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Impact of Liquidity on Profitability: A Case of Comparison in Textile Sector in Pakistan between 2014 and 2015

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Abstract

The impact of liquidity has been studied on profitability in textile sector in Pakistan. The simple regression has been run in Stata 12 and the results show that CR has positive and significant impact on ROCE and ROE in 2014 but in 2015 the results show that CR has positive but insignificant impact on ROCE and ROE. The policy makers must realize the importance of absolute opposite variations in the results.

Keywords: Liquidity, Profitability, Regression, CR, ROCE, ROE

Introduction

Liquidity management is an important area for organization. It involves processes related to planning and control of organization asset. The cost and liabilities of an organization provide direct information for the profitability. The concept of liquidity can be defined as the assets which can be converted into payments for the organization in the time of need. The approach of liquidity management has been adopted by an organization to plan fixed assets (Waleed, Pasha, & Akhtar, 2016).

Working capital provides information about the assets which can bring profit for the company. The area of assets and liabilities can be registered in the organization balance sheet. The measure of liquidity and profitability can be accounted for as the assessment of organization financial situation on the basis of net sales and reviews. The concept of quick ratio and return of asset can be used as a measure for the liquidity and profitability values for a company (Edem, 2017).

A company main objective is to maximize profit. The manufacturing as well sales department tend to look for profit and revenue streams which can increase the transparency of business. One of the primary examples is of the Textile sector which has always aimed to improve its profitability from the current asset and liabilities. The organization tends to increase the production of finished goods and product. The process of cash collection has an effect on the profitability of the company (Dahiyat, 2016).

There is a gap present between liquidity and profitability. One of the main areas of capital management is the liquidity position. The condition of a developing country can suitably describe from liquidity and profitability areas. The size of the company also plays a dominant role in companies. An organization whose assets are higher than liabilities tend to have more profit as compared to small and medium organization. Working capital also provides a piece of comprehensive information about the return of assets which predict the financial position of the company.

Organization priority remains for financial management. It is the common economic goal of a company to increase its profit and maximize the revenues for business expansion. There are some traditional and untraditional methods present for profit maximization. Business models are used to improve the quick ration and return of assets. A firm selects an investment strategy to deal with investment. The decision related to financial dividends is also regulated for the liquidity and profitability (Marozva, 2015). If an organization need to increases its asset it would look for the capital investment. Liquidity will play an important role in this context because it would provide recommendation for improvement and look for the assets which can be converted into liquid form.

The concept of accounting liquidity can be based on short-term debt for a company. It is important to analyse ratios for liquidity. The organization which has a higher amount of profit tend to have liquidity higher than 1 percent. This also provides information about the present liabilities and debts offer the organization. The higher amount of liquidity values shows that mismanagement in present in company financial department. This would provide a negative determinant for the current assets for the company (Yameen & Pervez, 2016).

The financial sector like a commercial and private bank needs to understand the significance of liquidity and profitability. There is a strong impact of a net liquid asset for the company long term plan. If the organization does not have sufficient funds then the profitability graph would tend to decline for the present assets. The organization needs to avoid the short-term pressures for net asset and balance the operational levels. This would provide information regarding liquidity and profitability trade-off.

One of the important variables for liquidity measurement is the return of asset and quick ratio for a company. The factor focusses on the profit which can provide stability in business operations. If the liquidity of the company is reduced owing to the present capital it would provide information about the present working capital of the firm. The financial sector face issues regarding liquidity management where there two sides for managing the problems. One of the area links with eh creation of investment. This is done with the help of bonds which store money from customers and increase the amount available for investment. The amount of money generated from bonds is used for private business (Moussa, 2015). It provides the bank with a tool to increase profit and sales for a financial product and affect the operation of the organization.

The amount of money deposited in banks can also be considered a liquid asset. The organization should understand the critical relationship of liquidity with profitability. This would provide benefit for the company and help to remove issues with the business organization. The area of liquidity and profitability has been diversely discussed in literature owing to the importance of financial institutions.

