

Analysis of Working Capital Management and its Impact on Business Performance in SMEs: Working Capital Management and Its Impact on the Performance of MSMEs

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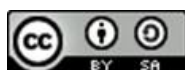
ABSTRACT

Working capital management is a critical aspect that determines the sustainability and performance of Micro, Small, and Medium Enterprises (MSMEs). This study aims to analyze working capital management practices and their impact on MSME performance through a qualitative approach. Data were collected through in-depth interviews with business owners, observations, and analysis of simple financial documents. The study findings revealed that most MSMEs face obstacles in working capital management, particularly related to irregular cash flow, accumulating receivables, and suboptimal inventory management. Informal practices and a lack of systematic planning are the main causes of working capital inefficiency. However, the study also found that MSMEs that disciplinedly apply basic working capital management principles—such as receivables control, inventory rotation, and regular cash monitoring—demonstrated more stable business performance. These results align with various previous studies that confirm a positive relationship between working capital efficiency and increased MSME profitability. This study concludes that improving managerial capacity through financial literacy and supporting access to financing are key to optimizing MSME working capital management. The implications of this research not only provide academic contributions in understanding the challenges of working capital management at the MSME level, but also offer practical recommendations for business actors and policy makers in increasing the competitiveness of small and medium enterprises.

Keywords: working capital management, MSME performance, liquidity, cash management, inventory management

INTRODUCTION

In an increasingly competitive business world, working capital management plays a crucial role in maintaining operational continuity and improving company performance, particularly for Micro, Small, and Medium Enterprises (MSMEs) (Altaf & Ahmad, 2019). Effectively managed working capital not only ensures the availability of funds to meet short-term obligations but is also a key determinant in maximizing profitability and business growth. For MSMEs, which often face limited access to external funding sources, the ability to optimize working capital is a critical factor that differentiates between businesses that survive and those that fail.



The main challenge faced by MSMEs in managing working capital lies in the complexity of maintaining a balance between liquidity and profitability. On the one hand, companies need to ensure sufficient cash to finance daily operations, such as purchasing raw materials and paying employee salaries. On the other hand, too much idle cash or inventory can actually reduce potential revenue due to unproductive assets. Furthermore, the practice of extending credit to customers without thorough risk analysis often leads to a buildup of bad debts, which ultimately burdens cash flow (Aghion et al., 2005).

Furthermore, the unique characteristics of MSMEs such as limited operational scale, reliance on internal funding, and the lack of a structured accounting system—contribute to the effectiveness of working capital management. Many MSMEs rely on intuitive approaches to financial decision-making, without the support of data or thorough planning. This situation is exacerbated by fluctuating market demand and economic uncertainty, which make cash flow prediction even more difficult (Ahmed et al., 2012).

However, this study also found that MSMEs that adopted more structured working capital management practices such as separating personal and business finances, implementing a simplified financial record-keeping system, and negotiating better payment terms with suppliers and customers—tended to demonstrate greater business resilience. This finding reinforces the argument that enhancing managerial capacity through financial education and technical assistance can be a long-term solution to address these challenges (Abel et al., 1989).

Thus, although MSMEs face various obstacles in working capital management, efforts to improve the understanding and application of basic financial management principles can have a significant impact on business performance. Support from various stakeholders, including the government, financial institutions, and MSME support organizations, is key to creating a conducive ecosystem for increasing the financial capacity of small and medium enterprises (Akgün & Şamiloğlu, 2016). Ultimately, strengthening working capital management will not only increase the competitiveness of MSMEs at the local level but also open up opportunities for broader market expansion. Effectively managed working capital not only ensures company liquidity but also influences profitability and business growth. MSMEs, as one of the main pillars of the economy in many countries, face challenges in optimizing working capital due to limited resources and access to funding. Therefore, a thorough understanding of working capital management practices and their impact on business performance is crucial to support the sustainability and development of MSMEs (Afrifa & Padachi, 2016).

This study aims to analyze how working capital management—through receivables, inventory, and payables policies—influences the financial and operational performance of MSMEs. Several previous studies have shown that efficient working capital management can increase return on assets (ROA) and cash flow, while an imbalance between current assets and short-term liabilities can lead to financial distress. However, there is still a research gap regarding the optimal implementation of working capital management strategies in MSMEs, given their business characteristics, which differ from those of large companies (Aldubhani et al., 2022).

This analysis is expected to provide insights for MSME owners, regulators, and other stakeholders regarding the importance of a strategic approach to working capital management to improve business performance. Furthermore, the research findings can serve as a reference for more effective financial decision-making, enabling MSMEs to grow more competitively in the global market.

