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CAPITAL STRUCTURE: IMPACT OVER MANAGEMENT EFFICIENCY STUDY OF THE TEXTILE SECTOR OF PAKISTAN

Faheem Shahid[1]

[1]National College of Business Administration & Economics Lahore, Pakistan

Umbareen Chaudhry[2]

[2]University of Central Punjab Lahore, Pakistan

ABSTRACT

This research paper investigate an important question that what is the relationship between capital structure and efficiency of the management, in a company where the management has direct vested interest in shape of equity financing, will the management perform more efficiently, vice versa or there is no relationship between management efficiency and capital structure, the scope of study is limited to textile sector of Pakistan. The previous study based upon the variables like Profit Maximization etc but in this study to calculate the management's efficiency, Assets Turnover Ratio has been taken into consideration, which reflects that how efficiently the company is utilizing its assets to produce goods for sale purpose and to analyze the vested interest of the company's management, debt equity ratio of the company has been chosen. The results indicate that there is no significant relationship between the financing structure and management efficiency. The work is primarily important to ascertain the indirect cost/benefit while approaching optimal capital structure, the work done so far in the field of optimal capital structure account for only the direct cost of capital and the repayment capacity of the company. This research paper opened a new field of thought that indirect cost/benefits, those actually relate with utilization of the raised capital, should be account for while reaching the optimal capital structure.

KEYWORDS: *Financing Structure, Cost of Capital, Bankruptcy Costs, Assets, Return on Equity*

INTRODUCTION

There are different characteristics including the ownership structure of the organization, capital structure and management efficiency, all these factors has an impact on the overall performance of the company (Kokoreva, & Stepanova, 2013). Research in corporate finance theory began with the famous work of Modigliani and Miller, they argued that if market is perfect and information is available at all levels the capital structure has no impact over the firm value (Modigliani, The cost of capital, corporation finance and the theory of investment, 1958). But later Modigliani and Miller found that capital structure determines the performance of the firms, this happened with the inclusion of taxes and bankruptcy costs which are to be taken into consideration while determining the optimal capital structure of a firm. (Modigliani, 1963). Whenever the management move into decide the way to finance its assets the decision need to be made very carefully and usually followed a complex process that include comprehensive analysis at different levels. Different ways have been chosen by different researcher and analyst to evaluate the capital structure with optimal level and one was the mean average return. (Margaritis & Psillaki, 2009).

LITERATURE REVIEW

Many studies have been made in the area. It has been argued that firms with more profits usually have less portion of debt in its capital structure (Myers, 1977). Further it was argued years back that, managers start using assets of the corporate for their own use when they hold little share of ownership and shareholders are spread around to be united and ensure value maximization (Berle, A.A. Jr. & G.C. Means, 1932). Another study reveals that when firm is growing it usually maintains high debt ratio in capital structure (Zeitun & Tian). With the use of debt the company's get the benefit of the tax deduction. An appropriate capital structure can be define as the level where company is paying the cost beyond which the bankruptcy cost increase than the tax sheltering, and a firms target is to minimize the cost with maximum benefits, however due to tax shelter it has been observed that usually firms have more debt in its capital structure to get more benefits. Agency cost is another type of cost considered while moving on optimal capital structure level. The theory of agency cost argues that this cost occurred due to conflict of interest between stakeholders at different levels, this cost dealt as an important financial and non-financial issue related with corporate governance. Capital structure got influenced by Information asymmetry and agency problems because of signaling power and agency costs (DeMarzo, P., & Sannikov, Y, 2004).

The property rights of the firm can be protected with a reduction of agency cost by separating ownership and management (Barbosa, N., & Louri, H., 2002). However the separation in ownership and control may cause inefficient performance by the managers by taking into consideration their own preferences that may not in the best interest of the firm. The agency cost occurred due to external ownership is equal to the value lost because of personal agendas of the managers (Berger & di Patti, 2003). Higher level of leverage on one side also reduce the agency cost by threatening manager with liquidation that may lead to loss of salaries, reputation etc. (Grossman, 1982). With higher level of leverage the company has very low choices of investment so low chances of conflict of opinion (Myers, 1977). Conceptually, performance improvement can be achieved with concentrated ownership as it increases the monitoring (John S. Earle, Csaba Kucsera, & Álmos Telegdy, 2004). In another perspective, rise in ownership concentration will lead to entrenchment of management (Fama, 1983).

