

Short Essay on Empirical Finance Research: Current Trends and a Call for Future Studies

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Abstract

Corporate finance practice is a function that deals with the financing needs of a company. In this paper, a critical survey was conducted to identify the key literature in order to isolate the leading theoretical and empirical issues surrounding company financing and capital structure that are particularly relevant for developing economies. The paper aims to take stock of existing knowledge in the area and identify the main strands of theoretical and empirical literature, considering the policy implications of existing knowledge, and spelling out the current policy problems which should be addressed by future research. The suggested areas resulted purely from a PhD research conducted in the area of construction finance in Ghana. The methodology adopted for the main PhD work involved multiple research approach. The empirical investigation was conducted using structured interviews and survey questionnaire. The interviews were conducted prior to the survey to solicit in-depth information about the financing practices and constraints of these large contractors. The interviews led to the identification of key issues which were not mentioned in literature. These concerns were later investigated and tested using survey questionnaires. Conforming to the orthodoxy of purposive and cluster sampling techniques, the dataset was obtained from 49 large construction firms operating in Ghana. The consideration of overlapping aspects of the study largely motivated the use of factor analysis to analyse the data which made it possible to make scientific deductions, descriptions and built explanations from the results. The development of

regression models using explanatory variables such as financial condition of the firm, macro-economic indicators, bankruptcy cost, financial risk, transaction cost and financial policy to establish the relationship between the corresponding dependent variables (thus, equity finance and debt finance) together with the management and sustainability of suitable financing programme for construction firms in Ghana recommended policy problems further research.

Keywords: Capital Structure, Corporate Finance, Financial Practices, Further Research

1.0 Introduction

Corporate finance practice is a function that deals with the financing needs of a company (Graham and Harvey, 2001). According to Heaton (2002), corporate finance is the realm of tactics used to increase cash flow as well as make practical investment decisions in such a manner that the company starts registering growth in all spheres. Lamont (1997) stated that project cash flows could not be sole contributors of cash, which is required to realize essential financing needs of the company. This would mean that the financial structure of a company arises from the ways in which it finances new investment. There are three main funding choices which are then reflected in a firm's capital structure: employ retained earnings, borrow using debt instruments or issue new shares (Owusu, et al 2008). These components of capital structure also reflect firm ownership in the sense that retentions and equity correspond to shareholder interests

while borrowing gives rise to claims by debt holders (La-Porta, *et al* 1999). Capital structure also affects corporate behaviour (Hutton and Kenc, 1998).

Thus financial structure is concerned with the closely-linked relationships among financing policy, capital structure and firm ownership. The development of these relationships is a key factor in explaining how economic agents acquire and utilize assets through firms and capital markets, and creates returns, whether in the form of direct remuneration, capital gains, debt interest or dividends. Fawthrop (1969) reported that the decision to use one method of financing a particular project would usually interrupt the decisions as to the financing of other projects, which the firm may wish to implement sometime in the future. Although these financial decisions may vary depending upon the nature of the company, all of them are concerned with enhancing the corporate value of the company by ensuring that the return on capital always exceeds the cost of the capital, without taking excessive financial risks (Levy and Marshall, 1990). Corporate finance decisions could be segregated into two categories *viz.* long-term decisions, also called capital investment decisions, and short-term decisions, commonly known as working capital management (Levy and Marshall, 1990).

While the former is concerned with decisions on fixed assets and capital structure, the latter includes decisions that manage short-term assets and short-term liabilities in such manner that the company has sufficient cash flow to fulfil the maturing short-term debt as well as forthcoming operational expenses (Larrain and Matias, 2005). Long-term corporate finance decisions comprise of an investment decision, a financing decision and a dividend decision (Myers and Majluf, 1984). The investment decision relates to the selection of assets in which the company will invest funds. Thus, the investment decision is broadly concerned with the asset mix or the composition of assets in which the company must make the investment (Levy and Marshall, 1990). The second component of capital investment decisions is the financial decision, which relates to the choice of the proportion of debt and equity capital sources to finance the investment requirements (Graham and Harvey, 2001).