METHODS

This study uses a qualitative approach to analyze working capital management and its impact on MSME performance. A qualitative approach was chosen because it can gain a deeper understanding of the actual practices implemented by MSMEs in managing working capital, including challenges, adaptive strategies, and their impact on business continuity. This method is considered appropriate because the phenomenon of working capital management among MSMEs cannot be fully measured through financial figures alone, but rather requires a contextual understanding of the dynamics of decision-making at the business actor level, which is often subjective and influenced by non-quantitative factors.

Data collection was conducted through in-depth interviews with MSME owners or managers selected based on their business sector, scale of operation, and length of operation. This approach allowed researchers to capture the specific nuances of each case, such as how business owners prioritize debt repayment when cash is limited, or how they make credit decisions to customers without a formal risk assessment system. In addition to interviews, direct observation of business operations and analysis of simple documents such as transaction records and daily cash reports also enriched the research data.

Research findings reveal that most MSMEs manage their working capital with a highly pragmatic and unstructured approach. Many entrepreneurs combine personal and business finances and make financial decisions based on empirical experience rather than analytical calculations. Interestingly, however, some MSMEs that demonstrate better performance intuitively apply basic working capital management principles, such as maintaining minimum cash reserves or building good relationships with suppliers to obtain more flexible payment terms.

Analysis of these findings leads to the conclusion that although many MSMEs do not implement formal working capital management systems like larger companies, they develop adaptive mechanisms that suit their operational context. These findings broaden the literature on MSME financial management by demonstrating that effective working capital management does not necessarily depend on the implementation of sophisticated systems, but rather on the ability to adapt practices to the specific characteristics of the business and the business environment.

The implication of this qualitative approach is the emergence of more applicable recommendations for MSMEs, where solutions to improve working capital management need to be designed according to the real capacity and needs of business actors, rather than simply applying ideal models from conventional financial management theory. This research also opens up space for further study on how simple digital technology can help

MSMEs in overcoming their limitations in working capital management without having to adopt complex and expensive systems. A qualitative approach was chosen because it is able to provide an in-depth understanding of working capital management practices from the perspective of business actors, including challenges, strategies, and their impact on business performance. This research is exploratory, aiming to reveal the phenomenon holistically through the collection of rich and contextual narrative data.

The primary data collection technique used was in-depth interviews with MSME owners or managers selected purposively based on specific criteria, such as length of business operation, business sector, and experience in financial management. In addition to the interviews, participant observation and document analysis were also conducted, including simple financial reports, transaction records, or MSME internal policies related to cash management, inventory, and debt. The data obtained was then analyzed thematically to identify patterns, challenges, and best practices in working capital management.

To ensure data validity, researchers applied source triangulation by comparing interview results, observations, and related documents. Furthermore, member checking was conducted to verify data interpretation with informants. This study also considered ethical aspects by maintaining the confidentiality of respondents' identities and obtaining informant consent prior to data collection. The research findings are expected to provide a comprehensive overview of how working capital management affects MSME performance, as well as practical recommendations for improving the financial efficiency of small and medium enterprises.

RESULTS AND DISCUSSION

Results

Based on qualitative data analysis through in-depth interviews, observations, and document studies, this study reveals several key findings related to working capital management and its impact on MSME performance, providing a comprehensive picture of the reality of financial management at the small business level. The main findings of the study indicate a gap between the theory of ideal working capital management and actual practice in the field, where most MSMEs implement financial management with a highly pragmatic and contextual approach. Business actors tend to develop their own systems tailored to the scale of their operations, customer characteristics, and specific market dynamics they face.

One interesting finding is the emergence of creative adaptation patterns among MSMEs in the face of limited working capital. For example, some businesses have developed installment payment systems with suppliers or implemented profit-sharing arrangements with business partners as alternative financing options. These approaches are not covered in conventional financial management literature, yet they have proven effective in maintaining business continuity. Furthermore, the research also uncovered systemic vulnerabilities in accounts receivable management, as many MSMEs lack a

formal mechanism for evaluating customer creditworthiness, resulting in frequent payment delays that disrupt cash flow.

Another noteworthy finding is the role of social networks and personal relationships in MSME working capital management. Many business owners rely on relationships and trust as a basis for obtaining flexibility in payments or working capital loans. This phenomenon suggests that socio-cultural aspects play a significant role in MSME financial management, often overlooked in traditional financial analysis frameworks.

