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The Effect of Liquidity Ratio on the Company Financial Performance: Evidence from a Developing Economy

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ABSTRACT

This study purposes to analyze the link between liquidity ratios and the company financial performance of companies in developing economy. It used secondary data from 118 companies from 2020 to 2024 by using Stata data analysis software. The study found a important and positive association between liquidity ratios and company financial performance. The connection is of great significance to financial managers, investors, and policymakers, particularly in environments in the economy characterized by instability and financial variability. It was found that firms that hold moderate liquidity lacking investing professionally may smart from a lower return on investment, representative that unnecessary liquidity can be main to ineffective utilization of capital. The study suggests that firms keep a suitable balance in liquidity ratios, enough to cover short-term requests without disrupting utilization of existing funds for productive investments. Firms should grow continuing logical models to display liquidity depending on variations in the global and local economic environment to confirm high financial flexibility. The findings of this paper help financial managers make the best decisions concerning the best liquidity ratio, which balances financial safety and investment in profitable changes. Good liquidity administration increases company financial performance by decreasing financing expenses or avoiding liquidity issues.

Keywords: liquidity, company financial performance, developing economy.

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INTRODUCTION

The Liquidity is the main key financial display that returns a company's capability to chance short-term responsibilities, making it essential component in evaluating the "financial stability" and operational productivity of organizations. In developing and emerging economies, where firm face a volatile economic situation and various financing experiments, analyzing the connection among "liquidity ratios" and CFP becomes increasingly significant, particularly specified inadequate admission to established capital sources (Abbas et al., 2023). The "liquidity ratio" is a significant financial indicator utilizes to evaluate a firm's capability to chance its "short-term" financial tasks. This ratio is mainly significant in the current corporate environment described by rapid variations and economic variations, as liquidity signifies the component of financial safety that enables firms to challenge crises and pay debts when due without having to "liquidate their assets" or alternative to borrowing.

Developing and emerging economies expression various liquidity issues that influence their "financial stability" and the CFP of their economic organizations and businesses and. These issues contain little liquidity in financial stock markets, which are often rigid and superficial, subsequent in absence of obtainable cash to easily selling and buy assets. This mange to advanced financing expenses and problems in attaining investments and loans. A full confidence on "short-term financing". Several organizations and businesses trust on "short-term loans" or financing to fund their processes, which raises liquidity issues, particularly throughout times of issues. The absence of "long-run" financing few development and investment. The fluctuations of cash flow too occur in developing and emerging economies, which capability instability due to "exchange rate fluctuations", great inflation, and the decrease of a advanced financial system. This influence the capability of companies to chance their financial responsibilities. Poor liquidity management within companies, as well as a lack of expertise or advanced systems in this area, leads to an inappropriate allocation of financial resources, which can lead to financial difficulties or bankruptcy. The effects of inflation and external financing generate high inflation rates, which reduce the real value of available currency. Dependence on external financing or international loans can increase liquidity risks associated with foreign currency obligations. Weak financial laws and supervision, as well as the absence of adequate monetary policies, jeopardize the provision of sufficient liquidity to the productive sector. In developing economies, liquidity is affected by the limited availability of cash and liquid assets, the high volatility and scarcity of long-term financing,

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as well as poor financial management and regulation, which hinder economic growth and increase financial risks (Al-Saedi & Abbas, 2023).

The challenges facing developing economies have a significant effect on companies' financial performance. Below are the main problems faced by companies in these countries and their impact on their financial performance. For example, weak financial infrastructure, the lack of advanced financing systems such as investment banks, capital markets, and specialized financing systems, as well as difficult access to financing at low interest rates, hinder companies' ability to grow and invest. Extreme economic instability, “high inflation rates”, and monetary instability also affect businesses' ability to grow and invest. These fluctuations generate increased financial risks and hinder long-run planning. A lack of managerial services within businesses manages to poor analysis and financial planning, which hinders “decision-making”. Additionally, the reduce of modern equipment and technologies, in addition to their misuse in financial management and operational, negatively impacts the effectiveness of competitiveness and CFP (Abdullah et al., 2019).

This paper tests the concept of liquidity and its most important financial ratios, for example the “current ratio”, while analyzing their effects and impact on company performance and financial stability. As well as test the applied cases from the “financial reality” of some firms to illustrate how these ratios can be utilized in managerial and investment “decision-making”. CFP is one of the most main indicators reflecting the extent of which administrations are successful in achive their strategic objectives and economic. It show the main instrument relied upon by the investors, senior administration, and “decision-makers” to evaluate the effectiveness of operational processes, the level of success, and the companies capacity to continue and develop in a moving and “competitive economic environment” (Inrawan, et al., 2025).

