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Impact of Working Capital Policy on Profitability : A Study of Nepal's Manufacturing Sector

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Abstract

Effective working capital management (WCM) is crucial for assessing an organization's performance. An optimal WCM approach is expected to enhance profitability and contribute to overall company value. This study also examines the influence of working capital policy alongside control variables such as business growth, firm size, and debt on profitability. This research aims to investigate the relationship between working capital policies and business profitability within three public cement industries in Nepal: Hetauda Cement Limited, Shivam Cement Limited, and Udayapur Cement Limited. The profitability of the selected firms is measured using market and accounting metrics, specifically Net Operating Profitability (NOP), Return on Equity (ROE), and Return on Assets (ROA). The study employs the Ordinary Least Squares (OLS) regression method to evaluate the research hypothesis. Data is collected from the Nepal Stock Exchange for the period between 2011 and 2020.The results indicate that working capital policies have a significant negative impact on the profitability of the firms studied. The findings underscore the importance of effective working capital management in enhancing profitability within Nepal's cement industry, suggesting that firms must optimize their working capital policies to improve financial performance.

Keywords: net operating profit, return on asset, return on equity, working capital policy

Introduction

In the competitive and ever-changing corporate world of today, maintaining profitability and long-term survival are significant problems for enterprises. These difficulties continue even when businesses are making money if they have trouble fulfssinilling their immediate obligations. Capital structure, capital budgeting, and working capital management are important decision-making domains that fall under the umbrella of corporate finance. A company's liquidity, profitability, and total value are all directly impacted by working capital management (WCM), making it a crucial component of these (Mishra et al., 2021; Mishra & Kandel, 2023).

The primary objective of working capital management (WCM) is to ensure the effective allocation and financing of current assets and obligations. This involves achieving an optimal balance between maximizing profitability and minimizing the risk of liquidity constraints. Effective WCM requires meticulous planning and management of components such as cash, receivables, inventory, and payables (Eljelly, 2004). A sound financial strategy ensures that businesses maintain sufficient cash reserves without over-investing in current assets, which could hinder their capacity to finance long-term growth.

WCM is a critical aspect of corporate strategy, focusing on the interplay between profitability and liquidity. Striking this balance can be particularly challenging in environments characterized by intense competition, rising capital costs, and fluctuating economic conditions (Imegi et al., 2003). Given that WCM significantly influences risk, efficiency, and shareholder value, financial executives must adopt strategic measures to navigate these complexities (Smith, 1980). For instance, excessive investment in current assets may mitigate liquidity risks but could lead to suboptimal profitability. Conversely, a lean working capital structure might yield higher returns at the expense of increased liquidity risk.

Theoretical frameworks categorize working capital management strategies into two main approaches: aggressive and conservative. An aggressive policy is characterized by a high reliance on current liabilities and low levels of current assets relative to total assets, which increases risk but offers greater potential returns (Gardner et al., 1986; Weinraub & Visscher, 1998) In contrast, conservative policies prioritize stability by maintaining higher levels of current assets to ensure liquidity, albeit at the cost of lower profitability. Firms must tailor their strategies to align with their operational scale, industry dynamics, and financial objectives.

The industrial sector in Nepal, particularly the cement industry, provides a compelling context for examining the impact of working capital policies on business profitability. Among the 48 companies in this sector, three are publicly traded while 45 are private entities listed on the Nepal Stock Exchange (NEPSE). With an average capacity utilization rate of 80%, this industry serves as a representative sample for analyzing the effects of various working capital management techniques on profitability.

The objective of this research is to explore the relationship between working capital policies and business profitability within Nepal's manufacturing sector. By investigating the implications of both aggressive and conservative approaches, this study aims to enhance understanding of best practices in working capital management and their broader effects on value creation and organizational performance.

