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Impact of working capital policy on financial performance of selected companies on the London stock exchange

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Abstract

The study investigated the impact of working capital policy on the financial performance of selected companies listed on the London Stock Exchange (LSE), focusing on the Consumer Staples sector. Using a positivist research philosophy, a deductive approach, and quantitative methodology, the study analyses financial data from 65 firms published between 2018 and 2023. The study examines working capital investment policy (WCIP) and working capital financial policy (WCFP) as independent variables, with return on assets (ROA) and return on equity (ROE) as dependent variables. The results reveal that working capital investment policy (WCIP) positively impacts Return on Assets (ROA) (Pearson correlation 0.366, $p=0.046$) and return on equity (ROE) (Pearson correlation 0.485, $p=0.007$), while working capital financial policy (WCFP) shows no significant relationship with financial performance. The regression model explains 31.6% of the variance in financial performance. It is recommended that firms adopt a conservative working capital investment policy and a conservative financial policy to enhance their financial performance.

Keywords: Working Capital Policy; Working Capital Investment Policy; Working Capital Financial Policy; Return on Assets; Return on Equity

1. Introduction

The relationship between working capital policy (WCP) and financial performance is of interest to both the academic and business worlds. This relationship has been researched in both developed and developing economies, and many studies have suggested different outcomes in relation to the impact of Working Capital Policy (WCP) on profitability and the overall financial performance. In spite of the considerable amount of literature available on the subject, the results have been contradictory, particularly with regard to the most appropriate way of working capital management (WCM). Numerous researchers, such as Sario (2019), Syaharani & Chalid (2020), Prempeh et al. (2016), Qazi et al. (2011), and Farooq (2019), have examined the effect of working capital strategy on profitability. The empirical literature on how working capital management affects financial performance, however, has produced conflicting findings. The most effective way to manage working capital has been the subject of several studies, which the company's management should consider and use as a helpful benchmark when making decisions. Therefore, this research examined the evidence and theories surrounding working capital policy (WCP) and its impact on the financial performance of firms on the London Stock Exchange (LSE).

Numerous theories of finance provide a foundation for the study of working capital management (WCM), particularly how firms balance their short-term assets and liabilities. Notable among these are the Pecking Order Theory and the Trade-Off Theory, both of which provide different perspectives on managing working capital. In 1984, Myers and Majluf introduced the Pecking Order Theory, which posits that firms have a hierarchy of priorities when it comes to their financing sources. Firms will first exhaust their internal resources (retained earnings), finance shortfalls through borrowing, and will only, as a last resort, tap into equity financing. Preference for internal financing is a direct result of

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the internal/external information asymmetries that exist regarding the firm's operations. Financial managers, as Reyad, et al. (2022) point out, tend to take a more conservative stance on the Working Capital Financing Policy (WCFP) in order to control asymmetry and external financing costs. Within this framework, firms may resort to short-term debt to meet working capital needs and, in the process, preserve liquidity without assuming excessive long-term liabilities. On the other hand, an investment in working capital beyond conventional limits, which drives current assets lower, is also a potential source of increased profitability, with the trade-off of elevated liquidity risk.

In contrast, the Trade-Off Theory of working capital proposes that firms should evaluate the trade-off between the benefits of liquidity and the cost of holding too much current assets. Deloof (2003) argues that working capital is a double-edged sword. Too much of it can lead to inefficiencies and added costs, such as increased costs associated with the holding of excess inventory, but too little of it can result in the firm's being unable to satisfy its short-term obligations. The theory of working capital management posits that a firm should strive to achieve an appropriate balance between the two extremes. From the perspective of liquidity, a firm that has too much working capital will suffer from high opportunity costs. Conversely, a firm with inadequate working capital may suffer from operational difficulties. Hence, it is critical for financial managers to create a balance between liquidity and the costs of holding excess current assets (Weinraub & Visscher, 1998). The theory of working capital management (WCM) posits that working capital management should be flexible in relation to the firm's operational requirements and the external environment.

