous dynamics. Depending on the dynamics of spreads and other GDP components, higher wages are well matched with higher profits. In other terms, efficiency gains determine rising profits. High trade profits can prompt the people to go into the market and start to compete with current traders. In manufacture, this effect, although still present, crucially depends on the easy of imitation of product structures and production processes. It is often hard to enter into highly cost-effective markets. If markets were all perfectly economical in their long run equilibrium, all firms in the economy would have the same constant level of profits: zero. By disparity, in the real world, firms have different profits with certain segments and certain firms systematically reaching better profits than others do. This is due to imperfect rivalry, barriers to entry, innovation and product distinction.

1.1.4 Working Capital Management

Efficiency in working capital management is so vigorous in a production firm; assets are typically composed of current assets (Home and Wachowitz, 1998) as it conventional affects liquidity and profitability of any firm (Rabeman and Nasr, 2007). According to Kargar and Bluementlhal (1994), impoverishment may also be possible for firms that put imprecise working capital management processes into practice, even though their profitability is continually positive. Hence, it must be avoided from optimal working capital level by carrying the aim of profit maximization in the forefront, or just in direct inconsistency, to focus only on liquidity and so pass above profitability. While extreme levels of working capital can simply result in a substandard return on assets, small amount of it may incur scarcities and difficulties in maintaining day-to-day processes. Working capital is also a major external source of capital for especially small and medium sized and high-growth firms. These firms have fairly limited access to capital markets and tend to above come this difficulty by short-term borrowing. Working capital situation of such firms is not only an inside firm-specific matter, but also an important indicator of risk for creditors (Moyer, 1992). Higher amount of working capital allows a firm to meet its short-term duties easier. This results rise in borrowing capability and decrease in defaulting risk (and consequential decrease in cost of capital and increase in firm value). Therefore, it is likely to state that competence in working capital management touches not only short-term financial performance (profitability), but also long-run financial performance (firm value maximization). Liquidity, as a function of current assets and current liabilities, is a substantial factor in determining working capital policies and designates firm's capability of generating cash in ease of need. Current, significant test and cash ratios as traditional methods of liquidity are incompetent and static balance sheet based methods

that cannot provide detailed and exact information about working capital management effectiveness (Finnerty, 1993; Jose, 1996). Formulations used for calculating them reflect both liquid and operating assets in common.

Cash conversion cycle as a part of operating cycle is a continuing liquidity measure developed by Gitman (1974). Carefully related with operating cycle, cash conversion cycle is, in brief, the amount of operating cycle financed by the company itself (McLaney, 1997) and is calculated by adding inventory period to financial records receivables period and at that moment subtracting financial records payables period from it. It emphasizes on the length of time between the gaining of raw materials and other contributions and the inflow of cash from the sale of goods (Arnold, 1998). The smaller this cycle, the fewer resources the firm needs to link. Traditional method to interaction between cash conversion cycle and profitability postulates that relatively long cash conversion periods tend to reduce profitability. Trade activities of a firm can be measured as a process in circulation where cash is converted into assets to cash. Cash available for trade activities of the firm has an important multiplier effect due to its turn above ratio. Higher cash turn above ratios allow managers to minimize short-term investments whose rates of reappearance are relatively lower compared to long-term investments and consequently growth profitability.

1.1.5 Companies in Azerbaijan

The companies began above five thousand years ago, in the Middle East, seeping up through the ground was used in waterproofing boats and baskets, in paints, lighting and even for medication. Azerbaijan has no known oil or gas reserves. The Azerbaijan government is encouraging foreign interest in exploration and there is a modest upstream company like the one USA is working on some sites in Azerbaijan but so far

none has home fruit. Petroleum is Azerbaijan's major source of commercial energy and has, above the years, accounted for about 80% of the country's commercial energy requirements.

1.2 Statement of the problem

Working capital management is significant since of its effects on the firm's profitability and risk, and subsequently its value (Smith, 1980). Working capital management is momentous part in firm financial management decision. An optimal working capital management is predictable to contribute positively to the formation of firm value. Working capital is an important issue during financial decision making since its being a part of savings in asset that necessitates appropriate financing investment. It should be serious for to a firm to sustain their short-term investment since it will ensure the ability of firm in time-consuming period (Rabeman & Nasr, 2007).

The optimal mixture of the various working capital financing bases has been a topic since its theoretical increase and the empirical research that have followed. Numerous revisions have investigated the working capital financing strategies of firms in various subdivisions of the economy, such as manufacturing firms, electric-utility corporations, non-profit clinics and agricultural firms (Jensen and Langemeier, 1996). One of the key conclusions of empirical revisions is that industrial classification is a significant factor of working capital financing. A continuing debate in corporate finance occurs above the question of how firms make their working capital financing decisions, and the influence of these on the profitability of the business. Most studies on working capital financing strategy have used data from American and European companies. However, investigation on the determinants of working capital financing of developing and evolving market such as nature of business, market and demand situation, credit

policy, operating efficiency, conditions of supply firms has appeared as an extended new line of research since of the alterations in levels of effectiveness and institutional arrangements among developed markets and emerging markets (Eldomiaty, 2007).

