CHAPTER V

FINDINGS, SUGGESTIONS AND CONCLUSION

PREMABLE

In this chapter an attempt has been made to brief the findings of the study as follows

Major findings
1. There is a negative relationship between market value of a firm and its financial leverage.
2. The relation between market value of the firm and its financial leverage varies between mid capitalization and large capitalization companies.
3. Financial leverage decision of a firm is influenced by the following factors:
   ➢ Market Capitalization
   ➢ Profitability
   ➢ And Ownership
4. Financial leverage decision of a firm is not influenced by the growth.
5. Financial leverage decision of a firm is not influenced by the free cash flows.
6. Contingency coefficient revealed a significant association between type of sector and type of returns.
7. Contingency coefficient revealed a significant association between type of sector and type of margin.
8. Contingency coefficient revealed a significant association between type of sector and public and government ownership.
9. Contingency coefficient revealed a significant association between type of sector and growth.
10. The tax issues have a major influence on the financial leverage decisions because the financial risk will be high with debt component and the
overall cost of capital will be less because interest is a charge against profit and not appropriation.

11. Size of the company affects the financial leverage because small company’s volume will be less and hence capacity to repay interest and principal will be less. There is no synergy effect and hence the benefit cannot be passed on to the shareholders.

12. Good earning capability has a bearing on the financial leverage. If the potential is high, then all the stakeholders would be with the company inclusive of the government too. Companies then can give suggestions to the government to reduce certain tax rates.

13. Good dividend payouts have a bearing on the financial leverage because the company has not defaulted on its payment. The market value of the company will be high as well as the equity base would be high.

14. International/domestic money market variables have a bearing on financial leverage because cross border funding, monetary policy of that, country and political stability would have an impact on financial leverage.

15. Top Guidelines will have a bearing on financial leverage as it is a mirror to all the outsiders. Exhibiting to outsiders about the top guidelines of the company will improve the company image and this would enhance the efficiency and sales and inturn the revenue would go up and the financial leverage would be taken care.

16. Organizations’ flexibility will affect financial leverage because, with 1:1 debt-equity ratio, the investors will be dissatisfied when cheap funds are available in the financial market. This indicates that, whether the organization is flexible enough to go in for it and also to face contingency. The organizations’ survival would be difficult due to flexibility criterion.

17. Social factors/social responsibility accounting has a bearing on financial leverage; this will bring intangible benefits to the companies. Most of the companies spend 10-20 percent of the profits on social responsibility
accounting in the form of charity, donation or adoption. All these factors do have a positive influence on the organization in terms of goodwill, sales would increase as revenue increases, the market capitalization of the companies will also be good and overall the stakeholders would be happy and satisfied and these firms will be able to tap cheaper sources of funds.

5.1 VERIFICATION OF THE HYPOTHESES

H1: There is a negative relationship between return on equity of a firm and its financial leverage.

There is a negative relationship between financial leverage and return on equity of the firm. Hypothesis one is rejected as there is an inverse relationship between the return on equity of the firm and its financial leverage. To study the impact of financial leverage on the return on equity of firm, this study analyzed 200 companies from eight different dominant sectors of Indian capital market, that is, durable, non-durable, and industrial product, service, chemical, infrastructure, metal and others. This study used only secondary data, which are extracted from the Annual Reports from the selected companies’ Balance Sheets and Profit and Loss account for the financial year 2006 to 2011. The study carefully attempted to select a number of factors that are essential to enhance the present status of the financial leverage of firms, as well as to take further movement towards the success. It is found among the sectors, on the whole, that, return on equity is high for non-durable, that is, 8.61, but at the same time it is affected by debt. It is noticed from the table 4.1 that, higher the return on equity lesser is the debt employed and lower the return on equity, higher is the debt employed and the obtained correlation is negative .436 with the significance level of .001. Durable is another sector where it is noticed that, return on equity is 5.12 and the obtained correlation (return on equity with debt) is negative .312 with the significance level of .001. The infrastructure has a return on equity of 4.24
with the correlation of negative .097 (P=.317). This is followed by chemicals sector, which has a return on equity of 4.07 and the correlation of negative .239 with .008 significance level. The industrial production sector has a return on equity of 3.81, with the correlation coefficient of .152 (P=.085). The service sector has a return on equity of 3.80 with correlation of negative .085 (P=.111). The metal sector too has a return on equity of 3.61, with correlation coefficient of negative .038 (P=.733). The last includes the others sector which has a return on equity of 2.09 with a correlation coefficient of negative.038.

The rate of change observed from table 4.1 through regression analysis for various sector ranges from -.00001 to 1.0094 units. Where correlation increases resulting in the rate of change.

A firm more heavily exposed to debt will be exposed to the constant variable nature of that, debt and other relevant debt covenants, example over the last few years firms have favoured debt due to cheap debt markets but are now suffering from high debt claiming high interest repayments etc., Equity is less of a drag on cash flow but can limit organizational effectiveness in regards to the greater power of shareholders. The idea is that, debt overhang reduces the incentives of the shareholder–management coalition in control of the firm to invest in positive net-present value investment opportunities, since the benefits accrue, at least partially, to the bondholders rather than accruing fully to the shareholders. Hence, highly levered firms are less likely to exploit valuable growth opportunities as compared to firms with low levels of leverage. A related underinvestment theory centers on a liquidity effect in that, firms with large debt commitments invest less irrespective of the nature of their growth opportunities. In theory, even if debt creates potential underinvestment incentives, the effect could be attenuated by the firm taking corrective action and lowering its leverage, if future growth opportunities are recognized sufficiently early. Leverage is optimally reduced by management ex ante in view of projected valuable ex post growth opportunities, so that, its
impact on growth is attenuated. Thus, a negative empirical relation between leverage and growth may arise even in regressions that control for growth opportunities because managers reduce leverage in anticipation of future investment opportunities. Leverage simply signals management’s information about investment opportunities. Another possible agency problem discussed in literature is the “overinvestment” problem where the conflict is between management and shareholders the argument is that, managers have a propensity to expand the scale of the firm even if that, means undertaking poor projects and reducing shareholder welfare. Management’s ability to carry out such a policy is constrained by the availability of free cash flow, and this constraint can be further tightened via debt financing. The issuance of debt pre-commits the firm to pay cash as interest and principal, forcing managers to service such commitments with funds that, may have otherwise been allocated to poor investment projects. Thus, leverage is one mechanism for overcoming the overinvestment problem suggesting a negative relationship between debt and investment for firms with weak growth opportunities.

