Impact of asset utilization and finance expenses on profitability of the textile industry of Pakistan

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Abstract

The textile industry of Pakistan is one of the top most industries of the country as Pakistan is the fourth largest producer of cotton in the world. Despite of the adverse economic conditions this industry has always contributed to the Gross Domestic Product of the country. In order to sustain and increase the firm's profitability there are certain determinants which need to be maintained out of which the financing costs and fixed asset turnover ratio are the two noticeable determinants of the firm's profitability. This study is predominantly focused on the impact of financing costs and fixed asset turnover ratio of the textile sector of Pakistan. The study is conducted to determine whether the high financing costs and low fixed asset turnover ratio is affecting the profitability of textile sector. For this purpose a research model is developed and tested. The study was conducted with the textile firms of Pakistan and the inputs were obtained from the corporate segment of textile industry. The result and analysis depicted that there is a high impact of financing costs and low impact of fixed asset turnover ratio on the industry's profitability.

Keywords: Fixed asset turnover, financing expense, profitability, textile

Introduction

The textile sector is the fourth largest producer of cotton in the world. With all the favourable scenarios the textile manufacturing organizations in Pakistan also faces some issues internally which are greatly influenced by the external factors such as currency devaluation, raw material prices, interest rates, taxes imposed and many more. These uncontrollable external factors majorly impact the financing costs of the industry. Any organization needs finances to run its operations regardless of the size or how huge profits does it make. Similarly textile firms face the same issue when it comes to financing the firm's operations. The fluctuations in the interest rate by the central bank disturb the operations of the industry which in turn hampers the firm's profitability. On the other hand the other important factor that we have taken into consideration to investigate its impact on the industry's profitability is fixed asset turnover ratio. This ratio refers to how efficiently the organization is employing its fixed assets that are plant, equipment and machinery to generate sales out of it. Normally the low fixed asset turnover ratio reflects the inefficiency of the organization to utilize its assets to the full capacity in generating sales and a relatively high ratio for the industry is desirable as per the industry's benchmark. We selected to work on these issues because this study will give a new direction to the industries and readers of this study, that other than the economic issues, profitability can be increased if the industry control and manage the its financing expenses and fixed asset turnover ratio. This article evaluates the impact and outlines the research methodology of this study where the market insights were gathered through the questionnaire and interview. The hypotheses are developed for testing the assumptions made in the study after thoroughly going through the previous literature and published annual reports. The inputs obtained are tested and analysed through central tendency test of arithmetic mean where the average value of each factor is interpreted to give direction to the study. After testing the hypothesis, the study is concluded where the rejection or acceptance of hypotheses of the study is determined. There were few limitations of the study among which the lack of proper timespan to be given to any research work was on the top. The author tried to cover all the aspects of a proper research study that is conducted for the academic purpose. This study has a larger scope and can be conducted in any sector of the world. The textile sector of Pakistan is a widespread sector and further study in different segments can be conducted.

Review of literature

(Baker, 1973) compared the two variables that are financial leverage and profitability and after the data was analysed it was surprisingly revealed that the firms which had huge level of borrowings had better performance as compared to the firms having lower level of borrowings. It was concluded that these higher borrowings had a good impact in the financial outlook of the firm as the organization get good returns and the profitability of the firm was also increased but it also poses a risk of higher debt for the industry. (Miller, 1977) proposed a theory where in perfect capital market the organizations are not bound to pay taxes and they are independent to take their financing decisions, he proposed theories like trade off theory, pecking order theory, agency theory and theory of cash flow to explain the capital structure of the firm. The trade-off theory requires the firm to determine what kind of capital structure to employ through measuring its costs and benefits which are emerged because of extra dollar of debt financing. Once these are identified the firm now needs to curtail the prevailing costs in the market and at the same time need to inflate the firm value by choosing the target capital structure accordingly. The pecking order is all about the internal factors of the organization, likewise the risks and capabilities of the organization and then picking up the most inexpensive and affordable method of financing internally available to the firm. Agency theory deals with the cost bear by the equity owners due to the presence of management. These costs are analysed by judging the financial decisions of the firm with respect to risk, profitability and trade-off among the interest of the parties. The theory of cash flows says that the elevated debt financing increases the worth of the organization and that is achieved when the operating cash flows of the firm are way ahead than that of good investing opportunities however the peril of financial distress cannot be disregarded. According to (Murphy, 1968) the financial leverage an organization have has nothing to do with how it performs as the firms with inflated level of debts has even better performance than those with low levels of debt financing. And the argument that was put forward was that the stock prices and stagnant debt ratios had no impact on the financial performance of the firm.

