World Applied Sciences Journal 12 (11): 1967-1973, 2011
ISSN 1818-4952

Practices of Working Capital Policy and Performance Assessment Financial Ratios and Their Relationship with Organization Performance

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Abstract: The purpose this study is to highlight the application of working capital policy and the performance assessment financial ratios and to determine their relationship with organization performance. The target respondents were the finance executives/financial analysts of the companies. 64 properly filled questionnaires were processed for analysis. This study concludes that the finance executives consider that the proper practices of working capital and financial ratios are very important for the growth and performance of the organization. This research study also finds that there is positive and significant relationship between these practices and organization performance.

Key words: Working capital policy · Financial ratios · Corporate sector · Organization performance · Significant Relationship

INTRODUCTION

The corporate culture depends on attitudes, beliefs and company management's values, education and work experience and its impact on corporate decision making processes. When the executives were rewarded (or punished) for their work, it's not written in company policy, but referred to be an important corporate culture's components. The IMF report provides strong evidence regarding the crises that took place in 1997, was an out come of poor corporate sector [1]. Working capital policy relates to the management of short term assets and liabilities within the maturity period of one year. Working capital management is really vital for the financial health of business no matter what is the size of the business. For the growth and survival of firms efficient working capital is indeed a requirement because it shows the level of inventory, production and sales [2]. Probably, financial managers spare more time for working capital management than any other financial activity. The debate on working capital policy is having different views in a way that financial distress leading to bankruptcy is believed to be a result of poor short-term asset and liability management. The financial performance assessment is viewed as an important factor in evaluating company performance.

The results of efficient working capital and financial ratios can be useful in analyzing the efficiency of a company in different operations. If these practices such as working capital policy and performance assessment financial ratios are exercised an organization would achieve a better resource utilization and profit margin. Pakistani corporate sector has grown over the period of time through the courtesy of privatization and liberalization, yet practice of these functions should be implemented in Pakistani corporate sector. Working capital policy and financial performance assessment ratios are very important for the organizational success and growth and hence must be practiced in Pakistani corporate sector at large. The proper exercise of working capital policy and financial ratios are very important for every organization and has a significant impact on company performance and growth. In Pakistan, many

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private and public sector organizations are not carrying out these practices, mainly due to obsolete business processes and structure of the company. As a result, there are huge deficiency problems in Pakistani corporate sector. Preliminary investigation and published data reveal that Textile, Banking, Insurance, Chemical, Fertilizer, Cement, Oil and Gas and Automobile are the leading industries in terms of these practices. Therefore, firms related to these sectors are the target respondents for measuring the perception and application of these practices. These industries are also the main contributors towards economy in terms of profitability, contribution to GDP, employment generation and growth.

In comparison to the globe these practices in Pakistan are still immature in the monetary management policies of the corporate sector. If corporate sector in Pakistan (public or private) adopts comprehensive working capital policy and financial ratios, these would be directly affecting profits and value maximization of the organizations. A growing stream of research shows that these changing monetary policies have a strong influence on the organization performance. In Pakistan the growth in different industries has been beneficial for the economy and the country. Simultaneously, it has changed the attitudes of the businesses towards the monetary policies, which indeed has a positive affect on the significance and worth of an individual organization. The expectations of financial managers and executives have escalated due to the financial management revolution but still there is lot to be done to achieve the anticipated profit and value for the firm. The literature on Pakistani corporate sector suggests that financial management practices are not being followed across the economy. There is less realization regarding application of these practices and contribution towards organization success. For the last decade or so Pakistan economy has been growing at a steady rate. The sectors like Oil and gas, cement, fertilizer and automobiles are among the most growing industries. Whereas, Textile, Tobacco, Sugar, Pharmaceutical industries have shown growth initially and then there is a decline in these industries. There are so many reasons behind the decline in these industries such as political instability, failing law and order situation, increasing power shortage, monitory reduction, food and energy crises and increasing operating costs of business? There is decline in the performance of manufacturing sector in the last part of this decade as compared to initial years where the growth was satisfactory [3]. Banking, insurance and telecommunication are the most growing industries in service sector and there is need to givesupport to maintain the high growth for the economy. Pakistani Service sector has a remarkable development and the growth over the last decade. Since last quarter of 2007, as a whole the corporate sector performance is on the decline constantly. The investigation reveals that inappropriate application of financial management practices is one of the reasons of this downfall along with above mentioned issues faced by the economy.