In this line, a number of enquiries requires an answer. Whether impartiality multiplier affects profitability? Whether logistic entire assets touch profitability? Whether entire assets turn above touches profitability?

This study required to bridge this knowledge gap by investigating the influence of working capital management on profitability of the companies in Azerbaijan.

1.3 Objective of the Study

To establish the impact of Working Capital Management on Profitability of the companies in Azerbaijan.

1.4 Significance of the Study

The study findings will benefit management and staff of marketing companies under revision to gain vision into how their companies can efficiently manage their working capital to improve their financial performance. The management will service the best policies for request. The research will deliver valuable information concerning the business sector. Being future entrepreneurs the academicians will be equipped with relevant information concerning working capital management. The investigation will contribute to the overall body of knowledge and procedure a basis for additional research. The Science Academy of Azerbaijan would also use the discoveries to enhance its curriculum.

Controlling bodies like Energy Regulation commission and the Ministry of Energy can use the discoveries to improve on the framework for controller of marketers in Azerbaijan. Policy makers will also be able to express and implement new usual of

policies regarding the working capital management in the main income manufacturing. With the recently published bill on price panels, and the new instruction from the Ministry of Energy for the Azerbaijan's parastatal to obtain 65% of national consumption as a tactical stock, the study will make useful insights in the feasibility of such national policies.

LITERATURE REVIEW

1.5 Working Capital Management Policies

Financing of current assets from current liabilities mainly in the form of interest free credit obverse supplies is less exclusive source of financing than equity or long-term debt capital (Van Vome, 1095). The type of working capital policy operated will be verbalized by such factors as the growth rate of the company, its scope, nature of its industry whether it is manufacturing or non-manufacturing and by the risk height of the firm's management Pandey and Parera (1997) provided an empirical suggestion of working capital management strategies and practices of the private sector manufacturing companies in Sri Lanka. They found that most businesses in Sri Lanka have informal working capital policy and company scope has an effect on the above all working capital policy (formal or informal) and approached (conservative, moderate or aggressive).

Anand (2001) asserted that an individual company's investment in working capital would be related to the type of industry it operates in and the crucial working capital policy each individual company adopts. Working capital investment decisions concerns

how much of firms incomplete resources should be invested in working capital. Financing decisions relate to how investment in working capital is to be invested. What may be measured as an optimal level in one company may change from another company due to alteration in operations or business characteristics crossways industries.

Working capital requirements are also possible to change above time in reply to changes in company's operation (Block and Hilt 1992). Companies can accept any of these three distinct working capital policies; an aggressive policy, moderate policy and a conservative policy.

1.5.1 A Conservative Working Capital Policy

A far as investment is concerned; a conservative working capital policy is a production philosophy. At its most, the policy will effort to provide sufficient long-term financing to above all forestall eventualities. A conservative policy infers relative high investment in current assets in relative to sales, the current assets to sales ratio will be moderately high and contribution turn above ratio will be low. In a conservative technique stock and cash, levels will generally be kept high to avoid stock out and illiquidity costs. There is also probable to be a sizeable investment in short-term bank deposits and other short-term liquid investments (Copeland and Weston 1998).

1.5.2 An Aggressive Working Capital Policy

Gitman (1997) donated that an aggressive policy relies on minimum investment in current assets and is extremely dependent on access to short-term financing. He stated that with an aggressive policy, complete investment in current assets would be kept to a minimum. The current asset to sales ratio will be inferior and the current assets

turn above ratio much higher in contrast to a conservative policy. The study contributed that an aggressive working capital policy will use long-term finance to deposit its investment in permanent fixed assets and also a substantial part of its permanent current assets: short-term financing will be used to fund temporary current assets needs and part of the permanent current assets obligation. Gitman (1907) also observed that if conservative and moderate policies were to be compared, an aggressive policy will attain higher returns but will also transmit high risk due to its higher dependency on short-term financing.

1.5.3 A Moderate Working Capital Policy

Gitman (1997) stated that a moderate or balanced capital falls midway between the aggressive and conservative policies. With a moderate policy, the level of investment in the current assets is neither lean nor extreme. Following a moderate policy, long-term funds are used to finance the investment in fixed assets and the permanent components of current assets investments. Provisional or seasonal current assets are financed by short-term sources of finance. The moderate policy is less risky than the aggressive policy but more risky than the conservative policy. The company only resorts to short-term financing when seasonal or temporary demands require it. Returns under a moderate policy are corresponding higher than under a conservative policy but lesser than an aggressive policy.

