

Working Capital Management Policy and Profitability: An Empirical Study

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Abstract: *Management of working capital is an important tool to avoid business as well as financial risk. The effective working capital management includes the proper management of current assets and current liabilities. The working capital management policy is a key point that determines the volume of current assets and current liabilities with respect to total assets. On the basis of current liabilities working capital management policy indicates the working capital financing policy and on the basis of current assets it indicates the working capital investment policy. The strategy in respect of Working capital financing and working capital investment policy is different in different industrial sectors. This study tries to investigate the proper mix of working capital financing policy and working capital investment policy followed by textile industry listed under Bombay stock exchange. The sample of this study includes 43 textile sectors over the period of 2006 to 2017. The result of this study indicates Working capital investment policy has significant negative effect on profitability and working capital financing policy has also negative effect on profitability.]*

Keywords: *Working capital financing, Return on Assets, Profitability, Pooled Regression Analysis, Working Capital Management Policy*

I. INTRODUCTION INCLUDING OBJECTIVES

Working capital management is a fundamental instrument and as a component of overall corporate strategy it helps to maximize the firms' value. A firm mobilizes finance from long term as well as short term sources. The collected finance is used in fixed and also in current assets for running the business. A great part of the long term finance is used in the fixed assets. On the other hand a small part of long term finance and whole part of short term finance is employed in current assets to fulfill the daily financial need of business. By selecting the optimum mix of working capital financing and investment policy a finance manager can reach the goal of the value maximization. Current assets which are the part of total assets need to be minutely analyzed. Excess investment in current assets confirms the sound liquidity and consequently less risky. On the other hand low investments in current assets explain the liquidity crisis and signify the riskiness of the firm. As a part of current assets inventory play a great role in liquidity and profitability. It can be judged with the help of Quick ratio and Current ratio. A long gap between Quick ratio and Current ratio indicates that firms are maintaining large inventory. Therefore, large amount is blocked in the form of inventory within working capital (Das and Dhar, 2018).

Investment in long term assets is concerned with capital budgeting and capital structure planning. Management of firm's short term assets and liabilities is the functional area of finance. Firm with high liquidity profile is less risky than the low liquidity position of business. It is philosophically true that high risky firm earns more profit than the less risky firm. Therefore a tradeoff between liquidity and profitability is absolutely urgent for management. The optimization of working capital financing and its investment can help the finance manager to maintain a balance between liquidity and profitability.

The level of current liabilities from where finance, required for running business, is collected is called working capital financing. Working capital investment policy refers the level of current assets in which finance collected from current liabilities is invested. Therefore, the level of current assets and current liabilities are called together working capital policy. This is the situation of both working capital financing and working capital investment policy.

II. OBJECTIVES OF THE STUDY

A. *This Study Is Conducted For The Following Objectives*

- 1) To review the earlier empirical study.
- 2) To study the basic concept on working capital management policy.
- 3) To examine the effect of working capital management policy on profitability.

4) To provide valuable suggestion and recommendation for practicing manager in making optimum working capital policy.

The other part of the paper is structured as follow. Section-2 outlines the working Capital management-conceptual Issues. Section-3 reviews the earlier research study. In section- 4 explains the methodology of research work, Section-5 Result and Analysis. The empirical analyses are explained in section-6 and concluding part in the section-7.

B. Working Capital Management Policy: Conceptual Issues

Current assets are the short term investment for running operating activities of a firm. These assets are important components of total assets. A firm may squeeze its investment in fixed assets by taking lease or rented plant and machinery. But same policy cannot be adopted for current assets. The decision regarding volume of current assets and its financing from short term as well as long term sources is known as working capital policy. Working investment policy and working capital financing policy are jointly called working capital policy (Weinraub and Visscher, 1998).

C. Working Capital Investment Policy

A firm needs more current assets to increase the volume of production or sales. If a firm bears high level of current assets in relation to sales it is conservative current assets policy (CCAP). Aggressive current assets policy (ACAP) is a situation where a firm maintain low level of current assets in relation to sales. On the other hand if a firm have neither very high nor very low level of current assets it is moderate current assets policy (Chandra, 1993; Banerjee, 1993).

Some experts have explained the aggressiveness of working capital investment policy in respect of total assets. The ratio of total current assets to total assets (TCA/TA) is termed as working capital investment policy (Mwangi et al., 2014; Nazir and Afza, 2009; Vahid, Mohsen and Mohammadreza, 2012; AL- Shubiri, 2011). A low ratio of (TCA/TA) indicates an aggressive investment policy and higher value of this ratio indicates lower the degree of aggressiveness. In the aggressive investment policy the investment in current assets is poor but in conservative situation investment in current assets is very high.

