Research Paper
Impact Factor: 3.567
Peer Reviewed Journal

IJMDRR
E- ISSN –2395-1885
ISSN -2395-1877

FINANCIAL PERFORMANCE OF CORPORATE SECTOR: A REVIEW OF EMPIRICAL EVIDENCES

Krishan Gopal
Assistant Professor, Department of Commerce, Govt. National College, Haryana.

Abstract
The theory of corporate governance gives central place to the shareholder value maximization as an objective of a firm. Taking cue from this objective, the present study reviewed the empirical evidences regarding the factors affecting financial performance of corporate sector across the world. The study under consideration documents the robust negative presence of leverage in the shareholders' value creation in corporate sector. Regarding the size, the study reported results contradictory to hypothesized relationship. The literature regarding growth in assets has provided credence to acceptance of null hypothesis regarding age of firms. In addition to this, the working capital measure, which has significant positive relation with growth in total assets, turns out as significant negative determinant of growth in total sales. The empirical literature depicts age as significant negative determinant of gross profit margin while size, working capital and leverage as positive determinant. On the other hand, working capital measure exhibits the significant positive relation with net profit margin. On the whole, leverage and size exhibit negative relation with market based financial performance measure and have positive effect on accounting based financial performance measure.

Keywords - Tobin's Q ratio, Leverage, Gross profit margin, Regression, Size.

Introduction

The analysis of performance of corporate sector is of great importance to its various stakeholders. Economists and government need to analyse the performance for variety of purposes, including as guide to antitrust policy and in regulating the prices of natural monopolies. On the other hand for common equity investors, it assumes immense significance since they are investing their hard earned funds in the expectation of higher returns. Though the performance of corporate sector can be analyzed on various dimensions, the present study remains confined to its financial aspect. The theory of corporate governance gives central place to the shareholder value maximization as an objective of a firm. Taking cue from this objective, the present study followed it as conceptual and operational framework for evaluating the firm's performance. Shareholder value, which reflected in financial performance, is dependent on several factors such as firm's current profitability, its risk and its growth hence; there is a need to systematically study the determinants of performance over a long time-period. The present study is concerned with two sets of performance measures one based on capital market valuation of a firm and the other set based on accounting measures of profitability and financial performance. Broadly, there are three sets of variables which affect the financial performance of firm –

a. Factors, such as the level of marketing expenditure of a firm, which is (to a large extent) a reflection of strategic choice of firm managers or operating characteristic of the firm;
b. Factors such as ownership pattern of the firm's equity that can affect its governance
c. Factors such as size and age of the firm which are shaped more by the history of its evolution.
d. In this study an attempt has been made in this study review the factors affecting the financial performance of corporate sector across the world.

Review of Literature

In this section, an attempt is made to incorporate the findings of some of the relative and significant studies conducted across the world. Banz (1981) examined the historical monthly returns for NYSE common stocks for the period 1931-1975 and found that the size of the firm had been highly correlated with stock returns. The study indicated that the larger the market value of firm's common stock, the lower the rate of return generated by the stock. Roll (1981) studied the relationship between investment performance and market-capitalisation investment strategy. The study tested small firm effect anomaly and reported that misstatement of risk had the potential to explain why small firms, low P/E ratios firms displayed large excess returns. Varaiya et al (1987) examined predictions drawn from value-based planning models. The results indicated that profitability and growth influenced shareholder value in the manner predicted; however, the relationships were conditional. Wernerfel and Montgomery (1988) used Tobin's q as a measure of performance and found that industry effects accounted for the majority of the explained variance. The findings were consistent with profit maximization by firms with different factor endowments.

Chaganti & Damanpour (1991) showed that the size of outside institutional stockholdings has a significant effect on the firm's capital structure. Berger and Ofek (1995) examined the effects of diversification on firm value and found that

Diversification reduced value and this value loss average 13 per cent to 15 per cent over the 1986-91 sample period, occurred for firms of all sizes. Loderer and Martin (1997) examined the relation between managers' financial interests and firm performance. It found no evidence, however, that larger stockholdings lead to better performance. McGahan & Porter (1997) examined the importance of year, industry, corporate-parent, and business- specific effects on the profitability of U.S. public corporations within specific 4-digit SIC categories. The results indicated that year, industry, corporate-parent, and business-specific effects accounted for 2 percent, 19 percent, 4 percent, and 32 percent, respectively, of the aggregate variance in profitability.

