RESEARCH

Study of established financial management tools and techniques and their application by business houses (with reference to Mumbai based Companies" period-2002-2012)

S.S.Jape* and Tejal Korde**

ABSTRACT

This research is an attempt to ascertain the corporate financial practices followed in India Inc and analyze whether various financial tools and techniques available in texts and taught in business schools are actually used in practise. It further endeavours to find the impact of different firm's characteristics or variables on the selection of a particular financial management tool or technique.

It is not too uncommon to note practice differs from theory and vice a versa. As theory is constructed based on a framework of 'ideal conditions' and application in real - not so ideal - conditions is definitely a challenge. However unreal the theoretical conditions look, they are necessary to understand things better and deeper. The theories are finally outcome of practises. Executives make modifications in models and theorists absorb those modifications in coming out with newer -may be more practical - models. There were complaints by executives and there were corrections by theorists. New theories / models/ concepts kept coming in. The proposed research is an attempt to find first whether there is any gap and if yes then it will try to assess the gap.

KEY WORDS: Capital Budgeting, Capital Structure, Cost of Capital, Corporate Finance.

NEED FOR RESEARCH

The last detailed study conducted on corporate financial practises by "Dr. Manoj Anand published in vikalpa is also decade now". Further in post liberalisation period many changes have taken place so it is necessary to understand state of the art corporate financial practises that are abreast with what happening in the industry. The main problem is the issue of obsolete know how in textbooks and syllabi of various universities, business schools and Management Institutions in areas of finance. Given this problem, such a study will be an effort, small though to understand the conformities or gaps between the theory and practise. This will further help to

a) Enrich the text books

b) Eliminate outdated practises

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c) To place theory and practise side by side and understand mutual relationship and reinforcement as well as mutual inclusiveness and exclusiveness

There is perception that the theory is not followed while making major decisions hence to understand the real scenario and practises followed in corporate, such a research is necessary.

OBJECTIVES

a) To identify corporate financial management practices in India with focus on four areas viz Capital budgeting, capital structure, cost of capital, Dividend Policy

b) To examine the practices of corporate finance used by practitioners vis-a-vis theory and finance tools taught in business schools and professional Institutes

c) To assess the level of perceived awareness about tools and techniques of financial management

d) To examine the pattern of managerial use of the financial management tools and techniques by India Inc

e) To evaluate the impact of financial management practices on the financial decision making by India Inc

f) To suggest the practises, methods required to be modified and improved for better implementation in decision making of corporate finance

THEORETICAL ASPECT OF THE STUDY: THE FINANCE FUNCTION IN RETROSPECT

A redeeming feature of the twenty first century corporate scene is the emergence of Financial Management, as a distinct discipline at the level of, the individual enterprise. In the past financial management of business was considered as a part of the wider discipline of economics. As a result it was difficult to identify an independent function of and scope for finance in business. The functions of finance, and therefore the study, were more or less related and restricted to the individuals and institutions contributing 'money' or 'funds' or' finance' to the business. Thus, the focal point was the financial instruments and institutions which provided the required financial resources and the scope of the finance function was restricted to the procurement and deployment of funds. In this situation financial management was defined as "managing money or cash transactions of a business" or as "raising and administering funds used in the enterprise".* 1

The external environment like financial markets (money markets and capital markets), financial institutions and agencies and financial instruments dominated the finance function as well as the study of finance.

Lyton presented an almost uniform thought. As Archer and D' Ambrosio would put it "All of them typically use what may be referred to today as the "traditional approach to the study of business finance emphasizing as they do major episodic financial events2 in the life cycle of a firm and institutional factors that bear on them". And, the

purpose of corporation finance was to "describe and to document the rapidly evolving complex of capital market, institutions, instruments and practices"3x. But the traditional school of finance, referred to above, was Criticised, even in those days for the undue emphasis placed on the investment banker and the concomitant conspicuous attention given in text books to the 'outsiders looking at the inside'. It was also criticised for leaning in favour of long term financing decisions and the consequent neglect of Working Capital management. Further, the episodically approach to finance and the concentration of the studies of finance in favour of corporate forms of organisation to the exclusion of other sectors of the economy also came under heavy attack.

1 Ezra Solomon, The Theory of Financial Management, Page 2.

2 Promotion, incorporation, merger, consolidation, recapitalisation and reorganisation,

3 S.H. Archer and C.A.D. and Ambrosio, Business Finance: Theory and Management

An approach to corporate finance was rather narrow to effectively sub serve or meet either the then existing or emerging needs of society at large. It had to give way to an altered recipe of financial management which eventually came to be called as the 'Managerial Approach'. World War I brought in its wake a new cultural pattern which gave prominence to the corporate form of economic organization. Corporate securities were slowly becoming a popular mode of investments. The corporation became an useful avenue for the investor and an effective base for resource mobilisation for the resource mobilisation for the entrepreneur. And out of this emerged a mutually understood financial objective, between the corporate management on the one hand and corporate shareholders on the other, viz. "maximization of the economic welfare of the shareholders (owners or capital contributors)". Thus, an important function' in fact the cardinal function of finance is to protect and promote the investors (shareholders/ owners) stake in business. With the emergence of this accepted objective of financial management' the scope of the finance function within an individual enterprise was enlarged.

The corporate management were vested, as custodians of the assets of the enterprise, with the task of effectively communicating their terms of reference vis-a-vis the shareholders. Stated in a general way the corporate management had to promote the greatest good of the share-holders by producing the best possible results with the resources entrusted to them, or the highest possible output for any given input. So, for the first time, in a limited way though, financial management was to be viewed from "the insider looking out" rather than viza viz a traditional approach.

Active involvement of the finance manager in the functional areas of management was almost unheard of. But however it was only after World War II, as late as 1949, those internal financial problems of enterprise started dominating the study of finance. This new version of managerial finance gathered momentum and acquired its full stature as a sequel to the Keynesian General

Theory of Employment. Keynes said that the effective demand for investments depends upon the expected rate of return on incremental investment and the cost of incremental capital. This macro-analysis was systematically conceptualised into a feasible micro-level or enterprise level analysis.

