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Can Borrowing from Owners Supervision and Improvement Managers?

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ABSTRACT

In this research, the effect of capital structure reform of companies before and after capital structure reform is studied. It is expected that through borrowing from stockholders and creating a greater sensitivity, the performance of managers would be improved and this effect can be observed in corporate performance indicators. Accordingly, in this study all the companies that have increased their capital during 2007 to 2011 with the objective of reforming their capital structure are considered. 42 companies are selected according to the adjusting conditions of population and eliminative-selective sampling method. For this purpose, first the companies one of objectives of whose capital increase has been capital structure reform were identified and then a number of factors in each corporation were studied before and after capital increase. According to the hypotheses testing, it was revealed that financial leverage ratio, rate of return on assets, rate of equity, debt to equity ratio and weighted average cost of capital (WACC) before and after capital structure reform have had significant difference. However, such a significant relationship was not observed in other variables. Also, the significance level of rate of equity and the return on assets ratio were much more than the rest of financial performances. In addition, no audit clause was observed in audit reports concerning companies' liquidity problems until two years after capital increase.
KEYWORDS: Capital Structure, Financial Ratios.

INTRODUCTION

Companies pay high attention to financing or capital structure reforms which are among their vital decisions, [3] Many theories and ideas are presented discussing the ways and quality of financing[21]. Financial managers of companies exercise different methods of financing using these theories and ideas as well as the reasons that they think would help them achieve objectives such as equity increase, shareholders' confidence, etc [8],[13],[9],[1]. Accordingly, this fact that the issue of financing in companies is important for managers, shareholders and creditors encouraged us to study the relationship between capital structure of corporation and performance, liquidity and market indicators before and after capital structure reform.,[23],[17]. This study is trying to examine the effect of companies' capital structure reform before and after capital structure reform according to the guidelines of Securities & Exchange Organization (stating that the debt ratio of companies should not exceed a certain percentage and companies must act to reform their capital structure to improve the conditions of companies in such a way that the interests of shareholders are ensured and the overall risk of corporation is reduced).[22],[14]. For this purpose, first the companies one of the objectives of whose capital increase has been capital structure reform are identified and then a number of factors in each corporation before and after capital increase are studied[2],[13],[20].

RESEARCH BACKGROUND

The research results of Noravesh and Yazdani (2012) indicate that there is a negative and significant relationship between financial leverage and investment. Also, these results specify that the relationship between financial leverage and investment for companies with lower growth opportunities is stronger than companies with greater growth opportunities.[19]

In their article, Mashayekh and Shahrokhi (2006) examined the factors affecting capital structure and presented strategies for finding the optimal capital structure based on various national and international researches[16].

Ezadinia and Rasaeian (2009) studied the relationship between capital structure and taxes in 48 companies listed in Stock Exchange during 1995-2007 using cross-sectional and combined regression methods. The results of the two methods indicated lack of a significant relationship between capital structure and taxes[11].

Ahmadpur and Salimi (2007) empirically examined the effect of type of industry and size of corporation on capital structure of companies listed in Tehran Stock Exchange during 1993-2002. They concluded that capital structures in different industries are not identical and significant relationship between size of corporation and capital structure was not approved[4]

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Mehrani and Rasaeian (2009), through reviewing the relationship between capital structure and market value added of 189 companies listed in Tehran Stock Exchange during 1996-2007, concluded that change in capital structure explains 49 percent of variations in the performance of these companies and there is a positive and significant relationship between financial leverage and market value added.[17].

The study of Eeinhard and Li (2010) indicated that the target adjustment models of capital structure cannot determine whether companies adjust their capital structure toward a target. They may indeed show target adjustment behavior when their capital structure is actually away from their goals.[10]

Amidu (2007) obtained the following results in Banks of Ghana: profitability, corporation taxes, growth, asset structure and size of banks are affected by capital structure or financing decisions of banks. The findings of this study considerably demonstrate that more than 87 percent of banks assets are financed through liabilities and moreover the short term liabilities comprise more than 75 percent of banks capital structure. This highlights the importance of short-term liabilities over long-term liabilities in financing of Ghanaian banks[7].

Through an unbalanced combinative dataset of 10,416 firms in 12 industries during 1994-2006, Guney, Li & Fairchild (2010) found that there are considerable differences between debt ratio and product market competition among industries. The results indicated that the relationship between financial leverage and product market competition is a nonlinear relationship (parabolic or cubic) and is dependent on type of industry, size of corporation as well as growth opportunities. The results of GMM system demonstrate that Chinese companies have tendency to set up financial leverage ratio through time. In general, the fixed effects and GMM assessment identified an inverse linear relationship between the intensity of competition and financial leverage ratio[12].

Al-Ajmi *et al.* (2009), in a case study on 53 companies in Saudi Arabia during 2003-2007, concluded that the capital structure of companies is positively affected by profitability, size, growth opportunities and type of ownership and also state ownership, family ownership, market risk, payment of dividend per share as well as stocks liquidity have effects on it[5].

Viviani (2008) studied the financial leverage of 410 French companies in wine industry during 2000-2004. The results suggested that the hierarchy theory seems to explain better the financial leverage of French wine companies. Also, significant differences were observed in debt ratio between cooperatives and the legal structure. Besides, debt ratios are different between sub-sectors of industry (wholesalers, wine producers, wine makers, etc.)[24].

In his paper, Carpentier (2006) reviewed the unrelated suggestions which make changes in capital structure but will not affect the corporation value and concluded that there is no significant relationship between change in debt level and change in corporation value[15].

RESEARCH METHODOLOGY

Research Method

This study is considered an applied research in terms of research objectives which addresses the effect of capital structure reform among the variables. Also, this study is a descriptive and ex-post facto/comparative research in terms of data collection method.

