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Determinants of Firms' Profitability in Pakistan

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Abstract
The purpose of this study is to identify the determinants of firm's profitability of Pakistani firms. The variables used in this study are capital structure, financial leverage, firm size and corporate profitability. The data was collected from 50 companies for period of 7 years from website of Karachi stock exchange. The ordinary least square regression was used to observe relationships among the dependent and independent variables. This study finds positive correlation among financial leverage and corporate profitability, and firm size and corporate profitability. Capital structure revealed negative relationships with corporate profitability. The study further anticipated the addition of supplementary variables to recover the strength and descriptive power of the general model.
Keywords: Corporate Profitability, Capital Structure, Firm Size, Financial Leverage.

1. Introduction

The majority of organizations are started its businesses with seek of earning profit and providing in exchange of sufficient incomes to its shareholders. Corporate profitability can fundamentally be defined as the level to which an organization can successfully and efficiently make the most of its obtainable funds and assets, and alter them into outstanding profits. Profitability of corporate business enterprises permits organizations to enhance endures negative shocks and participates in strengthen the business surroundings. The significance of corporate profitability could be evaluated at two levels i-e: micro and macro of the financial system. Return at micro level is the vital precondition of an indomitable organization and the inexpensive resource of money. For carry out every business, it is crucial purpose of an organization's management to realize profit (Bobakova, 2003). Cost effective and profitable business surroundings at macro level are improved and contributed to strengthen of the business surroundings. For this cause, evaluating the factors determining firm profitability and recognition of the sources of distinction in firm-level profitability has been considered as key research themes by the researchers in the fields of economics, strategic management, marketing, accounting and finance (Gaur and Gupta, 2011; Nunes , 2009; Jonsson, 2007). Organizations are usually supposed to perceive vital responsibility in emergent economies and their performance is one of the mainly significant issues for many firm stakeholders such as shareholders, creditors, employees, suppliers and governments (Bhayani, 2010; Madrid-Guijarro, Auken & Perez-de-Lema, 2007). The profitability of an organization is pretentious by several factors. These factors include fundamentals internal to each organization and several important external forces shaping earnings performance (Ani, Ugwunta, Ezeudu & Ugwuanyi, 2012).

Due to the fact that firms' financial performance straightforwardly influence the stability of the countries' economic systems in today's capitalist world economy, the factors affecting firm profitability justify special attention (Akbas &Karaduman, 2012). Profitability is the most important belief of the majority business entities; hence it's comparative significance in the investigation of business enlargement and endurance. There are lots of factors that can have impact on the profitability of firms. Among these factors, capital structure, firm size, and financial leverage have been measured for investigation in this study as determinants of corporate profitability. The study for that reason projected the following research questions:
1. What is the relationship between capital structure and corporate profitability?
2. What is the relationship between financial leverage and corporate profitability?
3. What is the relationship between firm size and corporate profitability?

The objectives of this research are to:
1. Investigate the relationship between capital structure and corporate profitability.
2. Investigate the relationship between financial leverage and corporate profitability.
3. Investigate the relationship between firm size and corporate profitability.

Hypotheses are:
H1: There is a positive correlation between capital structure and corporate profitability.

H2: There is a positive correlation between financial leverage and corporate profitability.
H3: There is a positive correlation between firm size and corporate profitability.

2.Literature Review

2.1 Capital Structure and Corporate Profitability

Osuji and Odita (2012) observed the impact of capital structure on the financial representations with a sample of 30 non-financial Nigerian firms listed on the Nigerian Stock Exchange from the period of 2004 to 2010. Panel data was collected and evaluated by ordinary least squares (OLS) technique. The finding interprets that a firm's capital structure surrogated by debt ratio has considerably adverse effect on the firm's financial profitability measured by return on asset (ROA) and return on equity (ROE).

Ogbulu and Emeni (2012) examined the relationship between capital structure, size, growth, tangibility, age and profitability of a firm. By cross-sectional analysis of data from 110 firms listed on the Nigerian stock exchange and analysis of the data by the OLS method, they created that the relationship between capital structure and profitability was irrelevant, although positive.

Omorogie and Erah (2010) analyzed the association between capital structure and corporate performance in Nigeria. They consumed data ranging between 1995 and 2009. A model was précised for the study consists of five descriptive variables; based on hypothetical underpinnings. The Ordinary Least Squares (OLS) technique of model evaluation was employed to determine the subsistence of relationships along with the variables. They originate that capital structure shows evidence of a considerable relationship with corporate performance. They also initiate that the other explanatory variables were valuable and had a statistical relationship with corporate performance.

