

STUDY ON DIFFERENT LEADING PRACTICES IN CORPORATE FINANCE

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ABSTRACT

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 could help to device suitably fitted financial practices in compliance with central philosophy of modern finance theory. There are three leading areas of corporate financial 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.

Keywords: *Net Present Value (NPV), Capital Asset Pricing Model (CAPM), WACC*

I INTRODUCTION

Over the last century, the researchers from around the Globe have worked upon postulating models and theories facilitating firms to add 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 could help to device suitably fitted financial practices in compliance with central philosophy of modern finance theory.

There are three leading areas of corporate financial 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

II INVESTING PRACTICES IN CORPORATE FINANCE

Finance theory prescribes the net present value (NPV) rule which states that a firm should take an investment project when the present value of its expected future cash flows, discounted appropriately for the project's riskiness, exceeds the cost of investment. The NPV is computed by forecasting the project's cash flow and discounting it at a discount rate reflecting the price charged by the capital markets for the cash flow risk. For investors with well diversified portfolios, only the project's systematic risk affects its value: its idiosyncratic risk should not be considered. What capital budgeting tools and techniques are being practiced by the industry? How popular are they? Do firms use methods that help to maximize the value? In practice, the NPV method is used extensively, but it is by no means the only technique used. Alternative methods, such as the Payback method and the use of earnings multiples, are also common. The payback is seen as possibly the most seriously flawed method, since it ignores the time value of money and cash flows beyond an arbitrary cut-off date. Brigham (1975) surveyed 33 large firms and found that 94% use NPV, IRR or profitability index criterion in their capital budgeting decisions.

III DISTRIBUTION PRACTICES IN CORPORATE FINANCE

To start with, Miller and Modigliani (1961) viewed dividends as irrelevant, and believed that in a world without market imperfections like taxes, transaction costs or asymmetric information; dividend policy should have no effect on its market value. However, since the capital market is neither perfect nor complete the dividend irrelevance proposition needs to be re-visited, especially focusing the effects of information content of dividends, agency cost and institutional constraints. The market imperfection of asymmetric information is the basis for three distinct efforts to explain corporate dividend policy. The mitigation of the information asymmetries between managers and owners via unexpected changes in dividend policy is the cornerstone of dividend signaling models. Agency cost theory uses dividend policy to better align the interests of shareholders and corporate managers. The free cash flow hypothesis is an ad hoc combination of the signaling and agency costs paradigms; the payment of dividends can decrease the level of funds available for perquisite consumption by corporate managers.

Krishnamurty and Sastry (1971), Mahapatra and Sahu (1993), Bhat and Pandey (1994), Narasimhan and Asha (1997) and Narasimhan and Vijayalakshmi (2002) are the good examples of empirical research carried out in India in the field of dividend decisions. However, dividend payment pattern of firms is still not clear and also, why do they initiate and omit dividend payments or reduce or increase dividend payments. Mohanty (1999) survey of the dividend payout ratio of the 2535 Indian companies indicate that firms maintain a constant dividends per share and have fluctuating payout ratio depending on their profits.

There exist, however, a fundamental difference between commercial banks and non-financial industries. And the difference lies in the regulatory environment. Approximately three decades ago Stephen A. Buser, Andrew H. Chen and Edward J. Kane (1981) held that banks have traditionally been conceived as more than just another business firm; they operate under unusual regulatory restrictions including entry limitations, interest rate ceilings, reserve requirements and government guarantees on their deposit liabilities. The situation has not changed much since then. Only that the earlier systems of regulated deposit rates etc. have now been replaced by regulatory capital requirement (Matten, 2001). The regulatory zeal has traversed the national boundaries. Banking is now the only industry, which has been subjected to international capital regulation through Basel Capital Accords. The meaning of all such Accords is simply that someone else other than the market tells the bank promoter that he must bring in so much equity to the firm calculated by a certain prescribed methodology. It is often forgotten that the market laws are almost akin to natural laws. Any attempt to impinge on such laws will drive the market to seek alternative ways to reach equilibrium.

IV FINANCING PRACTICES IN CORPORATE FINANCE

The Capital Asset Pricing Model (CAPM) of Sharpe (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 rates in capital budgeting. Asset pricing models with even greater generality are based on CAPM's key arguments of optimal portfolio demands and market equilibration, 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 dividend 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 decisions in a different environment. Hence, the need to test the CAPM in the Indian context is justified. PricewaterhouseCoopers (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 Corporates 75% of the equity analysts regard 20% to be the cost of equity for Indian companies. The WACC of 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.

V OBJECTIVES AND METHODOLOGY

5.1 Research Objectives

The objective of this study is to perform an analytical analysis of corporate finance practices of Indian Banking and Information Technology Industries. To be precise, the study aims to acquire information regarding capital budgeting, capital structure, cost of capital, capitalization, dividend decisions and working capital of these two vital industries. The Indian Inc, in particular Banking and Information Technology Industries, has undergone radical change in the modern time. Now, they talk about international financial norms, corporate governance and shareholders' value. Shareholders' value is created by implementing corporate finance practices that best suit the industry in a given environment. It is very important to identify the factors that form basis of important corporate finance decisions.

VI SCOPE AND LIMITATIONS OF THE STUDY

Current study focuses on Indian Service Sector, namely, Indian Banking and Information Technology industries, listed on National Stock Exchange and finally selected in terms of market capitalization. The study has been conducted by taking into account data for last ten years, i.e. 1999-2008.

However, there are some limitations of the study, which are generally inherent in all such studies conducted at human being level. The present study is mainly confined to two industries for a period of ten years only. The computation of different variables is subject to a number of convinced postulations. Besides time and many other constraints, there have been some understandable handicaps like availability of data or information, responses generated through questionnaire, and statistical techniques put into application in the study. Another limitation of the study is that it is based on a sample drawn from NSE and may not stand for the cosmos in its unqualified stipulations. But all these limitations and constraints, perhaps, may not, in any way, affect the worth of this research work.

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