Working Capital Management

by Vinny Stephanie

WORKING CAPITAL MANAGEMENT, FREE CASH FLOW, PROFITABILITY AND FIRM VALUE

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Abstrak

Tujuan utama suatu perusahaan adalah mengoptimalkan nilai perusahaan. Pengelolaan modal kerja yang baik, arus kas bebas yang baik, dan profitabilitas yang baik diharapkan dapat meningkatkan nilai perusahaan. Penelitian ini mengkaji bagaimana keterkaitan antara working capital management, free cash flow, profitability, dan firm value. Penelitian ini menggunakan populasi seluruh perusahaan sub sektor food and beverage di Indonesia periode 2019 - 2021. Teknik yang digunakan untuk menguji hipotesis adalah multiples linier regression analysis. Hasil penelitian adalah working capital management, free cash flow, profitability memiliki pengaruh terhadap firm value. Sehingga perusahaan harus memperhatikan siklus konversi kas nya, memiliki arus kas bebas positif sehingga terdapat fleksibilitas keuangan perusahaan, juga meningkatkan profit sehingga ROA menjadi lebih tinggi sehingga investor akan merespon sinyal positif ini dan nilai perusahaan akan meningkat.

Keywords: WCM, FCF, Profitability, Firm Value

Abstract

The main goal of a company is to optimize the firm's value. A good working capital management, free cash flow, and profitability are expected to increase the firm's value. This study analyzes on how working capital management, free cash flow, profitability, and firm value relate. This study uses the population of all food and beverage sub-sector companies in Indonesia from the period of 2019 - 2021. The technique used to test the hypothesis is multiple linear regression analysis. The results of the study are, that working capital management, free cash flow, and profitability have an effect towards firm value. Therefore, companies must pay attention to their cash conversion cycle, have a positive free cash flow so that there is flexibility in the company's finances, also in increasing profits so that ROA becomes higher hence investors will respond to this positive signal and the firm value will increase.

Keywords: *WCM, FCF, Profitability, Firm Value*

INTRODUCTION

The Indonesian economy is largely driven by increased household consumption and one of the fastest growing industries is the food and beverage industry. The food and beverage industry continues to grow during the Covid-19 pandemic. Despite the slowdown, the industry has been able to survive and continue to grow since 2011 (djkn.kemenkeu.go.id, 2022). The Central Statistics Agency (BPS) reports the gross domestic product (GDP) of the national food and beverage industry at current prices (ADHB) of IDR 1.12 quadrillion in 2021, growing 2.54 % compared to 2020. This achievement was better than the previous year which only grew 1.58%, but lower than before the pandemic which grew above 7% (Kusnandar, 2022). Therefore, the food and beverage industry needs to improve operational efficiency and increase competitiveness amid intensification of trade. The intense competition in the business industry forces companies to compete in attracting investors to acquire the company's shares. The main goal of a company is to optimize the company's value, the higher the company's value, the more prosperous the shareholders. This can be achieved if the company has a good management to optimize company's performance. Businesses are not able to operate properly if they do not have an adequate working capital. In Obeng et al. (2021) research, working capital management is considered an important factor in a company. The main cause of failure in business is inefficient working capital control, improper management of working capital is detrimental to the added value of shareholders in the business. Efficient and effective working capital management is important because creditors would often seek short-term credit markets.

Another important factor in the company is free cash flow. The company is in good condition if it has positive free cash flow. Free cash flow can be used as a benchmark to assess a company's ability to provide profits to shareholders through debt reduction, share buybacks, or dividend payments, thus increasing the company's value. Free cash flow with negative value is cause a problem for the company, indicating that the company must make improvements in their management because expenses exceed its income, this gives a bad signal to investors so that the company's value decreases. Zurriah (2017) free cash flow itself has an impact on determining a company's value. Therefore, company managers will be more focused on efforts to increase the company's free cash flow. Gregory & Wang (2013) states that companies with high free cash flow have superior performance, and high free cash flow can be beneficial as long as shareholder monitoring is adequate.

Furthermore, another factor that can increase the firm value is profitability. Profitability is useful in measuring how capable a company is of generating profit or revenue. In addition to determining a company's ability to generate profit during a certain period, profitability also aims to measure the level of management effectiveness in conducting operational activities within the company (Hery, 2021). Profitability is crucial for companies because it can serve as an indicator of the company's success. Profitability is one of the fundamental aspects of a company because with high levels of profitability, the company can become attractive to potential investors to invest their capital and become an indicator of the company's effectiveness and efficiency in managing resources for operational activities.