Working capital policy (WCP) touches on multiple areas: finance, economics, operations management, and strategic management. Each discipline yields a particular perspective on the determinants of working capital and the effect of working capital on a firm's financial performance. In finance, the concern is the effect of a working capital policy on liquidity and the firm's short-term borrowing. Interest rates, for example, influence the expense of borrowing and the expense of holding cash. As Banafa (2016) points out, high interest rates make borrowing expensive, and this may force firms to apply more conservative working capital policies to avoid financing risks. In contrast, a firm experiencing low interest rates may find it beneficial to increase its current assets, and this may lead to a more aggressive stance on working capital policy (WCP).

Working capital policies (WCP) are equally influenced by aspects of economics (Kabir and Rashid, 2019). Some economic aspects, like inflation, recession, and boom, impact the amount of working capital required by a business. During a recession, cash flows and sales tend to decrease, and so, businesses revise their working capital policies to be more conservative (Hofmann et al, 2022). On the other hand, economic growth inspires businesses to adopt more aggressive working capital policies. Economic cycles are thus pivotal in determining the conservativeness or aggressiveness of working capital policies.

In operation management, working capital policies (WCP) affect payments, inventories, and receivables, and these are the core functions of management in a business. In some cyclical businesses like retail, working capital policies tend to vary due to the seasonal demand. For Tingbani et al. (2020), there is a need for equilibrium between operational functionality and costs in the current asset equilibrium. On the other hand, conservative working capital policies are likely more preferred in longer operational cycle industries like manufacturing.

Strategic management also plays a part in the shaping of working capital decisions, as firms in competitive market scenarios may put in place aggressive working capital policies for the purposes of cutting operational costs and improving the bottom line. On the other hand, measures aimed at extreme cost reduction may result in stockouts and/or create delays in the supply chains, which may damage the company. Hence, companies must develop policies that enhances efficiency of the firm's operations and at the same time, balance the operational liquidity (Qurashi, 2017).

The focal area of working capital management (WCM) is the financial health of the firm. The current assets and current liabilities management policy, whether aggressive or conservative, affects both the liquidity and profitability of the firm. The working capital policy (WCP) is influenced by two components, namely, the Working Capital Investment Policy (WCIP) and Working Capital Financing Policy (WCFP). The investment profile of a firm in current assets is defined by the Working Capital Investment Policy (WCIP). Aggressive Working Capital Investment Policy (WCIP) means that a firm maintains low current assets, thereby investing more in fixed assets of the firm, which increases profitability, but also increases the liquidity risk. On the contrary, a conservative position on Working Capital Investment Policy (WCIP) entails holding high volumes of current assets, which ensures adequate liquidity but at the cost of profitability. Nazir and Afza (2009) indicate that the degree of influence that Working Capital Investment Policy (WCIP) has on profitability is dependent on the ratio of total investments in current assets and fixed assets.

Working Capital Financing Policy (WCFP) involves strategies used by a company to fund its working capital, whether via short-term debt or long-term financing. Short-term debt is used to finance both the permanent and the temporary current assets in the case of an aggressive Working Capital Financing Policy (WCFP). In contrast, a conservative Working Capital Financing Policy (WCFP) finances current assets via long-term debt. As indicated by Nazir and Afza (2009), an aggressive financing strategy minimises short-term debt cost but exposes the company to a greater liquidity risk.

Financial performance is often quantified through Return on Assets (ROA) and Return on Equity (ROE). While both are measures of profit generation, Return on Assets (ROA) assesses how effectively a company is utilising its assets, while Return on Equity (ROE) measures the return on the shareholders' equity. Research in this area has produced contradicting results. Some studies conclude that there is a positive correlation between working capital investment policies (WCIP) and profitability (Nazir & Afza, 2009). This suggests that firms with larger amounts of current assets are financially successful. Other research claims that the working capital policy of a firm is aggressive if it results in a higher return, and thus profitability, but also results in increased liquidity risk (Mengesha, 2014). In the realm of Working Capital Financing Policy (WCFP), conservative policies, in general, lead to an improvement in financial stability, but can result in a loss of profitability because of the inefficient use of resources tied up in liquidity (Banafa, 2016).

