

DISTRIBUTION AND INVESTING PRACTICES IN CORPORATE FINANCE

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ABSTRACT

There are three leading areas of corporate finance practices that consistently require the academic concentration of scholars in corporate finance theory. These include corporate financial practices relating to investing, financing and finally the practices concerning distribution. However, in modern finance, the investing practices have been further classified into two categories, that is, long term financing and short term financing. The long term financing refers to capital budgeting practices and short term refers to working capital practices. A brief account of leading practices in these areas of corporate finance is presented in this research paper.

INTRODUCTION

Over the last century, the researchers from around the Globe have worked upon postulating models and theories facilitating firms to their efficiency in terms of competitive corporate financial practices. To what degree of success these scholars have made their way into corporate board-room is the question that still remains inconclusive? What are the leading practices World-wide regarding corporate finance and what is the standing of Indian corporate sector in such state of affairs are few equally important questions in the mind of researchers that ask for fitting resolution. As the pressure for better financial performance has been mounting largely because of increasing competition in the present globally competitive era, the researchers in finance have been left with no option but to explore a number of factors and techniques that central philosophy of modern finance theory.

DISTRIBUTION PRACTICES IN CORPORATE FINANCE:

The area of corporate dividend policy has mesmerized financial scholars and economists for a long time, resulting in intensive theoretical modeling and empirical examinations. Dividend Policy is one of the most complex aspects in finance. Four decades ago, Black (1976) wrote, "The harder we look at the dividend picture, the more it seems like a puzzle, with pieces that just don't fit together". Brealey and Myers (2002) have enlisted dividend policy as one of the top ten puzzles in finance.

To start with, Miller and Modigliani (1961) viewed dividends as irrelevant and believed that in a world without market imperfection like taxes, transaction costs or asymmetric information; dividend policy should have no effect on its market value. However, since the capital market is neither perfect nor complete the dividend irrelevance proposition needs to be revisited, especially focusing the effects of information content of dividends, agency cost and institutional constraints. The market imperfection of asymmetric information is the basis for three distinct efforts to explain corporate dividend policy. The mitigation of the information asymmetries between managers and owners via unexpected changes in dividend policy is the cornerstone of dividend signaling models. Agency cost theory uses dividend policy to better align the interest of shareholders and corporate managers. The free cash flow hypothesis is an ad hoc combination of the signaling and agency costs paradigms; the payment of dividends can decrease the level of funds available for perquisite consumption by corporate managers. The signaling theories posit dividend policy as a vehicle used by corporate managers to transmit private information to the market (Bhattacharyya, 1979; Miller and Rock, 1985; William, 1988; John and William, 1985). Agency cost models begins with the agency problems emphasized by Jensen (1986). Agency problems result from information asymmetries, potential wealth transfers from bondholders to stockholders through the acceptance of high-risk and high-return projects by managers and failure to accept positive net present value projects and perquisite consumption in excess of the level consumed by prudent corporate managers. Large dividend payments reduce funds available for perquisite consumption and investment opportunities and require managers to seek financing in capital markets. The efficient monitoring of capital markets reduces less than optimal investment activity and excess perquisite consumption and hence reduces the costs associated with ownership and control separation (Easterbrook, 1984). Lintner(1956) made an empirical attempt to explain corporate dividend behavior by means of conducting interviews of personnel of large firms of United States of America. It was established that the primary determinants of changes in dividends paid out were the most recent earnings and past dividends paid. It was found that management is concerned with change in dividends rather than the amount and it tries to maintain a level of dividends. Also, there was propensity to move towards some target payout ratio but speed of adjustment varies among companies. But to come out with concrete conclusion, intensive study of all theoretical models together with empirical proof is mandatory. In recent survey studies, Lazo (1999) survey of 110 managers from Standard & Poor's 500 companies finds that companies (90%) use dividends as a signal of their future earnings; and they are very reluctant to cut dividends, regardless of a purpose for such a cut. Even when the companies initiate stock buyback programs, they do not reduce the dividends to support the repurchase, 75% of the firms have actually increased their dividend payment.

