Effect of cash flow and liquidity on financial stability of listed firms in Nigeria

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Annotation. *The aim of this paper is to examine the impact of cash flow and liquidity on firms' financial status in Nigeria, especially the Depbt to Equity (DE or DER). This paper then uses the panel least square technique to estimate the regression model which gives insights on what factors influence the DER of the sampled companies. The intercept was set a priori at a positive value for DER and similarly for OCFR and ICFR, which display inverse relationships. Of these, the Net Cash Flow Ratio (NCFR) is clearly the most significant and positively related factor reinforcing the value of effective sales of net cash flows that enhance higher DERs. Also, the negative and significant coefficient estimate of Firm Size (FSZ) underlines the implications of this study that senior debt structures for firm size. Based on these findings, the following implications address Nigerian listed firms Current recommendations are as follows: Namely there is need to more effectively manage operating cash flow and investing cash flow in order to best manage debt to equity ratios. Therefore, when deploying control levers to positively influence the firm; the companies that have acknowledged the Firm Size (FSZ) as one of the major influential factors are advised to balance the debt structure of the firm. For this reason, it is important to pay attention to the Net Cash Flow Ratio (NCFR) and the focus to achieve positive net cash flows as a crucial aspect to sustaining a sound financial status.*

Introduction

In the realm of corporate finance, financial stability is a crucial determinant of long-term sustainability and resilience. Particularly in developing economies like Nigeria, where external economic shocks, regulatory fluctuations, and market volatility pose significant risks, the financial stability of listed companies becomes paramount. As Nigeria boasts the largest economy in Africa, the health of its corporate sector significantly influences the broader economic landscape. The Nigerian Stock Exchange (NSE) serves as a barometer for the financial well-being of its listed firms, which, in turn, mirrors the overall performance of the nation's economy. However, understanding the intricate factors that underpin the financial stability of these firms is both timely and necessary, especially in an era marked by global economic disruptions, such as the COVID-19 pandemic, which has exposed vulnerabilities in both developed and emerging markets.

One of the foundational pillars of financial stability is cash flow, often regarded as the lifeblood of any business. The adequacy and management of cash flow determine whether a company can meet its operational demands, invest in growth opportunities, and withstand financial shocks. In Nigeria, where businesses face unique challenges such as fluctuating exchange rates, inflation, and unpredictable

government policies, the efficient management of cash flow becomes even more critical. Numerous studies have highlighted the positive correlation between strong cash flow and the ability of firms to navigate periods of financial distress (Ugho & Egbuhuzor, 2022). Firms with robust cash flow systems are better positioned to sustain operations, avoid insolvency, and, more importantly, exploit opportunities that may arise even in adverse conditions (Etim, Daferighe, Enang & Nyong, 2022). However, the challenge lies not only in generating cash flow but in managing it efficiently, especially in an environment where capital can be difficult to access due to macroeconomic constraints.

Liquidity, on the other hand, is equally vital and often intertwined with cash flow in determining a firm's financial stability. Liquidity refers to a company's ability to meet short-term obligations without incurring significant losses, and its role in financial stability cannot be overstated. Firms with high liquidity are better equipped to manage short-term financial needs, maintain operational continuity, and buffer against external shocks. The liquidity of listed firms in Nigeria is particularly important, given the volatile nature of the country's economic environment, where access to credit and capital markets can be highly constrained. As businesses contend with fluctuating interest rates, inflation, and unstable financial policies, liquidity management becomes a delicate balancing act. A company may be generating significant revenues but still face financial distress if its liquidity is poorly managed or constrained (Hartlage, 2012; Myers & Majluf, 1984).

The global financial crisis of 2008, as well as the more recent COVID-19 pandemic, have highlighted the importance of liquidity in maintaining corporate resilience. Firms that were unable to adjust their liquidity positions quickly found themselves unable to meet short-term obligations, which precipitated broader financial instability. The Nigerian corporate sector, much like its global counterparts, experienced significant strain during these periods, with many companies struggling to maintain adequate liquidity levels (Chukwunwike, Ofoegbu, & Okoroiwu, 2018). Therefore, the ability of listed companies in Nigeria to manage liquidity effectively is crucial for maintaining both their financial stability and the confidence of investors, which in turn affects stock market performance and the broader economy.