D. Working capital financing Policy

Working capital financing Policy is the ratio of total current liabilities to total assets (TCL/TA). It identify the share of current liabilities in total sources of financing (Mwangi et al., 2014; Nazir and Afza, 2009; Vahid, Mohsen and Mohammadreza, 2012; AL- Shubiri, 2011). The higher value of this ratio indicates the higher aggressive financing policy on the contra lower the ratio indicates the conservative financing policy.

Optimum combination of current assets and current liabilities is condition to maintain the healthy situation in business. The different proportion of Current liabilities and current assets separated the working capital policy into three types. These are overall conservative policy, overall aggressive policy and moderate policy.

E. Review of Literature

Different types of studies have made on working capital management. Some of these studies have taken the components of cash conversion cycle (CCC). These components are inventory conversion period (ICP), debtors' conversion period (DCP) and accounts payable period (APP). But there has not been found any notable study in the Indian context on working capital policy. However some of the studies have been done on the topic of working capital policy outside India. We briefly review of these studies as follow:

AL- Shubiri (2011) found that there is a negative relationship between profitability and degree of aggressiveness of working capital policy. This relation is established by an empirical study on Jordanian Industrial companies. The study has considered 59 industrial companies listed in Amman Stock Exchange. The collected secondary data for four years from 2004 to 2007 have been analyzed using two independent variables such as aggressive investment policy (AIP) and aggressive financing policy (AFP). On the other side return on assets (ROA) and return on equity (ROE) and Tobin's Q are selected as dependent variables. By the use of regression analysis this study showed a negative relationship between profitability and aggressive working capital policy. The study recommended that the practicing manager should have proper idea about the source of financing and temporary investment avenues to appropriately manage the short-term funds. The study also suggests that there should remain sufficient current assets in excess of current liabilities. This study suffers from some limitations. The selected sample is very small and study period is very short.

Similar types of study have been done in the context of Impact of Aggressive Working Capital Management Policy on Firms' Profitability by Nazir and Afza, (2009) by considering the same variables and the result also show that degree of aggressiveness of working capital policy and profitability inversely related. Thakur (2017) has tried to analyze the relation between working capital

policy and profitability. The study has considered 80 manufacturing firms listed in Dhaka stock exchange (DSE). The sample companies are categories into 8 different group according to the nature of activities such as food and allied, textile, engineering, cement, ceramics, fuel and power, jute, paper and printing, pharmaceutical and chemical, and tannery. The secondary data were collected over a period of six years from 2009 to 2014. The study indicates that there is a negative relationship between profitability and aggressive working capital financing policy. It was recommended that firm should follow low level of current liabilities. Mwangi et al. (2014) conducted a study to observe the impact of working capital management on financial performance of listed companies in Kenya. The study used the (TCL/TA) and (TCA/TA) as a proxy of working capital financing policy and working capital investment policy respectively and on the other hand return on assets (ROA) and return on equity (ROE) are used as a proxy of firms' performance. The 42 non-financial companies listed in Nairobi Securities Exchange (NSE) are selected for this study as sample and published data for the period seven years covering the year 2006 to 2012 have been considered. The result reveals that working capital financing policy has positive impact on ROA which is not consistent with the result found from the study of Afza and Nazira (2007). The results indicate the negative relationship between working capital investment policy and ROA. This observation of the study is resemblance with the results of the several studies (Afza and Nazira, 2007; Vahid, Mohsen and Mohammadreza, 2012). This study also concludes that working capital financing policy (TCL/TA) and ROE are not significantly related. These results are not in conformity with the result of study of Vahid, Mohsen and Mohammadreza (2012). Hassani and Tavosi (2014) investigated the effect of working capital policies on profitability. The study has taken the sample of 274 companies listed in Tehran Stock Exchange for the period of six years from 2006 to 2012. To observe the effect of working capital policy this study has considered two independent variables viz., investment policy (CA/TA) and financing policy (CL/TA), four dependent variables viz., absolute deviation in respect of return on assets (AD ROA), return on equity (ADROE), return on investment (ADROI), and return on capital (ADROC). On the other hand four control variables viz., size, sales growth leverage and net working capital to total assets (WCTA) are selected for the purpose of the study. Using regression model this study depicted that profitability and working capital investment policy is inversely related. It is also observed that working capital financing policy and profitability risk is directly related.