Examining the CFP needs a deep accepting of numerous “financial statements”, for instance the “balance sheet, income statement, and cash flow statement”, in addition to the use of financial analysis tools for example economic indicators and financial ratios that assistance disclose the “weaknesses and strengths of a corporate performance. In light of international economic tests, assessing CFP is no longer few to numbers alone. As well as contains an understanding of the effecting external and internal issues, for example market fluctuations, financial policies, and controlling changes. This subject is of particular significance in light

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of firms efforts to enhance support operational effectiveness, achieve increase shareholder value and sustainability, (Abbas et al., 2022).

Liquidity is a vivacious financial indicator that reveals a company’s ability to meet its financial responsibilities. It is a key factor in supporting and enhancing CFP. The importance of liquidity in enhancing profits can be summarized in the next points: Ensuring the continuity of operational processes. Adequate liquidity enables a company to purchase raw materials, pay wages, and meet current obligations on time, preventing production or service interruptions and maintaining revenues and, consequently, profits. Likewise, capitalizing on investment opportunities. Companies with high liquidity are better able to seize unexpected investment opportunities that may generate high returns, contributing to higher profit rates. Reducing financing costs. When liquidity is available, a company does not need to borrow short-term debt at high “interest rates”, reducing financing burdens and increasing net profit. Enhancing investor and financier confidence (Sanga et al., 2025).

Adequate liquidity reflects a firm’s financial stability, making it more attractive to investors and financiers, ultimately improving the company's valuation and long-term profitability. Financial flexibility to face crises. Liquidity provides a buffer to address emergency situations or economic downturns, protecting the company from severe losses and maintaining a certain level of profitability. Improving purchase terms and cash discounts liquidity allows a company to pay suppliers promptly, enabling it to obtain cash discounts or better purchase terms, which reduces costs and increases profitability (Hasidi et al., 2024). This paper purposes to study the financial performance of companies by analyzing a set of “financial indicators”, highlighting the factors that influence them, and demonstrating their implications for managerial and investment decision-making. This paper purposes to test the impact of liquidity ratios, for example the current ratio. The CFP indicators for example “return on assets (ROA)”, focusing on a sample of companies operating in developing economies. The research examines how this relationship interacts with macroeconomic factors, such as monetary stability and ease of access to credit.

By analyzing the financial data of selected companies, the research seeks to provide empirical evidence to support or refute the hypothesis that high liquidity enhances CFP. It also discusses whether this relationship differs from its counterpart in developed economies, with the aim of drawing up recommendations to support decision-makers and financial managers in improving liquidity management strategies.

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LITERATURE REVIEW

Liquidity is a key issue in financial management because it directly impacts a company's ability to meet its short-term obligations and ensure business continuity. Past studies have examined the link among financial liquidity and business performance by analyzing liquidity indicators such as the “current ratio” and the “quick ratio” and linking them to financial performance indicators such as “return on assets, return on equity”, and net profit. The results of these studies vary. Some studies find a positive correlation between the two, indicating that greater liquidity can improve business performance by reducing financial risk, while others suggest that excess liquidity can be main to misuse of resources and decreased operational efficiency. The results of these studies also vary depending on the economic sector and regulatory “environment” in which the subjects operate, highlighting the importance of studying this relationship in different local contexts. This review aims to highlight the most salient findings from previous literature in this area, to analyze similarities and differences between results, and to identify research gaps that can guide future research.

There are several liquidity ratio problems in developing economies. A shortage of long-term financing: Institutions rely heavily on short-term financing to cover long-term needs, causing liquidity pressure. Weak financial and banking infrastructure. Weak banks' ability to provide adequate financial facilities. Limited reach to financing, particularly for “small and medium-sized enterprises”. Currency volatility and inflation, high inflation reduces the real value of available cash. The depreciation of the local currency affects the efficiency of liquidity management. Weak financial and accounting oversight. The absence of strong accounting systems leads to miscalculations of actual cash needs; poor transparency impacts financial decisions. There are also CFP problems related to liquidity. A high negative liquidity ratio: If “current liabilities” exceed current assets, the firm is considered unable to see its short-term obligations. Excessive liquidity: Some firms hold excess cash for fear of funding shortages, reducing investment opportunities and generating returns, and inability to finance operations. Weak liquidity leads to problems covering operating costs such as wages and purchases, negatively impacting business continuity. Impact on profitability: low liquidity forces companies to borrow at high interest rates, reducing profitability.

