



# The Paradox of Managerial Ownership and Financial Decisions of the Textile Sector: An Asian Market Perspective

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## Abstract

The managerial ownership and its impact on financial decisions such as cash holding, and capital structure have been the subject of debate of corporate governance literature. The main objective of this study is to investigate the impact managerial ownership places on financing and cash holding decisions. In addition to that, the current study is also offering an interesting insight on the issue of simultaneity of financing and cash holding decisions and also will discuss that how the interdependence changes as the level of managerial ownership changes. This study examines the data of 60 companies listed on Pakistan Stock Exchange over the period from 2013 to 2017. To trace the endogeneity, we have employed the Wu Hausman test. It is evident from the results that the p-value of both models is significant, which confirms the endogeneity between cash holdings and capital structure decisions. In both models, the managerial leverage and cash holdings are in positive relation. The MO appears in a non-linear relationship with both cash holding and capital structure decisions of textile firms. The results of the study are also providing support to agency theory, pecking order theory and signaling theory.

**Keywords:** MO; Cash holdings; Financing; Textile; Pakistan.

**JEL Classification:** Code: G3.



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## 1. Introduction

The cash holdings and capital structure are corporate financial decisions which are central to the conflict between managers and owners and during the last few decades, their assemblage has attracted an increasing amount of attention. The debates had started with the proposition of the perfect market hypothesis by the [Sheikh and Qureshi \(2017\)](#) in which they argued that there is a perfect market, where the firm value is indifference of financial decisions because of no cost associated with them. According to them, the firm value must be seen as a function of the productivity of assets and the costs such as agency cost, transactional cost, opportunity cost and information asymmetry cost has no impact on firm value. Practically speaking, there are certain factors which affect the financial decisions and firm value, therefore, several researchers ([Basheer, 2014](#); [Jensen, 1986](#); [Sheikh and Wang, 2012](#); [Sheikh and Qureshi, 2017](#)) abandoned the MM ideal world and acknowledged the significance of certain costs such as agency cost, transaction cost, opportunity cost which affect the firm financial decision.

One of the theoretical models which has been used as a base model behind the formulation of the codes of corporate governance as well as examining the impact of financial decisions on the firm value in real or imperfect markets. Agency theory argues that there is a conflict between owners and managers on the issue of wealth maximization which is also termed as the conflict of interest ([Basheer, 2014](#); [Chen et al., 2018](#)). There is a cost associated with the agency conflict known as the agency cost, which has a significant impact on the firm value ([Chen et al., 2018](#); [Sheikh and Qureshi, 2017](#)). Many prior studies ([Basheer, 2014](#); [Sheikh and Wang, 2012](#); [Sheikh and Qureshi, 2017](#)) have reported that the agency cost has a significant impact on the managerial, financial decision and in turn on the firm value.

The pecking order theory [Myers and Majluf \(1984\)](#), views the company financing strategy follows a hierarchical approach, in which it starts from the cheapest source of funds that are the company's retained earnings in the form of cash ([Basheer, 2014](#)) which is further followed by safe debt issuance, finally equity issuance ([Myers and Majluf, 1984](#)). The pecking order theory views the financing decisions and cash holding decisions as interdependent. Therefore, this theory suggests a negative relationship between cash holding and capital structure ([Sheikh and Wang, 2012](#)). The capital structure is a blend of firm's debt and equity financing ([Basheer, 2014](#)).

The corporate governance is a mechanism which ensures to the stakeholders that the wealth maximization principle is being followed in a most honest and ethical way ([Allen et al., 2018](#)). The mitigation of agency cost arising from the agency mentioned above problem is a prime objective behind the formulation of any code of corporate governance ([Allen et al., 2018](#); [Basheer, 2014](#)). The managerial ownership which is proxied by the total shares held by the managers and directors is seen as the solution of agency conflict as it helps in aligning their interest

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(Basheer, 2014; Hoang *et al.*, 2017; Ozkan and Ozkan, 2004; Sheikh and Wang, 2012). However, many researchers (Basheer, 2014; Hoang *et al.*, 2017; Ozkan and Ozkan, 2004) have argued that the relationship between financial decisions such as cash holdings, a capital structure with MO is non-linear.