In the Indian context, a few studies have analyzed the dividend behavior of corporate firms. Krishnamurty and Sastry (1971), Mahapatra and Sahu (1993), Bhat and Pandey (1994), Narasimhan and Asha (1997) and Narasimhan and Vijayalakshmi (2002) are the good examples of empirical research carried out in India in the field of dividend decisions. However, dividend payment pattern of firms is still not clear and also, why do they initiate and omit dividend payments or reduce or increase dividend payments. Mohanty (1999) survey of the dividend payout ratio of the 2535 Indian companies indicate that firm's maintain a constant dividends per share and have fluctuating payout ratio depending on their profits.

With a view to revisit leading corporate financial practices in India, the researcher visualized to study the issue. Further, to make a concentrated attempt in select industry, the present study has picked up Indian Banking and Information Technology Industries for detailed investigation. The majority of the corporate finance studies have excluded Banking and Financial industry for their study (for instance, Rajan and Zingales (1995), Bhattacharyya and Banerjee (2001), Bhole and Mahakud (2004). Nevertheless, several previous studies, like, Fama (1980), Taggart and Greenbaum (1978) have taken the view that banks are corporations and thus susceptible to corporate finance theories. There exist, however, a fundamental difference lies in the regulatory environment. Approximately three decade ago Stephen A. Buser, Andrew H. Chen and Edward J. Kane (1981) held that banks have traditionally been conceived as more than just another business firm; they operate under unusual regulatory restrictions including entry limitations, interest rate ceilings, reserve requirements and government guarantees on their deposit liabilities. The situation has not changed much since then. Only that the earlier systems of regulated deposit rates etc. have now been replaced by regulatory capital requirement (Matten, 2001). The regulatory zeal has traversed the national boundaries. Banking is now the only industry, which has been subjected to international capital regulation through Basel Capital Accords. The meaning of all such Accords is simply that someone else other than the market tells the bank promoter that he must bring in so much equity to the firm calculated by a certain prescribed methodology. It is often forgotten that the market laws are almost akin to natural laws. Any attempt to impinge on such laws will drive the market to seek alternative ways to reach equilibrium. The study attempts to apply corporate theories on banking industry keeping in view the difference between financial and non – financial industry. Here is the brief overview of the two industries for the purpose of analysis.

The Indian Information Technology Industry has been one of great success stories of modern India. An industry that did not exist two decades ago is now the toast of the nation and the envy of the world. In the last two decades, the Indian IT industry has contributed significantly to Indian economic growth in terms of GDP, foreign exchange earnings and employment generation. However, equally significant though not as tangible, has been the ripple effect it has created on the general economic environment in the national and international economic space.

The industry has been the trigger for many “first” and has contributed not only to unleashing the

hitherto untapped entrepreneurial potential of the middle class Indian but also taking Indian excellence to the global market. It is arguably the most global of any Indian industry and has created international benchmarks for quality, proving to the world and to us that Indian companies can compete globally. Nearly 75% of Fortune 500 and 50% of Global 2000 corporations source their technology related services from India with an increasing number MNCs outlining their investment plans for setting up R&D operations in India. Industry's contribution to the country's GDP has been steadily increasing from a share of 1.2% in FY98 to 5.2% in FY07; it has contributed to foreign exchange reserves of the country by increasing exports by almost 36%. Export earnings for FY08 stood at approximately USD

40.0 billion as compared to USD 18.3 billion in FY05. The direct employment in the IT sector is expected to be 2.0 million by end of FY08 and has been growing at a CAGR of 26% in the last decade, making it the largest employer in the organized private sector in the country. The indirect employment generated, at the rate of 4 additional jobs created in the economy for every 1 job created in the sector, is even more socially relevant as nearly 75% of the workforce employed in those additional jobs are SSC/HSC or less educated. Moreover, in M&A era, while India Inc. has been witnessing an acquisition spree of overseas companies in recent years, the IT sector has led this phenomenon with the highest share (28%) of outbound M&A deals in 2007.

