

FINANCING PRACTICES IN CORPORATE FINANCE

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ABSTRACT

This research paper shows about the finance practices in the corporate finance. There are three leading areas of corporate finance practices that consistently require the academic concentration of scholars in corporate finance theory. These include corporate financial practices relating to investing, financing and finally the practices concerning distribution. However, in modern finance, the investing practices have been further classified into two categories, that is, long term financing and short term financing. The long term financing refers to capital budgeting practices and short term refers to working capital practices. A brief account of leading practices in these areas of corporate finance is presented in this paper.

KEY WORDS: Corporate Finance, capital budgeting, capital practice.

OBJECTIVES AND METHODOLOGY

The objective of the study is to provide the awareness about the corporate financial practices relating to financing, investing and distribution of the finance. Here in this section, an attempt has been made to design and define a brief methodology commonly used to carry out the research work. The study is descriptive in nature and based on the secondary data that is gathered from the books, various articles from journals and other valid online sources.

INTRODUCTION

Over the last century, the researchers from around the Globe have worked upon postulating models and theories facilitating firms to their efficiency in terms of competitive corporate financial practices. To what degree of success these scholars have made their way into corporate board-room is the question that still remains inconclusive. What are the leading practices World-wide regarding corporate finance and what is the standing of Indian corporate sector in such state of affairs are few equally important questions in the mind of researchers that ask for fitting resolution. As the pressure for better financial performance has been mounting largely because of increasing competition in the present globally competitive era, the researchers in finance have been left with no option but to explore a number of factors and techniques that central philosophy of modern finance theory.

Corporate finance is the area of finance dealing with monetary decisions that business enterprises make and the tools and analysis used to make these decisions. The primary goal of corporate finance is to maximize shareholder value (Damodaran, A.). Although it is in principle different from managerial finance which studies the financial decisions of all firms, rather than corporations alone, the main concepts in the study of corporate finance are applicable to the financial problems of all kinds of firms.

A standard assumption in corporate finance is that shareholders are the residual claimants and that the primary goal of executives should be to maximize shareholder value. Recently, however, legal scholars (Lynn Stout) have questioned this assumption, implying that the assumed goal of maximizing shareholder value is inappropriate for a public corporation.

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The researchers have explored various factors and techniques which help in estimation of cost of capital. The cost of capital is the most important yardstick to evaluate investment decisions. Not only the hurdle rate for investment projects but also the composition of the firm's capital structure is also determined by this variable. However, there still exist considerable ambiguity and confusion over how the theory of cost of capital can best be applied to the industry. The issue at stake is sufficiently important that differing choices on a few key elements can lead to wide disparities in estimated capital cost. Given the huge annual expenditure on capital projects and corporate acquisitions each year, the wise selection of discount rates is of material importance to senior corporate managers. Managers, investors and regulators have a compelling interest in identifying the factors that influence the cost of raising funds from the market. Managers require a precise estimate of their firm's cost of equity capital budgeting. Investors require the same for equity valuation; regulators need to understand the impact of new accounting standards on the cost of financial market opportunities, corporate uses of capital must be benchmarked against these capital market alternatives. The cost of capital provides this benchmark. Unless a firm can earn in excess of its cost of capital, it will not create economic profit or value for investors. A standard means of expressing a company's cost of capital is the weighted- average of the cost of capital. It is a weighted sum of the cost of equity and the cost of debt. Firms finance their operations by three mechanisms: issuing stock, issuing debt and internal financing. Rate of return that is necessary to maintain market value of a firm, also called minimum required rate of return. The cost of debt is relatively easy to calculate, as it is consisted of the interest paid (interest rate), including the cost of risk (the risk of default on the debt). In practice, the interest paid by the company will include the risk-free rate plus a risk component, which itself incorporate a probable rate of default. For companies with similar risk or credit rating, the interest rate is largely exogenous.

The Capital Asset Pricing Model (CAPM) of Shape (1964) and Lintner(1965 a) is the cornerstone of modern finance and has been widely accepted as the most appropriate technique of estimation of cost of equity as reported in the survey conducted by (Bruner, Eades, Harris and Higgins, 1998). Its decision- theoretic foundation, mean- variance analysis, has become a major guidance to asset allocation. Its equilibrium restriction provides the most important risk correction in the evaluation of portfolio performance. It is widely applied to determine appropriate discount rate in capital budgeting. Asset pricing models with even greater generality are based on CAPM's key argument of optimal portfolio demands market equilibrium and share its main prediction, namely , that expected returns increase with the co- variation with aggregate risk. Gitman and Mercurio (1982) study of 177 Fortune 1000 firms finds that 31.2% of the respondents use divided discount model and 29.9% use capital asset pricing model (CAPM) to estimate the cost of equity of the firm. Today the corporations are taking their financing and investment decision in a different environment. Hence, the need to test the CAPM in the Indian context is justified. Pricewaterhouse coopers (2000) survey of 34 representatives from across leading Indian companies, lenders and equity analysts/ investors find that CAPM is most widely used method (90% of the respondents use it) for computing cost of equity of a company, 89% of the respondents use the yield on ten-year GOI bonds as a proxy for risk free rate . 95% of the respondents' feel that currently average market risk premium is lower than 10%. 67% of the Corporate 75% of the equity analysis regard 20% to be the cost of equity for Indian companies is generally in the range of 15 – 20% as against 8-12% in case of US companies. This cost differential has been identified as a handicap for Indian companies in achieving global competitiveness.

