

**ETHIOPIAN COMPANIES OF CORPORATE FINANCE: OVERWHELMING THE PROFIT**

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**Abstract**

*This review article of corporate finance mentioned how the corporate finance is very important to bring the profits in Ethiopian Companies. It mentioned about the introduction, Importance of financial decision in Ethiopian corporate sectors. Techniques and strategies of corporate finance in Ethiopian Companies. The major strategies and techniques are time value of money, budgeting, cost of capital, capital structures, working capital management, dividend policy, derivatives and capital asset pricing model.*

**Key Words:** *Corporate Finance, Cost of Capital, Capital Structure, Working Capital Management and Dividend Policy.*

**JEL Classification:** *G10, G13*

**I. INTRODUCTION**

Generally known that finance is the life blood of any business. Is this answer enough? Possibly it may convenience us to understand the finance. But finance also currency, coins, negotiable instruments, bonds, papers and its value or equivalent. Unless the money or money value is multiplied, the amount of finance might not be more which can bring the utilization of the people or customers. In order to bring the good economy and economic prosperity of the people money and money value must be multiplied. As we are all know that this is the corporate world. In the corporate world corporate it is very essential to follow the corporate finance which will help to multiply the money to do the business appropriately with the appropriate protocol of accounting and finance.

Every corporate, might be followed the stock valuation, bond valuation, risk and return, capital budgeting, cost of capital, time value of money, capital structure, working capital management, dividend calculation and derivatives to take a financial decision to do the managerial functions. This also helps the operational activity of a business which is responsible for obtaining and effective utilization of the funds with efficient financial operations. Every main aim of the corporate finance is to arrange the sufficient funds for meeting short term, long term requirements of the company. The financial objectives of the company is to maintain the liquid assets at appropriate rate, profit maximization, to balance the business risk with variability of operating profit in Earning Before Income Tax. The term of financial risk refers to the risk on account of pattern of capital structure. And to having a higher debt content in its capital structure expects a higher rate of return as compared to a firm which has comparatively low debt.

Financial Plan like need of finance requirements of short, medium and long term purposes. Then, how to use these finance for the profit than how the profit can be utilized for the further improvement of the further profit through the appropriate circulation of the money.

The corporate finance manager must be appropriate person in terms of how to multiply the money through the various instruments like current assets, fixed assets, tangible assets and intangible assets. They should also spend money wisely like direct and indirect expenditure.

Corporate Finance Manager should not waste the money for the direct materials, direct wages, factory expenses, administrative expenses, selling and distribution expenses, maintenance expenses and research and development expenditure. They have to audit each and everything and utilize the money properly without any wastage of money but it should oblige the budget of the policy.

The importance of financial decision in Ethiopian Corporate Sectors are research for innovation and invention, employees motivation like perquisites and French benefits, company promotion with appropriate company law, good business conducts, company expansion, contingencies reserves, meeting the government agencies, appropriate calculation of dividends and interest and maintaining or replacement of assets.

To be in control any business needs a prompt and reliable comparison between budgeted and actual performance. The world of business is changing so rapidly that no business can be said to be in control unless month management accounts are prepared (Fitzgerald & Ray, 2002). Growing business can take advantage of structured business finance”, which is based on the value of companys’ assets and is a more flexible source of finance than bank loans and overdraft. (Baglay & John, 2002).

## **II. TECHNIQUES AND STRATEGIES OF CORPORATE FINANCE IN ETHIOPIAN COMPANIES**

It is true that money makes money with difficult strategies of financial plan. If we invest money today, we expect to have more money in future. This changes in the amount of money over a period is called time value of money. The money has a time value due to individuals preference of current consumption, an investor can profitable employee and in terms of inflationary economy, the money received today will have more purchasing capacity than money to be received in future.

In time value of money, there are compounding concept. i.e. future values of money discounting concept. i.e present values and future & present values of applications. In compounding means that a Birr in hand today has more value than a Birr to be received in future. Since, there is a interest involved the money could be earned by investing. In discounting concept a Birr to be received in future which has lower value than a Birr in hand today. In the future & present values, there are sinking fund investment, loan amortization, annual percentage rate and rate of growth.

### ***Capital Budgeting***

Capital Budgeting is one of the budgeting techniques which help to financial plan development of the available capital for the purpose of maximizing the long term profitability of the company.