According to research conducted on Working Capital Financing Policy (WCFP), aggressive financing policies almost always lead to short-term profitability as well as an increase in financial risk, while conservative policies lead to stability but lower returns on equity (Talonpoika, 2016). Generally, when firms implement conservative policies, the overall financial security of the firm is enhanced, though profitability may be negatively impacted due to the lack of sufficient use of available resources (Joshua, 2023). It is vital for firms to understand how working capital policy impacts financial performance in order to formulate appropriate strategies regarding liquidity, profitability, and risk to be balanced. This study addresses the lack of literature regarding the working capital policy (WCP) impacts on the financial performance of the top five consumer staples firms on the London Stock Exchange (LSE). Various statistical methods, including regression analysis, were used in this study to investigate the effect of differing working capital policies (WCP) on the financial performance of these companies.

2. Materials and Methods

The research used a positivist philosophy with a deductive approach, worked with a quantitative methodology. Most of the research's secondary data was accessed via the annual reports of the top five consumer staples companies for the years 2018-2023. Two major policies on working capital were the focus of the study: The Working Capital Investment Policy (WCIP) and the Working Capital Financing Policy (WCFP), and how they affect a company's financial performance as measured by Return on Assets (ROA) and Return on Equity (ROE) (Figure 1).

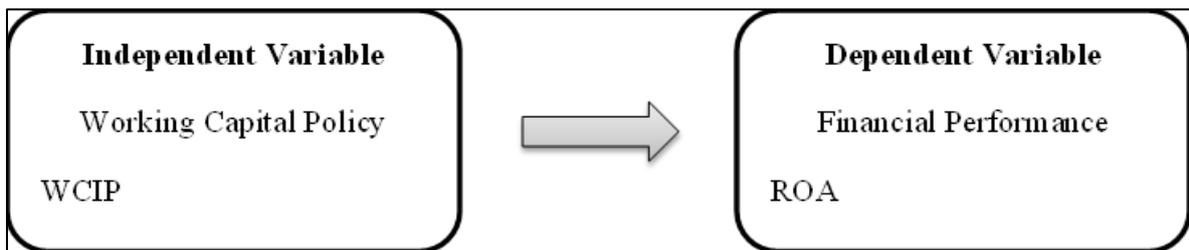


Figure 1 Conceptual Framework of the study

The study employed multiple regression, correlation, and descriptive statistical methods for the analysis of the collected data. The relationship of Working Capital Policy (WCP) and financial performance was tested using Pearson correlation, while regression analysis was used to examine financial performance and its components (WCIP and WCFP) with respect to their impact on the Return on Assets (ROA) and Return on Equity (ROE). The sample comprised the five companies with the highest market capitalisation in the consumer staples sector as of November 2024. These companies were Unilever, British American Tobacco, Reckitt Benckiser, Coca-Cola Euro pacific Partners, and DFI Retail Group.

The study was conducted within the ethical norms of the research, where only public data was used, and the analysis was kept as transparent and as objective as possible. The ethical norms were also ascribed to the University of Chester Ethics Committee, implying there was no data fabrication/ falsification or any other form of data misconduct in the study.

3. Results and Discussion

3.1. Case Processing Summary

Table 1 Case Processing Summary

Cases	N	%
Valid	30	100.0%
Excluded	0	0.0%
Total	30	100.0%

The study used data from five companies, from which thirty cases were in the consumer staples sector from 2018 to 2023 (5 companies, 6 years). The case processing summary in Table 1 shows that all 30 cases were valid; thus, the study achieved a 100% valid response rate, and there were no cases deemed as excluded items.

3.2. Reliability Test

Table 2 Reliability Statistics

Cronbach's Alpha	N of Items
0.562	4

Reliability addresses the attributes of measurement wherein results tend to be stable and are error-free. One of the commonly used methods to evaluate internal consistency is through a measurement known as Cronbach's alpha. With regard to this study, Cronbach's alpha was 0.562, which in this case is considered a moderate level of reliability (Table 2). Even though this value is low, it is enough to suggest that there is some reliability in the dataset to warrant undertaking the research.