F. Sample And Hypotheses Including Research Methodology

- 1) *Sample and Data:* This study is conducted on 43 textile sectors listed in Bombay Stock Exchange (BSE). The data was collected from secondary sources for 12 years period from 2005-06 to 2016-17 using PROWESS database. Thus a balance data set of 516 firm year observations is contained in this study. To maintain the homogeneity only textile sectors are selected for this study.
- 2) *Variable of the Study:* The variables selected for this study are of three types that are considered after analyzing the earlier studies. These are Dependent variables, Independent variables and Control variables. The dependent variables measure the profitability of the sample company. The independent variables are related with working capital policy. The item wise list of variables are listed in the Table-1

Table-1: Different Variables for this Study

Dependent variables	Independent Variables	Control Variables
Return on Assets (ROA)	Working Capital Financing Policy (WCFP)	Natural Logarithm of Sales (Size)
Return on Equity (ROE)	Working Capital Investment Policy (WCIP)	Sale Growth (Growth)
		Debt to equity ratio (D/E)
		Current liabilities to total capital (CLTC)

Both working capital financing policy and investment policy may be either aggressive or conservative in nature. Degree of aggressiveness in investment is measured by the volume of current assets. Higher the volume of current assets indicates the lower degree of aggressiveness and lower the amount of current assets higher the degree of aggressiveness. In case of working capital financing policy higher the amount of current liabilities indicates the lower degree of aggressiveness and vice versa. All selected variables are interpreted in Table-2.

Table-2: Interpretation of Variables

Variables	Interpretation
Return on Assets (ROA)	Profit before interest and taxes/ Total Assets
Return on Equity (ROE)	Profit after interest and taxes/ Equity capital
Working Capital Financing Policy (WCFP)	Current Liabilities/Total Assets
Working Capital Investment Policy (WCIP)	Current Assets/ Total Assets
Natural Logarithm of Sales (Size)	Ln(Sales)
Sale Growth (Growth)	$(\text{Sale}_1 - \text{Sale}_0) / \text{Sale}_0$
Net working capital to Total Assets (WCTA)	Net working Capital/Total Assets
Current liabilities to Total Capital (CLTC)	Current liabilities/Total Capital

3) Statistical Tools: To analyze the collected data specific statistical tools were used. The nature of secondary data is analyzed with the help of descriptive statistics. Pearson’s correlation is used to find the relations amongst the variables. This study uses some formal test to justify the problems of heterosecdasticity and multicollinearity within the variables. By using multiple regressions analysis (OLS) the impact of working capital policy on profitability has been measured.

III. RESULTS AND ANALYSIS

A. Test of Homosecdasticity

1) H_0 : Variables have constant variance: Heterosecdasticity is a condition where the variability of the variable is not equal across the range of values of the second variable that predict it. In regression analysis a good regression is possible in case of homosecdasticity of data. Therefore, heterosecdasticity is a problem in ordinary least square (OLS) regression. In homosecdasticity situation the residuals should have a constant variance. Table-1 depicts the result of Glejser test where absolute value of residuals is considered as independent variable and WCFP, WCIP, Size, Growth, CL/TC and D/E are considered as dependent variables. The null hypothesis is accepted due to the sig. value of all variable are greater than 0.05. Therefore the variables have constant variance and free from the problems of heterosecdasticity.

Table-3: Glejser test of Heterosecdasticity

	Coefficients ^a				t	Sig.
	Unstandardized Coefficients		Standardized Coefficients			
	B	Std. Error				
(Constant)	3.422	1.558		2.197	.028	
WCFP	3.128	1.857	.099	1.684	.093	
WCIP	9.235	2.111	.274	4.375	.070	
Size	.197	.433	.022	.456	.649	
Growth	-.728	.811	-.039	-.898	.370	
CL/TC	-.019	.024	-.036	-.777	.437	
D/E	-.008	.021	-.016	-.384	.701	

a. Dependent Variable: ABS(Residual)

Source: Computed from collected Data

B. Test of Multicollinearity

Variance Inflation Factor (VIF), the actual disparity to total disparity, is used to test the multicollinearity among the independent variable. Multicollinearity refers the perfect or exact linear relationship among some or all explanatory variables of a regression model. The variances and co-variances can be observed by the value of variance-inflating factor (VIF). If the values of VIF lie between one (1) to ten (10) then there exists no multicollinearity with in the explanatory variables. The result of Table-4 exhibits that value of VIF of each explanatory variable is not less than 1 and not more than 10. Therefore there found no multicollinearity among the variables and collinearity can not be a problem for the present model.