Al-Sarhan, Ali (2019) tested the Analysis of the connection among liquidity and profitability of “commercial banks” in Jordan. The results show there is a nonlinear relationship between liquidity levels and profitability, indicating the existence of an optimal level of liquidity.

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Other study by Ajanthan (2013) tested the link among profitability and liquidity Sri Lanka from 30 commercial companies for the period 2008-2012, the result show there is a negative connection among liquidity ratio and profitability, with increased liquidity negatively impacting return on equity. Additionally the study by the investigated the link between the "working capital management", companies performance and market evaluation in Nigeria stock exchange" the findings shows the "working capital management", particularly liquidity ratios, has a direct impact on a company's market value (Ogundipe et al., 2012). Deloof, (2003), tested the Working capital management affect profitability of Belgian firms, the study show although the study was conducted in Belgium, it used a methodology applicable to developing countries. An inverse relationship was found among the collection period, the liquidity ratio, and profitability. Sonia, Pedro, García, & Pedro. (2010) tested the working capital management in SMEs the results found that SMEs in developing countries tend to hold higher liquidity as a buffer due to the weak financial environment. Other study tested the influence of "working capital management" on companies performance in Turkey companies. The findings show the connect among liquidity and profitability was statistically significant and positive in the Turkish manufacturing sector, a developing economy (Al-Saedi & Abbas, 2023 & Gamze, Ahmet, 2012 & Vural, Sokmen, & Cetenak, 2012).

Given the importance of the link between financial liquidity and corporate earnings performance in assessing the effectiveness of financial management and the ability of organizations to sustain their growth, numerous studies have explored this relationship from different perspectives. Previous studies have focused on analyzing the impact of liquidity ratios, such as the current ratio and the quick ratio, on the generation and sustainability of profits in the banking, industrial, or commercial sectors. The results of these studies vary: some support a positive relationship between liquidity and profits, while others support an indirect or even negative relationship between the two, reflecting the influence of other factors and various management policies. These evaluation goals to existing the most notable results of past studies and classify knowledge gaps that can be drawn from future studt research. The results of these studies vary. Some highlight a positive relationship between liquidity and profits, while others warn against over investment in liquidity. This difference paves the way for future research, particularly in emerging markets like Iraq, to understand the impact of liquidity on the local economic context (Al-Sarhan, 2019). Past studies have shown a complex and diverse link between financial liquidity and corporate profitability. Arab studies have demonstrated a positive relation between various liquidity ratios and

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profitability. This reflects the importance of adequate liquidity to support operations and generate stable profits, especially in emerging markets facing multiple financial challenges. These studies also highlight the importance of balanced liquidity management to achieve higher returns and profitability. The diversity of results suggests that the influence of liquidity on profitability is influenced by environmental, sectorial, and administrative factors. This requires in-depth research in different environments, especially in the Iraqi market, to precisely understand this impact and provide practical financial management recommendations (Al-Sarhan, Ali, 2019).

Muhammad Azeem, & Syed Raza (2014) showed in the study that there is an opposite connection among liquidity and the profitability of industrial firms, as high excess liquidity may indicate misuse of resources. The earlier study investigated the influence of liquidity ratios on CFP the results show good liquidity improves a company's ability to continue and expand, but it is not always an indicator of high profitability Kartal Demirgüneş (2016). Shireen et al., (2019), study the analyzing the relationship between liquidity ratios and the profitability of Jordanian "commercial banks", the results found a strong direct relationship between the turnover ratio and the bank's profitability, especially in a stable economic environment. Hanumantha Rao (2016) study the corporate profitability and liquidity in the oil and gas sector the results reported the companies that maintain a moderate level of liquidity (neither too high nor too low) achieve better profits, due to management's efficient allocation of resources. The indicate a fluctuating relationship, influenced by external factors such as inflation and exchange rates, but overall, there is a moderate impact of liquidity on profitability.

The significant of "information" is hence confirmation from a developing economy, which shows a few about liquidity ratio and CFP. Therefore, this paper answer this effects by test this connection by proposed:

H1. "The liquidity ratio is important and positive with CFP of Malaysian companies.