Good working capital management, good free cash flow, and good profitability are expected to increase the firm value. Firm value is the selling value of a company that investors are willing to pay as an ongoing business (Dzahabiyya et al., 2020). Previous research conducted by Setyanto & Permatasari (2014), Le (2019) found that working capital management can significantly affect firm value. Sari & Wirajaya (2017), Mutende et al. (2017) found that free cash flow affects the firm value. Widiastari & Yasa (2018), Iswajuni et al. (2018) found that profitability has a positive effect on firm value. Based on the above explanation, the author makes firm value as the dependent variable, and working capital management, free cash flow, and profitability as independent variables. This study analyzes on how working capital management, free cash flow, profitability, and firm value relate.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Signaling theory

Signaling theory explains that companies are encouraged to be able to provide information on their financial reports to external parties (investors and creditors) to prevent information asymmetry. Information published as an announcement will provide a signal to investors (Hartono, 2017). Investors will analyze the published information as a good or bad signal. If investors interpret this information as a good signal, it will have an impact on increasing stock prices so that the company value also increases. This study aims to determine the effect of working capital management, free cash flow and profitability on firm value. Theoretically, the results of this study are expected to support the application of signal theory. Based on signaling theory, companies with efficient working capital management provide good signals to investors, companies that have positive free cash flow and high profitability are good signals for investors because they show healthy companies in good condition so that they have a good impact on company value.

Working capital management

Working capital management is an activity that includes management of current assets and short-term liabilities that are used to optimize the company's value by managing current assets so that the rate of return is equal to or greater than the cost of capital used and monitoring the flow of funds in current assets (Kasmir, 2016). There are three elements that require to be considered in managing working capital, namely cash, accounts receivable, and inventory. If the three elements have a rapid turnover rate, that means the working capital is considered to be efficient (Mardiyana & Murni, 2018).

Free cash flow

Free cash flow is the availability of cash flow to a company after deducting operating expenses and other expenditures within one accounting period (Kasmir, 2018). Free cash flow is cash flow available for distribution to investors and shareholders after the company invests in fixed assets and increases the working capital needed to maintain the company's growth (Kodriyah & Fitri, 2017).

Profitability

Profitability is useful in measuring how capable a company is of generating profit or revenue. In addition to determining a company's ability to generate profit during a certain period, profitability also aims to measure the level of management effectiveness in conducting operational activities within the company (Hery, 2021).

Firm value

Firm value is defined as the company's performance which is reflected by the share price formed by demand and supply in the capital market which reflects society's assessment of company performance (Kurnia, 2017). Tobin's Q is a ratio in measuring company value, Tobin's Q is a ratio measuring tool that defines firm value as value of tangible asset and intangible assets. Tobin's Q can also describe the effectiveness and efficiency of the company in utilizing all resources of assets owned by the company (Dzahabiyya et al., 2020). Lesmana et al. (2020) uses the Tobin's Q ratio to measure firm value of cigarette companies in Indonesia. Jadiyappa et al. (2020) uses the Tobin's Q ratio to measure firm value in banking companies in India.

Working capital management and firm value

Research related to the effect of working capital management on firm value has been conducted by Sulistyono et al. (2020), which shows that there is an effect of working capital on firm value. Setyanto & Permatasari (2014) in this study show that working capital management,

measured through the cash conversion cycle, has an effect on firm value. The results of this research are in accordance with the concept of working capital management, where companies with good working capital management will have high liquidity and high profitability. In more detail, through efficient working capital management policies, the company applies a short cash conversion cycle which is associated with a reduction in inventory conversion time, acceleration of accounts receivable collection from customers, and delay in payment of debts to creditors. Companies with efficient working capital management will eventually be able to provide value added for shareholders and stimulate investors in the market to invest in the said company. In this study, working capital management is measured using the cash conversion cycle (CCC). The cash conversion cycle reflects the net time interval between actual cash costs at the time the company spends productive resources and the last time the company receives cash from product sales. In short, the cash conversion cycle can also be considered to be the length of time or period needed to convert each cash spent into cash inflows in the company's daily operational activities. Research conducted by Le (2019) on 497 companies listed on the Hanoi Stock Exchange shows a significant negative relationship between working capital management and firm value. Working capital management is crucial for companies with limited access to capital, and is also essential when companies are expanding their investments. Based on this explanation, the following hypothesis is formulated:
H1: Working capital management has negative effect towards firm value.

