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Research Article

The Liquidity Issues and the Profitability Index of Small-Scale Business Entities in Sorsogon Province, Philippines

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ABSTRACT

This research was conducted to determine the liquidity issues and profitability index of small-scale businesses operating in the Second District of Sorsogon Province, Philippines as well as to establish the relationship of these two variables. This study used mixed design. A total of 223 small-scale business owners engaged in trading in the Second District of Sorsogon Province, Philippines were the primary respondents of this research. Vertical analyses and stepwise linear regression analyses were utilized.

This study concludes that small-scale business entities in the Province of Sorsogon are highly liquid and profitable depicting their ability to pay short-term maturing obligation. Limited and unavailability of capitalization, Absence of Credit Policy, High Finance cost for debt financing, Inventory obsolescence, Shortage of resources and Lack of markets of measure and scope are the identified liquidity issues by small-scale business owners. To address the issues, the Use equity financing than debt financing, Strengthen the company's policy of extending loan, Minimize the purchase of inventory or stocks, financial suffering by staying well-informed of your finances and Hiring Bookkeepers are highly recommended by the respondents.

Keywords: *Liquidity, Profitability Index, Small Scale Business Entities*

Introduction

Profit is the lifeblood of every business organization. This principle manifests that the sustainability of the business operations is largely dependent from the level of income earned by the entity. It is a common notion that earning an income is deemed to be one of the primary concerns of the business establishments. Thus, most of the potential investors and even the existing businesses intend to implement some measures to regularly evaluate the future and current performance of the

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business to determine its capacity to operate on a going concern basis to serve the respective consumers and consequently earn greater returns. Internal controls such as monitoring of financial statements on a timely basis are commonly adopted and implemented by many of the business industries to protect its assets and other properties from some malpractices. These controls enable the business owners to have direct access and Secondhand knowledge and information with regards to the liquidity and the profitability of the business operation. Hence, it might avoid the possibility of a gradual bankruptcy due to loss of ownership as well as the income unknowingly. Similar to large business establishments, almost all of the small-scale business entities are also craving for higher profits and better results for liquidity test.

The liquidity and profitability index (financial performance) are imperative in sustaining the operation of the business as well as in venturing for new business opportunities and expansions. Accordingly, liquidity enhances the financial position of the company with reference to its ability to manage its working capital and pay for its short-term obligation while profitability refers to the ability of the business to earn a satisfactory rate of return on owner's or investor's capital (Cruz-Manuel, 2016). It was stated further that profitability serves as a ticket to business growth and expansion. Moreover, it was expounded by Camposano (2010) that liquidity ratios reflect the ability of the firm to meet its financial commitments. He stated that the inability to satisfy the demands of the creditors is a sufficient reason to be wound up irrespective of how it is profitable. Ballada (2016) highlighted the importance of profitability to the sustainability of the business and he emphasized the concept of the return on investment which measures the management's efficiency and using its assets to earn profits. The stated literatures highlighted the fact that firm's liquidity and its financial performance have vital role in the success of every business entity.

Sorsogon is one of the Provinces in the Bicol Region. This area has favorable accessibility to other neighboring provinces such as Masbate and Samar that are frequently and habitually doing business, thus, bulks of business transactions are recorded and contracted in this Province. Apparently, amidst its civilization is the rampant existence of Small-Scale Business Entities that have substantial contribution to the income of the Sorsogon Province due to the legal fees and taxes collected from these businesses. Thus, the success and the sustainability of the business operations of the existing business establishments in the area substantially contributes to the realization of the vision and goals of the Province. This notion has captured the attention and willingness of the researchers to conduct this study in order to determine and evaluate the liquidity and financial performance of the existing small-scale business entities in Sorsogon Province. In this study, liquidity refers to the ability of the micro businesses operating in the Second District of Sorsogon Province to pay or settle its short-term maturing obligation (debt with a term of not more than one (1) year). However, the profitability index, also known as financial performance, operationally pertains to the level of income (revenues less expenses) as manifested by the return on investment in general. Specifically, the study aims to establish a business model or framework showing the relationship between the two variables, namely liquidity and profitability index, as shown in Figure 1.

The framework presumes that the level of working capital, acid-test (quick) and current ratios, and receivable and inventory turnovers reflect the liquidity level of the micro businesses which consequently affect the profitability index, as manifested by return on sales (margin), gross profit rate and the return on investment, of these particular business organizations. Such relationship is deemed to have a positive contribution on the sustainability of the operations of the small-scale businesses in the Province of Sorsogon.