1.6 Theories on Working Capital

1.6.1 The Operating Cycle Theory

The operating cycle theory expressions explicitly at one side of working capital that of current assets and so gives income statement measures of firms' operational activities that is about production, distribution and collection. Receivables, for instance are straight exaggerated by the credit collection policy of the firm and the incidence of converting these receivables into cash matters in the working capital management. By granting the customers more generous credit policy, the profitability will be increased but at the same time, liquidity will be forwent. The same analysis goes for other components of current assets account. However, the operating cycle theory inclines to be deceptive in that it suggests that current liabilities are not important in the course of the firm's operations. Given this insufficiency of the operating cycle theory, it is vital to infuse current liabilities in the picture to improve our analysis and understanding. Although the operating cycle considers financial flows come from receivables and inventory, it disregards the financial flow coming from financial records payables in this regard to Richards and Laughlin (1980) optional the cash conversion cycle that considers all relevant cash flows comes from the operations.

1.6.2 The Cash Conversion Cycle Theory

The theory assimilate both sides of working capital. In their influential paper Richards and Laughlin (1980) created this method of working capital as part of a wider frame work of analysis known as the working capital cycle. It privileges that the method is greater to other forms of working capital analysis that depend on ratio analysis or a deco in posts of working capital as requested above. The cash conversion cycle is calculated by deducting the payables deferral period ($365/\text{annual payables turn above}$), from the sum of the inventory conversion period ($365/\text{annual inventory turn above}$) and the receivable conversion period ($365/\text{annual receivable turn above}$).

Since, each of the three mechanisms is denominated by some number of days the cash conversion cycle is stated as a number of days. It has been interpreted as a time interval between the cash outlays that arise during the production of output and the cash inflows that result from the sale of the output and the collection of the financial records receivables.

1.6.3 The Net Trade Cycle Theory

The net trade cycle is essentially equal; to the cash conversion cycle where the three components of the cash conversion cycle (receivables, inventory and payables) are expressed as a percentage of sales this makes the net trading cycle easier to compute and less complex (Soenen, 1993) investigated the relationship between the net trade as an amount of working capital and return on investment in the us firms, the results of chi-square test indicated a negative relationship between the length of net trade cycle and return on assets. Additionally, this inverse relationship was found dissimilar across industry an important relationship for about half of the businesses studied indicated that the results might vary from industry to industry. A further study by shin and (Soenen, 1998) argued that the net trading cycle is a better working capital competence measure compared with the cash conversion cycle and the biased cash conversion cycle since it indicates the number of days sales the company has to finance its working capital and the working capital manager can simply estimate the financial needs of working capital expressed as the function of predictable sales growth. The reason for using net trading cycle is since it can be an easy expedient to estimate for additional financing needs about working capital expressed as a function of the predictable sales growth. This relationship can be examined using correlation and regression analysis by industry should working capital make stronger.

Using a Compustat sample of 58,983 firm years in the period 1975-1994 in all cases, they found a strong negative relationship between the length of the firm's net trade cycle and its profitability. In addition shorter net trade cycle is associated with higher risk adjusted stock returns. In other works, (Shin and Soenen, 1998) suggest that one possible way the firm to create shareholder value is by reducing firm's net trade cycle.

1.7 Working Capital Financing Management and Profitability

The relationship between efficient working capital management and firm's profitability (Slun & Soenen, 1998) used net-trade cycle (NTC) as an amount of working capital management. NTC is equal to the CCC whereby all three devices are expressed as a percentage of sales. The reason for using NTC is that it can be an easy device to estimate for extra financing needs with regard to working capital articulated as a function of the projected sales growth. This relationship is inspected using correlation and regression analysis, by industry and working capital intensity. Using a Compustat sample of 58.985 firm years in the period 1975-1994, in all cases, they found, a robust negative relation between the length of the firm's net-trade cycle and its profitability. In adding, shorter NTC are associated with higher risk adjusted stock returns. In other word, (Shin & Soenen, 1998) suggest that one likely way the firm to make shareholder value is by reducing firm's NTC.

The study of (Shin & Soenen, 1998) reliable with later study on the same impartial that done by (Deloof 2003) by using example of 1009 large Belgian non-financial firms for the period of 1992-1996. However, (Deloof, 2003) used trade credit policy and inventory policy are measured by number of days financial records receivable, financial records payable and inventories, and the cash conversion cycle as a complete measure of working capital management. He found an important negative relation between gross operating income and the number of day's financial records receivable, inventories and

financial records payable. Thus, he proposes that managers can make value for their shareholders by reducing the number of day's financial records receivable and inventories to a reasonable minimum. He also proposes that less profitable firms wait longer to pay their bills.

In another study, (Lyroudi & Lazaridis, 2000) usage food industry Greek to examined the cash conversion cycle (CCC) as a liquidity indicator of the firms and stabs to determine its relationship with the current and the quick ratios, with its component variables, and investigates the implications of the CCC in terms of profitability, indebttness and firm size. The results of their study indicate that there is an important positive relationship between the cash conversion cycle and the traditional liquidity measures of current and quick ratios. The cash conversion cycle also positively related to the return on assets and the net profit margin but had no direct relationship with the advantage ratios. Contrariwise, the current and quick ratios had negative relationship with the debt to equity ratio, and a positive one with the times interest earned ratio. Finally, there is no alteration between the liquidity ratios of large and small firms.