METHODOLOGY

Analyzing the relationship between liquidity and CFP is essential in financial management because it directly affects an organization's stability and growth. Various quantitative and qualitative methods have been used to measure the impact of liquidity ratios (e.g., current ratio and quick ratio) on financial performance indicators such as return on assets (ROA),

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return on equity (ROE), and net income. The methods employed in studies vary depending on the nature of the data and the objectives of the study. Several studies rely on "descriptive analytical" approaches to clarify determine and financial phenomena the connection among variables, while others utilize standard approaches depend on statistical models for example "panel data and multivariate linear regression analysis" models to measure the quantitative influence of liquidity on performance over the time. Tools for example "hypothesis investigating" and "correlation analysis" and are also utilized to control the direction and strength of the connection among liquidity variables and performance. These approaches goal to provide "quantitative data" to support the decision-makers adopt more real financial policies to profitability and balance operational liquidity.

Several firms suffer from lack liquidity even with attain accounting profits, supporting questions about the connecting among liquidity ratio and CFP. The importance of this study lies in clarifying the role of liquidity as a key element in sustaining financial and operational performance.

This research relies on a quantitative approach using a descriptive and analytical approach. Financial data from companies listed on stock markets in a number of developing economies will be used to analyze the relationship between liquidity ratios and CFP. Figure 1 shows the percentages of CFP and liquidity ration from 2020-2024

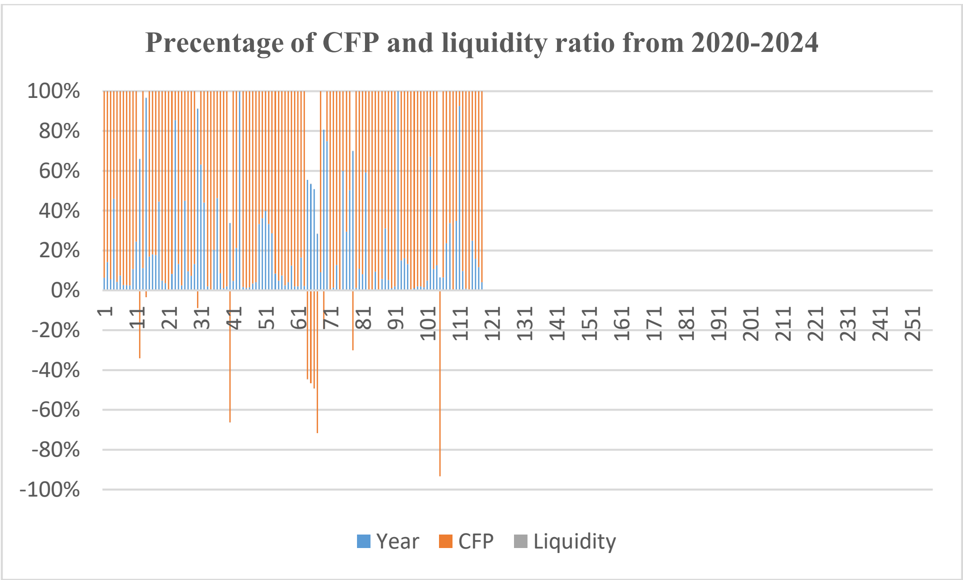

Figure 1: Percentages of CFP and liquidity ration from 2020-2024

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The methodology and procedures this study used on empirical analysis. It dealt with the liquidity ratio is independent variable, and the second variable, CFP is dependent variable. The study population consists of 118 Malaysian companies as a developing economy. This study used the OLS regression to test the model. The measurements of all the variable mention are as bellow. The variables measure in this paper are the CFP measured by using the return on assets (ROA), the liquidity ration measured by current ration = current assets/ current liabilities. “Corporate size measured by the natural logarithm of the total assets” at the date of the companies. The corporate age is tested by utilising the log of the number for the years since the establishment. This research shows the model which is with the link between two basic variables in order to show the impact of the first variable is the CFP and the liquidity ratio in the Malaysian companies. The regression of this study model under explains the connection.

$$CFP =_{it} \beta 0 + \beta 1\, LRit + \beta 2CSIZEit + \beta 3CAGEit \ + \varepsilon$$

RESULTS

Liquidity is a key factor that directly influences the improvement of a financial performance and sustainable profitability. The level of liquidity reflects a company's ability to meet its short-term financial obligations, which influences the confidence of investors and financial institutions in its stability and growth potential. The results of this study show a significant statistical correlation between the level of liquidity and a company's financial performance. Supporting liquidity ratios can make to support the profitability and performance by best greater efficiency and cash management and in financial guarantees. The findings also show that a perfect balance of liquidity can decrease the risk of “financial deficits, thus promoting operational stability” and, ultimately, profits. Conversely, excessive accumulation of liquidity can lead to the loss of investment opportunities and, ultimately, reduce return on assets. These paper goals to discover the connection among liquidity ratios and companies' financial performance by analyzing the financial data of a group of firms over a given period. The findings present a important connection among profitability and liquidity levels, as balanced liquidity support to improve operational effectiveness and decrease liquidity issues that can lead to funding gaps. The results also show that excess liquidity can lead to inefficient use of financial resources, which negatively impacts profitability. Therefore, this study highlights the importance of liquidity management combined with a rigorous financial strategy to ensure optimal financial performance and sustainability.