This study, situated within the Nigerian context, seeks to explore the complex and nonlinear relationship between cash flow, liquidity, and financial stability. Nigeria's economy is characterized by volatility, heterogeneity, and exposure to global economic forces, making it an ideal case for examining how internal financial practices can buffer against external shocks. As the global economy continues to evolve, with emerging markets like Nigeria playing an increasingly prominent role, understanding the dynamics of cash flow and liquidity within this context is crucial for both policymakers and corporate leaders aiming to foster sustainable economic growth. This study aims to provide insights into how Nigerian listed firms can strategically manage cash flow and liquidity to enhance financial stability and ensure long-term corporate resilience.

Literature Review

Theoretical Review

The theoretical framework for this study is grounded in several well-established financial theories that provide a comprehensive understanding of the relationship between cash flow, liquidity, and financial stability. These theories are instrumental in explaining how firms manage their financial resources in the context of Nigeria's volatile economic landscape and capital markets. Each of these theories sheds light on different aspects of financial decision-making and corporate behavior, and together, they form the backbone of this study's conceptual framework.

One of the key theories underpinning this research is the **Pecking Order Theory**, first introduced by Myers and Majluf (1984). The Pecking Order Theory posits that firms prefer internal financing (such as retained earnings)

over external financing options, like debt or equity, due to the higher costs and risks associated with external capital. This theory is especially relevant in the Nigerian context, where firms face high external financing costs and market volatility, making internal cash flow management a priority. According to the Pecking Order Theory, firms will first rely on retained earnings to fund operations and investments, only turning to debt when internal funds are insufficient, and equity financing becomes the last resort due to the high cost of issuing new shares and potential dilution of ownership. This hierarchical preference for financing sources is crucial for understanding how Nigerian listed firms manage their cash flows and liquidity in order to remain financially stable in a dynamic economic environment.

Complementing the Pecking Order Theory is the **Agency Theory**, as articulated by Jensen and Meckling (1976). The Agency Theory focuses on the conflicts of interest that arise between shareholders (principals) and management (agents). In the context of this study, it is particularly relevant in exploring how the divergence of interests between shareholders and managers can affect corporate governance, financial decision-making, and, ultimately, financial stability. Agency problems often lead to suboptimal financial decisions, such as excessive risk-taking or mismanagement of cash flow, which can jeopardize a firm's liquidity and long-term stability. This theory is especially pertinent in Nigeria, where weak corporate governance structures have often exacerbated agency problems, leading to inefficiencies in cash flow and liquidity management. By integrating Agency Theory into the analysis, this study highlights the importance of corporate governance reforms in Nigeria, which aim to mitigate these agency conflicts and improve financial stability.

Additionally, the **Market Timing Theory**, proposed by Baker and Wurgler (2002), provides a further layer of understanding of how firms make financing decisions. This theory suggests that firms time their capital-raising activities based on market conditions, opting to issue new equity when stock prices are high and avoiding it when prices are low. In the Nigerian financial space, characterized by market inefficiencies and volatility, the ability of firms to time their financing activities can significantly impact their liquidity and cash flow management. The Market Timing Theory is particularly relevant in assessing how Nigerian firms strategically manage their liquidity and capital structure in response to favorable or unfavorable market conditions, thus influencing their overall financial stability.

Another important theory incorporated in this study is the **Dynamic Trade-off Theory**, as proposed by Kraus and Lichtenberger (1973). This theory suggests that firms continuously adjust their capital structures in response to changing economic conditions to maintain an optimal balance between debt and equity. In contrast to the static Trade-off Theory, the dynamic approach recognizes that firms are constantly responding to external shocks, such as economic downturns, fluctuations in interest rates, or changes in market sentiment. For Nigerian listed firms, the Dynamic Trade-off Theory is critical in understanding how they manage their cash flow and liquidity to adapt to the country's volatile economic conditions. By adjusting their capital structures dynamically, firms can better position themselves to achieve financial stability, even in uncertain times.