The extent to which Pakistani corporate sector is following these practices needs to be investigated, especially in the period where economic indicators are declining after steady growth in last decade. The purpose this study is to highlights the application of working capital policy and the performance assessment financial ratios and their relationship with organization performance. To suggest measures to improve the level of application of these practices in Pakistani corporate sector.

Literature Review: Organizational performance has many dimensions, such as long-term performance, short-term performance, financial performance, non-financial performance, relationship-building performance [4]. Financial parameters like profitability, market share and sales growth are generally used to measure organizational performance. Financial indicators can only measure past performance, but they cannot provide current or future performance directions for a company [5].

Industry practices are, significantly, determined by a firm's management of working capital [6]. Working capital that is required by the business is determined by a number of factors [7]. Mismanagement and starvation of working capital is regarded as the important cause, if not major, for the failure of business in many countries, developed and underdeveloped [8]. [9] discussed that the way the companies manage the working capital it has a significant impact on their profitability since a large amount of cash, is invested in the working capital. Often working capital amounts are high in proportion as compared to total assets employed and therefore it is important that these amounts are managed and used in effective and efficient way [10]. [11] concluded that financial management practices are very important for the growth and performance of organization and found the significant relationship between organization performance and financial management practices. [12] explained working capital management as the administration of all the aspects of current assets and current liabilities.

It includes the firms' investments in short term securities, short term assets, inventories and account receivable. The volume of current assets and current liabilities, that the company is ready to incorporate in its balance sheet, is the decision of management determination of efficient working capital [13]. Working capital management is indeed a pre-requisite for the growth and survival of the firm [10].

The development of European financial system was analyzed by [14] and it unconcerned some complex linkage of economic, political and some global factors. There was no evidence of a significant association between corporate sustainability performance (CSP) and financial performance [15]. [16] indicated that leading corporate sustainability performance (CSP) firms are significantly larger, have higher levels of growth and a higher return on equity than conventional firms. The financial ratios are viewed as an important factor in assessing performance of a company. The results of these ratios can be useful in evaluating the efficiency of a company in different operations. However, [17, 18] discussed some of the weaknesses in the usage of common ratios such as proportionality, scaling and symmetric effects. The changes which are observed in the financial ratios and accounting are due to the adoption of strict requirements, regarding accounting issues and rules about fair value accounting [19]. [20] tested the effectiveness of four different techniques used to predict financial distress. They found that multiple discriminate analysis and recursive partitioning have the highest prediction accuracy for predicting "failed" companies.

The following theoretical framework has been developed on the basis of evidence available in above mentioned literature. The dependent variable is organization performance and five independent variables are capital structure decision, dividend policy, investment appraisal techniques, working capital policy and financial performance assessment.

Hypotheses Statements: To test the relationship between organization performance and working capital and financial performance assessment, following hypotheses have been developed:

H1: Working Capital Policy has significant impact on Organization Performance

H2: Performance Assessment Financial Ratios has significant impact on Organization Performance

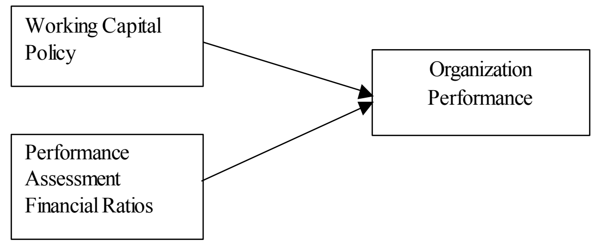

Fig. 1: Theoretical Framework

Research Methodology: In this study non probability sampling technique was used. The target population of the study was ten leading sectors companies of corporate sector (banking, telecommunication, oil and gas, cement, insurance, sugar, oil and ghee, automobiles, textile and fertilizer). Companies from each sector were selected on the basis of listing at Karachi stock exchange. The target respondents were the finance executives/financial analysts of the companies. 79 questionnaires were distributed among the respondents of different companies in Islamabad, Rawalpindi, Lahore, Faisalabad, Multan Gujarat, Gujranwala, Peshawar and Karachi of Pakistan but 67 filled questionnaires were received back and 64 properly filled were used for analysis in this study.