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Descriptive statistics test

This study shows in the table 1 the descriptive of statistics" examine in the "sample" of 118 in the "Malaysian" companies from 2020 to 2024. The CFP displays a mean with 10.610 and the liquidity ratio shows 0.152.

Table 1: *Descriptive Statistics Test*

Variable	Obs	Mean	Std. Dev.	Min	Max
CFP	118	10.610	3.121	-2.861	21.270
Liquidity ratio	118	0.152	0.159	0.000	0.878
Corporate size	118	11.265	1.698	7.615	16.431
corporate age	118	2.465	0.969	0.000	4.468

Correlation test

This paper is clarified in Table 2, the liquidity ratio, corporate size, and company age are positive and important linked with CFP. "In terms of multicollinearity, the correlation matrix proves that no multicollinearity exists between the variables because the "correlation values of all" the "variables" are less than 0.80.

Table 2: *Correlation test*

Variables	CFP	Liquidity ratio	Corporate size	corporate age
CFP	1.000			
Liquidity ratio	0.205**	1.000		
Corporate size	0.680***	0.440**	1.000	

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corporate age	0.148	0.160	0.358***	1.000

The results showed a statistically significant positive relationship between the liquidity ratio and CFP indicators. The control variables such as the corporate size and corporate age showed there is a positive correlation with CFP. This indicates that companies that maintain adequate liquidity levels are better able to meet their obligations and generate higher profits. The impact of liquidity on CFP varies from one sector to another. For example, in sectors that require large capital investments (such as industry and energy), high liquidity is not always associated with improved CFP. However, in service or commercial sectors, liquidity plays a more significant role in enhancing performance. Limits to optimal liquidity, the results indicate that excessive liquidity may lead to low resource efficiency, which negatively impacts CFP. Companies with very high liquidity tend to hold unemployed funds, leading to a lower rate of return on those assets.

The economic and regulatory environment affects the relationship, it was found that the environment of a developing economy including a weak banking system, currency volatility, and poor transparency affects the relationship between liquidity and performance. Companies in these environments tend to maintain higher levels of liquidity as a hedge against risk, which can impact their profitability. Financial policies play a pivotal role. The results showed that companies that follow flexible financial policies and effectively control working capital achieve better financial performance, even when liquidity levels fluctuate.

Regression test

The findings in Table 3 show there are positive and significant relation between liquidity ratio and CFP (t=1.46, p-value=0.015). The corporate size and corporate age showed a positive and important link with CFP. Developing economics regulators could growth from these results in their work to achieve growing process on. Furthermore, the findings of this research can too be used to define current liquidity ratio.

Table 3: *Regression test*

ROA	Coef.	Std. Err.	t-stat	sig

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Liquidity ratio	2.170	1.410	1.46	0.015**
Corporate size	1.430	1.485	8.55	0.000***
corporate age	-3.659	2.380	-1.49	0.014**
Constant	1.507	1.659	-9.10	0.000***
Sample size	118			
R-squared (%)	48%			
Adjusted R2 (%)	46%			
F-value	0.000			

The impact of this study lies in its improvement in the ability to meet short-term obligations. Companies with good liquidity can settle their debts and current expenses in a timely manner, which strengthens the confidence of investors and suppliers. It also improves financial stability. Adequate liquidity reduces the risk of bankruptcy and increases the company's flexibility in the face of unforeseen crises. It also improves financial performance and profitability.

CONCLUSIONS AND RECOMMENDATIONS

The liquidity ratio is an important indicator that reflects a company's ability to meet its short-term financial obligations. It is directly linked to the organization's overall financial performance. Through analysis, the following conclusions can be reached. The results of this study showed that there is a moderate positive relationship between the liquidity ratio and CFP. A high liquidity ratio enhances a company's ability to meet its short-term obligations, reducing financial risks and contributing to operational stability, thus improving CFP. However, excessive liquidity may indicate a weak investment in available funds, which may negatively impact profitability.

