CHAPTER 1 - PROLOGUE

1.1 BACKGROUND -

A small incident would justify the rationale behind selecting the topic of study by the researcher. In a typical Post graduate management degree class, at the time of ice breaking session, researcher asked one of the students, reasons behind pursuing the Post Graduate Degree program. Promptly the reply came was, to have demystification done with the help of knowledge, to be gained while studying the syllabi of corporate finance.

This reply enthused the researcher, and researcher was eager to know, from the said student, about the pertinent questions in the mind of the said student. The said student took a brief pause… and replied as, “Well sir I am Mr. So and So, I have completed my graduation in Engineering. I have many Questions in my mind like…How many paradigms a concept of Profit has? Whether Operating profit OR Gross profit OR Net profit be considered while comparing the firm’s progress. How is it possible that even if a manufacturing firm incurs loss in its Business endeavors and still shows Net profit? When a firm declares the dividend, which is sharing the profit with share holders, why it has to borrow, at times, to pay the dividend? Is profitability not linked with liquidity? So on and so forth….the list of questions was exhaustive.

The researcher was anxious to know that these questions were never asked before by anyone earlier. As a faculty member the researcher was bit annoyed as well. However the Questions raised by the said students were all valid and fundamental. The researcher became Curious.
The session got over. But restlessness was experienced by the researcher, which prompted him to think further. In fact this incidence was instrumental for initiating the study.

Researcher thought for a moment and asked a question to himself, Are we teaching what is Preached by the real world. Is there any connect between the theoretical wisdom and the Practitioner, or professional manager?

1.2 THE FINANCE PUZZLE -

The researcher, who happens to be a faculty, tried to stand in the shoes of the inquisitive Student and then he realized that there are so many areas which are being discussed in classroom But the real reasoning is different than what is being taught.

The array of questions was evident. Some of them are like…

How do companies decide the percentage of Debt and Equity in their total Capital?

When the dividend irrelevance model has been in the discussion since long, and payment of Dividend is not mandatory, still why firms pay dividend to its shareholders?

The basic characteristics of any form of debt is periodic return to the investor and redemption As per the agreed terms, then preferred stock has both the characteristics, still it is not considered as debt.. Why?

Even the rational and logical thinking at students’ level has become a rarity still such questions are raised by the students. Many a times the faculty members and over all academia is not geared to redress all the queries such students.

One should not construe that the sample questions innocently raised by the studious students of corporate finance are baseless and absurd. On the contrary these questions are
challenging the basics of the theoretical domain and our understanding and belief of the corporate finance theories.

The tendency of accepting the truth on face value is common and all pervasive in all the areas of science. Such belief makes science static. Essence of dynamism is change, progressive change. This is ongoing and never ending process. Probable this is also called as progress.

If such approach is to be believed then what is the truth? What has been portrayed as truth. And is being accepted as fact is really the factual thing? Management science is a social Science. In Social Science the society and human social action is systematically studied.

One needs to have a holistic approach while studying any specific interrelated subject. Social Science has many applied or interdisciplinary fields and management is one of them.

1.3 ANOMALIES -

Researchers in the field of Economics and finance have cited anomalies (Christopher L Gilbert, 2011) cited that, Anomalies are the events that are apparently incompatible with received scientific theory. Gilbert said Kuhn saw normal science as a puzzle solving activity. Further he said puzzles are phenomena which are discrepant with received paradigm but which the scientific community believes can be resolved by extending paradigmatic exemplars.

Persistent failure of resolving a puzzle together with the available alternative paradigm which offers prospect resolution transforms the puzzle into anomaly. Hence anomaly recognition is a component of paradigm shift.
The discussion of anomalies in finance was introduced by Jensen (1978) and in Economics by Kuhn (1987).

The Journal of Financial Economics devoted an issue in 1978 for discussing the deviations from Predictions of Efficient Market Hypothesis (EMH) as an editor of the said issue, Michael Jensen wrote “Yet in manner remarkably similar to that described by Thomas Kuhn in his book ‘The Structure of Scientific Revolutions, we seem to be entering a stage where widely scattered but as yet inconclusive evidence is arising which seem to be inconsistent with the theory…”

Further Gilbert has referred to the anomalies as cited by Jensen (Finance) and Thaler (Economics) as given below:

**Jensen’s Anomaly Examples:**

A. Announcement Effects (Abnormal Returns)

In intra-day market response to the announcement of new equity issues, it was observed by Researchers that, for fifteen minutes following the announcement there is abnormally high Volume and -1.3% average return. There is small but significant negative, average return in the hour before the announcement.