There were two parts of the questionnaire, general information regarding the respondents and company was collected through first part of the questionnaire and the second part contained the information related to three dimensions working capital policy, financial ratios and organizational performance. The response was measured through 5 point Likert scale in section two of the questionnaire, where 1 is highest degree of agreement and 5 is the least degree of agreement and nominal scale was used in section one. The statistical package social sciences program (SPSS) was used for analysis. It is an adapted questionnaire based on the financial practices followed by the local companies, from the study of [21] and to measure the organization performance scale was taken from [22]. The reliability of instrument was checked. The organization performance having three items with reliability of 0.776 and there are (five items) in working capital policy dimension and the Cronbach Alpha is 0.731, the performance assessment using financial ratios (eight items) and the reliability is 0.877. The reliability index for the instrument (16 items) was 0.807.

The questionnaire was personally distributed among 79 companies in Islamabad, Rawalpindi, Lahore, Multan, Karachi, Faisalabad, Gujarat, Gujranwala and Peshawar. The concern financial personnel were identified in each company through company profile, telephone and reference. Before giving the questionnaire, all the questions were explained to the respondents so that they could fill the questionnaire easily and with the relevant responses. The sample was limited to listed companies with Karachi Stock Exchange (KSE) of ten different sectors operating in Pakistan. Hence, convenient sampling method was followed. After the data was collected from the entire companies selected for the study, it was coded and entered into SPSS sheet for analysis. Dependent variable organizational performance and independent variables (working capital policy and financial performance assessment) were computed using SPSS. To review the characteristics of respondents and collected data descriptive statistics were performed and in order to test hypotheses regression test was applied. Descriptive statistics was used for the purpose of gaining a descriptive overview of collected data. Regression analysis was used to identify the relationship of, working capital policy and financial performance assessment on organization performance. The confidence interval for the present study is 95 % with 5 % Level of significance. The level of significance of the variable was checked at 5 %.

RESULTS AND DISCUSSION

The results of organizational performance, working capital policy and financial ratios and the degree of agreeableness and importance according to respondents and the relationship between working capital policy and financial ratios and organization performance are analyzed by descriptive statistics and regression technique and results are summarized below:

Table 1 depicts that more than two third of finance executives are agreed that market share is very important for the organization growth. Since 81 percent respondents are agreed with the statement that the profitability has a significant impact on companies' value, whereas 83 percent respondents replied that productivity plays an important role to enhance the performance, growth and success of the company. The mean values suggest that majority of the respondents have the response in positive side and the mean values are 1.9141, 2.1021 and 1.1061 respectively.

Table 2 presents the results of working capital policy based on managers' response. The most agreed statement of working capital policy is the importance to have good backup lines of credit from banks with response rate of 95%. Where as 80 percent of corporate subjects believe that more effort is needed to coordinate short term cash inflows and outflows. Majority of the respondents (75%) are agreed that cash management policy should be developed on the basis of formal cash management models. It is important to grant trade-credit terms to customers, 70 percent respondents are agreed to this statement. 65 percent of the respondents are agreed that companies which experience financial distress or ultimately bankruptcy can initially trace their problems to a poor working capital policy.

The results in the above table show that managers endorse high value to these standard measures of performance: price earning ratio, return on equity, return on assets, return on capital employed, time interest earned ratio and the cash ratio are consider them highly important. The level of importance to these

Table 1: Frequency Distribution and Descriptive statistics with respect to "Organization Performance"

	Percentage response rate (N=64)				
Items	Agree	Neutral	Disagree	Mean	St. Dev
Market Share	69	21	10	1.9141	0.8658
Profitability	81	25	4	2.1021	0.8095
Productivity	83	11	6	1.1061	0.7436

Table 2: Frequency Distribution and Descriptive statistics with respect to "Working Capital Policy"

	Percentage response rate (N=64)				
Items	Agree	Neutral	Disagree	Mean	St. Dev
More effort is needed to synchronize short-term cash inflows and outflows	80	10	10	1.8889	0.9673
It is important to have good back-up lines of credit from bankers	95	-	5	1.6111	0.9255
Cash management policy should be developed on the basis of formal cash management models	75	20	5	2.1111	0.7873
It is important to grant trade-credit terms to customers	70	20	10	2.2941	0.8438
Companies which experience financial distress or bankruptcy problems are due to a poor working capital policy	65	20	15	2.3333	1.1239

Table 3: Frequency Distribution and Descriptive statistics with respect to "Performance Assessment using Financial Ratios"