Taken together, these theories—Pecking Order Theory, Agency Theory, Market Timing Theory, and Dynamic Trade-off Theory—offer a multi-dimensional lens through which to analyze the complex relationship between cash flow, liquidity, and financial stability in Nigerian listed firms. Each theory contributes to a deeper understanding of how firms strategically manage their financial resources to navigate the challenges posed by the Nigerian financial environment, characterized by regulatory uncertainties, market fluctuations, and economic volatility. Through the application of these theories, this study seeks to provide a critical analysis of how Nigerian firms can improve their

financial stability by optimizing their cash flow and liquidity management practices, all while accounting for the unique challenges of operating in one of Africa's most dynamic economies.

Empirical Review.

In their study Onyemenam, Okwo and Eze (2023) proposed a model to analyze the effect of free cash flows on the performance of pharmaceutical companies listed in Nigeria. The study adopted an ex-post facto design and analyzed data from seven big audited financial reports of pharmaceutical firms over a period of 12 years (2010-2021). Overall, they used Panel multiple regression with Stata 14.2. Their response variable (dependent variable) is return on assets, while the explanatory variable (independent variable) are; operating cash flow, changes in working capital and investment in non-current assets. Result was arrived on through panel multiple regression, Where capital structure hold a significant effects on companies' performances because of its varied sources. The result reveal that, significant short-term effect was noticed as operating cash flow positively affect return on assets, while changes in working capital mode was greatly negative effect. On the other hand, investment in non-current assets demonstrate a non-significance negative effect on return on assets (ROA).

Using a liquidity risk management score (LRMS) as a dependent variable, Wuave, Yua and Yua (2020) found that liquidity is crucial for financial stability in Nigeria banks. The study concluded that liquidity requires 'proactive' management; for listed firms, liquidity risk management can be an 'indicator of financial resilience'.

In their research on liquidity and financial viability in quoted non-financial firms in Nigeria, Rosemary, Prince, Jack, Fausat, Enoch and Samuel(2021) conducted a regression model. They also employed tests such as the Spearman rank correlation test, and first-order and higher-order autocorrelations tests on data involving 13 non-financial sectors in Nigeria spanning 1999 to 2020.

The current ratio was significantly shown to be an important factor in explaining the level of return on equity while the cash flow ratio was not significantly important in explaining the level of return on equity. It was also possible to reveal a positive or negative feedback between the liquidity indicators (current ratio, cash flow ratio) and ROE.

Etim, Daferighe, Enang, and Nyong (2022) sought to investigate the impact of cash flow management on the financial performance of listed firms in Nigeria. The study was conducted using an ex-post facto design, and employing descriptive and inferential statistics. Analysing 63 firms listed on the NSE for the duration of the study period, the study was conducted between 2013 and 2019. The evidence reveals that Operating Cash Flow Margin, Operating Cash Flow Ratio, Investing Cash Flow Ratio, and Net Cash Flow Ratio have positive relationship and importantly affect directly on financial performance also Financing Cash Flow Ratio has negative relationship but less affect on financial performance.

All these empirical studies taken together provide a vivid understanding of the research uncovering the interaction between cash flows, liquidity and financial stability of Nigerian listed firms. As can be seen from the research work, the case studies unveiled diverse issues that, nevertheless, paint a consistent picture of the need for organisations to employ forward-planning approaches to manage the financial risks associated with economic cycles, regulation, and global markets.

Methodology

Research Design

The type of research design for this study is ex post facto since it enables the research to study variables in order to establish the causal effect after surveying them. This design is especially appropriate for assessing the connection between the proxies for cash flow management and the debt to equity ratio of the existing manufacturing firms in Nigeria's stock exchange.

Data Collection

The data for the study was sourced from the

Nigerian Stock Exchange and will comprise panel data obtained from 40 selected manufacturing firms operating out of Nigeria for the period from 2013 to 2022, the choice of panel data, enables to overcome the disadvantages of studying the variables for one type of entities at a time, and provides for a comprehensive analysis of the behavior of the variable throughout the cross-sectional and temporal dimensions.

Variables Measurements

Dependent Variable:

Debt to Equity Ratio (DER): A variable indicating how much of a company's capitalisation was acquired through debt loans, as opposed to from issuance of new shares of the company's stock. This is the primary variable of financial stability.