Capital structure is long term planning for making & financing proposed capital outlays. It also mention that planning for capital assets, funds and which should be invested in long term projects such as setting up an industry, purchase of plant and machinery etc. It can also be decide that the replacement of permanent assets such as fixed assets.

### **Method of appraisal in Capital Budgeting**

There is a traditional approach time adjusted or discounted method which has pay back period and net present value methods, improvement of traditional approach, internal rate of return method, rate of return method and profitability index method.

### **Method of Payback:**

It is also called as pay out or pay off method. It refers to the periods in which the project will generate the necessary cash to recoup the initial investment.

The formula of pay back period is, initial investment divided by annual cash inflow.

For instance, if a project requires Birr 40,000 as initial investment & it will generate an annual cash inflow of Birr 10000 for 10 years. The pay pack period will be 4 years. The calculation of pay back period is =  $40,000/10000 = 4\text{Years}$

The pros of the payback period is to simple to understand and very easy to calculate by any body. It saves the expenditure which requires lesser time & labor as compared to other method of capital budgeting.

The cons of pay back period is it can not measure properly the profit of the project due to inflation and other factors so that this method only can be used for short period of the projects.

There are different traditional approaches can be used it for the pay back period to improve the efficiency for the enhancement. They are post pay back profitability method, payback reciprocal method, post pay back period method and discount pay back method.

**Rate of Return Method:** The rate of return method is earnings expected from the investment of their whole life of the company. It may be 20 – 25 years. The project with higher rate of return is selected as compared to the one with lower rate of return of the investments. It is not necessary that the decision of all the

higher rate of return can be selected and all the lesser rate of return not selected. It is all depends up on the different strategies of the company.

There are several methods can be used to evaluate the project. They are average rate of return method, return per unit of investment method and return on average investment method.

**Net Present Value Method:**

This is the modern method to evaluate the investment proposals. It always recognizes the face that a Birr earned today is worth more than the same Birr earned tomorrow. The financial tools which used to find this method is as under,

$$\text{Present Value} = 1/(1 + \text{rate of interest})^{\text{number of years}}$$

The present value for all the cash inflow for a No. of years:

$$\text{Present Value} = \frac{A1}{(1+r)} + \frac{A2}{(1+r)^2} + \dots + \frac{An}{(1+r)^n}$$

R = Rate of Return

N = No. of years

An = Future Net Cash Inflows (Profit After Tax Before Depreciation)

**Internal Rate of return:**

It is also a modern technique of capital budgeting that takes into account the time value of money. It can be defined as that rate of discount at which the present value of cash outflows

$$C = \frac{A1}{(1+r)} + \frac{A2}{(1+r)^2} + \dots + \frac{An}{(1+r)^n}$$

Where,

C = Initial outlay at time zero

An = Future net cash flows at different periods

n = No. of years

r = Rate of discount of internal rate of return

IRR = Initial outlay / Annual cash flow

**Profitability index:**

It is also a time-adjusted method to evaluate the project investment proposals. The other name of this method is Benefit – Cost Ratio. The formula is,

$$\text{Profitability index} = \frac{\text{Present value of cash inflow}}{\text{Present value of cash outflow}}$$

**Method of Terminal Value:**

It is an improvement over the net present value method of making capital investment decisions. The terminal rate of return method is also called as modified internal rate of return. This method is presently being used in advanced countries like U.S.A.

**Risk and uncertainty in capital budgeting factors**

There are different risks and uncertainty involved. They are expected economic life of the project, salvage value of the asset at the end of the economic life, capacity of the project, selling price of the product, production cost, depreciation rate and future demand of the product.

**Cons of capital budgeting**

The limitation of capital budgeting are, uncertainty & risk is the biggest limitation to the technique of capital budgeting. Urgency is the limitation in the evaluation of capital investment decision. There are certain factors like moral of employee & goodwill of the firm, which cannot be correctly quantified, otherwise substantially influence the capital decisions. The techniques of capital budgeting requires estimation of future cash in flows & out flows the future is always uncertain & the future may not be exact. The result based upon wrong data may not be good.

**Capital Cost**

Capital cost or cost of capital is that minimum rate of return which a firm must & is expected to earn on its investments, so as to maintain the market value of its shares.

