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Nexus Between Firm Performance and Cash Conversion Cycle: Evidence from Pakistan

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ABSTRACT

The purpose of the research is to investigate the impact of cash conversion cycle on the performance of the Pakistani textile listed firms. In this study, the data of 80 firms between the years 2011 and 2020 were utilized and amounted to 800 observations. Findings show that the effect of cash conversion cycle on the return on assets are negative and significant. There are also regression findings which provide that cash conversion cycle has negative but non-significant impact on performance earnings per share. This imply that companies associated with textile industry of Pakistan, are required to reduce the cash conversion cycle to improve the company performance. This research makes theoretical contributions that reduce the length of cash conversion cycle, enhance the performance of the firm which was associated with the effective working capital management. Based on control variables, asset turnover has positive and debt ratio has negative and significant influence on the earnings per share and return on assets. This study finding can be applied by policy makers and investors in decision making
Key words: *Return on assets, Earnings per share, cash conversion cycle*

INTRODUCTION

Corporate finance has the long-term objective of maximizing the shareholder value, a goal that has always been emphasized in the history of corporate finance. The decisions regarding capital structure, capital budgeting, dividend decisions, and others can be considered as instrumental in the achievement of this long-term business objective. Nonetheless, we cannot deny that the short-term objective adoption assists a corporation in realizing its long-term objectives. Liquidity management, which is commonly referred to as working capital management (WCM), is one of the most important decisions that a firm has to make country of its short term. The WCM theory presented by Richards and Laughlin (1980) is based on traditional currency conversion cycle (CCC) theories. WCM elements, and especially CCC, play a central role in the liquidity, solvency and profitability of the company (Deepak, 2004). The WCM has been examined in many ways by academics. Various researches examined the impact of optimal inventory management and other researchers examined the relevance of receivables management in the process of determining and speculating how to maximize profit (Besley and Meyer, 1987; Lazaridis and Tryfonidis, 2006). Another factor of liquidity that is significant is the trade credit, which enables a company to test

the quality of the product then proceed to pay (Long et al., 1993; Raheman and Nasr, 2007). As several studies have indicated, managers dedicate a significant portion of work on the day to day short term capital management decisions, due to the fact that current assets are investments in short-term assets that are constantly converted to other assets (Rao, 1989).

Cash cycle is a significant pointer since it connects the operations of inbound materials in terms of manufacturing processes, suppliers and outbound operations of distribution and sales to customers. Consequently, managers should know the quality of CCC measure and its importance as a financial and supply chain measure (Farris II and Hutchison, 2002). In the case of manufacturing companies, CCC refers to the period between the time of payment of cash on the purchases of raw materials and resalable goods and the time of conversion of receivables into cash generated out of the sale of the goods (Khan and Jain, 2011; Rahmatika and Kholid, 2021). CCC is commonly differentiated as a fixed measure of corporate liquidity in terms of its time or flow aspect. The gap between the inventory conversion time and the outstanding days of the receivables minus the average days which it will take to convert the payables into payment is the gap. The greater the value of CCC the higher the investment in the working capital of the firm (Abuzayed, 2012). Two measures of liquidity that consider the values of the balance sheet at rest are CR and acid test (QR). Although these are traditional measures that help in determining the capacity of a company to meet its commitments once they become payable, they do not provide a measure of cash management competence of a company (Moss and Stine, 1993). Manufacturing businesses retain a big proportion of their resources in current assets. A manufacturing firm has more than half of the total assets in current assets (Raheman and Nasr, 2007).

Consequently, one of the key aspects that a decision-maker should consider is the present-day asset management that could enhance the profitability of the company. A wealth of literature has been developed to determine the effect of the CCC on the profitability of companies in diverse manufacturing sectors, and its outcomes are both adverse as well as beneficial, both negligible as well as impactful. Negative significant effects of CCC on the profitability of the corporation have been identified in Chang (2018), Linh and Mohanlingam (2018), Al-Mohareb (2019), Jaworski and Czerwonka (2022), Maduka et al. (2022), and Mandalaputri et al. (2021). Contrarily, Lin and Lin (2021) and Amahalu and Beatrice (2017) found a significant positive effect of the cash cycle on the profitability of a firm, and AL-Zararee et al. (2021), Kasozi (2017), Mbathi et al. (2021), and Chowdhury et al. (2018) found no impact.

