CHAPTER – 2

REVIEW OF LITERATURE

Knowledge is growing by leaps and bounds in all the fields. This can be ascribed mainly to constant research work being undertaken by scholars, researchers and writers. There is a tremendous increase in the number of publications: books and periodicals in the concern subject. This implies that a researcher has to read voraciously and regularly update himself with relevant issues in a particular subject. This calls for a meticulous survey of the available literature in the chosen field by the researcher. Such a survey of various books, periodicals, journals, reports, dissertations and theses is also known as Review of literature.

In India, there have been significant changes in the capital market over the last few decades. The government rules and regulations have also been changing from time to time. Hence, the expectations of the investing community have also changed in keeping with the aforementioned changes. How the corporates raise funds and utilize the same has become a make or break point so far as the financial performance of the corporate world is concerned. Leverage has always been and continues to be the buzz-word for the corporates and the investors as well as other stakeholders.

The word ‘Leverage’ sounds like it has a positive ring to it. But the reality is as different as chalk from cheese. It has its pros under a particular set of financial circumstances and also its cons in a different set of financial circumstances. Financial Leverage has always been a favourite topic with the business community as well as the academia. It evokes a full gamut of responses from both the teaching community and the business community. To fully gauge this diversity of opinion and body of work, several books, journals and articles were reviewed to undertake theoretical study of Financial Leverage and its impact on Financial Performance of corporate entities. In this study utmost care has been taken to include as diverse literature as possible on the theoretical aspect of the topic and findings and exploratory studies.

In marketing the concept of Product Life Cycle (PLC) prevails. According to this concept every product undergoes four stages during its entire life, as it were. The stages begin with introduction of the product and end with death or decline of the product. In a similar fashion, every business entity has to pass through different
stages. In the initial stages the degree of Financial Leverage should be rationally incorporated. The debt as a source of fund has to be rationally employed or else it can endanger the survival of the firm in the very first stage of its inception. As the business unit gets more stable, mature and growth bound with greater certainty of income, it can enhance the debt element in its capital structure. However a firm facing dwindling of financial performance due to intense competition or stagnation cannot afford to resort to debt funding. Thus all the firms must take the call on use of debt with utmost care and caution.

The review of literature has briefly summarized as follows:

**FINANCIAL LEVERAGE AND LIQUIDITY AND PROFITABILITY**

2.1 **Rajan and Zingales (1995)** discuss various accounting based measures of leverage and their information-related content. They have suggested that to facilitate the proper measurement of leverage, the measure itself should be based on the objective of analysis. It cannot be selected randomly. They propound that the ratio of total liabilities to total assets cab be considered appropriate if the matter pertains to what is left for the shareholders after liquidation, but it is not at all a good indicator of whether the firm is likely to experience bankruptcy in the near future. They also state that the bills (payable and receivable) which are invariably included for ratio calculations are in fact used only for financial transactions so their inclusion leads to inaccurate assessment of the financial position of the firm. There is still one issue of concern since the measure contains liabilities that are not related to financing e.g. pension liabilities, thereby underestimating the size of leverage. The ratio of total debt to capital is defined as total debt plus equity, is assumed to solve this problem and they opine that it can be seen as the best accounting based proxy for leverage.

2.2 **Doron Nissim and Stephen Penman (2001)** have tried to analyse the favourable and unfavourable impact of leverage on the profitability of various companies. The paper also distinguishes the profitability of Operations from the profitability of Financing Activities.
The paper outlines the mathematical equations and derivations regarding the impact of financial leverage on the shareholders’ profitability. The authors have also presented the impact that financial leverage has on the shareholders’ value. The authors have briefly stated the age-old theories of capital structure such as the pecking order theory or traditional trade-off theory etc. the paper goes on to analysing the shareholder profitability that arises from operations and it also distinguishes such profitability from that which arises from borrowing to finance operations. The paper presents a financial statement analysis that identifies the effects of financing liabilities on rates of return on book value with explicit leveraging equations that explain when the leverage is favourable and when unfavourable with the help of a case of Dell Computers, USA. The authors have stretched the concept of leverage from very basics to its intricate impact on the profitability and the mathematical presentations of the same.

