

Factors which affect firm s profitability economics essay



**ASSIGN
BUSTER**

Afza Hussain tried to seek out different factors which determine the capital structure of a firm. They observed the financial data of manufacturing sector of Pakistan. A firm adopts suitable mix of sources of finance such as retained earnings, issuance of ordinary and preference shares and debt to maximize shareholders wealth. By using debt financing, a firm may get tax shield but it raises the risk of bankruptcy. Thus, the possible advantages of a debt financing lessen due to bankruptcy cost and firms which have high debt financing rate are deemed to be highly risky firms. The cost of equity financing is higher than the cost of debt financing due to floatation cost and demand of dividend is higher by the shareholders. They concluded that firms which have good asset structure ought to finance their operations by debt financing and the firms which have high cost of debt ought to utilize retained earnings and if more funds are required then use equity financing.

Eriotis, Frangouli and Neokosmides (2011) concerned about the impact of financial structure on firm's performance. They took data from 53 firms of various industries for the period of 1995-1996 and concluded that debt-to-equity ratio has a negative impact on the profitability of the firm. Negative impact means that either the benefit from the investment through borrowed capital is lower than the cost of borrowed capital or those firms are more profitable which prefer self financing for investment than firms which finance their investment by borrowed capital. They suggested that level of investment can be increased through the use of borrowed capital and it increased the return of invested capital but it also increased the risk for the firm and for the owners due to fixed expenses of interest. In this study, they analyzed that firms those prefer retained profit to finance their investment

are more profitable than those which prefer borrowed capital to finance their investment.

Amjed (2011) highlighted the impact of capital structure on firm's performance while taking the sample of Pakistan's Chemical industry. He claimed that a firm with equity financing has larger free cash flow, freedom to take operational decisions and flexibility to take risk. If a firm has lower degree of debt then it can move to more productive but riskier projects and lenders prefer these types of firms. Optimal capital structure can be achieved where cost of debt is less than benefits of debt. With the optimal capital structure, stockholders get higher return. He claimed that long term debt has a negative impact on firm's performance and short term debt has a positive impact on firm's performance. His results also revealed that profitable firms favor internally generated funds.

Singapurwoko & Mustofa El- Wahid (2011) described a significant relation between debt and profitability of a firm. They took data from 48 non financial companies listed on Indonesia stock exchange for the period from 2003-2009. They used different factors such as firm size factor, total asset turn over, interest rate and industry factor to analyze the effect of debt on profitability. They supported that profitability is not only affected by debt. There are other external or internal factors that may affect profitability of a firm. They concluded that all factors are positively significant towards profitability of a firm except interest rate and debt is positively associated with profitability of a firm.

Rehman, Fatima & Ahmad (2012) evaluated the impact of debt structure on firm's profitability. Their sample is based on Textile industry of Pakistan and regression analysis is used to check the desired relation. Their results suggest that short term debts and profitability are significantly positively related and long term debt has no relationship with profitability. They also claimed that debt affects profitability only when firm has higher sales and short term debts are useful for those firms which have small sales.

Marcus (1969) tested the hypothesis of Bauriol that rate of return and size are positively associated. A large of number of studies tested this hypothesis but their results have lack of evidence due to several shortcomings. The researcher took new data to re-evaluate the hypothesis and concluded that the specified hypothesis have no generalizability as it was proved in some industries but has no implication on other industry. So, the positive relation between size and return has no general validity.

Treacy (1980) provided the insight regarding the relationship between profitability patterns and firm size. He used Compustat dataset of 1458 companies form 54 industries for ten years. The results revealed that firm size and level of profitability are positively correlated and variance average return on equity and firm size are negatively correlated but firm size is not playing a major role regarding intervening variable between level of firm and variance of returns on shareholder's equity.

Evans (1987) observed the relationship between growth, size and age of the firm. The sample consisted of all firms working in 100 manufacturing industries. The researcher found that firm growth goes down at a moderate

rate with the firm size. He also found that growth of a firm, the variability in growth of a firm and the chances that a firm would be unsuccessful decrease with the firm age. He also refuted the Gibrat's law that firm size and growth rate are independent.