B. Stock Splits and Dividend announcements

The literature supports the significant positive abnormal returns for firms around the stock
Split announcements (Ajit Jain and Mohammad Robbani). McNichlos and Dravid (1990) observed this phenomenon and noted that stock split is a way to signal superior performance in future. The information theory proposed by Fama, Fisher, Jensen and Roll (1969) and Grinblatt, Masulis and Titman (1984) pointed out that managers convey positive information about firms performance. Whereas liquidity theory proposed by Baker and Gallagher (1980) and Lakonishok and Lev (1987) asserted that stock split Improves the liquidity of the stock which results in reduction in stock price.

C. Close end Mutual Funds (Existence of Profitable Trading Rules)

Researchers’ observed that closed ended mutual funds usually trade at substantial discounts relative to their net asset value. Over the period 1965-1985 researchers noted that in U S The discount was 10.1 percent.

D. Stock and Cash Dividend (Valuation Differences)

Researchers observed that, returns on the stock portfolio were superior then the cash portfolio. And positive returns on stock portfolio (Stock dividend) were more prominent when holding period was more.

E. Stock and Options Prices (Small violations of Arbitrage conditions)

The researchers Efendi et al., (Jap Efendi, Anup Srivastava and Edward P Swanson, 2007) noted when CEO’s have sizeable holdings of stock option ‘in-the-money’(i.e. stock price above the exercise price) then misstatement of financial information was noted.

F. Informational Content of Option Prices (Implied Volatilities contain Information)
Implied volatility has been widely believed to be informationally superior to historical volatility, because it is the markets forecast of future volatility. But S & P 100 index options are most traded contracts in US, researchers found implied volatility is a poor forecast of subsequent realized volatility.

**Thaler’s anomalies**

G. Market Efficiency- January Effect (Existence of Profitable Trading Rules)

The overall stock prices rise in the month of January. This happens more in case of Small Cap stocks than large cap stocks.

H. Seasonality in Securities Prices

Well document seasonal effects on stock prices have been noted. Markets give strong positive results at the turn of the year. (As narrated above). The summer months usually give positive returns, however September is traditionally a down month.

I. Mean Reversion of Stock Prices Foreign Exchange

Mean Reversion is a mathematical methodology. When used in stock investing, it tries to find the average price using the analytical techniques. It helps to find out the trading range for a particular stock. When the current market price is less than the average price then, the stock is considered as a ‘buy’.

J. Endowment effect (Selling Prices exceed Buying Prices)

In behavioral economics it is also known as divestiture aversion. This means people would ascribe more value to things because they own them. People would tend to pay more to retain
something they own than to obtain something owned by someone else- even when there is no cause for attachment.

K. Equity Premium Puzzle

This is a phenomenon where anomalously higher returns of stocks over the bonds. Equity premium is equity returns less bond returns. These returns have been observed around 6% over the past century. This reflects the relative risk of stock as compared with risk free bonds. Puzzle arises because of unexpectedly large percentage implies a suspiciously high level of risk aversion among investors.

L. Risk Aversion

As it indicates, an investor when offered two investment proposals yielding similar expected return but having different risks, then the investor selects the proposal having lower risk attached.

M. Saving out of windfall income

Har R Arkes et al.,(1994) observed that windfall gain are spent more readily than other types of assets.

N. Inter-industry wage differentials

Working performing similar or same duties in similar industries are paid differently. This anomalous phenomenon has been observed by many researchers however no specific solution has been offered by any one as yet. The difference in emoluments could be substantial. For example, in India the salary paid to an employee in government sector job is much lower than the salary paid to private sector employee performing similar job, and having similar skill set and acumen.
Above mentioned are some of the anomalies, these are the representative anomalies.

The little looser interpretation of Efficient Market Hypothesis allows that there may be profitable trading rules but states that once rule becomes known, it will cease to be profitable.

In line with this Schwert(2003,p.947) has stated “week-end effect seem to have disappeared or at least substantially attenuated, since it was first documented in 1980”. He has summarized his Review on anomalies and said “All of these findings raise the possibility that anomalies are more apparent than real….”