Pandya and Rao (1998) found that on average, diversified firms showed better performance compared to undiversified firms on both risk and return dimensions. It also tested the robustness of these results by classifying firms by performance class. The results showed that among the best performing class of firms, undiversified firms had higher returns, but these returns were accompanied by high variance. While the highly diversified firms showed lower returns, and much lower variance.

Bharadwaj et al (1999) used Tobin's q, a financial market-based measure of firm performance and examined the association between IT investments and firm q values. The results based on data from 1988-1993 indicated that, in all of the five years, the inclusion of the IT expenditure variable in the model increased the variance explained in q significantly. The results also showed that, for all five years, IT investments had a significantly positive association with Tobin's q value. Kakani et al (2001) attempted to provide an empirical validation of the widely held existing theories on the determinants of firm performance in the Indian context. The study found that size, marketing expenditure, and international diversification had a positive relation with a firm's market valuation. Rogers (2001) examined the association between diversification and firm performance in a sample of up to 1449 large Australian firms (1994 to 1997). Results from the full sample showed that more focused firms have higher profitability. Tsuru (2001) examined the bank relationships and firm performance and discovered weak evidence that firms with stronger ties with banks might have had higher profitability in the late 1970s.

Haynes et al (2002) examined the impact of divestment on firm performance; using an unbalanced panel of 132 UK quoted companies over the period 1985 to 1993. The result suggested that divestment had a positive, significant and substantial effect in raising the profitability of the vendor company. Kakani (2002) studied the performance of Indian business houses vis-à-vis their diversification strategy using aggregated financial statement data and capital market data of 240 large Indian business houses. The study found that product diversification strategy was negatively related to business groups shareholder value (Tobin's Q Ratio) for all the three periods of the study and shareholder value maximization was related to a group's growth, profitability, risk and the general capital market conditions.

Amess and Drake (2003) examined the empirical relationship between the remuneration of: the highest paid director (HPD), mean Board remuneration (Director), and the Chairperson of the Board and firm-level performance on a panel of mutual building societies over the 1991 to 1996 period. Two measures of performance were employed: profitability and the change in total factor productivity (TFP). A strong positive relationship between profitability and pay was found for the HPD but not for the Director or Chair. Gartner (2003) investigated the relation between the wage structure with in firm and performance of the firm. The results suggested a positive, but nonlinear relation between wage dispersion and firm output.

Andersson et al (2004) explored the link between ownership structure and firm performance Sweden's listed companies. The results indicated that companies with a dispersed ownership structure, meaning the largest owner holds less than 20 per cent of total votes, were associated with worse performance regarding stock return, ROA and ROE, but were highly valued relating to Tobin's Q. Gioia (2004) investigated the effects of ownership change on the performance of small and medium size, private and closely held companies. The study found empirical support for the hypothesis that changes in ownership via acquisition could be a mechanism to correct for lapses in efficiency. Favero et al (2006) studied the performance of Italian listed family firms in the period 1998-2003. They measured their performance by using both accounting and market data. The study found that the data and the methodology used to measure performance strongly affected the results. When performance was measured by accounting data (ROA), using a static model, evidences were in favour of a superior performance of family firms. Such evidences were not confirmed by the application of the same model to market measures of performance. On the whole these studies point size, ownership pattern, marketing expenditure, corporate governance and age as influential variables to firms' performance. Furthermore, some studies reported CEO remuneration, employee involvement, bank relationship and wage structure as significant factor behind performance.

Conclusions

The theory of corporate governance gives central place to the shareholder value maximization as an objective of a firm. Taking cue from this objective, the present study reviewed the empirical evidences regarding the factors affecting financial

performance of corporate sector across the world. The study under consideration documents the robust negative presence of leverage in the shareholders' value creation in corporate sector. Regarding the size, the study reported results contradictory to hypothesized relationship. The literature regarding growth in assets has provided credence to acceptance of null hypothesis regarding age of firms. In addition to this, the working capital measure, which has significant positive relation with growth in total assets, turns out as significant negative determinant of growth in total sales. The empirical literature depicts age as significant negative determinant of gross profit margin while size, working capital and leverage as positive determinant. On the other hand, working capital measure exhibits the significant positive relation with net profit margin. On the whole, leverage and size exhibit negative relation with market based financial performance measure and have positive effect on accounting based financial performance measure.