The main control concepts are,

- It is the rate of return that a firm requires to earn from its projects so it is not cost.
- It is the minimum rate of return cost of capital of a firm is that minimum of return which will at least maintain the market value of the shares.
- They are the expected normal rate of return at zero level, the rate of interest allowed by bank are the three components.

Business Risk Premium:

The premium for financial risk on accounts capital structure.

$$\text{Cost of capital}(K) = r_0 + b + f$$

Where,

K= Cost of capital

$r_0$  = Normal rate of return at zero risk level.

B = Premium for business risk.

F = Premium for financial risk.

Significance of the Cost of Capital: It is an acceptance criteria in capital budgeting, determining of capital mix in capital structures decisions like debt and equity, basic for evaluating the financial performance and basis for taking other financial decision.

**Classification of Cost:** The classification of costs are historical cost & future cost, specific cost & composite cost, explicit cost & implicit cost and average cost & marginal cost.

**Factors affecting Cost Capital :** The main factors which are affecting cost of capital are conceptual controversies regarding the relation ship between the cost of capital & capital structure, historic cost & future cost, problems in computation of cost of equity, problems in computation of cost of retained earnings and problems in assigning weights.

**Computation of cost of capital :** The computation of overall cost of capital of a firm involves computation of cost of specific source of finance and computation of weighted average cost of capital.

**1. Computation of each source of Finance**

Computation of each source of finance are cost of debt, cost of preference capital, cost of equity share capital and cost of retained earnings.

**a. Calculation of Weighted Average Cost of capital**

Cost of dept: It is the rate of interest payable on debt.

$$K_{db} = I/P$$

Where,  $K_{db}$  = Before Tax Cost of Debt

I = Interest, P= principal

**b. Preference Capital Cost**

A fixed/floating rate of dividend is payable on preference shares. It is a function of dividend excepted by its investors.

The cost of preference capital would be calculated

$$K_p = D/P$$

Where,

- $k_p$  = Cost of Preference Capital
- D = Annual Preference Dividend
- P = Preference Share Capital.

**c. Equity Share Capital Capital**

It is the maximum rate of return that the company must earn on equity financed portion of its investment. It is a function of the excepted return by its investors.

**d. Retained Earnings Costs**

The retained earnings never involve any cost because a firm is not required to pay dividends on retained earnings. The S/HS except a return on retained projects.

$$K_r = D/NP + G$$

Where,  $K_r$  = Cost of Retained Earning

D = Excepted Dividend

NP = Net Proceeds of Share Issue.

G = Rate of Growth.

**2. Calculation of Weighted Average Cost of Capital**

**Cost of Capital**

It is the average cost of the costs of various sources of short, medium and long term financing. It is also known as composite cost of capital, overall cost of capital (Or) average cost of capital.

$$K_w = EXW/EW$$

Where,  $K_w$  = Weighed Average Cost of Capital

X = Cost of Specific Source of Finance, so,

W = Weight, Proportion of Specific of finance

**Capital Structure**

Capital structure is the different proportion of equity and debt but full fill the company law. Ex: Loans, Resources, Shares, and Bonds. The capital structure is made up of debt and equality securities and refers to permanent financing of firm. It is composed of long term debt, preference share capital and shareholders fund. Capitalization, capital structure and financial structure: Capitalization financial planning of an enterprise. It refers to the total amount of securities issued by a company. It is short term debt and capital structure as financial structure. The kinds of securities and the proportionate amounts that make up capitalization. i.e., Equality shares, Preference shares and Debentures.

**Financial Structure:**

It means the entire liabilities side of the balance sheet. It is composed of a specified percentage of short term debt, long-term debt and shareholders funds. For example, given the following information, you are required to compute i) Capitalization, ii) Capital structure and iii) Financial structure.

<u><b>Liabilities</b></u>	<b>Birr.</b>
Equity share capital	20,00,000
Pref.share capital	10,00,000
Long term loans and debenture	4,00,000
Retained earnings	12,00,000
Capital surplus	100,000
Current liabilities	30,0000
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	50,00,000
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**Answer:**

i) Capitalization: It refers to the total amount of securities issued by a company.

	<b>Birr.</b>
Equality share capital	20,00,000
Pref. share capital	10,00,000
Long term loans and debenture	4,00,000
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Capitalization	34,00,000
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ii) Capital structure:

A firm make up of its capitalization.