To verify the hypotheses following variables were used in the study. The amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested. Return on equity is expressed as a percentage and calculated as:

\[
\text{Return on Equity} = \frac{\text{Net Income}}{\text{Shareholder’s Equity}}
\]

Net income is for the full fiscal year (before dividends paid to common stock holders but after dividends to preferred stock.) Shareholder’s equity does not include preferred shareholders. Also known as "return on net worth" (RONW). Debt is the combination of both secured and unsecured loans and equity to compare the relationship between return on equity and market value of a firm.
The return on equity is high for non-durable, this is because the non-durable sector goods life span is very short and the frequency of consumption is high and hence the equity shareholders would be willing to deploy there funds due to the good turnover which leads to better return on equity and the risk taking would also be high due to the high variance factor. whereas due to the high variance the debt holders would be skeptical to invest their funds in short life span sector. This affects on the credibility of the business and its profitability too and comparatively the risk is high with uncertain perishment of the goods. In some case the transaction cost is higher than the actual cost of procuring resources which would lead to lower deployment of debt in this sector. The non-durable sector would not be in a position to deploy more debt funds because the high cost of debt funds. Cost of equity is comparatively lower than cost of debt funds.

The return on equity is second highest for durable sector. The equity shareholders being the true owners of the company they have been associated with the company keeping in view the long term success and profitability whereas the debt holders prefer short term profitability that, is the reason debt employment is less in durables. The durable goods consumption not being frequent the debt holders choose more volatile and growth sector instead of slow growth sector.

As the infrastructure is booming sector in this current era despite of recession what has been observed here is that, there is growth factor in infrastructure sector and hence the debt holders and the equity shareholders would be willing to deploy their funds in this sector. It is also noticed that, the return on equity is also high with comparison to debt and equity investment. This sector is one such sector which has not been affected much even during recession though the risk is minimum because there is always an appreciation in its value. Nowadays, it is noticed that, the government is also taking up more initiatives to improve the basic infrastructure facilities leading to more developments in terms of increase in investment and savings leading to the
contribution of Gross Domestic Product. And hence, due to the promising growth is this sector which could be visualized the equity shareholders would be willing to deploy more.

The Indian service sector is the major sector contributing towards the total Gross Domestic Product but the major ones are information technology sector. But during the recession it was the information sector which was affected because this sector gets major portion of their business from United States which had brought down its reliance on outsourcing on India.

Metal sector has more risk due to less growth factor. Scarcity of resources due to less number of companies to cater the demand of industrial production companies, competition is also high due to scarcity of resources which lead to increase in prices. Due to this the agency cost incorporates wherein the financial manager would never wish to take more burdens and hence would always influence the directors to go in for more of equities than debt funds.

Due to the impact of the ongoing worldwide financial and economic crisis, foreign direct investment (FDI) flows declined by more than 20 per cent in 2008. A further decrease in FDI flows continued in 2009, as the full consequences of the crisis on Transnational Corporations’ (TNCs)’ investment expenditures continued to unfold. The fall in global FDI in 2008–2009 is the result of two major factors affecting domestic as well as international investment. First, the capability of firms to invest has been reduced by a fall in access to financial resources, both internally – due to a decline in corporate profits, and externally, due to lower availability and higher cost of finance. Second, the propensity to invest has been affected negatively by economic prospects, especially in developed countries that are hit by severe recession. The impact of both factors is compounded by the fact that, as of early 2009, a very high level of risk perception is leading companies to extensively curtail their costs and investment programmes in
order to become more resilient to any further deterioration of their business environment. All of the three major types of FDI (market-seeking, efficiency-seeking, and resources-seeking) has been impacted by these factors, though with different magnitudes and consequences on location patterns. Among industries, FDI flows to financial services, automotive industries, building materials, intermediate goods and some consumption goods have been the most significantly affected to date. But the consequences of the crisis are now quickly expanding to FDI in other activities, ranging from the primary sector to non-financial services.

The slack in the economic scenario such as interest rates going up further and instability in the political situation, the regulatory authority requirement to be catered by the companies became stringent; the fiscal and monetary policies are all the reasons for negative correlation between the return on equity and leverage for few of the sectors. All Indian companies have their customer base in U.S, Europe which is in crisis already and hence the Indian companies are in receiving end. The crisis has affected the Indian companies in terms of receiving their payments. Because of recession period normally having debt adds value to shareholders, whereas, the company is able to mobilize equity fund at a lower cost than debt fund. So the dynamics of financial leverage may not been seen here. Another reason why these companies have gone for more equity fund is due to the fact that, these are all good old companies having many years of existence those associated equity shareholders are paid good dividend and now during recession they are inclined to show loyalty. And this might be the reason why the companies have more of equity than debt in its financial leverage.
H2: The relation between return on equity of the firm and its financial leverage varies between mid capitalization and large capitalization companies.

