

IMPACT OF POLITICAL STABILITY AND MANAGERIAL OWNERSHIP ON FIRM'S PROFITABILITY

Zeshan Anwar, Dr. Kausar Abbass, and Sadia Shaikh

ABSTRACT

The vibrant business sector is a dynamic segment for Pakistan's economic development because it offers employment to a larger population of skilled and unskilled labour; creates foreign reserves through exports; and also satisfies local demand for the products. Moreover, the listed companies perform a significant function in the growth of an economy, however, on pragmatic grounds, access to capital is evidenced as a matter of grave concern for the business sector in Pakistan. Moreover, it has been observed that in order to reduce the firms' agency costs, managerial ownership is utilized. Hence, in this essence, this research investigates the relationship of political stability, managerial ownership, dividends, sales, and total assets with the firm's profitability in Pakistan during 2013-2017. The findings depict that the variables of political stability, total assets, dividends, and sales, positively and significantly affect the firm's profitability, while, managerial ownership is in significantly associated with profitability.

Keywords: *Political Stability; Managerial Ownership; Pakistan; Profitability.*

INTRODUCTION

The combination of debt and equity which is used to finance the capital assets is labelled as the firm's capital structure. The extent of debt finance is measured through leverage as the debt and equity are fundamental components of the capital structure. For businesses in a developing country like Pakistan, acquiring finance is considered as a critical issue due to informational unpredictability for external finance and also due to inadequate internal financial resources. Hence, the opportunities for capital financing are lesser and far-off as compared to developed economies. Moreover, government policies affect the interest rate on debt finance and other financing resources. In this regard, Singh (1995), claimed that

businesses in developing economies depend more on external financing than internal finance. The corporate governance literature presumes a key conflict between stockholders and management in business (Berle & Gardiner, 1933; Jensen & Meckling, 1976). The stockholders' major concern in business is their investment return, whereas, the managers may want power and repute of running a larger business in addition to other perquisites. Therefore, more availability of insider information to managers and relatively weaker situation of numerous segregated stockholders propose that the managers may have more advantage. The researchers have offered various measures to reduce this agency issue including realignment of perquisites, monitoring, and discipline.

A business can realign the incentives of stockholders and managers by stock options and market incentives (Fama & Jensen, 1983). The monitoring of operations by independent directors confirm that managers work for the best interest of stockholders (Fama & Jensen, 1983). If the CEO of a firm is unable in maximizing stockholders' interest, then the board directors can remove them, and if a firm ignores the benefit of the stockholder, it will be disciplined through hostile takeovers (Jensen & Ruback, 1983). Jensen and Meckling (1976), asserted that separating the ownership and control results in more differences between managers and stockholders. The authors also described that the managerial ownership assists the organization in aligning owners and managers' interests and thus reduce the agency issues. Contrarily, the researchers also argued that managers are entrenched due to greater managerial ownership which aggravate the agency issues (Demsetz, 1983; Fama & Jensen, 1983).

This study investigates the association of political instability, managerial ownership, sales, firm size, and dividends with the firm's profitability in Pakistan by employing OLS model on data from 2013 to 2017. As, previously, there is limited research which attempted to analyze this association for Pakistani listed companies, thus justifies the rationale of this research endeavour. The remaining paper is structured as follows: Literature review is discussed in the next section, research methodology and results have been discussed in further sections, whereas, the conclusion has been provided in the end.

