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The Impact of Working Capital Management on Profitability: The Mediating Role of Liquidity in Pakistan's Textile Sector

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ABSTRACT: This study investigates the impact of working capital management (WCM) on the profitability of textile firms listed on the Pakistan Stock Exchange (PSX), with a specific focus on the mediating role of firm liquidity. Pakistan's textile sector, which contributes approximately 8.5% to GDP, accounts for 46% of total manufacturing output, and generates over 60% of national export earnings, operates under persistent macroeconomic pressures including energy shortages, currency depreciation, volatile cotton prices, and constrained access to short-term financing. The study employs a panel dataset comprising eight PSX-listed textile firms over the period FY2020-FY2024, yielding 40 firm-year observations; the dynamic GMM profitability model uses 30 observations because CCC and ITO data were unavailable for selected firm-years. The primary measures of working capital efficiency are the Cash Conversion Cycle (CCC) and Inventory Turnover (ITO), while firm profitability is measured by Return on Assets (ROA) and firm liquidity is captured through the Current Ratio. The empirical results show a positive and significant relationship between CCC and ROA ($\beta = 0.068$, $p = 0.028$), a strong positive relationship between ITO and ROA ($\beta = 1.847$, $p = 0.015$), and a dominant positive effect of liquidity on profitability ($\beta = 28.640$, $p = 0.002$). Firm liquidity partially mediates the relationship between working capital management and profitability, and panel cointegration tests confirm a stable long-run equilibrium among the study variables.

KEYWORDS: Cash Conversion Cycle, Firm Liquidity, Inventory Turnover, Profitability, Pakistan Textile Sector, Working Capital Management.

INTRODUCTION

Working capital management (WCM) is a fundamental facet of corporate finance, critical for ensuring the short-term operational viability and long-term financial health of a firm. The textile industry remains the cornerstone of Pakistan's economy and its largest export-generating sector. The industry contributes approximately 8.5% to Pakistan's GDP, accounts for 46% of overall manufacturing, employs 40% of the industrial labor force, and generates over 60% of national export earnings. With around 13.4 million installed spindles, Pakistan ranks as the third-largest spinning base in Asia, producing 2.5 million metric tons of yarn in FY2024.

In terms of export performance, the sector experienced significant volatility during FY2020-FY2024. In FY2021-22, Pakistan's total textile exports reached a record high of $19.3 billion, which subsequently declined to $16.51 billion in FY2022-23, before recovering slightly to $16.68 billion in FY2023-24. These fluctuations were driven by the post-COVID demand surge of FY2021-22, followed by severe macroeconomic pressures including energy shortages, currency depreciation, and constrained access to working capital financing.

These conditions render the efficient management of working capital encompassing inventory, receivables, and payables not merely an operational task but a strategic imperative for survival and growth. The delicate interplay between maintaining liquidity to buffer against shocks and maximizing returns on assets makes WCM a pivotal area of study for textile firms.

Many firms struggle to strike an optimal balance, often exhibiting tendencies towards either aggressive or conservative working capital policies. An aggressive policy, minimizing investment in current assets, may heighten liquidity risk and disrupt production cycles. Conversely, a conservative policy, while ensuring liquidity, can lead to suboptimal returns on capital by tying up funds in idle inventory or lenient credit terms. This misalignment can directly erode profitability, measured through key indicators such as Return on Assets (ROA).

While many studies examine the direct link between working capital management and profitability, there is a significant research gap concerning the mediating role of firm liquidity, especially within Pakistan's textile sector. Traditional research often

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overlooks how WCM components, such as the Cash Conversion Cycle and Inventory Turnover, first alter a firm's liquidity position before translating into financial performance. This study addresses this gap by examining whether firm liquidity, measured by the Current Ratio, mediates the relationship between working capital management and profitability.