Dependent upon the financial decision is the dividend decision where the corporate finance decision-makers decide whether to distribute the company's profit as dividends to shareholder or to retain for investment in the company itself (Baker and Wurgler, 2002). This decision depends upon the dividend payout ratio, preferences of the shareholders and the investment opportunities available, and the dividend policy of the company (Koutsoyiannis, 1982; Mwenda, 1993).

Obviously, there is no doubt about the numerous volume of research on company financial structure and financing practices in developed countries, but virtually no work has been done on developing countries (LDCs), apart from a limited amount of empirical research pioneered particularly by Singh: for example, Hamid and Singh (1992), Singh (1995) and Brada and Singh (1999). It is scarcely an exaggeration to state that, until recently, corporate finance did not exist as an area of research for LDCs. Some of the reasons for this are clear. Many LDCs initially chose a state-sponsored route to development, with an insignificant role assigned to the private corporate sector. In the poorer countries, irrespective of development strategy, there is only an embryonic corporate sector and most corporate financing needs have been met by regional and international development banks. However, in almost all these countries, development banks have experienced serious difficulties (Murinde, 1996; Murinde and Kariisâ-Kasa, 1997). Thus there is a conspicuous gap in the empirical research on corporate finance in LDCs; this gap requires urgent attention, given that the research is likely to have profound policy implications for promoting poverty-reducing economic growth. It is against this backdrop that this paper is initiated to identify the possible researchable areas for the consideration of future studies.

In this paper, a critical survey was conducted to identify the key literature in order to isolate the leading theoretical and empirical issues surrounding company financing, capital structure and ownership that are particularly relevant for developing economies. The paper aims to take stock of existing knowledge in the area and identify the main strands of the theoretical and empirical literature,

considering the policy implications of existing knowledge, and spelling out the current policy problems which should be addressed by future research. The literature as a whole is fragmented, and there are numerous ways in which a review could be organized. As the subject area is vast, the survey is highly selective. Well-known theories are not discussed at length; only the main arguments within the literature are summarized.

The paper does not cover the numerous topics, such as dividend policy, which indirectly relate to capital structure but which are the subject of a substantial literature in their own right. In the empirical part of the survey, the paper again concentrates on research involving the direct description and analysis of possible areas that need urgent attention. The paper mainly reports on suggested future study areas which evolved from a PhD research conducted by the author himself. The paper is carefully structured as follows; first, it begins by drawing lessons from current finance studies relevant to developing countries. These lessons made it possible to identify the main strands of research directions in finance studies and where deliberation is needed. The paper continues by discussing the abstract of the main PhD research. This was intended to provide a summary of the main research that made it possible to derive the policy problems presented in this paper. The abstract is concise and informative and focuses primarily on findings of the research and the methodology that drove the research process. The final section deals with the policy problems with invitation directed to experts and researchers to join hands in producing knowledge to fill the empirical research gap in the field of construction finance in Ghana.

2.0 Recent Trends in Corporate Finance Research

The recent corporate finance literature reflects two major evolutionary trends, and two rather significant departures from prior work. One major trend is the integration of industrial organization theories into finance. This linkage is obvious when one is discussing the merits and demerits of internal and external capital for the firm. The second major trend is the continued refinement of ideas related to the impact of taxation on corporate decision making. One of the sharp departures from prior

paradigms is the literature's increased focus on law and finance, especially on corporate governance issues.

