International Journal of Scientific Research in Engineering and Management (IJSREM)
Volume: 08 Issue: 01 | January - 2024 SJIF Rating: 8.176 ISSN: 2582-3930

Investigating How Variations in Earnings Influence Capital Structure Decision-Making

T H Sai Varun

Abstract

the paper investigates the connection among a company's revenue changes and its fiscal choices. It explores two main theories that imply that an enterprise may choose the type of funding based on changes in earnings volatility refers the notion of pecking order and the notion of trade-offs. The goal is to comprehend how decision-makers in the business sector make financial decisions in response to changing economic conditions. The two companies Reliance Industries as well as the Adani Enterprises are used as instances in the investigation to show how a business might handle funding choices.

Introduction

For companies, figuring out how to get money for everyday tasks and future growth is a big deal – that's where capital structure decisions come in. These choices involve thinking about whether to use loans or sell shares. The choices taken by the executives are significant as they affect the business's general success and serve the needs of investors who want to maximise earnings. Earnings volatility, or the degree that the profits of a business vary over time, is a further significant consideration. The capital framework is also determined in part by this aspect.

If a company's earnings are all over the place, it's like there's more risk and uncertainty. This messes with how the company deals with getting money and keeping a steady capital structure. So, what the company decides on its capital structure might have something to do with how much its earnings jump around. If earnings are going crazy, it could be a sign that there are problems coming up. That might make the company want to change how it gets money to lower those risks. For example, they might borrow more money to spread the risk over a longer time, or they might use less money from selling shares to protect the shareholders from losing out.

Two ideas, the Trade-off theory and the Pecking Order theory, give us different ways to look at how companies pick their capital structure. The Trade-off theory says companies think about the trade-offs between borrowing money and selling shares. When a company's earnings are all over the place, the

Trade-off theory suggests they might prefer selling shares because borrowing gets more expensive with unpredictable earnings. On the flip side, the Pecking Order theory says companies like using their own money and the money they've saved up before taking on debt.

When researchers have studied how earnings volatility and capital structure decisions connect, they've gotten different results. This might be because of things like how many companies they looked at, the type of industry, and differences between countries. There are also other things like how big the company is, the chances for it to grow, and how much money it's making, which can make this connection even more complicated.

Literature reviews

As researchers dig into the complex relationship between how much a company's earnings bounce around and the choices it makes about its money, they've found some interesting stuff. Franks and his team (2012) looked at European companies and, surprisingly, didn't find a clear connection between how much earnings jump around and how much debt the companies take on. This suggests that there are probably other important things influencing these decisions.

Demirgüç-Kunt and Maksimovic (1999) had a cool idea: they think the link between how earnings jump around and borrowing money is stronger for companies that have more room to grow.
On the other hand, De Jong and his crew (2004) found that companies that aren't making as much money seem to have a stronger connection between earnings volatility and borrowing.
However, Barclay as well as Smith's (1995) twist came next. They discovered that businesses that experience frequent fluctuations in their profits frequently wind up taking on more debt. They contend that when a business's funds are dispersed widely, it may become necessary for them to take out loans in order to maintain operations and expand.

On the flip side, Rajan and Zingales (1995) found something interesting when they looked at big U.S. companies – they noticed that when a company's earnings are all over the place, they tend to take on less debt. Their thinking is that if a company's earnings are going crazy, they might prefer getting money by selling shares to keep their financial structure in good shape.

Adding another layer to the story, Titman and Wessels (1988) discovered that companies with really unpredictable earnings usually don't borrow a lot of money. They suggest that when a company's earnings are all over the map, they might like the idea of selling shares more.

All these observations come back to the trade-off hypothesis, a basic idea that says companies think about the tax perks of borrowing money versus the risks of getting into financial trouble. Myers (1984) came up with this theory, saying that companies with crazy earnings might avoid borrowing too much because it comes with a higher risk of a financial crisis.