Independent Variables (Cash Flow Management Indicators):

OCF Ratio (operating cash flow ratio): the ratio of operating cash flow to total assets. It measures the capability to generate cash relative to the total asset base of the company.

Investing Cash Flow Ratio (ICFR): Investing cash flow divided by its total assets and revealing the quality of the investing by way of the cash generated through these activities.

Financing Cash Flow Ratio (FCFR): The ratio of financing cash flow to total assets, reflecting the impact of financing decisions on cash generation.

NCFR indicates the overall cash-efficiency of the operation. Net Cash Flow Ratio (NCFR) = Net cash flow / Total assets.

Control Variables

Interest rate, Exchange rate and Firm size

Estimation Procedure

The estimation methodology used for this study involves analyzing the cash flow management indicators using fixed and random effects models of panel data regression, to thoroughly analyze the effect of the firms chosen debt-to-equity ratio. It will be imperative to consider the selection of both models to ensure that the right model specification has been selected..

Fixed-Effects Panel Data Regression Model

The fixed-effects model, represented as:

$DER_{it}=\beta_0+\beta_1 OCFM_{it}+\beta_2 OCFR_{it}+\beta_3 ICFR_{it}+\beta_4 FCFR_{it}+\beta_5 NCFR_{it} + \beta_6 FSZ_{it}+ \beta_7 ITR_{it} + \beta_8 EXR_{it}+\alpha_i+u_{it}$

Incorporates individual fixed-effects (αi) to account for time-invariant characteristics specific to each firm. This model helps control for unobservable heterogeneity, capturing firm-specific effects that may impact the debt-to-equity ratio.

Random-Effects Panel Data Regression Model

The random-effects model is specified as:

$DERit= \beta_0+\beta_1 OCFM_{it}+\beta_2 OCFR_{it}+\beta_3 ICFR_{it}+\beta_4 FCFR_{it}+\beta_5 NCFR_{it} + \beta_6 FSZ_{it}+ \beta_7 ITR_{it} + \beta_8 EXR_{it} +\alpha i+uit$

Where αi is a random effect assumed to be uncorrelated with the independent variables. The random-effects model allows for the inclusion of time-invariant firm-specific effects while assuming these effects are uncorrelated with the explanatory variables.

Hausman Test

Thus to identify what model to use fixed or random, the Hausman test will be used. The Hausman test determines whether fixed effects estimator in which, the fixed effects are assumed to be related to independent variables is better than random effects estimator which assumes no relation between them. The choice of the suitable model was based on the results of the Hausman test, providing insights into the presence or absence of endogeneity in the model.

Data Analysis and Findings

Table 1: Summary of Descriptive Statistics for the Study Variables

	DER	OCFR	ICFR	FCFR	NCFR	FSZ	ITR	EXR
Mean	1.025	0.077	-0.040	-0.028	21.736	0.262	11.711	16.432
Median	0.859	0.072	-0.028	-0.017	19.285	0.247	11.397	16.724
Maximum	2.183	0.590	2.400	0.551	33.157	0.363	16.524	17.580
Minimum	0.195	-0.914	-0.533	-2.121	15.846	0.179	8.063	14.985
Std. Dev.	0.579	0.137	0.140	0.128	4.841	0.055	2.710	0.770
Skewness	0.604	-0.711	9.096	-5.720	1.045	0.070	0.370	-0.768
Kurtosis	2.366	10.017	143.468	96.437	3.531	2.154	2.117	2.620

Source: Author's Computations Using EView (2024)

Starting with the Debt-to-Equity Ratio (DER), the mean of 1.025 indicates a slight inclination towards more debt than equity on average. The moderate standard deviation of 0.579 suggests a reasonable degree of variability in the companies' debt-to-equity structures. Moving on to the Operating Cash Flow Ratio (OCFR), the mean of 0.077 implies a generally positive cash flow from operations. However, the negative minimum value of -0.914 indicates instances of negative operating cash flows among some companies. This variability is reflected in the standard deviation of 0.137.

