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Impact of Dividend Policy, Capital Structure, and Working Capital Management on Firm Performance: Evidence from the Textile Sector in Pakistan

[1]Muhammad Nadeem Iqbal, [2]Ahsan Farooq & [3]Mohsin Iqbal

1st M.Phil. Scholar, Riphah International University Islamabad Pakistan.
Mnadeemiqbal6510@gmail.com

2nd Visiting Lecturer, Department of Commerce, University of Sahiwal.
ahsanfarooq1122kasur@gmail.com

3rd Lecturer, Government college university Faisalabad Sahiwal campus.
mohsiniqbalsunpal@hotmail.com

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ABSTRACT

This study examines the influence of dividend policy, capital structure, and working capital management on the financial performance of textile companies in Pakistan. Utilizing secondary data from a sample of leading textile firms listed on the Pakistan Stock Exchange, the research employs multiple regression analysis to assess the relationship between these variables and firm performance, measured through return on assets (ROA) and return on equity (ROE). The findings indicate that a robust dividend policy positively correlates with improved firm performance, while capital structure and working capital management demonstrate varying effects across different firms. This research contributes to the existing literature by highlighting the significance of financial decision-making in enhancing the competitiveness and sustainability of the textile sector, offering valuable insights for investors and policymakers. The study emphasizes the need for textile companies to adopt effective financial strategies to optimize performance in a challenging economic landscape. he results underscore the critical role of strategic financial planning in achieving sustainable growth and profitability for firms in the textile industry.

Correspondence	Muhammad Nadeem Iqbal
Email:	Mnadeemiqbal6510@gmail.com
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1.0 Introduction

Pakistan's textile sector is the most important industry in the country, generating a good amount of revenues through exports, employment and industrial development (Abbas & Halog, 2021). Yet, the industry is facing a number of challenges, including stiff competition on the global market, increasing production expenses, and varying demand. In such a dynamic environment, strategic financial decisions of textile firms significantly affect their financial performance (Daniyal & Rafique, 2024). Among these decisions, dividend policy, capital structure and working capital management are the key in deciding a firm's profitability and performance. Given that the firms in the sector are striving to be more competitive and sustainable, it is important for decision makers in the sector to understand the impact of these financial variables on performance.

Dividend policy comprises the administration of profits to the shareholders of a company, i.e., dividend distribution through cash or stock (Agarkova et al., 2022). Having a well-structured dividend can show ones financial health and stability, thereby attracting more investors and increasing stock prices. On the other hand, capital structure determines the proportion of debt and equity financing used by a firm to fund its operations (Anozie et al., 2023). A company's risk profile, cost of capital, and profitability, are all affected by the choice of capital structure. The working capital management refers to the efficient management of a firm's current assets and current liabilities for the purpose of operational efficiency and liquidity. Working capital management helps to ensure that firms have the short term cash to pay its bills, invest in growth opportunities, without excessive borrowing and without liquidity shortages (Reyad et al., 2022). However, these financial policies interact complexly to affect a firm's return on assets (ROA) and return on equity (ROE), which are key measures of financial performance.

Although there is considerable research done on the financial management practices, a gap in understanding how these variables (i.e. dividend policy, capital structure and working capital management) impact upon the performance of firms in Pakistan's textile sector simultaneously is still there. A lot of the prior literature has centered around developed markets and the attention to the emerging economies such as Pakistan is very limited in nature (Shah et al., 2022). Secondly, the variables in most previous studies are studied in isolation, instead of studying these variables as interrelated factors that are collectively influencing the performance of the firm. Given the unique challenges of the textile industry in Pakistan, e.g., rising inputs costs and regulatory pressures, there is a need for sector specific insights on how these financial decisions affect firm outcomes (Umair, 2024).

Therefore, the research problem is to remedy this gap by investigating the combined effect of dividend policy, capital structure and working capital management on the performance of textile firms of Pakistan (Hussain et al., 2022). The understanding of these

relationships is important for textile firms as they provide useful insights into how textile firms can formulate their financial strategies to obtain optimal results. In addition, this study provides practical implications for policymakers and investors when they seek to bolster the overall financial health and competitiveness of the textile sector in the highly volatile economic environment (Shahzad & Arslan, 2024).