More importantly, previous empirical studies of the association between working capital and performance were anchored on the cumulative sample of non-financial enterprises and not on analysis of the impact with data of a particular economic group. To fill this gap, the paper examines the effects of working capital on the performance of textile companies on the Pakistan Stock Exchange Limited (PSX). The primary reason to choose the textile industry is that it is the largest manufacturing roadshow in Pakistan and one of the principal GDP contributors, with a substantial labor force and using 40 percent of debt available in the manufacturing industry (Sheikh et al., 2016).

Very little research focusing on the Pakistani textile industry has attempted to examine the effectiveness of working capital on performance, and the findings are inconsistent. Sheikh et al., (2016), Tahir and Anur (2016) and Yousaf et al., (2023) have discovered positive and significant, whereas Ansar and Qaisar (2013) have discovered negative and significant impact to the firm performance. This study adds up in the field of literature pertaining to textile sector of Pakistan in the following ways. To begin with, this study utilized current data 2011-2020. Finally, earnings per share (EPS) was used as a dependent variable in this research.

In this research, it is expected that the results of this study will inform the minds of managers about the contribution of the cash conversion cycle to the performance of the companies.

The rest of the paper is structured in the following way. The second part of the paper will talk about empirical research on the relationship between CCC and performance done in the past.

The third section is that of sample and technique. The fourth section provides the results. The fifth section is discussion and conclusion where references are added at the bottom.

LITERATURE REVIEW

Liquidity management is among the critical needs of normal operations of a company with or without size or structure since it is the capability of the firm to fulfill the existing obligations and cover the operating expenses. Consequently, the liquidity management strategy of the corporation can significantly affect the financial performance. Past studies, primarily addressing the issue of WCM, explored various issues that determine the liquidity status of a firm and whether it will affect its performance. The past studies on the problem of WCM discussed a range of parameters indicating liquidity and their influence on the financial performance of a company. Over the past years, many scholars have utilized the CCC as a vibrant and useful tool in measuring the level of liquidity of the firm. The CCC has been viewed as one of the most effective methods to examine the liquidity management of business firms and many empirical studies have indicated that fluctuations in the profitability of a firm are caused by the CCC.

The CCC technique is discovered to be one of the influencing variables of the firm's profitability utilizing several proxies (Anser and Malik, 2013; Gill et al., 2011; Panigrahi, 2013). Several empirical research has investigated the relationship between the CCC and profitability and discovered a significant negative relationship (Anser and Malik, 2013; Attari and Raza, 2012; Chowdhury et al., 2018; Farris II and Hutchison, 2002; Quayyum, 2011). The CCC also has a significant impact on the firm's worth (Gentry et al. 1990). Effective CCC management gives managers more control over a company's short-term investments, which can affect risk, profitability, and firm value (Ebben and Johnson, 2011; Peel et al., 2000). Moss and Stine reported that the CCCs of larger retail enterprises were shorter. They also concluded that small retail enterprises are more likely to enhance their CCC by implementing measures that reduce inventory conversion time, receivable conversion time, or both (Moss and Stine, 1993). Schilling claimed that an increase in the CCC increases the firms' lowest liquidity requirements and vice versa (Schilling 1996). Furthermore, he stated that the best level of liquidity is achieved by using the fewest resources possible, and this study discovered a relationship between the CCC and the least threshold scale of liquidity, such that as the CCC increases, so does the minimum necessary liquidity.

According to Dong and Su (2010), CCC has a significant impact on the firm's return on investment (ROI). Randall and Farris II (2009) contended that utilizing an average cost of capital to run a joint CCC will increase the firm's profitability. While Lee et al. (2021) discovered that enterprises with longer CCC have a higher cost of equity. Firm-specific features, such as the level of debt in the capital structure and asset turnover (ATO), have also been identified as factors influencing corporate profitability. Financial leverage (LEV) and profitability are negatively associated (Ahmed et al., 2018; Al-Mohareb, 2019; Grau and Reig, 2021), however some have shown a favorable correlation (Dalci, 2018; Raheman and Nasr, 2007). Some studies have found a negative relationship between the firm's ATO and corporate profitability (Muritala, 2012; Niresh and Thirunavukkarasu, 2014), while others have found a positive relationship (Azad et al., 2018; Pouraghajan et al., 2012), while Warrad and Al Omari (2015) and Santosuosso (2014) found no significant relationship. Although some studies on the effect of CCC on a firm's profitability have found positive results, Attari and Raza (2012) discovered a significant positive correlation between CCC and a firm's profitability as measured by ROE and ROA, with CCC having a statistically significant impact on ROA. Panigrahi (2013) analyzed cement manufacturing firms listed on the BSE in India for ten years, from 2001 to 2010, and found that the CCC and profitability of his sample company, as measured by ROA and ROE, were both positive. Gill et al. (2010) conducted a three-year exploratory study on US enterprises between 2005 and 2007 and showed a strong positive link between