LITERATURE REVIEW

Rajan and Zingales (1995), analysed leverage and different components of leverage in G-7 economies and found that there was a

positive association of profitability with leverage only in Germany, whereas, tangibility has a positive tendency in all economies. The variable of leverage is positively associated with size except for Germany. Opler, Saron, and Titman (1997); Levy and Alderson (1998), both attempted to find a formula which reveals a firm's appropriate capital structure and found consideration analyses as their research outcome. Nonetheless Aswath (2001), found factors of debt and equity financing and stated that businesses should recognize the costs and benefits of debt finance, but businesses use the following benchmarks based on businesses in similar industries, pecking-order theory; and the life cycle for choosing the capital structure. Deloof (2003), suggested that management of working capital has a positive association with profitability; whereas, profitability was found to have a negative association with receivables in the collection period. If a business reduces the collection, then there will be an increase in profitability. Moreover, better working capital management is extremely significant for stockholders as well. Antonios, Guney, and Paudyal (2002), analysed factors of leverage for the firms in Germany, Britain, and France and reported that variable of leverage has a positive effect on the size, whereas, size positively affect leverage. Mukhopadhyay (2004), found that an effective structure of working capital assists in increasing a firm's value. The study was conducted on fifty-eight smaller businesses in Mauritius during 1998-2003. The results also depict that lower profitability is associated with higher investment in receivables. Shah and Sana (2006), described that managerial ownership has a positive return through careful management of working capital. The study was conducted on data from 2001 to 2005 from seven oil and gas companies. Lazaridis and Tryfonidis (2006), examined the association of profitability with capital management for Greece firms and depicted that cash conversion is positively associated with profitability. Frank and Goyal (2008), concluded that several variables are associated with debt ratio while some factors have significant influence. The authors also described that variables of leverage and size have a positive association. Ilyas (2008), stated that owing to different reasons, the businesses develop a capital structure that assists them in guiding to raise funds and it would be an ideal structure.

For Pakistan's economy, Butt and Hasan (2009) determined the relation of capital structure with governance practices for Pakistani firms for 2002-2005 and depicted that board's size and managerial

ownership have a negative and significant association with debt to equity ratio. The results also depict that the firm's financing has an insignificant relation with independent directors and CEO duality. The variables of business size and ROA significantly affect capital structure. Raheman, Afza, Qayyum, and Bodla (2010), concluded that smaller conversion cycles and management of working capital affect a firm's profitability and have a major contribution to business performance. The managers can improve stockholders' value through better management of working capital and reduction in the conversion cycle. Nazir, Hussain, and Nawaz (2011) demonstrated that businesses in Pakistan employed pecking order and trade-off theories in their financing arrangements and the variable of leverage has no effect on ownership. Shah and Wasim (2011), studied the influence of ownership structure on the organization's dividend pay-out policy for Pakistani businesses during 2002-2006 and concluded that ownership structure has a significant impact on dividend-pay-out policy. Din and Javid (2011) examined the association of managerial ownership and firm performance during 2000-2007 and concluded that leverage variable has a negative impact on managerial ownership, whereas, managerial ownership significantly and negatively affect dividend policy.

Al-Jafari and Al Samman (2015), determined important factors of profitability for businesses in Oman by utilizing the data from 2006 to 2013 and concluded that business size, fixed assets, growth, and working capital significantly affect profitability. Margaretha and Supartika (2016), determined determinants of profitability for SME's in Indonesia and discovered that business size, lagged profitability, growth, industry affiliation and productivity significantly affect profitability. Chen, Hung, and Wang (2018) examined the association of mandatory CSR disclosure with profitability for Chinese firms and concluded that CSR disclosure negatively and significantly affect profitability. Khan, Shamim, and Goyal (2018) identified determinants of profitability for telecom businesses in India during 2004 to 2017 and reported that growth and firm size positively affect profitability, whereas, leverage has a negative impact on profitability for Indian telecom organizations.

Azhar and Ahmed (2019), explored the association of business size with firm's profitability in Pakistan's textile sector for a period of 2012-2016 and found an insignificant association of business size with firm's profitability in Pakistan's textile sector. Fuertes-Callén and Cuellar-

Fernández (2019), determined relation of growth with profitability during a crisis for manufacturing business in Spain by utilizing data for the pre-crisis period and crisis period. The authors concluded that growth positively affects profitability in the short run, whereas, the effect of profitability on growth is dependent on growth measure employed.