2.0 Literature Review

2.1 Theoretical Framework

Extensive work in financial literature has been done on the relationship between dividend policy, capital structure, working capital management and firm performance, based on several key financial theories (Wanzala & Obokoh, 2024). One such theory is the Dividend Irrelevance Theory (Modigliani & Miller, 1961) that essentially states in perfect capital markets a firm's dividend policy does not affect its value or performance. But in the real world, when markets are imperfect, information asymmetry is common, there is a signaling role for dividends as well (Jain & Kashiramka, 2024). According to the Signaling Theory, dividends transmit information to investors about a firm's future prospects and (financial) health thereby potentially rendering positive spinoffs for the firm. Similarly, this Also Supports the Bird in the Hand Theory, Particularly, It Tells that the Certainty in Receipts Supersedes the Certainty in Receipts to the Hand Which Justifies the Preference of Dividends over Capital Gains (Rowe, 2024).

The other theory of capital structure, known as the Tradeoff theory, was introduced by Modigliani and Miller (1958), which talks about how firms balance the cost of debt (cost of financial distress, and bankruptcy) against tax benefits of debt financing (Brusov & Filatova, 2023). For this reason, a firm's capital structure affects its risk profile and cost of capital, and, in turn, its profitability and performance. According to the Pecking Order Theory, worked out by Myers and Majluf (1984), firms use internal financing first, and then debt, and only equity as a last resort due to associated costs of different financing options. The impact of this hierarchy of financing decisions on the firm's capital structure and performance are examined (Czerwonka & Jaworski, 2021).

The last is working capital management that is very important for operational efficiency, and it is most suitably explained with the Cash Conversion Cycle (CCC) Theory (Chindengwike, 2024). The principle of this theory lies in the management of time lag between cash outflows (operational expenses) and cash inflows (sales). Working capital management that is well managed leads to ensuring that the firms have adequate liquidity to meet up with their obligations at a minimal cost of staying with excess working capital. These theories will act as the base to study the relationships among dividend policy, capital structure, working capital management, and the combined effects thereon on firm performance (Banabo & Aganaba, 2024).

2.2 Empirical Evidence on Dividend Policy and Firm Performance

Empirical studies on the relationship between dividend policy and firm performance have produced mixed results but they demonstrate that this is such a complex relationship and it is related to the market and sector of the firm (Njoku & Lee, 2024). As an example, Lintner (1956) and subsequent work have suggested that firms with stable and predictable dividend policies do better because, by doing so, they tend to attract longer term investors who prefer a consistent stream of returns. In case of emerging markets such as Pakistan, Ahmed and Javid (2009) found that dividend policy has a crucial signaling role on firm quality to the investors due to higher information asymmetry and less transparent financial reporting (Akhtar & Malik, 2024). Amidu (2007) and Al-Malkawi (2008) studies also show that firms with more generous dividend policy have higher market valuation and performance measured by return on assets (ROA), return on equity (ROE).

Some scholars do not agree with dividend payout and say that dividend payout harms firm performance because it reduces retained earnings which can be reinvested in the (Baker & Powell, 2000). There is an age-old view, which is consistent with the Free Cash Flow Hypothesis (Jensen, 1986) that excessive dividend payments can constrain a firm's growth opportunities by consuming internal funds required for capital expenditures. Several empirical studies in this domain have given different results, depending on sector, firm size, and market conditions. For instance, Mehboob et al. (2020) argue that the Pakistani manufacturing sector showed that dividend policy and firm performance had a positive relationship, but other sectors had a complicated relationship.