1.8 Empirical Review

Various scholars have done the impact of working capital on a firm's performance. Abovevly it can be inferred that there exist an important relation between performance and working capital management by using dissimilar variable selection for analysis for 1990-1991 to 1999-2000 signify that working capital management and profitability of the company revealed both negative and positive connotation. He found suggestion that increase in the profitability of a company was less than the proportion to decrease in working capital. Demonstrate a strong negative relationship exists between variables of

the working capital management represented by liquidity and debt with profitability of the firm.

On his part, Ganesan (2007) analyzed the working capital management efficiency of firms from telecommunication equipment industry. The variables used to signify the working capital are day's sales unresolved, days inventory outstanding, days payable outstanding, days working capital, and current ratio while profitability and liquidity signify by cash conversion efficiency, income to entire assets and income to sales. This study found indication that even though "day's working capital" is negatively related to the profitability, it is not meaningfully impacting the profitability of firms in telecommunication equipment industry. However, this was conflicting to the results of Amin (2007) who had found positive correlations between WCM with financial performance. Nazir (2007) through cross-sectional regression models on working capital policies, profitability and risk of the firms, found a negative relationship between the profitability dealings of firms and degree of aggressiveness on working capital investment and financing policies, their result indicates that the firms yield negative returns if they survey an aggressive working capital policy by investigating the relative relationship between the aggressive or conservative working capital policies for 208 public limited companies.

According to Padachi (2006), high investment in inventories and receivables is related with lower profitability. He used return on entire assets as a measure of profitability for a sample of 58 small manufacturing firms. His findings reveal a growing trend in the short-term component of working capital financing. Their correlations and regression analysis signifying that working capital component specifically current ratio, cash turn above ratio, current assets to operating income and leverage negatively influence profitability.

Using data on a panel of U.S. corporations from 1990 through 2004, established the importance of working capital management to firm value. Their study used stock's excess return to represent the firm worth and findings show that on average, an extra dollar invested in net operating working capital decreases firm value and this indicates that their study is reliable with industry surveys suggesting that some firms above invest in net operating working capital.

The cash conversion cycle had been extensively used as a major component representing working capital. One of the preceding studies done by Jose, Lancaster and Stevens (1996) for the twenty-year period from 1974 through 1993 of 2,718 firms' proposals strong indication that aggressive working-capital policies designated by shorter cash conversion cycle increase profitability. Their findings are similar to Lazaridis (2006) that showed there is a numerical suggestion between profitability, measured through gross operating profit and the cash conversion cycle using the example of 131 companies listed in the Athens Stock Exchange (ASF) for the period of 2001-2004. By utilizing ANOVA and Pearson correlation analyses of the companies listed in the Istanbul Stock Exchange (ISE) for the year 2007, he designates that the firms with shorter CCC are more likely to be more profitable than the firms with longer CCC.

On his part, Nazir (2009) analyzed the influence of aggressiveness of working capital investment and financing policies for a sample of 204 non-financial firms listed at Karachi Stock Exchange for the period of 1998-2005. They assessed on firm returns i.e. return on assets and Tobin's Q to signify market performance and designates that firms adopting an aggressive approach towards working capital financing policy provide more value to the firms while opposite relationship between the aggressiveness of working capital investment policies on firms' performance exist. These results are reliable with Afza and Nazir (2007) that using Tobin's Q to represents stock market

performance of Karachi Stock Exchange. According to Irene & Lee (2007) who explored on the prevailing working capital management practices of some well-performed Malaysian public firms listed on Bursa Malaysia, they inspected the correlation between profitability and the level of working capital of the sample firms and originate that profitability and working capital are linearly related positively to a definite extent.

Schilling (1996) mentions optimum liquidity position, which is minimum level of liquidity necessary to support a given level of business activity, in his writing. He says it is serious to deploy resources between working capital and capital investment, since the return on investment is typically less than the return on capital investment. Therefore, organizing resources on working capital as much as to uphold optimum liquidity position is essential. Then he sets up the relationship between CCC and minimum liquidity required such that if the CCC lengthens, the minimum liquidity required increases; conversely, that if the CCC shortens, the minimum liquidity required decreases.

The relationship between efficient working capital management and firm's profitability (Shin & Semen, 1998) used net-trade cycle (NTC) as a measure of working capital management. NTC is equal to the CCC whereby all three modules are expressed as a percentage of sales. The cause by using NTC since it can be an easy expedient to estimate for additional financing needs with regard to working capital articulated as a function of the projected sales growth. This relationship is examined using correlation and regression analysis, by industry and working capital intensity. Using a Compustat sample of 58985 firm years in the period 1975-1994, in all cases, they found, a strong negative relation between the length of the firm's net-trade cycle and its profitability. In addition, shorter NTC are related with higher risk adjusted stock returns. In other

word, (Shin & Soenen, 1998) propose that one possible way the firm to create shareholder value is by reducing firm's NTC .