It can be observed from the literature review that very few researchers have analyzed the association of managerial ownership and political instability with the firm's profitability for Pakistani firms. Thus, this research attempts to bridge this gap by determining the association of managerial ownership, political instability, total assets, dividends, and sales with firm's profitability for Pakistani businesses by employing OLS model during 2013 to 2017.

RESEARCH METHODOLOGY

To determine the association of political instability and managerial ownership with the firm's profitability, the data for the study is used for years 2013 to 2017. Firstly, the descriptive analyses technique have been conducted and the results were explained; secondly, correlation analyses among the variables have also been conducted. Finally, the OLS model is used for analysing the relationship between the variables.

This study has used the following regression model:

$$\text{Profitability} = \beta_0 + \beta_1\text{PolStab} + \beta_2\text{ManagOwn} + \beta_3\text{TotalAssets} + \beta_4\text{Sales} + \beta_5\text{Dividends} + U_t$$

Where:

Profitability = Natural log of earnings after taxes

PolStab = Value of 0 for military government and 1 for civilian government

ManagOwn = Ratio of managers' shareholdings

TotalAssets = Natural log for total assets of a firm

Sales = Amount of total sales divided with total revenue

Dividends = Percentage of dividend payments

The SPSS software version 20 is utilized for performing the above-stated analyses.

RESULTS

Firstly, descriptive analyses are measured, and results have been reported in Table 1:

Table 1. Descriptive Statistics

	Profitability	PolStab	Dividend	Sales	Total Assets	Manag Own
Mean	3.926	0.580	12.779	8.716	8.627	53.692
Median	5.020	1.000	7.330	8.800	8.530	57.840
Maximum	8.990	1.000	70.000	11.130	11.580	84.350
Minimum	-5.920	0.000	0.000	6.750	6.160	1.450
Std. Dev.	4.553	0.502	13.770	0.837	0.784	21.080
Skewness	-0.654	-0.344	2.138	-0.183	0.256	-0.247

Table 1 depicts that Dividends and Profitability variables have higher variation as the standard deviation value for these variables is larger than their mean value. The correlation matrix is depicted in table 2.

Table 2. Correlation Matrix

Name of Variable	Profitability	Pol Stab	Total Assets	Sales	Dividends	Manag Own
Profitability	1					
PolStab	.248**	1				
TotalAssets	.484*	-.312	1			
Sales	.491**	.406	.548**	1		
Dividends	.521**	.209	.312	.406*	1	
ManagOwn	.172	.115	-.319	-.169	.204	1

Table 2 indicates that all the variables have reasonable correlation and multicollinearity issue does not exist in data. Finally, the OLS model is to determine the association of independent variables with the dependent variable and findings have been reported in tables 3, 4 & 5.

Table 3. Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.826a	.782	.619	2.275	1.578

Table 4. ANOVA

Model	Sum of Squares	Df	Mean Square	F	Sig.
1 Regression	238.098	4	50.022	6.760	.000a
Residual	268.184	38	6.637		
Total	506.282	42			

Table 5. Coefficients^a

Model	Unstandardized Coefficients		Standardized Coefficients Beta	t Sig.	
	B	Std. Error			
(Constant)	-10.501	3.853		-3.134	.003
PolStab	0.586***	0.301	-1.942	0.064	.006
ManagOwn	-0.008	0.014	0.027	0.167	.725
TotalAssets	1.365**	0.750	-0.327	-1.547	.026
Sales	2.158**	0.672	0.726	3.569	.002
Dividends	0.075**	0.026	0.252	1.803	.045

a. Dependent Variable: Profitability

*** Significant at 1% level, ** Significant at 5% level, * Significant at 10 level

The results presented in table 3 depict that adjusted R Square value is 0.619 which indicate that all independent variables are able to explain 61.9 percent of variations occurred in the firm's profitability for Pakistan. The findings also indicate that the Durbin-Watson figure is 1.578 which means that there is no multicollinearity issue in data. Table 4 depicts that the P-Value is 0.000 which means that overall the model has a significant impact in explaining the firm's profitability.