The investments in fixed assets also have a greater impact on firm’s profitability. According to (Pandey, 2004) the fixed assets turnover ratio determines the productive efficiency of the organization. It denotes how efficiently the organization is utilizing its investment in fixed assets to generate sales revenue. A high turnover ratio indicates the productive efficiency of the fixed assets employment by the firm in generating sales and low ratio indicates the inefficiency in the management and utilization of the fixed assets. (Ibam., 2007) Believed that it highly depends on the nature of the business that what type of fixed assets should a company invests in. The investors keep an eye on generation of sales revenue and firm’s profitability through assessing the fixed assets employed. The analysis of the investors indicates that the higher the fixed asset turnover ratio is, the more profitable is the organization. (Enekwe, 2014) Defined that investment is the art of planning expenditures on which the return is anticipated to surpass one year. It requires foregoing of present expenditures and consumption in the trade-off for future benefits. Since investment involves the foregoing of present situation, it also involves an element of threat that the future outcome may not be the desired one. To minimize this threat one can measure the efficiency of fixed assets with fixed assets turnover ratio.

Research methodology

The framework and design of the study along with data collection and sampling methods will be elaborated which will strengthen the hypotheses of this study. This research framework can be applied to every manufacturing industry locally or globally which further enhances the scope of this study. To give a clearer picture of the issue, problem statement is developed for the better understanding.

Problem statement

The profitability of an organization can be measured through various factors. Financing options of any organization varies from one industry to another industry. The cost of financing is affected by various factors in the industry which are both internal and external. On the other hand how efficiently industry uses the fixed assets in generating sales revenue for the firm determines the profitability of the organization. The high finance cost and low fixed asset turnover rate both can affect the performance of the organization by eroding its profits and revenues earned. This study deals with the impact of financing expenses and fixed asset utilization on organization's profitability.

Hypothesis

On the basis of the problem defined and the previous researches the following hypothesis has been developed.

H1 Profitability of the textile sector has been declining due to high finance expenses for the past ten years.

H2 Profitability of the textile sector has been declining due to low fixed asset turnover ratio for the past ten years.

The hypotheses are developed according to the problem statement, profitability is the variable that is dependent on other various factors and here profitability is dependent on financing costs and fixed asset turnover ratio of textile sector. It is assumed that the dependent variable, profitability, is declining due to high finance costs, which is further driven by certain factors, and low fixed asset turnover ratio, since they are affecting the profitability so they are termed as independent variables in this research study. Similar to the previous researches it is expected that the low fixed asset turnover ratio and high financing costs are eroding the profitability of textile sector in Pakistan for the past ten years.

Data collection

The total population of textile firms all over Pakistan is 396 as per APTMA. Questionnaire and interview were the instruments used to obtain input for the study from the corporate level of the textile industry. The questionnaire was developed accordingly with the dependent and independent variables, whereas interview was unstructured so there were no formal questions developed. For further analysis the published annual reports of ten years of three renowned textile firms were also studied and the relevant information is incorporated in the research to strengthen and validate the data collected.