The performance of the firm to is a controversial issue to discuss because it can be judge from different ways. Organization theory and strategic management raised this issue (Murphy G. B., 1996). Performance measures can be categorized into financial measures and operational measures. Financial performance to determine the firms effectiveness includes increase in profit, maximizing profit on assets, and maximizing benefits for the shareholders (Chakravarthy B. S., 1986). Operational performance measures, such as growth in sales and growth in market share, provide a broad definition of performance as they focus on the factors that ultimately lead to financial performance (Hoffer C. W., 1987). Environmental factors also influence the firm performance for example if a performance measure based upon the market then an inefficient market will not provide an appropriate result. Commonly used performance measures based upon the returns like return on assets, return on equity etc. Most widely used performance measure is return on assets (Reese, 1978). Two terms Accounting profits and increase in shareholder value are not same (Berger & di Patti, 2003).

Different researchers found different relationships between performance measures and firm's capital structure; Krishnan (1997) found that there is significantly negative relationship between debt to equity and return on equity. Schiantarelli and Sembenelli (1999) found that there is a positive relationship between medium term performance and initial debt maturity. A study by Barclay and Smith (1995)proves that when a firm is in low growth or big in size usually prefer to use debt financing by way of issuing long term debt Berger & di Patti (2003) conduct their study on the banking sector and it has been found that higher leverage lead to higher profit efficiency.

Pushner (1995) analyzed the empirical relationship between capital structure, ownership structure and performance of the firm in Japan. He found that the leverage and productivity has negative relationship. Kokoreva, & Stepanova (2013) found that concentrated ownership and involvement of owners into company lead to higher market performance even in the crisis where growth rates are negative, the study was conducted in Russian market. In a study within the scope of Czhech Republic market it was found that the more concentrated the ownership of a firm, the higher its market value (Stijn Claessens,, Simeon Djankov,, & Gerhard, 1997).

VARIABLES

Financial Structure:-

Financial structure of the company can be ascertain through its debt to equity ratio, the debt represents the amount of long term loans so obtained by

the company to finance its assets, and the equity reflects the amount of funds provided by the shareholders in form of capital and the reserves (if any) comprises of previous years' accumulated profits. In the study Debt to Equity ratio serve as an independent variable in relation to company's performance.

Management Efficiency:-

This study differentiate from all previous studies, as in all the previous studies the efficiency model used were based upon variables based upon returns only. Farell (1957) describe efficiency by dividing it into two major components the first is technical efficiency relates to firm's ability to obtain maximum output with minimum input and the second is allocative efficiency which describe the optimal mix of firm's input. In a study in the Indian Market, the study was done by taking Leverage i.e. Debt to Total Assets as a efficiency measure, the result was there is no significant relationship between leverage and firm's performance (Khan, Capital Structure, Equity Ownership adn Firm Performance: Evidence from India, 2008).

In this study the variable to ascertain the efficiency of the firm chosen is Asset Turnover Ratio of the company as, more efficiently the assets will be utilized; more will be the revenue for the company. Who will utilize the assets or who is responsible for the efficient utilizationof resources, for sure the owner(s) or the top management of the company. Their performance can be measured by accounting for the utilization of assets they are managing.

The utilization of assets leads to production and then revenue generation by selling that production. So to ascertain the efficiency of management the Asset Turnover ratio has been taken into account which actually describes that how much sales revenue generated through utilization of One Rupee Asset, more the ratio more efficient will be the utilization of the assets. This ratio differentiate this study from previously conducted analysis as all of them were based upon ratios like Profit Maximization, but Profit Maximization is not the only task, there is a need to comprehensively focus on management efficiency not the financial tactics of the management.