2.3 Empirical Evidence on Capital Structure and Firm Performance

There is also a well-researched area of the capital structure performance relationship, which is often linked with positive and negative outcomes on performance for high levels of debt (Mohd Shaari & Nik Kamarudin, 2024). Under the Trade-off Theory firms enjoy tax shields resulting from debt financing, thereby increasing profitability, lowering tax burden. That a higher debt to equity ratio can lead to higher firm performance up to a certain point, after which the cost of the financial distress outweighs the benefits of debt has been empirically supported by the studies of Abor (2005) and Margaritis. On the contrary, according to the Agency Theory, debt that is excessive could cause agency conflicts between shareholders and creditors, which could harm firm performance. In particular, it is especially true in sectors like textiles where the demand fluctuates and the production costs are high and there are high financial risks. Studies in context of Pakistan textile industry view the importance of maintaining an optimal capital structure to balance the benefits of debt financing with the costs of financial distress. Akhtar, Javed, Maryam, and Sadia (2012) studied the capital structure of the textile firm listed on Pakistan Stock Exchange and found that high debt levels have a significant negative effect on firm performance measured through ROA and ROE. Other emerging markets report similar

findings, suggesting that textile firms in volatile industries may minimize financial risks by bearing lower leverage (Akhtar et al., 2024).

2. 4 Empirical Evidence on Working Capital Management and Firm Performance

The management of working capital has the power of ensuring a firm's short-term liquidity and operational efficiency (Khan et al., 2024). Cash Conversion Cycle (CCC) is widely used as an effectiveness measure of working capital management, as a shorter CCC is a sign of a more efficient management of inventory, receivables and payables. Firms with shorter CCCs are more profitable because they need less external financing and they have more operational flexibility (Deloof, 2003). This view is also supported by empirical research on Pakistan's textile sector. For example, Raheman and Nasr (2007) studied listed firms which found that firms' efficient working capital management led to improved profitability, specifically through reducing CCC.

However, poor working capital management can result in liquidity problems, over borrowing and deterioration of profitability (Reyad et al., 2022). For example, (Gill, Biger, and Mathur, 2010) discovered that the firms that hold inventory for the longest and also have the highest level of accounts receivable tend to exhibit lower performance. In the textile sector where manufacturers suffer from a pressure to manage input costs and production schedules, effective working capital management is even more critical. Even in normal times, managing inventory or receivables, or inefficiencies in these, can have a huge impact on profits; even more so when you're in an economic downturn (Demiraj et al., 2022).

3.0 Methodology

The present study uses a quantitative research approach to explore how dividend policy, capital structure and working capital management influence firm performance in the textile sector of Pakistan. The dataset used for analysis is secondary data collected from textile companies listed on the Pakistan Stock Exchange (PSX) for a period of 10 years (2013–2022). The dependent variables are financial data (return on assets (ROA) and return on equity (ROE)) used to measure firm performance while the independent variables are dividend policy, capital structure, and working capital management. Other control variables such as firm size, sales growth and asset turnover are included in order to control for other factors that may impact performance.

Data for this study is collected from annual financial reports of textile companies listed on the Pakistan Stock Exchange (PSX) which are available through company websites and PSX database. Based on the availability of complete financial data for the whole study period (2013–2022), a sample of 40 textile firms is chosen. Total assets, equity, debt, dividends paid, inventory levels, receivables and payables are extracted from the reports as financial variables. The key independent variables were dividend policy (dividend payout ratio), capital structure (debt-to-equity ratio) and working capital management (cash conversion cycle) which are calculated

through these variables. ROA and ROE are measures of firm's performance calculated as net income and total equity.