	Percentage response rate (N=64)				
Items	Important	Unsure	Unimportant	Mean	St. Dev
Price Earnings (PE)	85	5	10	1.8500	0.9333
Return on Equity (ROE)	90	5	5	1.6000	0.8208
Return on Assets (ROA)	95	5	-	1.6000	0.5982
Return on Capital Employed (RCE)	90	10	-	1.6000	0.6806
Profit margin to total assets (PMA)	75	15	10	2.1500	1.0399
Asset Turn Over (ATR)	60	30	10	2.1500	1.0399
Times interest earned ratio (TIE)	85	10	5	1.9500	0.7592
Cash ratio (CR)	80	15	5	1.9500	0.8256

Table 4: Regression coefficients, standard errors in parentheses, t-values in brackets and p-values in italic (N=64)

Constant	Financial Ratios	Working Capital Policy	R-Square	F-Statistics
2.587	0.448	0.529	0.597	19.130
(1.013)	(0.612)	(0.475)		
[1.684]	[5.191]	[4.152]		
0.079	0.000	0.000		0.000

ratios ranges from 95% to 80%. In terms of short-term performance, 75 percent of respondents consider the profit margin to total assets ratio is important. The relatively low emphasis is placed on the asset turn over ratio with 60 percent respondents perceive that it is important.

Table 4 presents the results of regression analysis. The results show that the model is significant ($p<0.05$) and there is positive relationship between organizational performance and working capital and financial ratios (R-Square=0.597 and the F-value=19.130). The independent variables of the model account for 59.7% variation in dependent variable. When these practices are reviewed on individual basis, both are significant ($p<0.05$) and positively related to organizational performance. The regression coefficients of financial ratios and working capital policy are 0.448 and 0.529 respectively. Though working capital policy contributes almost 53% in organization performance in this model and the most important factor towards organization performance, financial managers are giving substantial weight to working capital policy and performance assessment financial ratios as well. The results of regression analysis suggest that independent variables have positive and significant impact on organization performance and financial managers perceive them valuable for organizational performance and growth. These results validate hypotheses (H1 and H2) and it establishes that Pakistani corporate sector perceives practices working capital and financial assessment ratios as critical for organizational performance.

The results of present study are in line with previous researches; in the response of working capital policy, it is important for the growth and performance of the company and it is proved that the volume of current assets and current liabilities, that the company is ready to incorporate in its balance sheet, is the decision of management-determination of efficient working capital [13]. Financial management discloses that working capital management is unavoidable for corporate growth and survival [10]. For the growth and survival of firms efficient working capital is indeed a requirement because it shows the level of inventory, production and sales [2]. Efficient management of working capital will increase the profitability of the organization in order to meet with the financial needs. [23] indicated that within specific groups of industry financial ratios might, normally, be more distributed. [17, 18] discussed some of the weaknesses in the usage of common ratios such as proportionality, scaling and symmetric effects. [20] tested the effectiveness of different techniques used to predict financial distress. They found that multiple discriminate analysis and recursive partitioning have the highest prediction accuracy for predicting "failed" companies.

Conclusion and Recommendations: The results reveal that the decision makers are well aware and agreed to the importance of practices of working capital policy and performance assessment financial ratios in Pakistani corporate sector. It is proved from the results that theory and application of practice in different areas are closely related, as the importance of working capital management and the role of financial ratios in performance assessment. Almost respondents have most degree of agreement on the importance of having good back-up lines of credit from bankers and use of standard cash flow models for cash management. Corporate managers are agreed that financial ratios are important for the assessment of performance and these ratios are being practiced in Pakistani corporate sector and consider these techniques are important for long term profitability and survival of the company. This study also determines the relationship between organization performance and these practices and present research study concludes working capital and financial performance assessment ratios have positive and significant impact on organization performance. However, during the survey it is observed that some organizations are not following these policies but consider these practices as important.

On the basis of above results, here are few suggestions for the improvement of financial management practices in this area. Both companies and policymakers should devise strategies to promote and trained the managers to making decisions regarding the working capital. Application of related financial ratios practices across the firms and industries will help to standardize the rules/regulations and procedures which can result in industrial growth in the country. One crucial issue which came across during a visit to the companies was the services of relevant and expert finance personnel there is need to hire the new financial managers. The potential trends in the sector, financial implications in restructuring, treasury operations management and use of secondary data of various financial practices in terms of profit, revenue, productivity and market value, however, can be analyzed in future research.

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