EARLIER RECIPES OF FINANCIAL MANAGEMENT

One common approach was first to keep aside a given amount of capital on the basis of broad financial policy and then to allocate the said amount among alternative, competing, end uses of funds (investment proposal)" To quote Ezra Solomon "A revered recipe for setting the cut-off point for the amount of expenditures is the New England Theory of business expansion which limits the amount of capital expansion in any period to the volume of profits being earned in that period. An alternative approach for determining the volume of expenditures is to spend enough to maintain a company's relative position in a growing economy. Many companies have prospered using these recipes but it is hard to believe that they would not have done even better without them." Ezra Solomon pg 33.

Yet another theory Known as Bankers Theory states that "Expansion by borrowing should occur when as and if the rate of earnings on the added capital is in excess of rate paid by corporation for that capital"*

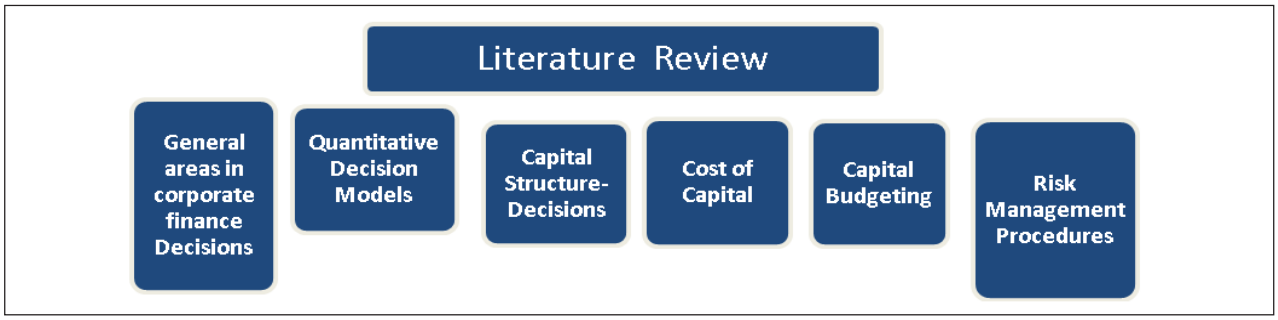
*(Floyed F.Burichett, Corporation Finace (New York Harper bros 1934) p 730)

