THE MODERATING EFFECT OF COST OF CAPITAL ON THE
RELATIONSHIP BETWEEN WORKING CAPITAL MANAGEMENT
AND FINANCIAL HEALTH IN SELECTED MALAYSIAN PUBLIC
LISTED FIRMS

By

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The topic on how working capital management policies affect a firm’s financial health was first conceived after serious discussions with my mentor and supervisor Dr. Zahiruddin Ghazali. We had several meetings at train stations in Kuala Lumpur over cups of coffee amidst both our heavy schedules and other responsibilities. After several discussions on the direction of the thesis, the decision to study the effects of cost of capital as a moderator on the abovementioned relationship was taken mainly due to the paucity of such studies both in the local and international context. My initial efforts looked so daunting but as time went by, the journey became a little easier until I was able to see the light at the end of the tunnel after several weeks.

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<td>ROIC</td>
<td>Return on Invested Capital</td>
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<td>Return on Equity</td>
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<td>ROA</td>
<td>Return on Assets</td>
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<td>SME</td>
<td>Small and Medium Sized Enterprises</td>
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<td>WCM</td>
<td>Working Capital Management</td>
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<td>Variance Inflation Factor</td>
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ABSTRAK

Polisi pengurusan modal kerja sering dianggap sebagai faktor utama yang mempengaruhi operasi dan kesejahteraan kedudukan kewangan sesebuah firma secara keseluruhannya. Dalam kajian yang melibatkan syarikat-syarikat yang disenaraikan di Bursa Malaysia dalam sektor perdagangan, perkhidmatan dan pengguna ini, polisi pengurusan modal kerja telah dikategorikan mengikut dasar pelaburan aset jangka pendek, dasar pembiayaan aset jangka pendek dan kecekapan dalam menguruskan modal kerja. Dengan menggunakan analisis data panel, model kesan tetap (fixed effects) mendedahkan bahawa di antara ketiga-tiga metrik pengurusan modal kerja, kos modal memberi kesan kesan moderator hanya ke atas hubungan antara dasar pembiayaan aset jangka pendek firma dengan keteguhan kewangan. Kajian ini menunjukkan bukti empirikal bahawa apabila kos modal firma meningkat, hubungan negatif di antara polisi pembiayaan aset jangka pendek firma dan keteguhan kewangan akan berkurangan. Walau bagaimanapun, kos modal tidak memainkan peranan sebagai moderator terhadap kesan desas pembiayaan modal kerja yang lain (iaitu polisi jangka pendek pelaburan aset dan kecekapan pengurusan modal) ke atas keteguhan kewangan. Kajian ini juga menunjukkan bukti empirikal bahawa kos modal tidak mempunyai banyak kaitan dengan keteguhan kewangan firma. Kajian ini mempunyai implikasi ke atas perspektif teori dan pengurusan. Dari perspektif teori, oleh kerana komponen modal kerja firma dianggap sebagai sumber penting, terdapat bukti empirikal bahawa polisi pengurusan modal kerja memberi kesan yang signifikan terhadap keteguhan kewangan firma. Dari perspektif pengurusan, analisis moderator membantu pengurusan kewangan membuat keputusan mengenai polisi pengurusan modal kerja. Secara lebih khusus lagi, apabila kos modal firma menjadi lebih tinggi, kesan negatif polisi pembiayaan aset jangka pendek yang agresif terhadap keteguhan kewangan akan berkurangan. Dalam keadaan ini, pihak pengurusan firma boleh menyokong satu dasar pembiayaan aset jangka pendek yang agresif kerana kesan negatifnya kini berkurangan.

Kata kunci: kos modal, kesan tetap (fixed effects), pengurusan modal kerja, keteguhan kewangan, analisis data panel.
ABSTRACT

Working capital management policies have been touted as key to influencing a firm’s operational and overall financial well-being. In this study involving Malaysian firms in the trading, services and consumer sectors, working capital management policies were categorized by its short-term asset investment policy, its short-term asset financing policy and its efficiency in managing its working capital. Using panel data analysis, the fixed effects model reveals that among the three working capital metrics, only a firm’s short-term asset financing policy’s relationship with financial health was moderated by its cost of capital. The study provides empirical evidence that when a firm’s cost of capital increases, the negative relationship between its short-term asset financing policy and its financial health seems to weaken. However, cost of capital does not play a moderating role on the effects of a firm’s other working capital policies (short-term asset investment policy and working capital management efficiency) on financial health. The study also provides empirical evidence that cost of capital has little to do with a firm’s financial health. This study has implications on both theoretical and managerial perspectives. From a theoretical perspective, since a firm’s working capital components are considered important resources, the findings imply that working capital policies seem to significantly affect financial health. From a managerial perspective, moderator analysis helps finance managers make decisions on working capital policy matters. More specifically, when a firm’s cost of capital becomes higher, the negative impact of its aggressive short-term asset financing policy on financial health is now reduced. In other words, its management can advocate an aggressive short-term asset financing policy since its negative impact is now lessened.

Keywords: cost of capital; moderating effects; working capital management; financial health; panel data analysis.
CHAPTER ONE
INTRODUCTION

1.0 Introduction

Major theories in the study of corporate finance over the years have concentrated on long-range financial decisions such as investment appraisal, capital structure, payout decisions and other financial strategy formulations. These areas of finance were deemed to be relatively more productive in terms of time, resources and energy spent. Perhaps, this is because long-term investment and financing decisions provide future cash flows which when discounted determine the market value of the firm. Although these areas of finance are still taking precedence and stealing the limelight, short-term decision studies regarding current assets and liabilities have increasingly begun to get noticed. Fears that a firm’s liquidity position is at stake have become common and steps need to be taken so that liquidity and eventual bankruptcy is unthreatened. Over the years, researchers have realized that the ‘oil’ of working capital is needed for the ‘engine’ of non-current assets to function. For instance, Fazzari and Petersen\(^1\) (1993) emphasized the advantage of a good working capital management plan to ensure firms smooth fixed capital investment in the face of cash-flow shocks.

In the late 1970’s and early 1980’s, Pass and Pike\(^2\) (1984) pointed out that liquidity concerns had been increasingly discussed amongst finance practitioners and researchers. Following these concerns, firms were beginning to adopt and adapt strategies within the firm to manage and improve cash flows even during favorable

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1 Fazzari and Petersen (1993) in their paper on the role of working capital on investment smoothing among US firms suggest that finance constraints link inventory movement and cash flow.
2 Pass and Pike (1984) explained that working capital management involves ensuring firm profitability and maintaining sufficient liquidity levels to meet short-term obligations.
The contents of the thesis is for internal user only
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