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2010

World Applied Sciences Journal 9 (9): 997-1002, 2010
ISSN 1818-4952

Financial Management Practices and Their Impact on Organizational Performance

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Abstract: This study measures the relationship between organizational performance and financial management practices like capital structure decision, dividend policy, investment appraisal techniques, working capital management and financial performance assessment in Pakistani corporate sector. Sample of the study consisted of forty companies operating in Pakistan, related to different sectors and listed at Karachi Stock Exchange. The finance executives and financial analysts of the companies responded to questionnaire that identified through company profiles and references. The questionnaires were self administered to collect the data from respondents. The results show a positive and significant relationship between financial management practices and organizational performance in Pakistani corporate sector.

Key words: Corporate sector % Financial management practices % Karachi stock exchange % Organizational performance

INTRODUCTION

The corporate sector plays a vital role in the economic outlook of any country. Financial literature suggests that capital structure has a greater impact on the economic system [1] and managers should identify the ideal corporate structure for the company [2]. Moreover, financing mix serves as the guiding force, when looking for the new investment opportunities. The value of dividend decision is found critical primarily by [3]. They believe that the markets without capital market imperfections like transaction costs and taxes, dividend policy can bring no changes to the value of the firm. This has given rise to unstoppable discussions on the dividend policy and the firm value [4]. The corporate culture depends on attitudes, beliefs and management's values, education and work experience and their impact on corporate decision making processes. In the last decade concept of corporate culture has attracted interest among business writers [5]. Financing strategies and investments moves by the firm result in the performance of any corporation. Whenever a firm focuses on the maximization of shareholder wealth, always get proper care of its financing and investments [6].

Investment decision of the company shifts its effect on share prices through dividend policy. Thus, dividend contribution to firm’s future earnings performance is quite evident from literature. Investment appraisal technique is one of the regularly studied areas of financial management. According to [7, 8] there are a variety of concerns in investment appraisal, the type of technique is the starting point for management. The objectives and constraints affecting project selection are, therefore, highly important. Projects are opted on the basis of net present value (NPV), internal rate of return (IRR), accounting rate of return and payback period. Working capital policy addresses the management of short term assets and liabilities within the maturity period of one year. Working capital policy is primarily based on a day to day cash inflows and outflows, thus managing the surplus and interest rates. Companies should find out co-ordination between cash inflows and cash outflows to reduce potential liquidity problems and to have a backup credit support for the adjustment of short term fluctuations. The debate on working capital policy is having different views in a way that financial distress leading to bankruptcy is believed as a result of poor short-term asset and liability management. The financial performance assessment is viewed as an important factor in reviewing performance of a company. The results of these assessments can be useful in evaluating the efficiency of a company.

In comparison to the financial management practice around the world Pakistan is progressing in the financial management policies in the corporate sector. If our corporate sector follows comprehensive financial

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management practices it would be directly affect its profits and value maximization. If these practices are applied on the different levels, an organization can achieve a better resource utilization and profit. Research shows that these monetary practices have a strong influence on the organization's performance. Pakistani corporate sector is growing over the period of time through the courtesy of privatization and liberalization, yet financial management practices are not properly implemented especially capital structure, dividend policy and investment appraisal techniques. No well known study is available in literature that evaluates application of financial management practices in Pakistani corporate sector and their contribution towards organizational performance. This study examines the application of these practices in Pakistani corporate sector and their relationship with organizational performance. The study reviews the core finance functions and outlines capital structure decision, dividend policy, investment appraisal techniques, working capital and financial assessment as the most common financial management practices in Pakistani corporate sector.

Literature Review: Financial literature suggests that optimal application and commitment towards financial management practices result in an increased company's performance. The financially well-managed companies are operationally efficient. This stands as a positive sign for investors and regulatory authorities. According to [9], managers contracted to make decisions in the large, open corporation and received compensation for services rendered. Thus, the contractual nature of the publicly held corporation provided specialization between owners who specialized in risk bearing and managers who specialized in decision management. [10] examined the financial practices in Indian corporate sector. The study reviewed the financial behavior and practices of different segments of the Indian private corporate sector with a view to bring out the differences between public and private limited companies, medium, large and small companies, Indian and foreign companies and companies in different industrial categories.

[11] proposed that the modern corporation based upon the efficient separation of ownership and managerial control. Owners purchased shares that entitle them to the residual returns in the firm after obligations had been paid. This privilege, however, required that the owners bear the risk of zero or negative returns. Corporate investment, dividend, compensation and financial policies interconnected and debt and equity substituted governance structures rather than just financial structures. A firm with higher asset would find debt financing very costly. The board of directors not only supervised the management team, but also as a way by which to cut down the cost of capital for projects that involved limited redeployed ability [12]. Corporate restructuring shifted a firm from an internal governance system that characterized by low investment in monitoring and bonding and large residual losses in the form of excessive diversification towards a new equilibrium that characterized by low residual losses and high monitoring costs [13].