The second sharp departure is evidenced by many authors' willingness to adopt behavioural approaches, including a willingness to assume that informational inefficiencies are an important determinant of managerial choices. In addition to changes in its underlying theoretical paradigms, the corporate finance literature has also experienced several notable methodological changes with particular emphasis on capital structure of the firm. Finance and capital structure research has gone through three phases in a half-century since Modigliani and Miller's (1958) pioneering work introduced arbitrage proofs into finance and remains one of the most important focuses of corporate finance research. Modigliani and Miller (1958) assume market efficiency and treat operating decisions as exogenous when analyzing corporate finance decisions. The first phase of research focused on relaxing assumptions regarding the "perfect market" assumptions about taxes, inflation and interest rate. Theoretical developments in the 1980s were affected by the increasing use of game theory in corporate finance. In this golden age of asymmetric information models in finance, the assumptions of exogenous operating decisions and semi-strong form market efficiency continued to prevail. The second phase of capital structure research began with the publication of Jensen and Meckling (1976) and Myers (1977).

The takeover battles of the 1980s, and Jensen's (1986) free cash flow analysis suggesting that financial policy's effect on managerial incentives was the primary motivation for leveraged buyouts and debt-financed takeovers changed the paradigm. The dependence of operating decisions on financial policy is explicit in literature on contracting and on product market-financial structure interactions. But almost all of the analysis maintains the assumption of semi-strong form market efficiency. The third phase of capital structure research dropped the assumption of market efficiency.

Following the publication on the long-run performance of initial public offerings (Ritter, 1991),

many studies have examined corporate financial decisions where existing shareholders can create value for themselves not only by having the firm undertake positive projects, but also by timing external financing decisions to take advantage of time-varying relative costs of debt and equity caused by market asymmetry. **Graham and Harvey (2001)**, survey practitioners about their views on capital structure, securities issuance, payout policy, and other central questions of corporate finance. In general, the practitioners' opinions reflect tax and other traditional literature views of the forces shaping these financial decisions.

But the respondents also report strong support for market timing based upon temporary misvaluations, a consideration dismissed in most literature. **Heaton (2002)** developed several predictions based on the assumption that managers are over-optimistic about their abilities and their firm's prospects. Heaton predicted that managers are loath to issue external equity because they think that their firm is undervalued, and that they are inclined to acquire other firms because they think that their superior managerial abilities will create value. **Baker and Wurgler (2002)** demonstrate that a firm's debt ratio today is heavily dependent on its market-to-book ratios in the distant past. They interpret this finding as consistent with firm's successfully timing the market to take advantage of overvalued external equity. **Baker and Wurgler (2002)** and **Weich (2004)** both argue that, as with the pecking order theory of capital structure, inertia is of first-order importance in explaining observed capital structures. While an active literature in recent years deals with the determinants of capital structure, relatively little work considers what managers *should* consider in setting capital structure.

This paucity of analysis is apparent in literature, which contain few prescriptions on how to determine the optimal debt ratio for a firm with specific characteristics. One of the few papers that tackle the difficult issue of what managers should do is **Stein (1996)**. Stein identifies the managerial decision rules and argues that what a manager should do depends upon 1) whether the firm is

financially constrained or not, and 2) whether managers have a short-term or long-term objective function. Although some of the most exciting recent work on capital structure and securities issuance has dropped the assumption of market efficiency, traditional approaches remain relevant. While the traditional static model of capital structure that trades off the tax advantage of debt financing and the costs of financial distress has been in literature for some time, most studies have little to say about the empirical estimates of these two factors. **Opler, et al (1999)** investigates the determinants and implications of corporate cash holdings. They interpret their findings as consistent with excessive caution on the part of corporate managers, with only slight tendencies to boost payouts.

3.0 Précis of The Empirical Findings from the Main Research

The study of financing practices of construction firms is largely considered an important subject in relation to the growing number of projects that demand considerable financial input and equipment investment. It is clear that firms' financing issues play a significant role in their day-to-day business operations. However, it is hard to find any empirical research which investigates and analyses the financing practices of construction firms in Ghana. In addition, knowledge on how best to engage stakeholders towards suitable financing options for construction firms is lacking. This study thus, advanced knowledge on strategic decision choices in relation to large construction firms' financing practices in Ghana and examined the factors that influence the financing strategy adopted by these large Ghanaian construction firms. A review of literature on corporate finance practices in terms of capital structure and financing decisions revealed some gaps in knowledge, which guided the setting of the objectives and the key research questions in this study.