The table 5 depicts that the variable of political stability is positively and significantly affecting the profitability of Pakistani businesses which means that if there will be 1 percent increase in political stability, it will result in 0.86 percent increase in profitability. The variable of total assets has a significant and positive association with profitability which means that if total assets will increase by 1 percent, it will result in an increase of 1.365 in profitability. The findings also indicate that Sales variable is also positively and significantly affecting profitability which means that if this variable will increase by 1 percent, it will result in an increase of 2.158 percent in firm's profitability. The dividends variable also has a significant and positive relationship with the firm's profitability which means that if this variable will increase by 1 percent, it will result in an increase of 0.075 percent in profitability. Furthermore, managerial ownership has an insignificant association with profitability in Pakistan. The findings depict that the variable of political stability has a significant impact on profitability, but managerial ownership does not have a significant impact.

CONCLUSION

This study investigates the association of managerial ownership and political stability with firms' profitability in Pakistan. To achieve this objective, the relationship of managerial ownership, political stability, total assets, dividends, and sales with the profitability of Pakistani firms is determined by OLS model from 2013 to 2017. The findings depict that variable of political stability, sales, total assets, and dividends are significantly affecting the profitability of organizations, whereas, managerial ownership is insignificant in explaining the firm's profitability. The findings suggest that a firm's profitability of Pakistani businesses is affected by political stability but not by managerial ownership.

Based on the findings, the following measures are suggested for improving the profitability of Pakistani firms:

- The political environment should be stabilized for increasing profitability.
- The firms should increase their assets for improving profitability.
- The businesses should pay more dividends cautiously to improve profitability.
- The firms should work to enhance their sales for boosting profitability.

RESEARCH IMPLICATIONS

Following are the recommendations and practical implications of this research:

- The Government of Pakistan should take some effective measures for improving political stability to promote the business environment, attract local and overseas investors, and for improving profitability of firms.
- The organizations should distribute higher dividends for increasing the trust of investors and improving profitability.
- The managers should take effective measures for increasing sales volume and improving profitability.
- The organizations should invest in those assets which ultimately result in higher profitability for business organizations.

RECOMMENDATIONS FOR FUTURE RESEARCH

- In this study due to time and resource limitations, a smaller sample size has been considered. For future studies, a larger sample size with inclusion of more diverse subgroups can be included.
- To embrace diversity, comparison of different economic sectors can be considered.
- This study has taken Pakistan as the study area, to widen the research sphere and to conclude more generalized results, cross country data analysis can be utilized.
- For expanding the research scope, other factors such as terrorism and electricity load-shedding can also be considered in future similar studies.

REFERENCES

- Al-Jafari, M. K., & Al Samman, H. (2015). Determinants of profitability: evidence from industrial companies listed on Muscat Securities Market. *Review of European Studies*, 7(11), 303-311.
- Antonios, A., Guney, Y., & Paudyal, K. (2002). Determinants of Corporate Capital Structure: Evidence from European Counties. *Journal of Economics*, 3(10), 1-12.
- Aswath, D. (2001). *Corporate finance: theory and practice (International Edition)*. New York: Willey.
- Azhar, K. A., & Ahmed, N. (2019). Relationship between firm size and profitability: investigation from textile sector of Pakistan. *Business and Management*, 11(2), 62-73.
- Berle, A. A., & Gardiner, C. (1933). Means. Book IV: Reorientation of Enterprise. *The Modern Corporation and Private Property*. New York: Macmillan Co.
- Butt, S. A., & Hasan, A. (2009). Impact of ownership structure and corporate governance on the capital structure of Pakistani listed companies. *International Journal of Business & Management*, 4(2), 50-57.
- Chen, Y. C., Hung, M., & Wang, Y. (2018). The effect of mandatory CSR disclosure on firm profitability and social externalities: Evidence from China. *Journal of Accounting and Economics*, 65(1), 169-190.
- Deloof, M. (2003). Does working capital management affect the profitability of Belgian firms? *Journal of Business Finance & Accounting*, 30(3&4), 573-588.
- Demsetz, H. (1983). The structure of ownership and the theory of the firm. *The Journal of Law and Economics*, 26(2), 375-390.
- Din, S. U., & Javid, A. Y. (2011). Impact of managerial ownership on financial policies and the firm's performance: evidence Pakistani manufacturing firms. *International Research Journal of Finance and Economics*, 81(1), 13-29.
- Fama, E. F., & Jensen, M. C. (1983). Agency problems and residual claims. *The Journal of Law and Economics*, 26(2), 327-349.