Sampling

After determining corporate sector as the source of this study, the sample size was determined by applying 10% on total size of the population. The sample size we took is 40 and the instruments used are questionnaire and interview to gain the market insights. Simple random sampling was applied for the questionnaire inputs to be obtained as the organizations were reached through emails so there was an equal chance of any organization to be selected as the email was sent to every possible textile firm.

Data analysis

The inputs obtained from corporate through questionnaire were analyzed by applying the central tendency test of arithmetic mean where the average value of each factor of the questionnaire is determined and analyzed. The central tendency test refined the inputs obtained from questionnaire. The information from the published financials of textile firms is analyzed and interpreted according to its relevancy to the dependent and independent variables. The interview analysis of each factor is also incorporated.

Determinants of finance expense affecting the profitability of the industry

The major players in an economy of a country are interest rates, taxes, currency value and many similar forces. The information provided regarding these forces by organizations through questionnaires and interview is analysed and interpreted. The arithmetic mean of central tendency test is applied on each factor and represented through diagrams which interpret the industry trend. The results of the data collected are interpreted below where the most important factors regarding the hypotheses are discussed. The results are interpreted according to the hypotheses variables.

The results are interpreted through the calculation of arithmetic mean. The most important factor that influenced the financing expenses is the interest rate. The scale used to assess the degree of importance was very high to very low scale. The arithmetic mean of forty respondents was calculated and as per the calculations and coding done the mean value is -1.7 which can be interpreted that there is a positive relationship between the interest rates and financing expenses of the organization. The next factor which has a role to play in defining the financing expenses of the organization is the size of the organization. The calculated arithmetic mean was -0.6 which can be interpreted that there is a neutral relationship between size of the organization and financing expenses. Subsidized loans by the government for different sectors play a major role in the financing expenses of a sector. As the mean value calculated -0.4 it is interpreted that there is a neutral relationship between subsidized loans and financing expenses. Hence from the above analysis and interpretation it can be elucidated that the high financing expenses leads to the decline in the profitability of textile industry.

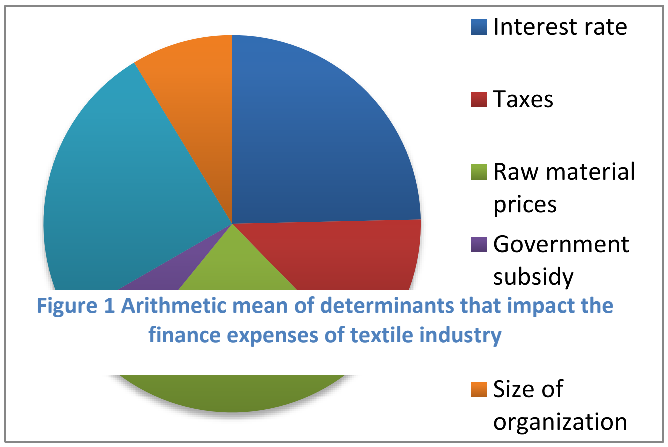

Figure 1 Arithmetic mean of determinants that impact the finance expenses of textile industry

The other instrument used to gather market insights was the interview which was conducted with the textile manufacturing firm. The interview analysis revealed that the interest rates had a very important role to play in the financing expenses of the industry and the 1.5 increase in the interest by the government increased the financing expenses of the industry. The size of the organization was not considered as an important determinant of financing expenses because as per the data provided every organization requires finances to run its operations no matter what size. The taxes will impact the industry if imposed by the government but right now the textile sector is not the tax payer as per the government policy of encouragement of industries involved in exports. In fact the government provide subsidized loans to the industries to encourage the manufacturing processes which will aid the exports of the country. The raw material prices and currency go hand in hand. The devaluation leads to raw material prices but the financing expense are increased due to currency devaluations investments will go towards the bank deposits more increasing the interest rate too.

From the above analysis it is interpreted that H1 is accepted which says the high financing costs of the textile industry are eroding the profitability if the sector.

