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Title

MANAGEMENT OF CORPORATE LIQUIDITY AND PROFITABILITY: AN EMPIRICAL STUDY

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ABSTRACT:

The primary aim of this paper is to investigate the relationship between Cash Conversion Cycle(Liquidity) and firms' profitability. The analysis based on a sample of 20 Indian Automobile firms for the period 1996-2009. The results suggest that the managers can increase profitability of their firms by shortening the cash conversion cycle, accounts receivables period and inventory conversion period. The results suggest that managers can also increase the profitability of their firms by lengthening the accounts payables period. The study suggest an optimal cash conversion cycle as more accurate and comprehensive measures of liquidity analysis.

Key words: profitability, Accounts Receivables Period, Inventory Conversion Period, Accounts Payable Period, Cash Conversion Cycle , Automobile industry and Liquidity analysis.

Introduction:

Liquidity management is necessary for all businesses, small, medium or large because it means collecting cash from customers in time so that having no difficulty in paying short-term debts. Therefore, when a business does not manage its liquidity well, it will have cash shortages and will results in difficulty in paying obligations. As a result, in addition to profitability, liquidity management is vital for ongoing concerns. Promoters of capital theory share the axiom that profitability and liquidity comprise the salient (albeit frequently conflicting) goals of working capital management. The conflict arises because the maximization of firm's returns could seriously threaten the liquidity and on the other hand, the pursuit of liquidity has a tendency to dilute returns. The crucial part in managing working capital is required maintaining its liquidity in day-to-day operation to ensure its smooth running and meets its obligation **(Eljelly, 2004).** Yet, this is not a simple task since managers must make sure that business operation is running in efficient and profitable manner. There are possibilities of mismatch of current assets and current liabilities during this process. If this happens and firm's manager cannot manage it properly then it will affect firm's growth and profitability. This will further lead to financial distress and finally firms can go bankrupt.

Corporate liquidity is examined from two distinct dimensions: static or dynamic view **(Lancaster et al., 1999; Farris and Hutchison, 2002: and Moss and Stine, 1993).** The static view is based on commonly used traditional ratios, such as current ratio and quick ratio, calculated from the balance sheet accounts. These traditional measures of liquidity are incompetent measures that cannot provide detailed and accurate about liquidity management effectiveness **(Jose et al., 1996).** These ratios measures liquidity at a given point in time. For example, the current ratio, are simple to apply and have some theoretical merit increases in say, accounts receivables will increase the current ratio, suggesting improved liquidity. However, the ability to match short-term obligations has only improved from a liquidation perspective providing current assets may be liquidated at current market value and not from a going-concern approach **(Shulman and Dambolena, 1986).** Liquidity for the ongoing firm is not reliant on the liquidation value of its assets, but rather on the operating cash flow generated by these assets **(Soenen, 1993).**

On the other hand, dynamic view measures ongoing liquidity from the firm's operations. As a dynamic measure of the time it takes a firm to go from cash outflow to cash inflow which is measured by Cash Conversion Cycle (CCC) introduced by **Hager (1976)** and has been recommended by **Largay and Stickney (1980), Kamath (1989)** and others. Drawing attention to limitations of traditional liquidity ratios, **Richards and Laughlin (1980), Kamath (1989), Gentry et al., (1990), and Schilling (1996)** have insisted on using ongoing liquidity measures in working capital management. Ongoing liquidity refers to the inflows and outflows of cash through the as the product acquisition, production, sales, payment and collection process takes place overtime. As the firm's ongoing liquidity is a function of its cash (conversion) cycle, it will be more appropriate and evaluate effectiveness of working capital management by cash conversion cycle, rather than traditional liquidity measures.

