The Impact of Debt Financing on Corporate Financial Performance: An Evidence of Pakistani Non-Financial Listed Firms

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Abstract:
The aim of this study is to check the impact of debt financing on performance of the firms of non-financial firms constituting Pakistan stock exchange (PSX). The current research study collected secondary data from reports published by State Bank of Pakistan (SBP) for a period of fourteen years from 2005 to 2018. The study sampled 150 firms from non-financial sector of Pakistan Stock Exchange (PSX) using convenience sampling technique. This study used long term debt to total assets, short term debt to total assets, total debt to total assets to measure the debt financing (leverage ratios) and return on assets (ROA) to measure financial performance. To derive the results of the study; descriptive statistics, correlation matrix and ordinary least square (OLS) regression analysis were applied using Eviews9. According to results of the study, the short term, long term and total debt have negatively significant relationship with ROA. Further research studies may take into account the data of financial firms registered on the PSX.

Keywords: Debt Financing, Financial Performance of firms, Pakistan Stock Exchange

I. Introduction
The capital structure is the arrangement of the capital from various sources to finance assets. The debt financing plays an importance role to build up the capital structure of any firm. (Scher and Hulburt, 2001). All types of financing decisions relates directly with wealth maximization and effect the performance of a firm. The term financial leverage means that what quantity of debt is used in capital structure. Financial structure is used as important parameter from the point of view of financial economist because it relates with the ability of a firm to fulfil the requirements of stakeholders. Firms use internal and external source of financing while arranging their capital structure. The arrangements of investment edifice can effect a firms governing structure. A comprehensive capital structure help a firm to raise the market value of its securities and shares. Modigliani and Miller (1958) studied the tradeoff among debt and equity. Model suggested that capital
structure is irrelevant in deciding the profits or boosting the financial performance of firms. As an outcome a firm’s market value is not affected by the firm’s leverage. The capital structure leads towards controversy and clarity. Irrelevance theory presented by Modigliani and Miller (1958) states two assumptions; first assumption holds that firm’s value is self-regulating of its capital structure and second assumption holds that a firm’s given investment policy, dividend pay-out policy will not affect the shareholder’s total return and market prices of shares. Later, in the 1970s, other authors began to focus on debt financing study. Jensen and Mekling (1976) have discovered the conflicts among shareholders and debt holders and its impact on financial performance of companies. It is also evident that high leverage deepens financial losses in time of financial distress (Opler & Titman, 1994).

In the light of developing markets a few evidences were found to examine the debt influences on structure of the firm performance. The objective of this study is to observe the influence of debt financing on corporate financial performance. An optimum structure of capital is challenging since financial crisis of 2007-08 for firms in both developing and developed countries. It is scholarly worthwhile to study case of developing countries. This research focuses Pakistani manufacturing firms listed on Pakistan Stock Exchange. In addition Lara (2003) and Weill (2008) also reported positive impact of firm performance. Given previous findings, the study extended the view of the current literature on debt financing by considering their maturity and its impact on financial performance.

The Research Questions are (1) What is the influence of debt financing on corporate financial performance for Pakistani nonfinancial listed firms? (2) What is the consequence of debt financing on return on assets of firms listed on PSX? The Research Objectives are (1) to check the impact of debt financing on performance of the firms for Pakistani nonfinancial listed firms and (2) to examine the effect of debt financing on return on assets of firms listed on PSX. This study is significant for students as well as for scholars who are keen to study the capital structure. Research will support companies in their decision making processes and its efforts to exploit their financing options and performance of firms and thus contribute to maximizing the wealth of shareholders.

II. Literature Review

A. Theory

*Pecking Order Theory*

This theory tells the order of formulating capital structure. For this purpose you must have the information about the source of finance. Basically pecking order theory suggest us to choose the source of finance for which we should realize minimum information to others. If we realize minimum information, less control will be dilute. This theory suggest internal source of finance (retained earnings) first, when internal finance is fully used then move toward debt because it is a low cost of financing. Then move toward external equity. So according to pecking order theory this should be your order of pecking of capital structure. Myers and Majluf (1984), this theory stated that firms choose to use internal financing for external financing.