Free cash flow and Firm Value

Free cash flow is the availability of cash flow to a company after deducting operating expenses and other expenditures in one accounting period. Free cash flow itself has an effect on determining the firm value. Research related to free cash flow was conducted by Andini & Wirawati (2014), which analyzed the impact of the amount of free cash flow on a company's long-term performance, stating that companies with the highest free cash flow will provide a greater return than companies with lower free cash flow. Harijanto & Mildawati (2017) in their research stated that free cash flow has a positive effect on a company's performance. Mutende et al. (2017) in their research on companies listed on the Nairobi Securities Exchange for the period 2006-2015 had obtained results, that states free cash flow has a significant positive effect on financial performance, as proxied by Tobin's Q value. Therefore, it can be concluded that the higher the free cash flow that a company possesses, the better the company's performance. Good company performance will certainly affect firm value, hence it can be even better. Based on the above explanation, the following hypothesis is formulated:
H2: Free cash flow has positive effect towards firm value.

Profitability and firm value

Increasing profits and firm value are interrelated because they are essential for the sustainability of the company. Firm value is also affected by the level of profitability it generates. Profitability is the ability of a company to generate profit or the effectiveness of its management. Investors who invest in a company aim to get a return. The higher the profit a company can generate, the greater the investor's expectation of getting a high return from the company. Widiastari & Yasa (2018) stated in their research that high profitability indicates that the company's future prospects are predicted to be profitable by investors, so investors will be interested in responding to positive signals given, thus increasing the firm value. The research conducted by Iswajuni et al. (2018) concluded that ROA has a significant positive effect on the firm value, where the firm value increases in accordance with the increase in ROA. In this research, profitability is measured by return on assets (ROA) because ROA can measure how a company's ability to generate profits from its assets. Hafidh & Priono (2022) conducted research with the results of ROA having a significant positive impact on firm value, research was conducted on food and beverage sub-sector companies in 2015-2019. Based on the above explanation, the following hypothesis is formulated:
H3: profitability has positive effect towards firm value.

Next, the research model is presented as follows:

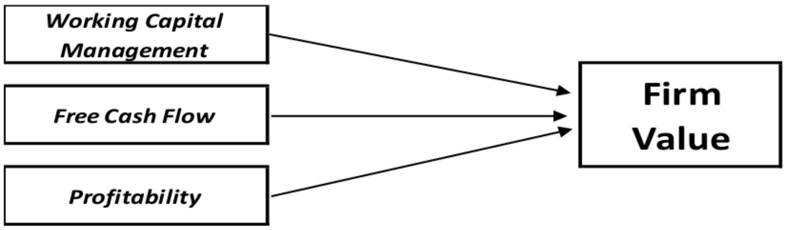

Figure 1. Research model

RESEARCH METHOD

In this study, the author used the population of all consumer goods industry companies in the food and beverage sub-sector located in Indonesia from 2019 to 2021. Secondary data was obtained from a financial market data provider called Refinitiv. The author chose the food and beverage sub-sector as it has always been a favorite sector in business even before the pandemic. This is because food and beverages are basic necessities that cannot be excluded by the society. The food and beverage industry is an important sector that supports the performance of the non-oil and natural gas industry. In the first quarter of 2022, food and beverage industry contributed more than a third or 37.77% of the Gross Domestic Product (GDP) of the non-oil and natural gas industry (Kemenperin.go.id, 2022).

The sample used in this study was selected using the purposive sampling method with the aim of obtaining a representative sample according to the following criteria:

1. The company has published annual reports consecutively from 2019 to 2021.
2. The company presents complete data on working capital management, free cash flow, profitability, and company value during the period of 2019-2021.
3. The company uses the Indonesian rupiah currency, so that all companies included in the sample have the same currency measurement criteria.