	<b>Birr.</b>	<b>Proportion</b>
Equality share capital	20,00,000	58.82%
Pref. share capital	10,00,000	29.41%
Long term loans and debt	4,00,000	11.77%
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Capitalization	34,00,000	100.00%
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3) Financial structure:

	<b>Birr.</b>	<b>Proportion</b>
Equality capital	20,00,000	40%
Pref.share capital	10,00,000	20%
Long term loans and debt	4,00,000	08%
Retained earnings	12,00,000	24%
Capital surplus	1,00,000	02%
Current liabilities	3,00,000	06%
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	50,00,000	100%
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**Capital Structure Forms**

The forms of capital structures are equality shares, equality and preference shares, equality shares and debenture and equality, preference shares and debentures.

**Importance:**

The term ‘capital structure’ refers to the relationship between the various long term financial such as debenture, preference share capital and equality share capital.

**Capital Structure Theories**

Theories of capital structure are net income approach, net operating income approach, the traditional approach and MM Approach ( Modigliani and Miller approach ).

**i. Net Income approach Method:**

A firm can minimize the weighted cost of capital and increase the value of the firm as well as market price of equality shares by using debt financing to the maximum possible extent of a company can increase its value and reduce the overall cost of capital by increasing the proportion of debt in its capital structure.

**Assumption:**

- The cost of debt is less than the cost of equality.
- There is no tax.
- The risk perception of investors is not changed by the use of short, medium and long term debt.
- The total market value of a firm on the basis of Net Income Approach Method.

$$V = S + D$$

Where, D = Market value of debt.

V = Total market value of a firm.

S = Market value of equality shares.

$$= \frac{\text{Equality available to equality shareholders}}{\text{Equality capitalization rate}}$$

**2) Net Operating Income Approach:**

It changes in the capital structure of a company does not affect the market value of the firm. The overall cost of capital remains constant. Whether the debt equality mix of 50:50 or more but the ratio must be followed based on the company policy or company law.

**Assumptions:**

- There are no company taxes.
- The business risk of debt equality mix.
- The market capitalizes the value of the firm as a whole of company.

Approach can be differentiated as below:

$$V = \frac{\text{EBIT}}{K_o}$$

Where, V = Value of a firm.

EBIT = Earnings before interest and tax or net operating income.

Ko = Overall cost of capital.

The market value of equality,

$$S = V - D$$

Where, S = Market value of equality share

V = Total market value of a firm.

D = Market value of debt.

**3) The traditional Approach:**

It is also known as Intermediate approach method. It is a compromise between the two extremes of net income approach and net operating income approach. According to the theory, The value of the firm can be increased initially 1 or 0, cost of capital can be decreased by using more debt and debt is cheaper source of funds than equality.

**4) MM Approach: (Modigliani and Miller)**

M & M hypothesis is identical with the net operating income approach if taxes are ignored. When corporate taxes are assumed to exist, their hypothesis is similar to the net income approach.

**Assumptions:**

- There is no corporate tax.
- There is a perfect market i.e enough buyers and sellers
- Investors are rationally moved their business.
- All the earnings are distributed to the shareholders like equity and preferences.
- The cost of point investment in a firm is capitalization rate.

**Capital Structure Affecting Factors**

The various factors such as financial coverage, growth and stability of sales, cost of capital, cash flow ability to service debt, nature and size of a firm, controlling, flexibility, requirement of investors, capital market condition, asset structure, purpose of financing and period of financing.

**Dividend policy**

Dividend refers to that part of profits of a company which is distributed only by the company among its shareholders. Dividend policy of a firm, affects both long term financing and the wealth of the shareholders. The company should distribute a reasonable amount as dividends i.e part of the profits to its members and retain the rest for its growth.

**Types:**

There are different types of dividend policies are involved. They are regular dividend policy, stable dividend policy like constant dividend per share, constant payment ratio, stable rupee dividend plus extra dividend, irregular dividend policy and no dividend policy.

**i. Continuous dividend policy.**

The payment of dividend at the usual rate is termed as regular dividend policy. The investors such as retired person, widows and economically weaker person prefer to get regular dividend.

**ii. Constant dividend policy**

It means consistency in the stream of dividend payments. Atleast minimum amount of dividend regularly.

