Research Journal of Finance and Accounting
ISSN 2222-1697 (Paper) ISSN 2222-2847 (Online)
Vol.4, No.18, 2013

Impact of Aggressive investment policy on the firm performance (Listed manufacturing companies in Sri Lanka)

Miss.Tharshiga Murugesu
Assistant Lecturer , Department of financial management, University of Jaffna
Tharshi09@gmail.com

Abstract

The working capital management plays an important role for success or failure of firm in business because of its effect on firm's profitability as well on liquidity. An optimal working capital management is expected to contribute positively to the creation of firm value. To reach optimal working capital management firm's manager should control the tradeoff between profitability and liquidity accurately. The study sample consists of 20 Manufacturing companies listed in Colombo stock Exchange. Here, Correlation, and Regression are used to analyze the data. According to our results return on equity and Tobin Q have not significant impact on the aggressive investment working capital policy. But correlation analysis had shown strong negative relationship between return on assets and Aggressive investment policy. Therefore we can conclude aggressive investment policy have negative relationship between return on Assets

Key words: Aggressive investment policy, Return on equity, Return on assets, Tobin Q

Introduction

Working capital is a financial metric measuring the amount of liquidity available to an organization as a consequence of its daily operational processes. Working capital is live blood of the firm likewise blood in human being (Achchuthan and Kajanathan, 2013) Every one can agree on this high level definition. The measurement and daily management of working capital will vary widely by organization. Executive management has recently re-focused on working capital management because access to external liquidity comes with more and more strings attached. Measures taken by governments and the Basel Committee suggest that credit will remain tighter and more expensive for a prolonged period. John L.O.Donell and Milton S.Gladbergo observe "Many a times business failure takes place due to lack of working capital". Hence, working capital is considered the life blood and the controlling nerve Centre of a business. Inadequate working capital is business ailment. Therefore, a firm has to maintain a sound working capital.

A firm may adopt an aggressive investment policy with a low level of current assets as percentage of total assets or it may also use for the financing decisions of the firm in the form of high level of current liabilities as percentage of total liabilities. Excessive levels of current assets may have a negative effect on the firm's profitability whereas a low level of current assets may lead to lower level of liquidity and stock outs resulting in difficulties in maintaining smooth operations.

Literature review

The ultimate objective of any firm across the globe is to maximize the profit and stay strong in global competition. But this objective changes due to the course of time, and for such, preserving the liquidity became another important objective too. In this case, a firm should learn how to balance the two objectives to gain the competitiveness. This means that the firm should monitor the continuous profit gaining of the organization while managing the liquidity on the other side. If the organization did not care to face the objectives, the firm might fall in between insolvency or bankruptcy. These are the reasons for working capital management should be given proper consideration. Many researchers attempt to study the relationship between working capital management and profitability. Various studies identified the determinants of profitability (Velnampy & Nimalathasan, 2008, Velnampy& Kajananthan 2013, Velnampy, 2005 & 2005, 2010, 2013, Velnampy and Pratheepkanth, 2012; Kajananthan, 2012; Achchuthan and Kajanathan, 2013).

Sathyamoorthi (2002) focused on good corporate governance and in turn effective management of business assets. He observed that more emphasis is given to investment in fixed assets both in management area and research. However, effective management working capital has been receiving little attention and yielding more significant results. He analyzed selected Co-operatives in Botswana for a period of 1993-1997 and concluded that an aggressive approach has been followed by these firms during all the four years of study.

For the first time, Soenen (1993) indicated that a negative correlation between the length of net trade cycle and return on assets. Lamberson (1995) said that the most of the financial managers' time and efforts are allocated in optimizing the level of current assets and current liabilities back towards optimal levels. Jarvis et al (1996) concluded that the success of a firm depends ultimately, on its ability to generate cash receipts in excess of disbursements. The cash flow problems of many small businesses are exacerbated by poor financial management and in particular the lack of planning cash requirements. Herbert J. Weinraub and Sue Visscher (1998) found that there is a high and significant negative correlation between industry asset and liability policies. Relatively aggressive working capital asset management seems balanced by relatively conservative working capital financial management. The study undertaken by Peel et al (2000) revealed that small firms tend to have a relatively high proportion of current assets, less liquidity, exhibit volatile cash flows, and a high reliance on short-term debt. Afzaand Nazir (2007) investigated the relationship between the aggressive/conservative working capital policies for seventeen industrial groups and a large sample of 263 public limited companies listed at Karachi Stock Exchange for a period of 1998-2003 and found a negative relationship between the profitability measures of firms and degree of aggressiveness of working capital investment and financing policies.