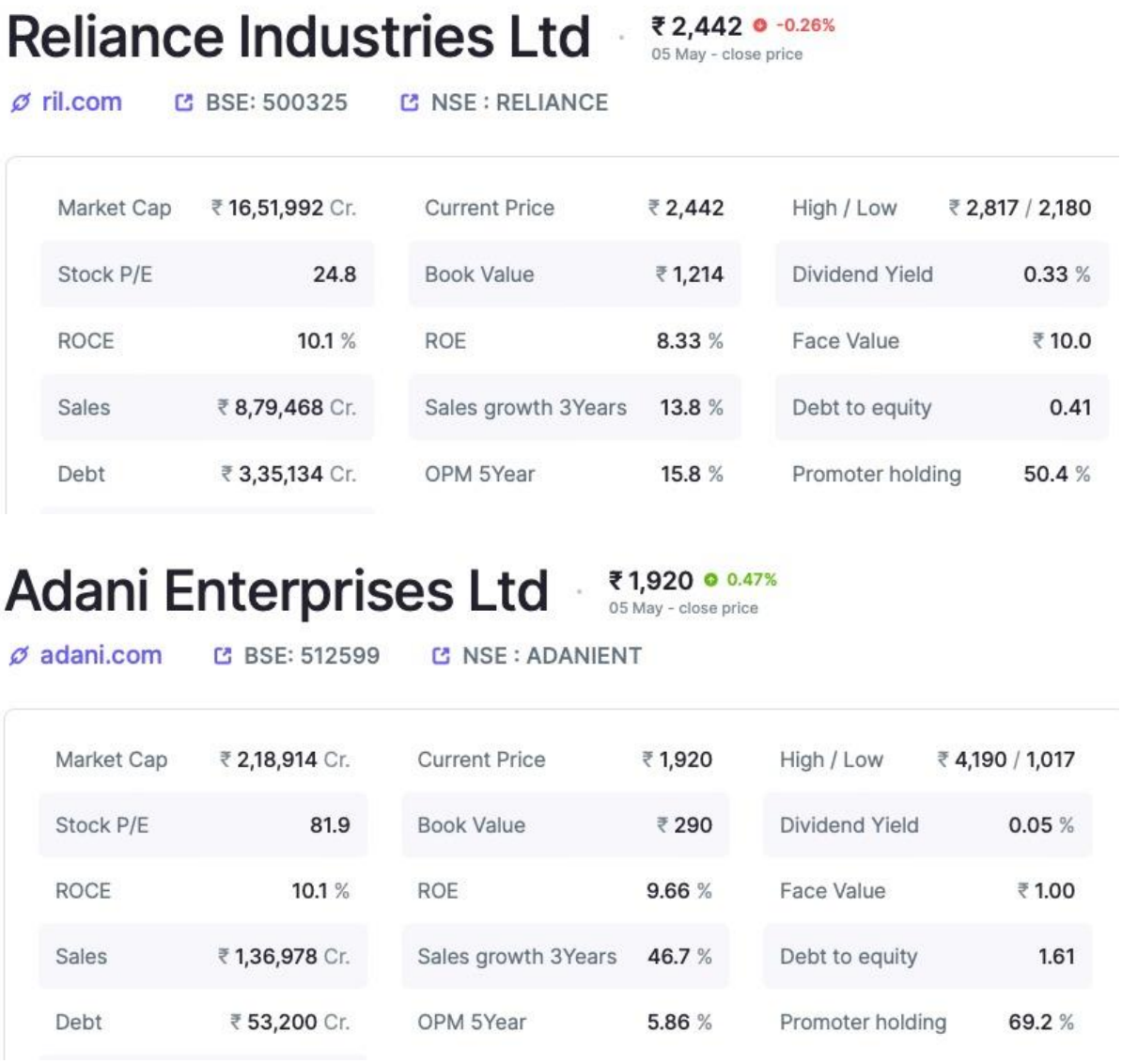
In the Chinese business scene, Li, Li, and Wang (2011) noticed something similar – when a company's earnings are all over the place, they usually don't borrow much. But here's the twist:
Huang and Song (2006) found that for companies that can grow a lot, the link between unpredictable earnings and borrowing money isn't as strong. This hints that companies with good growth potential might be okay with borrowing money, even if it brings more risk.

Fischer, Heinkel, and Zechner (1989) took a deep dive into the idea that companies with more unpredictable earnings might use more debt. They suggest that these companies might see borrowing money as a safety net when things aren't so steady in terms of making a profit.

Objectives

To investigate how the ups and downs in a company's earnings affect the choices it makes about its money structure.
To dig into the details of the trade-off theory and pecking order theory when it comes to deciding how a company uses its money.
To carefully look at how things like chances for growth and making a profit influence the complicated link between how much a company's earnings jump around and the decisions it makes about its money structure.
Methodology
For this study, we are using existing information from two companies, namely Reliance and Adani Enterprises Limited. Our goal is to examine how these companies use debt and equity in their financial structures and figure out which one seems to be more financially rewarding based on their chosen money setup.