The study of (Shin & Soenen, 1998) reliable with later study on the similar objective that done by (Deloof, 2003) by using sample of 1009 large Belgian non-financial firms for the period of 1992-1996. Though, (Deloof, 2003) used trade credit policy and inventory policy are measured by number of days financial records receivable, financial records payable and inventories, and the cash conversion cycle as a complete measure of working capital management. He originated a significant negative relation between gross operating income and the number of day's financial records receivable, inventories and financial records payable. Thus, he suggests that managers can make value for their shareholders by reducing the number of day's financial records receivable and inventories to a sensible minimum. He also proposes that less profitable firms wait longer to pay their bills.

In other study, (Lyroudi & Lazaridis, 2000) use food industry Greek to inspected the cash conversion cycle (CCC) as a liquidity pointer of the firms and tries to determine its relationship with the current and the quick ratios, with its constituent variables, and investigates the inferences of the CCC in terms of profitability, indebttness and firm size. The results of their study designate that there is an important positive relationship between the cash conversion cycle and the traditional liquidity measures of current and quick ratios. The cash conversion cycle also positively related to the return on assets and the net profit margin but had no direct relationship with the advantage ratios. Contrariwise, the current and quick ratios had negative relationship with the debt to equity ratio, and a positive one with the times interest earned ratio, in conclusion, there is no alteration between the liquidity ratios of large and small firms.

1.9 Summary

Working capital management is an important area of financial management, and the organization of working capital may have a significant influence on the profitability and liquidity of the firm. Most experiential studies relating to working capital management and profitability provision the fact that aggressive working capital policies improve profitability. Working capital, sometimes-called gross working capital, just refers to the firm's entire current assets (the short-term ones), cash, marketable securities, financial records receivable, and inventory. While long-term financial analysis mainly concerns strategic planning, working capital management contracts with day-to-day operations.

The leading objective of working capital management is to uphold an optimal balance between each of the working capital constituents. The hedging approach advises that the long-term funds should be used to finance the fixed helping of current assets requirements. Corporate performance has been recognized as a potential determinant of working capital financing policies. Dissimilar authors on working capital have given different interpretations of the influence of taxation on working capital financing decisions in the main industrial countries. Some are disturbed conventional with tax policy. Size plays a significant part in decisive the working capital financing policies of a firm. Two variables are used as proxies for the firm's condition for debt financing. These are return on assets (profitability) and the ratio of dividends to capital (dividends). A firm's stream of holdings will lead to a steady, semi-automatic reduction in the book debt ratio above time. Most preceding studies emphasis on developed market (Peel & Wilson, 1996; Shin & Soenon, 1998 and Deloof, 2003). Thus, there happens a gap in literature on the consequence of working capital financing policies on the profitability of the firm in developing countries. Thus, exploring this issue could provide additional perceptions and perhaps different evidence on the

working capital management in emerging capital market. This will surely supplement the finance literature on this issue. As a result, it will build up sureness in investor to invest in that firm.

CHAPTER TWO

RESEARCH METHODOLOGY

2.1 Research Design

The research design approved was cross-sectional study in which data will be collected just once above the period 2007 to 2011. This study was approved out with subordinate data as detailed in companies in Azerbaijan annual reports from the same financial statements, the researcher found the data for various variables involved in the study from the financial statements in their yearly report. The research design for this study was fundamental as the study tried to determine the relationship between working capital management and financial performance of marketing firms in Azerbaijan.

2.2 Population

The population of the research contained of all marketing firms in Azerbaijan registered with Science Academy of Azerbaijan within Russia and its environs. There are 35 companies register by SAA in Azerbaijan.

2.3 Sample Design and Sample size

Selection is a process of choosing a number of characters for a study in such a way that this individual selected signifies the large group from which they are designated (Tagiyev, 2003: 260) Gay (1983) recommended that for correlation research, 30 cases or more are compulsory. Since this study intricate correlation analysis to classify the relationship between working capital management in the companies in Azerbaijan to act, a sample of 30 companies was nominated from the population.

2.4 Data Collection

Data was composed from annual reports from financial statements. These involved the latest published yearly reports. Profit after tax, current assets, current liabilities, fixed assets and long-term debt and equity of institutions to be measured. The Annual report of the firm was obtained between 2007 to 2011, which was the study period.

2.5 Data Analysis

The data composed was analyzed by use of Microsoft fixed 2010 and Statistical Package for Social Sciences (SPSS) Version 17. Microsoft Excel aided in grouping the data to facilitate contrast. The data will be transformed into percentages to lie between 0 and 1. This study used SPSS software package to assistance in data analysis. Regression analysis was used to determine the relationship between two variables (working capital management and profitability) was used to find out whether independent variables projected a given movement in the dependent variable. The Chi-square test, a non-parametric test was used to test the goodness of fit, test the implication of association between two qualities, and test the homogeneity or the significance of population variance (Babayev, 1999). The analysis was at 0.05 level of significance.