The Investing Cash Flow Ratio (ICFR) stands out with a mean of -0.040, emphasizing a potential challenge in the efficiency of companies' investments. The highly positive skewness and kurtosis values suggest a non-normal distribution, possibly influenced by outliers. Similarly, the Financing Cash Flow Ratio (FCFR) reveals a mean of -0.028, indicating a trend towards negative financing cash flows. The distribution appears negatively skewed, reflecting potential challenges in financing activities.

Net Cash Flow Ratio (NCFR), with a mean of 21.736, demonstrates a generally positive overall cash flow position among the companies. The moderate standard deviation of 4.841 indicates a degree of variability in net cash flows. Firm Size (FSZ) showcases a mean of 0.262, indicating a moderate average size among the sampled companies. The low standard deviation of 0.055 suggests a relatively consistent distribution of firm sizes.

Interest Rate (ITR) and Exchange Rate (EXR) present means of 11.711 and 16.432, respectively. ITR's distribution appears moderately right-skewed, while EXR demonstrates a relatively normal distribution with a slight left skewness. These variables provide insights into prevailing interest rates and exchange rates.

Correlation Analysis

Table 2: Correlation Matrix

DER	1.000							
OCFR	0.106	1.000						
ICFR	-0.149	-0.442	1.000					
FCFR	0.047	-0.289	-0.446	1.000				
NCFR	0.626	0.109	-0.066	0.048	1.000			
FSZ	-0.785	-0.090	0.127	-0.025	-0.296	1.000		
ITR	-0.279	-0.073	0.057	0.009	-0.597	-0.070	1.000	
EXR	0.356	0.014	-0.081	-0.003	-0.100	-0.521	0.213	1.000

Source: Author's Computations Using EView (2024)

The following correlation analysis examines the relations of the most critical variables to each other.

Overall, high level of Debt-to-Equity Ratio (DER) seems to contribute directly to the increased number of overall net cash flows. It has a positive correlation to Net Cash Flow Ratio (NCFR)

Furthermore, Debt-to-Equity Ratio (DER) has a negative correlation with Firm Size (FSZ), such that small companies tend to have higher debt-to-equity ratios with respect to their size.

Moving on to the Operating Cash Flow Ratio (OCFR), its weak positive correlation with DER suggests that positive operating cash flows are linked to higher level of debt in a nuanced manner. On the other hand, the Investing Cash Flow Ratio (ICFR) displays a negative correlation with DER such that as the ratio of debt to equity goes up, the efficiency of investments declines.

Cash Flow from Operations Ratio (CFOR) has a low positive correlation with DER, but this suggests that there is a slight relationship between operating activities and higher indebtedness. Net Cash Flow Ratio (NCFR) has a strong positive correlation with DER which may suggest that firms indebted to a high extent have larger net cash flow as well.

FSZ displays the highest negative correlation coefficient, which means that a firm's debt-to-equity ratio would tend to be higher if the firm was smaller. ITR's negative correlation coefficient with DER implies that as interest rates increase, debt-to-equity ratio would tend to be lower. Exchange Rate (EXR) displays the highest positive correlation coefficient, strongly suggesting that exchange rates are related with higher levels of debt.

Overall this correlation analysis presents a picture of how the variables in the study relate. The strong positive correlation between DER and NCFR denote a financial landscape that has greater debt levels with higher over all net cash flows, while the negative correlation of DER with FSZ and ITR as well as the negative but weak correlation with ICFR suggest that possibly firm size, interest rates and investment efficiency play a role to some extent on debt structures.

Panel Regression

Table 3: Hausman Test

Test Summary		Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random		6.710	7	0.457
Cross-section random effects test comparisons:				
Variable	Fixed	Random	Var(Diff.)	Prob.
OCFR	-0.1253	-0.1234	0.0014	0.9602
ICFR	-0.2388	-0.2126	0.0014	0.4842
FCFR	-0.0804	-0.0799	0.0016	0.9899
NCFR	0.0454	0.0454	0.0000	0.8187
FSZ	-6.6134	-6.6162	0.0004	0.8820
ITR	-0.0243	-0.0243	0.0000	0.9377
EXR	0.0636	0.0637	0.0000	0.9220

Source: Author’s Computations Using EView (2024)

