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An Evaluation of Liquidity and Profitability of Selected Indian Companies in the Context of Ind AS Adoption

Narayan Kafle
Assistant Professor
Department of Commerce, Jagiroad College
Jagiroad, Morigaon(Assam), India

Abstract : Liquidity and profitability are two correlated aspects linked with working capital management of a business organisation. Most of the earlier studies conducted in this area revealed that there exists a negative correlation between liquidity and profitability. However, in India, companies were using Indian GAAP (IGAAP) in preparation and presentation of their financial statements till 2016-17. Since then, adoption of Indian Accounting Standards (Ind AS) has been made mandatory in a phased manner replacing the earlier IGAAP. The new accounting and disclosure norm is said to have a significant impact on the reported values of net profit and net worth. In this context, the present paper is an attempt to evaluate the relationship between liquidity and profitability before and after adoption of Ind AS. The study uses secondary data obtained from annual reports of fifteen selected companies and comes to a conclusion that the said relationship pattern is different during the two periods.

Key Words: 1.Liquidity, 2.Profitability, 3.Financial Statements, 4.IGAAP, 5.Ind AS.

Introduction:

Liquidity and profitability are two important aspects of a firm's working capital management policy. Liquidity refers to firm's ability to pay its current liabilities. A firm with high liquid resources will be able to meet its current obligations in time without any failure. On the other hand, maintenance of excess liquid assets will result in more funds blocked in current assets which in turn may hamper the firm's profitability. As such, high liquidity is as undesirable as low as the profit earning ability of current assets are usually considered to be low than fixed assets. Therefore, efficient allocation of firm's resources between current assets and fixed assets is essential so that there is a balance between liquidity and profitability.

Statement of the Problem:

In India, adoption of Indian Accounting Standards (Ind AS) has been made mandatory from the accounting year 2016-17 in a phased manner. As a result, most of the Indian companies except Banks, NBFCs, Insurance Companies and SMEs have started adoption of Ind AS in preparation and presentation of their financial statements. The new shift to IFRS converged Ind AS is said to bring many changes in the reported financial parameters of companies. These changes are expected to be brought abouton account of shift to fair valuation method, new norms for classification and reclassification of assets and liabilities, change in revenue recognition norms etc. apart from other factors. In the light of the above, this paper is an attempt to examine the relationship between liquidity and profitability before and after adoption of Ind AS. It attempts to examine whether the liquidity-profitability relationship existing at the time of Indian GAAP (IGAAP) exits after adoption of Ind AS also.

Review of Literature:

Eljelly (2004) in his study about liquidity and profitability trade – off: an empirical investigation in an emerging market, found a negative relationship between profitability and liquidity indicators.

Chakraborty (2008), in his study evaluated the relationship between working capital and profitability of Indian pharmaceutical companies. The study pointed out two schools of thought on the issue. One school of thought advocates that working capital is not an important factor for improving profitability while according to the other school of thought working capital plays an important role to improve corporate profitability.

Vieira (2010), conducted an exploratory study of airline companies between 2005 and 2008 and found a significant negative correlation between liquidity and profitability on the short run, whereas for the medium run, the relationship was found to be positive.

Joshi and Ghosh (2012), in their study conducted on CIPLA ltd. found that there exists a negative correlation between liquidity and profitability.

Research Gap:

A large number of studies have been conducted in the area of working capital management and on liquidity-profitability relationship. Some studies found positive relationship while some other found negative relationship between the two aspects. However, there has not been any study relating to evaluation of liquidity profitability relationship post implementation of Ind AS in India. This study is an attempt to fill the gap by making comparative study of liquidity profitability relationship during IGAAP and Ind AS period.

Objectives of the Study:

The study is designed with the objective to examine the position of liquidity and profitability of selected companies and theirrelationship during IGAAP regime and Ind AS regime.

Research Questions:

Based on the above mentioned objective, following research questions are set-

1. Are the current ratios of the selected companies same during IGAAP regime and Ind AS regime?
2. Are the ROCEs of the selected companies same during IGAAP regime and Ind AS regime?
3. Is the liquidity-profitability relationship in the selected companies same during IGAAP regime and Ind AS regime?