3.3. Descriptive Statistics

Table 3 Descriptive Statistics

N	Minimum	Maximum	Mean	Std. Deviation
WCIP	30	0.09	0.30	0.1834
WCFP	30	0.11	0.67	0.2900
ROA	30	-0.12	0.16	0.0410
ROE	30	-0.39	0.80	0.1534

Data summary statistics present the mean, minimum, maximum and standard deviation for each variable. Table 3 outlines the summary statistics for the independent (WCIP and WCFP) and dependent (ROA and ROE) variables. Standard deviation for Working Capital Investment Policy (WCIP) was 0.05558, and the mean was 0.1834, suggesting a moderate variation in working capital investment for the firms analysed. Mean for Working Capital Financing Policy (WCFP) was 0.2900, and standard deviation was 0.13902, which suggests that variability in financing policies was more pronounced. In terms of financial performance, Return on Assets (ROA) and standard deviation were 0.05609, and the mean was 0.0410. Mean for Return on Equity (ROE) was 0.1534, and standard deviation was 0.21263.

3.4. Correlation Statistics

Correlation analysis examines the strength and direction of relationships between variables. Tables 4 and 5 present the Pearson correlation results for the relationships between the independent variables (WCIP and WCFP) and the dependent variables (ROA and ROE).

Table 4 Correlation Statistics - Independent Variables with ROA

Correlations				
		WCIP	WCFP	ROA
WCIP	Pearson Correlation	1	0.661**	0.366*
	Sig. (2-tailed)		<0.001	0.046
	N	30	30	30
WCFP	Pearson Correlation	0.661**	1	-0.014
	Sig. (2-tailed)	<.001		0.943
	N	30	30	30
ROA	Pearson Correlation	0.366*	-0.014	1
	Sig. (2-tailed)	0.046	0.943	
	N	30	30	30
**. Correlation is significant at the 0.01 level (2-tailed).				
*. Correlation is significant at the 0.05 level (2-tailed).				

In Table 4, the correlation between Working Capital Investment Policy (WCIP) and Return on Assets (ROA) is 0.366 (36.6%), with a p-value of 0.046, which is statistically significant at the 0.05 level. This indicates a moderate positive correlation between Working Capital Investment Policy (WCIP) and Return on Assets (ROA). However, the correlation between Working Capital Financing Policy (WCFP) and Return on Assets (ROA) is -0.014, with a p-value of 0.943, which is not statistically significant, suggesting a very weak negative relationship between Working Capital Financing Policy (WCFP) and Return on Assets (ROA).

Table 5 Correlation Statistics - Independent Variables with ROE

Correlations				
		WCIP	WCFP	ROE
WCIP	Pearson Correlation	1	0.661**	0.485**
	Sig. (2-tailed)		<0.001	0.007
	N	30	30	30
WCFP	Pearson Correlation	0.661**	1	0.089
	Sig. (2-tailed)	<0.001		0.639
	N	30	30	30
ROE	Pearson Correlation	0.485**	0.089	1
	Sig. (2-tailed)	0.007	0.639	
	N	30	30	30
**. Correlation is significant at the 0.01 level (2-tailed).				

In Table 5, the correlation between Working Capital Investment Policy (WCIP) and Return on Equity (ROE) is 0.485 (48.5%), with a p-value of 0.007, which is significant at the 0.01 level. This indicates a strong positive relationship between Working Capital Investment Policy (WCIP) and Return on Equity (ROE). However, the correlation between Working Capital Financing Policy (WCFP) and Return on Equity (ROE) is 0.089, with a p-value of 0.639, which is not statistically significant, indicating a weak positive correlation.

3.5. Regression Statistics

An analysis of the data was performed to establish the influence of two policies on financial performance measured through ROI (Return on Investment) and ROE (Return on Equity), namely Working Capital Investment Policy (WCIP) and Working Capital Financing Policy (WCFP).

Table 6 Model 01: Relationship Between WCIP and ROA

Model Summary				
Model	R	R Square	Adjusted R-Square	Std. Error of the Estimate
1	0.366 ^a	0.134	0.103	0.05312
a. Predictors: (Constant), WCIP				

The impact of Working Capital Investment Policy (WCIP) on Return on Assets (ROA) is significant, with an R-squared of 0.134, which means that Working Capital Investment Policy (WCIP) explains 13.4 % of the variance of Return on Assets (ROA) (See Table 6).

