FINANCIAL STRUCTURE OF INDIAN COMPANIES

CS RABINDRA NATH SWAIN*; DR. B.C.M.PATNAIK**

*Professor,
School of Management,
KIIT University,
Bhubaneswar, Odisha, India.
**Associate Professor,
School of Management,
KIIT University,
Bhubaneswar, Odisha, India.

ABSTRACT

The present study is an attempt to understand the financial structure of Indian Companies. For this purpose selected companies considered and the financial structure analysis made and accordingly the inputs developed. Financial Structure of the company is a specific mixture of short term borrowings and long term debt and equity that it uses to finance its operations. Capital Structure accounts for only Long Term Debt and Equity where as Financial Structure accounts for both Long Term and Short Term borrowings and Owners' Equity with which the company's assets are financed. Capital Structure is a mix of company's long term debt, specific short term debt, common equity & preferred equity. Capital structure is how a firm finances its overall operations and growth by using different sources of funds. Debt comes in the form of bond issues or long term notes payable while equity is classified as paid up capital and retained earnings. A short term debt such as working capital requirements is also considered to be part of the capital structure.

A high debt/equity ratio generally means that the company has been aggressive in financing its growth with debt. This can result in volatile earnings as a result of the additional interest expense. If a lot of debt is used to finance increased operations, the company could potentially generate more earnings than it would have without this outside financing. If this were to increase earnings by a greater amount than the debt cost i.e., interest cost, then the shareholders benefit as more earnings are being spread among the same number of shareholders. However, the cost of this debt financing may outweigh return that the company generates on the debt through investment and business activities and become too much for the company to handle. This can lead to bankruptcy which would leave shareholders with nothing. A company's reasonable, proportional use of debt & equity to support its assets is the key indicator of balance sheet strength. A healthy capital structure that reflects a low level of debt and a corresponding high level of equity is a very positive sign of investment quality (Richard Loth).

Financial Structure is divided in to the amount of the company's cash flow that go to the creditors and the amount that goes to the shareholders. Financial Structure is the way in which a company's assets are financed.

Thus an ideal financial structure is such an optimal financial structure that maximizes the firm's value and minimizes firm's cost of capital with a tolerable risk.

INTRODUCTION

A strong balance sheet is that which has a healthy proportion of equity capital vis a vis its debt capital. Financial structure of a company indicates strength of the company's fundamentals. It describes the composition of a company's permanent capital consisting of debt and equity. Equity consists of paid up share capital and the retained earnings that belong to the owners. The more the proportion of owners' funds the less risky the firm is. Financial fitness depends upon the owners funds in comparison to debt fund employed in a business. As such this financial mixture directly affects the risk & value of the business of the company. What concerns a Finance Manager is how much to borrow vis a vis its equity contributions to finance its operations so that the best mix of debt and equity for the firm can be obtained. The Finance Manager strives to obtain the least expensive source of funds so that returns and value of the firm can be maximized.

Each business has its own mixture of equity and debt and they differ depending upon its business needs and expenses. A company may raise funds from the public by issue of bonds to buy stock or may raise funds by way of issue of stock to repay its debt. Thus each company has its own debt to equity ratio at different point of time. An optimal Financial Structure is the best mix of borrowings and owners' equity base that maximizes its value. The company's ratio of short term and long term debt should be considered when examining its financial structure. A company's financial structure provides a deeper insight into how risky a company is for potential investors. Determining an optimal capital base is the chief requirement of any company's corporate finance department.

The composition of a company's long term capital is described as its capitalization. The debt component of a company's capitalization consist of short term borrowings, the current portion of long term debt, 2/3rd of the principal amount of operating leases and redeemable preference shares. Use of debt finance brings leverage effect and increases the amount of financial resources available to the company for growth and expansion. It is assumed that management earns more on borrowed funds. But it is also to be kept in mind that a company which is considered as a highly leveraged company, finds its freedom of action restricted by its creditors and may hurt its profitability. Meeting operating liabilities and debt liabilities may bring adverse situations which can worsen the financials of the company. It may so happen that if the company is in a highly competitive business it may lose its market share to its competitors who can take advantage of such highly levered companies.