B. Variables

*Dependent Variables*

Return on assets examines the credibility of firms to earn profit by utilizing its assets. It identifies that weather firm is utilizing assets properly or not. States that the return on assets compares available assets with the profit. Basically, it identifies the credibility of managers of organization in the utilization of resources. In actual Return on assets shows the earning on total assets.

\[
\text{Return on assets} = \frac{\text{Net income}}{\text{average total assets}}. \quad \text{(Kajirwa, 2015)}.
\]

*Independent Variables*

**Short Term Debt**

It is measure of short term debt relative to the company’s total assets within one year time period. Teruel and Solano (2014) examined that there was a positive correlated with profitability and firm’s growth.

**Total Debt**

The ratio of a firm’s total debt to the total assets that inversely distresses the financial recital of the company. It income that upsurge in the debt leads to reduce in the financial performance of a company used by commercial banks (Kajirwa, 2015).

C. Hypotheses

H1: There is an adverse association among short term debt and monetary performance of firms listed on PSX.

H2: There is a negative relationship among long term debt and financial performance of firms listed on PSX.

H3: There is a negative relationship between total debt and and financial performance of firms listed on PSX.

III. Research Methodology

*Conceptual Framework*

<table>
<thead>
<tr>
<th>Short Term Debt to Total Assets</th>
<th>ROA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long Term Debt to Total Assets</td>
<td></td>
</tr>
<tr>
<td>Total Debt to Total Assets</td>
<td></td>
</tr>
</tbody>
</table>
B. Research Design

Research approach can be divided into two type’s firstly inductive approach and secondly deductive approach. The inductive approach jerks with precise explanations and the conclusions are generalized. Inductive researchers believe that explanations can be rationally sweeping to general and inclusive rules, and that systematic expectations can be confirmed (Godfrey and Hudson, 2010). This study tend to focus on quantitative research can be experimental or descriptive.

C. Population and Sample

The sample of study consists of 150 firms (non-financial firms) from the population of 576 firms excluding financial firms. The population of study consist 10 sectors and sample having 150 firms (oil and gas companies, technology, communication and transport and glass & ceramics, sugar, cement, chemicals, textile, food and personal care products, automobile, power generation and distribution, engineering, leather and tanners). The sample refers to a period of 14 years, from 2005 to 2018, and it is collected from the official website of the Pakistan Stock Exchange. The sampling techniques has been used in this study is convenience, it is easy to accessible. The convenience sampling researchers only used easy and accessible data with complete information. Incomplete and delisted firms not a part of this study.

The correlation matrix was used to inspect the association between long, short total debt and total debt and ROA. Correlation matrix also shows the issue of multicollinearity between different variables. Ordinary least square regression is simple method for linear regression. Accordingly, the sum of square errors from the data is minimized. According to the study by Salahudin (2011) suppose that intercept and co-efficient are constant.

D. Econometric Model

\[ F_{P_{it}} = \alpha_0 + \alpha_1 T_{LTDA_{it}} + \alpha_2 L_{LTDA_{it}} + \alpha_3 S_{LTDA_{it}} + \epsilon_{it} \]

IV. Results and Analysis

A. Correlation Matrix

<table>
<thead>
<tr>
<th></th>
<th>ROA</th>
<th>TDTA</th>
<th>LTDTA</th>
<th>STDTA</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA</td>
<td>1.000000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TDTA</td>
<td>-0.139502</td>
<td>1.000000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>LTDTA</td>
<td>-0.140467</td>
<td>0.452819</td>
<td>1.000000</td>
<td></td>
</tr>
<tr>
<td>STDTA</td>
<td>-0.048703</td>
<td>0.451914</td>
<td>-0.241574</td>
<td>1.000000</td>
</tr>
</tbody>
</table>

The correlation matrix was used to investigate the correlation among explanatory variables. Accodrning to the results, there is no issue of multicollinearity. In line with above table the highest value is 0.452819. If the value between any two or more variables exceed the limit of 70% then the issue of multicollinearity exist. Finally there is no single value more than 70%. It indicate that there is no issue of multicollinearity exist in the data. And it indicates that all variables are connected with each other.
B. Regression Analysis

The LTDTA has a significant negative impact on ROA. Similarly, other debt ratios also explain a negative impact on the performance of firms. Peter (2015) from Kenya, studied on debt financing and economic presentation of SMEs. Pragmatic outcomes provided sufficient indication that long term arrears affect SMEs financial performance harmfully. The association between STDTA and return on assets is negative which means that when STDTA increase the return on assets will also decrease. Maina and Ishmail (2014) in Kenya, studied the effect of debt funding on firm productivity of commercial banks. In this study, there was also a negative correlation between short term debts enterprise and performance of firms (Obuya, 2017).