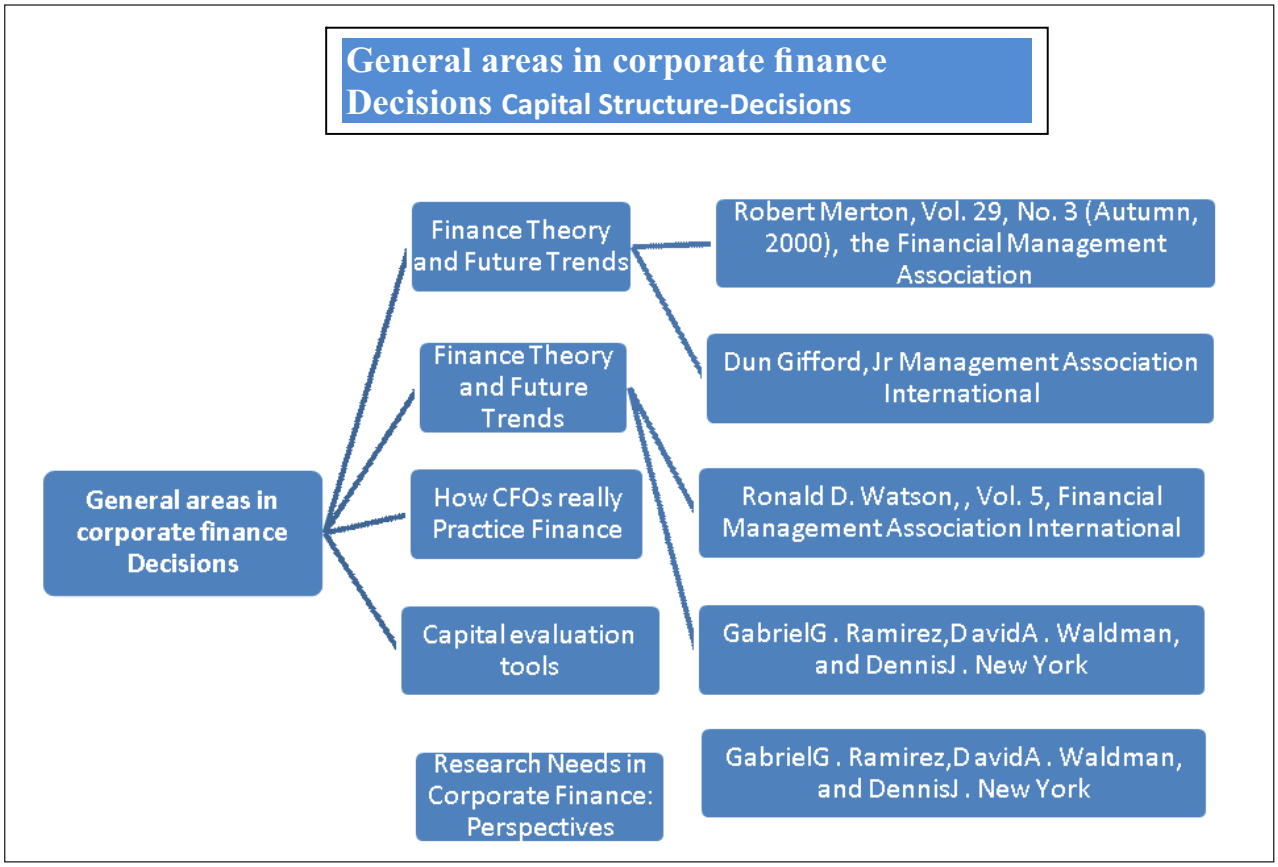
EZRA SOLOMON AND AFTER

Post world war two it was Ezra Solomon who brought the micro economics version of John Maynard Keynes to the micro level. As he puts it "How should the scope of financial management be defined for the purposes of academic study? There is no clear cut answer to this question but rather a whole range of possible approaches. Thus the classical treatment given to finance, as mentioned earlier was the version of investment banker rather than from the point of view of financial decision making at the level of the firm .The second criticism of traditional school was that it placed most of its emphasis on corporate finance rather than addressing other forms of organisation too. The third criticism was that the sequence of treatment of events was related to episodes occurring sporadic though over the life cycle of the business. There was an overemphasis on events like promotion incorporation. Mergers and acquisitions, consolidation, restructuring, recapitalisation and reorganisation. The last criticism was that the traditional school played too much importance on long term financial decisions and ignored the day to day operations of the business namely working capital. These criticisms had to be addressed in the new emerging discipline of financial management. The seeds for the same which were sown by Ezra Solomon through his book the "Theory of Financial Management "who discovered and redefined decision making with respect to procurement and deployment of finance. The key questions raised here 1) What specific assets should an enterprise acquire2) what total volume of funds an enterprise should commit? 3) How should the funds required be financed? Again he puts the same questions in an alternate fat ion as follows

1) How large should an enterprise be? And how fast should it grow? 2) In what form should it hold assets 3) What should be the composition of its liabilities?

Arthur.S.Dewing A typical work of the traditional phase is The Financial Policy of corporations by Arthur S.Dewing .This book discusses at length the types of securities, procedures, used in issuing these securities bancruptcy, reorganisations, mergers, consolidations, and combinations. The treatment of these topics is essentially descriptive, institutional and legalistic. However the focus shifted slowly but surely from tracking and tracing episodes to micro level financial issues of enterprise viz. Thus day to day problems faced by financial mangers in areas of funds analysis, Planning and control.