Problem Statement

The primary challenge in working capital management (WCM) is achieving an optimal balance between maximizing profitability and minimizing liquidity risks. Effective allocation and financing of current assets and obligations are essential, yet many firms struggle to maintain sufficient cash reserves without over-investing in current assets, which can impede long-term growth potential. In highly competitive environments with rising capital costs and economic volatility, financial executives face the dilemma of excessive investment in current assets that mitigates liquidity risks but may lead to suboptimal profitability. Conversely, a lean working capital structure can enhance returns but increases liquidity risk.

Theoretical frameworks categorize WCM strategies into aggressive and conservative approaches. Aggressive policies, characterized by high reliance on current liabilities and low levels of current assets, heighten risk while potentially yielding greater returns. In contrast, conservative strategies prioritize stability through higher current asset levels to ensure liquidity at the expense of profitability. This dichotomy presents a significant problem for firms as they must tailor their strategies to align with operational scale, industry dynamics, and financial objectives.

In the context of Nepal's industrial sector, particularly the cement industry, there is a pressing need to examine how different working capital policies impact business profitability. With 48 companies in this sector—three publicly traded and 45 private entities listed on the Nepal Stock Exchange (NEPSE)—the average capacity utilization rate of 80% provides a representative backdrop for analysis. Understanding the implications of aggressive versus conservative working capital management approaches is crucial for enhancing organizational performance and value creation.

Research Objective

This research aims to address the specific problem of how working capital policies affect business profitability within Nepal's manufacturing sector. By investigating these relationships, the study seeks to identify best practices in WCM that can help firms navigate the complexities of profitability and liquidity management effectively.

Literature Review

Working capital management (WCM) has emerged as a pivotal topic in financial research, with numerous studies investigating its influence on firm profitability. While much of the existing literature emphasizes the general significance of working capital, there is a

notable gap in research specifically examining the effects of different working capital policies—particularly aggressive versus conservative strategies—on firm performance. This review synthesizes key studies that explore the relationship between working capital policies and profitability, highlighting findings relevant to various sectors and economic environments.

Weinraub and Visscher (1998) conducted a seminal study analyzing the working capital management policies of U.S. firms across three distinct industry groups. Their findings revealed significant variations in working capital strategies employed by different industries. Notably, industries characterized by aggressive working capital asset policies often balanced these with conservative financing approaches. This interplay between asset management and liability management has been a recurring theme in subsequent research.

Building on this foundation, Filbeck and Krueger (2005) extended the analysis to 32 non-financial industries in the U.S., uncovering substantial differences in working capital practices across sectors. They observed that these practices evolved over time within individual industries, suggesting a dynamic relationship between working capital strategies and firm profitability. This observation aligns with earlier studies by (Soenen, 1993; Long et al., 1993), which similarly identified industry-specific variations in working capital management.

In a focused study on Pakistan, Rehman and Asar (2007) investigated the impact of working capital management on profitability by analyzing key metrics such as average collection periods, inventory turnover, average payment periods, and the cash conversion cycle (CCC) across 94 firms listed on the Islamabad Stock Exchange. His findings established a significant negative relationship between these working capital ratios and firm profitability, indicating that optimizing the CCC can positively influence profitability—a conclusion supported by (Smith & Begemann, 1997; Howorth & Westhead , 2003).

Afza and Nazir (2007) further explored this relationship by examining aggressive versus conservative working capital policies among 204 public companies listed on the Karachi Stock Exchange. Their study found a negative correlation between the aggressiveness of working capital policies and profitability, suggesting that firms adopting more aggressive strategies for both investment and financing often struggled to achieve higher profits. This highlights the necessity for a balanced approach to working capital management.

In a subsequent analysis using analysis of variance (ANOVA) and least significant difference (LSD) tests across 17 industrial groups with a sample of 263 public companies from the Karachi Stock Exchange, Afza and Nazir reaffirmed their earlier conclusions regarding the detrimental impact of aggressive working capital policies on profitability.

Pandey and Parera (1997) examined working capital practices among private sector manufacturing companies in Sri Lanka, discovering that most firms lacked formal working capital policies. Their research indicated that firm size influenced whether companies adopted conservative, moderate, or aggressive approaches to WCM, with profitability also playing a role in shaping their strategies.