Research Methodology:

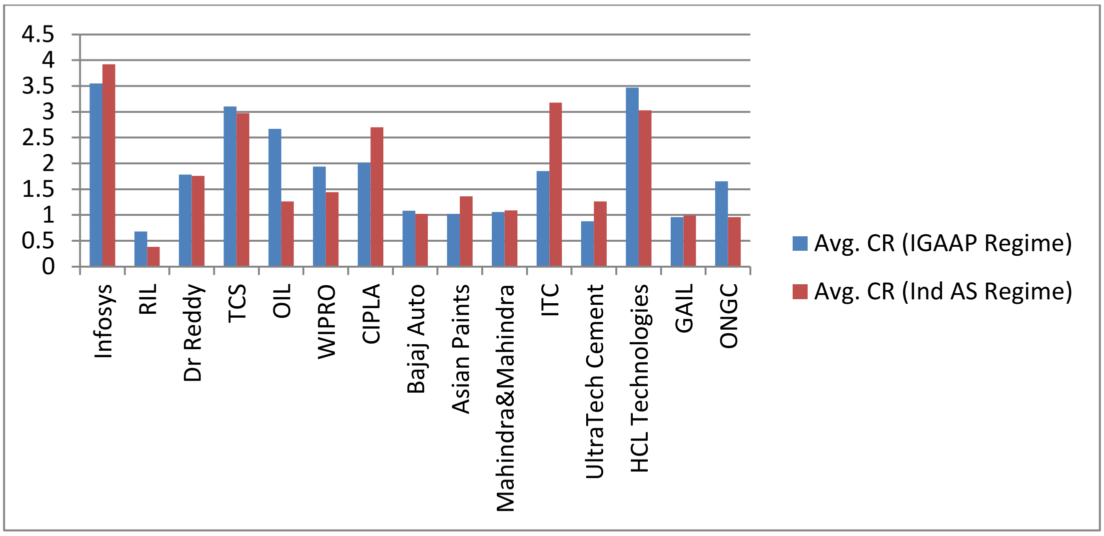
The study is descriptive and analytical in nature. It is based on secondary data collected mainly from the published annual reports of the companies selected as sample. Apart from annual reports of sample companies, various research journals and books have been used to collect the necessary information.

Convenient sampling method has been used to select the companies for the purpose of the study. While selecting the sample, only those companies which started mandatory adoption of Ind AS in the first phase i.e. 2016-17 have been considered so that a comparative study between IGAAP and Ind AS is possible. Accordingly, annual reports of 15 companies for four years from 2014-15 to 2017-18 have been considered for the purpose of the study of which 2014-15 and 2015-16 represent IGAAP period whereas 2016-17 and 2017-18 represent Ind AS period.

In order to measure liquidity, Current Ratio (CR)has been used while profitability has been measured on the basis of Return on Capital Employed (ROCE). Simple correlation analysis has been used to examine the relationship between liquidity and profitability.

Data Analysis and Interpretation:

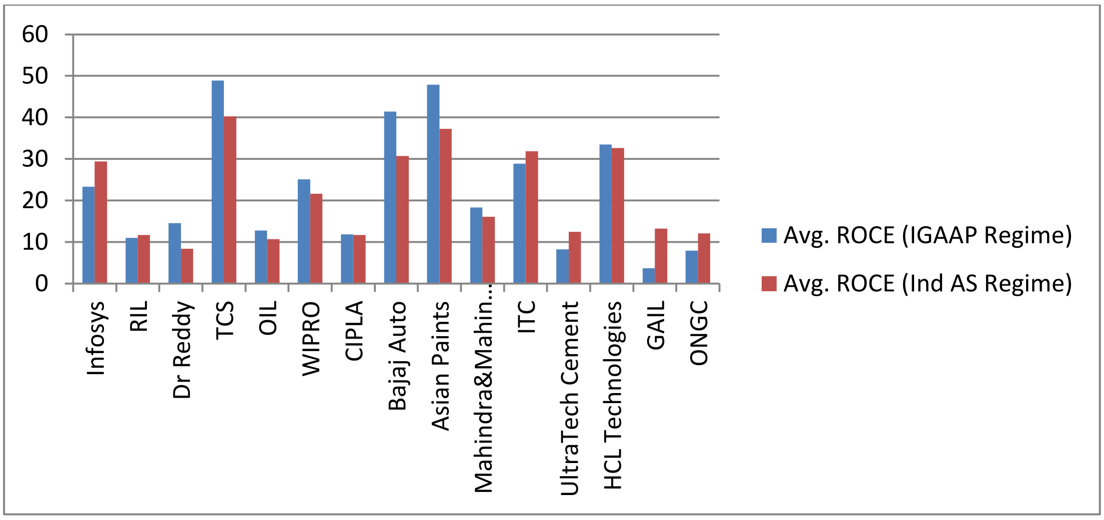
Fig.1 Analysis of Position of Current Ratio during IGAAP and Ind AS regime.