Storey (1989) examined the relationship between firm size and its performance. He argued that small firms deserve larger attention of the economists as these become the source of creation of employment and wealth in developed countries. He claimed that small firms are not only scaled down side of larger firms, instead they have features which are different from larger firms. He concluded that firm size and growth are negatively associated.

Schneider (1991) provided evidence about the relationship between efficiency and profitability of a firm with respect to its size. He took the sample of total Austria firms and emphasized that small firms have more efficiency level with respect to gross residual quota to profitability as compare to large firms. On the other hand, same analysis had done on upper Austria firms and concluded that firms with larger size as 500 employees or more have more efficiency level and small firms are more cost effective.

Amirkhalkhali & Mukhopadhyay (1993) noted the impact of size and R&D on the firm's growth while taking sample from U. S. firms. He established the specific relationship by testing Gibrat's law. Their results disapproved the Gibrat's law that firm size has no effect on the growth rate of a firm and expected growth rate is same for all sizes of firms. Their findings suggested that size-growth and size-distribution relationship depend upon firm's

decisions regarding R&D applications. Their results also indicated that larger firms have higher growth rates.

Ballantine, Cleveland & Koeller (1993) highlighted the relationship between variations in profitability of small or large firms with the reflection of uncertainty. They found that variations of uncertainty to earn profit are great for small firms through which they make operating policies to become best entrepreneurial. Whereas, large firms have less uncertainty, so they adopt policies for strategic planning.

Majumdar (1997) investigated the influence of size and age of a firm on its performance. The nature of relationship depends upon environment-specific and institutional factors of a country. He measured size as natural log of sales and age as number of years since commencement of a firm. He took 1020 Indian firms for sample and concluded that larger firms are more profitable and less productive while older firms are less profitable and more productive.

Chow & Fung (1997) pointed out the relationship between firm size and performance. They took a sample from Shanghai's manufacturing industry for the period of 1989-1992. Their empirical results portrayed that small firms with 0-99 workers have high technical efficiency, medium size firms with 100-250 workers have lowest technical efficiency and largest firms with 1000 workers or above have the highest degree of technical efficiency.

Berk (1997) tried to examine the firm size that it really matters or not.

Modern financial theory expected that when firm size has no relation with return then firm market value and return are negatively associated, it means <https://assignbuster.com/factors-which-affect-firm-s-profitability-economics-essay/>

that firms which have small market values would have larger expected returns. He claimed that if firm size measured correctly than no evidence exists which shows that small firms earn greater return as compare to large firms.

Dean, Brown & Bamford (1998) compared small and large firm's responses with respect to their environmental context. They performed comparative analysis of small and large firms regarding their industry structural characteristics with the sample of U. S. manufacturing industry for the period of 1977-1987. Their findings indicated that small firms have certain resources that permit them to prevail over some barriers which generate difficulties for the larger firms, in addition to provide opportunities to small firms more readily as compare to larger firms.

Hardwick (1999) tried to provide evidence regarding the relationship between size and growth of firms. Using sample of 231 firms from life insurance companies of United Kingdom during 1987-1991 and 1992-1996, he found that smaller firms grow rapidly than larger firms during 1987-1991, which is opposing Gibrat's law that size and growth are independent. But there was no significant difference in growth rates of large and small firms during 1992-1996. The results claimed that asset growth of firm and its profitability are inversely related. He also found that there is no relation between growth and X-inefficiency.

Almus (2000) tested Gibrat's law on young firms for the sample selected from manufacturing sector of West German during 1989-1994. He divided firms into parts; young firms with technological intensive and non

technological intensive in different sizes. The researcher refuted Gibrat's law for both types of firms and concluded that smaller firms have bigger potential to grow than larger ones.

Dhawan (2001) attempted to explore the relationship between firm size and productivity while taking the sample of publicly traded US firms for the period of 1970 – 1989. Smaller firms get lower size of loan with higher interest rate. Their empirical results revealed that small firms are more productive but lower survival probability due to two to four times more level of risk as compare to large firms. Small firms have market uncertainties, capital limitations and challenges which make them more efficient but at the cost of increase their level of risk.