Content analysis was used to test data that is qualitative nature or feature of the data collected front the open-ended questions. A multivariate regression model was practical to determine the relative position of each of the three variables with respect to the status of effect of working capital management on profitability.

Profitability will be measured using:

(i) Return on equity (ROE) ratio. The reason is that ROE ratio is similar between one companies to the other and can indicate the profitability of one industry with the other (Helfert, 2001). Return on equity (ROE) ratio designates the profitability of the company. ROE measures the rate of return on common stockholder's investment

ROE $\text{Net Income Common Equity}$

(ii) Equity multiplier -which defines the value of all assets associate to the value of equity of the company. It can too be measured as the amount of debt used above the entire assets that the company has. The formula for equity multiplier is:

Equity Multiplier = $\text{Entire Assets/Entire Equity}$

It can also be:

Equity Multiplier = $\text{Entire Debt/Entire Equity}$

The correlation analysis is done to analyze the association between working capital management efficiency and profitability. To examine the relationship among there variables, Pearson correlation coefficients was calculated.

DATA ANALYSIS AND INTERPRETATION OF THE RESULTS

2.6 Descriptive Statistics for Selected Measures of Working Capital Management and Profitability

Descriptive statistics were computed for both metrics measuring profitability and that measuring working capital management. The consequences show that the average Net Operating Profitability among to companies in Azerbaijanis 0.08 i.e. 8° with a standard deviation of 0.13. The companies have an Average Collection Period of 17 days with a standard deviation of 4.06. The Average Inventory turn above in Days is 48 days while Average Payment Period for the firms is 68 days. The average Cash Conversion Cycle is 11 days with a huge standard deviation of 35.7. The negative CCC is very strong for the companies as it means that they get paid 11 days earlier by their customers before they pay their creditors. Debt Ratio on the other hand is 0.21.

Table 2.1 Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
NOP	30	-.46	.29	.0783	.13411
ACP	30	2.35	17.06	8.1993	4.11290
ITID	30	19.67	139.72	48.7288	32.98869
APP	30	36.75	165.02	68.3580	27.44568
CCC	30	112.41	71.02	-11.4299	35.54924
DR	30	0.99	1.12	.2050	.31751
Valid N (List wise)	30				

2.6 Comparative means of various WCM ratios and NOP for each of the companies

Apart from Bosshelf LLC which had a negative mean for Net Operating Profitability of 0.04, all the other retail chains had positive net operating profitability. The best performing in this respect was Baku Shipyard LLC (mean 0.13) while the least performing was Bosshelf LLC (mean - 0.04). Baku Shipyard LLC had the least ACP of 5 days while Baku Shipyard LLC had the highest at 14 days. Similarly, Baku Shipyard LLC had the highest ITID of 116 days while National Oilwell Valco had the lowest of 28 days. Baku Shipyard LLC had the highest APP of 96 days while Caspian Drilling Company had the lowest of 41 days. The worst CCC was that of Baku Shipyard LLC of 44 days followed by Caspian Drilling Company of 1 day. All the other marketing firms had negative cash convention cycles with the lowest being that of Caspian Drilling Company of 48 days. These results suggest the existence of company-specific factors that potentially affect WCM and NOP. As such, test for fixed effects are carried out in the proceeding sections to verify this.

Table 2. 2: Comparative means of various WCM ratios and NOP for each of the companies

COMPANY						
	Caspian Drilling Company	Weather Ford	National Oilwell Valco	Statoil	Bosshelf LLC	Baku Shipyard LLC
	Mean	Mean	Mean	Mean	Mean	Mean
NOP	.09	.08	.11	.12	-.04	.13
ACP	5.06	5.00	14.24	7.17	10.59	7.17
ITID	37.14	28.27	116.48	36.33	37.81	36.33
APP	41.48	47.09	85.87	69.71	96.30	69.71
CCC	.72	-13.8	44.83	-26.2	47.9	-26.2
DR	.04	.05	.34	.04	.79	.01
OTHER	10	8.58	35.32	79.04	58.04	.82

2.7 Comparative Means of Various WCM Ratios and NOP for the Years under Review

The results in the table below suggests that profitability across the six firms was highest in 2010 (mean 0.15) and lowest in 2007 (mean 0.04). ACP has remained constant oscillating between 7 and 10 days. ITID varied above time with the highest being in 2008 and 2010 at 58 days and the lowest being, 36 days in 2007. Apart from year 2007 which had a high APP of 80 days. APP remained constant above time at 65 days. CCC was negative for all the years and it fluctuated a lot between -1 day and 29 days. DR on the other hand remained constant for years 2008 and 2009 at 0.15 and then increased to a new level of 0.25 in 2008 and remained in this level until 2010. These findings seem to indicate that these ratios are time-invariant. Again, fixed effects panel data analysis model is used in the next section to verify this.