2.3 The authors Ram Kumar Kakani, Biswatosh Saha and V. N. Reddy (2001) have attempted to provide an empirical evidence of the widely held existing theories on the determinants of firm performance in the Indian context. The authors emphasise on the fact that analysis of the determinants of firm performance is of utmost importance to all stakeholders of a firm, especially to its common equity investors. For this purpose, the authors have used financial statement and capital market data of 566 large Indian firms over a time frame of eight years divided into two sub-periods (viz., 1992-96, and 1996-2000) to study Indian firms. Financial performance across various dimensions viz., shareholder value, accounting profitability and its components, growth and risk of the sample firms and leverage component the capital structure. It reveals that even on the same data, the determinants of market based performance measures and accounting-based performance measures differ due to influence of capital market conditions. In the process of research the authors have found that unlike leverage component, the size, marketing expenditure, and international diversification had a positive relation with a firm’s market valuation. Apart from these firm attributes that reflect either operating parameters of firms or strategic choice of firm managers, the authors also found that a firm’s ownership composition, particularly the level of equity ownership by Domestic Financial Institutions and Dispersed Public Shareholders, and the leverage of the firm were important.
factors affecting its financial performance. The different implications of the findings for various stakeholders of a firm have also been discussed in the paper.

2.4 Jean-Philippe Bouchaud, Andrew Matacz and Mark Potters (2001) have tried to investigate quantitatively the so-called leverage effect, which corresponds to a negative correlation between returns earned in the past and future volatility.

The authors have worked on the impact of financial leverage on the liquidity and possibility of returns and the resultant variations in stock prices of different companies. They aver that the perception of the investors is affected by the use of leverage. As such stock prices variations and its impact on derivatives are not in the purview of this research work. They have presented several models for the same such as a one factor leverage model, retarded model etc. which are again not within the purview of this research work. However, the authors have observed that most (57%) of the companies which are listed in France and those which have issued debt instruments to raise finance have done so when the markets were not under recessionary pressure. But when the markets showed signs of slow-down, the investors almost had a panicky approach and viewed the presence of debt in the capital structure as a sure recipe for lower returns. They got rid of the stocks expecting the companies to experience financial distress. This further adversely impacted the prices at which such stocks were traded at the bourses. This research again reaffirms the beliefs about leverage that have always been prevalent.

2.5 In a paper titled “Theory Of Capital Structure – A Review” published in a business magazine called “Norway Business World” in 2004 the author Stein Frydenberg has initially examined the popular capital structure theories such as pecking order theory and trade-off theory. He then proceeds to propose that leverage increases with fixed assets, non-debt tax protection as also with firm’s size and other investment opportunity. Conversely leverage decreases with volatility, advertising expenditure, and the probability of bankruptcy, profitability and niche products. The author portrays the effects of tax reforms in Norway on the financial markets and the subsequent views of the investing
community on the profitable avenues of investments and how they look upon the instruments of debt as an investment avenue. He proves that tax system matters for the debt ratio. That so many firms resort to debt funding merely because it reduces the tax burden on the corporate and that the control over management is not compromised. He opines that debt plays a major role in deciding the type of industry that is promoted.

The capital-intensive industry is assumed to fetch better returns than the labour-intensive industry. He opines that debt can be used to control management incentives by setting debt level so high that an investment in labour-intensive industry is not feasible. He concludes that how a company gathers its finance remains enigmatic. And that the capital structure is not bound in any watertight compartment, hence a firm may float bonds and debentures at one time and the same firm may choose equity for capital formation at another. Not always these decisions are governed by a single criterion. Debt employment is interplay between what interests are sacrificed and what interests are retained.

2.6 Long Chen and Xinlei Zhao (2005) have sought economic interpretations for two well-known empirical regularities. First, it is well known that more profitable firms tend to have lower leverage ratios, a pattern driven by the preference on internal funds by these profitable firms. Some recent theoretical development has used dynamic tax considerations to explain this phenomenon. The authors have tried to show that the phenomenon largely remains even after these factors are controlled for. Second, through both theoretical and empirical illustrations, the paper attempts to show that leverage ratios can revert to mean mechanically regardless of which theory better describes financial decisions; and that opposite conclusions can be drawn depending on whether financing decisions or leverage ratio changes are studied. Therefore, leverage ratio changes might not be informative in distinguishing the competing theories. The authors also warn that the common practice of relying on the dynamics of leverage ratio changes to draw conclusions on the validity of capital structure theories should be dispensed with. After discussing various capital structure theories in the initial section of the paper, the authors state that more profitable firms have lower leverage ratio. This is observed from the fact that the leverage ratios are too low for profitable and liquid firms. More profitable firms then raise a
significant portion of capital from internal accruals or internal funds and hence they avoid contracting debt. In such a situation, the firms do not really see tax benefits as a major incentive they have to forgo. The authors argue that the amount of debt raised by a firm is dependent on the availability of internal equity. They aver that all the past theories and their own observations point to the fact that there is a negative relation between profitability and leverage ratio. To substantiate this, the authors selected 94,571 observations for the period from 1972 to 2002. The authors carry out univariate analysis, multivariate analysis and multiple regressions analysis of the collected data to draw conclusions. The authors conclude that studying financial decisions and leverage ratios can lead to opposite conclusions. Inferences based solely on leverage ratios changes can be misleading. They contend that the future research that relies on leverage ratio changes to draw conclusions should also show how the leverage ratio changes are achieved through financing decisions. They reiterate that highly profitable firms tend to borrow less and prefer internal funds.