Binti Mohammad and Binti Mohd Saad (2010) analyzed the working capital management practices of 172 listed Malaysian firms, revealing a significant negative relationship between current ratio and financial performance. Their study emphasized the importance of efficient WCM in enhancing market value and profitability, advocating for integration of WCM into strategic and operational processes.

Ghosh and Maji (2003) focused on the Indian cement industry from 1992 to 2002, finding that overall performance in terms of WCM was suboptimal. They recommended improvements in working capital efficiency as essential for enhancing profitability and operational effectiveness within the sector.

Ali and Hassan (2010) conducted research on firms listed on the OMX Stockholm Stock Exchange, finding no significant relationship between profitability and various WCM policies—whether aggressive, defensive, or conservative—when assessed through the cash conversion cycle. However, limitations related to data normality affected their results' robustness due to reliance on dummy variables.

Collectively, these studies illuminate the complex relationship between working capital policies and firm profitability. While there is general agreement that overly aggressive working capital strategies may not consistently enhance profitability, industry-specific factors significantly influence outcomes. The diverse findings underscore the need for further research to understand how contextual elements shape the effectiveness of different WCM approaches across various sectors.

This comprehensive review serves as a foundation for future investigations into best practices in working capital management, aiming to inform practitioners about optimal strategies that align with their unique operational contexts while maximizing profitability.

Research Methodology

This study seeks to analyze the effect of working capital policies on the profitability of firms in the Nepalese manufacturing sector. It emphasizes evaluating the degree of aggressiveness or conservativeness in investment and financing policies and their influence on financial performance.

Research Design

This study employs a quantitative research approach to investigate the relationship between working capital policies and firm profitability. A descriptive and correlational design is utilized to assess the impact of investment and financing policies on profitability indicators, specifically Return on Assets (ROA) and Return on Equity (ROE).

Population and Sampling

Target Population : The research focuses on firms within the Nepalese manufacturing sector, particularly those listed on the Nepal Stock Exchange (NEPSE).

Sampling Technique : A purposive sampling method is employed to select firms that have consistently published financial statements from 2011 to 2020. This approach ensures the reliability and relevance of the data collected.

Data Collection

Sources of Data: The research relies on secondary data obtained from audited financial statements, annual reports, and publications of the selected manufacturing firms.

Regulatory Reports: Additional data sources include reports from regulatory bodies such as NEPSE and other relevant industry publications.

Variables and Measurement

Dependent Variable

Profitability. Measured using indicators such as Return on Assets (ROA), Return on Equity (ROE), and Net Profit Margin (NPM).

Independent Variables

Investment Policy (IP). Defined as the ratio of Total Current Assets to Total Assets (TCA/TA). A lower ratio indicates an aggressive policy, while a higher ratio reflects a conservative approach.

Financing Policy (FP). Defined as the ratio of Current Liabilities to Total Liabilities (CL/TL). A higher ratio indicates an aggressive financing policy, while a lower ratio signifies a conservative approach.

Control Variables

Firm Size: Measured by Total Assets or Sales Revenue.

Debt-to-Equity Ratio: Used to assess leverage.

Analytical Tools and Techniques

Descriptive Analysis: To summarize data and provide an overview of working capital policies and profitability measures among the selected firms.

Correlation Analysis: To examine the relationships between working capital policies and profitability metrics.

Regression Analysis: To quantify the impact of investment and financing policies on profitability while controlling for other variables such as firm size and leverage.

To analyze changes in working capital policies and profitability over the ten-year period from 2011 to 2020.

Theoretical Framework

The study is grounded in established theoretical frameworks, particularly those proposed by Afza and Nazir (2007), Weinraub and Visscher (1998), and Salawu (2006), which explore the relationship between working capital management practices and firm performance.

Scope and Limitations

The research is confined to Nepalese manufacturing firms, which may limit the generalizability of findings to other sectors or geographical regions. The reliance on secondary data assumes accuracy and completeness in financial reporting by the selected firms. This methodology aims to provide a comprehensive framework for analyzing how working capital policies influence firm profitability within Nepal's manufacturing sector, contributing valuable insights for both academic research and practical application in management science.