This hypothesis is accepted as it is noticed that, the relation between market value of the firm and its financial leverage varies between mid capitalization and large capitalization companies. Among the mid capitalization and large capitalization companies it is noticed that, the return on equity of mid capitalization companies are higher than the large capitalization companies where in the correlation coefficient of -.093 (P=.024), and that, of large capitalization companies correlation coefficient of -.081 (P=.082).

The margin of mid capitalization companies is good and hence the return on equity is high. The mid capitalization companies have more scope for venturing out into diversified business due to flexibility. The large capitalization companies in the long run would wish to attain self sufficiency and hence they would not like to have more of long term liabilities this is what happened even with Tata’s, when they wanted to acquire Tetley Tea company, they could have issued debentures to acquire but they preferred to issue more of equities, this is due to the reason that, large cap sectors preference for tax shield would be less when they attain self sufficiency. The market capitalization change based on a market estimate of a company's value, based on perceived future prospects, economic and monetary conditions. Stock prices can also be moved by speculation about changes in expectations about profits or about mergers and acquisitions.

It is possible for stock markets to get caught up in an economic bubble, like the steep rise in valuation of technology stocks in the late 1990s followed by the dot-com-crash in 2000. Hype can affect any asset class, such as gold or real estate. In such events, valuations rise disproportionately to, what many people would consider the fundamental value of the assets in question. In the
case of stocks, this pushes up market capitalization in what might be called an "artificial" manner. Market capitalization is, therefore, only a rough measure of the true size of a market. However, it does represent the best estimate of all market participants at any point in time bubbles are easy to spot retrospectively, but if a market participant believes a stock is overvalued, and then of course they can profit from this by selling the stock (or shorting it, if they do not hold it).

From the present study it is observed that, all the BSE 200 Companies have its international presence and the large capitalization companies have been affected the most due to the US crisis which has its impact on all these major companies but for the mid capitalization companies the impact has been felt in a small scale. And hence the mid capitalization companies have more potential for growth compared with large capitalization companies. What is also observed from the table 4.2 is that, for large capitalization, there is indifference point of interest cost of funding which is evident from coefficient of correlation working. Debt equity ratio of mid capitalization is comparatively higher than the large capitalization companies. So it is evident that, the mid capitalization companies financial risk is comparatively higher than large cap companies which is evident from return on equity.

**H3: Financial leverage decision of a firm is influenced by the following factors:**

1. Market Capitalization
2. Growth prospects
3. Profitability
4. And Ownership

The hypothesis has been accepted for three variables such as market capitalization, profitability and ownership and rejected for growth. As it is noticed from the table 4.3 that, all the above mentioned factors do influence the financial leverage decision except growth. As far as capitalization factor is
considered, mid capitalization and large capitalization differed significantly with the ‘t’ Value of 6.885 and significance level of .000. The mean financial leverage was found to be significantly high for large capitalization compared to mid capitalization. The capitalization of a company greatly influences the availability of funds from different sources. A mid capitalization company may often find it difficult to raise long-term loans. If somehow it manages to obtain a long-term debt, it is available at a high rate of interest and on inconvenient terms. The highly restrictive covenants in loans agreements of small companies make their financial leverage quite inflexible. The management thus cannot run business freely. Mid capitalization companies, therefore, have to depend on owned capital and retained earnings for their long-term funds. A large capitalization company has a greater degree of flexibility in designing its financial leverage. It can obtain loans at easy terms and can also issue ordinary shares, preference shares and debentures to the public. A company should make the best use of its size in planning the financial leverage. It is found that, large capitalization is having highest frequency (70.6 percent) in high financial leverage and mid capitalization having more frequency (66.3 percent) in low financial leverage. The contingency coefficient of .345 was found to be significant at .000 levels.

Then as far as growth sector is considered low growth and high growth companies differed significantly with the ‘t’ value of 3.130 and significance level of .002. The mean financial leverage was found to be significantly high for low growth companies compared to high growth companies. Growth aspect (high and low) has not contributed to financial leverage, as both regression analysis and contingency coefficient values failed to reach the significance level of .05 levels. The contingency coefficient value of .005 was found to be non-significant at .879 levels. Compound annual growth rate formula was used to ascertain the high growth and low growth of the BSE 200 Companies, (CAGR) is a business and investing specific term for the smoothed annualized gain of an investment over a given time period. CAGR is
not an accounting term, but remains widely used, particularly in growth industries or to compare the growth rates of two investments because CAGR dampens the effect of volatility of periodic returns that, can render arithmetic means irrelevant. CAGR is often used to describe the growth over a period of time of some element of the business, for example revenue, units delivered, registered users, etc.,

This can be written as follows:

\[
CAGR = \left( \frac{1}{\text{No.of.Year}} \right)_{-1} \frac{\text{Ending Value}}{\text{Begining Value}}
\]

As Jensen and Meckling (1976) and Myers (1977) argue, when the firm has risky debt outstanding and when managers act to maximize equity value rather than total firm value, managers have incentives to under- and overinvest in future growth opportunities. The loss in firm value attributable to these suboptimal investment decisions constitutes a significant component of the agency cost of debt. The other component is the cost of contracting mechanisms that, the firm uses to mitigate stockholder bondholder conflicts. Two such contracting mechanisms, which they discuss, are the use of short-term debt and restrictive covenants in debt contracts. Absence of these contracting mechanisms, rational bondholders anticipates conflicts and will require a higher cost of debt financing. It is therefore in the firm’s interest to mitigate potential conflicts over the exercise of future growth options. The obvious solution is to avoid them altogether by using less debt financing. This leads to the prediction that, firms with more growth opportunities would have less leverage.