These are some of the anomalies acknowledged by the eminent researchers in the field of Finance and Economics.

The researchers are trying to explore the reasons and are in the constant search of solutions for all the above referred anomalies. There are some Hypotheses; some explanations offered by the researchers however these explanations are incapable arriving at the factual thing. Hence overall experience is, there is very little connect between the industry and academia. Some of the pertinent questions are why consistently superior returns cannot be earned by the investors? The efficient market hypothesis has three variants weak form of EMH says prices efficiently reflect all the information in the past series of stock prices. The semi strong form of EMH says prices reflect all published information. The strong form of EMH says stock prices impound all the available information. As an investor which form of EMH is to be believed?

The general academic text discusses the theoretical aspects in more detail, rarely questioning the Existence of a theory. Specific questions are raised by Brealey et al., in their book on Corporate Finance (Richard A Brealey, Stewart C Myers and Alan J Marcus). Nine pertinent questions are raised by the authors.
1. What Determines project risk and present value? The basic question asked is why some of the firms earn superior returns and other cannot. When are superior returns mere windfall gains? For how long firms enjoy such gains? Can such gains be anticipated?

2. While citing the risk-return, these authors have said CAPM is hard to prove or disprove conclusively. CAPM is incomplete but extremely useful way of linking risk and return.

3. Further they ask are there any important exceptions for the Efficient Market Theory? Why asset prices go out of line is not understood by the theory.

4. They have observed that managers and employees co invest with stockholders and creditors human capital from insiders and financial capital from outside investors, very little is known about this co investment.

5. They feel that still coherent and accepted theory for capital structure is not available.

6. Why firms pay dividends is not fully understood as yet.

7. The wave of merger was observed in 2004. Till 2002 firms were not keen for mergers and all of a sudden the financial fashion of merger was experienced. This is not fully understood by the researchers.

8. What is the value of Liquidity? When firms maintain cash as a precautionary measure the cash is considered as liquidity. This cash has value which is seldom considered.

9. Why financial Systems are are prone to crisis? The situation of crisis is never satisfactorily explained by the academic literature.

Besides this, anomalies in the financial performance analysis are experienced.

In the analytical tool like Ratio Analysis, There are benchmarks like Debt : Equity ratio is preferred to be 2:1. This ratio of 2:1 is very subjective and cannot be taken as target ratio.
There is a strong possibility where 4:1 or even 6:1 ratio could be observed and tolerated without any problem.

While studying working capital, when the statement showing changes in working capital is prepared, whether provisions be considered as current liabilities or not, is a gray area.

Whether unsecured loans be considered while calculating the working capital as current liabilities?

When profitability of a firm is assessed then whether EBIT/Operating Profit should be considered? Or PAT should be considered?

**1.4 SOME RESOLUTIONS IN FINANCE -**

Even though there are certain anomalies and unanswered questions, there are definite answers for quite a few concepts, as elaborated in various text books on Corporate Finance. However, the researcher found that Breley and Myers (Richard A Brealey, Stewart C Myers and Alan J Marcus) have summarized the same in a lucid manner.

What we know about finance- the seven most important ideas in finance

1. **Net Present Value (NPV)**- this is most valuable concept in finance and is the only way of evaluating the assets. All the corporate finance managers strive for increment in NPV.

2. **Capital Asset Pricing Model (C A P M)**- Provides thinking about Risk and Return. This model tells us that assets have two kinds of risks diversifiable and undiversifiable. Only the non-diversifiable or market risks count. So Assets return is a function of market risk and risk premiums are calculated as direct function of market risk measure, beta.
3. Efficient Capital Markets- believes that security prices reflect information accurately.

The three forms viz. Strong, Semi strong and Weak form give us the degree of efficiency. It is good to observe that capital markets are by and large efficient.

4. Value Additivity and Law of Conservation of value- states value as a whole is given by the sum of its parts. Its implications on mergers and acquisitions states that value is not added unless combined firm produces better cash flows than either firm produced when it was independent.

5. Capital Structure Theory- Miller and Modigliani stated that in perfect market, changes in capital structure do not change the value of the firm.

6. Options Theory-In finance options means more than alternatives, it means opportunity to trade or not to trade, in future, on terms that are fixed today.