Statistical Population & Sample

The statistical population of this research includes all the companies listed in Tehran Stock Exchange during 2007-2011, which the goal of their capital increase has been capital structure reform. The samples were determined using systematic elimination method which can be considered as available sampling. The samples are adjusted according to the following conditions:

1. Intermediary and investing companies, financial, credit and holding institutions are not included.
2. The companies that on 2011 were authorized to raise capital but due to the fact that their fiscal year has not yet terminated and their auditor and board reports are not available have not been considered.
3. The companies that the end of their fiscal year is not February have been removed.

The measurement method of research variables is as follows:

Degree of operating leverage: is equal to the percentage of changes of earnings before interest and taxes (EBIT) divided by the percentage of sale changes.

Degree of financial leverage: is equal to total liability divided by total assets.

Ratio of market price to earnings per share (P/E): is equal to the market price per share at year-end divided by earnings per share (EPS) of corporation at year-end.

Free cash flow: is equal to net profit (loss) plus depreciation cost of assets minus payments for the purchase of capital assets minus dividends per share (DPS).

Return on equity (ROE) ratio: is equal to net profits divided by total equity.

Return on assets (ROA) ratio: is equal to net profits divided by total assets.

Weighted average cost of capital (WACC): (sources of capital ratio multiplied by financing costs through intake facilities) + (capital ratio multiplied by the cost of equity) + (ratio of retained earnings multiplied by financing costs from retained earnings).

Research Hypotheses

The research hypotheses are as follows:

1. There is significant difference between the ratios of operating leverage before and after capital structure reform.
2. There is significant difference between the ratios of financial leverage before and after capital structure reform.
3. There is significant difference between the ratios of market price to earnings per share before and after capital structure reform.
4. There is significant difference between the ratios of current assets to total assets before and after capital structure reform.
5. There is significant difference between the ratios of return on equity before and after capital structure reform.
6. There is significant difference between the ratios of return on assets before and after capital structure reform.
7. There is significant difference between the ratios of debt to equity before and after capital structure reform.
8. There is significant difference between the profit before tax ratios before and after capital structure reform.
9. There is significant difference between the weighted average cost of capital ratios before and after capital structure reform.
10. There is significant difference between the free cash flow ratios before and after capital structure reform.

RESULTS AND DISCUSSION

In this study, the effect of capital structure reform of companies before and after capital structure reform is discussed. For this purpose, first the companies that one of the objectives of their capital increase has been capital structure reform were identified and then a number of factors in each corporation before and after capital increase were studied. The error level of 0.05 was used to test the hypotheses and the null hypothesis as well as alternative hypothesis can be written for each hypothesis as follows:

H0: There is no significant difference between the operating leverage ratios before and after capital structure reform.

H1: There is significant difference between the operating leverage ratios before and after capital structure reform.

The results of testing hypotheses are summarized in Figure (1):

Hypothesis	Average	P-value	Sign	Result
DOL ratio-pre adjust capital	0/1512	-1/823	0/076	Not Confirm
DOL ratio-after adjust capital	8/9148			
Leverage ratio-pre adjust capital	0/6790	3/266	0/002	Confirm
Leverage ratio-after adjust capital	0/6088			
P/E ratio-pre adjust capital	5/7548	-1/104	0/276	Not Confirm
P/E ratio-after adjust capital	6/6307			
Tax / EBT ratio-pre adjust capital	0/1245	-0/381	0/705	Not Confirm
Tax / EBT ratio-after adjust capital	0/1286			
WACC -pre adjust capital	0/1764	2/325	0/021	Confirm
WACC -after adjust capital	0/1124			
Cash flow ratio-pre adjust capital	127143/5	-0/267	0/791	Not Confirm
Cash flow ratio-after adjust capital	150982/7			

Based on hypothesis testing, it was determined that there were significant differences between the ratios of financial leverage, ratios of current assets to total assets, ratios of debt to equity as well as the ratios of weighted average cost of capital before and after capital structure reform and such a significant difference was not observed in other variables.

By studying the system of corporate financing in capital market of Iran, it can be observed that most companies are faced with two approaches in order to ensure finance for implementation of profitable projects:

1- Finance through equity.

2- Finance through applying financial leverage or creating liability.

Application of the first approach results in decrease of return on share and the second approach increases corporation value, but its excessive increase will enhance financial risk. With increased financial risk due to increase of expected return on shareholders and creditors, the effective rate of corporate debt and financial costs

will be increased. By understanding this issue, companies generally consider a right combination of these two approaches which leads to optimal capital structure. However, due to legal pressures originating from tax laws or Securities & Exchange Organization of Iran, companies sometimes carry out a specific type of financing. The results of the present study also confirm this fact. The majority of changed and important financial ratios are ratios that have no impact on cash flows of companies, rather focus on capital structure reform in order to observe and reduce the pressures of auditor reports and legal inspectors as well as stock requirements. Also, the capital market reacts smartly towards this issue and has found out that performance improvement of companies has not occurred, therefore, no significant change has taken place in market-based ratios.

SUGGESTIONS

1- The managers of finance companies and institutions in their evaluations should pay special attention to profit opportunities as well as development of corporation activities and required strategies, so that the extent of performance, developmental goals and growth prospects of companies in the market are scrutinized. Also, the size and future growth opportunities in selection of financing methods are among other facts that should be considered by managers.

2- The existence of indirect state ownership in many companies has undermined consideration of capital structure adjustment and application of debt in the capital structure which due to transition toward privatization would have desirable effects in future.

3- The companies that are intended to stage profitable investment should try to use fewer debts in order to be highly flexible to avoid limitations.

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