the CCC and gross profit. They also discovered no association between the company's size and profitability. Lin and Lin (2021) discovered that the aggregate CCC is a significant positive predictor of the stock market's overall return by analyzing the returns on the Standard & Poor's 500 index (S&P 500 index) of US markets, whereas Samo and Murad (2019) discovered a significant positive relationship between firm profitability and liquidity holdings. However, some experts have discovered that the CCC has little effect on a firm's success. Ali and Hassan (2010) investigated the relationship between profitability and liquidity in 37 OMX Stockholm Stock Exchange Listed businesses during a five-year period from 2004 to 2008 and concluded that there is no link between gross profit and CCC liquidity. The effect of liquidity on the profitability of firms is therefore blurred and ambiguous, but the majority of researchers have reached a decision on the negative correlation of liquidity and profitability of commercial firms- the longer CCC the less corporate profit. Consequently, the question of the effect the length of CCC has on the corporate profitability of textile businesses listed on the Pakistan Stock Exchange in Pakistan can be explored.

METHODOLOGY

Data And Sample Selection

The data of Pakistani Stock Exchange listed firms of the textile sector was used in this research. This paper was using the data between the years 2011 and 2020. This sample was complete enumeration of textile companies of Pakistan. Following the filtering of data such as non-availability of data of annul reports, missing value, and outlier values concerning variables and negative equity value firms the ultimate sample to be employed in the analysis is 80 firms and 800 year-wise observations.

Variables

The present research borrowed variables used by Chang (2018), Linh and Mohanlingam (2018), Al-Mohareb (2019), Jaworski and Czerwonka (2022), Maduka et al. (2022), Mandalaputri et al. (2021),Karim et al (2024) and Nazeer et al (2023). This paper utilized return on asset (ROA) and earnings per share (EPS). Return on assets is done by taking earnings before interests and taxes divided by assets. Earnings per share is computed taking the earnings after taxes, which are added to the total figures of shares outstanding. One such study exploratory variable is cash conversion cycle(CCC). Cash conversion cycle = inventory turnover in days + Receivable turnover in days - payable turnover in days. Inventory turnover in days = End value of inventory reported in annual report/cost of goods sold(multiplied by 365) Receivable turnover in days is determined as receivable/ 365/ sales. Payable turnover in days is estimated as payables/ cost of goods sold x 365. In this study, the control variables were the asset turnover(ATO) and leverage(DR). The asset turnover is the rate of sales divided by the total assets. The leverage is determined as the total debt/total assets.

Estimation Equation

OLS was the method of estimating this research. Hausman test is used in order to choose the most appropriate model between fixed effects model and random effect model. Adhering to two estimation equations.

$$ROA_{it}=a_{it}+CCC_{it}+ATO_{it}+DR_{it}+u_{it} \quad \text{.....1}$$

The effects of cash conversion cycle (CCC) on the return on assets(ROA) are estimated using equation 1. The control variables are assets turnover (ATO) and leverage (DR).

$$EPS_{it}=a_{it}+CCC_{it}+ATO_{it}+DR_{it}+u_{it} \quad \text{.....2}$$

The effects of cash conversion cycle (CCC) on the earnings per share (EPS) are determined using equation 2. Use of control variables is assets turnover (ATO) and leverage (DR).

RESULTS

Table 1: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
ROA	800	0.093	0.113	-0.600	1.139
EPS	800	15.271	51.181	-352.945	734.723
CCC	800	48.611	187.764	-1383.760	3367.428
ATO	800	1.338	0.933	0.000	6.877
DR	800	0.552	0.210	0.034	1.888

Table 1 shows the descriptive statistics of this research. Mean value of ROA is 0.093. Average value of EPS is 15.271. Mean of cash conversion cycle is 87.764. Average of asset turnover ratio is 1.338. Debt ratio mean value is 0.552.

