

# Liquidity management, operating performance, and corporate value: evidence from Japan and Taiwan

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## Abstract

This study examines the relationship between liquidity management and operating performance, and that between liquidity management and corporate value for firms in Japan and Taiwan. We observe that the cash conversion cycle (CCC)–returns on assets (ROA) and CCC–returns on equity (ROE) relationships are commonly negative and sensitive to industry factors. Both Japanese and Taiwanese firms with  $q > 1$  have significantly lower CCC than firms with  $q \leq 1$ . In addition, Japanese firms with  $q > 1$  have significantly higher ROA and ROE than firms with  $q \leq 1$ . Overall, the findings indicate that aggressive liquidity management enhances operating performance and is usually associated with higher corporate values for both countries in spite of differences in structural characteristics or in financial system of a firm. © 2002 Elsevier Science B.V. All rights reserved.

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## 1. Introduction

Liquidity management, though many times a neglected aspect in financial management, occupies a major portion of a financial manager's time and attention. In a sense, a deficiency of liquidity implies that the firm is unable to take advantage of favorable discounts or profitable business opportunities as they come into being. A serious

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insufficiency of liquidity means that the firm is lacking ability to pay its current debts or other obligations. This may, in turn, result in the forced sale of investments and properties and, in its most severe condition, to insolvency and bankruptcy.

Financial practitioners perceive that traditional measures of corporate liquidity (such as the current ratio, the quick ratio, and even net working capital) are static in terms of what cash resources are ready for use at a given moment in time to satisfy the current obligations. The existing supply of cash resources does not have a causative relationship to the cash that will flow through it. Static liquidity indicators underline basically a liquidation approach to liquidity analysis, rather than a going-concern. Gitman (1974) notes the limitations of traditional 'static' ratios and starts to advocate the use of the operating approach—a cash conversion cycle (CCC) to liquidity analysis. Then, a flowing concept of liquidity is developed by extending the static balance sheet analysis of potential liquidation value coverage to include income statement measures of a firm's operating activity. From this point of view, Richards and Laughlin (1980) argue that investors should focus their concern on two things: (1) avoiding default situations by emphasizing a firm's ability to cover its obligation with cash flow from mobilizing inventory and receivable investments within the normal course of the firm's operations and (2) keeping these operating cash flows sensitive to declining sales and earnings during periods of economic adversity.

The CCC focuses on the length of time between the company making payments and receiving cash flows. In other words, it is the net time interval between actual cash expenditures on a firm's purchase of productive resources and the recovery of cash receipts from product sales. The CCC measure explicitly recognizes that the life expectancies of some working capital components depend upon the extent to which four basic activities—purchasing/production, sale, collection, and payment—are fulfilled noninstantaneously and unsynchronizedly. The CCC is a dynamic measure of ongoing liquidity management in the sense that it combines both balance sheet and income statement data to generate a measure that tells a time difference. According to Richards and Laughlin (1980), the interrelationship among a CCC, an inventory conversion period, a receivables conversion period, and a payables conversion period can be illustrated in Exhibit 1.

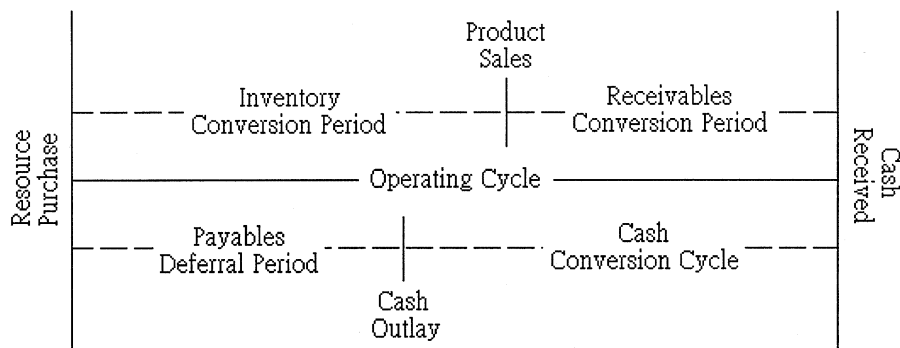


Exhibit 1. Cash conversion cycle.

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