Investment appraisal was one of the important areas of management practices [14]. There were a number of apprehensions in investment appraisal, the method of appraisal (Net present value, internal rate of return and payback period) and objectives and constraints in project selection [7, 8]. The better performance that led to quality gave rise to an immense challenge for corporations. These could also help companies to develop a comparative advantage in terms of future forecasting for the companies [15]. Therefore it was imperative that in the corporate sector, main focus for overcoming the financial concerns be placed on corporate debt management and restructuring [16-19]. One of the important sources of financing in corporate firms was the use of debt. The highly cost firms using the debts represented its commandment with production even without profits [20]. Corporate takeovers did not have the maximum effect on firm stock value, as demonstrated by some earlier work [21, 22] which believed that taking over firm shareholders witnessed as normal profit within a time span of five years but [23, 24] contradicted with it by observing the shareholders dividend going down. On this series of evidence, many managers suggested the firm size to keep it larger. [1] demonstrated that equity issues found it difficult because of inadequate information that they possess. Firms kept their prices low at initial public offerings (IPOs) or the stock prices started going down when equity offerings were made. Firms depended on financial information to overcome the information problems in equity offerings. The internal financing gap of developing countries, they contended, should be reduced or completely filled by net capital imports that expanded the external debt of the country. In this approach, huge financial flows from industrial to developing countries were seen as beneficial for both sides [25].

Graham, and Harvey, [26] found that capital structure was a subject of interest to US managers as well as they demonstrated that firms adopted trade off theory and managed the debt ratios. Pecking order theory was having a support of their research as well. Their results showed that firms viewed financial flexibility highly but its importance was not having anything to do within appropriate information or the growth options indicated by pecking order theory. Other factors like agency costs, signaling, asset substitution, free cash flows and product market worries had also some impact on capital structure selection. Managers used some informal techniques like credit rating and earnings per share intensity in marketing financing decisions. The companies which set their capital structure better, management with factors like tax advantage of debt, bankruptcy costs, agency costs and approachability to outside financing [27]. The development of European financial system was analyzed by [28] and it unconcerned some complex linkage of economic, political and some global factors. There was no significant association between corporate sustainability performance (CSP) and financial performance [29, 30]. [31] studied the financial management practices in Indian corporate sector. From the results it was important to note that corporate sector in India was rapidly adopting the new methodologies. [32] analyzed the financing strategies of multi business firms, suggesting the relevance of sorting the diversification phenomena into its related and unrelated components. The implications of their findings were important because they explained how the degree of product specialization/diversification and the direction of diversification translate into different corporate financial behaviors. [33] indicated that leading corporate sustainability performance (CSP) firms are significantly larger, have higher levels of growth and a higher return on equity than conventional firms.

Hypothesis: The review of empirical literature reveals that financial management practices influence organizational performance. On the basis of such evidence following hypotheses can be developed.

H1: Investment appraisal techniques have significant impact on organizational performance

H2: Financial Assessment has significant impact on organizational performance

H3: Capital structure decision has significant impact on organizational performance

H4: Dividend Policy has significant impact on organizational performance

H5: Working Capital Policy has significant impact on organizational performance

Method: This study measures the relationship between organizational performance and management practices like capital structure decision, dividend policy, investment appraisal techniques, working capital policy and financial assessment in Pakistani corporate sector. Sixty companies related to eight leading sectors of the economy were approached (Banking, Telecommunication, Cement, Insurance, Leasing, Textile, Fertilizer and Oil and Gas companies). The companies in each sector were selected on the basis of; listing at Karachi stock exchange, profitability and application of financial management practices. 39 companies responded and returned questionnaires, 35 complete questionnaires were included in analysis; remaining 4 incomplete questionnaires were ignored. A response rate of 65% was obtained by self administrating the questionnaire.

The respondents were the finance executives and financial analysts of the company. The questionnaires were self-administered and distributed personally among sixty companies. The concern financial personnel were identified in each company through company profile, telephone and reference. Before giving the questionnaire, all the questions were explained to the respondents so that they could fill the questionnaire easily and with the relevant responses. The sample was limited to listed companies of eight different sectors operating in Pakistan. The questionnaire comprised of two sections, the first section contained general information about the company and respondents including company name, industry, years in business, respondent name, contact number, company revenue/sales and capital expenditure for the period 2008-2009. Second section related to questions that covered five dimensions (capital structure decision, dividend policy, investment appraisal techniques, working capital and financial assessment). In section one nominal scale was used. The scale to measure application practices was Likert scale ranking (5-Point) where 1 is the most degree of agreement and 5 is least degree of agreement. The statistical package social sciences program (SPSS) was used to check the reliability of data and run the regression. It was an adapted questionnaire based on the financial practices followed by the local companies, from the study of [34].