Table-4: Test of Multicollinearity

	Coefficients ^a						
	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	6.263	1.773		3.532	.000		
WCFP	-12.325	2.270	-.315	-5.428	.000	.496	2.017
WCIP	.985	2.409	.025	.409	.683	.443	2.255
CL/TC	.080	.027	.136	2.914	.004	.767	1.303
Size	-.493	.491	-.048	-1.003	.316	.719	1.390
Growth	3.463	.917	.162	3.776	.000	.906	1.104
D/E	-.081	.023	-.144	-3.475	.001	.972	1.029

a. Dependent Variable: ROA

Source: Computed from collected Data

C. Descriptive Statistics

During the period of descriptive analysis the result shows the average and standard deviation of different variables of the study. In this part of analysis we have also maximum and minimum values. To justify the nature of variables this study also taken skewness and kurtosis. Table-5 depicts the descriptive statistical value of profitability measurement factors considered in this study. The average value of ROA for the study period is 3.59% the range of this value is (-) 30.54% to 52.64%. This indicates those firms involved in this industry are generating return on assets. The standard deviation from the average value is 6.88 that revealed that several firms are earning profit around this average value. The returns on asset of the maximum firm are on the positive direction because of positive value of skewness. The quantum of skewness of this variable is low. This table also depicts the trend of return on net worth (RONW), the other profitability measurement factor. Its mean value is 8.8% within the range of (-) 78.46% to 54.49%. The values of Std. Deviation explain the great variability of this value from mean.

Table-5: Descriptive Statistics of Profitability

	N	Range		Mean	Std. Deviation	Skewness	Kurtosis
		Max.	Mini.				
RONW	516	-78.46	54.49	8.8031	17.53310	-1.279	4.453
ROA	516	-30.54	52.64	3.5580	6.88048	0.296	6.528

Source: Computed from collected Data

The Table-6 analyzes the descriptive statistics of independent variables for a period of 12 years from 2006 to 2017 for 516 observations. The working capital management policy is measured by the two variables. These are WCFP and WCIP. The average value of working capital financing policy is 0.14 with minimum value zero to maximum value 0.98. Considering the mean value of WCFP it can be explained that firms are following conservative policy in working capital financing. In case of WCIP mean value is .18 with minimum value zero to maximum value 0.99 and standard deviation is 0.17. In the context of investment in working capital firms have taken the aggressive policy. This policy reveals that firms are investing less working capital in current assets which in return effect adversely on volume of sale as well as profitability.

The result also reveals that mean value CL/TC is 7.71 times maximum value 91.27 and minimum value is .07 distribution indicates that this variable is positively skewed and leptokurtic. The mean value of size is 3.36 its minimum value is .6 and maximum value is 5.09. But this variable is negatively skewed. In evaluating growth factor it is seen that the average value is 0.06 with minimum value (-) 3.75 and maximum value 0.95. This variable is also negatively skewed. The most important control variable is D/E. Its mean value is 1.96 with minimum value zero to maximum value 43.13.

Table-6: Descriptive Statistics of independent variables

	N	Minimum	Maximum	Mean	Std. Deviation	Skewness	Kurtosis
WCFP	516	0.00	0.98	0.14	0.15	2.5	8.04
WCIP	516	0.00	0.99	0.18	0.17	2.3	6.16
CL/TC	516	0.07	91.27	7.71	11.74	3.34	15.34
Size	516	0.60	5.09	3.36	0.67	-0.41	0.82
Growth	516	-3.75	0.95	0.06	0.32	-4.64	44.87
D/E	516	0.00	43.13	1.96	3.25	6.18	59.02

Source: Computed from collected Data

D. Correlation

Table-7 analyzed the strength of linear association amongst independent and control variables. We have not found the correlation coefficient between independent variables more than 0.80. This represents the non-multicollinearity among the independent variables.

Table-7: Correlations analysis

	WCFP	WCIP	Size	Growth	CL/TC	D/E	RONW	ROA
WCFP	1.000							
WCIP	.654*	1.000						
Size	.032	-.268*	1.000					
Growth	-.143	-.246*	-.041	1.000				
CL/TC	.545*	.360*	.011	-.018	1.000			
D/E	.109*	.073	-.047	.060	.019	1.000		
RONW	-.108*	-.157*	-.075	.192*	-.010	-.170*	1.000	
ROA	-.276*	-.175*	-.078	.191*	-.093	-.162*	.715*	1.000

Asured by RONW and ROA) and working capital management policy (measured by WCFP and WCIP) and other control variables. The correlation co-efficient between RONW and WCFP is (-).108 that implies WCFP has negative effect on RONW. This relationship is significant at 0.01 levels. The coefficient of correlation between WCIP and RONW is (-) 0.157. This implies a negative and significant relationship at 0.01 levels.

