Chapter 10
Concluding Observations

The objective of this concluding chapter is to provide a bird's eye view of financial management practices followed by the sample companies and their implications. This study has examined financial management practices amongst the 166 nonfinancial companies (segregated into 11 constituent sectors) comprising the BSE-200 index. The analysis is based on secondary as well as primary data. The secondary data is related to the 11-year period with effect from 2000–2001 to 2010–2011. The primary data takes into account the survey responses from 31 companies (amongst the 166 companies) on various aspects of financial decision-making. The study has dwelt upon the following specific dimensions of financial management of the sample companies:

- Capital budgeting practices.
- Capital structure decisions.
- Management of working capital.
- Dividend policy decisions.
- Risk management practices (especially related to international transactions).
- Corporate governance practices.
- Profitability analysis.

In the light of financial management practices followed, an attempt has been made to devise/develop an index of professionalism in financial management (IPF), based on normative framework/sound tenets to be used for such financial decisions.

The important conclusions emerging out of the study may now be underlined.

Capital budgeting practices in India, at least amongst the sample companies, appear to have improved over the past two decades with an increasing number of companies using more sophisticated DCF techniques. A striking finding of the survey is that internal rate of return (IRR) is preferred over the net present value (NPV) method by most of the sample companies, in spite of the superiority of the NPV method. The theory–practice gap is a recurrent theme in the capital budgeting literature, in particular with regard to NPV. Despite the recommendations of the financial

P.K. Jain et al., *Financial Management Practices: An Empirical Study of Indian Corporates*, India Studies in Business and Economics,
DOI 10.1007/978-81-322-0990-4_10, © Springer India 2013

literature on using NPV as the primary technique, this research too found that respondent firms indicated a preference for IRR compared to NPV.

As far as the capital expenditure activity is concerned, the sample companies have made substantial investments in acquisition of new fixed assets. It is pertinent as well as satisfactory to note that paucity of funds is not an inhibiting factor in undertaking capital projects by the sample companies. While it is true that the post-liberalisation period has witnessed a salubrious effect on their investment activity, the rate of investment in new fixed assets (measured on a year-to-year basis) has been impressive in that it has been at a rate of 18.06% during the 11-year period of the study. This is in contrast to the modest figure of less than 5% recorded for the public sector enterprises (PSEs) over a 13-year period (1991–2003) in a separate study conducted by the authors (Jain and Yadav 2005). Above all, the global recession has not impacted the sample companies (representing vital segment of Indian economy) significantly.

As far as the financing pattern of long-term investment projects is concerned, it is satisfying to note that the sample companies are following sound policies in this regard – their fixed assets have been financed from long-term sources. In fact, more commendable is the aspect that their permanent working capital needs have also been financed through long-term sources of finance. This is in conformity with the sound principles of financial management.

Cost of capital constitutes an integral part of capital budgeting proposals. It is encouraging to note that the vast majority of the sample companies follow theoretically sound and conceptually correct basis of computing cost of capital, that is, weighted average cost of capital (WACC). More than two-thirds (67.85%) of the firms have been following the appropriate WACC basis compared to other methods, suggesting a reduction in the theory–practice gap compared to the past studies. Also, consistent with finance theory, the survey reveals that the sample companies are risk-averse. Sensitivity analysis is the most popular approach used by these companies to incorporate risk in their capital budgeting decisions, followed by shorter payback period method and higher cut-off rate for more risky projects.

Another notable finding is the emergence of new techniques of real options and abandonment options as a part of practice by the sample companies, while evaluating capital budgeting proposals. This perhaps signals the adoption of emerging techniques by our the sample companies, an encouraging indication of growing professionalism amongst them. Half of the respondent firms (50%) used real options while evaluating their investment projects. The results are in sharp contrast with other international studies reporting low usages.

Very high fixed-cost components of capital projects and the irregularities in prediction of future cash flows due to decrease in sales and increased competition seem to be the major factors leading to failures of capital budgeting decisions for the sample companies. This is perhaps a reflection of the growing challenges of a volatile global marketplace.

As far as designing of *capital structure* is concerned, the study brings to fore that debt (which was the most important constituent of corporate financing during pre-economic liberalisation period) is steadily being replaced by equity by the majority

of the sample companies in India. This is an aspect that is corroborated as well, from the steadily declining debt–equity ratios over the past two decades brought forth by the earlier studies.

Another notable finding of the study is that there seems to be a significant portion of short-term debt in the total debt. Reliance on short-term debt to such a marked extent in preference to long-term debt is not in conformity with sound tenets of finance theory as it causes grave risk, at least, in terms of non-renewal and interest rate fluctuations. Therefore, there is need for substitution of short-term debt with long-term sources, in particular, when the requirements are permanent in nature.

It is also pertinent to revisit here that the development/public financial institutions (DFIs/PFIs) constituted the backbone of the Indian financial system until 2000; however, their relative significance in the emerging financial scenario had been declining, indicating a shift in corporate financing in India, in terms of greater reliance of industry on non-institutional sources of finance and greater recourse to the capital market.