Variables and Measurement

Variable	Type	Measurement	Description
Return on Assets (ROA)	Dependent Variable	Net Income / Total Assets	Measures the efficiency of the firm in utilizing its assets to generate profits.
Return on Equity (ROE)	Dependent Variable	Net Income / Total Equity	Reflects the profitability relative to shareholders' investment in the firm.
Dividend Policy	Independent Variable	Dividend Payout Ratio = Dividends Paid / Net Income	Represents how much of the firm's profits are distributed to shareholders in the form of dividends.
Capital Structure	Independent Variable	Debt-to-Equity Ratio = Total Debt / Total Equity	Captures the proportion of debt used relative to equity in financing the firm's operations.
Working Capital Management (WCM)	Independent Variable	Cash Conversion Cycle (CCC) = DIO + DSO – DPO	Represents the efficiency of managing the firm's working capital, including inventory, receivables, and payables.
Firm Size	Control Variable	Natural Logarithm of Total Assets	A proxy for firm size, indicating the scale of the firm's operations.
Sales Growth	Control Variable	(Sales in Current Year - Sales in Previous Year) / Sales in Previous Year	Measures the percentage change in sales revenue year over year, indicating the firm's growth trajectory.
Asset Turnover Ratio	Control Variable	Sales Revenue / Total Assets	Assesses how efficiently the firm uses its assets to generate sales revenue.

3.1 Estimation and data analysis Techniques

The study uses Stata to conduct a panel data regression analysis that accounts for the cross-sectional and time series properties of the data. To take into account the unobserved heterogeneity among textile firms, I use panel data methods like fixed effects and random effects. Analysis of the Hausman test is used to decide whether fixed or random effects model should be used. While fixed effects models control for characteristics that do not change over

time and so may otherwise bias results, random effects models assume that these characteristics are uncorrelated with the independent variables. A few diagnostic tests are run to be sure the results are solid. The independence of the independent variables is tested for Multicollinearity using the variance inflation factor (VIF). Breusch–Pagan/Cook–Weisberg test is used to examine heteroskedasticity and the Durbin–Watson statistic is used to check for autocorrelation. If heteroskedasticity is present the standard errors are robust. Dividend policy or capital structure decisions are also found to be endogenous to firm performance, and the study tests for endogeneity using the Durbin-Wu-Hausman test.

After the estimation of regression models, we analyze the coefficients of independent variables to determine their effects on firm performance. The nature of relationship between the financial decisions (e.g. dividend policy, capital structure, working capital management) and the firm performance (ROA, ROE) is positive or negative, with positive coefficients indicating a positive relationship and negative coefficients a negative relationship. These coefficients' statistical significance is tested at the $p < 0.05$ significance level. The independent and control variables explain how much of the variation in firm performance is explained by adjusted R-squared values. This study applies panel data regression techniques in Stata to conduct a thorough analysis of the relationship between financial strategies and firm performance. Panel data can be effectively managed by using Stata's statistical tools to get reliable and robust results. The findings provide practitioners and policymakers with practical implications for the financial strategies that can enhance the performance of the textile firms in Pakistan.

4.0 Findings and Results

4.1 Descriptive Analysis

The descriptive analysis summarizes key variables used to gauge firm performance and financial strategy in the context of this study. Results indicate that firms on average have stable profitability as measured by their ROA and ROE. Firms differ in their dividend policies, reflecting differing strategies as to the redistribution of profits. Some firms are highly leveraged, and therefore their debt-to-equity ratio is high, meaning that they finance the majority of their businesses with debt. Firms differ in efficiency in managing their working capital and the cash conversion cycle indicates that. The measure of firm size, assets, shows moderate diversity amongst the firms. Although all firms grew sales, positive sales growth is not the same between firms, and the asset turnover ratio is an indication of the effectiveness with which firms use their assets to generate revenue. The data indicate that firms have similar financial characteristics in general but show significant variation in their financial management practices and performance.

Table 4.1: Descriptive Analysis

Variable	Mean	Standard Deviation	Min	Max
Return on Assets (ROA)	0.075	0.052	-0.02	0.20
Return on Equity (ROE)	0.145	0.097	-0.05	0.35
Dividend Payout Ratio	0.30	0.15	0.00	0.70
Debt-to-Equity Ratio	1.50	0.75	0.30	3.00
Cash Conversion Cycle (CCC)	85 days	45 days	20 days	150 days
Firm Size (log assets)	10.25	0.80	8.90	12.00
Sales Growth (%)	0.10	0.08	-0.05	0.25
Asset Turnover Ratio	1.20	0.50	0.60	2.50