Cash Conversion Cycle (CCC):

In text books related to finance, CCC is maintained in the context of working capital management **(Keown et al., 2003; and Bodie and Merton, 2000).** The cash conversion cycle is used as a comprehensive measure of working capital as it shows the time lag between expenditure for the purchase of raw material and the collection of sales of finished goods

(Padachi, 2006; Bodie and Merton, 2009; Keown et al., 2003; Jordon, 2003; and Eljelly, 2004).

$$CCC = RCP + ICP - APP$$

In the above formula, the three variables to which CCC is dependent are defined as follows;

RCP – Receivables Collection Period (in days)

(Accounts Receivables / Sales) * 365

ICP – Inventory Conversion period (in days)

(Inventory / Cost of goods sold) * 365

APP – Accounts Payable Period (in days)

(Accounts Payables / Cost of goods sold) * 365

There seems to be strong relation between the cash conversion cycle of a firm and its profitability. The three different components of CCC (accounts receivables, inventory and accounts payables) can be managed in different ways in order to maximise profitability. It is an indication of how long a firm can carry on if it was to stop its operations or it indicates the time gap between purchase of goods and collection of sales. The optimum level of inventory will have a direct effect on profitability since it will release working capital resources which in turn will be invested in the business cycle, or will increase inventory levels in order to respond to higher product demand. Similarly both credit policy from suppliers and credit period granted to customers will have an impact on profitability. In order to understand the way working capital is managed, CCC and its components will be statistically analysed.

Cash conversion cycle is likely to be negative as well as positive. A positive result indicates the number of days a company must borrow or tie up capital while awaiting payment from a customer. A negative result indicates the number of days a company has received cash

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from sales before it must pay its suppliers (**Hutchison et al., 2007**). Of course the ultimate goal is having low CCC, if possible negative. Because the shorter the CCC, the more efficient the company in managing its cash flow. The purpose of this paper is to investigate the implications of the CCC as an indicator of liquidity on profitability of selected firms in Indian Automobile Industry.

Literature Review – Theoretical Underpinnings:

In a study by **Kamath (1989),** it has been concluded that there is a reverse relationship between cash conversion cycle and profitability. In another study of **Shin and Soenen (1998),** a sample consisting of American manufacturing firms for the period of 1974-1995 has been analysed and a statistically negative relationship between cash conversion cycle and profitability has been confirmed. To test the relationship between working capital management and corporate profitability, **Deloof (2003)** used a sample of 1009 large Belgian non-financial firms for a period of 1992-1996. He discussed possible relationships between cash conversion cycle and profitability by dividing cash conversion cycle into its components (inventory, account receivables and account payables period). Results of the study have concluded that increase in all of these periods affect profitability negatively. **Lazaridis and Tryfonidis (2006)** conducted a cross sectional study by using a sample of 131 firms listed on the Athens Stock Exchange for the period of 2001-2004 and found cash conversion cycle affects profitability negatively.

Eljelly (2004) empirically examined the relationship between profitability and liquidity as measured by current ratio and cash conversion cycle on a sample of 929 Joint stock companies in Saudi Arabia. It has been concluded that the effect of cash conversion cycle on profitability is stronger than the effect of current ratio on it and found significant negative relationship between the firm's profitability and its liquidity level. **Raheman and Nasr (2007)** studied the effect of different variables of working capital management including cash conversion cycle on the profitability of 94 Pakistani firm listed on Karachi Stock Exchange for a period between 1999-2004 and found that as cash conversion cycle increases, it leads to decreasing profitability of the firm. **Garcia-Teruel and Martinez-Solano (2007)** collected data for 8872 SMEs from Spain for the period 1996-2002 and tested the effects of working capital management on profitability. The results demonstrated that shortening cash conversion cycle improves the profitability. **Falope**

and Ajilore (2009) used a sample of 50 Nigerian quoted non-financial firms for the period 1996-2005. They found a significant negative relationship between net operating profitability and the average collection period, inventory turnover in days, average payment period and cash conversion cycle.

Mathuva (2009) examined the influence of working capital management components on corporate profitability by using a sample of 30 listed on the Nairobi-Stock Exchange (NSE) for the periods 1993 to 2008. He found that there exists a highly significant negative relationship between the time it takes for firms to collect cash from their customers and profitability. **Amarjit Gill, Nahum Biger and Neil Mathur (2010)** studied the relationship between the cash conversion cycle and profitability and found significant relationship between them. The other studies, **Ali Uyar (2009), Moss Stine (1993), Jose et al., (1996), Hutchison et al., (2007), Vaidyanathan et al., (1990), Lyroudi and McCarty (1993), Soenen (1993) and Wang (2002)** empirically examined the relationship between profitability and liquidity showed that there exists a significant and negative relation between profitability and CCC. However, the study conducted by **Katerina Lyroudi and Lazoridis (2000)** in the Food Industry of Greece found that there was positive relationship between CCC and return on assets.