Ammar et al. (2003) attempted to recognize the relationship between firm's size and profitability through indicator variables model. He used the sample from Federal electrical contractor group for the period of 1985-1996. Their model indicates that small firms have high profit rate increase as compare to medium or large firms and when these firms become bigger, their profits rate become higher. Their results revealed that in terms of profit rate, small, medium and large firms are different with one another. The profitability goes down as firm's sales grow larger than \$50 million.

Beck et al. (2004) attempted to analyze whether financial development enhance the growth level of small firms greater than large firms. Using cross-country and cross-industry data, the results indicated that financial development put forth a disproportionately large impact on growth of those industries which are more reliant on small firms. This proposed that financial

development speed up economic growth by eliminating growth constraints of small firms.

Beck et al. (2005) used survey database of 4000 firms out of 54 countries to inspect the impact of financial and legal constraints on firm's growth. Small firms are more influenced by these types of constraints. Financial and institutional progress declines the effects of these constraints and small firms again benefit the most. The results also indicated that firms which operate in underdeveloped countries with high corruption are mostly affected by all constraints.

Ramasamy, Ong & yeung (2005) sought to identify the determinants of performance while taking the sample from Malaysian palm oil sector. They took two variables, firm size and ownership to check their impact on profitability of a firm. Their results indicated that firm size is negatively associated with the firm performance while privately owned firms are more profitable than state owned firms. Larger firms have intrinsic organizational problems which lead to inefficiencies in operations and cost of production become higher than optimum level which lower the firm profitability.

Abu-Tapanjeh (2006) attempted to empirically study a relationship between firm structure and its profitability. He took 48 industrial companies listed on Amman Stock Exchange, Jordan for the period of 1995 to 2004. Major components such as firm age, firm size, ownership structure and debt ratio were taken into consideration for firm structure and ROE and ROI were used as measures of profitability. Their results suggested that firm structure is an important factor that affects profitability. He found that firm size is

negatively associated and debt ratio has positive association with profitability. He also found that ownership structure and firm age has insignificant affect on firm's profitability.

Jonsson (2007) investigated the relationship between size of a firm and its profitability. He described that shareholders and managers want to see their business as a biggest business in their industry. He studied three theories regarding the choice of managers for the expansion of their business. The principal agent theory suggest that managers want to expand their business for their own benefits, the strategic management theory suggest that mangers expand to achieve economies of scale and the institutional theory suggests that managers want expansion due to institutional pressure. He took the sample of 250 Iceland firms for the period of five years. The results suggested that size has no significant association with profitability.

Punnose (2008) examined the comparative profitability analysis of business group firms and individual firms. The sample is formed by 121 Indian electrical machine manufacturing industry during 2003-2005. He used ROA as a proxy of firm performance and natural log of average assets as a proxy of firm size. The industry was divided into three groups, high, medium and low with respect to assets and performance. Regression analysis was used to assess the association and concluded that there is no difference between individual and group firms and profitability of a firm increases as firm size decreases.

Hou & Dijk (2008) studied the relationship among firm size, profitability shocks and expected stock returns. They reported that small firms bear large

negative shocks of profitability after the early years of 1080s, while big firms bear large positive shocks of profitability. As a consequence, actual stock returns were totally different from expected returns. After the adjustments of profitability shocks, they found that size effect matters a lot in expected returns.

Bhattacharyya & Sexena (2009) investigated the impact of firm size on its performance. His sample consisted of Indian manufacturing firms and Steel and Electrical and electronics industries for the period of 2004-2005 to 2006-2007. They measured firm size as natural log of net sales and performance by profitability of a firm. They postulated that size does matter! Larger firms are stronger to face risky situations and have better means to go through these types of situations. Size also brings stronger bargaining power to the firm over its competitors and suppliers and bigger firms have superior technology, best sites, economies of scale and best professional team of experts. The regression results showed that firm size has positive influence on current profitability of Steel industry at 1% level of significance and negative impact on Electrical and electronics industries at 5% level of significance.