The financial sector reforms have brought about a sea change in the profile of the banking industry. The implementation of the reforms process has had several unique features. The reforms were carefully sequenced with respect to the instruments to be used and the objectives to be achieved. As regard the prudential regulatory framework for the banking system, industry has come a long way from the administered interest rate regime to deregulated interest rate, from the system of Health Codes for an eight-fold, judgmental loan classification to the prudential asset classification based on objective criteria, from the concept of simple statutory minimum capital and capital-deposit ratio to the risk-sensitive capital adequacy norms – initially under Base I framework and now under the Base II regime. There is much greater focus now on improving the corporate governance set up through “fit and proper” criteria, on encouraging integrated risk management systems in the banks and on promoting market discipline through more transparent disclosure standards. The policy endeavor has all along been to benchmark our regulatory norms with the international best practice, of course, keeping in view the domestic imperatives and country context. The Indian banking sector is growing at an astonishing pace and recorded a CAGR of 21% from March 2004 to March 2008. Till 2010, retail banking is expected to grow at a CAGR of 28% to touch a figure of Rs 9,700 billion. It has been undergoing major changes, reflecting a number of underlying developments. Advancement in communication and information technology has facilitated growth in Internet banking, ATM Network, Electronic transfer of funds and quick dissemination of information. Structural reforms in the banking sector have improved the health of the banking sector.

The average capital adequacy ratio for the scheduled commercial banks has increased to 13.08% as on March 31, 2008. The improvement in the capital adequacy ratio has come about despite

significant growth in the aggregate asset of the banking system. This level of capital ratio in the Indian banking system compare quite well with the banking system in many other countries- though the capital adequacy of some of the banks in the developed countries has remained under considerable strain in the recent past in the aftermath of the sub – prime crisis. In regard to the asset quality also, the gross NPAs of the scheduled commercial banks, which were as high as 15.7 % at end-March 1997, declined significantly to

2.4 % as at end- March 2008. The net NPAs of these banks during the same period declined from 8.1 % to 1.08 %. These figures too compare favorably with the international trends and have been driven by the improvement in loan loss provisioning by the banks as also by the improved recovery climate enabled by the legislative environment. What is noteworthy is that the NPA ratios have recorded remarkable improvements despite progressive tightening of the asset classification norms by the RBI over the years. The reform measures have also resulted in an improvement in the profitability of banks. The Return on Assets (RoA) of scheduled commercial banks increased from 0.4 % in the year 1991-92 to

0.99 % in 2007-08 .The Indian banks would appear well placed in this regard too vis-à-vis the broad range of RoA for the international banks . The banking sector reforms also emphasized the need to improve the productivity of the banks through appropriate rationalization measures so as to reduce the operating cost and improve the profitability. However, when world's biggest banks are facing liquidity crunch and their corporate practice are being question everywhere; Indian banks need to take every step attentively.

The foregoing discussion throws some light on the increasing awareness among the Indian Corporate managers as they have started realizing the most significant component in their business is the Shareholder's Value. The success of the company may be gauged by the extent of value, which it generate for its shareholders and this is the key objective of modern Corporate Finance. The researcher intends to undertake the research study with a view to become wiser with practices of two major Indian industries vis-à-vis corporate financial practices. It is presumed that the findings of this study in the context of India will be of use to academia in developing new theories and identifying areas where finance theory is not appropriately implemented.

INVESTING PRACTICES IN CORPORATE FINANCE

One of the most imperative objectives of finance theory is guiding firms on how to make investment decisions. The search for a reliable method of long term project appraisal method dates back to decades. The issue not only continues to be a matter of concern for academics or managers, is also becoming more and more important to investors and shareholders.

Finance theory prescribes the net present value (NPV) rule which states that a firm should take an investment project when the present value of its expected future cash flows, discounted appropriately for the project's riskiness, exceeds the cost of investment. The NPV is computed by forecasting the project's cash flow and discounting it at a discount rate reflecting the price charged