Another important aspect that may be favouring equity financing (even though it is a more expensive source of finance vis-à-vis debt) is the growing impression that credits publicly traded (listed) companies with greater transparency and enhanced goodwill and more professional operations (when compared to their debt dominated counterparts). After clause 49 of corporate governance becoming mandatory in India (from 1 April 2006), companies that disclose material information (as a part of being publicly traded) are assumed to have better financial discipline, diversified/pedigree ownership, better corporate governance and management and corporate social responsibility. It is our contention that these aspects (now and in the future) will perhaps increasingly affect the valuations of companies. This could be the possible future indication of our findings and the road ahead for corporate financing.

Yet another notable finding of the study is that the sample companies seem to be comfortable with the servicing of debt in terms of both payment of interest and repayment of principal. It is pertinent to note here that this level of comfort could also be brought about by the steadily declining proportion of debt in the capital structure of such companies (over the past two decades). Further, companies are even able to meet their total external obligations comfortably indicating sound earning capacity. Given the fact that the companies raise funds (externally) to meet their financial needs, they are perforce to have sound fundamentals in terms of reasonable/low risk and so on. It is satisfying to note, then, that they have low operating and financial risk (as per operating and financial leverage).

A matter of concern is the finding of a low component of secured loans to total borrowings. These large the sample companies with substantial assets base should be able to raise finance from secured loans as it will relatively (probably) be the cheaper source of finance compared to other borrowings. Hence, there is untapped opportunity of lowering cost of capital by having the relatively lower cost of debt.

Another important finding is that the sample companies show non-adherence to the pecking order hypothesis (in its entirety). This could perhaps be due to the robust capital markets in the country making it easier for the companies to raise equity. This further strengthens our contention that equity for aspects like signalling

theory and reduction in agency costs is finding favour with the sample companies over the traditional model of debt being utilised first and equity finance only being raised as the last resort (under the pecking order hypothesis).

Majority of the sample companies follow stable *dividend policy* (they seem to follow an approach similar to Lintner's model). The survey findings on the preference to adopt stable dividend policy were in fact more encouraging. This practice is in tune with the sound principles of financial management. In terms of amount, however, the companies have paid out less than one-quarter of their net profits after taxes as dividends during the 11-year period of the study. The low dividend payout ratio signifies that retained earnings constitute an important source of finance for the sample companies and also that the companies have growth opportunities necessitating the ploughing back of earnings.

It is satisfying to note that the sample companies have comfortable short-term liquidity/financial position (reflected in mean current ratio and acid-test ratio for the 11-year period) and, therefore, are not likely to encounter any major difficulty in paying/discharging their short-term obligations in time. As far as cash management is concerned, it is encouraging to note that the sample companies are following sound cash management practices. While cash credit limit (from the banks) constitutes the major source of dealing with cash deficit situations, deposit with banks for short term has been identified as the important method of deploying cash by majority of the sample companies. Further, cash credit facility from the banks appears to be an enabling factor for the sample companies to operate at lower cash balances.

Likewise, it is a matter of satisfaction to note that the sample companies have reasonably low holding period for raw materials, work-in-process and finished goods inventory. Given the fact that carrying inventory involves substantial financial costs, this is sound inventory management. Debtors and creditors form other significant constituents of *working capital* cycle. It is common practice amongst the sample companies to assess the financial health of customers before granting credit and to prepare ageing schedule of debtors for monitoring purposes.

Another notable finding is that the sample companies use the professional method of 'determination of individual components of current assets and current liabilities (based on raw material holding period, debtors' collection period, creditors' payment period and so on)' as the basis of working capital determination. As far as the policy towards financing working capital is concerned, 'permanent needs from long-term sources and temporary/seasonal needs from short-term sources' (the 'matching' approach) seem to be favoured by the majority. These findings are in conformity with sound theory of financial management.

Although extraordinary situations involving shortage and surplus of working capital (including cash) cannot be completely eliminated, their frequency can be minimised through rationalisation and standardisation of working capital management practices. It is encouraging to note that the majority of the sample companies have not experienced working capital shortage and if they do, they face it only occasionally. Poor collections from debtors and accumulation of excess inventory have been cited as the two major reasons for working capital deficiency by such companies. In surplus working capital situation, it is equally satisfying to note that

funds are not kept idle. They have been temporarily parked in banks in the form of special deposits or utilised to retire short-term debt by most of the sample companies.

It appears that the components of cash and bank, inventory and debtors and bills receivables account for more than 60% of the total current assets for the sample companies indicating a high degree of advance payments and/or prepaid expenses in the balance sheets of the companies.

Perhaps for the first time, the concept of zero working capital (inventory + debtors − payables) and its practice amongst the sample companies was studied. It is encouraging to note that one-fourth of the sample companies are operating on zero working capital. Even though the statistics supporting zero working capital seem modest, the trend does support growing aggressiveness/professionalism in the management of working capital by the sample companies.

