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Examining The Critical Role of Working Capital Management and Capital Structure on Financial Performance of Manufacturing Firms: An Empirical Assessment

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Abstract: This research aims to examine the relationship between working capital management, capital structure decisions, and financial performance of manufacturing firms listed on the Pakistan Stock Exchange. The study aims to fill the gap in the literature by exploring the impact of various working capital components and capital structure choices on firm profitability and shareholder wealth. The study employs panel data regression analysis to investigate the relationship between observed variables. The data for the study is collected from secondary sources, primarily annual reports of listed manufacturing companies, and covers a six-year period from 2017 to 2022. The study finds that working capital management, as measured by metrics like current ratio, average collection period, and cash conversion cycle, significantly impacts the firm's economic value added (EVA) and Tobin's Q. Capital structure decisions, particularly leverage, also have a significant effect on the firm's performance. However, sales growth does not show a significant impact on the firm's performance. The study highlights the importance of effective working capital management and capital structure decisions for manufacturing firms' financial performance and shareholder value. Policymakers, investors, and business owners need to consider these factors while assessing and managing the performance of manufacturing companies. The research is limited to the manufacturing sector and considers data from the Pakistan Stock Exchange. Generalizations to other industries or regions should be made with caution. Additionally, the study uses financial indicators like EVA and Tobin's Q as proxies for performance, which may not capture all aspects of a firm's success.

Keywords: Working Capital Management, Capital Structure, Manufacturing Sector, Firms Profitability

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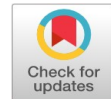
INTRODUCTION

In recent years, there has been a significant focus on Working Capital as a strategic approach to effectively manage a company's funding and ensure its ability to meet its daily financial obligations. Working Capital Management (WCM) is often associated with corporate finance due to its impact on a company's liquidity and profitability (Arnaldi et al., 2021). Likewise, these impacts frequently arise from the working capital of organizations. Managers maintain regular communication with risk minimization strategies, implementing various routine operational measures to ensure the organization remains secure while also pursuing profit maximization. The mismanagement of working capital is a significant factor contributing to the failure of many small businesses in both developed and developing countries (Lefebvre, 2022). In order for any successful organization to thrive, it is imperative to possess a comprehensive understanding of working capital. Given its impact on the profitability and liquidity of the firm, the management of current assets and liabilities is regarded as being of equal importance to the management of fixed capital (Kayani et al., 2020).

The evaluation of the capital structure or financial outcome is a critical managerial decision as it has a substantial impact on investor returns (Wang et al., 2020). The decision regarding the capital structure of enterprises is also influenced by market conditions, as it is imperative for them to establish an appropriate capital structure in order to facilitate their progress (Haralayya, 2022). Hence, the determination pertaining to the structure holds significant importance in facilitating asset growth. The significance of the funds raised necessitates a thorough analysis

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that leads to an alternative capital structure (Nguyen & Duong, 2022). The utilization of debt financing within a company's capital structure, referred to as financial leverage, has garnered considerable attention from both scholars and practitioners over an extended period of time. The utilization of financial leverage plays a crucial role in determining a company's level of risk and profitability (Boateng et al., 2022).

The capital structure has played a pivotal role in facilitating the growth and advancement of companies operating within the manufacturing sector. Over the course of time, researchers have conducted comprehensive studies on the relationship between financial leverage and various economic factors (Venâncio & Jorge, 2022). There are various factors that influence the economic landscape, such as the growth rate of Gross Domestic Product (GDP), corporate taxation, interest rates, exchange rates, stock market development, and public debt, among others. The primary objective of this research article is to investigate the relationship between the factors mentioned earlier and financial leverage in the manufacturing industry (Jamil et al., 2023).

The development of more precise instruments for evaluating the financial performance of companies is widely acknowledged as a crucial cornerstone of modern financial research. The measurement of financial performance is of utmost importance in any business as it allows managers to assess the degree to which corporate goals and objectives are being achieved. Additionally, it aids managers in making informed decisions and effectively implementing them. Furthermore, it provides comprehensive information regarding the financial position of the firm and the creation of shareholder wealth (Agyemang et al., 2019). Nevertheless, accounting performance indicators such as net profit (NP), net operating profit after tax (NOPAT), return on investment (ROI), and earnings per share (EPS) have faced criticism for their inability to accurately reflect an organization's complete cost of capital. Consequently, relying solely on accounting income to assess corporate success or interpret firm value consistently is deemed inadequate (Ilham, 2020). Therefore, it is evident that there is a notable missing in the assessment of a manufacturing company's performance, as both economic value addition (EVA) and Tobin's Q are disregarded as relevant indicators. It is crucial for policymakers, investors, and business owners to possess a comprehensive understanding of the implications that capital structure decisions and working capital management have on the financial performance of manufacturing organizations within this industry. Despite the extensive attention given to this topic in the literature, there is still a lack of consensus regarding the association between observed variables.