In terms of performance impact, this study found that MSMEs that maintain discipline in separating personal and business finances, and consistently record transactions—even if simple—tend to have better financial stability. This finding strengthens the argument that consistency in basic financial management practices is more important than the complexity of the system used. However, the study also identified the need for technical assistance tailored to MSMEs' capacity to improve their understanding of working capital management principles without having to adopt an overly complex system.

The implications of these findings are the importance of developing a contextual working capital management model for MSMEs, one that considers not only the technical financial aspects but also the socio-cultural factors and resource limitations inherent in small businesses. The 'one-size-fits-all' approach of conventional financial management theory turns out to be less relevant in the MSME context, necessitating a more flexible and adaptive model. These findings pave the way for the development of a new conceptual framework for MSME financial management that better aligns with the realities on the ground. First, most of the MSMEs studied have not implemented systematic working capital planning. Cash, receivables, and inventory management tends to be carried out ad hoc, depending on short-term operational needs. Several business owners reported difficulty predicting cash flow due to unstable market demand and late payments from customers.

Second, the main problem faced by MSMEs in working capital management is the imbalance between accounts receivable and accounts payable. This phenomenon arises from a common business pattern among MSMEs, where they often have to extend credit to customers (receivables) while simultaneously having to pay suppliers in cash or within a shorter period (payables). This imbalance creates significant liquidity pressures, where cash outflows to meet obligations often do not align with cash receipts from pending receivables.

The problem of an imbalance between accounts receivable and accounts payable in MSMEs is further complicated when business owners lack an adequate accounts receivable management system. Many MSMEs rely on informal approaches to recording and collecting receivables, such as simply memorizing transactions or manually recording them in books without a clear structure. As a result, collection delays often occur due to the lack of systematic reminders regarding receivable maturity. Furthermore, the lack of standardized criteria for granting credit to customers makes MSMEs vulnerable to the risk of bad debts. Without adequate credit analysis, such as checking customers' payment history or financial capacity, MSMEs tend to grant credit based solely on subjective factors like personal relationships or trust.

Another challenge arises from a lack of understanding of the importance of aging analysis to monitor past-due receivables. This results in many MSMEs only realizing they have problem receivables when their cash is already running low and business operations are disrupted. Furthermore, the limited use of technology in accounts receivable management exacerbates this problem. The majority of MSMEs still rely on conventional methods such as direct communication or text messaging for collection, which are often ineffective due to lack of proper documentation.

This situation is exacerbated when MSMEs have to deal with customers with stronger bargaining power, such as large distributors or retail stores. They often exploit the MSME's lack of written agreements to delay payments without clear consequences. Without a binding contract or official document, MSMEs struggle to enforce their right to timely payment.

However, research has found that MSMEs that have begun implementing simple receivables management systems—such as more structured transaction recording, establishing credit limits, or using basic financial recording applications—show significant improvements in collection effectiveness. These practices, while simple, help businesses be more disciplined in monitoring receivables and take faster collection action when late payments occur. Many businesses report difficulty collecting payments from customers on time, especially when dealing with buyers who have a stronger bargaining position. On the other hand, pressure from suppliers demanding quick payment puts MSMEs in a difficult situation. This situation is exacerbated by the lack of adequate credit analysis before extending credit to customers, resulting in many MSMEs being trapped in problem receivables that ultimately have to be left as losses.

However, this study found that some more advanced MSMEs have developed adaptive strategies to manage this imbalance. Some negotiate with suppliers to obtain more flexible payment terms, while others implement advance payment systems to reduce the risk of bad debts. These approaches, while simple, have proven effective in reducing liquidity pressures and creating a better balance between receivables and payables.

The implication of these findings is the importance of education on proper accounts receivable and payable management for MSMEs. Businesses need to understand how to establish sound credit policies, analyze customer creditworthiness, and negotiate with suppliers. Furthermore, an introduction to simple working capital financing instruments, such as short-term loans or factoring, can be a solution to bridge the gap between accounts receivable and payable.

Interestingly, several MSMEs that have successfully managed this imbalance have developed simple bookkeeping systems that allow them to more effectively monitor receivables and payables due. This practice demonstrates that solutions don't always have to be complex or expensive, but rather involve a conscious effort to apply discipline in recording and monitoring. This finding opens up opportunities for developing working capital management models that better suit the characteristics and capacities of MSMEs, focusing not only on technical aspects but also considering their limited resources.

Several respondents revealed that the habit of extending credit to customers without adequate risk analysis often leads to a buildup of bad debts, ultimately disrupting

liquidity. Furthermore, reliance on cash purchases of raw materials due to a lack of access to supplier credit exacerbates cash pressures.