Ethical Considerations

All data used in this study are publicly available, and no confidential information has been accessed. Proper citations and acknowledgments have been made to ensure ethical compliance.

Results and Discussion

Conceptual Framework

The conceptual framework of the study is designed to analyze the relationship between independent variables (Investment Policy and Financing Policy) and dependent variables (profitability indicators: NOP, ROA, and ROE), while accounting for control variables (Firm Size, Sales Growth, and Financial Debt Ratio).

Table 1

Measurement of Variables and Abbreviations

Variables	Measurement	Abbreviation
Dependent Variable		
Net Operating Profitability	N/A	NOP
Return on Assets	N/A	ROA
Return on Equity	N/A	ROE
Independent Variable		
Investment Policy	Total Current Assets / Total Assets	IP
Financial Policy	Total Current Liabilities / Total Assets	FP

Control Variable		
Firm Size	Natural Logarithm of Sales	Size
Sales Growth	(Current Year Sales - Last Year Sales) / Last Year Sales	SG
Financial Debt Ratio	Total Financial Debt / Total Assets	DEBT

By defining and analyzing these variables, this study aims to provide a comprehensive understanding of the impact of working capital policies on firm profitability in the Nepalese manufacturing sector.

Statistical Analysis

To evaluate the impact of working capital policies on the profitability of firms in the Nepalese manufacturing sector, panel data regression analysis has been employed. This method allows for the examination of both cross-sectional and time-series variations in the dataset spanning from 2011 to 2020. The analysis focuses on assessing how aggressive and conservative working capital policies influence profitability measures, while controlling for key firm-specific variables.

Data Analysis tool

The regression models have been estimated using **EViews software**, which provides robust statistical tools for panel data analysis.

Regression Models

Three separate regression equations are formulated to analyze the impact of working capital policies on three profitability indicators: Return on Assets (ROA), Return on Equity (ROE), and Net Operating Profit (NOP).

The equations are as follows:

Model 1: Impact on return on assets (ROA)

ROA=β0+β1(IP)t+β2(FP)t+β3(Size)t+β4(Growth)t+β5(Debt)t+□ROA = β□ + β□(IP)t + β□(FP)t + β□(Size)t + β□(Growth)t + β□(Debt)t + \epsilonROA=β0+β1(IP)t+β2(FP)t+β3(Size)t+β4(Growth)t+β5(Debt)t+□

Model 2: Impact on return on equity (ROE)

ROE=β0+β1(IP)t+β2(FP)t+β3(Size)t+β4(Growth)t+β5(Debt)t+□ROE = β□ + β□(IP)t + β□(FP)t + β□(Size)t + β□(Growth)t + β□(Debt)t + \epsilonROE=β0+β1(IP)t+β2(FP)t+β3(Size)t+β4(Growth)t+β5(Debt)t+□

Model 3: Impact on net operating Profit (NOP)

NOP=β0+β1(IP)t+β2(FP)t+β3(Size)t+β4(Growth)t+β5(Debt)t+□NOP = β□ + β□(IP)t + β□(FP)t + β□(Size)t + β□(Growth)t + β□(Debt)t + \epsilonNOP=β0+β1(IP)t+β2(FP)t+β3(Size)t+β4(Growth)t+β5(Debt)t+□

Variable definitions

Variable	Definition
Dependent Variables	
ROA	Return on Assets, a measure of profitability derived from asset utilization.
ROE	Return on Equity, indicating profitability relative to shareholder equity.
NOP	Net Operating Profit, measuring profitability from core operations.
Independent Variables	
IP	Investment Policy (Total Current Assets / Total Assets).
FP	Financing Policy (Total Current Liabilities / Total Assets).
Control Variables	
Size	Natural logarithm of firm sales, representing firm size.
Growth	Growth in sales (Current year sales – Last year sales) / Last year sales.
Debt	Financial leverage ratio (Total Financial Debt / Total Assets).