Research Objectives of the Study

- To examine the effect of working capital management (Current Ratio, Cash Conversion Cycle, and Account receivable ratio) on Firm's Performance (EVA and Tobin's Q)
- To examine the effect of capital structure (Leverage) on Firms Performance (EVA and Tobin's Q)

LITERATURE REVIEW

The ideal capital market hypothesis by Modigliani and Miller (1958) posits that the association's value is independent of asset capitalization. Local businesses can benefit from economies of scale, profitability, internationalization, and globalization in the export domain, which is the primary driver of economic growth in the era of globalization. Increasing product exports can boost profits in foreign currencies, help the nation acquire raw materials, and aid in meeting its development needs. Rao et al. (2019) analyzed how various enterprises in India make capital structure decisions. The study identified 174 non-financial businesses as the sample, and the GMM was used to identify the organization drivers that affect SMEs' financing decisions in India. Profitability, reliability and responsiveness, size, age, development, flexibility, cash flow ratio, non-debt tax shield, and return on equity are all factors that are considered in the study. Januário and Cruz (2023) analyzed the impact of capital structure on productivity in four different Asian countries and found a negative correlation between leverage and profitability in three countries but a positive relationship between growth and leverage. The study also found a strong positive association between leverage and firm in each nation.

According to Agyemang et al. (2019) a company's liquidity may be assessed using working capital. Working capital is essential for a company's success, but it also entails extra expenditures, such as credit losses on accounts receivable and storage and shipping fees for items. In the business world, one of the most significant financial decisions is how to allocate a company's working capital (WCM). For the sake of an organization's long-term viability, corporate financial sustainability is heavily influenced by this aspect (Arnaldi et al., 2021). It's a fundamental idea to ensure that a company can meet its short-term commitments and assets. Cash, inventory,

accounts receivable, and accounts payable make up the four components of the balance sheet. A company's capacity to manage its short-term financial resources is at the heart of working capital management (Akgün & Memiş Karataş, 2020).

The objective of cash management is to maintain a consistent cash flow while reducing expenditures. The same principle applies to inventory management, which must be controlled to prevent product expiry, excessive storage expenses, and increased insurance prices (Akgün & Memiş Karataş, 2020). "Accounts receivable turnover" refers to the length of time it takes to receive payment once a transaction has been completed. Finally, accounts payable turnover is the period required for suppliers to receive payment for things acquired (Arcuri & Pisani, 2021; Shahbaz et al., 2014). To achieve these goals, it is essential that each component be well managed to optimize working capital. Working capital management is therefore a managerial concern (Akbar et al., 2021; Al Muhaissen & Alobidyeen, 2022). A crucial aspect of effective working capital management for any business is ensuring that short-term obligations are fulfilled on schedule and long-term assets are adequately insured.

Collection time is inversely related to the number of days before payment is due in short-run activities. There are several types of accounts that a company or organisation may give its consumers. Successful receivables management means being paid more quickly once sales are made. In return, customers have a responsibility to treat the organisation that provides the goods or services with respect. Reduce the number of clients who are behind on their payments. Customers that owe money are those who have done business with a company but have not yet paid for the products or services they got. CCC evaluates how long it takes a company to convert its investments in inventory and other resources into cash flows from sales. The majority of the cash conversion cycle raises and enhances sales, resulting in a higher profit margin and improved firm profitability. Inventory is a vital component of the cash conversion cycle and must be properly maintained to maintain a state of equilibrium. CCC is often used to measure working capital management in academic literature(Samo & Murad, 2019).

As a financial theory tool, Tobin's Q has been widely utilized to explain many aspects of economics. TQ has been examined extensively by a broad spectrum of scholars, including psychologists (Muhtadi, 2019; Singhal et al., 2016). According to Perera and Priyashantha (2018), TQ is defined as the sum of equity and liabilities multiplied by total assets. A company's TQ is equal to the market value multiplied by the cost of replacing its assets. It is possible to resell the company's property for a profit if the TQ is larger than one as opposed to one. Businesses with higher TQ values, according to (Fitriani, 2020), perform better over time than those with lower TQ values.

Hypothesis of the Study

H1: Capital Structure ratio Leverage has a significant effect on the performance.

H2: Average collection period has a significant effect on the performance of manufacturing companies.

H3: Cash conversion cycle has a significant effect on the performance of manufacturing companies.

H4: Current ratio has a significant effect on the performance manufacturing companies.

H5: Sales growth has a significant effect on the performance of manufacturing companies.