The test carried out was the Hausman test in order to decide between the fixed effects model and random effects model in a panel data analysis. It can be computed also that the chi-square statistic is 6. 710 and 7 degrees of freedom: P(approximately equal to) 0. 457, which is higher than the typical 0, level of statistical importance in analysis.. undefined As a result, the test fails to produce enough evidence to reject the null hypothesis and this suggests that

there is no general tendency in estimates derived from the random effects model to differ from those derived from the fixed effects model. Therefore, random effects are added into the model and the test results for those coefficients show them to be consistent and efficient**.**

Table 4: Random Effect Regression

Dependent Variable: DER				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1.008	0.334	3.021	0.003
OCFR	-0.125	0.107	-1.169	0.243
ICFR	-0.239	0.112	-2.134	0.033
FCFR	-0.080	0.115	-0.696	0.487
NCFR	0.045	0.003	15.778	0.000
FSZ	-6.613	0.236	-28.020	0.000
ITR	-0.024	0.005	-5.078	0.000
EXR	0.064	0.016	4.065	0.000
	Effects Specification			
R^2	0.801	Mean dependent var		1.025
Adj R^2	0.776	S.D. dependent var		0.579
F-statistic	32.890	Durbin-Watson stat		2.049
Prob(F-statistic)	0.000			

Source: Author's Computations Using EView (2024)

In the random effect regression analysis predicting the Debt-to-Equity Ratio (DER), a panel least squares method was employed. The model includes various independent variables, and the coefficients are estimated with their respective standard errors, t-statistics, and probabilities. The intercept (C) is significantly positive at 1.008 ($t = 3.021$, $p = 0.003$), suggesting a baseline value for DER. Operating Cash Flow Ratio (OCFR) and Investing Cash Flow Ratio (ICFR) show negative coefficients of -0.125 ($t = -1.169$, $p = 0.243$) and -0.239 ($t = -2.134$, $p = 0.033$) respectively, indicating potential negative associations with DER. Financing Cash Flow Ratio (FCFR) is not statistically significant ($t = -0.696$, $p = 0.487$). Net Cash Flow Ratio (NCFR) exhibits a highly significant positive relationship with DER (Coefficient = 0.045, $t = 15.778$, $p < 0.001$). Firm Size (FSZ) has a strong negative impact on DER (Coefficient = -6.613, $t = -28.020$, $p < 0.001$), while Interest Rate (ITR) and Exchange Rate (EXR) show negative and positive effects, respectively, with statistically significant coefficients. The effects specification reveals a high R-squared value of 0.801, indicating a good fit for the model, and the F-statistic of 32.890 is significant at $p < 0.001$. Overall, the model provides substantial explanatory power for variations in the Debt-to-Equity Ratio based on the considered variables**.**

Conclusion and Recommendation

From the regression analysis, overall it is shown that the factor of financial liability significantly affect to DER through a panel least squares method. First of all, it is showed that the intercept has a high significance. From this, it is confirmed that the level of DER is at the difference of approximately as a positively significant value with DER.

Secondly, as shown in the main term, other financial ratios seem to be negatively correlated. Among them, the OCFR and ICFR show negative results, although the critical value of OCFR exceeds the acceptance region. On the other hand, the NCFR value is negatively correlated with a very high significance. This could mean that the companies have more stress in maintaining DER because they have high debt compared to the net cash flow.

Finally, the FSZ appears to have a large negative influence on DER. From this result, in general, enterprise scales are appropriately reflected in debt structures, which implies that the size is an important factor that can be significantly adjusted when setting DER terms.

According to the obtained results, it can be recommended that companies pay their utmost attention for excellent management of their Cash Flow From Operating Activities (CFOA) and Cash Flow from Investing Activities (CFIA) to have higher flexibility in their debt-to-equity structures, also do not forget about Firm Size (FSZ) influence to the DER and design strategies for maintaining right levels of debt relative to company size. Due to highly influential impact of Net Cash Flow Ratio (NCFR), companies should think deeply and take all possible actions for minimising the negative values of this variable in order to have a healthy position of their company. Monitoring for the changes of Interest Rate (ITR) and Exchange Rate (EXR) and coming up strategies in response to those changes can be viewed as one of the most important steps to define what and how debt the firm needs to adopt now.

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