The results of the study serve as bases in the formulation some measures or designing an operational manual to address the liquidity issues of small-scale business entities in the Second District of Sorsogon Province, thus, enhancing its profitability index.

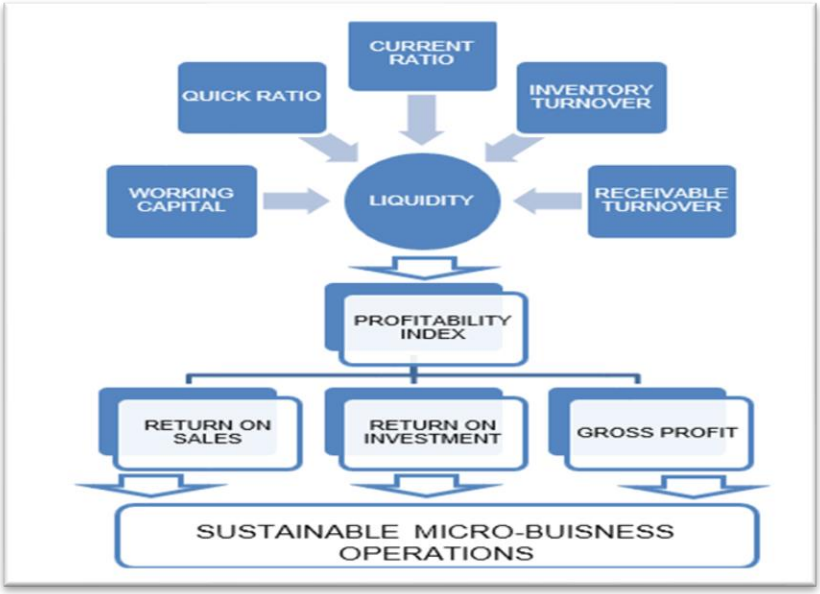

Figure 1. Framework of the Study

Objectives of the Study

This research generally aims to establish the relationship between the liquidity level and the profitability index of small-scale businesses operating in the Second District of Sorsogon Province, Philippines. Specifically, this was conducted to realize the following objectives:

1. To assess and determine the liquidity level of small-scale business entities in terms of working capital, quick and current ratios and inventory and receivable turnovers.
2. To evaluate and identify the profitability index of small-scale business entities in terms of return on sales, gross profit and return on investment.
3. To know and establish the relationship of the liquidity level of small-scale business entities and its profitability index.
4. To explore the liquidity issues commonly encountered by the owners of small-scale business entities.
5. To explore some measures or formulate a manual to address the liquidity issues and thus further enhance the profitability index of the small-scale business entities.

Methods

This study used mixed design. This was utilized to assess and determine the liquidity level and profitability index of small-scale business entities. This research design was deemed relevant and instrumental in establishing the relationship between the two variables used in this study. Also, this was used to explore the underlying issues affecting the entities' liquidity and the ways by which it could be improved.

Small-scale business owners engaged in trading in the Second District of Sorsogon Province, Philippines are the primary respondents of this research. Second District of Sorsogon includes the Municipalities of Bulan, Barcelona, Bulusan, Gubat, Juban, Matnog, Prieto Diaz, Irosin and Sta. magdalena. Financial figures from their financial statements (Years 2017 to 2019) and their sentiments were the main source of data for analysis. There were 223 business owners who participated in this undertaking (C.I.=95%, M.E.=5%). The sample was then proportionately distributed based on the papulation size per municipality.

This employed two data gathering methods: documentary analysis and the interview with key informants (KI). Documentary analyses were used to quantitatively account and determine the level of liquidity and the profitability index of small-scale business entities based on their reported financial statements. Interview with KI, on the other hand, was conducted using a structured survey questionnaire. This was done to explore the issues

affecting the firms' liquidity and the ways by which it could be addressed.

The quantitative data obtained from the financial statements of the small-scale business owners were analyzed using common-size financial statements (vertical) analyses and step-wise regression analyses. Vertical analyses were used in order to determine and measure the liquidity level and the profitability index of small-scale businesses through the use of financial ratios. Step-wise regression was utilized in order to create a model depicting which among the determinants of liquidity level is/are predictor/s of profitability index. The applications and functions of these correlation and regression analyses were made easier through the aid of the Statistical Packages for the Social Science (SPSS).