Rehman (2006) investigated the impact of working capital management on the profitability of 94 Pakistani firms listed on Islambad Stock Exchange (ISE) for the period 1999-2004. He concluded that there is a strong negative relationship between working capital ratio mentioned above and profitability of firms. Mian Sajid Nazar and TalatAfza(2007) investigated the traditional relationship between working capital management policies and firm's profitability using the panel data set for the period 1998-2005, the impact of aggressive working capital investment and financing policies has been evaluated using return on asset as well as Tobin's q. Managers can create value if they adopt a conservative approach towards working capital investment and working capital financing policies. The study also finds that investors give weight to the stocks of those firms that adopt an aggressive approach to managing their short term liabilities.

Research problem

When considering about the Aggressive investment policy effects on the profitability of listed companies in manufacturing sector, it has some impacts on the profitability. Therefore the Aggressive working capital of the companies has the influence on the profitability of listed companies in manufacturing sector. Further, in many countries, many investors or public don't have the perfect knowledge and understandings when dealing with the investment activities. Therefore, it should be made clear understanding on the impact of Aggressive working capital on the firm's profitability.

Research questions

Research questions are of the study presented below:

- Has the aggressive investment policy impact on the profitability of the company
- To what extent aggressive investment policy affects the firm's profitability

Objective of the study

Every research must have some objective. Those objectives will give the overview about the research. Here also, the specific objectives of this study are as follows:

- ❖ Identify the relationship aggressive investment policy and profitability
- ❖ To investigate the relevance of aggressive investment policy to profitability

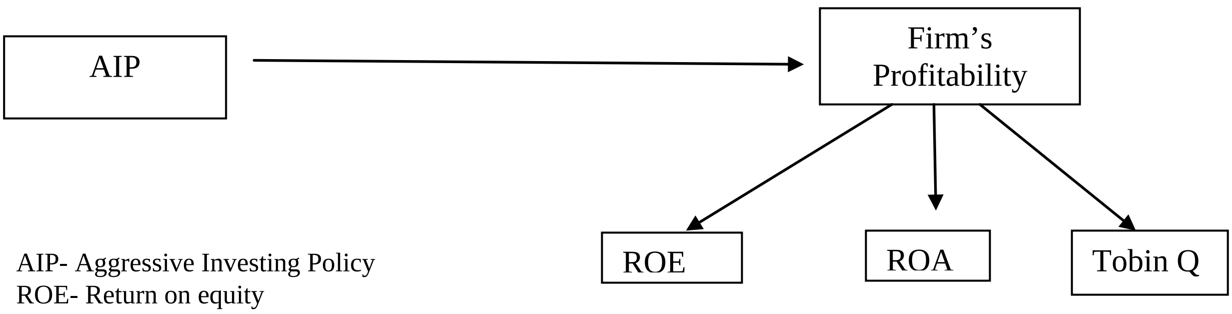
Hypothesis of Study

H1: There is a significant relationship between aggressiveness investment policy and return on equity

H2: There is significant relationship between aggressiveness investment policy and return on Assets

H3: There is significant relationship between aggressiveness investment policy and Tobin Q

Conceptual frame work



AIP- Aggressive Investing Policy
ROE- Return on equity

ROA- Return on Assets

Definitions of key concepts and variables

- **Aggressive Investment Policy(AIP)**

AIP results in minimal level of investment in current asset versus fixed assets. In contrast, a conservative investment policy put a larger proportion of capital in current assets with the opportunity cost of lesser profitability. A lower ratio means a relatively aggressive policy.

$$AIP = \frac{\text{Total current Asset (TCA)}}{\text{Total Asset (TA)}}$$

- **Return on equity (ROE)**

ROE is calculated by taking the net result over shareholders' equity for each specified year.

$$ROE = \frac{\text{Equity Earning}}{\text{Average equity}}$$

- **Return on assets (ROA)**

ROA is defined as the operating earnings before interest, depreciation and taxes over the book value of total assets. ROA measures how efficiently the company's assets are used to generate profit. This ratio is often used by the investors and potential investors to evaluate a company's leadership.

$$ROA = \frac{\text{Net Earnings after Tax (NEAT)}}{\text{Book value of asset (BVA)}}$$

- **Tobin's q**

Tobin's q compares the value of a company given by financial markets with the value of a company's assets. A low q (between 0 and 1) means that the cost to replace a firm's assets is greater than the value of its stock. This implies that the stock is undervalued. Conversely, a high q (greater than 1) implies that a firm's stock is more expensive than the replacement cost of its assets, which implies that the stock is overvalued.

$$\text{Tobin's q} = \frac{\text{Market Value of Firm (MVF)}}{\text{Book Value of Asset (BVA)}}$$

Methodology

Data collection

Twenty listed manufacturing were selected for the study purpose as a random sampling. Five year (2008-2012) data were collected from selected companies' secondary sources.

Data analysis

Table 1 correlation analysis

	ROE	ROA	TOBINSQ	AIP
ROE	1	.320	.038	-.122
ROA		1	.411	-.515*
TOBINSQ			1	.033
AIP				1

*. Correlation is significant at the 0.05 level (2tailed).