High liquidity does not always mean better performance. It has been shown that companies that hold excessive liquidity without investing it efficiently may suffer from a lower return on investment, indicating that excessive liquidity can lead to inefficient use of capital. The

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impact of the liquidity ratio on CFP varies from sector to sector; companies in the industrial and commercial sectors exhibit a stronger impact on liquidity compared to sectors such as technology or services. Unstable economic environment in developing economies, unstable fiscal and monetary policies and high inflation in some developing economies may limit the effectiveness of liquidity as a tool for ensuring financial stability for companies.

The study recommends that companies maintain an appropriate liquidity balance, sufficient to cover short-term responsibilities without disrupting the use of available funds for productive investments. Adopt dynamic liquidity management policies, companies should develop continuous analytical models to monitor liquidity based on changes in the local and global economic environment to ensure high financial flexibility. Focus on improving the operating cycle, improving inventory and accounts receivable management is recommended to enhance operational efficiency, which positively impacts liquidity and, consequently, CFP. Enhancing transparency and financial disclosure. Companies in developing economies are recommended to provide more transparent and detailed financial reports on liquidity levels, helping investors accurately assess the quality of CFP in developing economies provide a stable economic environment that reduces market volatility, enhancing companies' ability to manage liquidity effectively. Since the study results show a strong correlation between a company's liquidity level and financial performance, this study recommend that companies effectively manage their liquidity by maintaining an appropriate balance between available cash and investment resources to increase their profitability. Excess liquidity without effective investment can lead to missed opportunities, while a significant decrease in liquidity exposes the company to the risk of being unable to meet its obligations. The findings of the study showing a statistically important relationship between the level of financial liquidity and the company's financial performance, the study recommends prioritizing liquidity management in a company's financial policy, as it plays a key role in improving the firm's ability to meet its financial responsibilities and ensure its financial and operational stability.

Furthermore, this study suggests that achieving an appropriate balance among liquidity and profitability can increase liquidity ratios, which reflect a company's capability to meet its short-term responsibilities. However, excess liquidity can lead to lower profitability because it implies that funds are either not invested or are invested at a very low rate of return. Similarly, low liquidity can temporarily improve profitability if funds are invested efficiently, but it exposes the company to the risk of not being able to meet its urgent financial

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responsibilities. Improving working capital management requires optimizing the operating cycle and controlling inventories and receivables to reduce the need for excess cash, which can help improve profitability without compromising liquidity. Effective use of cash involves investing excess cash in projects or assets with good returns, thereby improving profitability, rather than leaving it idle. Continuous monitoring of liquidity ratios requires regular monitoring of liquidity indicators such as the "current ratio" and the "quick ratio" to ensure they are not exposed to liquidity risks or missed investment opportunities. Liquidity allocation by sector: A company's liquidity needs vary based on the nature of its business. For instance, a manufacturing company may require less liquidity than a trading company with large inventories. Therefore, liquidity must be tailored to the nature of the business to maximize profitability. Balancing liquidity and financing: Balancing the use of short- and long-term financing sources helps maintain an adequate level of liquidity to maintain profitability without incurring high financing costs.

This study recommends expanding the research to different sectors in the future and broadening its scope to several sectors, such as manufacturing, agriculture, services, and banking, to understand the influence of liquidity on "financial performance" in different environments. In addition, the use of other liquidity indicators, such as the current ratio and the quick ratio, is recommended. This study also recommends analyzing the link between liquidity and financial performance over several periods (before and after economic or financial crises) through longitudinal (temporal) research to study its temporal impact, which can help measure the stability of this relationship. Study influential external factors: It is recommended to analyze the impact of the economic environment (such as inflation, interest rates, or economic crises) on the link between liquidity and financial performance. Concentration on "small and medium-sized enterprises (SMEs)": several studies concentration on large firms. It is recommended that future study research concentrate on the connection among liquidity and CFP of SMEs, as they are more depend on cash flow. Relation among profitability, liquidity, and sustainability: It is recommended to analyze the effect of liquidity on the profitability and financial sustainability of firms, particularly in unstable or increasing environments.

Firms should strive to strike a smart balance among keeping sufficient liquidity to insurance responsibilities and avoiding tying up capital in unproductive assets. They should too design liquidity management policies and internal cash depending on the nature of their business and

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seasonal demand. This ensures adequate liquidity is continued without negatively effecting profitability opportunities.

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