The data gathered from the KIs were transcribed and coded to determine the emergent patterns or themes with regards to the issues affecting firms' liquidity and the ways by which it could be addressed. The external validity of the study results was deemed to be the main delimitation of this paper. As a result, the findings of this undertaking could not be generalized to other populations or businesses outside the Sorsogon Province. As protection to the respondents, all the data were used and kept by the researchers with strict adherence to the provisions of Privacy Act of the Philippines.

Results and Discussion

Liquidity Level

Liquidity refers to the ease with which an asset, or security, can be converted into ready cash without affecting its market price (Chen, 2020). In this paper, the liquidity level is represented by the working capital (WC), quick ratio (QR), current ratio (CR), inventory turnover (IT) and receivable turnover (RT) based on the results of vertical analyses.

Table 1 presents the liquidity level of small-scale business entities in terms of working capital, quick and current ratios and inventory and receivable turnovers. Generally, the respondents found to have very high liquidity level in all indicators of business liquidity using documentary and vertical analyses based on their submitted financial statements.

Working capital is defined as current assets minus current liabilities. Current assets include cash (which is *not* restricted for a long-term purpose) plus the company's other resources that will turn to cash, trading securities, inventories or will be used up within one year (of the date shown in the heading of the balance sheet) (Averkamp, 2020).

Table 1. Liquidity Level – Vertical Analysis

Liquidity Measure	Computed Liquidity Value	Description
Working capital	125,641	Very Much Liquid
Quick ratio	86.89	Very Much Liquid
Current ratio	94.66	Very Much Liquid
Inventory turnover	7.76	Very Much Liquid
Receivable turnover	19.54	Slightly Liquid

Overall Liquidity Level: Very Much Liquid

The data in table 1 specifically revealed an average working capital of P125,641which appeared to be substantially higher than their short-term debts. Such figure depicts the ability of the small-scale business entities in the Province of Sorsogon to settle their short-term maturing obligations.

Moreover, with respect to quick and current ratios, the respondents appeared to be very much liquid with financial ratios of 86.89:1 and 94.66:1, respectively. It can be gleaned from these results that the respondents' quick assets or those items which are highly convertible into cash are almost nine (9) times larger that its current liabilities which consequently show the entities' capabilities to pay their financial obligations with terms of not more than one (1) year. The computed quick or acid test ratio also implies that the respondents remain highly liquid even without relying from

the sale of their inventories as well as from other prepayments.

The computed current ratio, on the other hand, reflects that the liquidity level of the respondents increases the moment the inventories, prepayments and other current assets other than quick assets are taken into consideration. Nonetheless, the results validate the notion that test of liquidity using quick ratio results to more accurate liquidity level than that of the current ratio. Folger (2020) mentioned that computed quick ratio measures the liquidity of a company by measuring how well its current assets could cover its current liabilities. However, the quick ratio is a more conservative measure of liquidity because it doesn't include all of the items used in the current ratio. The quick ratio, often referred to as the acid-test ratio, includes only assets that can be converted to cash within 90 days or less. Folger (2020) elaborated further that the quick ratio offers a more conservative view of a company's liquidity or ability to meet its short-term liabilities with its short-term assets because it doesn't include inventory and other current assets that are more difficult to liquidate (i.e., turn into cash). By excluding inventory, and other less liquid assets, the quick ratio focuses on the company's more liquid assets.

Other tests of liquidity employed in this research are the inventory and receivable turnovers with computed value of 7.76 days and 19.54 days, respectively. Inventory turnover is a ratio showing how many times a company has sold and replaced inventory during a given period. A company can then divide the days in the period by the inventory turnover formula to calculate the days it takes to sell the inventory on hand (Hargrave, 2020). Conversely, accounts receivable is an accounting measure used to quantify a company's effectiveness in collecting its receivables or money owed by clients (Murphy, 2020).

The figures shown in the table mean that it took almost eight (8) days for the respondents before inventories can be sold to the outside customers. The calculated inventory turnover, therefore, can help the respondents make better decisions on pricing, manufacturing, marketing and purchasing new inventory. However, the computed receivable turnover revealed that the respondents have to wait for almost twenty (20) days before cash collections can be made from credit customers. The receivable turnover manifests that small-scale businesses in the Province of Sorsogon are slightly liquid in terms of their credit collections. Murphy (2020) highlighted that receivable turnover shows how well a company uses and manages the credit it extends to customers and how quickly that short-term debt is collected or is paid. The receivables turnover ratio is also called the accounts receivable turnover ratio.