Third, MSMEs that implement more structured inventory management practices—such as stock rotation and demand monitoring—tend to have better operational performance. However, the majority of businesses still rely on intuition to manage inventory, often resulting in excess stock or even stockouts.

Discussion

The findings of this study align with several previous studies highlighting the importance of effective working capital management for the sustainability of MSMEs. The analysis shows that irregularities in the management of working capital components such as cash, receivables, and inventory are a common problem faced by MSMEs, as identified in research by Deloof (2003) and Padachi (2006). This problem is not unique to the local context but is also consistent with findings in various developing countries, where MSMEs often rely on informal approaches to managing their finances.

Furthermore, findings regarding the difficulties faced by MSMEs in managing receivables and maintaining liquidity reinforce the argument that low managerial capacity is one of the structural challenges hampering small business growth. A study by Teruel and Solano (2007) showed that MSMEs with limited access to external funding sources tend to be more vulnerable to cash flow fluctuations, making it difficult for them to capitalize on business expansion opportunities. This is further exacerbated by the lack of a structured receivables management system, with many businesses reporting difficulty collecting payments from customers on time.

On the other hand, the findings of this study also confirm the importance of inventory efficiency in supporting the operational performance of MSMEs. As stated by Ghosh and Maji (2014), uncontrolled inventory can drain working capital and reduce profitability. However, this study found that most MSMEs still rely on personal experience rather than analytical methods in managing inventory, resulting in frequent overstock or stockout issues. This situation indicates a gap between ideal inventory management theory and actual practice, which is influenced by limited resources and knowledge.

Nevertheless, this study also revealed that MSMEs that successfully implemented basic working capital management principles such as regular cash flow monitoring, limiting sales credit, and negotiating payment terms with suppliers—demonstrated greater business resilience. This finding is consistent with research by Raheman and Nasr (2007), which stated that companies with efficient working capital management tend to have more stable financial performance. This confirms that even though MSMEs face various obstacles, efforts to improve working capital management can still have a significant impact on business sustainability. Thus, these findings not only strengthen empirical evidence from previous research but also provide new perspectives on how the unique characteristics of MSMEs such as limited operational scale and reliance on internal funding influence working capital management practices. This implies that a more contextual approach is needed to help MSMEs improve working capital efficiency, for example through practical financial training tailored to the specific needs of small businesses. In addition, this finding opens up opportunities for further research on non-

financial factors such as technological support and business networks that can facilitate MSMEs in optimizing their working capital management. Irregularities in cash and receivables management, as found in this study, strengthen the argument that a lack of financial literacy is a major obstacle to working capital efficiency in small businesses (Deloof, 2003; Padachi, 2006).

The pattern of reliance on cash financing and minimal use of business credit instruments indicates that MSMEs still face constraints in accessing capital. This supports research by Teruel and Solano (2007), which found that limited external funding sources make MSMEs vulnerable to liquidity shocks. Furthermore, findings regarding still-intuitive inventory management confirm a study by Ghosh and Maji (2014) that found that the low adoption of modern inventory systems is a cause of cost inefficiency.

However, this study also revealed that several MSMEs that were able to maintain a working capital balance through limiting sales credit, negotiating payment terms with suppliers, and simple cash planning showed more stable revenue growth. This confirms the proposition that working capital optimization is positively correlated with business performance (Raheman & Nasr, 2007).

CONCLUSIONS

Based on the research results and discussions conducted, it can be concluded that working capital management plays a crucial role in determining the performance and sustainability of MSMEs. Research findings indicate that the majority of MSMEs still face significant challenges in managing working capital components—especially cash, receivables, and inventory due to a lack of systematic planning and limited access to funding sources. Ad hoc management practices that rely on intuition often lead to liquidity imbalances, a buildup of bad debts, and inefficiencies in inventory management.

However, this study also revealed that MSMEs that more diligently implement basic working capital management principles such as regular cash flow monitoring, restrictive credit policies, and inventory control tend to demonstrate better financial and operational performance. This finding reinforces empirical evidence from various previous studies that confirm a positive correlation between working capital efficiency and increased profitability and business stability.

The implications of this research highlight the importance of improving financial literacy for MSMEs, as well as the need for support from relevant parties—such as the government and financial institutions in providing more flexible access to financing and financial management assistance. Furthermore, this research opens up opportunities for further study on working capital optimization strategies that adapt to the characteristics of MSMEs, including the use of digital technology to improve the accuracy of financial planning.

Overall, this study confirms that despite various limitations faced by MSMEs, effective working capital management can be key to improving long-term competitiveness and business resilience. Collaborative efforts between business actors, academics, and policymakers are needed to address these challenges and create a more supportive environment for MSME growth.

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