The sample selection is shown by the following table:

Table 1. Sample Selection

Description	Total
The food and beverage sub-sector companies in Indonesia	74
Companies did not submit complete financial statements and data during research period (2019-2021)	(10)
The food and beverage sub-sector companies that meet sample selection criteria	64
Total research data (2019-2021)	192

Source: research data, 2022

The operationalization of research variables is as follows:

1. Y Variable → Firm Value

   To measure the firm value using the Tobin's Q ratio was carried out by (Lesmana et al., 2020), (Iswajuni et al., 2018), (Setyanto & Permatasari, 2014), (Mutende et al., 2017) with the following formula:

$$Q = \frac{EMV + D}{EBV + D}$$

EMV (Equity Market Value) is the equity of market value obtained by multiplying the closing price at the end of the year by the number of shares outstanding at the end of the year.
EBV (Equity Book Value) is the equity of book value obtained from the difference between the company's total assets and total liabilities.
D (debt) is the book value of total debt.

2. X1 Variable → Working Capital Management
   Measurement of working capital management is measured using the cash conversion cycle (CCC) (Le, 2019), (Oseifuah & Gyekye, 2018), (Indradewi & Widyarti, 2016) with the following formula:
   CCC = (accounts receivable period + inventory period) – accounts payable period.
   Accounts receivable period = (accounts receivable/sales) x 365
   Inventory period = (supply/cost of goods sold) x 365
   Accounts payable period = (accounts payable/cost of goods sold) x 365
3. X2 Variable → free cash flow
   Free cash flow is calculated using the following formula (Mutende et al., 2017), (Andini & Wirawati, 2014), (Pradnyavita & Suryanawa, 2020):
   $$FCF = \frac{AKO - PM - NWC}{\text{Total of assets}}$$
   AKO = company's operating cash flow
   PM = company's net capital expenditure
   NWC = net working capital of the company (current assets – current liabilities)
4. X3 Variable → profitability
   Profitability in this study is measured by return on assets (ROA). Return on assets (ROA) is a ratio that measures a company's effectiveness in generating profits by utilizing the company's assets (Subramanyam & Wild, 2017). ROA formula according to (Subramanyam & Wild, 2017), (Hafidh & Priono, 2022), (Pradnyavita & Suryanawa, 2020) is presented as follows:
   ROA = net profit/total of assets

Multiple regression test was used for the hypothesis test. The multiple regression model is stated in the following equation: $Y = \alpha + \beta 1X1 + \beta 2X2 + \beta 3X3 +$

RESULTS AND DISCUSSION

The data in this research have been tested and met the classic assumption test which consists of normality test, multicollinearity test, autocorrelation test, and heteroscedasticity test (Ghozali, 2018), (Sugiyono, 2021). The classic assumption test results are shown from the table is as follows:

Table 2. Classic Assumption Test Results

The classic assumption test	Result			Description
Normality test (Kolmogorov-Smirnov)	Asymp. Sig. (2-tailed) 0.830			normal data
Multicollinearity test (VIF)		Tolerance	VIF	no multicollinearity
	CCC	0.965	1.036	
	FCF	0.935	1.069	
	ROA	0.918	1.090	
Autocorrelation test (Runs test)	Asymp. Sig. (2-tailed) 0.201			no autocorrelation
Heteroscedasticity test (Glejser)	CCC	0.180		no heteroscedasticity
	FCF	0.393		
	ROA	0.091		

Source: research data, 2022

The feasibility test of the research model is shown by the following table:

Table 3. Feasibility Model Test Result

ANOVAa

Model	Sum of Squares	df	Mean Square	F	Sig
Regression	37.693	3	12.564	7.251	0.000
Residual	372.529	188	1.733		
Total	410.222	191			

Source: research data, 2022

The feasibility test of the research model is shown by the anova significance value is 0.000 <0.05, hence it can be concluded that the significance value proves that the model in this research is feasible to study because it meets the Goodness of Fit.

Next, a table of the results of multiple linear regression analysis processed with the SPSS program is presented:

Table 4. The Hypothesis Test Result

Model	Unstandardized Coefficients B	t	Sig
(Constant)	1.457	4.938	0.000
CCC	-0.197	-2.773	0.006
FCF	0.028	0.543	0.032
ROA	0.196	2.922	0.004

Source: research data, 2022

Based on statistical data processing:

CCC significance value of 0.006 (less than the error rate of 5%) was obtained in a negative direction. This means that working capital management has negative significant effect on firm value.