Profitability index

Profitability is a measurement of efficiency and ultimately its success or failure. A further definition of profitability is a business's ability to produce a return on an investment based on its resources in comparison with an alternative investment (Horton, 2020).

The profitability index as used in this context is manifested by the computed return on sales, gross profit and return on investment based on the reported financial statements of the small-scale business organizations in the Province of Sorsogon based on the results of vertical analyses. The data on the profitability index of small-scale business entities in terms of return on sales, gross profit and return on investment are presented in table 2.

Table 2. Profitability Index - Vertical Analysis

Liquidity Measure	Computed Liquidity Value	Description
Return on sales (ROS)	19 %	High Profitability
Gross profit (GP)	21 %	High Profitability
Return on investment (ROI)	36 %	High Profitability

Overall Liquidity Level: High Profitability

The results of vertical analyses generally revealed that the small-scall business owners are highly profitable with their ventures based on the computed return on sales (19%), Gross profit (21%) and return on investment (36%).

The computed ROS is above the average ideal minimum ROS of 10%. This indicates that the respondents have a better profitability ratio in terms of sales. This measure further provides insight into how much profit is being produced per peso of sales. Hayes (2020) expounded that an increasing ROS indicates that a company is growing more efficiently, while a decreasing ROS could signal impending financial troubles.

In addition, the respondents also showed a favorable profitability index in terms of GP (21%) which appeared to be above the 10% threshold. Gross profit is the profit a company makes after deducting the costs associated with making and selling its products, or the costs associated with providing its services. Gross profit will appear on a company's income statement and can be calculated by subtracting the cost of goods sold (COGS) from revenue (sales). The result suggests that the business owners earn at least 20% markup per peso sales. Hence, such trend is a sign of efficient operation.

This is in line with the notion of Hayes (2020) which says that gross profit can be used to calculate another metric, the gross profit margin. This metric is useful for comparing a company's production efficiency over time. Simply comparing gross profits from year to year or quarter to quarter can be misleading, since gross profits can rise while gross margins fall, a worrying trend that could land a company in hot water.

Finally, the concept of ROI was also used to represent the profitability index on the respondents in terms of the income earned from the utilization of company's resources. Fernando (2020) defines return on investment (ROI) as a performance measure used to evaluate the efficiency of an investment or compare the efficiency of a number of different investments. ROI tries to directly measure the amount of return on a particular investment, relative to the investment's cost.

The result found out that the respondents are highly profitable in terms of ROI (36%) which is substantially higher than the historically average ROI been of 10% per year (Fernando, 2020). Within that, though, there can be considerable variation depending on the industry. This infers that business owners are very much efficient and effective in the utilization of their available financial resources.

Step-wise linear regression analyses

In these analyses, the computed values for working capital (WC), quick ratio (QR), current ratio (CR), inventory turnover (IT) and receivable turnover (RT) based on the results of vertical analyses were regressed separately against the computed scores for return on sales (ROS), gross profit (GP) and return on investment (ROI).

Hence, the variables representing the liquidity level are the independent variables and the indicators of profitability index are the dependent variables.

1. ROS in relation to independent variables

The data in table 3 shown that the independent variables namely WC, QR, CR, IT and RT have no significant impact on the profitability index of the respondents in terms of ROS.

This implies that none of the independent variables have relationship to the dependent variables. Hence, the level of liquidity of the business neither diminishes nor enhances the company's profitability index.

The collinearity statistics for each regression model exhibited a high acceptable levels of tolerance values, except for QR and CR, which are comfortably above the recommended minimum level of tolerance value of .20 (Menard, 1995) as well as acceptable levels of variance inflation factors (VIF) which did not exceed the recommended maximum VIF value of 5.

The tolerance and VIF values generally indicate that there was no evidence of multicollinearity in the regression results. These further shows that there were no overlapping independent variables in the regression analyses which could adversely affect its results as also evidenced by minimal standard errors.

Table 3. Step-wise linear regression analyses - ROS

Independent Variables	Coefficients, β	Sig.	Std. Error	Collinearity Statistics	
				Tolerance	VIF
Constant	9.314	.000	.022		
WC	.031	.976	.000	.836	1.196
QR	-1.510	.132	.001	.017	59.770
CR	1.111	.268	.001	.016	60.662
IT	-.238	.812	.001	.995	1.005
RT	1.079	.282	.000	.933	1.072
F Value	2.686				
R Square	.058				
Adjusted R Square	.037				

*** Significant at the 0.5 level*

2. GP in relation to independent variables

Table 4 presents the result of the regression analysis between the independent variables namely WC, QR, CR, IT and RT and the profitability index of the respondents in terms of GP.