Model parameters

- β0β□β0: Intercept term representing the constant effect on profitability.
- β1,β2,β3,β4,β5β□, β□, β□, β□, β□β1,β2,β3,β4,β5: Coefficients estimating the impact of the independent and control variables on profitability.
- □\epsilon□: Error term capturing unexplained variations in profitability.
- ttt: Time period spanning from 2011 to 2020.

Significance testing

- **P-Values:** Used to determine the statistical significance of the independent variables.
- **Adjusted R2R^2R2:** Measures the explanatory power of the model, indicating the proportion of variation in profitability explained by the independent variables.
- **Durbin-Watson Test:** Checks for autocorrelation in the residuals.

Expected outcomes

The analysis aims to reveal whether aggressive or conservative working capital policies (as measured by IP and FP) have a significant impact on profitability measures (ROA, ROE, NOP). Furthermore, the control variables are expected to provide additional insights into the relationship between firm size, growth, leverage, and profitability.

Data set

The sample of the study consists Hetauda cement limited, Shivam cement limited and Udayapur cement limited listed in Nepal stock exchange (NEPSE). This study used annual financial data of Hetauda cement limited, Shivam Cement Limited and Udayapur Cement Limited for the period 2011-2020. The reason for restricting to this period was that the latest data for investigation was available for this period. The panel data set was developed for 10 years and for the 3 sampled firms. The required financial data for the purpose of the study was obtained from the respective companies' annual reports and publications of NRB of Nepal. The data regarding annual average market prices was collected from the daily quotations of NEPSE.

Empirical Analysis

The empirical analysis evaluates the impact of working capital policies on the profitability of firms in the Nepalese manufacturing sector, focusing on three public cement companies over the period 2011–2020. Profitability indicators—Return on Assets (ROA), Return on Equity (ROE), and Net Operating Profit (NOP)—have been assessed in relation to the firms' investment policy (IP) and financing policy (FP), along with control variables such as firm size, sales growth, and debt.

Model fit and statistical significance

The regression models' performance has been validated using F-statistics and the Durbin-Watson test.

- **F-Statistic:** The significance value of the F-statistic is 0.000 for all models, which is below the threshold of 0.05. This indicates that the models are statistically significant, and the variation explained by the models is not due to chance.
- **Durbin-Watson Statistics:** Values below 2 suggest a positive correlation among the independent variables.

Key findings :

Investment policy (IP)

- A positive coefficient of IP indicates that a less aggressive investment policy, characterized by higher proportions of current assets relative to total assets, leads to higher profitability.

- Results confirm a negative relationship between the degree of aggressiveness in working capital investment policy and profitability measures (ROA, ROE, NOP). Firms with less aggressive policies allocate more resources to fixed assets, generating higher returns.

Financing policy (FP)

- A negative coefficient for FP suggests that an aggressive financing policy, which relies on higher current liabilities relative to total assets, negatively impacts profitability.
- The results indicate that a conservative financing policy, emphasizing long-term debt and equity over short-term liabilities, enhances firm performance.

Control Variables

- **Firm Size (Size):** A significant positive relationship exists between firm size and profitability. Larger firms benefit from economies of scale and better resource utilization.
- **Sales Growth (Growth):** The impact of sales growth on profitability is mixed and statistically insignificant in most models, indicating limited influence over the study period.
- **Debt (Financial Leverage):** Financial leverage has a statistically significant negative impact on profitability, aligning with the increased cost of borrowing, which erodes profit margins.

Regression Results Overview

Table 2

Regression Analysis of Performance Measures and Working Capital Policy

Variables	ROA	ROE	NOP
	β	t-statistic	B
C	0.031892	0.555129	0.040928
IP	0.323418	2.605166	0.433165
FP	-0.456228	-4.567405	-1.55664
Size	0.00772	4.168114	0.02454
Growth	0.000482	0.107862	0.00244
Debt	-0.13319	-2.916221	-0.118617
R-squared	-2.307463	0.331575	0.253568
Adj. R^2	0.321947	0.231575	0.453568
F-stat.	0.761949	3.505939	13.01748
Prob(F)	0.00000	0.000548	0.00000
DW Stat.	1.158325	1.559628	1.213225

Interpretation of Results

The relationship between working capital policies and firm profitability is a critical area of study in financial management. Recent findings indicate that a less aggressive working capital investment policy positively contributes to profitability. Firms that allocate more resources to fixed assets tend to achieve higher returns, suggesting that a balanced approach in managing working capital can enhance financial performance.