Diamond (1991) argues that, debt exposes the firm to a liquidity risk of the loss of unassignable control rents, if lenders will not allow refinancing and the firms are liquidated. Because of this liquidity risk, he argues that, only the low growth firms use debt. Further, Childs, Mauer, and Ott (2005) argue
that, although debt can mitigate incentives to under- and overinvest in growth options, this benefit must be balanced against the greater liquidity risk of refunding debt. They show that, for riskier firms, optimal leverage decreases as the maturity of debt decreases. Therefore it is predicted a negative relationship between leverage and growth.

On the other hand, Titman and Wessel (1988) find no relationship. (Pandey, 2001) states that, due to more investment opportunities, high growth firms can venture into risky projects thus lenders want high risk premium. This high risk premium raises the cost of debt, thus firms tend to use less debt for their financing. And hence only few studies prove that, high growth companies have more debt compared to low growth companies.

High and Low profitable companies are ascertained based on the formula:

\[
\text{Net profit margin} = \frac{\text{Net Profit}}{\text{Sales Turnover}}
\]

The net profit is later classified as high margin low margin with comparison to the benchmark, that is, the nifty margin which stood on 10 percent during the research period. Any net profit margin less than 10 percent is low margin companies and above 10 percent are high margin companies.

As profitability sectors is considered high margin and low margin companies differed significantly with the ‘t’ value of 4.893 and significance level of .000. The mean financial leverage was found to be significantly high for high margin companies compared to low margin companies. It is found that, low margin companies have highest frequency (58.8 percent) in low financial leverage and high margin companies having more frequency (55.3 percent) in high financial leverage. The contingency coefficient is .135 at significance level .000. The pecking order and trade-off theories also have opposite implications about the relationship between profitability and debt ratio. The pecking order theory opts for a negative, while trade-off theory opts
for a positive relationship between the two variables (Benito, 2003; Krasker, 1986; Myers, 1984; Myers and Majluf, 1984; Narayanan, 1988; Qian et al., 2007). According to the trade-off theory, high profitability level renders a high level of borrowing capacity. This situation promotes the use of tax shield. Thus, the trade-off theory hypothesizes a positive relationship between profitability and debt level (Frank and Goyal, 2003; Um, 2001). According to the pecking order theory, high-profit firms outperform low-profit firms in terms of using retained earnings in internal financing. As a result, the empirical study reveals a positive relationship between profitability and financial leverage.

At last the ownership is considered, public ownership companies and government owned companies differed significantly with the ‘t’ Value of 8.418 and significance level of .000. The mean financial leverage was found to be significantly high for government companies compared to public owned companies. It is found that, government owned companies having highest frequency (70.2 percent) in high financial leverage and public owned companies having more frequency (55.5 percent) in low financial leverage. The contingency coefficient is .205 at significance level .000. The government owned companies irrespective of the performance they ought to borrow more in order to meet the required investment whereas the public sector is not compelled to make such unproductive investment and hence the financial leverage has found to be more for government sector.

**H4: Financial leverage decision of a firm is not influenced by the free cash flows.**

This hypothesis is rejected as both the variables are independent of each other, as there is no significance level. Free cash flow and financial leverage are independent of each other and hence it does not influence the financial leverage. Large capitalization companies is capital intensive and hence they would need to go in for minimum investment depending on the
capital intensiveness and hence irrespective of having free cash flows their
dependence on financial leverage may vary depending on the capital
orientation of the companies. Firms with free cash flows will always be in a
stronger position to command in the market and their requirement for debt
would be less comparatively. The study also reveals that, the free cash flows
do not influence the financial leverage decisions as they are independent of
each other.

It is perceived that, with free cash flows the companies will be in a
commendable position and their dependence on debt is less. With free cash
flows the companies should be in a position to invest it fruitfully in profitable
ventures so that, the return on equity would be high which inturn maximizes
the shareholders wealth.

**H5: The management of a firm has a positive bias towards financial
leverage decision.**

The management of a firm has a positive bias towards financial leverage
decision which has been studied under nine different variables, which are as
follows:

**Tax Issues, Size of the Company, Earning Capability, Good
Dividend Payouts, International/Domestic Money Market Variables, Top
Guidelines, Organizations’ Flexibility, Social Factors/Social Responsibility
Accounting Controlling/Ownership Interest of Promoter Group.**

1. **Tax Issues:** There is 100 percent response ‘yes’ for the question that,
“Does tax issues have a bearing on financial leverage decision?” and this is
due to the following reasons. The liability side of the balance sheet, that is,
the debt and equity component determines the financial risk of the business.
The tax issues has a major influence on the financial leverage decision
because the financial risk will be high with debt component and the overall

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cost of capital will be less because interest is a charge against profit and not appropriation.

The tax system encourages companies to absorb more business-cycle risk than they would otherwise. It does so in two respects: first, it provides a relative subsidy to debt finance; second, it restricts debt for tax purposes from indexing the principal to common disturbances. At a deeper level, the issue hinges on the institutional aspects of debt renegotiation. If renegotiation were costless, then debt implicitly would have the equity features relevant for responding to business cycle risk. However, because of the diffuse ownership pattern of much of the newly issued debt and also because of certain legal restrictions, renegotiation is likely to be a costly activity.