Among the studies conducted in the Indian context showed both the positive and negative association between liquidity and profitability. **Amit K. Mallik, Debdas Rakshit (2005)** studied the relationship between liquidity and profitability in the context of Indian Pharmaceutical industry and concluded that no definite relationship can be established between liquidity and profitability. **Narware (2004)** in his study of working capital management and profitability of NFL, a fertilizer company disclosed both negative and positive association. **Bardia (2004)** in his study on steel giant SAIL for the period from 1991-92 to 2001-2002 concluded that there was a positive relationship between liquidity and profitability. **D. Sur, J. Biswas and Ganguly, P. (2001)** revealed in their study of Indian Aluminium producing industry, a very significant positive association between liquidity and profitability. **Vijayakumar and Venkatachalam (1995)** in their study on Tamil Nadu Sugar Industry with regard to relationship between liquidity and profitability concluded that liquidity was negatively associated with profitability.

In summary, the literature review indicates that working capital management impacts on the profitability of the firm but there still is ambiguity regarding the appropriate variables that

might serve as proxies for working capital management. The present study investigates the relationship between a set of such variables and the profitability of a sample of Indian Automobile firms. Further, most of the Indian studies used traditional liquidity ratios viz., current and quick ratio as a measure of liquidity. Only a very few studies used Cash Conversion Cycle (CCC) as a measure for liquidity. Therefore, to fill this gap in the literature, as attempt has been made in this part to study the relationship between cash conversion cycle and profitability of Indian automobile firms. The present study postulates the following hypothesis: **"Firms liquidity negatively affects profitability"**

Variables specifications and Empirical model:

This study investigates the effects of cash conversion cycle on firm's profitability. The dependent variable of the regression model is return on assets (PR). The Cash Conversion Cycle (CCC) used as a comprehensive measure of liquidity is independent variable, and is measured by adding ARP to ICP and then subtracting the APP. It is expected that there is a negative relationship between profitability and cash conversion cycle. This is consistent with the view that the time lag between expenditure for the purchase of raw materials and the collection of sales of finished goods can be too long, and that decreasing the time lag increases profitability. Along with cash conversion cycle, the present study has taken into considerations some control variables relating to firms such as the size of the firm, the growth in its sales and its financial leverage. The size of the firm (SIZE) has been measured by the natural logarithm of its total sales. The growth of the firm (GROWTH) is measured by variations in its annual sales value with reference to previous year's sales $[(sales_t-sales_{t-1})/sales_{t-1}]$. Moreover, the financial leverage (LEV) was taken as the debt to equity ratio of each firm for the whole sample period. Finally, since good economic conditions tend to be reflected in a firm's profitability **(Lamberson, 1995),** this phenomenon has been controlled for the evolution of the economic cycle using the GDPGR variable, which measures the real annual GDP growth. Table 1 below summarises the definitions and theoretical predicted signs.

Table 1

Proxy variables definition and predicted relationships

Proxy variables	Definitions	Predicted Sign
ARP	Account receivables divided by sales and multiplied by 365 days	+/-
ICP	Inventory divided by cost of goods sold and multiplied by 365 days	+/-
APP	Accounts payables divided by cost of goods sold and multiplied by 365 days	+/-
CCC	No. of days A/R plus No. of days of IC minus No. of days A/P	+/-
Size	Natural logarithm of firm's sales	+/-
Growth	Difference between current year sales and previous year sales divided by previous year sales	+/-
Leverage	Total debt divided by equity	-
GDPGR	Difference between current year GDP and previous year GDP divided by previous year GDP	+

Empirical Model:

The study uses panel data regression analysis of cross-sectional and time series data. The pooled regression is one where both intercepts and slops are constant, where the cross-section firm data and time series data are pooled together in a single column assuming that there is no significant cross-section or temporal effects.