The philosophical position of the research influenced the methodology adopted for this study. While taking an idealist view in ontological assumptions, it holds social constructionist stance in epistemological traditions with value laden axiological undertakings. Adopting multiple research

approach, the empirical investigation was conducted using structured interviews and survey questionnaire. The interviews were conducted prior to the survey to solicit in-depth information about the financing practices of these large contractors. The interviews led to the identification of key issues which were not mentioned in literature. These concerns were later investigated and tested using survey questionnaires. Conforming to the orthodoxy of purposive and cluster sampling techniques, the dataset was obtained from 49 large construction firms operating in Ghana. The consideration of overlapping aspects of the study largely motivated the use of factor analysis to analyse the data which made it possible to make scientific deductions, descriptions and built explanations from the results. By the performance of this research, *four major findings have emerged with regard to the problems inherent in contractors' equipment finance practices, which were manifested in legal policy gap, information gap, repayment gap and credit gap.* The study established that finance gap exists between construction firms and financial institutions in Ghana, mainly because of the imbalance between the demand and supply side of finance. With regard to the causes of the finance gap; lending policy gap, management gap, financial strength gap and information gap were observed by the study as the main origins. The study provides fresh contribution to knowledge and fills the empirical research gap by deriving six new brands of uncorrelated variables that better explain firms' financing practices and decisions. These variables were manifested in the financial condition of the firm, macro-economic indicators, bankruptcy cost, financial risk, transaction cost and financial policy of the firm. Several policy measures have emerged by the performance of this research and explained in terms of establishing specialized construction bank, constitution of adequate fiscal legal framework, formation of reliable information bureau system, establishment of credit guarantee scheme, development of strategy for financial capability and introduction of diminishing partnership formula.

4.0 Recommended Policy Problems for Future Research

This research is a pioneer study that endeavoured to investigate the financing practices of construction

firms in Ghana and has opened up several directions for future studies. The following research areas and themes are therefore suggested for future studies to enrich the empirical research in Ghana and other developing countries. Invitation is therefore thrown to the entire research community in this field to join hands in embarking on this endeavour.

4.1 Development of Regression Models

Five new brands of independent (explanatory) variables that explain the choice between equity and debt finance (dependent variables) of construction firms in Ghana were established by the study as earlier stated. Regression models could be developed using these variables to examine and establish the relationship between the explanatory variables (financial strength, financial policy, financial risk, bankruptcy cost and transaction cost) and dependent variables (equity finance and debt finance). This would be a valuable contribution to the body of knowledge. Again, regression models could be developed using the macro-economic indicators (i.e. interest rate, taxation and inflation), which have been used to explain firms' financing behaviour in developed countries. Such a study would validate and establish the relationship between theoretical models and empirical findings in the context of developing countries.

4.2 Management, Sustainability and Success Factors of Construction Bank

Establishing a specialized construction bank was highly recommended by the PhD research as a policy direction. It should be recognized that this would require investment in time, expertise, systems and methodologies, and organizational structures. Research would have to be undertaken to identify institutions and organizations that would want to participate, and the role they could play. Critical to the success of the proposed bank would be effectiveness of the board in guiding senior management and analyzing its plans and reports. There are no easy answers to effective governance. An essential ingredient, however, would be to clearly outline the functions of the board to enable selection of members. Considering the diversity of the construction process, and the need for several interrelated factors to be addressed, it would be necessary for the board to comprise diversity of expertise. It must be recognized that, past

experiences should give as a clue on future possibilities and should give us a sense of vision that will direct us onto strategic actions to achieve corporate success tomorrow. By this, it is reasonable to suggest a research to probe into what led to the eventual liquidation of the defunct Bank for Housing and Construction. The findings of such a study would give insight into areas such as profitability, productivity, project evaluation and monitoring techniques, management and stakeholders, marketing, recruitment of manpower, among other variables.