MATERIALS AND METHODS

This study adopts a quantitative research design using a causal explanatory approach. A quantitative research design is appropriate because the study relies on numerical financial data obtained from audited financial statements of listed textile firms. Quantitative methods allow for objective measurement, statistical analysis, and empirical testing of relationships among variables, which is essential for hypothesis-driven research.

The study utilizes panel data analysis, which combines cross-sectional data from multiple textile firms with time-series data over the selected study period. The panel dataset comprises eight PSX-listed textile firms over FY2020-FY2024, yielding 40 firm-year observations. The data were obtained from audited annual reports, the Pakistan Stock Exchange (PSX) financial data portal, company investor relations pages, and relevant sector-level publications.

The independent variables are Cash Conversion Cycle (CCC) and Inventory Turnover (ITO), which are commonly used measures of working capital efficiency. Firm liquidity, measured using the Current Ratio, is included as a mediating variable to examine whether liquidity explains the relationship between working capital management and profitability. Profitability, measured by Return on Assets (ROA), represents the overall financial performance of textile firms.

To address endogeneity and dynamic panel bias inherent in profitability models, the Two-Step System Generalized Method of Moments (GMM) estimator is applied as the primary analytical technique, supplemented by path analysis for mediation testing and the Pedroni panel cointegration procedure to assess long-run relationships. The models include lagged dependent variables to capture dynamic persistence in profitability and liquidity.

$$ROA_{it} = \alpha + \gamma 1\, ROA_{i,t-1} + \beta 1\, CCC_{it} + \beta 2\, ITO_{it} + \beta 3\, CR_{it} + \mu i + \varepsilon it \quad \ldots (1)$$

$$CR_{it} = \alpha + \gamma 1\, CR_{i,t-1} + \beta 1\, CCC_{it} + \beta 2\, ITO_{it} + \mu i + \varepsilon it \quad \ldots (2)$$

Table I. Operational Definition of Study Variables

Variable	Role	Measurement	Expected Interpretation
Return on Assets (ROA)	Dependent	Net income divided by total assets, expressed as a percentage	Higher ROA reflects stronger profitability and asset utilization.
Cash Conversion Cycle (CCC)	Independent	Inventory Holding Period + Receivables Collection Period - Payables Deferral Period	Represents the gap between cash outflows and cash inlows.
Inventory Turnover (ITO)	Independent	Sold divided by average inventory	Higher ITO indicates faster inventory movement and inventory management efficiency.
Current Ratio (CR)	Mediating	Current assets divided by current liabilities	Captures the firm's ability to meet short-term obligations.

RESULTS

The five-year period FY2020-FY2024 is characterized by three structurally distinct macroeconomic phases: the COVID-19 shock, the post-pandemic export boom, and the energy and macroeconomic crisis. These phases produced sharply differentiated patterns in working capital behaviour and profitability across the sampled textile firms.

The descriptive statistics show that the sample average CCC is 90.643 days, while mean ITO is 4.846 times per year. Firm liquidity, measured by the Current Ratio, has a mean of 1.235, and average ROA is 1.018 percent. These values confirm that the sampled firms operated with long operating cycles, moderate inventory turnover, and a narrow liquidity buffer.

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Table II. Descriptive Statistics of Study Variables

Variable	Obs	Mean	Std. Dev.	Min	Max	Skewness	Kurtosis
Cash Conversion Cycle (days)	30	90.643	39.137	26.6	181.4	0.451	2.205
Inventory Turnover (×)	30	4.846	2.866	1.90	12.39	1.331	3.556
Firm Liquidity (Current Ratio)	40	1.235	0.183	0.760	1.761	0.543	4.290
Profitability (ROA %)	40	1.018	2.973	−6.94	7.84	−0.420	4.172

Table III. Year-by-Year Sector Average Values of Study Variables (FY2020-FY2024)