**. Correlation is significant at the 0.01 level (2-tailed).

Above table exhibit the relationship between aggressive investment policy and the firms' profitability. This study express strong negative relationship between ROA and AIP(.-515*). But week relationship between ROE (.-122) and Tobin Q(.033).

Regression analysis

profitability and Aggressive Investment Policy (AIP)						
Variables	ROE		ROA		Tobin's q	
	β	t-value	β	t-value	β	t-value
AIP	-0.122	-0.521	-0.515	-2.546	0.033	0.139
Sig.	0.609		0.020		0.891	
R-square	0.015		0.265		0.001	

The above table explores the impact of Aggressive investment policy and profitability. There is a negative relationship between AIP and ROE and ROA. So, there is a negative relationship between the relative degrees of aggressive working capital policy on Firm's profitability.

Discussion and Conclusion

According to our results return on equity and Tobin Q have not significant impact on the aggressive investment working capital policy. But correlation analysis had shown strong negative relationship between return on assets and Aggressive investment policy.H2 only accepted by correlation analysis. Others were rejected

However, firms adopt aggressive approach in managing their short term liabilities, investors give more value to those firms. Further, firms with more aggressive policy towards working capital may not be able to generate more profit. So far as the book value performance is concerned, managers cannot generate more return on assets by following aggressive approach towards short term asset and liabilities.

Reference

1. Achchuthan, S., & Kajananthan, R. (2013). Corporate Governance practices and Working Capital Management Efficiency: Special Reference to Listed Manufacturing companies in SriLanka. In Information and Knowledge Management (Vol. 3, No. 2, pp. 216-226).
2. Achchuthan, S., & Kajananthan, R. (2013). Corporate Governance practices and Firm Performance: Evidence from Sri Lanka. European Journal of Business and Management, 5(1), 19-26.
3. Deloof M (2003), "Does Working Capital Management Affect Profitability of Belgian Firms?" Journal of Business, Finance and Accounting, Vol. 30, Nos. 3-4, pp. 573-587.
4. Kajananthan, R. (2012). Corporate Governance Practices and Its Impact on firm Performance: Special Reference to Listed Banking Institutions in Sri Lanka.Global Journal of Management And Business Research, 12(21).
5. Kajananthan, R., & Achchuthan, S. Liquidity and Capital Structure: Special reference to Sri Lanka Telecom Plc.
6. Kajananthan, R., and S. Achchuthan. "Corporate Governance Practices and Its Impact on Working Capital Management: Evidence from Sri Lanka." Research Journal of Finance and Accounting 4.3 (2013): 23-31.
7. Lamberson M (1995). Changes in Working Capital of Small Firms in Relation to Changes in Economic Activity. Mid-American Journal of Business 10(2): 45-50.

8. Main SajidNazir and TalatAfza .2009." Impact of Aggressive Working Capital Management Policy on Firms' Profitability".
9. Nazir, Main Sajid and Afza, Talat .2007." Is it Better to be Aggressive or Conservative in Managing Working Capital? ".
10. Raheman, A., Afza, T., Qayyum, A. &Bodla, M.A. 2010, "Working capital management and corporate performance of manufacturing sector in Pakistan", International Research Journal of Finance and Economics, vol. 47, pp. 156-169.
11. Rehman A (2006), "Working Capital management and profitability: case of Pakistan. Firms (Unpublished Dissertation)", COMSATS Institute of Information Technology (ciiT), Island, Pakistan
12. Sathamoorthi CR (2002). The Management of Working Capital in selected co-operatives in Botswana. Finance India Dehli 16(3): 1015-1034.
13. Soenen LA (1993). Cash conversion cycle & corporate profitability. Journal of Cash Management 13(4): 53-58.
14. Velnampy, T. (2005). A Study on Investment Appraisal and Profitability. Journal of Business Studies, 2, 23-35.
15. Velnampy, T. (2010). Firm Size on Profitability: A Comparative Study of Bank of Ceylon and Commercial Bank of Ceylon Ltd in Srilanka. Global Journal of Management And Business Research, 10(2).
16. Velnampy, T. (2010). Firm Size on Profitability: A Comparative Study of Bank of Ceylon and Commercial Bank of Ceylon Ltd in Srilanka. Global Journal of Management And Business Research, 10(2).
17. Velnampy, T. (2013). Corporate Governance and Firm Performance: A Study of Sri Lankan Manufacturing Companies. Journal of Economics and Sustainable Development, 4(3), 228-235.
18. Velnampy, T., & Kajananthan, R. Cash Position and Profitability of Telecommunication Sector in Srilanka.
19. Velnampy, T., & Nimalathasan, B. (2008). An association between organisational growth and profitability: A study of commercial bank of Ceylon LTD Srilanka. Annals of University of Bucharest, Economic and Administrative Series, 2, 46-57.