Table 7 Coefficient Values for Regression Model 1

Coefficients ^a						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-0.027	0.034		-0.788	0.437
	WCIP	0.370	0.177	0.366	2.083	0.046
a. Dependent Variable: ROA						

The regression coefficient for Working Capital Investment Policy (WCIP) is 0.366, indicating that an increase in Working Capital Investment Policy (WCIP) by one-unit results in an estimated increase of 0.366 in Return on Assets (ROA), which is significant at the 0.05 level (See Table 7).

Table 8 Regression Analysis with WCFP and ROA

Model Summary				
Model	R	R Square	Adjusted R-Square	Std. Error of the Estimate
1	0.014 ^a	0.000	-0.036	0.05708
a. Predictors: (Constant), WCFP				

For Working Capital Financing Policy (WCFP) and ROA, the R-squared value is 0.000, indicating that Working Capital Financing Policy (WCFP) has no significant impact on ROA (see Table 8).

Table 9 Coefficient Values for Regression Model 2

Coefficients ^a						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	0.043	0.024		1.745	0.092
	WCFP	-0.006	0.076	-0.014	-0.072	0.943
a. Dependent Variable: ROA						

The regression coefficient for WCFP is -0.014, which is not statistically significant ($p = 0.943$), suggesting that Working Capital Financing Policy (WCFP) has no significant impact on Return on Assets (ROA) (Table 9).

Table 10 Regression Analysis with WCIP and ROE

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.485 ^a	0.235	0.208	0.18926
a. Predictors: (Constant), WCIP				

For the relationship between working capital investment policy (WCIP) and return on equity (ROE), the regression results in Table 10 show an R-squared value of 0.235, explaining 23.5% of the variance in return on equity (ROE).

Table 11 Coefficient Values for Regression Model 3

Coefficients ^a						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-0.187	0.121		-1.543	0.134
	WCIP	1.855	0.632	0.485	2.933	0.007
a. Dependent Variable: ROE						

The regression coefficient for working capital investment policy (WCIP) is 1.855, indicating that working capital investment policy (WCIP) has a positive and statistically significant impact on return on equity (ROE) ($p = 0.007$).

Table 12 Model 04: Relationship Between WCFP and ROE

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.089 ^a	0.008	-0.027	0.21553
a. Predictors: (Constant), WCFP				

Table 13 Coefficient Values for Regression Model 4

Coefficients ^a						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	0.114	0.092		1.233	0.228
	WCFP	0.137	0.288	0.089	0.474	0.639
a. Dependent Variable: ROE						

However, for Working Capital Financing Policy (WCFP) and return on equity (ROE), the regression results in Table 12 show that the relationship is not statistically significant, with an R-squared value of 0.008 and a p-value of 0.639 (see Tables 12 and 13).

3.6. Hypotheses Testing

The hypotheses developed for this study were tested through Pearson correlation and regression analysis. The results are summarised in Table 14.

Table 14 Hypotheses Testing

Hypotheses	Pearson Correlation	Regression Coefficient	Accept/Reject
H1: WCIP and ROA	0.366	0.046	Accept
H2: WCIP and ROE	0.485	0.007	Accept
H3: WCFP and ROA	-0.014	0.943	Reject
H4: WCFP and ROE	0.089	0.639	Reject

Hypotheses H₁ and H₂ were accepted, as the correlation and regression analyses showed significant positive relationships between working capital investment policy (WCIP) and Return on Assets (ROA) (0.366, $p = 0.046$) and working capital investment policy (WCIP) and return on equity (ROE) (0.485, $p = 0.007$). Hypotheses H₃ and H₄ were rejected due to the lack of a significant relationship between Working Capital Financing Policy (WCFP) and Return on Assets (ROA) (-0.014 , $p = 0.943$) and Working Capital Financing Policy (WCFP) and Return on Equity (ROE) (0.089, $p = 0.639$).

3.7. Findings for Research Question

The research question, "How does the working capital policy affect the financial performance of the top five consumer staples companies on the London Stock Exchange?" was addressed through regression analysis.