- Frank, M. Z., & Goyal, V. K. (2008). Trade-off and pecking order theories of debt. In *Handbook of empirical corporate finance* (pp. 135-202). Elsevier. Retrieved from: <https://doi.org/10.1016/B978-0-444-53265-7.50004-4>
- Fuertes-Callén, Y., & Cuellar-Fernández, B. (2019). Inter-relationship between firm growth and profitability in a context of economic crisis. *Journal of Business Economics and Management*, 20(1), 86-106.
- Ilyas, J. (2008). The determinants of capital structure: Analysis of non-financial firms listed in Karachi stock exchange in Pakistan. *Journal of Managerial Sciences*, 2(2), 279-307.
- Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behaviour, agency costs and ownership structure. *Journal of Financial Economics*, 3(4), 305-360.
- Jensen, M. C., & Ruback, R. S. (1983). The market for corporate control: The scientific evidence. *Journal of Financial Economics*, 11(1-4), 5-50.
- Khan, T., Shamim, M., & Goyal, J. (2018). Panel Data Analysis of Profitability Determinants: Evidence from Indian Telecom Companies. *Theoretical Economics Letters*, 8(8), 3581-3593.
- Lazaridis, I., & Tryfonidis, D. (2006). Relationship between working capital management and profitability of listed companies in the Athens stock exchange. *Journal of Financial Management and Analysis*, 19(1), 26-35.
- Levy, H., & Alderson, M. J. (1998). *Principles of corporate finance*. Tennessee: South-Western Publications.
- Margaretha, F., & Supartika, N. (2016). Factors affecting the profitability of small medium enterprises (SMEs) firm listed in Indonesia Stock Exchange. *Journal of Economics, Business and Management*, 4(2), 132-137.
- Mukhopadhyay, D. (2004). Working capital management in heavy engineering firms-A case study. *Management Accountant-Calcutta*, 39(1), 317-323.
- Nazir, S., Husnain, R., & Nawaz, M. M. (2011). Capital structure Decision a Case of Pakistani Listed Textile Firms. *Middle East J. Sci. Res*, 9(2), 218-224.

- Opler, T., Saron, M., & Titman, S. (1997). *Corporate Liability Management*. New York: Mimeo.
- Raheman, A., Afza, T., Qayyum, A., & Bodla, M. A. (2010). Working capital management and corporate performance of the manufacturing sector in Pakistan. *International Research Journal of Finance and Economics*, 47(1), 156-169.
- Rajan, R. G., & Zingales, L. (1995). What do we know about capital structure? Some evidence from international data. *The Journal of Finance*, 50(5), 1421-1460.
- Shah, A. Z., & Wasim, U. (2011). Impact of ownership structure on the dividend policy of the firm. In *International Conference on E-Business, Management & Economics*. Hong Kong: IPEDR.
- Shah, S. A., & Sana, A. (2006). Impact of working capital management on the profitability of the oil and gas sector of Pakistan. *European Journal of Scientific Research*, 15(3), 301-307.
- Singh, A. (1995). Corporate financial patterns in industrializing economies: A comparative international study. *Working paper (2)*, World Bank- International Finance Corporation.