References

1. Banz, R., "The Relationship between Return and the Market Value for Common Stocks", Journal of Financial Economics, Vol. 9(1), (1981):1-19.
2. Roll, Richard, "A Possible Explanation of the Small Firm Effect", Journal of Finance, Vol.36, (September 1981): 849-888.
3. Varaiya, Nikhil, Roger A. Kerin, and David Weeks, "The Relationship between Growth, Profitability, and Firm Value", Strategic Management Journal, Vol. 8, (1987):487-497.
4. Wernerfelt, Briger and Cynthia A. Montgomery, "Tobin's q and the Importance of Focus in Firm Performance", The American Economic Review, Vol. 78(1), (March 1988): 246-250.
5. Chaganti R. and F. Damanpour, "Institutional Ownership, Capital Structure, and Firm Performance", Strategic Management Journal, Vol. 12, (1991): 479-491.
6. Berger, P., and E. Ofek, "Diversification's Effect on Firm Value" Journal of Financial Economics, Vol. 37, (January 1995): 39-65.
7. Loderer, Claudio and Martin, Kenneth, "Executive Stock Ownership and Performance Tracking Faint Traces", Journal of Financial Economics, Vol.45, (1997): 223- 255.
8. McGahan, Anita M., and M. E. Porter, "How Much Does Industry Matter, Really?", Strategic Management Journal, Vol. 18 (summer special issue), (1997): 15-30.
9. Pandya, Anil M. and Rao, Narendar V., "Diversification and Firm Performance: An Empirical Evaluation", Journal of Financial and Strategic Decisions, Vol.11, No. 2, (1998).
10. Bharadwaj, Anandhi S., Bharadwaj, Sundar G., and Konsynski, Benn R. "Information Technology Effects on Firm Performance as Measured by Tobin's Q", Management Science, Vol.45, Issue 7,(1999):1008 – 1024.
11. Kakani, Ram Kumar, Saha, Biswatosh and V. N. Reddy., "Determinants of Financial Performance of Indian Corporate Sector in the Post-Liberalization Era: An Exploratory Study", (2001):http://www.nseindia.com /content/research/Paper18.pdf.
12. JBFSIR Volume 1, Issue 4 (July, 2011) ISSN 2231-4288 Sri Krishna International Research & Educational Consortium http://www.skirec.com - 11 -
13. Rogers, Mark, "The Effect of Diversification on Firm Performance",(2001):http://ideas.repec.org /p/iae/iaewps/wp2001n02.html.
14. Tsuru, Kotaro, "Bank Relationships and Firm Performance: Evidence from Selected Japanese Firms in the Electrical Machinery Industry", RIETI Discussion Paper Series 01-E-004, (2001):http://www.rieti.go.jp /jp/publications /dp/01e004.pdf.
15. Haynes Michelle, Thompson Steve and Wright Mike, "The Impact of Divestment on Firm Performance: Empirical Evidence from a Panel of UK Companies", (2002) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=313492
16. Kakani, Ram Kumar, "Financial Performance and Diversification Strategy of Indian business groups", Indian Institute of Management Calcutta, Unpublished Doctoral Dissertation, (March 2002).
17. Amess Kevin and Drakeb Leigh, "Executive Remuneration and Firm Performance: Evidence from A Panel of Mutual Organisations" (2003): http://www.le.ac.uk/economics/research/RePEc/lec/leecon/dp03-13.pdf.
18. Gartner Hermann, "Wage Inequality and Firm Performance in Germany",(2003):http://www.ces.census.gov /docs/caed/abstracts/abs_105_Hermann_Gartner.pdf.
19. Andersson, Nordwall John, Salomonsson Jacob, and Daniel, "The Link between Ownership Structure and Firm Performance Evidence from Sweden's Listed Companies", (2004): http://gupea.ub.gu.se/dspace/handle/2077/2266
20. Gioia, C., "The Impact of Acquisitions on Firm Performance Evidence from Private & Closely Held Companies", (2004): http://papers.ssrn.com/sol3/papers.cfm?abstract_id=500233
21. Favero Carlo A., Giglio Stefano W., and Honorati Maddalena, "The Performance of Italian Family Firms", Finance Working PaperNo.127/2006,(2006):http://papers.ssrn.com/sol3/papers.cfm?abstract_id=91818 .