Table-1. Yearly Mean Value of Shareholding Pattern

Percentage of share held by	2012	2013	2014	2015	2016	2017	Mean N=6
a. Directors	45.0	45.00	45.00	46.00	47.00	48.00	46.00
b. Financial Institutions	10.00	10.00	9.00	8.00	7.00	6.00	8.00
c. General Public	10.00	11.00	11.00	12.00	12.00	12.00	11.00
d. Other firms	35.00	34.00	35.00	34.00	34.00	34.00	34.00
*Grand Total	100	100	100	100	100	100	100

Note: \*Grand total is the summation of (a, bc and d); N=60

Source: Company's Annual reports

The prime objective of the current study is exploring the impact of managerial ownership on the financial decisions. In addition to that, we are also interested in knowing that how the relationship between the cash holding and capital structure changes with changing the level of managerial ownership. We are also interested in knowing that either there is endogeneity between the cash holding and capital structure decisions. The reason why we have chosen the textile sector are; 1) it is the biggest non-financial sector in Pakistan ii) the average managerial ownership in textile sector of Pakistan is around 46 percent which is higher than the mean value of 22 percent in the sample of 138 non-financial firms reported by Basheer (2014) and 29 percent in 155 firms reported by Sheikh and Wang (2012) as shown in table 1.

## 2. Literature Review

### 2.1. MO and Capital Structure

The percentage of shares held by the company's directors is proxied as the managerial ownership (Basheer, 2014; Ozkan and Ozkan, 2004). Many notable researchers (Akhtar *et al.*, 2018; Basheer, 2014; Fama and Jensen, 1983; Jensen and Meckling, 1976; Mishra and Kapil, 2017; Ozkan and Ozkan, 2004; Sheikh and Wang, 2012) have reported that the managerial ownership as a solution of the agency problem. According to them, the managerial ownership helps in aligning the interest of owners and managers which in term mitigates the agency cost. This also provides a solution to agency problem broached by Ozkan and Ozkan (2004), Basheer (2014) and Sheikh and Wang (2012) that in the absence of the managerial ownership the entrench managers may accept any project with lower NPV. This is providing support to the Fama and Jensen (1983), who are among the first to broach the issue of managerial opportunism and argued it as the main determinants of agency problem and also claimed that the MO inversely affects the managerial opportunism behavior. The capital structure decisions are among the most debated topics in corporate finance (Sheikh and Wang, 2012). Different theoretical models offer different justification for the factors affecting the capital structure decisions such as the agency theory view the debt as a control mechanism on the managers (Brailsford *et al.*, 2002)

Empirical evidence concerning the relationship between MO and capital structure offers no consensus. A group of studies (Kim and Sorensen, 1986; Salehi *et al.*, 2017) found a positive relation between MO and capital structure and provided support to the managerial incentive hypothesis that the managers with more incentives are closely aligned with outsiders and prefer higher level of debt as compared to independent managers. Whereas Sheikh and Wang (2012) have found that the MO is in a negative relationship with capital structure. They argued that firms in developing countries trade-off MO and debt to control agency cost. Friend and Lang (1988) argue that increased ownership of insiders leads to reducing leverage level as managers try to reduce the bankruptcy risk. This leads to a negative relationship between MO and leverage (Wahyudin and Solikhah, 2017). However, increased MO could lead to enhanced managerial influence and voting power.

Consequently, they might change the debt level to maximize their benefits by obtaining more cash (Ozkan and Ozkan, 2004). This could lead to a positive relationship between managerial ownership and financing decision. Meanwhile, many prior studies (Al-Najjar and Clark, 2017; Basheer, 2014; Ozkan and Ozkan, 2004) argued that MO offers a non-linear relationship with agency cost. So, by literature reviewed we have drawn the following hypothesis

H1: MO is a non-linear relationship with firm capital Structure.

### 2.2. MO and Cash Holding

Cash holdings are one of the major financial decisions made by managers. In the occurrence of inflow of cash, a manager must decide whether pay cash dividend or stock dividend. Some studies examine the determinants of corporate cash holding (Opler *et al.*, 1999; Rashid, 2016).