Source: Compiled from published annual reports of selected companies.

The above chart shows that in five companies viz. Infosys, CIPLA, Asian Paints, ITC and UltraTech Cement, the average current ratio during Ind AS regime were more than that of IGAAP regime. On the other hand, in six companies viz. RIL, TCS, OIL, WIPRO, HCL and ONGC, the average current ratio decreased during Ind AS regime as compared to that of IGAAP regime. Furthermore, in remaining four companies, the average current ratio remained more or less same during the two regimes.

Fig.2. Analysis of Position of ROCE during IGAAP and Ind AS regime.



Source: Compiled from published annual reports of selected companies.

The above chart shows that in six companies viz. Infosys, RIL, ITC, UltraTech Cement, GAIl and ONGC the average ROCE increased during Ind AS regime as compared to that of IGAAP regime. On the other hand, in eight companies viz. Dr Reddy, TCS, OIL, WIPRO, Bajaj Auto, Asian PaintsHCL and ONGC, the average current ratio decreased during Ind AS regime as compared to that of IGAAP regime. Furthermore, in remaining four companies, the average current ratio remained more or less same during the two regimes.

Table1. Analysis of liquidity-profitability relationship during IGAAP period:

Company	Current Ratio			% Change in CR (x)	ROCE			% Change in ROCE (y)
	2014-15	2015-16	Avg. CR		2014-15	2015-16	Avg. ROCE	
Infosys	3.12	3.98	3.55	26.92	25.92	20.75	23.34	(19.95)
RIL	0.89	0.47	0.68	(47.19)	10.42	11.47	10.95	10.08
Dr Reddy	1.81	1.74	1.78	(3.87)	15.43	13.61	14.52	(11.76)
TCS	2.78	3.41	3.10	22.66	52.77	45.03	48.90	(14.67)
OIL	2.45	2.89	2.67	17.96	13.63	11.86	12.75	(12.99)
WIPRO	2.16	1.71	1.94	(20.83)	26.85	23.25	25.05	(13.04)
CIPLA	1.83	2.19	2.01	19.67	11.65	12.06	11.86	3.52
Bajaj Auto	0.89	1.27	1.08	42.70	41.01	41.82	41.42	1.98
Asian Paints	1.09	0.95	1.02	(12.84)	46.31	49.38	47.85	6.63
Mahindra&Mahindra	1.05	1.10	1.06	4.76	18.51	18.13	18.32	(2.05)
ITC	2.05	1.65	1.85	19.51	29.54	28.18	28.86	(4.60)
UltraTech Cement	0.90	0.86	0.88	(4.44)	7.62	8.78	8.20	15.22
HCL Technologies	3.13	3.80	3.47	21.40	39.92	27.07	33.50	(32.19)
GAIL	0.97	0.95	0.96	(2.06)	3.55	3.82	3.69	7.61
ONGC	1.57	1.72	1.65	9.55	9.38.	7.91	7.91	(15.67)

Source: Compiled from published annual reports of selected companies

The above table shows liquidity position and profitability position of selected companies during two years of IGAAP period as measured by Current Ratio and Return on Capital Employed respectively. Percentage change in CR between 2014-15 and 2015-16 has been denoted by x and percentage change in ROCE between 2014-15 and 2015-16 has been denoted by y. Karl Pearson's simple correlation coefficient (r) has been applied to examine the relationship between x and y. The calculated value of r is -0.41 which indicates a negative correlation between the two variables. However, the degree of this relationship has been moderate.