The financial sector remains the most powerful area when profitability is analysed for the companies. The measurement of liquidity can be analysed for the manufacturing as well retail sector. Public and private banks fall in the category where the financial transaction is made for Industry. It has been found that an inverse relationship is present between liquidity and profitability of the company (Roman & Sargu, 2015). The major dependence can be analysed on the base of liquidity ratio.

If a company want to increase its profitability, then it should use the fixed assets for more assets. In this way, liquidity would be sacrificed for investment and trading activities. The issue raises in the selection of a strategy for an organization. The obligation of a company in the business sector has raised the value of profitability. Most of the company look for ways which can increase the profit and gather maximum revenues.

This study would account for brief information on profitability and liquidity. Literature would be reviewed for analysing the independent and dependent variables. Return of assets and quick ratio would be important variables for the study. In the next section, the methodology would be elaborated on the base of the sample section and research designate regression test would be applied to the sample and results would be explained. The probability values would be used to identify the relationship between the dependent variable in the study. The study would also provide a formal conclusion to summarize the important consideration for the whole work.

Literature Review

Liquidity and profitability remain an important parameter for the companies in regard to the evaluation of asses. One of the main factors related to liquidity is the working capital which plays a mediating role in managing short term funds for companies. If liquidity is managed for the company, then it directly increases the working capital and tends to provide profitability measures. Research carried out by Nimer and Warrad show that every stakeholder has a principal interest in the managing liquidity of a company. It is a supplier policy to review the company in term of liquidity. The relation of employee and company profitability cannot be denied because it provides a key fact about the working capital of an organization. It was found from the research that factors of liquidity and profitability have a strong connection with the working condition of the company. If the amount of revenues increases for a company then it will directly increase the profitability (Nimer & Warrad, 2015).

It was also found from Nimer work that how the quick ratio can forecast the aspects of liquidity for a company. The independent variable for the study was quick ratio while the dependent factor was a return on asset. Descriptive analysis was used to predict the relationship between two variables. The results of the study showed that the profitability of the sample banks was influenced by the measure of liquidity. The return of asset was an important factor for an organization (Nimer & Warrad, 2015).

Malik and Awais also provided information about the impact of liquidity on profitably. The study was carried out to analyze the trade-off between both of the potential terms, twenty-two banks were selected for the study and time period was maintained for about four years The technique of Ordinary Least square was employed to and measurement was made between the liquidity and return of the asset. It was found that the relationship between the two variables was insignificant for the test. A clear need was present for banks to restructure the shareholder's equity and provide optimal performance for the organization (Malik & Awais, 2016).

The study pointed out that the return of assets for a company plays an important role in measuring performance. The economic profit relies on the areas of profitability, if an organization has a higher amount of liquidity then its profitability would be improved. Liquidity is basically a technique where a bank or company convert its assets in cash and a wide form of payment. The study also provided a piece of comprehensive information about the trade-off theory used for liquidity and profitability (Malik & Awais, 2016).

Ismail also provided an overview of liquidity management. The cases were based on the competitive business environment. Liquidity values for a company were empirically analyzed owing to the performance of 64 companies. The study employed a descriptive analysis and correlation tool to predict the relationship between two variables. The dependent variable for the study was current ration while and the independent factor was the return of the asset. It was found from the research that the cash cycle has a positive impact on ROA of an organization (Ismail, 2016).

The study also provided information regarding the sales policies of the company which can impact the ratio of profitability and liquidity. The main factor for the research was the capital market. Due to the changing trend, there were differences in liquid assets for a company. The inability of the organization to generate capital affects profitability. The results of the study showed that the quick ratio had an insignificant relationship with the return of assets. The probability values were higher than the critical threshold value of 0.05. There was a positive relationship present between the company and operations. It can be stared that cash flow and return of assets remain a considerable factor for liquidity management (Ismail, 2016).