Table 15 Regression Model 05

Model	R	R Square	Adjusted R-Square	Std. Error of Estimate
1	0.562	0.316	0.266	0.11411

Table 15 shows the regression model summary, where $R = 0.562$, indicating a moderate correlation between working capital policy and financial performance. The R-squared value of 0.316 suggests that working capital policy explains 31.6% of the variance in financial performance. This implies that while the working capital policy has a significant influence, there are other factors contributing to the financial performance of these companies.

The findings indicate a significant positive relationship between working capital investment policy (WCIP) and both Return on Assets (ROA) and return on equity (ROE), while Working Capital Financing Policy (WCFP) had no significant impact on financial performance.

4. Conclusion

This study examines the effect of working capital policy (WCP) on the financial performance of the five largest consumer staples firms on the London Stock Exchange (LSE). The research focused on a quantitative methodology while developing five research objectives to answer the main research question. The research employed a positivist philosophy, focusing on the analysis of structured, countable data. A quantitative methodology utilising secondary data from the annual reports of the top five consumer staples firms on the London Stock Exchange (LSE) was the most suitable. The deductive approach to research, using the regression and correlation analysis framework to examine the hypotheses, was also justified. A Cronbach's alpha of 0.562 was moderately positive and suggests that the research had a low but positive degree of reliability. The research context supports the appropriateness of the methodology used in data collection, measurement of the variables, and hypothesis testing, thereby improving the reliability and validity of the research findings.

The goals that the study set out to accomplish were successfully attained. The effect of working capital policy (WCP) on financial performance was the main goal. The results indicate that working capital investment policy (WCIP) is constructive to return on assets (ROA) and return on equity (ROE), and the correlation was significant ($p \leq 0.05$). On the other hand, Working Capital Financing Policy (WCFP) had poor and insignificant correlation with Return on Assets

(ROA) and return on equity (ROE), which shows that it is not constructive to financial performance. The results are consistent with the literature, which shows that working capital investment policy (WCIP) is positively related to financial performance and working capital Financing policy (WCFP) is negatively related to financial performance.

The relationships with working capital investment policy (WCIP), Working Capital Financing Policy (WCFP) and financial performance metrics, made it possible to respond to the question, "How does the working capital policy affect the financial performance of the top five consumer staples companies on the London Stock Exchange (LSE)?" working capital investment policy (WCIP) was the only variable that the regression analysis showed to have financial performance variance and the R-squared value was 56.2%. This shows that working capital policy (WCP) is important to the financial performance of these companies, and that other variables account for the other 44% of variance. To wrap up this study, it is evident that the impact of the working capital policies, especially the working capital investment policy (WCIP), relates to the financial outcome of the top five consumer staples' companies listed on the London Stock Exchange (LSE). A more conservative working capital investment policy (WCIP) was suggested since it is more positively aligned with financial performance. On the other hand, a more conservative approach to Working Capital Financing Policy (WCFP) was recommended since the poor financial outcome was more aligned with the Working Capital Financing Policy.

Some of the limitations of the study include the five-company sample size, the six-year time span, and the industry-specific working capital policies that may not necessarily apply to other industries. Future researchers may want to increase the sample size and time span, and perhaps include other variables and industries.

More research is necessary on larger, multi-industry studies and the effect of different working capital policies on financial outcomes. The greater the timeframe, the more beneficial the research will be, as it will capture multiple economic cycles and will be able to show the effect of more stable and more volatile periods on working capital policies on financial outcomes.

Given the findings, the study suggests employing a conservative working capital investment policy strategy to maintain liquidity while optimising profitability, and a conservative Working Capital Financing Policy strategy to hedge the financial risks associated with short-term liabilities, for the case of the consumer staples companies on the London Stock Exchange (LSE). A policy implementation plan is provided, which details the necessary activities for increasing cash, rationalising inventories, and acquiring long-term financing. These policies will help improve the financial position while increasing operational efficiency.

Compliance with ethical standards

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Disclosure of conflict of interest

The author declares no conflict of interest.

Statement of ethical approval

This study is based on secondary data obtained from publicly available resources on the London Stock Exchange. It does not involve human participants or confidential information. Therefore, ethical approval was not required.

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