There is accordingly, reason to suspect that, the current tax system encourages corporations to adopt a financial structure more exposed to common cyclical risks than would be the case in the absence of any subsidy to debt. In Gertler and Hubbard (1989), they sharpen this point. They study a model of firm investment behavior where the kind of incentive problem deemed important by Jensen is present. Because of certain informational asymmetries, firm insiders (say corporate managers and directors) may try to misallocate investment funds on their own behalf. The financial structure is designed to address the incentive problem. However, the tax system introduces a tradeoff between optimally insulating the firm against business cycle risk and minimizing the expected tax burden. Under a tax system that, treats debt favourably, firms are induced to issue a smaller fraction of indexed securities (i.e., equity) and thus to absorb more business cycle risk than they would choose in the absence of the distortion. Indeed, if the probability of a recession is sufficiently low, it may be in a firm's interest ex ante to obtain the tax advantage of a high debt-equity ratio at the risk of having a quantity of debt that, makes it infeasible to operate in the (ex post) event of a general business downturn. In this situation, because of the large quantity of debt being carried, a recession lowers the net asset position of the firm's insiders to
the point where the agency costs are so severe that, lenders will no longer supply credit. The tax system thus encourages the firm to risk the possibility of having a debt-overhang problem in a recession.

The legal requirement has a bearing on the financial leverage decision and this is due to policy of the government, inflationary impact, real time cost would go up as demand increases cost increases due to artificial increase in demand.

Every company has to comply the law of the country regarding the issue of different types of securities. Therefore, the hands of the management are tied on these legal restrictions. For example, in India, Banking Companies are not allowed to issue any type of securities except equity shares under the Indian Banking Companies Act. Again, Under Control of Capital Issues Act in India, 4:1 ratio between debt and equity and 3:1 between equity and preferred stock has been fixed. Within this overall frame work, the management should strive towards financial leverage.

If government says no companies will go for debt only, equity will have an impact on financial leverage and the overall cost of capital will be high, risk will be less which is not appreciated by the stakeholders. Since after liberalization it has not happened but before 1992 it has happened due to conservative principle, now government has allowed the companies to go for outside funding hence there is Foreign Direct Investments(FDI), Foreign Institutional Investors (FII’s).

2.Size of the Company: The size of the company do influence the financial leverage of the companies. For small companies volume will be less and hence capacity to repay interest and principal will be less. There is no synergy effect and hence the benefit cannot be passed on to the shareholders. The availability of funds is greatly influenced by the size of the enterprises. A small company finds it difficult to raise debt capital. The terms of debentures are less favorable to small companies so they have to rely on equity share and
retain earning for funding business. Large companies are generally considered to be less risky by the investors and thus, they can issue common shares, preference shares and debentures to the public. The size of a company greatly influences the availability of funds from different sources. A small company may often find it difficult to raise long-term loans. If somehow it manages to obtain a long-term loan, it is available at a high rate of interest and on inconvenient terms. The highly restrictive covenants in loans agreements of small companies make their financial leverage quite inflexible. The management thus cannot run business freely. Small companies, therefore, have to depend on owned capital and retained earnings for their long-term funds. A large company has a greater degree of flexibility in designing its financial leverage. It can obtain loans at easy terms and can also issue ordinary shares, preference shares and debentures to the public. A company should make the best use of its size in planning the financial leverage.

3. Earning Capability: Earning capability does have a bearing on the financial leverage of the company. If the potential is high then all the stakeholders would be with the company inclusive of the government too. Companies then can give suggestions to the government to reduce certain tax rates.

4. Good Dividend Payouts: Good dividend payouts have a bearing on the financial leverage which is shown in the table 4.16. This is because investors’ mood in the market, that is, secondary market will be very good because the company has not defaulted on its payment. The market value of the company will be high as well as the equity base would be high.

There are some scholars who emphasize the informational content of dividends. Miller and Rock (1985), for instance, developed a model in which dividend announcement effects emerge from the asymmetry of information between owners and managers. It is argued that, dividend announcement provides shareholders and the marketplace the missing piece of information
about current earnings upon which their estimation of the companies’ future earnings is based. These expected future earnings have been found to determine the current market value of a company. The dividend announcement, therefore, provides the missing piece of information and allows the market to ascertain the company's current earnings. These earnings are then used in predicting future earnings. In a study by John and Williams (1985) a signaling model was constructed in which the source of the dividend information is liquidity driven.

5. International/Domestic Money Market Variables: Majority of the respondents do agree that, the international/domestic money market variables do have a bearing on financial leverage because cross border funding, monetary policy of that country and political stability would have an impact on financial leverage.

The degree of integration of financial markets around the world increased significantly during the late 1980s and 1990s. A key factor underlying this process has been the increased globalization of investment seeking higher rates of return and the opportunity to diversify risk internationally. At the same time, many countries have encouraged inflows of capital by dismantling restrictions, deregulating domestic financial markets and improving their economic environment and prospects through the introduction of market-oriented reforms. This increase in the degree of integration of world capital markets has been accompanied by a significant increase in private capital flows to developing countries like India. Financial openness is often regarded as providing important potential benefits. Access to world capital markets expands investors’ opportunities for portfolio diversification and provides a potential for achieving higher risk-adjusted rates of return. It also allows countries to borrow to smooth consumption in the face of adverse shocks, the potential growth and welfare gains resulting from such international risk sharing can be large (Obstfeld, 1994). It has also been argued that, by increasing the rewards of good policies and the penalties
for bad policies, free flow of capital across borders may induce countries to follow more disciplined macroeconomic policies that translate into greater macroeconomic stability. An increasingly common argument in favour of financial openness is that it may increase the depth and breadth of domestic financial markets and lead to an increase in financial intermediation process by lowering costs and “excessive” profits associated with monopolistic or cartelized markets, thereby lowering the cost of investment and improving resource allocation.