Table2. Analysis of liquidity-profitability relationship during Ind AS period:

Company	Current Ratio			% Change in CR (x)	ROCE			% Change in ROCE (y)
	2016-17	2017-18	Avg. CR		2016-17	2017-18	Avg. ROCE	
Infosys	4.05	3.78	3.92	(6.67)	27.80	31.00	29.40	11.51
RIL	0.35	0.41	0.38	17.14	11.16	12.24	11.70	9.68
Dr Reddy	1.83	1.68	1.76	(8.20)	11.47	5.27	8.37	(54.05)

TCS	3.09	2.85	2.97	(7.77)	38.43	42.00	40.22	9.29
OIL	1.56	0.95	1.26	(39.10)	9.71	11.69	10.70	20.39
WIPRO	1.50	1.37	1.44	(8.67)	21.09	22.17	21.63	5.12
CIPLA	2.48	2.91	2.70	17.34	9.39	13.93	11.66	48.35
Bajaj Auto	1.10	0.94	1.02	(14.55)	31.11	30.25	30.68	(2.76)
Asian Paints	1.41	1.34	1.36	(4.96)	37.51	36.97	37.24	(1.44)
Mahindra&Mahindra	1.12	1.06	1.09	(5.36)	14.66	17.43	16.05	18.89
ITC	3.59	2.77	3.18	(22.84)	32.76	30.87	31.82	(5.77)
UltraTech Cement	1.55	0.96	1.26	(38.06)	13.96	10.88	12.42	(22.06)
HCL Technologies	3.02	3.04	3.03	0.66	32.03	33.14	32.59	3.47
GAIL	1.01	0.97	0.99	(3.96)	12.36	14.08	13.22	13.92
ONGC	1.55	0.44	0.96	(71.61)	11.59	12.56	12.08	8.37

Source: Compiled from published annual reports of selected companies

The above table shows liquidity position and profitability position of selected companies during two years of Ind AS regime as measured by Current Ratio and Return on Capital Employed respectively. Percentage change in CR between 2016-17 and 2017-18 has been denoted by x and percentage change in ROCE between 2016-17 and 2017-18 has been denoted by y. Karl Pearson's simple correlation coefficient (r) has been applied to examine the relationship between x and y. The calculated value of r is 0.22 which implies a positive correlation between the two variables.

Summary of Findings:

- The finding of the study regarding the position of current ratio during the two regimes showed some mixed results. In five companies, the average current ratio during the two years of Ind AS regime was more than that of IGAAP regime whereas the result was opposite in case of six companies. Moreover, the said ratio was more or less same during the two regimes in case of remaining four companies. However, the overall average of current ratio taking all the companies together during the IGAAP period was 1.85 whereas the same ratio was 1.82 implying almost similar level of current ratio between the two regimes under study.
- Regarding profitability position of the selected companies, the study revealed that in six companies viz. Infosys, RIL, ITC, UltraTech Cement, GAIl and ONGC the average ROCE increased during Ind AS regime as compared to that of IGAAP regime. On the other hand, in eight companies viz. Dr Reddy, TCS, OIL, WIPRO, Bajaj Auto, Asian Paints HCL and ONGC, the average current ratio decreased during Ind AS regime as compared to that of IGAAP regime. Furthermore, in remaining four companies, the average current ratio remained more or less same during the two regimes. The overall average of ROCE taking all the companies together was 22.47 during IGAAP regime whereas it was 21.32 during Ind AS regime implying a slight decline in the reported profitability of the selected companies during Ind As regime.
- The finding of the study regarding liquidity-profitability relationship during the two regimes suggested two completely different results. During the IGAAP regime, the relationship was found to be negative with Karl Pearson's correlation coefficient value of -0.41 whereas the same relationship during Ind AS regime was positive with r value of 0.22.

Conclusion:

Ind AS is a reporting standard and as such it does not have any impact on business fundamentals. But a change in accounting standard certainly implies a change in the recognition, measurement and disclosure norms regarding various accounting events. Moreover, the shift to Ind AS from former IGAAP has brought various changes in the reporting framework with regard to classification and reclassification of assets and liabilities, revenue recognition norms, valuation of assets and liabilities etc. which eventually have an impact on the reported net profit and assets and liabilities.

Working capital management is one of the important aspects related with the assets and liabilities structure of a company. As such, analysis of the impact of Ind AS on working capital structure and its relationship with the company's profitability is of paramount importance for the management. The present study has made an attempt to make a comparative analysis of the liquidity-profitability relationship with the help of four years data of the selected companies. Since, Ind AS has been newly implemented; in future researchers may go for further analysis of the same with broader database coming out with more reliable findings.

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