The constituent sectors exhibit variations amongst all aspects of working capital management. Some sectors (FMCG, housing, metals and power) appear to have been impacted from the recession, but most of the sectors seem to have withered the post-recession period with little/no alterations in their working capital management.

In brief, the importance of liquidity is not lost on the sample companies. However, the sample companies could do well to be more aggressive with their working capital management as they are large and stable companies and may attempt a better trade-off between risk and profitability.

In spite of the sample companies being amongst the largest companies in India (with substantial international exposure in terms of size of transactions), their holding pattern still remains dominantly domestic. This is perhaps due to the restrictions imposed on FDI by RBI. This factor could have been responsible in part for the relative insulation of the Indian economy in the aftermath of the financial crisis originating in the USA in the later part of 2007. Though the Indian economy has faced a recession, the profitability of the sample companies has not suffered any considerable damage.

The survey on *risk management* practices with regard to international operations in the sample companies elicited responses from practitioners on political risk, exchange rate risk and interest rate risk, respectively. The responses revealed that the sample companies are taking steps to mitigate such risks currently and also envisage using newer risk management instruments/techniques in future.

The sample companies would like to reduce political or country risk by incorporating a risk premium in the cost of capital. Amongst other measures, creating a joint venture with an enterprise of the host country is the most preferred one. As regards exchange risk management, in case of anticipated depreciation, companies are selling local currency forward, borrowing locally and invoicing exports in foreign currency and imports in local currency. In the case of anticipated appreciation, the most likely ways are to buy local currency forward and to reduce local currency borrowing. From the survey, it is apparent that the sample companies are only using netting and back-to-back swap (internal techniques of exchange risk management) in any significant manner. As regards the use of external techniques, forwards are the most preferred, followed by currency swaps, currency options and currency

futures. Exchange risk management is organised by internal teams as well as with the help of outside institutional consultants. The survey revealed that the sample companies are faced with interest rate risk and they would like to use newer instruments including derivatives such as interest rate options, swaps and futures as they become more and more prevalent in the market.

An overwhelming majority of companies (96.42%) respond that risk is understood in its entirety by the company and measures are taken to mitigate it. This is an indication of the sophisticated risk assessment and management practices being followed by the sample companies.

Profitability of the sample companies (measured through gross profit and net profit), prima facie, appears to be stable and attractive (as an investment choice). Though the recession in phase four did witness some fluctuations in the profitability of certain constituent sectors like the metals sector, sectors like housing and power increased profits in a statistically significant manner, overall, the sample seems to have emerged unscathed from the impact of the recession, perhaps due to its strong management fundamentals. The other aspects of profitability, namely, return on total assets (ROTA), return on capital employed (ROCE) and earnings for equity owners (reflected in ROSE) appear to be equally satisfactory. All in all, not only are the sample companies deploying funds efficiently and providing adequate returns to the capital providers, they are working towards generating better returns for their shareholders. These findings are notable as well as they support the RBI's views on the resilience of the Indian economy.

It appears that the sample companies do adhere to certain aspects of *corporate governance* but not in its entirety. This is an area of concern as the sample companies are amongst the largest companies in the country (and as such have a large number of stakeholders they are responsible to). In that regard, they have a larger image to protect. At the time of writing this monograph, 6 years have passed since the date when clause 49 became mandatory. The companies have had adequate time to set up corporate governance structures and practices (in the meanwhile). It is important that the Indian corporates need to regard the issue of governance not as an irritant or impediment but as an essential tool and mechanism for their very survival in the new economic environment. The sample companies, thus, can do well to be more serious and professional about adopting and practising good corporate governance.

Finally, what has been described and discussed above was included in the development of an *index of professional practices* relating to financial management. The index has been developed in the basis of the responses received to a questionnaire sent to all the 166 the sample companies. Though the number of responses received, being 31, was not very high, it can be considered a fairly good representation of the sample. In conclusion, it can be said that the sample companies are using sound financial management practices in a great measure. However, there is a greater scope for improving professionalism in some categories of financial management practices (like capital structure and risk management) than others.

In conclusion, it appears safe to summarise that the sample companies seem to be following sound financial management practices. Needless to say, there are several

areas where more emphasis in training and practice could further enhance financial decision-making (this has been highlighted in the form of a normative framework at the end of the chapters). Nonetheless, this research adds to the body of knowledge on financial decision-making by showing where Indian companies stand in this decade and identifying specific areas for improvement. There are surprising (rather positive) findings like use of WACC, extensive use of DCF methods, prevalence of use real options, easy financing of assets, aggressive working capital management, adequate coverage of total external obligations, stable dividend policies and encouraging profitability and efficiency levels, indicating the growing sophistication in financial decision-making.

Reference

Jain PK, Yadav SS (2005) Financial management practices – a study of public sector enterprises in India. Hindustan Publishing Corporation, New Delhi