The general form of model is

$$\text{n}$$

$$PR_{it} = \beta_0 + € \beta_i X_{it} + e$$

$$\alpha_{it}$$

where PR_{it} - Return on assets of firm i at time t;

i = 1, 2, 3….., 20 firms

β_0 - The intercept of equation

β_i - Co-efficients of X_{it} variables

X_{it} - The different independent variables for working capital management of

firms i at time t

t - Time = 1, 2, 3, ……

e - The error term

To investigate the impact of cash conversion cycle on profitability the model used for the regression analysis is expressed in the general form as given above. Specifically, when convert the above general least squares model into specified variables it becomes:

$$PR_{it} = \beta_0 + \beta_1 CCC_{it} + \beta_2 SIZE_{it} + \beta_3 GROWTH_{it} + \beta_4 LEV_{it} + \beta_5 GDPGR_{it} + e_{it}$$

Where,

PR - Measures the firm profitability with gross profit as a percentage of total

assets for firm (i) in the year (t).

CCC - Cash Conversion Cycle for firm (i) in the year (t).

Size -Natural logarithm of firm's sales for firm (i) in the year (t).

Growth -Growth of firm's sales for firm (i) in the year (t).

Leverage -Measures the leverage with debt to equity for firm (i) in the year (t).

GDPGR -Measures the growth of GDP for firm (i) in the year (t).

β_0-Constant term for firm (i) in the year (t).

$\beta_1, \beta_2\ldots$-Regression Co-efficient.

e-disturbance term for firm (i) in the year (t).

Research Design:

Keeping in view the scope of the study, it is decided to include all the companies under automobile industry working before or from the year 1996-97 to 2008-09. There are 26 companies operating in the Indian automobile industry. But, owing to several constraints such as non-availability of financial statements or non-working of a company in a particular year etc., it is compelled to restrict the number of sample companies to 20. The companies under automobile industry are classified into three sectors namely; Commercial vehicles, Passenger cars and Multiutility vehicles and Two and three wheelers. For the purpose of the study all the three sectors have been selected. It accounts for 73.23 per cent of the total companies available in the Indian automobile industry. The selected 20 companies include 5 under commercial vehicles, 6 under Passenger cars and Multiutility vehicles and 9 under two and three wheeler sectors. It is inferred that sample company represents 98.74 percentage of market share in commercial vehicles, 89.76 percentage of market share in passenger cars and Multiutility vehicles and 99.81 percentage of market share in two and three wheelers. Thus, the findings based on the occurrence of such representative sample may be presumed to be true representative of automobile industry in the country.

The study is mainly based on secondary data. The major source of data analysed and interpreted in this study related to all those companies selected is collected from "PROWESS" database, which is the most reliable on the empowered corporate database of Centre for Monitoring Indian Economy (CMIE). Besides prowess database, relevant secondary data have also been collected from BSE Stock Exchange Official Directory, CIME Publications, Annual Survey of Industry, Business newspapers, Reports on Currency and Finance, Libraries of various Research Institutions, through Internet etc.

Results and Discussion:

In Table 2, the summary statistics of the variables included in the regression models are presented. Descriptive statistics shows the mean and standard deviation of the different variables of interest in the study. It also presents the standard error of mean, median, minimum and maximum values, kurtosis and skewness of the variables. Table 2 presents descriptive statistics for 20 Indian automobile companies for the period of 13 years from 1996-97 to 2008-09 and for a total 216 companies year observations. Overall, the mean profit rate on total assets is 22.29 per cent with the standard deviation of 105.3 per cent. It means that value of the profitability (profit rate on total assets) can deviate from mean to both sides by 105.3 per cent. The maximum value for the profit rate on total assets is 1638.9 per cent for a company in a year while the minimum is -189.4 per cent. The mean cash conversion cycle is 30 days (approximately one month) with the standard deviation of 66 days, implying that Indian automobile company's turnover their stock on an average of 12 times a year.