Impact of Working Capital Investment Policies

A conservative working capital investment policy allows firms to maintain sufficient liquidity while maximizing their asset utilization. This strategy minimizes the risks associated with over-investment in current assets, which can tie up cash that could otherwise be used for long-term growth initiatives. By focusing on fixed asset investments, firms can leverage their resources more effectively, leading to improved profitability metrics such as Return on Assets (ROA) and Return on Equity (ROE).

Aggressive Financing Policies

Conversely, aggressive financing policies that rely heavily on short-term liabilities can adversely affect profitability. Such strategies increase the firm's exposure to liquidity risks, making it challenging to meet immediate obligations during economic downturns or unexpected financial strains. This underscores the importance of adopting conservative financing approaches that prioritize stability and long-term sustainability over short-term gains.

Control Variable Analysis

The analysis of control variables reveals that larger firms and those with lower financial leverage tend to perform better in terms of profitability. Larger firms often benefit from economies of scale, allowing them to operate more efficiently and reduce costs. Additionally, lower financial leverage indicates a more stable capital structure, which can enhance a firm's ability to weather economic fluctuations and maintain consistent profitability.

Comparison with Previous Studies

The findings from this research align with the work of Afza and Nazir (2008), who confirmed that less aggressive working capital policies enhance profitability. Their study emphasizes the need for firms to adopt a balanced approach in managing their working capital.

However, this research contrasts with studies such as Ali and Hassan (2010), which found an inverse relationship between firm size and profitability. Their results suggest that larger firms may not always translate their scale into higher profits, indicating that other factors may influence this relationship. Similarly, Gill et al. (2010) reported no significant

relationship between firm size and profitability, highlighting the complexity of these dynamics.

Furthermore, this study corroborates earlier research by Deloof (2003) and Eljelly (2004), which emphasized the detrimental impact of high leverage on profitability. High levels of debt can strain a firm's resources and limit its ability to invest in growth opportunities, reinforcing the need for prudent financial management.

The empirical analysis concludes that firms in the Nepalese manufacturing sector can enhance profitability by adopting less aggressive investment and financing policies. These findings provide valuable insights for financial managers aiming to optimize working capital management strategies for improved performance.

Conclusion

This study provides a comprehensive analysis of the intricate relationship between working capital policies and firm profitability within the Nepalese manufacturing sector, particularly focusing on three public cement firms over the period from 2011 to 2020. The findings reveal that a less aggressive working capital investment strategy is positively correlated with enhanced profitability. Firms that allocate a larger proportion of their resources to fixed assets rather than current assets tend to experience better financial outcomes, underscoring the importance of strategic asset allocation in driving profitability. Furthermore, the research highlights that aggressive financing policies, characterized by a heavy reliance on short-term liabilities, adversely affect profitability. This finding reinforces the significance of adopting conservative financing approaches that prioritize long-term stability over short-term gains. Additionally, the analysis indicates that larger firms are better positioned to manage their working capital effectively, leading to higher returns. In contrast, excessive financial leverage negatively impacts profitability, emphasizing the need for firms to maintain a balanced capital structure.The study also identifies a synchronization between the aggressiveness of working capital investment and financing policies. Firms pursuing aggressive investment strategies tend to adopt similar aggressive financing approaches, while those with conservative investment policies are more likely to favor conservative financing strategies. This interconnectedness suggests that firms must adopt a holistic approach to working capital management, ensuring alignment between their investment and financing decisions. Overall, these insights contribute significantly to understanding how working capital management can enhance firm performance in an increasingly competitive economic landscape.

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