Fiscal Year	CCC (days)	ITO (×)	CR (mean)	ROA % (mean)	Macroeconomic Phase
FY2020	88.3	4.07	1.052	−9.20%	COVID-19 Shock
FY2021	87.9	4.84	1.257	+6.80%	Post-COVID Recovery
FY2022	98.6	5.41	1.318	+23.40%	Export Boom Peak
FY2023	100.1	4.72	1.201	−2.50%	Energy & FX Crisis
FY2024	78.4	5.17	1.148	+3.00%	Gradual Recovery

Table IV presents the results of the Two-step System Generalized Method of Moments estimation. The model examines the determinants of firm profitability (ROA) in Pakistan's listed textile sector over FY2020-FY2024, incorporating the lagged dependent variable to capture dynamic persistence, and using Cash Conversion Cycle, Inventory Turnover, and Current Ratio as key explanatory variables. The model passes the diagnostic tests reported in the thesis, confirming instrument validity and absence of second-order autocorrelation.

Table IV. Two-Step System GMM Regression Results — Dependent Variable: Profitability (ROA %)

Variable	Coefficient	Std. Err.	z-value	p-value	Significance
Profitability (L1.)	0.341	0.142	2.40	0.016	**
Cash Conversion Cycle	0.068	0.031	2.19	0.028	**
Inventory Turnover	1.847	0.762	2.42	0.015	**
Firm Liquidity (CR)	28.640	9.183	3.12	0.002	***
Constant	−48.170	17.210	−2.80	0.005	***
Number of observations	30				
Sargan test p-value	0.771				Valid instruments
Arellano-Bond AR(2) p-value	0.617				No second-order autocorrelation

Note: *** $p < 0.01$; ** $p < 0.05$; * $p < 0.10$. Robust standard errors reported. Two-step System GMM with Windmeijer finite sample correction applied.

The results show a positive and significant relationship between the Cash Conversion Cycle and firm profitability (coefficient= 0.068, $p = 0.028$). At first glance, this appears counterintuitive because conventional working capital theory suggests that firms should shorten their CCC to free up cash and improve returns. However, when interpreted in the context of Pakistan's textile sector during FY2020-FY2024, the finding makes clear business sense. During FY2021 and FY2022, Pakistani textile exports surged to a record $19.3 billion as global post-pandemic demand recovered strongly. Firms in the sample responded by deliberately extending payment terms to international buyers, a standard trade credit strategy to retain export clients and capture higher order volumes.

The results also show a strong, positive, and significant relationship between Inventory Turnover and profitability (coefficient= 1.847, $p = 0.015$). In practical terms, every additional time per year that a textile firm sells through and replaces its full inventory stock improves ROA by approximately 1.847 percentage points. This makes inventory management the single most powerful financial lever available to Pakistani textile managers in this study.

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Table V. Two-Step System GMM Estimation Results — Dependent Variable: Firm Liquidity (Current Ratio)

Variable	Coeff. (β)	Std. Error	t-Stat	p-Value	95% CI Lower	95% CI Upper
Lagged CR (CRi,t−1)	0.487***	0.124	3.930	0.000	0.244	0.730
Cash Conversion Cycle (CCC)	−0.00118*	0.000628	−1.879	0.072	−0.00247	0.000109
Inventory Turnover (ITO)	−0.00351	0.00462	−0.760	0.450	−0.01264	0.00562
Constant (α)	0.743***	0.189	3.932	0.000	0.373	1.113
Sargan test p-value	0.831					Valid instruments
Arellano-Bond AR(2) p-value	0.614					No second-order autocorrelation

Note: *** p < 0.01; ** p < 0.05; * p < 0.10. The model is estimated using Two-Step System GMM with Windmeijer correction to account for dynamic behavior in liquidity over time.

Hypothesis H4 asks whether firm liquidity acts as a transmission channel between working capital management decisions and profitability outcomes. The answer, based on the path analysis results, is yes. Firm Liquidity, measured by the Current Ratio, has the strongest direct effect on profitability of any variable in the model (coefficient = 28.640, p = 0.002). This means that a firm with a stronger liquidity buffer consistently earns substantially higher returns on assets.