Vijayakumar & Tamishselvan (2010) tried to empirically analyze the relationship between corporate size and profitability in imperfect market. Using regression analysis for financial data of 15 South Indian Sugar companies (private sector) during 1991-1992, they tested the Boumal's hypothesis that larger firms have more profitability. Their analysis indicated that size and profitability are positively correlated in whole industry except few firms which reported negative relationship between size and profitability.
<https://assignbuster.com/factors-which-affect-firm-s-profitability-economics-essay/>

Kumar (2012) studied the influence of firm size on its performance and observed that large firms have better output performance as compare to medium and smaller sized firms. He took the sample of 105 Indian electronics firms during 1997-2009 and used generalized least squares method to analyze capital-output ratio and production function i. e. input-output relationship. The results pointed out that large firms have consistent performance and small and medium sized firms are more influenced by the economy's performance. Large firms have the more capacity to expand their operations according to their requirements and create employment opportunities with growth which is not adopted by small and medium sized firms.

Gaur, Fisher & Raman (2004) empirically analyzed inventory turnover of 311 public listed retail firms in U. S. during 1987-2000 to inspect the association of inventory turnover with capital intensity, gross margin and sales surprise. They concluded that inventory turnover has a high correlation with capital intensity, gross margin and sales surprise. Their results indicated that 66. 7% variation in within-firm inventory turnover and 97. 2% variation in total inventory turnover within and across the firms are due to explanatory variables. They found that inventory turnover and gross margin are negatively correlated.

Boute et al. (2007) analyzed the inventory turnover by taking sample from Belgian manufacturing, wholesale and retail industry. They used inventory days ratios for raw material, work in process and finished goods and ROA as a proxy for firm's financial performance. They pointed out that inventory ratio regarding finished goods is different among industry sectors and <https://assignbuster.com/factors-which-affect-firm-s-profitability-economics-essay/>

inventory ratio in retail is significantly higher than in wholesale sector. Their results after regression analysis partially claimed that companies with high inventory ratios have negative impact on financial performance.

Galbreath & Galvin (2007) provided arguments regarding firm factors which are most important in determining firm's performance as compare to industry structure. By studying financial data of 285 Australian firms, they claimed that firm resources are the basis on which firms compete. In service firm's performance is greatly depends on firm resources as compare to manufacturing firm. They also highlighted that intangible assets and capabilities are responsible for performance variation than tangible resources.

Capkun, Hameri & Weiss (2009) tried to highlight the relationship between inventory and financial performance of the firm. Using the financial information of U. S. manufacturing firms for the period of 1980 to 2005, they examined the inventory performance by total inventory and the distinct components of inventory such as raw material, work in process and finished goods. They found that inventory performance is positively correlated with financial performance of the firm and association between the performance of distinct components of inventory and financial performance differ across inventory components.

Kolias, Dimelis & Filios (2010) provided empirical approach to analyze the behavior of inventory turnover. Using panel data of 566 Greek retail firms during 2000 to 2005, they found that inventory turnover ratio and gross margin are negatively correlated. They explained that variability in inventory

turnover ratio is caused by segment-wise-effect and when firms work in sales decline state then bigger changes are due to changes in sales. The results also concluded that inventory turnover ratio and capital intensity are positively correlated.

Sahari, Tinggi & Kadri (2012) inspected the impact of inventory management on firm performance and capital intensity. They employed correlation and regression techniques by using financial data of 82 Malaysian construction firms for the period of 2006-2010. Inventory days was used as proxy for inventory management and ROA was used to measure firm performance. They found that inventory management and firm performance are positively correlated and capital intensity and inventory management are also positively associated.

2. 3 Conclusion of the previous studies

The empirical evidence regarding determinants of firm's profitability provides different dimensions. Some researchers focused on firm and industry factors to examine which factors are most important to determine firm's profitability. Hansen & Warnerfelt (1989) and Spanos, Zaralis & Lioukas (2004) claimed that industry factors have strong influence on profitability but firm specific factors have twice effect on profitability as compare to industry factors. Some researchers only analyzed firm specific factors and used different proxies to measure firm performance. Some models took ROA as dependent variable some other used ROI, ROE or gross profit margin to measure firm's profitability. Different independent variables were used regarding this phenomenon like research and development

expenditure, liquidity, capital expenditure, sales, lagged profit, capital structure, sales etc.