Zeitun and Tian (2007) considered the cause of capital structure on corporate performance with a panel data sample of 167 Jordanian corporations during the period 1989 to 2003. Their outcome showed that a firm's capital structure has a appreciably negative impact on the firm's performance measures. They also found that the level of leverage has a extensively positive effect on the marketplace performance measures.

2.2 Firm Size and Corporate Profitability

Akbas and Karaduman (2012) observed the consequence of firm size on the profitability of manufacturing companies listed on the Istanbul Stock Exchange. Panel data has been used from the period of 2005 to 2011. Profitability was calculated by using Return on Assets, whereas as the alternatives of firm size were utilized by both total assets and total sales. According to the outcomes of the research, firm size had an affirmative contact on the profitability of manufacturing companies of Turkey.

Salawu, Asaolu and Yinusa (2012) measured the basis of financial policy and firm specific characteristics i-e: firm size on corporate performance. Panel data of 70 firms has used in this study for the period 1990 to 2006. Pooled OLS, Fixed Effect Model and Generalized Method of Moment panel model have been utilized in the assessment. Their results demonstrated that firm size, growth and foreign direct investment are negatively associated with firms' performance.

Ani, Ugwunta, Ezeudu and Ugwuanyi (2012) studied the determinants of the profitability of Nigerian banks. Their data placed was through up of 147 bank level observations more than a 10-year period, (2001 to 2010) regarding 15 banks that pleased the study responsibilities. Pooled OLS declared in a multiple regression form was made use for approximation of the coefficients. Their foremost results hinged on the reality that raise in firm size may not essentially direct to higher profits as a result of diseconomies of scale; as higher capital-assets ratio, and loans and advances contribute robustly to bank profitability.

Abu-Tapanjeh (2006) inspected the association between firm structure and profitability, taking into contemplation major uniqueness such as firm size, firm age, and debt ratio and ownership structure of 48 Jordanian companies from 1995 to 2004, listed in the Amman Stock Exchange.

The study occupies two model specifications with the intention of test the anticipated hypotheses, using the profitability determine of return on equity (ROE) return on investment (ROI). The results designate that a positive, insignificant association subsisted between the independent variables (including firm size) and profitability; with the exclusion of debt ratio.

2.3 Financial Leverage and Corporate Profitability

Ojo (2012) looked at the outcome of financial leverage of corporate performance on selected indicators in Nigeria. In an effort to contrast the former findings that were explicit to developed countries, econometric Vector Auto Regression (VAR) technique was utilized to evaluate the model. The conclusion of the study discovered that leverage shocks apply significantly on corporate performance in Nigeria.

Soumadi and Hayajneh (2011) explored the consequence of capital structure and financial leverage on the performance of firms of Jordan listed on the Amman stock market. The research exercised multiple regression model correspond by ordinary least squares (OLS) technique for identifying the effect of capital structure on the firm performance. The study explored 76 firms which include 53 industrial firms and 23 service firms from the period 2001 to 2006.Their results specified that capital structure was negatively related with firm performance. Moreover, research established that there was no considerable difference of financial leverage between high and low financial leverage firms.

Gill and Mathur (2011) observed the factors that inclined financial leverage of Canadian firms. In the middle of these factors was profitability considered by Returns on Assets (ROA). A sample of 166 firms of Canada listed on the Toronto Stock Exchange was preferred for a period of 3 years (2008 to 2010). The study practical relationship and non-experimental research design. Their results portray a negative non-significant correlation between financial leverage and profitability.

3.Research Methodology

The study exploits secondary data sourced from the financial statements of the listed companies on Karachi Stock Exchange. The data was collected from 50 companies for period of 7 years between 2006 and 2012. The data for the a number of years consist of Corporate Profitability i-e: returns on assets, Capital Structure that is measured as the summation of: reinvested profit, new capital, and long-term debt financing, Firm Size symbolize by sales turnover and Financial Leverage calculated as the amount of fixed interest bearing funds.

A model was assembled with the aim of analyzing the continuation of relationships between the dependent and the independent variable, and in addition probable relationships between and amongst the variables. The variables were examined through descriptive statistics, and the different relationships amongst the variables analyzed throughout the correlation matrix. The Ordinary Least Squares (OLS) regression technique is used with the aid of E-Views software.