The next imperative issue in financing decision is capital structure of the company. Fifty years ago, Miller and Modigliani (1958) maintained that operating asset and intangibles that a firm possesses and not the manner in which these asset are financed, drive the value of a firm. The only advantage of debt lies in the tax shield that debt enjoys. The underlying rationale for the MM argument is that the value of the firm is determined solely by the company's investment policy. The economic substance of the firm is unaffected whether the liability side of the firm's balance sheet which is sliced into more or less debt. To increase the value of the firm, it must invest in additional projects with positive net- present value. In their second seminal paper on corporate capital structure, Modigliani and Miller (1963) show that firm value is an increasing function of leverage due to the tax deductibility of interest payments at the corporate level. However, the implication of the model with corporate taxes seems embarrassingly extreme: value- maximizing firms should finance with 100% debt. The solution implied by their model is very much at odds with empirical observations of firm behavior. Afterwards, the agency theory, developed by Jensen and Meckling (1976), considered the modern corporate firm as a complex of agency relationships.

Debt agency cost arises due to the conflict of interest between debt providers on one side and shareholder and managers on the other side. Managers have the motivation to invest funds in risky business for shareholders' interest, because if the investment fails, the lenders are likely to bear the cost as the shareholders have limited liability, this may lead to an asset substitution problem. The use of short-term sources of debt, however, may ease the agency problems, as any attempt by shareholders to extract wealth from debt holders is likely to restrict the firms' access to short term debt in the immediate future. Capital structure theory acquired yet another dimension with the explicit modeling of private information in financial theory. Ross (1977) assumed in the study that managers (the insiders) know the true distribution of firm returns, but investors do not. The study establishes that investors interpret larger levels of leverage as a signal of higher quality. Adding debt to the capital structure can be interpreted as a credible signal of higher future cash flows and managers' confidence about their own firm. Lower quality firms will not imitate higher quality firm by issuing more debt because they have higher bankruptcy costs at any level of debt. Accordingly, it is observed that investors take larger level of debt as a signal of higher quality and that profitability and leverage are thus positively related. In addition, Myers and Majluf (1984) suggested that the capital structure can help to mitigate inefficiencies in a firm's investment program that are caused by information asymmetries. In contrast to the trade-off theory, there is no well-defined target leverage ratio in the pecking order theory. It came out as result that there is a pecking order of corporate financing: (i) firms prefer internal finance; (ii) if internal finance is not sufficient and firms require external finance, they issue the cheapest security first. In this case, they start with debt, then possibly hybrid securities such as convertible bonds and issue equity only as last resort. In the context of asymmetric information and market imperfection firms' choice of debt-equity ratio depends upon multiple factors. What determine the corporate capital structure in corporate world? These issues have been of strong interest for quite a long time. The empirical studies on corporate capital structure in industrialized countries are immense, for example studies of Titman and Wessels (1988) and Rajan and Zingales (1995). These studies provided that how institutional factors could explain differences in firm's capital structure in largest industrialized countries. However, there exists chaos in the industry as well as academics about determinants of capital structure. Few research studies have tackled this issue in India. Varma (1998) observes that at the beginning of the reform process, the Indian corporate sector was significantly over levered because of availability of subsidized institutional finance and operating risk was lower due to protected economy. The average debt to equity ratio of corporate India has reduced from 1.72:1 in 1990-91 to 1.05:1 in 1996-97. Babu and Jain (1999) survey of 91 Indian private sector firms finds that pecking order theory of capital structure holds. The studies that have focused on the issue include Nagaishi (2005), Sahoo and Omkar Nath (2005), Bhole and Mahakud (2004), Bhattacharyya and Banerjee (2001), Kaknai (1999) and a few more. All these researchers have concentrated on manufacturing or other private industries.

Earnings and equity book value, the summary measures of two primary financial statements, occupy a central place in equity valuation. They provide essential inputs for valuation whether using informal techniques (such as price-to-book and price-to-earnings multiples) or more sophisticated models (such as residual income model). A question that has long intrigued both practitioners and academic researchers is: What roles do earnings and book value play in value determination? The accounting input to the valuation mapping has two components: equity book value and profitability (ROE), which convey, respectively, the amount of capital employed and the efficiency with which capital is employed, the two essential aspects of value-generating activities. Zhang (2000), Ohlson (1995) and Feltham and Ohlson (1995, 1996) establish that equity value arises as a linear function of earnings and equity book value. "Earnings" indicates the directions in which the firm will move forward. "Equity book value" measures the amount of (equity) capital invested, whereas earnings and book value together convey profitability. The price-to-book ratio and the price-to-earnings ratio are both shown to vary with profitability and growth opportunity and they behave in ways as predicted by the theory. The price-to-book ratio increases with profitability and in the high profitability range, also with growth opportunity. The use of P/E multiples relies on the notion that value derives from the future earnings stream. As such, this ratio is meaningful only if a firm is expected to remain in operation and continue to produce earnings. As predicted by the theory, as the profitability increases (which increases the firm's chance of continuing as a going concern versus being abandoned, the value impact of earnings increases whereas that of book value decreases.

CONCLUSION

This study presents preliminary evidence on the practice of finance in an emerging market. Field research in corporate finance enables a better understanding of the decision-making process of financial managers. Cross-cultural field research such as this one may help highlight the role of the legal, institutional, and macroeconomic frameworks in the financial manager's decisions. Therefore, cross-country comparative field studies are a promising path for the furthering of financial theory. This study provides the different ways for the further researches for different researchers. Of course, the analyses presented in this study are only preliminary.

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