Data Analysis



Reliance Industries Ltd ₹ 2,442 -0.26%
05 May - close price
ril.com BSE: 500325 NSE : RELIANCE

Market Cap	₹ 16,51,992 Cr.	Current Price	₹ 2,442	High / Low	₹ 2,817 / 2,180
Stock P/E	24.8	Book Value	₹ 1,214	Dividend Yield	0.33 %
ROCE	10.1 %	ROE	8.33 %	Face Value	₹ 10.0
Sales	₹ 8,79,468 Cr.	Sales growth 3Years	13.8 %	Debt to equity	0.41
Debt	₹ 3,35,134 Cr.	OPM 5Year	15.8 %	Promoter holding	50.4 %

Adani Enterprises Ltd ₹ 1,920 0.47%
05 May - close price
adani.com BSE: 512599 NSE : ADANIENT

Market Cap	₹ 2,18,914 Cr.	Current Price	₹ 1,920	High / Low	₹ 4,190 / 1,017
Stock P/E	81.9	Book Value	₹ 290	Dividend Yield	0.05 %
ROCE	10.1 %	ROE	9.66 %	Face Value	₹ 1.00
Sales	₹ 1,36,978 Cr.	Sales growth 3Years	46.7 %	Debt to equity	1.61
Debt	₹ 53,200 Cr.	OPM 5Year	5.86 %	Promoter holding	69.2 %

To learn more about how Reliance as well as Adani Enterprises, Ltd. manage their finances, let's examine the state of their finances in more detail. Reliance has a major debt of 3,35,134 thousands of dollars, but its solid equity of 8,17,400 hundreds of millions balances it out. Adani Enterprises Limited, on the other hand, has 53,200 millions in fairness and 53,000 crores in loans, which seems more moderate.

The true revelation, though, becomes apparent when we evaluate these businesses' market valuations. With a significant price tag of 16,51,992 crores, Dependence arises as an accounting powerhouse, while Adani Enterprises Limited trails behind with 2,18,914 crores. This significant discrepancy demonstrates how an organization's debt to equity ratio affects how the general public values it.

These figures highlight how crucial it is to strike the correct balance among taking on credit and owning stock in the business. Reliance has a large amount of debt, but its high market value suggests that the way it handles its finances is regarded favourably. Reliance has managed borrowing within a way that maintains its general financial stability, and the overall market appears to be appreciative of this.

Other businesses can learn a lot from this: they should exercise caution when giving on debt. Achieving financial stability in the short term is not as important as making wise choices that benefit different groups of people, such as financiers, financiers, and investors. Reaching this equilibrium is an approach that supports steady growth and guarantees a company's long-term resilience, not just a band-aid solution. In the world of finance, it involves more than just adding up numbers; it's about causing choices that will set up a business for success and harmony in the years to come.

Conclusion

In summary, we've discovered that the way a company deals with its money (capital structure) is connected to the ups and downs in its earnings. However, it's not a straightforward relationship where one thing always causes another. According to the trade-off theory, if a company's earnings are unpredictable, they might prefer getting money by selling shares of the company (equity) rather than borrowing money (debt). On the flip side, the pecking order theory suggests that when things get uncertain with earnings, companies might quickly opt to borrow money.

Now, the research we've explored in this paper provides us with a bit of a mixed picture. Some studies indicate that when earnings decrease, the way companies handle their money decreases too. Others suggest the opposite – when earnings increase, companies are more likely to borrow.

The goal of this research is to highlight how intricate it is. It resembles putting together a puzzle with different pieces where each piece is dependent upon the other Like people making decisions in their personal lives, businesses must take various factors into account when determining how they should handle their finances. That isn't a simple either-or response, next. It's more important to understand every aspect that affects how businesses in the commercial world render fiscal choices.

References

Demirgüç-Kunt, A., & Maksimovic, V. (1999). Institutions, financial markets, and firm debt maturity. Journal of Financial Economics, 54(3), 295-336.

De Jong, A., Verbeek, M., & Verwijmeren, P. (2004). Does the corporate bond market anticipate economic activity? Journal of Banking & Finance, 28(8), 1927-1947.

Barclay, M. J., & Smith, C. W. (1995). The maturity structure of corporate debt. Journal of Finance, 50(2), 609-631.

Rajan, R. G., & Zingales, L. (1995). What do we know about capital structure? Some evidence from international data. Journal of Finance, 50(5), 1421-1460.

Titman, S., & Wessels, R. (1988). The determinants of capital structure choice. Journal of Finance, 43(1), 1-19.

Li, Y., Li, X., & Wang, X. (2011). Does earnings volatility affect the relationship between capital structure and firm value? Evidence from China. China Journal of Accounting Research, 4(2), 111-130.

Myers, S. C. (1984). The capital structure puzzle. The Journal of Finance, 39(3), 574-592.

Huang, R., & Song, F. M. (2006). The determinants of capital structure: Evidence from China. China Economic Review, 17(1), 14-36.

Fischer, E. O., Heinkel, R., & Zechner, J. (1989). Dynamic capital structure choice: Theory and tests. The Journal of Finance, 44(1), 19-40.

https://www.screener.in/company/ADANIENT/consolidated/

https://www.screener.in/company/RELIANCE/consolidated/