**a. Constant dividend per share:** Some companies follow a policy of paying fixed dividend per share irrespective of the level of earnings every year after year.

**b. Constant payment ratio:** It means payment of a fixed % of net earning as dividends every year. It is related to their ability to pay dividend.

**c. Stable Birr dividend plus extra dividend:** Some companies follow a policy of paying constant low dividend per share plus an extra dividend in the year of high profits.

The advantages of stable dividend policies are stabilize the market value of shares, creating the confidence among the investors, providing a source of livelihood to those investors who view dividends as a source of funds to meet day-to-day expenses and stabilization of rational income. i.e. it results in a continuous flow of the national income. The disadvantages of stable dividend policies are stable dividend policy is followed by a company and it is not easier to change it.

**Irregularity of Dividend Policy.**

The irregular dividend policy is uncertainty of earnings, unsuccessful business operations and lack of liquid resources.

**Zero Rate Dividend Policy.**

A company may follow a policy of paying no dividends policy because of its unfavorable working capital position for future growth expansion.

**Working Capital**

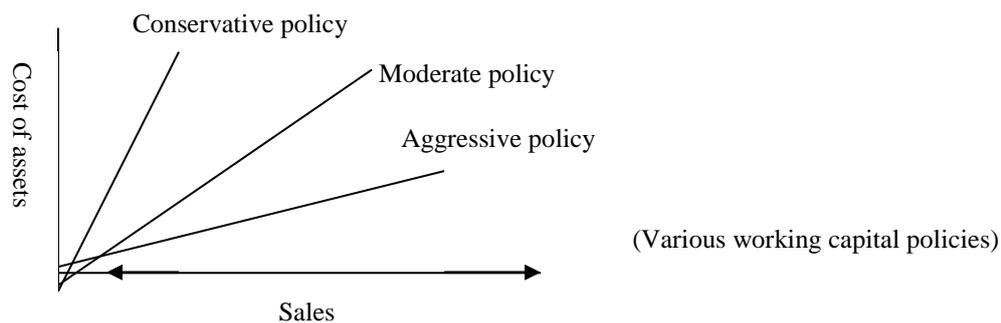
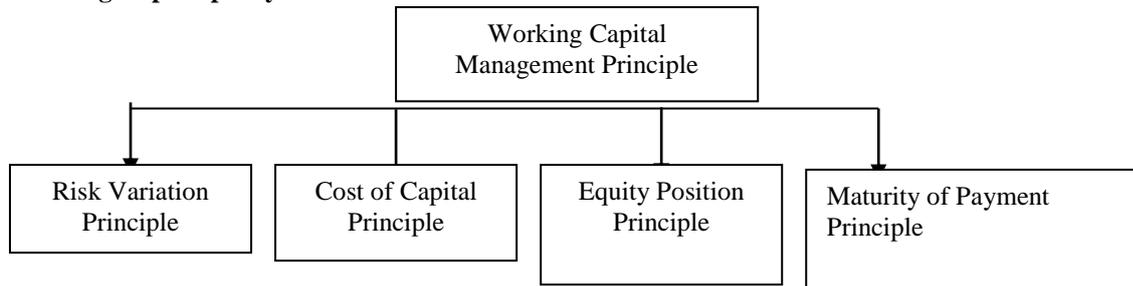
The working capital means the difference between current assets & current liabilities i.e Working Capital = Current Assets – Current Liabilities

**The Concept of Working Capital as follows,**

1. Gross Working Capital is total of Current Assets
2. Net Working Capital is the excess of Current Assets divided by Current Liabilities

<b>Current Assets</b>	<b>Current Liabilities</b>
Cash in hand / at bank	Sundry Creditors
Sundry Debtors	Bills Payable
Bills Receivable	Outstanding expenses
Short term loans	Accrued expenses
Investors/ stock	Bank over draft
Temporary investment	
Prepaid expenses	
Accrued incomes	

**Working Capital policy**



**Risk Variation Principle**

The risk refers to the inability of a firm to meet its obligation, when they become due for payment. There is a definite inverse relationship between the degree of risk & profitability. A management prefers to minimize risk by maintaining a higher level of current assets or working capital.

**Cost of Capital Principle**

Generally, higher the risk lower is the cost & lower the risk, higher is the cost. A sound working capital management should always try to achieve a proper balance b/w these two.