Another policy aspect that arises from the analysis of financial markets is the increasing importance of foreign interest rates in the formation of domestic rates and foreign influence on the local economy in general. This in turn may change the synchronization of economic cycles between countries. Financial asset prices play a key role in the economy, since they affect marginal valuations and decisions and since they contain future expectations. As financial asset prices across countries converge, some shocks that were previously idiosyncratic should become common and the impulses they generate should be common to the local and foreign economies. The economy may respond to the same impulses but the generating mechanism of the impulses would change with internationalization. Financial integration, therefore, may imply greater integration of real economies. (Brouwer, 1999)

The macroeconomic impact of international financial integration depends on the extent of domestic financial integration, that is, to say the integration of domestic institutional interest rates such as deposit and loan interest rates with domestic money market rates which themselves turn on the regulatory and competitive structure of domestic financial markets. Bhoi and Dhal (1998) have attempted to empirically evaluate the extent of integration of India’s financial markets in the post-liberalization period. According to them, there exists a fair degree of convergence of interest rates among the short-term markets-money, credit and gilt markets – but the capital market
exhibits fairly isolated behavior. Furthermore, they find that, the integration of domestic and overseas financial markets is not robust.

6. **Top Guidelines:** Top Guidelines do have an influence on financial leverage because it is a mirror to all the outsiders. Exhibiting to outsiders will improve the company image and this would enhance the efficiency and sales and inturn the revenue would go up and the financial leverage would be taken care.

7. **Organizations’ Flexibility:** With 1:1 debt-equity ratio, the investors will be dissatisfied when cheap funds are available in the financial market. This indicates that, whether the organization is flexible enough to go in for it and also to face contingency. The organizations’ survival would be difficult due to flexibility criterion. Flexibility means the firm's ability to adapt its financial leverage to the needs of the changing conditions. The financial leverage of a firm is flexible if it has no difficulty in changing its capitalization or sources of funds. Whenever needed the company should be able to raise funds without undue delay and cost to finance the profitable investments. The company should also be in a position to redeem its preference capital or debt whenever warranted by future conditions. The financial plan of the company should be flexible enough to change the composition of the financial leverage. It should keep itself in a position to substitute one form of financing for another to economize on the use of funds.

8. **Social Factors/Social Responsibility Accounting:** The social factors/social responsibility accounting has a bearing on financial leverage, this will bring intangible benefits to the companies. Most of the companies spend 10-20 percent of the profits on social responsibility accounting in the form of charity, donation or adoption all these factors do have a positive influence on the organization in terms of goodwill, sales would increase as revenue increases the market capitalization of the companies will also be good and
overall all the stake holders would be happy and satisfied and these firms will be able to tap cheaper source of funds.

9. **Controlling/Ownership Interest of Promoter Group:** The majority of the respondents do agree that, the principal driving force behind leverage decisions is not the cheaper cost of debt, but the consideration of controlling/ownership interest of promoter group because of agency cost associated with it. In designing the financial leverage, sometimes the existing management is governed by its desire to continue control over the company. The existing management team may not only what to be elected to the board of directors but may also desire to manage the company without any outside interference.

The ordinary shareholders have the legal right to elect the directors of the company. If the company issues new shares, there is a risk of loss of control. This is not a very important consideration in case of a widely held company. The shares of such a company are widely scattered. Most of the shareholders are not interested in taking active part in the company's management. They do not have the time and urge to attend the meetings. They are simply interested in dividends and appreciation in the price of shares. The risk of loss of control can almost be avoided by distributing shares widely and in small lots. Maintaining control however could be a significant question in the case of a closely held company. A shareholder or a group of shareholders could purchase all or most of the new shares and thus control the company. Fear of having to share control and thus being interfered by others often delays the decision of the closely held companies to go public. To avoid the risk of loss of control the companies may issue preference shares or raise debt capital.

Since holders of debt do not have voting right, it is often suggested that, a company should use debt to avoid the loss of control. However, when a company uses large amounts of debt, lot of restrictions are imposed on it by
the debt-holders to protect their interests. These restrictions curtail the freedom of the management to run the business. An excessive amount of debt may also cause bankruptcy, which means a complete loss of control. The consideration of retaining "control" is also very important. The ordinary shareholder can elect the directors of the company. If company sells the common stock, it will bring new voting investors into the firm, making the control difficult. To maintain control within the hand of limited members, a firm uses more amount of debt or preferred stock because they have no management and voting right. If the firm wants to have more equity shares the management right will be diversified.

5.2 GENERAL DISCUSSION

The capacity of a firm to operate its activities is based on the availability of funds. Normally, the funds in finance literature is termed as long term funds, which are contributed by owners (shareholders) and outsiders. The owners’ funds are represented by equity contributions and internally generated financial resources. A unique characteristic of procuring funds is that, a firm may tap any of these sources and hence the blend of these different sources of long term funds is termed as Capital structure in finance literature financial leverage ordinarily implies the proportion of debt and equity in the total capital of a firm. In the term, ‘financial leverage’ capital refers to long term funds and structure refers to the proportion of debt and equity in capital. Further, capital is easily comprehended through accounting as the difference between total assets and current liabilities, and this residual difference is always represented by debt and equity.

