LEADING PRACTICES WORLD-WIDE REGARDING CORPORATE FINANCE

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ABSTRACT

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 affair s 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.

I INTRODUCTION

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

One of the most imperative objectives of finance theory is guiding firms on how to make investment decisions. The search for a reliable method of long term project appraisal method dates back to decades. The issue not only continues to be a matter of concern for academics or managers, but is also becoming more and more important to investors and shareholders. 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. They are not using multiple hurdle rates and 61% use hurdle rate based on weighted average cost of capital (WACC). 39% of the respondents revise hurdle rates less than once a year and they do not have a system for its review. Pandey (1989) studied 14 Indian companies in 1984 and found that payback period method is most widely used followed by IRR as a capital budgeting technique. In Indian corporate, there is a lack of familiarity with the discounted cash flow methodology amongst the corporate executives. The project risk is assessed through sensitivity analysis and conservative forecasts. Surprisingly, Graham and Harvey (2001) report that 57% of the CFOs in their survey of US firms always or almost always use the Payback method in capital budgeting decisions, as compared to the 76% using the NPV method. They find the Payback method to be the most frequently used method among firms in the UK, Germany, and France, and it is also very common in the Netherlands, where it is the second most popular method after the NPV. A number of tools are available to determine the extent of profitability of a project (Akalu, 2001).

However, some of these methods are unable to accommodate the current changes in business environment, especially, where increasingly shareholder value is of importance. In addition, their continuous application reveals significant limitations in their capacity to address the basic problems of investment appraisal and some of these methods require complex decision processes. Thus, the choice of appropriate appraisal method is becoming a difficult task for project managers, which requires critical analysis of various tools.

III FINANCING PRACTICES IN CORPORATE FINANCE

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 for capital budgeting. Investors require the same for equity valuation; regulators need to understand the impact of new accounting standards on the cost of raising funds from the market. Since investors have access to a host 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 incorporates a probable rate of default. For companies with similar risk or credit ratings, the interest rate is largely exogenous. 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.

IV RESEARCH DESIGN

A research design is a definite plan for obtaining a sample from a given population. Research design means a sketch or a drawing of a research project's structure. It comprises of a series of prior pronouncements that, taken together, provide a roadmap for carrying out a research project. The research design of the present study is outlined hereunder:

4.1 Nature And Sources Of Data: For the purpose of this study, both primary as well as from websites like www.indiainfoline.com, www.nseindia.com and www.finmin.nic.in; database like CMIE-Database

PROWESS and research Journals like Finance India, Management Accountant, Decision, Business Review and have also been referred to obtain the relevant and authentic information. The validity of data has been confirmed through cross verification process.

4.2 Selection Of Sample: For the underlying principle of this research work, the Information Technology industry sample is comprises of top 40 companies of the industry, in terms of market capitalization, which are listed on National Stock Exchange. In Banking Industry, 37 companies, which are listed on National Stock Exchange constitute sample for the purpose of analysis.

4.3 Data Editing: For this study, the major part of data comes from secondary sources. The data has been collected in raw form from „PROWESS and then it was made suitable for analysis as per the methodology defined for the purpose.

4.4 Time Frame: The study is based on the data available for the period 1998-99 to 2007-08.

4.5 The Models: The task of statistical models is imperative in analyzing the data and drawing inference there from. In order to derive the open handed results from the information collected through secondary data and duly filled up questionnaires, various statistical tools like Panel Data Analysis, Granger Causality Test, correlation and multiple regression, tests of hypotheses have been accomplished through EXCEL, E-View software, and SPSS software. Furthermore, financial models like CAPM and Lintner s Model have been applied to the data.

V CONCLUSION

Over the last century academics from around the globe have worked on postulating models and theories enabling firms to enhance the efficiency of their corporate finance operations. The Modern Theory of corporate finance began with the renowned papers of Modigliani and Miller (1958, 1963), Sharpe (1964), Lintner (1965) and Black (1972). Nobel prize winning concepts like the capital asset pricing model and capital structure theories have been praised and taught in class rooms but to what extent and in what way these models are exercised by professionals and managers. In this study, an attempt has been made to bring out the practices of Indian Banking and Information Technology industries and to narrow the gap between scholars and professionals by conducting a survey as well as the secondary data based analysis on how professionals deal with different dilemmas within modern corporate finance. More precisely, objectives of the study are to identify the techniques used by sample units to evaluate their projects particularly for long-term and short-term duration; to evaluate and analyze practices with regard to capitalization, capital structure and cost of capital of sample units; to ascertain the determinants financing practices with regard to distribution and retaining of earning; and to suggest and recommend some workable suggestion for the better financial management of these select industries. For the underlying principle of this research work, the Information Technology industry sample is based on top 40 companies, in terms of market capitalization, which are listed on National Stock Exchange. In Banking Industry, 37 companies, which are listed on National Stock Exchange constitute sample for the purpose of analysis. In order to derive the open handed results from the information collected through secondary data and duly filled up questionnaires, various

statistical tools like Panel Data Analysis, Granger Causality Test, correlation and multiple regression, tests of hypotheses have been accomplished through EXCEL, E-View software, and SPSS software. Furthermore, financial models like CAPM and Lintner s Model have been applied to the data.

This paper presents insights and concluding remarks on corporate finance practices of the selected industries by taking a closer look at the analysis of theoretical framework and empirical study.

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