FCF significance value of 0.032 (less than the error rate of 5%) was obtained in a positive direction. This means that free cash flow has positive significant effect towards firm value.

ROA significance value of 0.004 (less than the error rate of 5%) was obtained in a positive direction. This means that profitability has positive significant effect on the firm value.

The effect of working capital management towards firm value

The first hypothesis in this research is accepted, that working capital management has negative effect towards firm value. A company's working capital management can be measured through the cash conversion cycle. The cash conversion cycle is the period of time in which the company purchases raw material inventory until the cash is collected from sale of finished goods. The length of the cash conversion cycle will determine size of a company's working capital needs (Setiawan & Sari, 2021). The concept of working capital management is that a company with good working capital management will have a high level of liquidity and profitability. In more detail, through efficient working capital management policies, a company implements a short cash conversion cycle, which is associated with a reduction in inventory conversion time, acceleration of accounts receivable collection from customers, and delay in payment of debts to creditors. Companies with efficient working capital management will eventually be able to provide value added for shareholders and stimulate investors in the market to invest in the company, thereby increasing the company's value.

This research is in accordance with the previous studies conducted by Indradewi & Widyarti (2016), Sulistyono et al. (2020), Setyanto & Permatasari (2014), Le (2019) who concluded that a short cash conversion cycle can indicate the effective and efficient working capital management in a company, thus indicating good company performance.

The effect of free cash flow towards firm value

The second hypothesis in this research is accepted that free cash flow has positive effect towards firm value. Companies that have positive free cash flow and greater value will be able to provide benefits for shareholders such as dividend payment, debt reduction can also be done when the company has free cash flow, hence the firm value will be high according to the investors.

This research is in accordance with a study conducted by Andini & Wirawati (2014). In this research, they analyzed the impact of free cash flow on the long-term performance of a company and stated that companies with the highest free cash flow will provide greater returns than companies with lower free cash flow. Harijanto & Mildawati (2017) and Mutende et al. (2017) also stated in their research that free cash flow has a positive effect on a company's performance. Therefore, it can be concluded that the higher the free cash flow that a company has, the better its performance will be. A good company performance will certainly increase the firm value.

The effect of profitability on firm value

The third hypothesis in this study is accepted that profitability has positive effect towards firm value. Increasing profits and firm value are interrelated because they are important for the company's survival. The firm value is affected by the level of profitability it generates. Profitability is the company's ability to generate profits or the effectiveness of its management. High profitability indicates good company performance and is predicted to be beneficial to investors, making them interested in responding to the positive signal given, resulting in an increase in the firm value.

In this research, profitability is proxied by ROA, because ROA can measure the management's achievements in the overall efficient use of capital. Research conducted by (Hafidh & Priono, 2022) shows consistent results, profitability has a significant positive impact on company value. The research results are in accordance with the research conducted by Widiastari & Yasa (2018), Sulistyono et al. (2020) and Iswajuni et al. (2018).

CONCLUSION

The results that can be concluded from this research are:

1. Working capital management, which is proxied by the cash conversion cycle (CCC), has negative effect towards firm value. Companies with efficient working capital management will eventually be able to provide value added for shareholders and stimulate investors in the market to invest in the company, thereby increasing the company's value.
2. Free cash flow (FCF) has positive effect towards firm value. The higher the free cash flow that a company has, the better its performance will be. A good company performance will certainly increase the firm value.
3. Profitability which is proxied by return on assets (ROA) has positive effect towards firm value. High profitability indicates good company performance and is predicted to be beneficial to investors, making them interested in responding to the positive signal given, resulting in an increase in the firm value.

This research was conducted on a food and beverage industry companies over a period of 3 consecutive years (2019-2021). The independent variables studied, namely CCC, FCF, and ROA, have a significant effect on firm value.

SUGGESTION

Practical suggestion:

The company should pay attention to their cash conversion cycle to be effective, have a positive free cash flow to maintain financial flexibility, and increase profits so that the ROA becomes higher. This will result in investors responding positively, leading to an increase in the firm value.

Theoretical suggestion:

Suggestions for future researchers to conduct the research in different industries such as manufacturing, property and real estate, hotels and tourism or other industries. Future researchers can also research at different time frames, and may also conduct research by adding variables such as dividend payout ratio, earnings per share and leverage to develop factors that affect the firm value.

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