7. Agency Theory-Helps us to explain why complex contracts and arrangements are needed in many corporate transactions. An organization comprises of many men, women, lenders, borrowers, shareholders, customers. The conflicts cannot be eliminated completely but understanding them can help us get the best working results.

For these theories the explanation of the relevance and usefulness has been established. In facts because of the same theses are considered the theories of corporate finance.

1.5 THE RESEARCH CONCEPT

Besides the above theories there are large number of Theories / Concepts / Approaches in the domain of corporate finance. The theory is efficient when it explains or answers the relevant concepts. An effort is made to know whether select corporate finance theories are relevant in present time or not? By the researcher. so to understand the efficacy of the theory researcher attempted to review the research papers and articles, in detail, relevant to the specific Theory/ Concept / Approach.
The broad classification of select corporate finance theories has been done as

A. The Financing Decisions
B. The Investing Decisions
C. The Dividend Decisions
D. Other Decisions

Further the relevant theories / concepts / approaches were considered as per the individual decision.

1.6 – THE CHAPTER SCHEME -

The research work carried out by the researcher has been elaborated in Seven chapters as elaborated below -:

1. **Prologue**

The rationale of this study has been explained in the chapter-1, Prologue. The researcher experiences several anomalies and confusions while practicing the as a faculty in the business management School as well as in professional life. What is a theory? What is a concept? How an approach is different than theory and concept? If there is a difference then why the thinkers and researchers in the field of corporate finance use these words interchangeably? Were the questions in the mind of the researcher. Can clarity of thought be achieved? Can some demystification be made possible? Was thought by the researcher.

In this chapter what we know of corporate finance? And what we do not know about the corporate finance has been briefly discussed. As stated earlier four broad aspects viz. the financing decisions, the investing decisions, the dividend decisions and the areas which are relevant but cannot be classified in these classes are considered in other decisions.
2. Research Methodology

The various types of research, the discussion about qualitative and quantitative research including the comparison have been discussed in this Chapter-2 of Research Methodology. In the domain of the quantitative research, which specific type of research is suitable for this study has been discussed. The methods of Qualitative data analysis have been elaborated in research methodology. The theoretical concepts / beliefs are considered as normative statements for each relevant theory, the exhaustive list of such normative statements has been provided in research methodology. The process of analyzing the data and arriving at the inference with the help of descriptive statistics has been elaborated.

3. The Financing Decisions

In Chapter-3, the crucial function of making the financial resources available for the enterprise is studied in the financing decisions. The relevant theories / Concepts / Approaches are considered and an effort has been made to study the relevance of these, for the same. The relevant research papers / research articles were studied in detail and congruence or rejection or indifference was noted and analyzed.

4. The Investing Decisions

The Investment aspect and financing are interlinked. In Chapter-4 largely the capital budgeting related decisions are considered in investment decisions. As mentioned above, in chapter-3, the relevant theories / concepts / approaches related with the investment decisions were studied and the researchers’ views on these theories / concepts / approaches were analyzed.

5. The Dividend decisions
In Chapter-5 Dividend theories are studied. The relevant theories /concepts / approaches with respect to dividend decisions are considered. The specific theories like bird-in-hand theory, clientele effect are the dividend decision specific theories, discussed in this chapter. The researchers findings/ conclusions and the relevance of the same with the existing select dividend theories / concepts / approaches were analyzed to find out the usefulness of such theories in present context.

6. Other Decisions

Corporate finance theories which cannot be classified in Financing, Investing and Dividend decisions are classified in other decisions. In Chapter-6 such theories / concepts / approaches are considered. Concepts like Average Rate of Return (ARR), Behavioral Finance, Cash Flow, Corporate Governance, E V A , Tobin’s Q, Profit Maximization, Prospect Theory, Tunneling effect are considered in this chapter. The relevance of these theories / concepts / approaches in the light of researchers’ conclusions were analyzed.

7. Epilogue

In Chapter-8, Epilogue, the review of the study of all four selected broad categories of corporate finance theories has been taken. The present status of these theories/ concepts / approaches on the basis of the analysis done by the researcher is explained. Besides this further more areas which are largely remaining un-answered till date have been enlisted. Though researchers are trying to find logical solutions since long, no conclusive answer in seen in the vicinity.

8. Bibliography

The detailed references and bibliography has been enlisted in this concluding section of the chronicler.