Table 2: Correlation Analysis

	ROA	EPS	CCC	ATO	DR
ROA	1				
EPS	0.450***	1			
CCC	-0.0369	-0.00883	1		
ATO	0.202***	0.136***	-0.0270	1	
DR	-0.430***	-0.320***	-0.169***	0.137***	1

* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 2 displays the correlation analysis of this empirical investigation. Correlation is to perform to estimate the possible multicollinearity between variables. Value above 0.70 and less than -0.7 is consider the value of multicollinearity. Correlation table 3 suggest no muticollinerarity between variables, because value of correlation is too small, below the threshold value of multicollinearity.

Table 3: Regression Results

Equation	1			2		
Method	OLS	Fixed	Random	OLS	Fixed	Random
Variable	ROA	ROA	ROA	EPS	EPS	EPS
CCC	-0.0000568**	-0.0000552**	-0.0000568**	-0.0169	-0.0167	-0.0169
	(0.0000196)	(0.0000211)	(0.0000196)	(0.00955)	(0.0103)	(0.00955)
ATO	0.0404***	0.0564***	0.0404***	11.23***	12.78***	11.23***
	(0.00520)	(0.00726)	(0.00520)	(2.560)	(3.544)	(2.560)
DR	-0.224***	-0.175***	-0.224***	-88.58***	-88.90***	-88.58***
	(0.0211)	(0.0262)	(0.0211)	(10.36)	(12.79)	(10.36)
_cons	0.165***	0.116***	0.165***	49.98***	48.07***	49.98***
	(0.0150)	(0.0188)	(0.0150)	(7.409)	(9.194)	(7.409)
Hausman test			0.00			0.92
N	800	800	800	800	800	800

Standard errors in parentheses

* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

The results of regression are presented in table 3 to demonstrate this empirical study. The current study applied the OLS technique in determining the effect of cash conversion cycle on the performance of firms. The appropriate model between fixed and random effects are selected with the help of Hausman test. Results of return of assets are the dependent variable in the first panel of the table 4. The findings show that the cash conversion cycle has a negative relationship with the return of assets. It is in line with Chang (2018), Linh and Mohanlingam (2018), Al-Mohareb (2019), Jaworski and Czerwonka (2022), Maduka et al. (2022), and Mandalaputri et al. (2021). Among the control variables, assets turnover has positive and debt ratio has negative and significant impact on the return on assets. Hausan test indicate fixed effects model can be used as the dependent variable of return on assets.

Table 4 panel 2 reveals the results of earnings per share as dependent. The regression analysis indicates that cash conversion cycle has negative and non-significant impact on earnings per share. This observation goes in line with AL-Zararee et al. (2021), Kasozi (2017), Mbathi et al. (2021), and Chowdhury et al. (2018). Out of control variables, the assets turnover has positive effect with negative and significant effect on earnings per share respectively. The earnings per share is a dependent variable that Hausan test suggest random effects model fits.

DISCUSSION AND CONCLUSION

The purpose of the research is to examine how cash conversion cycle influences the performance of the firm in the context of Pakistani textile listed firms. The study employed the data of 80 firms during the years 2011-2020, and it had 800 observations. Sheikh et al., (2016), Tahir and Anur (2016) and Yousaf et al., (2023) have found positive and significant, whereas Ansar and Qaisar (2013) has found negative and significant effect on the firm performance, which indicates mixed results. This study employed new information to draw the conclusion of the finding of textile sector in Pakistan.

The outcome of equation 1 shows that the effect of cash conversion cycle has a negative and significant implication on the return on assets. This implies that firms associated with the textile industry of Pakistan, should reduce the cash conversion cycle to improve the performance of the firm. Firms in the textile sectors have a greater inventory or stock, and it may reduce their performance. The greatest interest of firm is the efficient working capital management.

According to the regression analysis of equation 2, the conversion cycle of cash has negative but insignificant influence on performance earnings per share. And which also supports the discovery of equation 1.

Among the control variables, assets turnover has positive meanwhile debt ratio has negative and significant impact on earnings per share and return on assets.

The theoretical contribution to this study is that a shorter cash conversion cycle would contribute to a better performance of the firm that was associated with effective management of working capital.

This study used limited time data and limited numbers of firm performance proxies. Future research may use other market based performance indicators like TobinQ and cost of equity. Policy makers and investors can use this study finding for decision making.

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