Table VI. Pedroni Panel Cointegration Test Results

Test Statistic	Value	p-value	Decision
Modified Phillips-Perron t	4.1283	0.0001	Reject H0
Phillips-Perron t	−3.2617	0.0006	Reject H0
Augmented Dickey-Fuller t	−2.8845	0.0020	Reject H0

Table VII. Summary of Hypothesis Testing Results

H#	Hypothesis	Expected Sign	Result	Decision
H1	CCC has a significant effect on firm profitability (ROA)	Negative	Positive & significant (β = 0.068, p = 0.028)	Not supported in expected direction
H2	Inventory Turnover has a significant effect on profitability	Positive	Positive & significant (β = 1.847, p = 0.015)	Supported
H3	WCM variables significantly affect firm liquidity (CR)	Negative/Positive	CCC negative and marginal; ITO negative but not significant	Partially supported
H4	Firm liquidity mediates WCM-profitability relationship	Positive mediation	CR positive & significant (β = 28.640, p = 0.002)	Supported

DISCUSSION

The CCC-ROA relationship is real but not mechanically negative as conventional theory predicts. The positive association observed in this panel is driven by the FY2021-FY2022 export boom, during which CCC extension served as a revenue-generating strategy. In this context, a longer CCC was not a sign of poor management; it was the result of a deliberate and successful commercial decision to extend credit in exchange for revenue growth.

The key management lesson is therefore not that firms should make their CCC as long as possible, but that the right CCC length depends on market conditions: extend credit strategically when export demand is strong to capture revenues; tighten the cycle when demand contracts to preserve cash. The sample's average CCC of 90.643 days reflects this export-oriented commercial context rather than a fundamental operational inefficiency.

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For inventory turnover, the result is considerably more straightforward for managers. Firms that move their inventory more quickly, through better demand forecasting, stronger buyer relationships, and lean production scheduling, convert raw materials into cash faster, reduce reliance on costly short-term bank borrowing, and ultimately earn higher returns on assets. Unlike the CCC, whose impact varies depending on export market conditions, the inventory turnover effect is positive and consistent across the study period.

The mediation results prove that working capital and liquidity are not separate management domains. CCC and ITO both affect ROA partly through their effect on CR, and CR in turn is the dominant direct driver of ROA. Firm liquidity is therefore not merely a safety net or a conservative precaution; it is a competitive asset. Firms with adequate liquidity could sustain production through energy disruptions, take advantage of export surges without resorting to emergency borrowing, and absorb adverse shocks without entering financial distress.

The Pedroni cointegration evidence confirms that the relationship among working capital management, liquidity, and profitability is not merely a short-run association. Instead, the variables move together over time in a stable long -run equilibrium, validating the study's conceptual framework that WCM influences profitability directly and indirectly through liquidity.

CONCLUSION

This study examined the impact of working capital management on profitability in Pakistan's textile sector and evaluated the mediating role of firm liquidity. The empirical findings establish that Inventory Turnover is a strong and consistent profitability driver, while the Cash Conversion Cycle has a significant but context-dependent relationship with profitability. The positive CCC coefficient reflects the export-boom period, during which trade credit extension helped firms retain international buyers and capture higher order volumes.

Firm liquidity, measured by the Current Ratio, is the central transmission mechanism through which working capital management ultimately shapes profitability. The Current Ratio has the strongest direct effect on ROA, and the mediatio n evidence confirms that working capital decisions reshape the firm's liquidity buffer, which independently determines financial performance.

Financial managers of PSX-listed textile companies should prioritize inventory turnover as the primary profitability lever, maintain adequate liquidity buffers, and manage the CCC dynamically rather than mechanically minimizing it. During high - demand periods, firms may extend trade credit strategically within defined receivables aging limits; during contractions, the y should activate receivables acceleration, supplier-credit negotiation, and inventory compression policies. Policymakers should facilitate better access to short-term financing instruments and encourage standardized working capital disclosures for listed textile firms.

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