How Firm and Market Characteristics Affect Profitability: An Empirical Study

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ABSTRACT

This study aims to assess the impact of specific corporate and market features on the profitability of firms. More precisely, the variables examined for the purposes of this study are firms' size, financial leverage, accruals, volatility of profitability, growth rate of the Greek economy, the 10-year Greek government bond yield, and the Greek sovereign debt crisis. The empirical results exhibit an average profitability of 10.71%, which varies significantly both between firms and during the time period examined. Another finding of this study is the verification of the theoretical relationship between the above variables and Greek firms' profitability between 2004 and 2012. Whereas variables such as firms' size, volatility of profitability and accruals do not seem to affect firms' profitability in a statistically significant way, the signs of the coefficients are consistent with those found in the literature review.

Keywords: Accruals, Earnings Smoothness, Financial Leverage, Firms' Profitability, Firms' Size

1. INTRODUCTION

The estimation of the factors that affect the future course of firms’ profits contributes to the acquisition of important information for the optimal financial management and profit maximization. Managers should follow an active policy in order to manage and offset potential risk. Therefore, the knowledge of the determinant factors’ impact on firms’ profitability will contribute to a better financial management and reduction of potential risk.

There are many important factors that affect firms’ profitability, and they usually vary depending on the country and time period. The main factors significantly affecting the future profitability of firms are firms’ size, financial leverage, R&D expenditures, accruals and volatility of profitability. Moreover, there are numerous macroeconomic factors that can affect the outlook of firms’ profits.

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Our research focuses on how the above factors affect Greek firms’ profitability. Before beginning to analyze the way and extent that firm and market characteristics influence profitability, it is very important to note that the course of the Greek economy affects firms’ profitability in a serious and deterministic way. More specifically, Greece’s economy after 2008 has shrunk and its GDP has decreased by approximately 20%. This chronic shrinking of GDP and the recession of the Greek economy have led to the increase of the Greek government’s borrowing cost, which, in turn, has affected the banking sector, loan provisions and the borrowing costs of Greek firms.

Prior empirical studies have examined the impact of such determinant factors on firms’ profitability. The results of these studies either agree with or contradict financial theory or fail to confirm the expected impact on net income. Nevertheless, in the frame of this study, the empirical findings of the relationship between the variables used and firms’ profitability show that the maximization of firms’ profitability is closely connected with better financial management and the favorable distribution of available resources.

The article is developed as follows: Section 2 presents a brief literature review, section 3 presents the theoretical background of the variables affecting firms’ profitability, section 4 describes the data and variables used, while section 5 and section 6 present the methodology and the empirical results, respectively. Finally, at the end of the paper, important conclusions are discussed and further research propositions are suggested.

2. LITERATURE REVIEW

The study of the literature concerning the factors that affect firms’ profitability, such as firms’ size, financial leverage and R&D expenditures, leads to equivocal results. Johnson (1967) and Newman (1968) did not detect any statistically significant relationship between R&D expenditures and firms’ profitability. However, Sougiannis (1994) supported that the above findings may be due to the use of a small sample, the econometric techniques used and the quality of the data used for the completion of the research. Storey et al. (1987) showed that small firms’ profitability increases with increasing size, while for large firms, profitability decreases with increasing size. Moreover, they found that the age of a small firm has a significant influence on small firms’ performance but little impact on large firms’ performance. In addition Christopoulos et al (2013) provided the liquidity status of firms as a significant factor that affects firms’ profitability and viability.

Klassen and McLaughlin (1996) studied the relationship between environmental management and firms’ profitability and found that firms with strong environmental management enjoy significant positive returns, while firms with weak environmental management indicate significant negative returns. Burghstaller and Dichev (1997) and Degeorge et al. (1999) mentioned that it is probable that a firm’s profit management corresponds to the firm’s size. As a result, it is presumed that large firms are more likely than smaller firms to enjoy profits. Their findings seem to be consistent with Yangseon et al. (2003), as large companies can develop stronger internal control systems and defend their reputation, avoiding earnings manipulation. Wald (1999) found that the most advanced countries are characterized by great cross-country differences in the correlation between financial leverage as approached though the long-term debt-to-total-assets ratio and firms’ riskiness, profitability, size, and growth. These discrepancies are due to the diversification of the implementation of tax policies and agency problems, including differences in bankruptcy costs, information asymmetries, and shareholder/creditor conflicts. Abor (2005) distinguished the effects of short-term and long-term leverage on firms’ profitability. More specifically, he revealed a significantly positive relationship between short-term financial leverage and firms’
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