There is no such thumb rule as to what should be the ideal debt to equity ratio for all types of companies. Such relationship varies according to industries involved, line of business and stage of development. Investors prefer companies with low debt portion in the capital mix as companies with strong financials to invest. The debt ratio (Total Liabilities / Total Assets) and the debt equity ratio are the indicator of a company's financial fundamentals. More the total liabilities mean less equity which indicates a highly levered position. But this gives equal weightage to operational liabilities and debt liabilities. The same problem is also with debt equity ratio. But capitalization ratio (total debt/total capitalization) provides a better insight into a company's capital position. This ratio compares the debt component of a company's capital structure (the sum of debt obligation + total shareholders equity) to the equity component. A low percentage is indicative of a healthy equity cushion which is always more desirable than a high percentage of debt. The total debt may consist of bonds & other similar long term fixed maturity type of borrowings. It also may consist of bank loans. Whatever may be the problematic condition of a company, if it continues to pay interest on time, bond holders can not demand repayment of the principal, but in case of debt fund from a bank, they have a covenant that they can call back the loan. This determines the degree of risk.

THE OBJECTIVE OF THIS STUDY

The Indian Companies in India has been assigned an added significance for removing the regional imbalances and for strengthening and safeguarding the overall interest of the society. They have contributed to the economic development of the country by developing basic and capital goods industries and helping in the rehabilitation of sick industrial units.

The working of Indian companies in India has, however invited criticism also. In certain spheres they have yet to prove their worth. The Indian companies in India possesses enormous capital investment and for viability they should yield at least a minimum general percentage of return on the 'Capital Employed'. The most serious problem with the Indian companies has been that of poor 'financial structure'.

The planning of the 'Financial Structure' is a must for the measurement of the efficiency of the Indian Companies. To evaluate the efficiency and performance of Indian Companies, the measurement of the 'Financial Structure' is resorted to. The performance and efficiency of Indian Companies is directly related to 'Financial Structure'.

FACTORS AFFECTING THE FINANCIAL STRUCTURE

The poor 'financial structure' may be due to diverse factors. The following factors, which often renders Indian companies with a poor 'financial structure' should be sorted out and highlighted with a view to suggesting remedial measures.

- ✓ Trading on equity:This implies taking advantage of equity share capital to borrow funds on reasonable basis. This is the additional profit equity shareholders earn because of issue of debentures & preference shares. It is based on the thought that if the rate of dividend on preference capital and the rate of interest on debt is lower than the rate of company's earnings, equity shareholders are at an advantage. This means that a company should go for a judicious blend of preference shares, equity shares and debentures. Trading on equity becomes important when expectation of shareholders is high.

- ✓ Degree of control: Board of Directors and shareholders of a company aims at retaining full control over the management and do not want any dilution in their authority & power in managing the affairs of the company. That's why they prefer more debt funds than funds from equity issue.

- ✓ Flexibility of Financial Plan: The capital structure should be such that the company should be able to change the financing plan by refunding/ repaying loans when necessary to retain a specific debt to equity ratio

- ✓ Choice of Investors: Generally bold investors go for equity financing where as cautious investors generally prefer investment in bonds/debts.

- ✓ Capital Market Conditions: Market price of share exerts significant influence on the financial structure.. During depression, the financial structure generally consists of loans/ bonds while during period of boom & inflation, company's financial structure generally consist of equity shares.

- ✓ Cost of Financing: Management always try to minimize the overall cost of capital. Hence if the debt cost for a company is high then the company prefers enlarging the equity base. Similarly if cost of debt is low for the company than the cost of equity, then company prefers financing through bonds or debt funds.

- ✓ Period of Financing: Period of financing also influences the capital structure of a company. Usually debt financing is for a shorter term where as equity financing is made for permanent investment. The financial structure of a company depends upon the nature of the business and industry, for e.g. projects with high gestation period, vulnerability of return, stability of sales, size of the company etc. usually smaller size companies prefer debt financing and financing with retained earnings where as big size companies prefer equity financing.