**Equity Position Principle**

It is concerned with planning the total investment in current assets. Every rupee invested in the current assets should contribute to the net worth of the firm.

The level of Current Assets may be measured with the help of the two ratios. They are,

- Current assets as a % of total assets.
- Current assets as a % of total sales.

**Maturity of Payment Principle**

It is concerned with planning the sources of finance for working capital. A firm should make each and every effort to relate maturities of payment to its flow of internally generated funds.

**Prediction / Forecast of Working Capital Requirements**

“Working capital is controlling nerve centre of a business.” No business can be successfully run with an inadequate amount of working capital. To avoid the shortage of working capital at once, an estimate of working capital requirement should be made in advance. But estimation of working capital requirements is not an easy task & a large number of factors have to be considered before starting this.

**Factors which should be for the Business Consideration while Estimating Working Capital.**

- The average credit period expected to be allowed by suppliers.
- Total costs incurred on material and wages.
- The length of time for which raw material are to remain in stores before they are issued for production.
- The length of the production cycle (or) work in process.
- The length of sales cycle during which finished goods are to be kept waiting for sales.
- The average period of credit allowed to customers
- The amount of cash required to make advance payment

**Determination of Working Capital Requirements**

There are various determining working capital factors are nature of business, size of business, production policy, manufacturing process, seasonal variations, working capital cycle, rate of stock turn over, credit policy, business cycles, rate of growth of business, price level changes, earning capacity & dividend policy and other factors which may experienced by the financial analysis.

**Derivatives**

A security whose price is dependent upon or derived from one or more underlying assets. The derivative itself is merely a contract between two or more parties. Its value is determined by fluctuations in the underlying asset. The most common underlying assets include stocks, bonds, commodities, currencies, interest rates and market indexes. Most derivatives are characterized by high leverage.

Futures contracts, forward contracts, options and swaps are the most common types of derivatives. Derivatives are contracts and can be used as an underlying asset. There are even derivatives based on weather data, such as the amount of rain or the number of sunny days in a particular region.

Derivatives are generally used as an instrument to hedge risk, but can also be used for speculative purposes. For example, a European investor purchasing shares of an American company off of an American exchange (using U.S. dollars to do so) would be exposed to exchange-rate risk while holding that stock. To hedge this risk, the investor could purchase currency futures to lock in a specified exchange rate for the future stock sale and currency conversion back into Euros.

**Capital Asset Pricing Model**

The Capital Asset Pricing Model (CAPM) is a model to explain why capital assets are priced and the way they are priced. An important consequence of the modern portfolio theory as introduced by Markowitz was that the

only meaningful aspect of total risk to consider for any individual asset is its contribution to the total risk of a portfolio. With the introduction of risk-free lending and borrowing, the efficient frontier was expanded and it was shown that only one risky portfolio (the tangency portfolio) mattered in evaluating the portfolio risk contribution characteristics of any asset. CAPM demonstrated that the tangency portfolio was nothing but the Market Portfolio consisting of all risky assets in proportion to their market capitalization. Since the Market Portfolio includes all the risky assets in the world in their relative proportions, it is a fully diversified portfolio. The inherent risk of each asset that can be eliminated by belonging to the portfolio has already been eliminated. The CAPM is a model for risky asset pricing that is related with the variability of returns in the Market Portfolio (its contribution to systematic risk) and the variability in its returns that is unrelated with the variability of returns in the Market Portfolio (called unsystematic risk). The systematic risk of a risky asset matters; it exists in the Market Portfolio and cannot be eliminated by further diversification. And since investors will want to hold the Market Portfolio, this is the risk that must be and is rewarded. The unsystematic risk for any risky asset cannot be eliminated by holding the market portfolio.

Generally, CAPM is that expected return on an asset is related to its systematic and not to its total risk or standard deviation. Its systematic risk is given by its beta coefficient. An asset's beta is a measure of its co-movement with the market index.

### III. CONCLUSIONS

Ethiopia is very fast growing economy in East Africa. There are so many companies are coming up to improve the economy. If every company would use the appropriate corporate finance strategies it would be better to bring the profit for the economy development. The major strategies are time value of money, budgeting, cost of capital, capital structures, working capital management, dividend policy, derivatives and capital asset pricing model.

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