Financial leverage is the combination of debt and equity, that funds an organization's strategic plan. The term Capital structure is used in the context of financial leverage. The "right" financial leverage supports strategic financial goals, while optimizing flexibility and minimizing cost. Financial leverage management can be approached by answering the question, what are
the appropriate amount, mix, structure, and cost of debt and equity to support the organization's strategic financial goals? The proper and strategic management of financial leverage ensures access to the capital needed to fund future growth and enhance financial performance. The key benefits of effective capital structure management are increased capital access, added flexibility, and lower overall cost of capital. Financial leverage "organized properly in an organization of any size, a financial leverage can be easily adjusted to meet changes in interest rates and the changing shape of interest rate yield curves," notes Kenneth Kaufman, managing partner of Kaufman Hall.

Unfortunately, there is no magic proportion of debt that a company can take on. The debt-equity relationship varies according to industries involved, a company's line of business and its stage of development. However, because investors are better off putting their money into companies with strong Balance Sheets, general logic tells us that, these companies should have, generally speaking, lower debt and higher equity levels.

A company considered too highly leveraged (too much debt versus equity) may find its freedom of action restricted by its creditors and/or may have its profitability hurt as a result of paying high interest costs. Of course, the worst-case scenario would be having trouble meeting operating and debt liabilities during periods of adverse economic conditions. Lastly, a company in a highly competitive business, if hobbled by high debt, may find its competitors taking advantage of its problems to grab more market share. Theoretically, the financial manager should plan an optimum financial leverage for his company. The optimum financial leverage is obtained when the market value per share is maximum. There is significant variation among industries and, among individual companies within an industry in terms of financial leverage. Since a number of factors influence the financial leverage decision of a company, the judgment of the person making the financial leverage decision plays a crucial part. Two similar companies can have
different financial leverages if the decision makers differ in their judgment of the significance of various factors. A totally theoretical model perhaps cannot adequately handle all those factors, which affect the financial leverage decision. These factors are highly psychological, complex and qualitative and do not always follow accepted theory, since capital markets are not perfect and the decision has to be taken under in perfect knowledge and risk.

Until the early nineties, corporate financial management in India was a relatively drab and placid activity. There were not many important financial decisions to be made for the simple reason that, firms were given very little freedom in the choice of key financial policies. The government regulated the price at which firms could issue equity, the rate of interest which they could offer on their bonds, and the debt equity ratio that, was permissible in different industries. Moreover, most of the debt and a significant part of the equity were provided by public sector institutions. At the beginning of the reform process, the Indian corporate sector found it significantly over-levered. This was because of several reasons:

- Subsidized institutional finance was so attractive that, it made sense for companies to avail of as much of it as they could get away with. This usually meant the maximum debt-equity ratios laid down by the government for various industries.
- In a protected economy, operating (business) risks were lower and companies could therefore afford to take more risks on the financing side.
- Most of the debt was institutional and could usually be rescheduled at little cost.
- The liberalization changed all of this. The corporate sector was exposed to international competition and subsidized finance gave way to a regime of high real interest rates. One of the first tasks for the Indian companies was substantial deleveraging. Fortunately, a booming equity market and
the appetite of foreign institutional investors for Indian paper helped companies to accomplish this to a great extent in 1993 and 1994. The downturn in the stock market that has followed since then has stopped this process from going any further and has probably left many companies still excessively levered. According to the figures compiled by the Centre for Monitoring the Indian Economy, the average debt-equity ratio of private sector manufacturing companies in India fell from 1.72 in 1990-91 to 1.05 in 1996-97, and more than half of this reduction took place in one single year 1994-95.

5.3 IMPLICATIONS OF THE STUDY

This study is perhaps the first of its kind which tests / explores the relationship between the leverage and value of the firm and studies the influence of the independent variables like market capitalization, growth, profitability and cash flows and surveys the attitudinal perception of the corporate managers towards the financial leverage decision. Empirical models and methodologies are followed. Publicly available accounting data from Annual report (capital line) of all the listed companies have been used along with survey of managers' opinion.

5.4 SUGGESTIONS

This section highlights a number suggestions extracted from the present study, according to the background and the findings. These suggestions have been made with the hope that, they can be used to improve and intensify the use of financial leverage practices in Indian corporate organizations:

Deficit in the orientation factors should be treated. Orientation factors of financial leverage practices should be capacitiated and ameliorated, in both their structural and contextual types, by re-engineering, restructuring, reorganizing, and even by altering fundamentals of financial leverage
practices so as to keep abreast of the rapid development and adapt dynamically to changes in business environment in India.

Financial leverage as the language of business reflecting the realities of a business situation has always played a vital role in ensuring information quality for an organization if reported with transparency. Therefore, the financial leverage practices should be enhanced and provided transparently, particularly by the authorities concerned with control and auditing.

The value-added is enhanced by sophisticated financial leverage practices. Hence organizations should adopt and improve financial leverage practices, and also enhance the capacity and the performance quality of these systems and their outputs so as to obtain the maximum perceived benefits.

Educational and academic institutions should work side by side with Indian organizations to ameliorate financial leverage practices in a way that, can keep these systems abreast of development in business so as to achieve equilibrium with market requirements.

Indian corporate organizations using financial leverage practices should contribute to improving and upgrading these systems in the light of these organizations aspects and needs.

To attain a vibrant financial leverage practices in India, the companies need to be focused in its approach, be effective and have efficient management at top-level. Study and eliminate drawbacks, if any, with multi-national companies partnering in India, and make Indian companies in par with foreign companies while turning Indian companies with “envisioning, energizing and enabling” performers.

5.5 FURTHER RESEARCH

Based on the dimensions of the present study regarding an empirical evaluation of capital structure practices of corporate organizations in India,
the study suggests a number of areas for further research in field financial leverage.