- ✓ Credit rating: Credit rating is done to judge a company's ability to repay the principal and interest on debt obligations, usually on bonds and commercial papers. Investors will be glad to see high quality rankings on the debt of the companies they are considering as investment opportunities. From investors point of view, greater the percentage of funded debt to total debt disclosed in the notes to financial statements, the better.

RECOMMENDATIONS

The 'financial structure' of Indian companies in general has been poor. The poor financial structure ultimately results into inefficiency and unsatisfactory performance of the Indian companies.

The Indian companies in India have assumed an ever increasing role and significance in India's economy. It is generally said that as finances are readily available to these companies, the persons in management usually pay a very scant regard to the proper and effective utilization of funds; so much so that they do not care to economies of the use of funds even to the required extent. In Indian reference, the 'financial structure' of Indian companies is significantly poor. Although a number of units have been making it to some extent, yet when we compare the overall position, the result is always seems to be unsatisfactory.

A number of factors cause poor financial structure in Indian companies, and few of them are:

- ✓ Corporate Mis-governance

- ✓ Excess investment in fixed assets
- ✓ Improper capitalization
- ✓ Poor profitability
- ✓ Excess investment in inventory
- ✓ Attitude of investors
- ✓ Use of short term funds in Investments, Loans & Advances
- ✓ Govt. policy etc.

It is often observed that companies with a good profile, take up business activities or projects which are beyond the core competency of the company. Due to a wrong decision of investment proposal, the company which had been performing well ultimately sinks and never revive. This often results in defective financial structure. Similarly diversion of funds has become one of the most significant factor for a defective financial structure. Verifying the financial statements of many companies in India it is found that companies with very good profile used to raise funds both short term and long term from banks and financial institutions and inter corporate market and divert substantial portion of such funds to companies under same management at nominal rate of interest to be invested in group companies shares in a complex chain of investment activities. Because of this, the 'loans and advances' component of "Current Assets & Loans & Advances" constitute substantial portion of top companies of most sectors in India. This gives a wrong impression about the true "Current Assets and Liabilities" position of Indian Companies. Substantial part of the 'Loans & Advances' component are irrecoverable or not intended to be recovered and by adopting a conservative policy if we subtract this component from the "Current Assets & Loans & Advances" Head of the Balance Sheet, then the remaining current assets portion consisting of cash in hand, cash at bank, inventories, sundry debtors, receivables etc together will become less than current liabilities. This means Indian companies are not optimally utilizing the funds from current liabilities to finance its current assets. Merger and amalgamations within the same group with an intention to divert funds from main business activities to other business activities like non banking financial services etc. also cause distorted financial structure of companies in India. Ultimately stakeholders suffer.

CONCLUDING OBSERVATIONS

In order to overcome the problems pertaining to 'financial structure' of Indian companies and solutions to the problem, companies must adopt best practices of corporate governance which alone would make these companies more suitable to the Indian economy. The Role of the Board of Directors particularly of the independent directors, independency and effectiveness of Board Committees, the efficiency and effectiveness of the Internal Control System, shareholders activism, professionalization of the Board by inducting financial experts, an attitude and mind to create value etc., would surely go a long way in formulation of an optimal financial structure in the best interest of the company and the economy. Other factors remaining constant, a 1:1 ratio of total borrowings (long term and short term) to shareholders funds would be regarded as an ideal financial structure.

Observing the performance of various mutual funds and efficiency of fund managers in India, investors now-a-days are more risk averse and concerned about safety of their capital than earning high returns from investments in the corporate world. Therefore, it is high time that corporate should dress up their financial structure in such a fashion so that potential investors would consider the company as the least risky investment avenue.

REFERENCES

- ✓ Madhu Dubhashi- Financial Analysis of Indian Companies- selected case studies- Global Data Services of India Ltd.
- ✓ Paresh P. Shah- Financial Management- Biztantra publication
- ✓ Pandy I.M- Financial Management
- ✓ Sashi K.Gupta & R.K Sharma- Financial Management, Kalyani Publisher
- ✓ Khan & Jain- Financial Management- Tata Mcgraw Hill
- ✓ Srivastava & Mishra – Financial Management- Oxford Publication