Three main theories are suggested by theoretical finance literature to explain the reasons for firms to hold cash. Firstly, about the separation of control and ownership, it has already been recognized as a source of agency problems between managers and shareholders in a firm. According Jensen (1986), managers tend to focus on having a large cash reserve to pursue their benefits. On the other hand, the study by Ozkan and Ozkan (2004) concludes that because of highly concentrated ownership in Asian firms, controlling shareholders attempts to maximize their benefits. This creates a conflict between majority and minority shareholders (Hamid *et al.*, 2016). Secondly, the information asymmetry theory, which is closely related to the pecking order theory, describes cash as the main

source of financing. Thirdly, trade-off theory weights the benefits and costs of holding cash by identifying optimal level of cash holdings (Ahmad and Ahmad, 2018). The main benefit related to cash holdings includes reducing the likelihood of financial distress. Moreover, Ferreira and Vilela (2004) declare that holding cash would help to reduce the costs of increasing external funds.

(Ozkan and Ozkan, 2004) find that MO at a lower level of ownership could be helpful in the alignment of benefits between shareholders and managers. They termed this alignment of interests as alignment effect. Thus, under the alignment effect, cash holding is negatively related to. However, where the managers' stake in the company tends to increase, managers may choose to hold excess cash to fulfil their interests. Therefore, under the entrenchment effect, cash holdings are positively related to MO. However, if the MO in the company is high, then the alignment effect would be greater than the entrenchment effect as engagement in behaviors that could increase managerial benefits might be punished by investors in the form of lower stock price. Consequently, many prior studies (Al-Najjar and Clark, 2017; Basheer, 2014; Kusnadi, 2011) have found a non-linear relationship between MO and cash holdings,

H2: MO is a non-linear relationship with corporate cash holdings.

### 2.3. Corporate Cash Holdings and Capital Structure

The empirical studies on the relationship between capital structure and cash holdings offer no consensus. The debate in the real market started when the Jensen and Meckling (1976) in their vintage paper have argued that the entrenched managers to pursue their self-interest prefers to hold a large amount of cash. They continued and argued that these entrenched managers hold cash for financing purpose and avoid debt financing which can act as a check on the entrenched managers, thus argued a negative relationship between leverage and cash holding (Basheer, 2014; John, 1993; Sheikh and Wang, 2011).

According to Faulkender, (2004) the information asymmetry problem is one the key determinate of the financing decisions, which can cause the bankruptcy and financial distress cost. This argument is supported by the Graham and Harvey (2001) and Al-Najjar (2015) found that the cash holdings are in negative relationship with capital structure decisions. Whereas the García-Teruel and Martínez-Solano (2008) found a positive and significant relationship between financing and cash holding decisions. The interactions between leverage and cash show that there is interdependence between cash holding and capital structure decisions. Therefore, in line with the theory we have developed the following hypotheses:

H3: Cash holdings affect leverage

H4: Leverage affects cash holdings

## 3. Data and Methodology

### 3.1. Data Source

To achieve the unique objectives of the current study, the data of textile firms are collected from the annual report of textile firms listed in Pakistani stock exchange throughout six years from 2012 to 2017. Initially all the listed firms operating in the textile sector of Pakistan are chosen as a sample, however, later the firms with incomplete data or the leverage ratio more than one are excluded from the final sample. The final sample comprises 360 firm-year observations.

### 3.2. Model Specification

To find the interdependence of corporate cash holdings and capital structure, and to examine the nonlinear relationship between MO and corporate cash holdings and between MO and capital structure we have used the following

$$Cash_{it} = \alpha_0 + \alpha_1Leverage_{it} + \alpha_2Man_{it} + \alpha_3Manc_{it} + \alpha_4Prof_{it} + \alpha_5Dividend_{it} + \alpha_6Mbr_{it} + \alpha_7cflow_{it} + \varepsilon_{it} \dots \dots \dots (1)$$

$$Leverage_{it} = \alpha_0 + \alpha_1Cash_{it} + \alpha_2Man_{it} + \alpha_3Manc_{it} + \alpha_4Prof_{it} + \alpha_5Dividend_{it} + \alpha_6Mbr_{it} + \alpha_7cflow_{it} + \varepsilon_{it} \dots \dots \dots (2)$$