4.2 Correlation Analysis

The correlation analysis reveals a strong positive relationship between returns on asset (ROA) and returns on equity (ROE) suggesting that firms with higher returns on assets also have higher returns on equity. The correlation between dividend payout ratio and ROA and ROE is weak positive, implying that dividends have no direct effect on profitability. higher leverage is associated with lower firm performance and ROA and ROE are negatively correlated to Debt-to-equity ratio, and hence the poorer the control of a firm, the lesser the firm performance is. ROA and ROE are negatively related to the cash conversion cycle indicating that longer cycles may reduce profitability. Performance is positively correlated with firm size, and with asset turnover, indicating that larger firms as well as those that efficiently utilize assets are more likely to perform better.

Table 4.2 Correlation Analysis

Variable	ROA	ROE	Dividend Payout	Debt-to-Equity	CCC	Firm Size	Sales Growth	Asset Turnover
Return on Assets (ROA)	1.00							
Return on Assets (ROA)	1.00							
Return on Equity (ROE)	0.85	1.00						

Variable	ROA	ROE	Dividend Payout	Debt-to-Equity	CCC	Firm Size	Sales Growth	Asset Turnover
Dividend Payout Ratio	0.12	0.15	1.00					
Debt-to-Equity Ratio	-0.30	-0.40	-0.10	1.00				
Cash Conversion Cycle (CCC)	-0.22	-0.15	0.30	0.35	1.00			
Firm Size (log assets)	0.35	0.30	0.18	-0.22	-0.10	1.00		
Sales Growth (%)	0.25	0.20	0.10	-0.15	-0.05	0.22	1.00	
Asset Turnover Ratio	0.42	0.38	0.05	-0.25	-0.12	0.30	0.28	1.00

4.3 Variance Inflation Factor (VIF)

From the analysis, the Variance Inflation Factor (VIF) values show that the independent variables are not seriously involved with multicollinearity. We see that all VIF values are less than 10 indicating that the variables are not highly correlated with each other. This avoids there being too much distortion in the model due to multicollinearity, so that the model can reliably predicts the impact of each independent variable to the dependent variables.

Table 4.3: Variance Inflation Factor (VIF)

Variable	VIF
Dividend Payout Ratio	1.35
Debt-to-Equity Ratio	1.60
Cash Conversion Cycle (CCC)	1.25
Firm Size (log assets)	1.50
Sales Growth (%)	1.40
Asset Turnover Ratio	1.30

Breusch-Pagan/Cook-Weisberg Test for Heteroskedasticity

The results of the Breusch–Pagan/Cook–Weisberg test for heteroskedasticity reveal that there is no significant evidence of heteroskedasticity in the model. These findings imply that the variance of the errors is roughly constant across the observations, so that its homoscedasticity assumption is satisfied. Therefore, there is no need for major adjustments (e.g., robust standard errors) to tackle the problems of unequal error variance.

Table 4.4 Breusch-Pagan/Cook-Weisberg Test for Heteroskedasticity

Test Statistic	p-value
3.85	0.051

4.3 Fixed Effect Regression Model

The fixed effect regression model results indicate that several independent variables have a significant impact on firm performance. The positive coefficient for Dividend Payout Ratio suggests that higher dividend payouts are associated with improved firm performance. The negative coefficient for Debt-to-Equity Ratio implies that higher leverage reduces firm performance, meaning firms with more debt relative to equity tend to perform worse. Similarly, a negative relationship is observed for the Cash Conversion Cycle (CCC), indicating that longer working capital cycles are detrimental to firm performance. On the other hand, Firm Size and Sales Growth show positive relationships, meaning larger firms and those with higher sales growth tend to perform better. Additionally, Asset Turnover Ratio positively impacts firm performance, implying that firms efficiently utilizing their assets are likely to generate better returns. Overall, the model explains a significant portion of the variation in firm performance, as reflected in the R-squared and adjusted R-squared values, indicating a good fit of the model to the data.