To check the size of the company and its relationship with profitability, natural logarithm of sales is used as a control variable. The mean value of log of sales is 6.90 while the standard deviation is 1.70. The maximum value of log of sales for a company in a year is 10.39 and the minimum is 0.92. In the same way to check the growth of the company and its relationship with profitability, sales growth is used as a control variable. The average growth of sales for Indian automobile companies is 10.60 per cent with a standard deviation of 36.83 per cent. The highest growth of sales for a company in a particular year is 356.66 per cent and in the same way the minimum growth of sales for a company in a year is -97.62 per cent.

To check the leverage and its relationship with the profitability, the debt ratio (obtained by dividing the total debt of the company by the equity) is used as a control variable. The results of the descriptive statistics show that the average leverage ratio for the Indian automobile companies is 1.33 with a standard deviation of 3.12. The maximum debt financing used by a company is 41.37, whereas the minimum level of the debt ratio is 0.00 which is unusual but may be possible. To check the GDP growth and its relationship with the profitability, GDP growth rate is used as a control variable. The mean value for this ratio is 12.73 per cent with a standard deviation of 3.41 per cent. The maximum GDP growth during the study period is 16.92 per cent and the minimum is 7.76 per cent.

Pearson's Correlation Co-efficient analysis:

Consistent with **Shin and Soenen (1998)**, Table 3 provides the Pearson correlation for the variables used in the regression model. Pearson's correlation analysis is used for data to see the relationship between variables such as those between liquidity (working capital management) and profitability. Table 3 shows the negative relationship between profitability and CCC, is consistent with the view that the time lag between the expenditure for the purchases of raw materials and the collection of sales of finished goods can be too long and that decreasing the time lag increases profitability **(Deloof, 2003)**. Firm size is positively related to profitability. This means that larger firm report higher profits compared to smaller firms. This may be due to larger firm's ability to exploit their economies of scale. Growth, which could be an indicator of a firm's business opportunities, is an important factor allowing firms to enjoy improved profitability, as can be seen in the positive sign for the variable GROWTH. With reference to other control variables, leverage and GDPG, profitability is negatively associated with leverage whereas profitability is positively associated with GDPG. Thus, by analyzing the results it is concluded that if the firm is able to reduce these time periods, then the firm is efficient in managing working capital (liquidity). This efficiency will lead to increasing its profitability. The results of correlation analysis indicate that as far as Indian automobile companies are concerned, the liquidity management very significantly and strongly affects their profitability.

Regression Analysis:

Although, Pearson linear correlations give proof of an inverse relationship between profitability and CCC, these measures do not allow us to identify causes from consequences **(Shin and Soenen, 1998)**. Therefore, the main analysis will be derived from appropriate multivariate models estimated using the overall least squares regression model. The model specifies above is estimated using the regression based framework (pooled OLS) as employed by **Deloof (2003), Raheman and Nasr (2007), Garcia Teruel and Martinez-Solano (2007), Padachi (2006), David M. Mathuva (2009) and Amarjit Gill et al., (2010)**. Table 4 report the pooled OLS regression results of the overall relationship which exists between working capital management (liquidity) and profitability.

Cash Conversion Cycle (CCC) and Profitability:

The results of the regression model shows that consistent with **Deloof (2003), Raheman and Nasr (2007), Shin and Soenen (1998), Garcia-Teruel and Martinez-Solano (2007), Padachi (2006) and David M. Mathuva (2009)**, a negative relationship exists between the Cash Conversion Cycle (CCC) and profitability. This supports the notion that the CCC is negatively related with profitability. **Shin and Soenen (1998)** argued that the negative relation between profits and the cash conversion cycle could be explained by the market power or the market share, i.e., a shorter CCC because of bargaining power by the suppliers and/ or the customers as well as higher profitability due to market dominance. The negative relationship between the firm's CCC and profitability can also be explained by the fact that minimizing the investment in current assets can help in boosting profits. This ensures the liquid cash is not maintained in the business for long and that it is use to generate profits for the firm.