## 4. Data Analysis and Research Findings

### 4.1. Descriptive Analysis

The summary statistics of the current paper are shown in table 2. The mean of the managerial ownership is 45 percent which is in line with table 2. The debt comprises of 60 percent of textile sector financing and cash level is considerably low at 1.3 perce

Table-2. Descriptive statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Cash	360	0.00004	0.19368	0.0131	0.019
Leverage	360	0.05719	0.99769	0.6048	0.188
Man	360	0.00091	0.98963	0.4590	0.263
Manc	360	0.00000	0.96923	0.1918	0.225
Prof	360	-0.47689	0.29285	0.0282	0.083
Dividend	360	-0.01440	0.27669	0.0064	0.018
Mbr	360	0.00000	15.25691	0.6314	1.322
Cflow	360	0.44568	0.92172	0.0923	0.134
Valid N (listwise)	360				

## 4.2. Correlation Analysis

To examine the correlation between the explanatory variables and the dependent variables we have used the bivariate correlation. The results are reported in table 3.

Table-3. Correlation Analysis

	Cash	Leverage	Mans	Manc	Prof	Dividend	Mbr	Cflow
<b>Cash</b>	1							
<b>Leverage</b>	-0.1830	1						
<b>Man</b>	-0.0257	0.1483	1					
<b>Manc</b>	-0.0810	0.1188	0.8929	1				
<b>Prof</b>	0.1456	-0.4363	0.1129	0.0579	1			
<b>Dividend</b>	0.1308	-0.2847	-0.0828	-0.0674	0.0882	1		
<b>Mbr</b>	-0.0220	0.2994	-0.1216	-0.0935	-0.3391	-0.0720	1	
<b>Cflow</b>	-0.1095	0.1030	-0.0027	0.0334	-0.2807	-0.2236	0.3642	1

The highest correlation coefficient of 0.89 is observed for the relationship between the higher level of MO and lower level of MO. The results of the correlation analysis are shown in table 3.

## 4.3. Regression Results and Discussion

The results of the corporate cash decisions are shown in the table 4 the Breusch-Pagan (BP) and Hausman test are used to choose the most appropriate model (Basheer *et al.*, 2019). The results of the Hausman test with Chi-square value of 9.32 and p-value of 0.342 indicates the random effect as most suitable technique for the cash holding model the results of the pooled OLS, fixed effect, and random effect estimates are reported in the table 4. To resolve the issue of multilinearity the managerial ownership square is removed from the analysis.

The relationship between managerial ownership and firm cash holding is positive whereas nonlinear as the relationship between the cube of the managerial ownership, and firm value is negative and significant.

The relationship of capital structure, a higher level of MO, and market to book ratio with corporate cash holdings are negative whereas the lower level of MO, profitability, dividend, and variability of cash flow is in a positive relation with corporate cash holdings. Profitability and dividend are in positive relation while the cash flow and dividend in a negative relationship with cash decision of Pakistani textile firms. The results are consistent with the prior findings of Basheer (2014) and Ozkan and Ozkan (2004).

We have started our analysis with the pooled OLS however the LM test, and Hausman test prove the fixed effect estimate as most appropriate estimates. The results of the study provide support to the hypothesized results as managerial ownership is a positive and significant relationship. Whereas all other factors are in a negative and significant relationship with financing decisions.

The results of the study are providing support to the third and fourth hypothesis of the current study as the leverage and cash holdings are in negative but significant relations. The results are consistent with the prior findings of Basheer (2014) and providing support to pecking order theory which argued that the firm with excessive cash would avoid debt financing. Overall the results are providing support to agency theory, signaling effect and pecking order theory.

The nonlinear relationship between the managerial ownership and financial decisions are providing support to alignment and entrenchment hypothesis (Basheer, 2014; Ozkan and Ozkan, 2004). According to these authors under alignment effect, financial decisions are negatively related to MO. However, where the managers' stake in the company tends to increase, managers may choose to hold excess cash or excessive debt financing to fulfill their own interests. Therefore, under entrenchment effect, cash holdings are positively related to MO. However, if the MO in the company is high, then the alignment effect would be greater than the entrenchment effect as engagement in behaviors that could increase managerial benefits might be punished by investors in the form of lower stock price which is in our case.