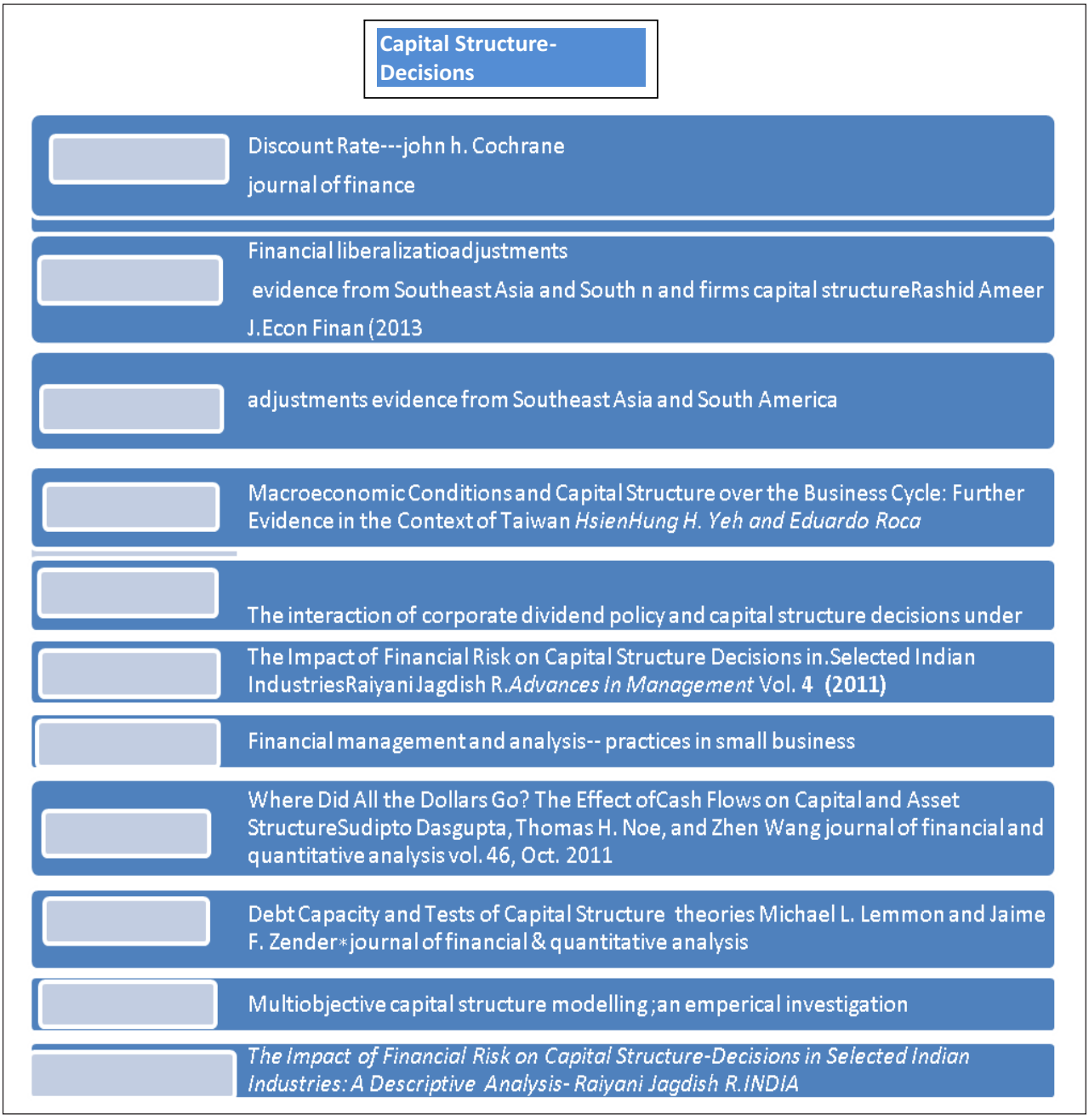


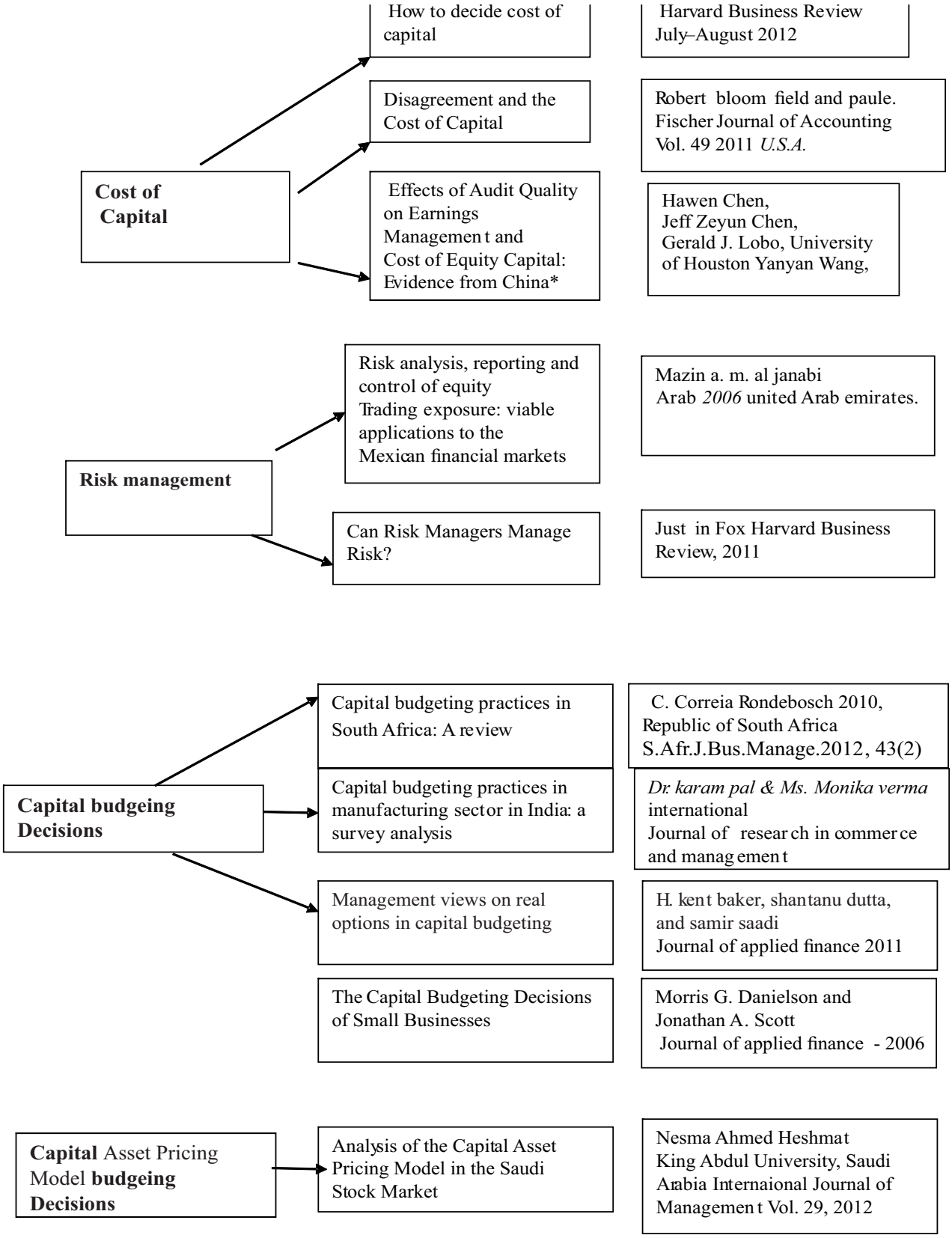


The focus shifted to working capital management (Wilford J. Eiteman, Essays on business finance Ann Arbor, MIchgan, Masterco Press Inc.

Source: Arthur.S.Dewing, The financial Policy of Corporations, NewYork, Ronalds, 1918

Keeping in mind in the foregoing paragraphs which explain the rediscovery of Financial Management through Ezra Solomon's views, a review of literature, for the purpose of this study, is based on a carefully selected list of papers which include the following:




How to decide cost of capital
Harvard Business Review July–August 2012
Disagreement and the Cost of Capital
Robert bloom field and paule. Fischer Journal of Accounting Vol. 49 2011 U.S.A.
Cost of Capital
Effects of Audit Quality on Earnings Management and Cost of Equity Capital: Evidence from China*
Hawen Chen, Jeff Zeyun Chen, Gerald J. Lobo, University of Houston Yanyan Wang,
Risk analysis, reporting and control of equity Trading exposure: viable applications to the Mexican financial markets
Mazin a. m. al janabi Arab 2006 united Arab emirates.
Risk management
Can Risk Managers Manage Risk?
Just in Fox Harvard Business Review, 2011
Capital budgeting practices in South Africa: A review
C. Correia Rondebosch 2010, Republic of South Africa S.Afr.J.Bus.Manage.2012, 43(2)
Capital budgeting Decisions
Capital budgeting practices in manufacturing sector in India: a survey analysis
Dr. karam pal & Ms. Monika verma international Journal of research in commerce and management
Management views on real options in capital budgeting
H. kent baker, shantanu dutta, and samir saadi Journal of applied finance 2011
The Capital Budgeting Decisions of Small Businesses
Morris G. Danielson and Jonathan A. Scott Journal of applied finance - 2006
Capital Asset Pricing Model budgeing Decisions
Analysis of the Capital Asset Pricing Model in the Saudi Stock Market
Nesma Ahmed Heshmat King Abdul University, Saudi Arabia Internaional Journal of Management Vol. 29, 2012

It may be noted that choice of articles and papers are based on the basic axioms of financial