Table 2. 3: Comparative Means of Various WCM Ratios and NOP for the Years under Review

	Year				
	2007	2008	2009	2010	2011
	Mean	Mean	Mean	Mean	Mean
NOP	.04	.06	.06	.15	.09
ACP	7.02	8.36	9.96	8.25	7.42
ITID	36.18	42.75	55.90	53.11	55.71
APP	64.72	80.38	66.54	64.22	65.93
CCC	- 21.52	- 29.28	-.68	2.86	-2.80
DR	.14	.15	.25	.25	.24

2.8 Correlation analysis

Table 2.4: Correlation Analysis

Correlations							
		NOP	ACP	ITID	APP	CCC	DR
NOP	Pearson Correlations	1					
	Sig(2-tailed)						
ACP	Pearson Correlations	-.296	1				
	Sig(2-tailed)	.112					
ITID	Pearson Correlations	.104	.677	1			
	Sig(2-tailed)	.585	.000				
APP	Pearson Correlations	.630	.659	.348	1		
	Sig(2-tailed)	.000	.000	.000			
CCC	Pearson Correlations	.548	.235	.738	-.373	1	
	Sig(2-tailed)	.002	.211	.000	.042		
DR	Pearson Correlations	-.181	.432	.295	.434	-.011	1
	Sig(2-tailed)	.338	.017	.113	.017	.954	

The correlation analysis above shows that there are high correlations between different measures of working capital management. The correlation between ACT and ITID is (0.677), ACP and APP is (0.659). CCC and APP is (-0.655). CCC and ITID is (0.738). To avoid multi-co linearity problem in the regression analysis, stepwise regression is used so that some of those variables that are highly correlated are removed from the model. The correlation coefficient between advantage i.e. financial debt ratio and net operating profitability reveals a negative non-significant relationship between the two variables this implies that increase in debt utilization by the firms will reduce profitability of the five WCM variables, only CCC and APP have a significant relationship with NOP. CCC has a strong significant positive correlation with NOP (Coefficient 0.548. P-Value 0.002). APP on the other hand has a negative strong correlation with NOP (Coefficient -0.63, P-Value 0.000).

2.9 Regression analysis

2.9.1 Regression Results for 2007 - 2011

Table 2.5: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.863	.7448	-0.726	0.148

Source, Research Data (2012)

R² is called the coefficient of determination and tells us how the profitability of marketing firms in Azerbaijan varied with working capital management. From table above, the value of R² is .7448. This implies that up to 74.5% of variations in profitability of marketing firms in Azerbaijan with changes in working capital management. 24.5% of variations in financial performance are due to other factors. The coefficient of correlation (R - 0.863). The coefficient of correlation shows that there was a strong relationship between profitability of companies and various factors of working capital management as shown by a factor of one.

Table 2.6 Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		R	Std. Error	Beta		
1	Constant	.399	1.033		1.091	0.255
	ACP	.019	0.107	.055	0.687	0.002
	ITID	-.011	0.139	.262	0.97	0.005
	APP	.003	0.097	.038	0.349	0.013
	CCC	-.002	0.069	-.021	0.787	0.255
	DR	1.507	1.033	1.174	1.091	0.002

Source, Research Data (2012)

From the above coefficient results old year 2007 – 2011 the established regression equation was;

$$\text{NOP} = 0.399 - 0.0602 \text{ CCC} + 0.019 \text{ ACP} - 0.011 \text{ ITID} + 0.003 \text{ APP} + 1.174 \text{ DR}$$

From the above equation, the study found that holding Average Collection Period, Inventory turn above in Days', Average Payment Period. Cash Conversion Cycle and Debt Ratio to a constant zero net operating profit would be equal to 0.399. A unit increase in Cash Conversion Cycle lead to decrease in profitability by a factor of 0.002, a unit increase Average Collection Period would lead to increase in profitability by a factor of 0.019, unit increase in Inventory turn above in Days' lead to increase in profitability by factor old 0.011, a unit increase in Average Payment Period leads to increase in profitability by factors of 0.003, further unit increase in debt ratio leads to increase in profitability by factors of 1.507.

CHAPTER THREE

DISCUSSIONS, CONCLUSIONS AND RECOMMENDATIONS

3.1 Discussions

Descriptive statistics were computed for both metrics measuring profitability and that measuring working capital management. The study found that the Net Operating Profitability among companies in Azerbaijan is 0.08 i.e. 8% with a standard deviation of 0.13. Companies have an Average Collection Period of 17 days with a standard deviation of 4.06. The Average Inventory turn above in Days is 48 days while Average Payment Period for the firms is 68 days. The average Cash Conversion Cycle is 11 days with a huge standard deviation of 35.7. The negative CCC is very healthy for the retail businesses as it means that they get paid 11 days earlier by their customers before they pay their creditors Debt Ratio on the other hand is 0.21.