The results show that of the five (5) variables of liquidity level, **only inventory turnover (p=.006) and receivable turnover (p=.027)** were found to significantly affect the profitability index in terms of gross profit. The value and positive sign of the coefficient for inventory turnover (β=2.801) suggests that a one-point increase in the degree of inventory turnover will increase the profitability index by 2.801 points.

From this trend, a linear regression model of {Y=.006IT + 2.801) was formulated where y represents the Profitability Index in terms of GP and IT represents the computed inventory turnover. This model shows that increasing the degree of IT would mean improving the company's profitability.

The computed coefficient for receivable turnover (β=2.221) also implies that a one-point increase in the degree of receivable turnover will increase the profitability index by 2.221 points in terms of GP. As a result, Y=.027RT + 2.221 model was established.

Table 4. Step-wise linear regression analyses - GP

Independent Variables	Coefficients, β	Sig.	Std. Error	Collinearity Statistics	
				Tolerance	VIF
Constant	11.678	.000	.017		
WC	.934	.351	.000	.836	1.196
QR	-1.965	.051	.001	.017	59.770
CR	1.499	.135	.000	.016	60.662
IT	2.801	.006**	.001	.995	1.005
RT	2.221	.027**	.000	.933	1.072
F Value	6.840				
R Square	.136				
Adjusted R Square	.116				

** Significant at the 0.05 level

In the said model, y represents the Profitability Index in terms of GP and RT represents the computed Receivable turnover. This manifests that enhancing and increasing the velocity of cash collections positively affect the entity's profitability index.

3. ROI in relation to independent variables

Table 5 depicts the result of the regression analysis between the independent variables namely WC, QR, CR, IT and RT and the profitability index of the respondents in terms of ROI.

Table 5. Step-wise linear regression analyses - ROI

Independent Variables	Coefficients, β	Sig.	Std. Error	Collinearity Statistics	
				Tolerance	VIF
Constant	17.747	.000	.024		
WC	-3.888	.000**	.000	.836	1.196
QR	-1.311	.191	.001	.017	59.770
CR	1.133	.258	.001	.016	60.662
IT	2.393	.018**	.001	.995	1.005
RT	-.996	.320	.000	.933	1.072
F Value	5.727				
R Square	.117				
Adjusted R Square	.096				

Significant at .01 level

Among the five (5) independent variables of liquidity level, only working capital (p=.000) and inventory turnover (p=.018) were found to significantly affect the profitability index in terms of gross profit. The value and negative coefficient for working capital (β=-3.888) suggests that a one-point increase in the amount of the working capital will reduce the profitability index by 3.888 points. This may be linked on the fact that a very high level of working capital makes some of the resources idle thus affecting the profitability index particularly the ROI.

However, the results show a direct and positive coefficient for inventory turnover (β=-2.393) which means that increasing the inventory turnover indicates increase in the ROI with a linear regression model Y=.018IT + 2.393. This result validates the fact that increase in the disposal or sale of the given inventories results to a better ROI due to reduction in the non-value-added costs.

Liquidity issues commonly encountered by the owners of small-scale business entities

The following presents the discussions of the results of the interviews conducted through KIs. Interviews with KIs were conducted using a structured survey questionnaire to explore the emergent patterns and issues affecting the firms' liquidity and the ways by which it could be addressed.

With the information supplied by the business owners, this research identified six (6) major liquidity issues encountered by the small-scale business owners, to wit:

1. Limited and unavailability of capitalization

During the interview, some of the KIs repeatedly mentioned that the very minimal and sometimes the unavailability of funds to finance the day to day affects their liquidity. They raised the fact that due to very limited capitalization most of them shift to capitalization by way of debt financing.

As a result, most of their currents assets become collaterals to their liabilities which adversely affect their ability to pay the principal loan and the interest therewith.

2. Absence of Credit Policy

The discussions with the business owners revealed that the absence of policies governing their credit transactions is one of the major dilemmas which negatively affect their liquidity level. They elaborated that the collections of receivables from their customers do require substantial period of time. This situation often results to lack or insufficient cash balances which could be used for paying their short-term maturing obligation.