Due to the limited scope of the present study, a large number of research issues are not attempted but are felt in the course of the study. Some of them are —

To study the Chief Financial Officers (CFOs') with strong financial background who claim to practice Shareholders wealth maximization has actually created Shareholders wealth.

A study to investigate more thoroughly Indian managers’ incentives behind Financial leverage decision;

To study the impact of credit rating vs. financial leverage planning. As the risk appetite of the company also depends on the credit rating from investor’s point of view.

Further studies may be conducted on the development of financial leverage practices, both structural and contextual, to enhance the ability of the financial leverage practices of Indian corporate organizations to dynamically adapt to sophisticated technology as well as to changing business environment.

To study the impact of Insider Trading and financial leverage in primary and secondary market.

The impact of regulatory requirement on financial leverage decision can be further studied.

An attempt may be made to examine how financial flexibility, under-investment cost, free cash flows, and corporate governance affect the financial leverage choices.
A study on management motivations governing share buyback decisions, sweat equity, bonus shares and right shares can be taken up.

Benchmarking of financial leverage practices of a traditionally family owned entity Vs multinational companies of Europe and United States.

5.6 CONTRIBUTIONS OF THE STUDY

The present research mainly contributes, based on the assessment of the financial leverage practices of Indian corporate organizations; also it evaluates some of the key factors such as, whether there is a relationship between market value of the firm and return on equity, factors that influence financial leverage decision and the attitudinal perceptions of managers towards financial leverage decision.

Basically, the present research is empirical in nature. It has been carried out by relying on both primary and secondary data, and has highlighted the conceptual framework and development of financial leverage, which are considered the gateway to the existence of financial leverage practices.

5.7 CONCLUSION:

Chapter one contains general background of the study, statement of the research problem and objectives and scope of the study and hypotheses developed. This chapter signifies the rationale of this study. So it gives a clear idea on concepts, developments, financial leverage determinants which are required for effective financial leverage practices. Scope mainly gives the path in order to achieve the suitable result and it mainly in line with the mentioned significance. The primary source of information in this research has been drawn from questionnaire developed for the above stated purpose. The questionnaire was designed to ensure that the precise data required would be collected from the respondents to achieve the objectives of the research.
Chapter two is devoted to theoretical foundation of financial leverage including review of empirical works. It is interesting to note that, the empirical literature on financial leverage is very vast and exhaustive at the international level and it is very much sporadic at the Indian level. Hence the review of literature has been presented through International studies; and Indian studies.

Chapter three consists of conceptual analysis on financial leverage. The last few years of financial reforms have changed all this beyond recognition. Corporate finance managers today have to choose from an array of complex financial instruments; they can now price them more or less freely; and they have access (albeit limited) to global capital markets. On the other hand, they now have to deal with a whole new breed of aggressive financial intermediaries and institutional investors; they are exposed to the volatility of interest rates and exchange rates; they have to agonize over financial leverage decisions and worry about their credit ratings. If they make mistakes, they face retribution from an increasingly competitive financial marketplace, and the retribution is often swift and brutal.

Chapter four consists of interpretation and analysis of data with different variables and research tools. An analysis of survey of the respondents’ opinion on various aspects of financial leverage management has been also presented. This chapter is very important in case of empirical study because the consistencies of the findings are solely based on empirical methodology employed.

Chapter five gives a complete crisp of results with appropriate discussions, and also the tested and verified hypotheses with suitable explanation along with explanation and complete view of general discussion. The research also identified some of the limitation which will help for others for future research. Major finding of the study include negative relationship between market value of a firm and its financial leverage, the relation between
market value of the firm and its financial leverage varies between mid capitalization and large capitalization companies, financial leverage decision of a firm are influenced by the factors such as market capitalization, profitability, and ownership however financial leverage decision of a firm is not influenced by the free cash flows and growth. Contingency coefficient revealed a significant association between type of sector and type of returns. Contingency coefficient revealed a significant association between type of sector and type of margin, between type of ownership and public and government ownership, type of sector and growth. Tax issues has a major influence on the financial leverage decisions. Size of the company affects the financial leverage, good earning capability has a bearing on the financial leverage, good dividend payouts have a bearing on the financial leverage, international/domestic money market variables have a bearing on financial leverage, top guidelines have a bearing on financial leverage, organizations’ flexibility have a bearing on financial leverage, social factors/social responsibility accounting have a bearing on financial leverage. This means to state that, the management has positive bias towards financial leverage decision.

The results of the present study are consistent with the theory and simultaneously revealing too. The shareholder value maximization objective is widely used by corporate India now than before. Firms place substantial emphasis on the maximization objective by reducing the cost of usage of funds. The results seem to suggest that, firms do not have specific financial leverage in mind, when deciding as to how best to finance their projects. Low growth firms prefer more use of debt in their financial leverage vis-a-vis the high growth firms. Firm size significantly affects the practice of corporate finance. So far as India is concerned, much remains to be done for industrialization. There exists the need to develop a synergic relation between the government and the public sector. State will have to keep constant dialogue with the entrepreneurs and their representatives to revive their
confidence. To overcome the severe demand contraction in the economy, India has to rely on higher government spending and tax cuts. The government has to play a dominant role for allocating the limited resources and for more public investments. In sum, the study leads to the conclusion that, India has to concentrate on domestic capital formation. In order to achieve this goal, we have to promote the private corporate investment from Indians nationals as well as non resident Indians. Despite, the relaxations in some regulatory acts, India continues to repel investors with interminable delays. Indians abroad have demonstrated to the world that its entrepreneurial and professional skills are as good as best. Corporate sector has entered into a world where only the fittest can survive. To be able to do so, Indian industry must become more quality conscious, invest in human capital and encourage professional management.