On the Comparative means of various WCM ratios and NOP for each of the companies'. The study found that Apart from Caspian Drilling Company which had a negative mean for Net Operating Profitability of 0.04 all the other retail chains had positive net operating profitability. The best performing in this respect was (mean 0.13) while the least performing was Bosshelf LLC (mean -0.04). Caspian Drilling Company had the least ACP of 5 days while Baku Shipyard LLC had the highest at 14 days. Similarly. Bosshelf LLC had the highest IIID of 116 days while Caspian Drilling Company had the lowest of 28 days. Bosshelf LLC had the highest APP of 96 days while Caspian Drilling Company had the lowest of 41 days. The worst CCC was that of Baku Shipyard LLC of 44 days followed by Statoil of 1 day. All the other marketing firms had negative cash conversion cycles with the lowest being that of Caspian Drilling Company of 48 days. These results suggest the existence of company-specific factors

that potentially affect WCM and NOP. As such, test for fixed effects are carried out in the proceeding sections to verify this.

The study also found that profitability across the firms was highest in 2009 (mean 0.15) and lowest in 2007 (mean 0.04). ACP has remained constant fluctuating between 7 and 10 days. ITID varied above time with the highest being in 2008 and 2011 at 58 days and the lowest being 36 days in 2007. Apart from year 2008 which had a high APP of 80 days. APP remained constant above time at 65 days. CCC was negative for all the years and it fluctuated a lot between 1 day and 29 days. DR on the other hand remained constant for years 2007 and 2008 at 0.15 and then increased to a new level of 0.25 in 2007 and remained in this level until 2010. These findings seem to indicate that these ratios are time-invariant. Again, fixed effects panel data analysis model is used in the next section to verify this.

From the correlation analysis, the study found that there are high correlations between different measures of working capital management. The correlation between ACP and ITID is (0.677), ACP and APP is (0.659), CCC and APP is (-0.655), CCC and ITID is (0.738). To avoid multi-co linearity problem in the regression analysis, stepwise regression is used so that some of those variables that are highly correlated are removed from the model. The correlation coefficient between advantage i.e. financial debt ratio and net operating profitability reveals a negative non-significant relationship between the two variables. This implies that increase in debt utilization by the firms will reduce profitability of the five WCM variables, only CCC and APP have a significant relationship with NOP. CCC has a strong significant positive correlation with NOP (Coefficient 0.548, P Value 0.002). APP on the other hand has a negative strong correlation with NOP (Coefficient -0.63. P-Value 0.000).

The study found that the regression equation for the period 2007 to 2011 to determine the relationship between Working Capital Management and Profitability of retail companies in Azerbaijan were:

$$\text{NOP} = 0.300 - 0.0602 \text{ CCC} + 0.010 \text{ ACP} - 0.011 \text{ ITID} + 0.003 \text{ APP} + 1.174 \text{ DR}$$

From the above summarized regression model for the five years, the study found that there exist a relationship between Working Capital Management and Profitability of companies in Azerbaijan. The study found the intercept to vary though with the highest value being 0.300 and the lowest being -2.626, this mean that profitability of companies' would range between -2.626 and 0.399 holding various factors of working capital management types to a constant zero. The study also found the coefficient of Cash Conversion Cycle, Average Collection Period, Inventory turn above in Days' and Average Payment Period vary from positive to negative. Debt Ratio was found to vary on the positive having it highest coefficient thus highest effect on profitability of companies in Azerbaijan. These findings contradict the findings of Myers and Majlof (1984), Rajan and Zingales (1995), Shin and Soenen (1998) and Deloof (2003) who predicted a negative relationship between advantage and profitability.

From the Adjusted R² the study found that, there was a variation of 100% of profitability of companies in Azerbaijan with changes in working capital management at a confidence level of 95%. This means that 100% of the profits of companies in Azerbaijanis attributable to working capital management. The coefficient of correlation shows that there was a strong relationship between profitability of companies and various factors of working capital management as shown by a factor of 1.

3.2 Conclusions

The study concludes that there exists relationship between Working Capital Management and Profitability of retail companies in Azerbaijan: advantage was found to positively influence the profitability of Companies in Azerbaijan.

3.3 Recommendations

The study recommends that for companies to remain profitable they should have working capital management that will help in making decisions about investment mix and policy, matching investments to objectives, asset allocation for institutions, and balancing risk against profitability. Working capital management techniques in companies should focus more on strategic issues for profitability and the ability to achieve strategic objectives.

3.4 Recommendations for further studies

This study has investigated the impact of working capital management on the profitability of the companies in Azerbaijan. To this end, therefore a further study should be earned out to assess the impact of working capital management on the profitability of other industrial sectors.

3.5 Limitations of the Study

A limitation for the purpose of this research was regarded as a factor that was present and contributed to the researcher getting either inadequate information or

responses or otherwise the response given would have been entirely different from what the researcher expected.

The main limitations of this study were; some was not readily available. This reduced the probability of reaching a more conclusive study. However, conclusions were made with this available data. The size of the sample could have limited confidence in the results and this might limit generalizations to other situations. Time-Due to official duties time was a major concern.

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