Similarly the result also identifies the negative and significant correlation within working capital financing policy and investment policy and ROA. The impact of working capital investment policy on ROA confirm the result of the study conduct by Hassani and Tavosi (2014) in the context of Teheran Stock exchange but not confirm the result of working capital financing policy. Furthermore there we find a positive and significant correlation between profitability and Growth. CL/TC ratio has a weak and negative correlation with profitability but the relation is not significant.

The impact of working capital financing and working capital investment policy on profitability is measured by the use of regression analysis. The profitability is assessed by using two variables. These are return on net worth (RONW) and return on assets (ROA). WCIP, WCFP, Size, Growth, CL/TC, D/E are considered as independent variables. Model-1 depict that WCFP, Growth and CL/TC have positive effect on RONW. But the effect of WCFP is not statistically significant. Therefore, working capital financing policies have negative effect on profitability. The higher the ratio of WCFP lowers the RONW. This indicates that firm will follow conservative working capital financing policy. Same type of result is found in case of Model-2 where WCFP is negatively related with ROA and which is statistically significant.

The other variables like WCIP, Size and D/E have negative effect on RONW. The effects of these variables are statistically significant. Here we found that working capital investment policy have negative relationship with RONW. The low ratio of WCIP specifies an aggressive investment policy and higher value of this ratio is the lower the degree of aggressiveness. The profitability of the firm in respect of working capital investment policy will be better if the firm follow aggressive investment policy in current

assets. In conservative working capital investment policy profitability will decrease. In model-2 it is seen that WCIP have also negative effect on ROA which is also statistically significant.

Table-8: Regression Model-1

Coefficients ^a						
Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	
	B	Std. Error	Beta			
1	(Constant)	18.379	4.602		3.994	.000
	WCFP	3.783	5.484	0.041	0.690	.491
	WCIP	-17.385	6.235	-0.177	-2.788	.005
	Size	-2.451	1.279	-0.094	-1.916	.056
	Growth	9.262	2.395	0.170	3.868	.000
	CL/TC	0.188	0.070	0.126	2.674	.008
	D/E	-.259	0.061	-0.181	-4.269	.000
	<i>R</i> = .321 <i>R Square</i> = .233 <i>Adjusted R Square</i> = .215 <i>F</i> = 25.77 (<i>df1</i> = 6, <i>df2</i> = 509) <i>F(Sig.)</i> = .000					

a. Dependent Variable: RONW Source: Computed from collected Data

It is found from the model-1 that the value of F-statistic is value 25.77 and the probability of F-statistic is 0.000 which is less than 0.05. Therefore overall model is significant. The model-2 also gives a picture of same result. It is observed from both the model that at 95% confidence level working capital management policy has a significant effect on RONW and ROA.

Table-9: Regression Model-2

Coefficients ^a						
Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	
	B	Std. Error	Beta			
2	(Constant)	5.872	1.803		3.256	.001
	WCFP	-5.956	2.149	-.164	-2.771	.006
	WCIP	-1.339	2.443	-.035	-0.548	.040
	Size	-0.444	0.501	-.043	-0.885	.377
	Growth	3.756	0.938	0.176	4.003	.000
	CL/TC	0.052	0.028	0.089	1.887	.060
	D/E	-0.091	0.024	-.162	-3.827	.000
	<i>R</i> = .325 <i>R Square</i> = .258 <i>Adjusted R Square</i> = .235 <i>F</i> = 29.47 (<i>df1</i> = 6, <i>df2</i> = 509) <i>F(Sig.)</i> = .000					

Dependent Variable: ROA Source: Computed from collected Data

The value of R-square is .233 and .258 in models-1 and Model-2 respectively. It shows that 23% and 25% of total variation in RONW and ROA can be explained by WCFP, WCIP, Size, Growth, CL/TC, and D/E respectively while the remaining 77% and 75% is explained by the error term.

IV. CONCLUSION

The profitability, liquidity, investment portfolio and financing composition are influenced by the management of working capital. To make a study on management of working capital of Indian textile sector we found some crucial point of working capital management policy. Working capital investment policy has significant negative relationship with profitability. Therefore, it may conclude that if the firm practiced aggressive investment policy, the profitability position in respect of RONW and ROA of Indian textile sector will better. Hence the management has to impress a closer attention to aggressive investment policy due to profitability concern.

The management of these sectors needs to plan and control the current assets and current liabilities in efficient way. In respect of study it is also found that the working capital financing policy has also negative effect on profitability. This means higher the ratio of WCFP higher is the current liabilities and higher aggressiveness in working capital financing. On the basis of result it is found that if the firm pursues aggressive financing policy the RONW and ROA of Indian textile sector will reduce severely. Therefore the study recommends that management should reduce the volume of current assets and volume of current liabilities that will enhance the profitability of the Indian Textile sectors.

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