**Table-4.** Regression results of Cash Model

Dependent Variable: <i>CASH</i>	Pooled OLS Coefficient (p-value)	Fixed Effect Coefficient (p-value)	Random Effect Coefficient (p-value)
<i>Leveage</i>	-0.0177*** (0.010)	-0.0005 (0.953)	-0.0089 (0.244)
<i>Man</i>	0.0198** (0.027)	0.0154 (0.395)	0.0170** (0.149)
<i>Manc</i>	-0.0254** (0.014)	-0.0238 (0.228)	-0.0243* (0.071)
<i>Prof</i>	0.0222 (0.176)	-0.0313* (0.074)	0.0284* (0.075)
<i>Div</i>	0.0797 (0.183)	-0.0488 (0.394)	0.0633* (0.248)
<i>Mbr</i>	-0.0004 (0.579)	-0.0001 (0.888)	-0.0002 (0.797)
<i>Cflow</i>	-0.0097 (0.286)	0.0147 (0.238)	0.0155 (0.864)
<i>R<sup>2</sup></i>	0.0740	0.018	0.06
Number of firms	60	60	360

\*Significant at the 10% level., \*\* Significant at the 5% level., and \*\*\* Significant at the 1% level

**Table-5.** Regression results of Financing Model

Dependent Variable: <i>Leverage</i>	Pooled OLS Coefficient (p-value)	Fixed Effect Coefficient (p-value)	Random Effect Coefficient (p-value)
<i>Cash</i>	-1.089*** (0.010)	-0.020*** (0.953)	-0.211 (0.541)
<i>Man</i>	0.256*** (0.000)	0.051*** (0.628)	0.182** (0.037)
<i>Manc</i>	-0.154* (0.059)	-0.176** (0.130)	-0.174* (0.076)
<i>Prof</i>	-0.756*** (0.176)	-0.661*** (0.000)	-0.697*** (0.000)
<i>Div</i>	-2.311* (0.000)	-0.460*** (0.174)	-0.794** (0.021)
<i>Mbr</i>	-0.004 (0.528)	-0.009*** (0.164)	-0.005 (0.389)
<i>Cflow</i>	-0.161** (0.024)	-0.098* (0.1.81)	-0.110 (0.113)
<i>R<sup>2</sup></i>	0.352	0.168	0.277
Number of firms	60	60	60

\*Significant at the 10% level, \*\* Significant at the 5% level, and \*\*\* Significant at the 1% level

## 5. Conclusion

The prime objective of the current study is exploring the impact of managerial ownership on the financial decisions. In addition to that, we are also interested in knowing that how the relationship between the cash holding and capital structure changes with changing the level of managerial ownership. We are also interested in knowing that either there is endogeneity between the cash holding and capital structure decisions. This study examines the data of 60 companies listed on Pakistan stock exchange over the period from 2008 to 2013. The period from 2008 to 2013 is selected because it comes before implementation of the revised code of corporate governance of Pakistan 2012.

According to regression results reported in the table 4 and table 5, the relationship of capital structure, a higher level of MO, and market to book ratio with corporate cash holdings are negative whereas the lower level of MO, profitability, dividend, and variability of cash flow are in a positive relation with corporate cash holdings. Which indicates that the Mo has significant impact on financing descensions. The results of the study provide support to the hypothesized results as managerial ownership is a positive and significant relationship with capital structure. Whereas all other factors are in a negative and significant relationship with financing decisions. The results of the study are providing support to the third and fourth hypothesis of the current study as the leverage and cash holdings are in negative but significant relations. The results are consistent with the prior findings of (Acharya *et al.*, 2012; Basheer, 2014) and providing support to pecking order theory which argued that the firm with excessive cash would avoid debt financing. Overall the results are providing support to agency theory, signaling effect and pecking order

theory. Simultaneity can cause endogeneity problem, which occurs when one or more dependent variables are jointly established with the other dependent variables, usually with the help of an equilibrium mechanism. Based on information asymmetric and agency theories, it was expected that cash holdings and leverage might be simultaneously determined. Therefore, the Wu Hausman test is performed to determine the existence of endogeneity problem. The p-value of both models is significant. This indicates that the cash holding and capital structure can be determined simultaneously.

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