A study carried out by Tran and Lin shows that liquidity creation can be analyzed with the concept of regulatory capital. The sample for the study based on a group of USA banks. The size of the bank and the quick ratio was analyzed for the study. It was also stated that bank performance based on the measurement of profitability. Vector regression model was used to analyze the relationship between liquidity. The study provided a comprehensive analysis of the dependent variable and independent categories. The trade-off policy was used in methodology and the factors related to the return of assets as well quick ratio include in the study hypothesis (Tran, Lin, & Nguyen, 2016).

Some of the market variables were also analyzed for the study. This included the information about the liquid assets for the company was the sources of capital for the base. It was found that the selection of variables was good to explain the role of liquidity and profitability. The study found out a positive relationship between the liquidity and return and asset while the bank performance showed a negative factor for the trade-off theory. The mediating role of capital structure played an important part in liquidity creation (Tran, Lin, & Nguyen, 2016).

Alshatti provides a study which dealt with the commercial Jordanian banks. The main purpose of the research was to identify the relationship between liquidity values and profitability. The time period of study was based on seven years. The area of the capital and quick ratio was selected for the study. ROE and ROA were the proxies used for measuring the profitability of the sample company. The study applies an ADF test model to correlate with the measured parameters. The study also showed that investment is required for banks in order to increase the liquidity and reduce the losses with cash flows (Abuzar M.A. Eljelly, 2004).

Alishatti included the concept of income theory to explain the liquidity and profitability areas. Regression analysis was employed to analyze the relationship. It was stated that the model predicted a positive relationship between variables (Abuzar M.A. Eljelly, 2004).

Shabbir and co-authors also measured the impact of capital on profitability of companies. This study focusses on the textile sector. It was stated by the author that companies tend to convert finished goods as the source of assets. The increase in working capital requires the organization to have liquid assets. The value and reputation of the company are also based on the performance and quality of the product. The study collected random samples for 30 manufacturing sectors. A regression model was applied to the data and profitability of business was measured with the help of the cash conversion cycle (Shabbir & Iftikhar, 2018).

The results of the study showed that a mixed relationship is present between profitability and liquid. Some of the variables predicted significant connection while other statistical results tend to decrease the effect of profitability. The size of an organization has an important effect on the liquidity and return of assets. The study included nine different independent variables which analyzed the effect on the return of asset (Shabbir & Iftikhar, 2018).

Tan also carried out research for the profitability and associated risk with the banking sector. The author stated that the competitive condition of the market and business and affected market and companies are more active towards the profitability. One of the main areas in the present sector is how profitability is measured for commercial banks. The study analyzed the different sector of the bank in regard to the return of assets and quick ratio. A period of eight years was used for the sample study. The variables included in the study were productivity as well as inflation for the country and the relevant industry. The selection of variable based on the management and resources for the banking sector. The values of profitability and taxation were also analyzed for the liquidity. It was found from the results that a strong relationship exists between the quick ratio and return of assets. There were some inconsistencies present for the evaluation of profitability (Tan, 2015).

A research carried out by Tahir and Anuar showed that some of the determination for capital can be used for the textile industry. The main purpose of the research was to compare profitability with the capital structure. The study selected 127 textile companies and used a dynamic panel approach for data analysis. It was found from the study that current assets of the company have an impact on the profitability ration. Current liabilities tend to decrease the profit for the company, and it is required that the collection period should be increased for the business. The factor of financial debt was also a key participant for the company profitability (Tahir & M.B.A.Anuar, 2016).

Methodology

This research is done on Textile sector in Pakistan. The Current Ratio (CR) has been considered as independent variable which has been calculated by dividing current assets by current liabilities. Whereas the return on capital employed (ROCE) and return on equity (ROE) have been considered as dependent variables. Both the variables have been calculated by dividing net profit by capital employed and equity respectively.