Management as rediscovered and restated by Ezra Solomon. Hence the areas explored include the financial objectives of a business, the sources and uses of funds(Capital Structure and Cap Budgeting) and other related areas like cost of capital, Impact of cash flow on the enterprise, and the immerging issues of modern finance in recent times (An article on theory of finance and future trends)

In the same vein the questionnaire to be used to elicit the responses from respondent companies addresses the following areas Objectives of financial decision making, Project appraisal, Cost of Capital, Risk Assessment, Dividend Decision, capital structure, Risk Assessment, Sources of Finance and Taxation

LITERATURE REVIEW (LR)-I Research papers

1) The Impact of Financial Risk on Capital Structure-Decisions in Selected Indian Industries: A Descriptive Analysis- Raiyani Jagdish R.INDIA- Volume 4 Advances in management, 2011

This paper addresses an important issue of the relationship between capital structure and financial risk of the company. This paper highlighted the impact of financial risk on capital structure decisions in Indian industries. The paper demonstrates that finance risk variables, particularly risk followed by volatility in ROE have significant effect on determining the additional variation in use of debt financing in business through long-term sources among firms. The paper also highlights, what Ezra Solomon had said in his book ,Theory of Financial Management, the following issues 1)the optimal mix of different sources of finance leading to optimal capital structure 2) the principal contents of the financial management can be i) How large should enterprises be and how fast should it grow? ii) In what form should it hold assets? And iii) What should be the composition of its liabilities? These three questions deal with the major financial problems of the firm. The paper also mentions As the author says "Of these three decisions, the most important decision to be made by the financial manager is decisions on financing". Further The central issue before the finance manager is to determine the proportion of equity and debt with the effects of financial and operating risk factors." In effect the combination of creditor ship and ownership capital produces the capital structure of the firm and through heuristic or mathematics result in optimal capital structure... The conclusions of this paper are interesting and reads as follows "With regard to financial risk -that is the risk arising out of degree of financial leverage, it is well understood that proportion of debt fund provided by the long term debt as well as by short-term debt is significantly related to the level of financial risk of the firms under Cement, Food, Pharmaceutical, Information technology, Steel and Textile sectors."

LITERATURE REVIEW (LR)-2

"The Theory and Practice of Corporate Finance: Evidence From the Field" How CFOs really Practice Finance Ronald D. Watson, Vol. 5, Financial Management Association International

This paper tries to focus more about the daily practices of CEOs, John Graham and Campbell Harvey of Duke University's Euqua School of Business compiled responses from 392 CFOs in a working paper titled "The Theory and Practice of Corporate Finance: Evidence From the Field" Their research focused on capital budgeting, cost of capital and capital structure.

Graham and Harvey found that the financial theories and tools of academia are slowly being adopted into financial theory, starting with the Nobel Prize-winning Franco Modigliani and Merton Miller papers in the 1950s, which asserts that companies choose their capital structure on the basis of a trade-off between the benefits of debt (the tax deductibility of interest payments) and the drawbacks of debt (higher interest payments). However, the surveyed CFOs considers "maintaining financial flexibility" - as the most important factor that is, keeping debt levels low in order to be ready for unforeseen opportunities. The tax benefits of debt and worry about financial flexibility for determining capital structure - were ranked fourth and fifth."Capital structure is the area where people use 'rules of thumb' the most. But, the responses did not strictly follow what is expected from the theory," says Graham. So the theory gives importance to the trade-off while making capital budgeting decisions where as results of the survey showed that CFOs considers "maintaining financial flexibility as most important.

As per the poll CFOs may be making decisions that are consistent with the theory of optimal structure, as their concern about their credit ratings indicates, even though they do not attribute those actions to the theory'.

Some of the country's leading companies have very little debt - Microsoft, Wal-Mart and Intel, for example - and they could probably take on more, increase their tax shield and still have an AA credit rating "Graham explains further that the study's results may have implications for shareholder value creation over the long term: For any company there is need to maintain proper balance between debt and equity. If CFOs Give emphasis on distribution of dividend by maintaining divisible profit ,then they forego the choice of maintaining more funds for development that is less attention towards capital budgeting So for any CFOs its difficult to decide optimal composition of capital structure with debt as well as equity. As imbalance of this can affect shareholders in the long run ,and can give benefits in the short run.

"The researchers also asked CFOs about the decision to issue common stock. The most relevant factor was earnings per share (EPS) dilution. "We don't have an academic theory that justifies EPS dilution as the leading concern of CFOs," Graham says. "If you dilute your earnings in the short term to invest in a valuable project that takes a number of years to pay off, you might think that shareholders would reward the company." Either management doesn't do a good job explaining why EPS decreases in the short term, or "the stock market knows something about why EPS matters that academics haven't yet figured out" CFOs do seem to flex their intellectual muscles when choosing financial measures for capital budgeting. The majority use internal rate of return (IRR) and net present value (NPV). However, the use of "payback period," which Graham and Harvey regard as a relatively

unsophisticated measure of corporate value compared to IRR and NPV, ranked third. When it comes to the actual implementation of IRR and NPV, CFOs tend not to spend much time adjusting the measures for risk, despite recent academic interest in the subject.

More than half of the CFOs do not adjust either cash flows or their discount rate for the risks presented by interest rates, foreign exchange, the business cycle, commodities or inflation. Despite these and other results, Graham remains optimistic about the future of financial decision making. "Many academic theories are relatively pervasive in practice," concludes Graham."For example the vast majority of companies do use the capital asset pricing model (CAPM), which they didn't do 20 years ago. On this and other matters, we are starting to see that business-school tools are actually starting to take hold in the field."From the study it can be observed that on certain matters CFOS are following the practises as expected according to theory including use of measures for capital budgeting such as IRR and NPV. When it comes to EPS Dilution or maintaining debt levels low in order to be ready for unforeseen opportunities theory gives less importance to these factors which are found very much important as per survey of CFOs.