Model Specification

CPRT = α + β1CSTR + β2FSIZ + β3FLEV + €

Whereas;

CPRT = Corporate Profitability
α = Constant
CSTR = Capital Structure
FSIZ = Firm Size
FLEV = Financial Leverage
€ = Error Term

4.Data Analysis

Table 4.1: Correlation Matrix

	CPRT	CSTR	FSIZ	FLEV
CPRT	1	-0.0085	0.0378	0.0172
CSTR	-0.0082	1	0.2797	0.5720
FSIZ	0.0368	0.2787	1	0.1958
FLEV	0.0172	0.5730	0.1957	1

Table 4.2: Descriptive Statistics

	CPRT	CSTR	FSIZ	FLEV
Mean	0.268516	15064.1	43267.33	7977.293
Median	0.1385	2497	9311.5	861.5
Maximum	13.380	262351	338420	194208
Minimum	-3.908	2	211	0
Std. Dev.	1.07328	34451.46	62729.37	25671.77
Skewness	9.02551	4.462748	2.078009	5.172686
Kurtosis	113.6473	25.70994	7.855359	30.67046
Jarque-Bera	104738.8	4961.717	340.3917	7272.343
Probability	0	0	0	0
Sum	53.9233	3012819	8653465	1593259
Sum Sq. Dev.	233.1376	2.36E+11	7.88E+11	1.31E+11
No. of Firms	50	50	50	50
Observations	150	150	150	150

5.Results and Discussions

An evaluation of the descriptive statistics for the dependent and explanatory variables relates the subsequent observations. Corporate profitability practiced a diminutive growth rate with the average growth rate standing at

26.85% (table 4.2). The discrepancy in profitability varies from -3.908 (table 4.2) minimum values to a maximum value of 13.380 (table 4.2). This characterizes a huge discrepancy between firms in case of performance.

In view of the standard deviation (SD) which indicates the level of difference or degree of distribution of the variables as of their mean, it discloses that corporate profitability is quietly stable (least unpredictable) with a SD of 1.07328 (table 4.2) in contrast with other variables.

OLS Regression Results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.278362	0.094771	2.937218	0.0037
CSTR	-2.08E-06	5.94E-06	-0.348659	0.7270
FSIZ	5.57E-07	1.60E-06	0.358073	0.7274
FLEV	6.61E-07	7.43E-06	0.088957	0.9292

R-squared	0.002940	Mean dependent var	0.269617
Adjusted R-squared	0.018932	S.D. dependent var	1.082380
S.E. of regression	1.091816	Akaike info criterion	3.038244
Sum squared resid	232.4522	Schwarz criterion	3.120702
Log likelihood	298.8244	F-statistic	0.143725
Durbin-Watson stat	2.213479	Prob(F-statistic)	0.964395

The ordinary least square regression (OLS) results show that a negative correlation exist between corporate profitability and capital structure with a t-value of -0.348659. Firm size shows an evidence of a positive correlation with corporate profitability with a t-value of 0.358073, whereas the correlation between financial leverage and corporate profitability was established to be negative. All the explanatory variables conversely display non-significant relations with the dependent variable. This is reasonable by an adjusted R2 of 0.018932; which illustrated that merely about 2% of the dependent variable is elucidated by the entirety of the independent variable.

The probability (F-statistics) of 0.964395 is a suggestion of a comparatively weak model in the purpose of the total organized variations of the dependent variable. The model though reveals nonexistence of auto correlation between the independent variables with a Durbin-Watson statistics of 2.213479, signifying that there is differentiation between the precedent and current error terms. The correlation matrix provides an image of the subsistence of relevant or irrelevant relationships among the independent variables; as a statistical value 0.50 to 1 is observed as significant. Capital structure shows an evidence of a significant correlation with liquidity and financial leverage; while financial leverage also demonstrates a significant relationship with liquidity. All other variables revealed non-significant relationships along with themselves.

6.Conclusion and Recommendations

Capital structure and liquidity obsessed negative correlations with corporate profitability. The negative correlation between liquidity and corporate profitability can be accepted out of the idealized liquidity-profitability substitution which speculates that raises in liquidity normally provides increase to decline in profitability planes due to the opportunity cost of holding cash rather than investing it. Firm size and leverage are observed to positively influence corporate profitability in Pakistan. Theories that are sufficient for original macroeconomic variables should be industrialized as an alternative of depending on the prearranged theories of the advanced developed countries, as these theories cannot be suitable proxies for move forward the way of the developing countries.

Several studies (Osuji & Odita, 2012; Abu-Tapanjeh, 2006) that employed diverse profitability measures accomplished diverse outcomes. Accordingly, it can be disputed that unusual conclusions can result from differences in performance measures. This occurrence may also be the end result of the reality that studies apply unsatisfactory performance measures, as the drawbacks of using untreated accounting measures to estimate corporate performance are well-known (Osuji & Odita, 2012). It is significance note down, nevertheless, that a large amount of the studies were only performed on one country. Therefore, different conclusions may effect from the persuaded of the institutional framework on the relations. Firm influences and uniqueness are to a large scope unwavering by the character of the business surroundings within which the firm functions. This occurrence could lead to inconsistencies in the generation of statistical outcomes that mean to give out the rationale of generality.

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