by capital markets for the cash flow risk. For investors with well diversified portfolios, only the project's systematic risk affects its value: its idiosyncratic risk should not be considered. What capital budgeting tools and techniques are being practiced by the industry? How popular are they? Do firms use methods that help to maximize the value? In practice, the NPV method is used extensively, but it is by no means the only technique used. Alternative methods, such as the Payback method and the use of earnings multiples, are also common. The payback is seen as possibly the most seriously flawed method, since it ignores the time value of money and cash flow beyond an arbitrary cut-off date. Brigham (1975) surveyed 33 large firms and found that 94% use NPV, IRR or profitability index criterion in their capital budgeting decisions. They are not using multiple hurdle rates and 61% use hurdle rate based on weighted average cost of capital (WACC). 39% of the respondents revise hurdle rates less than once a year and they do not have a system for its review. Pandey (1989) studied 14 Indian companies in 1984 and found that payback period method is most widely used followed by IRR as a capital budgeting technique. In Indian corporate, there is a lack of familiarity with the discounted cash flow methodology amongst the corporate executives. The project risk is assessed through sensitivity analysis and conservative forecasts. Surprisingly, Graham and Harvey (2001) report that 57% of the CFOs in their survey of US firms always or almost always use the Payback method in capital budgeting decisions, as compared to the most frequently used method among firms in the UK, Germany and France and it is also very common in the Netherlands, where it is the second most popular method after the NPV. A number of tools are available to determine the extent of profitability of a project (Akalu, 2001). However, some of these methods are unable to accommodate the current changes in business environment, especially, where increasingly shareholder value is of importance. In addition, their continuous application reveals significant limitation in their capacity to address the basic problems of investment appraisal (Akalu, 2001) and some of these methods requires complex decision making Processes. Thus, the choice of appropriate appraisal method is becoming a difficult for project managers, which requires critical analysis of various tools.

The concept of working capital management is substantial, particularly from research point of view, because of its effects on the firm's profitability and risk and consequently its value. Its major areas include inventory, receivable and payables. All these variables have immense impact on the risk and return of the firm. A firm is required to maintain liquidity in its day – to – day operation to ensure smooth running of the operation and to meet its short- term obligations. However, this is not a simple and straightforward task, as it has to operate its business both efficiently and profitably.

To start with, on the one hand, maintaining high inventory levels reduces the cost of possible interruption in the production process or of loss of business due to the scarcity of product, reduces supply costs and protect against price fluctuation. On the other, granting trade credit favors the firm's sale in various ways ; for instance, influence customers to acquire merchandise at times of low demand (Emery, 1987), to attract new customers . However, firms that invest heavily in inventory and trade credit can suffer reduced profitability. Thus, the greater the investment in current assets, the lower the risk, but also the lower the profitability obtained. Decisions about how much to invest in the customer and inventory accounts and how much credit to accept from

suppliers, are reflected in the firm's cash conversion cycle (CCC), which represents the average number of days between the date when the firm must start paying its suppliers and the date when it begins to collect payments from its customers. Cash Conversion Cycle is an outcome of working capital financing decision of a firm – whether the inventory and receivables are financed through suppliers' credit or through some other source. Some previous studies have used this measure to analyze whether shortening the cash conversion cycle has positive or negative effects on the firm's profitability. In particular, Shin and Soenen (1998) analyzed the relation between the cash conversion cycle and profitability for a sample of firm listed on the US stock exchange during the period 1974-1994. The results show that reducing the cash conversion cycle to a reasonable extent increase firm's profitability. More recently, Deloof (2003) studies a sample of large Belgian firms during the period 1992-1996. His results confirm that Belgian firms can improve their profitability by reducing the number of days accounts receivable are outstanding and reducing inventories. Moreover, he finds that less profitable firms wait longer to pay their bills. In case of financial firms as well, management of liquidity for day to day operations is of great importance. Providing liquidity to customers is one of the intermediation functions of financial concerns, namely, banks. It is therefore important that bank's own liquidity is at a comfortable level. Liquidity needs of an individual bank are to be related to the demands made or likely to be made by both depositors and borrowers for funds over a period of time. Looking at the varied customer profile of banks, liquidity needs also differ from bank to bank. Thus each bank needs to assess its liquidity needs based on the nature and composition of its assets and liabilities.

CONCLUSION

This research paper tells about the distribution of the finance and investing practices of finance in corporate sector. The concept of working capital management is substantial, particularly from research point of view, because of its effects on the firm's profitability and risk and consequently its value. Its major areas include inventory, receivable and payables. All these variables have immense impact on the risk and return of the firm.

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