The model also shows that profitability increases with firm size (as measured by natural logarithm of sales).The results of the regression indicate that the coefficient of growth (as measured by growth of sales) on profitability showed significant and positive relationship with profitability. The study used the debt ratio (measured by debt divided by equity) as a proxy for leverage, it shows a negative relationship with the profitability. This means that, when the leverage of the firm increases, it will adversely affect its profitability. Similarly, GDP growth of the country showed a significant positive relationship with profitability. It reflects that if the country's GDP increases, the profitability of Indian Automobile Industry will also increases. The model's adjusted R^2 is 66 per cent with an F-value of 5.65 which is significant($p<0.05$). The Durbin Watson statistic is 1.49.

Conclusion:

The study of empirical relationship between liquidity and profitability is one of the areas of performance of corporate enterprise. This study has shown that Indian automobile industry has been able to achieve high scores on the various components of working capital and this has positive impact on its profitability. Empirical results of the study found a significant negative relationship between profitability and Cash Conversion Cycle (CCC) for a sample of Indian

automobile industry. These results suggest that managers can create value for their shareholders by reducing the number of days of accounts receivable and inventories to a reasonable minimum. Further, companies are capable of gaining sustainable competitive advantage by means of effective and efficient utilisation of the resources of the organisation through a careful reduction of the cash conversion cycle to its minimum. In doing so, the profitability of the firm is expected to increase. Therefore, managers can create profits for their companies by handling correctly the cash conversion cycle and keeping each different component (accounts receivables, accounts payables and inventory) to an optimum level.

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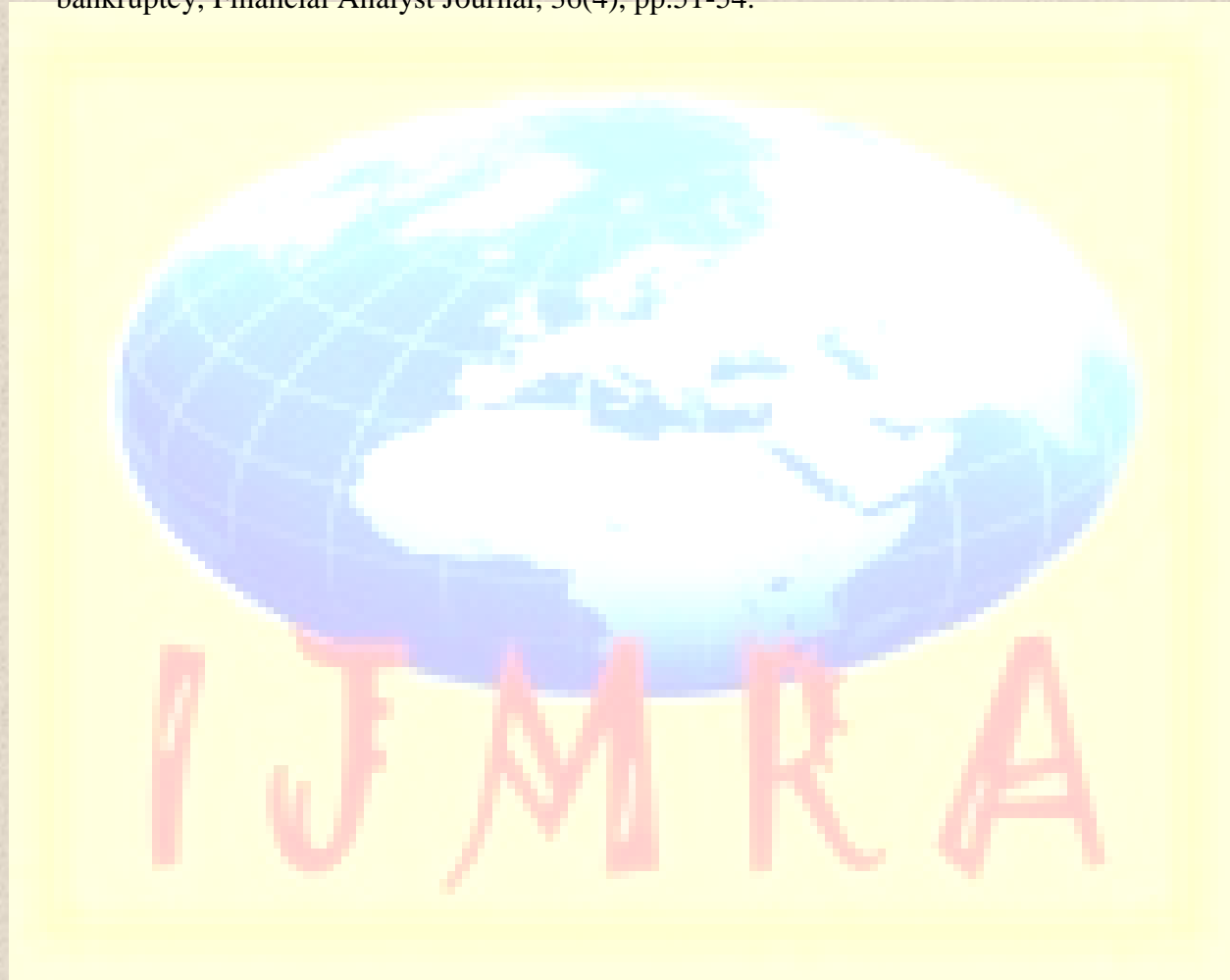
Table 2