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>t-Statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td>9.136586</td>
<td>0.884323</td>
<td>10.33173</td>
<td>0.0000</td>
</tr>
<tr>
<td>LTDTA</td>
<td>-27.94010</td>
<td>3.963859</td>
<td>-7.048712</td>
<td>0.0000</td>
</tr>
<tr>
<td>STDTA</td>
<td>-3.894516</td>
<td>1.446025</td>
<td>-2.693256</td>
<td>0.0076</td>
</tr>
<tr>
<td>TDTA</td>
<td>-3.962738</td>
<td>1.548923</td>
<td>-2.558382</td>
<td>0.0111</td>
</tr>
</tbody>
</table>

However, the direction of association among TDTA and return on assets is negative significant with .0111. It indicates that when TDTA increase the ROA will also decrease. It means that independents variables and return on assets will not progress on similar direction, when one factor increase the other one factor will decrease. According to this researcher Javed (2015) in order to established total debt and long term debt to harmfully relate to financial performance because firms tend to have less borrowing and sufficient funds to be built internally. This study of finding is also consistent with earlier empirical revision because debt financing is a negative significant relationship with financial performance. The ratio of a firm’s total debt of a firm to the total assets inversely distresses the financial performance of the business. It means that the upsurge in the debt leads to reduce in the financial performance of a company used by commercial banks (Kajirwa, 2015).

Moreover, when financial resources are used then risk is reduced. This study also accomplished that the inadequacy of the banks are negatively affected the SMEs productivity in Zimbabwe (Dube, 2013). R- Square is the statistical technique which measure in fitted regression line, how the data is closed. In regressions, the R-square is used as coefficient of multiple determinations. R- Square can be defined as the explained variation from total variation with a linear model. The value of R-Square must between 0% and 100%.

Adjusted R- square is the modified form of R-Square. Adjusted R-Square is used to adjust the number of predictors in the model. If the new term expands the model as compared to expectations by chance, then the value of adjusted R- square rises up. Summary in line with research objective one to examine the association among the debt financing and financial presentation. Debt financing is negative relationship with financial performance. Both variables will not change on similar course due to their landscape of association. Cheng (2009) In line with Taiwan stock exchange the effect of debt financing
V. Conclusions

It is concluded that the discoveries of the study on the result of debt financing on the financial performance of non-financial firms listed at the PSX. This study focused on debt financing as the independent variable and financial performance measured using ROA was the dependent variable. Eviews software is used for secondary data analysis. Redundant fixed effects tests and Hausman test is most suitable for panel regression. The effect of debt financing has negative significant relationship with financial performance. LTDTA has negative significant relationship with ROA. When LTDTA increase the ROA will also decrease. The reason is that when company debt increase to the major portion of profit goes in the shape of interest. That’s why dependent variable will decrease. STDTA has significant negative relationship with ROA. When STDTA increase the ROA will also decrease. The base is that when company debt increase to the major share of profit goes in the nature of interest. Consequently, dependent variable will decrease. TDTA has significant negative relationship with ROA. When TDTA increase the ROA will also decrease. The reason being, if a company’s debt increases, the major part of profit goes towards debt service, leading to a decrease in net income. The hypothesis of the study is accepted which shows that finding of this aligned with previous study. The results of the study will be useful for decision making, strategy making and particularly managing debt problems for survival of firms. It will provide information about debt financing and financial performance to the stakeholders. This study finding has a number of vital implications for Pakistani listed firms, researchers and investors. The paper is beneficial for investors, both existing vis-à-vis potential along with future researchers. The study is conducted on non-financial sector only with few debt ratios. The future research studies might use the data from financial firms listed on the PSX by increasing the number of years and the firms.

References


Myers, S. C. and N. S. Majluf (1984). Corporate financing and investment decisions when firms have information that investors do not have, National Bureau of Economic Research.