LITERATURE REVIEW (LR) 3

Capital budgeting practices in South Africa: A review C. Correia, University of Cape Town, Republic of South Africa S.Afr.Journal. Business .Management.2012, 43(2)

This paper highlights the capital budgeting practises over the period 1972-2008 an addresses an important dimension of capital investment decisions viz economic valuation. In fact CID has important steps which include economic evaluation, capital expenditure control and post audit .The focus of this paper is on capital investment decisions viz economic evaluation. The key findings of the surrey were as follows 1) Increasing no of companies in S.A use time adjusted method also known as discounted cash flow methods 2) NPV and IRR are being deployed for measuring the economic worthiness Of Investment proposals. Assessment of risk is finding an important place in economic evaluation process. Sensitivity analysis and key tools Monte karlo and decision tree approach has not attracted the fancy of the corporate in south Africa .Adjusting for inflation and arriving at inflation adjusted cash flow has found an increasing currency. Modifying IRR has limited role in the economic process Greater focus is given to financial analysis and projections rather than project definition and cash flow adjustment. As the author says **"Companies have increasingly used inflation-adjusted cash flows but the process of ranking mutually exclusive projects is not aligned with finance theory. There is limited use of the Modified Internal Rate of Return (MIRR) method and DCF dominant companies do not outperform non-DCF dominant companies."**

The paper highlights on such aspects as capital budgeting methods, risk analysis, discount rates and specific issues such as the performance of post audits, the evaluation of the relative performance of DCF dominant firms, the treatment of mutually exclusive investments. The survey is an useful contribution to the state of the art practises in capital decision making practises.

LITERATURE REVIEW (LR)-4

Debt capacity and tests of capital structure theories by Michael L. Lemmon and Jaime F. Zender in Journal of financial and quantitative analysis vol. 45, 2010, University of Washington,

We examine the impact of explicitly incorporating a measure of debt capacity in recent tests of competing theories of capital structure. Our main results are that if external funds are required, in the absence of debt capacity concerns, debt appears to be preferred to equity. Concerns over debt capacity largely explain the use of new external equity financing by publicly traded firms. Finally, we present evidence that reconciles the frequent equity issues by small, high-growth firms with the pecking order. After accounting for debt capacity, the pecking order theory appears to give a good description of financing behavior for a large Sample of firms examined over an extended time period.

LITERATURE REVIEW (LR)-5

Equity Mispricing and Leverage Adjustment Costs by Richard S. Warr, William B. Elliott, Johanna Ko¨eter-Kant, Journal of Financial and Quantitative analysis Vol. 47, 2012,.University of Washington

Equity mispricing impacts the **speed at which firms adjust to their target leverage (TL)** and does so in predictable ways depending on whether the firm is over or under levered. For example, firms that are above their TL and should therefore issue equity (or retire debt) adjust more rapidly toward their target when their equity is overvalued.

However, when a firm is undervalued but needs to reduce leverage, the speed of adjustment is much slower. The findings support the role of equity mispricing as an important factor that alters the cost of making capital structure adjustments.

The trade-off theory of capital structure states that a firm selects an **optimal target leverage (TL)** ratio that trades off the relative costs and benefits of debt. Empirically, however, it is well documented that firms deviate from their TL ratios and do not rapidly adjust back to their target if they face costs to do so. Over 25 years ago Myers (1984) noted in his Presidential Address to the American Finance Association (AFA): If adjustment costs are large, so that some firms take extended excursions away from their targets, then we ought to give less attention to refining our static trade-off stories and relatively more to understanding what the adjustment costs are, why they are so important, and how rational managers would respond to them.. If equity is overvalued in the market, the firm's cost of issuing equity is reduced, whereas undervalued equity results in a higher cost of equity. If the cost of issuing equity is altered in this fashion, and if the firm exploits or faces these costs, then the rate at which the firm adjusts toward a target debt ratio will depend on the degree of equity mispricing.

LITERATURE REVIEW (LR)-6

CORPORATE FINANICAL DECISIONS AN EMPIRICAL STUDY, Investment and Financing in the Corporate Sector in India by K. Krishna Murthy and D. U. Sastry; Published by Tata McGraw-Hall Publishing Co. Ltd. New Delhi; pp160.

A study conducted by K. Krishnamurthy and D. U. Shastri had brought out certain interesting inter-relationships between the triad decisions of investment, financing and dividends. The key findings of the study were as follows: Profit is the key determinant of deployment of funds in favour of consumption (dividends) / saving (reinvestments). In fact dividends get a first claim and hence internal generation available for re-investment is residual in character. Dividend decisions are autonomous of investment decisions and the availability of external financing.

Given stable dividend policies there is an upper limit on internal funds and an implied ceiling on external finance, particularly debt, because of the constraints posit by debt-equity ratio. Funds available for capital formation are influenced, in the main, by profits. Fiscal policies aimed at encouraging investment, unsupported by incentives for profit motivation, are rendered sterile. Fixed asset investment is conditioned primarily by internal sources and secondarily by borrowings. Inventory investment is influenced by borrowings and since interest is tax deductible the speculative motive is dominant. This has also been empirically proved by studies conducted by late Professor Dr. PR Brahmananda*. According to Professor Dr. PR Brahmananda, "We must deem the influence of the speculative motive as ubiquitous in the Indian economy … from1950-51 and 1971-72 the rate of gross profit in speculation would have been of the order of 13 per cent."The Krishnamurthy-Shastri study concluded that the triad decisions investment, dividends and external finance are not inter-dependent. However, taking two of the three parameters at a time viz. 'investment decisions and external financing', they found, are inter-dependent in many industries. Ratios per se may facilitate understanding the health of an enterprise from particular view pointviz. liquidity, profitability, valuation, capital structure or any other facet. However, the domain knowledge of corporate finance and the inter-relationships between key parameters affecting the triad decisions, referred to above, need to be kept in mind to facilitate quality, informed decision making. Of course, there will also be some exceptions to the rule.