Descriptive statistics of Independent, Dependent and Control variables

20 Indian Automobile Firms, 1996 – 2009 – 216 Firm -year observations (N = 216)							
Variables	**Mean ± S.D**	**Standard Error of mean**	**Median**	**Minimum**	**Maximum**	**kurtosis**	**Skewness**
PR	22.29 ± 105.3	6.62	14.58	-189.39	1638.92	222.83	14.44
CCC	29.90 ± 65.81	4.14	19.07	-255.76	312.03	5.58	-0.18
Size	6.90 ± 1.70	0.11	6.86	0.92	10.39	0.01	-0.27
Growth	10.60 ± 36.83	2.32	10.13	-97.62	356.66	31.46	3.48
Leverage	1.33 ± 3.12	0.20	0.67	0.00	41.37	110.30	9.32
GDPG	12.73 ± 3.41	0.98	13.44	7.76	16.92	-1.56	-0.33

Notes : **PR-Profit Rate on total assets; CCC-Cash Conversion Cycle; Size-Natural logarithm of sales (proxy for size);Growth-Sales growth; Leverage-Debt/Equity; GDPG-Gross Domestic Product Growth.**

Source **: Computed.**

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Table 3

Correlation Matrix

	PR	CCC	Size	Growth	Leverage	GDPG
PR	1.00					
CCC	-0.09	1.00				
Size	0.04	-0.11	1.00			
Growth	0.03	-0.13	0.18	1.00		
Leverage	-0.20	0.14	-0.22	0.02	1.00	
GDPG	-0.05	0.28	-0.69	-0.15	-0.24	1.00

Notes : PR-Profit Rate on total assets; CCC-Cash Conversion Cycle; Size -Natural logarithm of sales (proxy for size); S.Growth-Sales growth; Leverage-Debt/Equity; GDPG-Gross Domestic Product Growth.

Sources: Computed.

Table 4

Regressions of Profitability on Working capital variables

[20 Indian Automobile Firms, 1996-2009 : 216 Firm year observations]

(Dependent variable : Profit Rate on total assets(PR))

Independent Variables	Model
Intercept	15.07
CCC	-0.01 (2.31) ***
Size	0.55 (1.66)
Growth	0.14 (2.44)**
Leverage	-5.05 (1.23)
GDPG	0.36 (3.02)**
R²	**0.80**
Adjusted R²	**0.66**
F Value	**5.65***
Durbin Watson	**1.47**

Notes : PR-Profit Rate on total assets; CCC-Cash Conversion Cycle; Size-Natural alogarithm of sales (proxy for size); Growth-Sales growth; Leverage - Debt / Equity; GDPG-Gross Domestic Product Growth.

* P < 0.01; **P < 0.05; ***P < 0.10

Source : Computed