METHODOLOGY

The objective of this research is to examine the various factors that influence the financial performance of manufacturing companies listed on the Pakistan Stock Exchange. This study employs panel data regression analysis to examine the impact of working capital management and capital structure on the financial performance of publicly traded manufacturing firms in Pakistan. The selection of the manufacturing sector was made based on the availability of data, as it offers a more comprehensive understanding of the outcomes. The research data was sourced from secondary sources, specifically the annual reports of manufacturing companies. These reports encompass macroeconomic factors and firm-level variables. The study utilized a representative sample of manufacturing companies listed on the Pakistan Stock Exchange. Data from the period of 2017 to 2022, encompassing a duration of six years, was analyzed.

The investigation is conducted utilizing panel data regression analysis. The utilization of panel data regression is appropriate for this research study due to its coverage of a six-year time frame (2017-2022) and inclusion of a sample comprising all manufacturing businesses listed on the Pakistan Stock Exchange. Panel data regression is

considered suitable for this study due to its capability to analyze both time-series and cross-sectional data. Moreover, descriptive statistics are employed in research to provide a concise overview of the data collected from the sample. The provided statistics encompass the mean, median, and standard deviation of the variables under consideration, along with the minimum and maximum values associated with those variables. Furthermore, a correlation analysis is employed in the research to examine the relationship between observed variables. Furthermore, the research employs regression analysis to estimate the coefficients of the independent variables and assess their impact on the dependent variable under investigation. The regression analysis will enable the identification of pertinent factors, along with determining the magnitude and direction of their impact on decisions pertaining to capital structure and working capital within the manufacturing industry.

DATA ANALYSIS
Descriptive Analysis

Table 1: Descriptive Statistics

	EVA	LEV	TobinQ	ACP	SG	CCC	CR
Mean	15.66	15.03	16.06	14.21	13.01	12.98	14.04
Median	15.49	15.07	13.04	15.11	14.22	14.45	16.06
Maximum	18.14	19.89	17.02	19.56	13.02	18.72	15.44
Minimum	8.02	11.32	15.53	6.25	6.18	6.03	08.41
Std. Dev	3.89	1.38	1.43	1.32	1.45	2.12	3.84
Skewness	0.54	0.81	0.24	-0.52	0.48	-0.68	0.49
Kurtosis	4.69	5.98	2.15	5.32	6.27	4.45	6.28

To confirm the normality of the data, the means and medians of the variables were compared, and it was found that they were almost identical, indicating that the data was normally distributed. The values of skewness and kurtosis were also within an acceptable range, and the standard deviation was reasonable, further supporting the normality of the data. In Table 2, the mean values of all the variables were similar, indicating that the data was normally distributed. Since the data spanned ten years, there was a possibility of abnormality due to increased variability and temporal disparities.

Correlation Analysis

Table 2: Correlation Matrix

Variables	EVA	TobinQ	ACP	SG	CCC	CR	Lev
EVA	1.0000						
TobinQ	-0.005	1.0000					
ACP	0.7679	0.1193	1.0000				
SG	-0.072	0.3356	-0.0160	1.0000			
CCC	-0.293	0.4224	-0.1216	0.2291	1.0000		
CR	-0.528	-0.116	-0.3780	0.0792	0.3812	1.0000	
LEV	0.1368	-0.019	0.0699	-0.1159	-0.1673	-0.2300	1.000

The above table of correlation matrix indicated that majorly, there is a positive and significant correlation between the variables. Further the table indicated a negative relationship between some variables. The table indicated that EVA has significant and negative correlation with TobinQ with a value -0.005. Similarly, the EVA correlate with ACP (0.7679) positively and significantly. Further the table indicated that no value of *r* is higher than .80, that's why there is no chance of multicollinearity in this data.

Regression Analysis (Fixed Effect Model)

Table 3: Comprehensive Results

Name of Variable	EVA		TobinQ	
	Coefficient	T. Stat	Coefficient	T. Stat
ACP	.322774	4.20**	.030525	-0.46
SG	.0332033	0.13	.388641	1.44
CCC	-.2078964	0.50**	-.2445276	-1.24**
CR	-.1037125	1.25**	.02897	0.36**
Lev	.0334078	0.12**	.281302	0.59
CONS	.1288706	0.73	.227866	5.25
F-Stat	11.98	9.96		
R^2 within	0.5492	0.4188		
Between	0.5203	0.8867		
Overall	0.5331	0.4487		

***= 0.000, **= 0.001-0.005, *= 0 indicate significant value at 0.01-0.05

Economic Value Added (EVA) and Tobin's Q are two variables that are analyzed using regression along with a number of other control variables. The strength and importance of these correlations are shown by the coefficients and *t*-statistics. ACP, CR, and Leverage variables have statistically significant effects on EVA, but SG (Sales Growth) has a non-significant influence. With a substantial *F*-statistic and *R*-squared values showing that around 53% of the variance in EVA and Tobin's Q can be explained by the independent variables, the overall model statistics demonstrate a reasonable fit.