SOURCE: Investment and Financing in the Corporate Sector in India by K. Krishna Murthy and D. U.Sastry; Published by Tata McGraw-Hall Publishing Co. Ltd. New Delhi; pp160

*See Dr. Guruprasad Murthy, Book Reviews 'Inflation in India' S L N Simha (ed) Bombay, Vora and Co Publishers Pvt. Ltd. - Prajnan - Volume IV, No. 3 - The Quarterly Journal of the National Institute of Bank Management, Bombay, July-September, 1975.

LITERATURE REVIEW (LR)-7

Capital Structure - Private Corporate Enterprises Research Study

A study on the capital structure policies of the private corporate sector in India presents some very interesting results viz.

(1) For the period under study and also for the periods of study by other authors viz. Brajkishor (1951-74), Raut and Swain (1992-97) Jain and other (1995-98) and Suresh Babu and P. K. Jain (1980-94) have all reported the preference for short term debt in lieu of long term financing.

(2) For the period of the study (1980-94), there is a shift towards preference for long term debt in lieu of short term debt.

(3) Historically the private corporate enterprise had aggressive debt equity ratio and therefore relatively poor debt service coverage ratio. This is indicative of the high risk profile of the private corporate enterprises ranging from liquidity shortages to extreme cases of bankruptcy.

(4) Managing a capital structure requires the retention of some unused debt capacity to accommodate the future mobilisation of capital. The private corporate enterprise does not have scope for further mobilisation of debt capital in view of the aggressive debt equity ratio. Hence, private corporate enterprises are likely to face problems with resource mobilisation.

(5) The above findings of different studies need to be kept in mind in understanding various dimensions of capital structure management.

SOURCE: *The Management Accountant, February, 1999 pp. 107-113*

The literature review capture at least 17 well researched papers, articles, book reviews along with important text from the year 1950 onwards. But out of these this review paper covers 8 papers selected based on the topics capital budgeting and capital structures. The research papers explored as part of literature review, along with the text shown is on Annexture1 lay the foundation for research study. Thus the topics explored are presented below. An attempt is being made to capture the gaps and tries to explore the areas required to be focussed on the further research. The research tries to attempt to cover and emphasis these areas and tries to address the problems studied through the literature review.

LR 1-Financial Risk

LR2-The theory and Practise of Finance

LR 3- Research needs in corporate finance

LR4-Capital Structure

LR 5- Cost of capital

LR6-Sensitivity of cash flow

LR7- Capital Structure

LR8-Capital Budgeting

LR 9- Cash Flow

LR 10-Capital Structure

LR 11-Leverage	LR-12-Dividend Policy
LR-13- Capital Budgeting	LR-14- Cost of debt
LR 15- corporate financial decisions	LR16- Capital Structure

LR17-Multiobjective model

Thus it can be observed that the focus is on the state of the art theories of finance, corporate finance practises, Capital Structure, cost of capital ,dividend policy ,impact of cash flows, quantitative tools in Financial management, integrated view of the triad financial decisions viz investment finance, dividend and last but not the

least a few miscellaneous issues like gaps between theory and practise and ways and means of redressing the same.

The gaps which are explored through the literature review covers some of the following areas and papers as follows:

Lintners Path Breaking Analysis of Dividend Policy describes the current practice of corporate financial management. The results of that study are still quoted today and have deeply affected the way that dividend policy research is conducted. The theory and practice of corporate finance: Evidence from the field. Perhaps the best-known field study in this area is John Lintner's (1956) pathbreaking

Analysis of dividend policy. Many papers have been published on dividend policies. **But there is need that academicians will use results to develop new theories or potentially modify or abandon existing views. Practitioners can learn from the analysis by noting how companies operate by identifying areas where academic recommendations have not been fully implemented.**

The paper on "The Theory and Practice of Corporate Finance: Evidence From the Field" How CFOs really Practice Finance Ronald D. Watson, Vol. 5, Financial Management Association International focused on capital budgeting, cost of capital and capital structure. The financial theories and tools of academia are slowly being adopted into financial theory, starting with the Nobel Prize-winning Franco Modigliani and Merton Miller papers in the 1950s,which asserts that companies choose their capital structure on the basis of a trade-off between the benefits of debt and the drawbacks of debt However, the surveyed CFOs considers "maintaining financial flexibility" - as the most important factor that is, **keeping debt levels low in order to be ready for unforeseen opportunities**

There is a need to address some important issues in the literature through an examination of the effect of macroeconomic conditions on capital structure in the context of size of industries, Market Capitalisation and turnover with a focus on the Indian based Industries.

JOURNAL OF APPLIED FINANCE - FALL/ WINTER 2006 by Morris G. Danielson and Jonathan A. Scott

Many of the investments that small firms make cannot easily be evaluated using the discounted cash flow techniques recommended by capital budgeting theory. Many investments by small firms are not discretionary (a firm either makes a specific investment or it goes out of business), and future cash flows can be difficult to quantify. For example, if a firm is introducing a new product line, estimates of future cash flows can be imprecise (and market research studies required to obtain better cash flow estimates may not be cost effective).

When future cash flows cannot be easily estimated, discounted cash flow analysis may not provide a reliable estimate of a project's contribution to firm value, and it is not surprising that a firm might resort to gut feel to analyze the investment. For these reasons, small firms face

capital budgeting challenges that differ from those faced by larger firms. **Thus, it is possible that optimal capital budgeting methods for large and small firms may differ. However, a fully integrated capital budgeting theory- identifying the conditions under which discounted cash flow analysis is appropriate- has yet to be developed. The question of how to better tailor the prescriptions of capital budgeting theory for small firms remains unanswered.**

This paper on **Capital budgeting practices in South Africa, A review by C. Correia, University of Cape Town, Republic of South Africa S.Afr.Journal. Business. Management. 2012, 43(2)** highlights the capital budgeting practises over the period 1972-2008 an addresses an important dimension of capital investment decisions viz economic valuation.

