

# [Derivatives usage assignment](https://assignbuster.com/derivatives-usage-assignment/)

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Many researchers have analyzed the determinants of hedging policy and its correlation with firms’ leverages, investment and growth opportunities and very little work has been done to check the impact of derivatives usage on firms’ value and the empirical evidence on the effects of derivative use on firms’ value is still mixed. Modeling and Miller (1958) propose that in a perfect capital market where investors can equally access to these markets, the firms would not engage in hedging activities since they add no value.

If the perfect capital markets assumption is not net, there may be rational reasons for the firm to hedge. Allaying and Weston (2001) suggest that hedging foreign currency risk is associated with approximately 4% increases in market value. And Graham and Rogers (2002) find that hedging increases firms’ total arrest value by allowing firms to increase their debt capacity. By contrast, Guy and Katharine (2003) describe that the cash flows generated by hedging is modest and unlikely to change firms’ market value.

Most of the studies on derivatives usage have been done on the developed financial market, in China this topic has not been explored yet. And Allen (2005) comments China has been characterized as a counterexample to the findings of the finance growth literature. A significant drawback in the research concerning the derivatives usage in Chinese firms is the jack of available data is attributed to the fact that firms in China were not obliged to reveal to the public neither the risks they face nor the actions they take to manage these risks.

Until 2007, the convergence of Chinese Accounting Standard with the International Financial Reporting Standards (FIRS) requires listed firms to disclose whether they use derivatives contracts for hedging or trading purposes and to provide information about the whole amount of risks they face and the actions they take to properly handle them. The major change in the disclosure requirements of sites firms has allowed this study to investigate whether the use of derivatives for hedging purposes affects the firms’ financial performance.

This research aims to investigate whether hedging with derivatives materially improve firms’ market value as many related research in advanced financial markets has proven, or whether hedging does not affect firms market value, but can be attributed to other motivations. Therefore the central question in this research is “ what impact does derivatives usage By congou 5 2. Literature review Warren Buffet has labeled financial derivatives as “ financial weapons of mass extraction”.

The financial derivatives are instruments that allow financial risks to be traded directly because each derivative is linked to a specific instrument or indicator or commodity (Gray and Place, 1999). The value of a derivative depends on the future performance of the underlying asset. The researches have been done on the affects of derivatives on firms’ value showed the mixed results. Allaying and Weston (2001) made the first research to investigate the value perspective of derivatives usage on nonofficial firms.

The study adopts 720 large U. S. Non-financial firms teen 1990 and 1995 in order to examine the impact of using foreign currency derivatives and finds a positive relation between firm value and the use of derivatives. Specifically, the empirical results indicates that firms use currency derivatives have a 4. 87% higher value than firms that do not use currency derivatives when they face currency risk. Graham and Rogers (2002) examines the impact of derivatives usage on nonofficial firms’ value from two tax incentives for firms to hedge.

They use a sample of 496 non-financial firms and find firms hedge to increase debt capacity and interest deduction. The evidence shows that firms hedge to increase debt capacity and the tax benefits resulting from hedging add approximately 1 . 1% to firm value. Allaying et al. (2003) examines the use of foreign currency derivatives and its impact on firm value from 35 countries between 1990 and 1999. And they find hedging is valuable around the world on average for firms with strong internal corporate governance or good external governance. Carter et al. 2006) finds hedging is positively and significantly correlated with firm value by examining 28 firms from U. S. Airline industry. However, Callahan (2002) take a ample of 20 gold mining firms of North America between 1996 and 2000 to investigate the relationship between gold hedging and firm value, and finds that the extent usage of hedging is negatively associated with firm value. In consistent with Callahan (2002), Guy and Katharine (2003) find no significant relationship between use of derivatives and firm value. Jinn and Groin (2006) use a sample of 119 U. S. IL and gas producers for the period from 1998 to 2001 to investigate the impact of hedging on firm value, and find insignificant effects of derivatives on firm’s market value. The duty of Bertram, Brown and Conrad (2008) suggests that firms do reduce cash flow risk, total risk and systematic risk significantly through financial risk management with derivative, and they claimed the value put on this risk reduction in the market place is much less certain. And the work also shows that derivative use is more prevalent in firms with higher exposures to interest rate risk, exchange rate risk and commodity prices risk.

However, the evidence of using derivative is associated with firms value is weak. There are mixed empirical evidences on the impact of derivatives usage on firm value in Asian countries. First of all, Allusions et al. (2003) also find evidences that the use of hedging enhances the firm value in eight Asian economies. Aimer (2009) uses Malaysian firms between 2003 and 2007 and finds significant positive relationship between the use of derivatives and firm value. Opposite with Allusions et al. (2003) and Aimer (2009), Unguent and Oaf (2003) adopt negatively associated with firm value.

The literature reviews above clearly illustrate that the impact of use of derivatives on non financial firms’ market value is not clear. The derivatives has not been fully explored in Chinese finance market and its attention in improving firms’ market value is rather unknown, and there is no empirical evidences on association between derivatives usage and firm value. 3. Objective and research questions This research is motivated by the current development stage of financial derivatives market in China.

Chinese derivatives market is heavily weighted (80% annual turnover) on foreign exchange (FIX), followed by interest rate derivatives. In 2012, the total turnover of interest rate swaps reached $617 billion and exhibits high growth rate at 41% (USDA). Other ETC derivatives turnover is basically nonexistent in inland financial market, banks and corporate users use overseas derivatives market to hedge risk. In China, non-financial firms contribute 46% of total ETC derivatives turnover.

Though the derivatives market in China developed quickly, the market is still immature and there is big gap between Chinese financial derivatives markets and developed US and European financial derivatives markets. In China, there are only 4 Derivatives Exchange, 28 derivatives trading varieties are future products, and the trading volume and transaction are relatively small comparing to Chinese futures market growth. The lack of adequate understanding of the futures markets, the lag of regulations, markets manipulation and other issues, so that Chinese future financial derivatives markets are in disarray.

The need to reverse the situation is exigent. Literatures on derivatives has been associated with reduced firms currency risk, interest rates risk and commodity price risk in the advanced financial market and there is no clear evidences show the associate between using derivatives and firm value. And there is no empirical study on the impact of derivatives usage on firm value in China which creates the objectiveness of this search, therefore the central research question for this research is, “ what are the impacts of using financial derivatives on non-financial firms’ market value in China? In order to answer the central research question, this needs to be broken down into a set of manageable and coherent sub questions: Question one: what is the current stage of financial derivatives market in China? In order to investigate the effects of financial derivatives on the public listed firms, there is necessary to first of all understand the current development stage of financial derivatives in China. Question two: what are the motivations of using derivatives in advanced economies? This question more closely focuses on what motivates the use of finical derivatives by non-financial corporations in the developed economies. Financial distress, underinvestment, and management incentives) Question three: In which ways can financial derivatives affect firms’ market value in China? There have been numerous researches trying to analyses correlation between the usage of derivatives and firms market value, such as firms’ book value, cash flow, investment policy, and capital structure. In China, this kind of analysis has not been done. The empirical evidences will illustrate the influences of derivatives usage on firms’ financial policy and capital structure.