Hypothesis Testing

Table 4: Hypothesis Testing

Hypothesis	Decision
H1: Capital Structure ratio Leverage has a significant effect on the performance.	Supported
H2: Average collection period has a significant effect on the performance of manufacturing companies.	Supported
H3: Cash conversion cycle has a significant effect on the performance of manufacturing companies.	Supported
H4: Current ratio has a significant effect on the performance manufacturing companies.	Supported
H5: Sales growth has a significant effect on the performance of manufacturing companies.	Not-Supported

DISCUSSION AND CONCLUSION

There exists a significant correlation between the indicators of working capital and the financial performance of manufacturing enterprises operating within the Pakistani market. According to the data, the current ratio has a significant influence on manufacturing firms. According to Altaf (2020), the current ratio has a positive impact on company performance, a finding that is consistent with previous research. In their study, Kumar and Sharma (2011) discovered a significant correlation between company performance and working capital. In contrast, Kumar and Sun (2020) conducted a study on the negative impact of workplace conflict on organizational performance. The findings of this study further support the conclusion made by Marttonen-Arola et al. (2013) that the value of a company is influenced by liquidity, as measured by the Current Ratio.

Furthermore, the research findings suggest that the average collection time, used as a measure of working capital management, has a significant and negative impact on EVA, which serves as a proxy for business performance. However, its effect on Tobin's Q, another proxy for business performance, is found to be negligible. The velocity at which customers make payments is ascertained by the average collection period. Late payments can potentially contribute to the occurrence of bad debts, which in turn adversely affect a company's financial performance. The conclusions of the present study are supported by literature, as Lazaridis and Tryfonidis (2006) found evidence of a

negative relationship between the number of days' accounts receivable and profitability based on gross operational profit. The aforementioned adverse discovery suggests that businesses could potentially enhance their profit margins by implementing shorter loan terms for their clients. Deloof (2003) observed a significant negative correlation between the average number of days of accounts receivable and gross operating income, which serves as a metric for profitability.

The cash conversion cycle is an additional metric used to assess working capital and its impact on firm performance. It is observed that there exists a significant and positive correlation between the cash conversion cycle and a company's performance. Specifically, businesses that are able to convert their inventory into cash in a shorter period of time are anticipated to exhibit stronger performance. The findings of previous studies are also pertinent to those of the current study. The relationship between Economic Value Added (EVA) and Cash Conversion Cycle (CCC) is based on the premise that net operating profit should have an inverse correlation with CCC. Specifically, as the net operating profit increases, the CCC is expected to decrease. Hence, it can be inferred that a decrease in the cash conversion cycle (CCC) is likely to result in an increase in economic value added (EVA). Given the correlation between liquidity and profitability, it is logical to expect that beyond a specific threshold of liquidity, a decrease in the cash conversion cycle (CCC) will result in a subsequent decline in economic value added (EVA). The cash conversion cycle is widely regarded as a valuable metric for assessing the effectiveness of working capital management and its impact on a company's liquidity (Arnaldi et al., 2021).

Based on the findings of the study, it was observed that sales growth had a minimal effect on both performance indicators. Consistent with previous research findings, Nastiti et al. (2019) concludes that Leverage significantly impacts business value, while Profitability and Sales Growth do not exhibit a similar influence. Furthermore, the study conducted by Kabir et al. (2021) examines the influence of Profitability and Sales Growth on Firm Value, with consideration for the moderating effect of Leverage. Based on the research findings, it can be concluded that neither Sales Growth nor Profitability significantly influences the overall value of a business. Therefore, it is not possible for sales growth to simultaneously enhance the value of the company.

Finally, the study findings indicate that the capital structure (leverage) of the firm has a substantial impact on its performance. The results of recent research align with the findings of prior studies (Cordeiro & Jr, 2001). In summary, the study's findings contribute to the existing literature by highlighting the significance of working capital management and capital structure as key indicators of firm performance in the manufacturing sector. The study's scope is restricted to manufacturing companies.

The study highlights the importance of effective working capital management and capital structure decisions for manufacturing firms' financial performance and shareholder value. Policymakers, investors, and business owners need to consider these factors while assessing and managing the performance of manufacturing companies. The research is limited to the manufacturing sector and considers data from the Pakistan Stock Exchange. Generalizations to other industries or regions should be made with caution. Additionally, the study uses financial indicators like EVA and Tobin's Q as proxies for performance, which may not capture all aspects of a firm's performance.

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