Determinants of fixed assets turnover ratio affecting the profitability of the industry

The factors discussed in this group are the determinants that drive the fixed asset turnover ratio of an industry. The fixed assets of any organization play a key role in the revenue generation which in turn enhances the profitability. Similarly the discussion is about how sales, liquidity of assets, depreciation, their production capacity etc. drives the turnover rate of these assets. The findings from this group will add weight to the study and will determine further recommendations. The market insights were obtained to assess the importance and impact of these factors through questionnaire where input was provided by the corporate sector of textile industry. To validate the statistics obtained a central tendency test of arithmetic mean was applied which showed the average value of each factor so that the industry trend from those inputs can be interpreted.

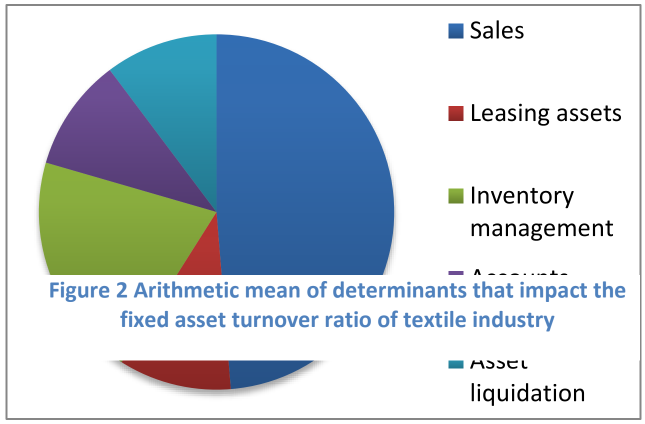

Figure 2 Arithmetic mean of determinants that impact the fixed asset turnover ratio of textile industry

The arithmetic mean of factors impacting fixed asset turnover ratio is calculated where sales of the organization is the most important aspect of efficiency of fixed assets employed. The forty respondents rated the impact of sales on fixed asset turnover ratio as very high which is also indicated by the mean value -1.9. The other factors included the leasing of assets, inventory management, accounts receivables, asset liquidation as seen in the figure 2 these factors did not have much impact on the fixed asset turnover ratio. After analysing the corporate response it can be interpreted that the low fixed asset turnover ratio is not declining the profitability of the company in fact the low ratio denotes that the organization has invested in the fixed assets purchases and the assets are not performing inefficiently.

The other tool used for obtaining market insights is interview conducted with the textile firm. As per the interview analysis the impact of fixed asset turnover rate on profitability of textile sector is very high as the sales of the organization are determined by the efficient utilization of fixed assets. When asked about the reason behind low fixed asset turnover and the profitability we were briefed that the low fixed asset turnover in the financials of an organization is not always the inefficiency, the low turnover ratio denotes the investment of organization in some new assets. While other factors like accounts receivables, inventory management, leasing assets and asset liquidation are all equally important to maintain the ratio.

From the above analysis it can be interpreted that the low fixed asset turnover ratio is not declining the profitability of textile sector, therefore H2 is rejected.

Conclusion

Financing expenses and fixed asset turnover ratio are the one of the many key determinants of the profitability of textile sector. In economic crisis the firm always try to finance its operations internally through equity financing but to maintain a balance it had to choose the mix capital structure for financing. The expenses regarding finances increases when there are uncontrollable factors like inflation, dollar-rupee parity these factors push other players in the environment which directly impacts the financing expenses of the sector. With increased finance costs it's very difficult for a firm to generate profits. In case of the fixed asset turnover ratio, the assets employed by the organization to assist the firm in generating sales have a role to play in the generation of profits. The high ratio indicates the efficiency of the organization whereas low ratio not always indicates inefficiency. Therefore a high fixed asset turnover ratio is always good for the firm's profitability if other determinants like accounts receivables and inventory management are in accordance. Hence it can be concluded that the high financing expenses decline the profitability whereas the low fixed asset turnover ratio not always results in low profitability, which indicates that H1 is accepted and H2 is rejected.

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