RESULTS

This study reviews the application of financial management practices in Pakistani corporate sector and perceived importance of these practices. The relationship between different financial management practices and organization performance is analyzed by regression technique and results are summarized below:

Table 1: Reliability of Measurements Instrument

Dimensions	No of Items	Cronbach Alpha
The capital Structure decision	9	0.764
Dividend Policy	14	0.853
Investment appraisal techniques	12	0.641
Working Capital Policy	5	0.742
Financial Performance assessment	8	0.785
Total	48	0.828

Table 2: Company Revenues/Sales and Expenditure for the year 2008-09

Company revenue/sales	No of companies	Capital expenditure	No of companies
Under Rs 100M	6	Under Rs 5M	5
Rs(100-500)M	7	Rs(5-50)M	7
Rs(500-1000)M	5	Rs(50-100)M	6
Over Rs 1000M	17	Over Rs 100M	17

Table 3: Regression coefficients, standard errors in parentheses, t-values in brackets and p-values in italic

Constant	Investment Appraisal Techniques	Financial assessment	Capital Structure Decision	Dividend Policy	Working Capital Policy	R-Square	F-Statistics
2.387	0.167	0.348	0.232	0.137	0.299	0.370	13.850
(1.338)	(0.760)	(0.657)	(0.350)	(0.197)	(0.539)		
[1.720]	[3.443]	[4.615]	[2.192]	[1.812]	[3.140]		
0.098	*0.015*	*0.014*	*0.019*	*0.060*	*0.002*		*0.028*

The above table demonstrates the reliability of each dimension of the questionnaire. The capital structure decision (nine items) with reliability of. 764 and the dividend policy (fourteen items) has reliability. 853, there are five items in working capital policy and the Cronbach Alpha is 0.742, the financial performance assessment using financial ratios (eight items) and the reliability is 0.785 and the investment appraisal techniques (twelve items) have minimum reliability of 0.641. The reliability index for the instrument (48 items) is 0.828.

Table 2 indicates the respondents' annual revenues/sales for the period 2008/09 ranges from under Rs 100 M to over Rs 1,000 M and their annual capital expenditures from under Rs 5 M to over Rs 100 M. Out of thirty five companies seventeen organizations have more than Rs 1,000M revenue/sales for the period of 2008-09 capital expenditures exceed Rs 100M.

Table 3 presents the results of regression analysis for organizational performance. The results show that the model is significant ($p<0.05$) and there is substantial positive relationship between organizational performance and financial management practices (R-Square=0.370 and the F-value=13.850). The independent variables of the model account for 37% variation in dependent variable. The variables when reviewed on individual basis, all the variables are significant ($p<.05$) and positively related to organizational performance. Financial assessment, capital structure decision and working capital policy are the most influential factors with regression coefficients of 0.348, 0.232 and 0.299 respectively. The regression coefficient for investment appraisal techniques is 0.167, which suggests that they contribute almost 18% to organization performance. In the case of dividend policy the regression coefficient is 0.137 which demonstrates that dividend policy contributes up to 14% to organization performance and is significant ($p<.10$). The model is overall significant ($p<.05$) and all the independent variables have significantly impact on organizational performance, though with varying degree of importance. Though financial performance assessment is still the most important factor towards organization performance, and financial managers are giving substantial weight to working capital policy and capital structure decision as well.

The results of regression analysis suggest that all five independent variables have positive and significant impact on organization performance and financial managers perceive them valuable for organizational performance and growth. These results validate all hypotheses (H1, H2, H3, H4 and H5) and it establishes that Pakistani corporate sector perceives financial management practices i.e. capital structure decision, dividend policy, investment appraisal techniques, working capital and financial assessment are perceived as critical for organizational performance.

DISCUSSION, CONCLUSION AND RECOMMENDATIONS

This study measures the effect of financial management practices on organization performance. On the basis of above results study concludes that capital structure decision, dividend policy, investment appraisal techniques, working capital and financial performance assessment all have positive and significant impact on organization performance. However, financial managers perceive financial performance assessment, working capital policy and capital structure decision more important than dividend policy and investment appraisal techniques. The results reveal that the decision makers and practitioners are well aware of and agreed to the importance of financial management practices in the corporate sector. However, the results of this study are based on a selected sample of firms that are applying financial management practices but during the survey it is revealed that a substantial number of firms in Pakistani corporate sector are not following these practices either partially or completely. So the efforts should be made to promote this culture in the sector. Top management should realize the usefulness of such practices and their contribution towards organizational performance. Companies should hire new employees or train existing employees to exercise high value financial management practices, especially the application of qualitative and quantitative investment appraisal techniques and optimal capital structure decisions. It is recommended that financial managers should also focus on dividend policy and investment appraisal techniques along with other practices because constructive dividend policy contributes towards shareholders wealth and get attention of investors that ultimately effect the organizational performance.

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