The survey evidence indicates a significant growth in Discounted Cash Flow (DCF) methods and a fall in the use of other methods. In particular, there has been growth in the use of Net Present Value (NPV). Yet, the Internal Rate of Return (IRR) technique remains the primary method used in practice despite some serious drawbacks. Larger companies are more likely to use DCF methods. There has been a significant growth in the use of sensitivity analysis and scenario analysis. However, there is little use of sophisticated risk analysis tools such as Monte Carlo simulation, and decision trees.

Although financial theory predicates the use of risk adjusted discount rates, surveys indicate that the majority of companies use a single firm discount rate. Companies have increasingly used inflation-adjusted cash flows but the process of ranking mutually exclusive projects is not aligned with finance theory. There is limited use of the Modified Internal Rate of Return (MIRR) method and DCF dominant companies do not outperform non-DCF dominant Companies. **The most important phase of project evaluation is the project definition and cash flow estimation phase and yet research studies have focused mainly on the financial analysis and project selection phase inflation and the treatment of risk and uncertainty. However, given these limitations, it is still useful to compare results, and to understand the longer term trends in capital budgeting practices and adaptation of firms to developments in theory and economic realities. Further, a survey of current practice is useful in terms of determining the methods in use at particular points in time.**

The theory and practice of capital budgeting

In terms of the theory of capital budgeting, it is generally accepted that firms should employ Discounted Cash Flow (DCF) techniques such as the Internal Rate of Return (IRR) and Net Present value (NPV) to select and rank capital investment projects. These methods have been traditionally termed sophisticated capital budgeting techniques as they consider the time value of money, future cash flows and project risk. In reality, the theoretically correct method is the NPV technique, that is, project selection should be determined by the project which maximises the NPV of the project's future cash flows. The use of the NPV method in relation to the use of the IRR method is based upon the

problems arising from the evaluation of mutually exclusive alternatives, when project sizes differ, when the timing of the project cash flows differ or when the project represents a non-conventional project, that is, a project which has significant positive and negative cash flows over the life of the project. **Future research needs to increasingly explore issues that arise in the *project definition and cash flow estimation* stage. There has been too much focus on the selection stage and too little research has been undertaken on the other stages of the capital budgeting process.**

Despite the limitations of comparing surveys over time, it is clear that there has been significant growth in the use of DCF capital budgeting techniques, a trend which is consistent with financial theory. Practice is moving closer to theory and the gap between theory and practice in relation to the adoption of DCF capital budgeting methods by firms is no longer a major consideration for academic study. In particular, there has been a dramatic increase in the use of NPV over the last thirty years and there has been a fall in the use of Payback and the Accounting rate of return methods. Yet, IRR remains the primary method used in project evaluation despite the fact that finance theory states that there are major disadvantages in the use of IRR as compared to NPV. In relation to project risk analysis, the most popular methods are sensitivity analysis and there has been a significant growth in the use of scenario analysis. There has been very little growth in the use of such methods as Monte Carlo simulation and decision tree analysis over the last 20 years. Although firms undertake risk analysis of projects, most firms do not use risk adjusted discount rates and may use the discount rate for the firm to discount expected future cash flows. Most firms tend to use a combination of capital budgeting methods to evaluate projects. **There is need to address these issues by diagnosing the reasons behind use of Monte Carlo and Simulation technique as not a popular tools and techniques amongst the companies.**

The survey literature indicates that larger firms tend to use DCF methods such as IRR and NPV and small firms make greater use of Payback and ROI (ARR). Most surveys indicate a preference for NPV by larger firms but there is also survey evidence that large companies prefer IRR. In South Africa close to nine out of ten companies undertake post completion audits. However, further **research is required to understand the nature and impact of such post completion audits and the forecasting accuracy in relation to revenues and costs.** In line with finance theory, most South African firms evaluate projects on the basis of after-tax cash flows.

The evidence presented is inconclusive in respect to the relative performance of DCF firms and non-DCF firms, yet DCF dominant firms do not appear to outperform non-DCF firms. Further **research needs to be undertaken to measure the relative performance of companies that have adopted DCF methods as compared to companies which use naive methods to evaluate capital projects. Although a number of capital budgeting practices are increasingly in line with finance theory, there remain unexplained differences between practice and theory relation to such issues as the**

continuing importance of IRR, the low use of advanced methods such as Monte Carlo simulation, MIRR and risk adjusted discount rates. Further, the survey literature has placed too much emphasis on the selection phase of the capital investment and future research should increasingly focus on the identification and control phases of capital investment.

Equity Mispricing and Leverage Adjustment Costs by Richard S. Warr, William B. Elliott, Johanna Ko¨eter-Kant, Journal of Financial and Quantitative analysis Vol. 47, 2012,.University of Washington.

More than 30 years after the term was coined, real options have yet to be adopted by most companies as a tool for strategic decision making. In fact, the use of real options ranks last among nine capital budgeting techniques.

Despite the attention given to real options, especially by academics, and In spite of the fact that real options are now part of many MBA finance textbooks, there is need to understand the reasons that still why many managers do not grasp the concepts underlying the framework for valuing projects embedded with real options, much less the analytical techniques required. DCF techniques took decades to become routine in analyzing capital budgeting., it does indicate that these firms have both a corporate culture that is not averse to using complex mathematical tools and the ability to make assumptions about uncertainties required in real options analysis. Thus, certain industries currently embrace this paradigm.

As Baldwin (1987, p. 61) noted more than two decades ago, "given the increase in variability in both product and financial markets worldwide, companies that recognize option values and build a degree of flexibility into their investments are likely to be at a significant advantage in the future, relative to companies that fail to take account of options in the design and evaluation of capital projects."

The primary purpose of this field research study is to ask practitioners directly about their **perceptions of important, less-addressed problems in corporate finance in order to direct future financial research. The profile embraces those areas in corporate finance where additional research can be expected to contribute to more efficient managerial decision-making.**

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