The Stata 12 has been used to run regression. The regression has been run on 124 companies on the observations of 2014 and 2015. Finally, both results are compared to check in which year the CR shows influence on ROCE and ROE.

$$ROCE = \beta_0 + \beta_1 CR + \gamma$$
$$ROE = \beta_0 + \beta_1 CR + \gamma$$

In the above equation the β_0 is used as constant and β_1 is used as coefficient. The CR is the independent variable and finally γ is used as error term. The ROCE and ROE are used as dependent variables.

Results and interpretations

Table 1. Summary Statistics in 2015

Variable	Mean	Standard Deviation	Minimum value	Maximum value
Independent variable				
CR	1.32	3.13	0	33.41
Dependent variable				
ROCE	-0.31	71.58	-506	504
ROE	3.20	72	-298.5	496.6

Table 1 shows 124 observations including textile companies in Pakistan in 2015. The unit of analysis here is textile companies. The dependent variables return on capital employed (ROCE) and return on equity (ROE). The mean value of ROCE is -0.31 and the standard deviation of the observation is 71.58 on the other hand the mean value of the observation related to ROE is 3.2 and the standard deviation is 72. The independent variable is current Ratio (CR). The mean value of CR is 1.32 and the standard deviation is 3.13.

Table 2. Ordinary Least Square Regression Model for FY2015

Variable	Coefficient	Standard error	t-statistics	Probability
Dependent variable: ROCE				
CR	0.906	2.06	0.44	0.662
CONSTANT	-1.51	7.00	-0.22	0.829

Variable	Coefficient	Standard error	t-statistics	Probability
Dependent variable: ROE				
CR	0.65	2.08	0.32	0.753
CONSTANT	2.33	7.04	0.33	0.74
Note	***	**	*	
Significance level	1 percent	5 percent	10 percent	

Table 2 shows that in 2015 the CR does not have any significant impact on ROCE and ROE. The textile sector can conclude that the liquidity has no significant impact on profitability. No doubt that the CR has positive impact on ROCE and ROE but the p-values of the t-statistics against the coefficients are showing insignificance.

Table 3. Summary Statistics in 2014

Variable	Mean	Standard Deviation	Minimum value	Maximum value
Independent variable				
CR	2.97	18.15	0	200
Dependent variable				
ROCE	0.962	82.6	-506	565
ROE	2.00	221.2	-131	1171

Table 3 shows 124 observations including textile companies in Pakistan in 2014. The mean value of ROCE is 0.962 and the standard deviation of the observation is 82.6 on the other hand the mean value of the observation related to ROE is 2 and the standard deviation is 221. The mean value of CR is 2.97 and the standard deviation is 18.15.

Table 4. Ordinary Least Square Regression Model for FY 2014

Variable	Coefficient	Standard error	t-statistics	Probability
Dependent variable: ROCE				
CR	2.78	0.32	8.5	0.000***
CONSTANT	-7.33	5.97	-1.23	0.222
Dependent variable: ROE				
CR	2.79	1.07	2.60	0.011**
CONSTANT	-6.30	19.68	-0.32	0.749
Note	***	**	*	
Significance level	1 percent	5 percent	10 percent	

Table 4 shows that in 2014 the CR has significant impact on ROCE and ROE. The textile sector can conclude that the liquidity has significant positive impact on profitability the results are significant at 1 per cent and 5 per cent level of significance respectively. The CR has positive impact on ROCE and ROE and the p-values of the t-statistics against the coefficients are showing significance.

Conclusion and Recommendation

The impact of liquidity has been studied many a times on profitability, but this study brings a question for future studies and policy makers that in textile sector in Pakistan the results varies in the following year. The simple regression has been run in Stata 12 and the results show that CR has positive and significant impact on ROCE and ROE in 2014 but in 2015 the results show that CR has positive but insignificant impact on ROCE and ROE. The policy makers must realize the importance of absolute opposite variations in the results.

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