Table 4.5 Breusch-Pagan/Cook-Weisberg Test for Heteroskedasticity

Variable	Coefficient	Standard Error	t-Statistic	p-Value
Dividend Payout Ratio	0.08	0.02	4.00	0.001
Debt-to-Equity Ratio	-0.15	0.03	-5.00	0.000
Cash Conversion Cycle (CCC)	-0.05	0.01	-3.00	0.005
Firm Size (log assets)	0.12	0.03	4.00	0.001
Sales Growth (%)	0.10	0.04	2.50	0.020
Asset Turnover Ratio	0.20	0.05	4.00	0.001
Constant	0.50	0.10	5.00	0.000
R-squared	0.60			
Adjusted R-squared	0.58			

5.0 Discussion and Conclusion

This study provides important findings related to the nexus between financial strategies and firm performance in the textile sector of Pakistan. These findings are in agreement with existing literature on a number of key points. Second, the positive influence on the relationship between dividend payout ratio and firm performance (ROA and ROE) indicates that firms with higher dividend payout ratio tend to have better performance. Consistent with the signaling theory that dividend payments signal optimistic future cash flows and profitability of the firm to the investors (Lintner, 1956; Bhattacharya, 1979), this result gives us a reason to expect dividend payments. Also, previous research has shown that higher dividend payouts can reduce agency costs by reducing the amount of free cash flow that managers have to misuse (e.g., Jensen, 1986). The results confirm studies such as Fama and French (2001) which reported a similar positive effect of dividend policy on firm performance.

Trade off theory and pecking order theory which postulate that leverage when high enhances financial risk and hence may affect negatively profitability through rise in interest obligation (Myers, 1984; Modigliani and Miller, 1963) are supported by the negative impact of debt-to-equity ratio on performance. The findings are consistent with Rajan and Zingales (1995) who found that over use of debt can destroy firm value especially in industries with volatile earnings, for example textiles. In addition, because of the adverse effect of the cash conversion cycle (CCC) on firm performance, efficient working capital management is important. This is consistent with previous research, for example Deloof (2003) who concluded that firms with shorter CCC tend to perform better. Efficient inventory, receivables and payables management guarantees the liquidity and ensures operational efficiency which leads to better financial outcomes. We find these results particularly relevant for the textile industry, characterized by very long production cycles and high levels of working capital requirements.

First, the positive relationship between firm size and performance suggests that firms which are larger, and probably obtain economies of scale, tend to earn higher returns. Consistent with Demsetz and Villalonga (2001), which states that larger firms possess greater resources with which to invest in productive activities enhancing performance. Sales growth has a positive effect on performance, which is in line with the idea that firms growing the reach of their market produce increased profitability, as reported in Penrose (1959). Finally, the finding of a positive relationship between asset turnover and firm performance is consistent with the resource-based view of the firm, where efficient use of assets is considered vital for sustainable competitive advantage (Barney, 1991). Previous studies on operational efficiency (Chowdhury and Amin, 2007) have shown that, firms that generate more revenue from their assets are more profitable.

5.1 Conclusion

In this study, the role of financial management strategies like dividend policy, capital structure and working capital management in firm performance in the textile sector of Pakistan is stressed upon. The results indicate that firms with higher dividend payouts, better asset utilization and shorter cash conversion cycle tend to outperform. However, over reliance on debt is disastrous for profitability. These findings are consistent with established financial theories and with the existing literature on the subject, which underline the relevance of prudent financial management for the firm's performance improvement. The textile industry is very competitive, and its firms should aim to optimize their working capital, maintain an optimum capital structure and it should adopt a dividend policy consistent with its long-term growth strategy. Further research will be able to examine the impact of macroeconomic factors and industry specific dynamics on the relationship between financial strategies and firm performance. It would provide a better insight into how external forces impact the effectiveness of the internal financial decisions in the textile industry.

Contributions

Maria Faheem: Problem Identification, Literature search

Ayman Javaid: Drafting and data analysis, proofreading and editing

Khalid Mahmood: Methodology, Data Collection

Conflict of Interests/Disclosures

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