4.3 Review and Modification of Financial Regulations and Policies in Ghana

Another important issue emerging from the study is the role of legislative policies as a major constraint to the development of accessible financial market for construction firms. It would be a valuable type of insight if the influence of these policies on the financing behaviour of construction firms could be studied. In particular, a research effort to explore and examine the impact of the various clauses, articles and sections of the existing financial regulations on the financing behaviour and choices of construction firms would be commendable. This would help unearth the hard rules and conclusively suggest possible amendments to the identified problem rules.

4.4 Investigate the Impact of Financial Ratios on Financing Behaviour of Firms

Little is known about the impact of financial ratios upon the financing behaviour and financial choices of firms. This study has been among the pioneering studies to introduce the topic of financial variables into empirical studies. There are hardly any empirical studies covering these topics. It is therefore recommendable to conduct a further research to examine whether any significant differences exist between financial variables such as liquidity, profitability, gearing and asset base of the firm with regard to their financing practices.

4.5 Define Framework for Achieving Financial Capability

This study has established that financial capability of managers is essential in achieving corporate financial success. However, there are no indications of how managerial financial capability could be

achieved. Though this study has attempted to provide possible directions and policy implications for achieving financial capability, this would merit further empirical probe to define a framework for achieving financial capability for managements. The results of such a study would be a valuable contribution to the body of knowledge.

4.6 Criteria for Setting Financial Policies

Firms' financial policies might be a grey researchable area. So far there are no empirical evidences about the determinants of financial policies of construction firms in Ghana. However, literature suggests that firms in developed countries set their financial policies under the following thematic topics, thus, operating management policies, capital management policies, debt management policies, reserve policies, and financial reporting policies. A study tailored to investigate the criteria for setting financial policies for construction firms in developing countries, particularly with Ghana would significantly contribute to the empirical debate. The findings of such a study would provide deep insights into how firms could develop strategic actions to achieve corporate financial targets.

4.7 Assessment of Financial Conditions of Firms

The study has endeavoured efforts to establish that financial conditions of firms have influence on firms' decision to use equity or debt to finance their investment activities. However, the study failed to establish the real financial conditions of construction firms in Ghana and the factors that determine financial conditions. This lack does not give any clue on whether the current financial position of construction firms would be able to accommodate financing their investment activities by debt. A clue about their past and current financial position would also provide evidence to lenders about their ability to service their debt if external finance is granted to them. A further study channelled to identify specific factors that affect firms' financial conditions and analysis of these factors to test performance of the firms against the identified indicators would provide informative tools for monitoring the financial conditions of the firms thereby, allowing managements to be alert and derive better understanding into the forces that affect the *cash and budgetary solvency* of the firms

and the obstacles associated with measuring the firms' financial condition. This would be a meaningful contribution to the finance literature pertaining construction finance.

4.8 Determinants of Lending Strategy

The study has given keen attention to one side of the equation, that is, the demand side of finance without looking at the supply side of finance. This was intentional because the time allotted for the study could not practically allow the consideration of both the demand side (i.e. construction firms) and the supply side (i.e. financial institutions) simultaneously. However, the literature review exhaustively considered both sides of the equation. To better contribute to the understanding of empirical debate on the topic and construction finance literature and how financial institutions respond to construction firms regarding provision of external finance to construction firms, an empirical study engineered to investigate the determinants of lending strategy would be a meaningful contribution to knowledge. Such a study would provide the necessary information about lending criteria of financial institutions, which positioned the potential borrower to meet set financing requirements.

5.0 Conclusions

This paper confirms the recognition that no research work, comparative or otherwise, is really complete or will provide answers to all questions. This stems from the fact that research is a continuous process, and a logical and scholarly answer to a research question is a stimulus to other research problems. Throughout the course of this research, a number of areas were identified and therefore opens many opportunities for further investigations, which could provide fruitful results if investigated further. The areas suggested are relevant and hoped to directly contribute to knowledge.

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