According to the respondents, most of their debtors are commonly not honoring their accounts. Hence, this unfavorably lessen their capacity to meet the short-term obligations. These ideas validate the quantitative result of the study which provides that the age of the receivables outstanding is unfavorably longer than the usual collection periods.

3. High Finance cost for debt financing

The respondents averred that the high interest rates imposed by financing institution adversely affect their liquidity level. Substantial majority of the respondents named excessive interest expense imposed by their creditors makes difficult for them to pay their loans in due time, thus, compromising their liquidity level.

4. Inventory obsolescence

Some of the respondents in the interview considered inventory wastage, spoilage and obsolescence as factors that hinder them to settle their debts on time. They strongly believed that inventory obsolescence increases their inability to generate cash that could be used as reserve for short-term maturing financial obligations.

5. Shortage of resources

Key informants highlighted that the absence of funding, technology, experienced labor, expertise in bookkeeping, and marketplace statistics highly diminish the level of their liquidity.

6. Lack of markets of measure and scope

The respondents raised the fact that their limited sales territory is another aspect that disabled them to improve the volume of their sales transactions thus resulting to very minimal cash inflows.

Measures to address the liquidity issues being experienced by the business owners

During the conduct of interviews with the KIs, the respondents provided five (5) measures that may be taken into account in order to address the identified liquidity issues, to wit:

1. **As much as practicable, use equity financing than debt financing.** The respondents suggested that as much as possible it is better to use personal fund than to resort to borrowings. This is to avoid payments of excessive operational costs including borrowing costs;
2. **Strengthen the company's policy of extending loan.** According to the respondents, by so doing, the entity can avoid the possibility of bad debts which commonly ruins the liquidity status of the business.
3. **Minimize the purchase of inventory or stocks.** This will help the business avoid unnecessary costs such as the ordering and strigae costs.
4. **Avoid financial suffering by staying well-informed of your finances.** The KIs mentioned that being inexperienced or in denial about the financial condition can halt the industry.
5. **Hiring Bookkeepers.** The respondents emphasized the importance of hiring bookkeepers in order to make actual financial data accessible to the business owners. With this, the owners could easily determine the status of their liquidity. They added that expertise in bookkeeping is the only way to keep your company afloat.

Output

This research provided to major outputs namely the research itself which contributes to the body of knowledge specifically the measures provide for by this study to address the liquidity issues encountered by small-scale business owners as well as a liquidity manual containing some quantitative techniques to better assess the company's liquidity issues.

Educators and researchers may similarly utilize the results of the study as material for academic instruction and as reference for future studies on a similar or related topic. Most importantly, output of which could also be used as a basis of the College in extending technical assistance to the business owners of small-scale business entities.

Conclusion and Recommendations

This study concludes that small-scale business entities in the Province of Sorsogon are highly liquid and profitable depicting their ability to pay short-term maturing obligation**.** Inventory turnover positively affect the profitability index both in terms of the ROI and gross profit. However, *receivable turnover directly affects the gross profit while the amount of the working capital has and inverse impact on the profitability index in terms of the ROI. Y=.027RT + 2.221 and Y=.018IT + 2.393 are models*

established based on the relationship of liquidity and profitability index. Limited and unavailability of capitalization, Absence of Credit Policy, High Finance cost for debt financing, Inventory obsolescence, Shortage of resources and Lack of markets of measure and scope are the identified liquidity issues by small-scale business owners. To address the issues, the Use equity financing than debt financing, Strengthen the company's policy of extending loan, Minimize the purchase of inventory or stocks, financial suffering by staying well-informed of your finances and Hiring Bookkeepers are highly recommended by the respondents.

This research highly recommends that the following:

1. The recommended liquidity manual may be adopted by the small-scale business owners.
2. Use cash basis in dealing with sales transactions with customers to avoid the possibility of bad debts.
3. The linear regression models formulated based on this paper may be used as a tool for closely monitoring the liquidity level and the profitability index of the small-scale business entities.
4. The company owners may consider using the inventory economic order quantity concept in maintaining their inventories so as to avoid the incurrence of non-value-added cost such as storage and ordering costs.
5. The business owners may switch from short-term to long term debt financing in order to fully maximize the cost of capital.
6. The small-scale proprietors may consider disposing their useless assets and minimize or control overhead expenses.
7. Future researches with a more in-depth approach may be conducted to establish a stronger relationship among these emergent variables.

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