SCOPE OF STUDY

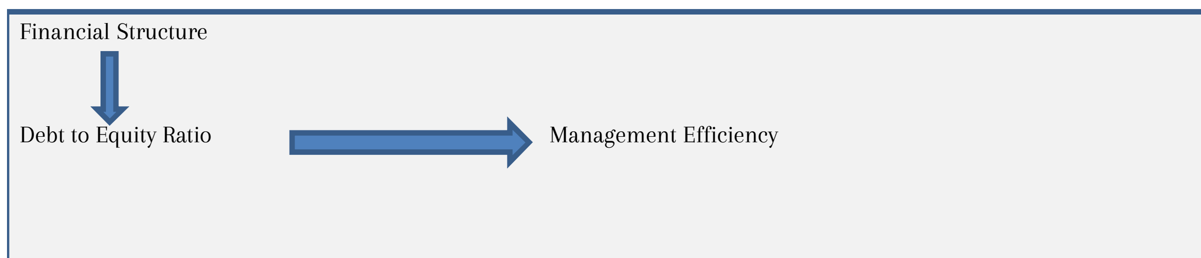
For study purpose the textile sector of the Pakistan has been chosen, the reason to choose this sector is the textile sector shows a volatile performance over the years and to meet up different types of crisis different strategies opt by the different companies, so the sector's capital structure and asset utilization covers a variety of circumstances.

HYPOTHESIS

H0 = There is no relationship between capital structure and Management efficiency.

H1 = There is relationship between capital structure and management efficiency.

Theoretical Framework and variable:



The Debt to Equity ratio has been taken into account as an independent variable as firms are free to choose its capital structure. The Asset Turnover is dependent variable in the study, the reason to choose Sales Turnover is the other ratio related with profitability etc, actually influenced by the indirect cost/benefits like management may earn more profit in proportionate due to cheaper cost of debt in the total cost of capital. But the ratio of asset turnover describe only the utilization of assets, it has not been influenced by any non operating income/expense.

MODEL OF STUDY

Asset Turnover= @+BDTE+eit

Case Processing Summary:-

	Cases					
	Valid		Missing		Total	
	N	Percent	N	Percent	N	Percent
Asset Turnover * Debt Equity Ratio	41	41.0%	59	59.0%	100	100.0%

Symmetric Measures:-

		Value	Asymp. Std. Error[a]	Approx. T[b]	Approx. Sig.
Interval by Interval	Pearson's R	.246	.097	1.587	.121[c]
Ordinal by Ordinal	Spearman Correlation	.299	.154	1.957	.058[c]
	N of Valid Cases	41			

a. Not assuming the null hypothesis.

b. Using the asymptotic standard error assuming the null hypothesis.

c. Based on normal approximation.

Regression:-

Variables Entered/Removed[b]

Model	Variables Entered	Variables Removed	Method
1	Debt Equity Ratio[a]	.	Enter

a. All requested variables entered.

b. Dependent Variable: Asset Turnover

Model Summary:-

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.246[a]	.061	.037	.7037687

a. Predictors: (Constant), Debt Equity Ratio

Model Summary:-

Model	Change Statistics				
	R Square Change	F Change	df1	df2	Sig. F Change
1	.061	2.519	1	39	.121

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1.248	1	1.248	2.519	.121[a]
	Residual	19.316	39	.495		
	Total	20.564	40			

a. Predictors: (Constant), Debt Equity Ratio

b. Dependent Variable: Asset Turnover

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	T	Sig.
1	(Constant)	1.140	.111		10.307	.000
	Debt Equity Ratio	.079	.050	.246	1.587	.121

a. Dependent Variable: Asset Turnover

RESULT ANALYSIS

The std error is on higher side and significant is also much greater than the acceptable level, the R square shows that there is very insignificant relation between the two variable, conclusively the result of the data shows that there is no relation between optimal Capital Structure and Asset Turnover Ratio which proves the null hypothesis correct.

CONCLUSION

This study solved an unanswered question, with the results it is clear that there is no relationship between efficiency of management and their vested interest in the organization, rather there may some other factors that has influence the management efficiency. The capital structure of the company will not affect the efficiency of the management, however, to utilize a capital we need an efficient management.

LIMITATIONS OF THE STUDY

The study based on following limitations;

- The data gathered for the textile sector of the Pakistan and of the firms related to corporate sector i.e. Public Limited listed only and there is a room to extend the study on other sector specifically the small and medium sector industry.
- To analyze the efficiency of the company we take into consideration the Asset Turn Over ratio the same study can be enhanced with respect to other efficiency ratios as well.
- The study based on Pakistani environment only, and may enhance to other geographical areas as well.

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