2.7 Murray Z. Frank and Vidhan K. Goyal (2005) have examined the relative importance of many factors in the leverage decisions of publicly traded American firms from 1950 to 2003. The most reliable factors are median industry leverage, market-to-book ratio, tangibility, profits, log of assets and expected inflation.

They opine “when corporations decide on the use of debt finance, they are reallocating some expected future cash flows away from equity claimants in exchange for cash up front.” From the American experience they state that they have disclosed the most reliable factors on the basis of which leverage can be predicted. It is also possible to know the pattern of financing. They have come out with interesting set of factors affecting leverage which are as under:

1) **Industry median leverage**: Firms in industries in which the median firm has high leverage tend to have high leverage.
2) **Tangibility**: Firms that have more tangible assets resort to higher leverage.
3) **Profits**: Firms that have higher profits tend to have lower leverage
4) **Firm size**: Firms that are large tend to have higher leverage.
5) **Expected inflation**: When the inflation is expected to be high, firms tend to have high leverage.
They opine that all these factors are not equally reliable. The last factor-inflation- is the least reliable of all, they suggest. Rather tangibility and profitability are more reliable among the factors. To conclude this they carried out several mathematical tests extensively using the sample data that was largely in congruence with the companies under study. The authors have discussed various theories of capital structure with their own views expressed in absolute clarity. They have also examined the growth story of a firm vis-à-vis leverage. Those firms which are still growing have higher costs of financial distress and reduced cash flow problems and this exacerbates the debt related problems.

2.8 **A.Cevdet Aydemir, Michael Gallmeyer and Burton Hollifield (2007)** have studied the effect of leverage at market and firm level where the firm is exposed to market risk. The authors have also associated stock volatility with leverage which again given the nature of this research work has very little relevance. Among the observations, the authors aver that the presence of leverage not only influences the firm’s profitability and liquidity but also the perception that outside investors or potential investors hold of the company. Financial leverage works in tandem with interest rate prevailing in the market. The authors have theorised the relationship that exists between the proportion of leverage and the profitability and liquidity of a firm. They have also discussed the effect that leverage has at market level. This encompasses the investors’ perception of use of debt, the outlook of the potential investors in the backdrop of fluctuating market conditions. They also aver that cash-flows projection also changes the investors’ vision of degree of risk involved. And cash flow is influenced by debt in the capital structure. They have used time-series as a statistical tool for analysis.

2.9 **Tobias Adrian and Hyun Song Shin (2008)** have attempted to document the relationship between balance sheet size and leverage. They have tried to show that leverage is strongly procyclical and that expansions and contractions of balance sheets have an impact on risk appetite of the corporates. The authors have redefined liquidity as the rate of growth of aggregate balance sheets. They opine that the financial market commentators often use the metaphors such as
“liquidity sloshing around in the market” or markets awash with liquidity do not capture the precise meaning of the term liquidity. The authors have explained the meaning of leverage using household leverage. They aver that leverage is inversely related to total assets. They authors have analysed the financial data of Lehman Brothers, Merrill Lynch, Morgan Stanley, Bear Stearns, Goldman Sachs and Citigroup for the years 1998-2008. They conclude that indeed leverage is procyclical and that leverage is heaving dependent on the size of the balance sheet. In manufacturing firms, they say, it’s the surplus capacity which the firms strive to utilise and for that they have to expand their balance sheet. In the process such firms have to resort to short-term borrowing. Thus expansion of balance sheet also results in expansion of debt-funds.

2.10 Murray Z. Frank and Vidhan K. Goyal (2009) aver that the literature on financial leverage has misinterpreted the relationship between profits and leverage and that highly profitable firm typically issue debt and repurchase equity and typically low profit firms reduce debt and issue equity. In order to analyse and corroborate their opinion they took a sample of 2,26,355 firm year observations from 1971-2006. They used time series analysis and regression analysis and scaling technique for the purpose of analysis. They conclude that the results of their research are consistent with the trade-off theory of capital structure. That implies that profits positively influence debt issuance. They also state, on the basis of the results, that the size of the firms is important because larger firms make more active use of debt and small firms make more active use of equity. It also means that the smallest firm will quite certainly resort to equity and the largest firm will most certainly resort to debt. The effect of firm size is substantially larger on debt issuances than it is on equity issuances. This tendency also affects the profitability of the firms. In the initial section of the paper the authors have discussed the fine aspects of capital structure theories and their impact on the firms. The authors state that the market conditions also influence the choice of debt as a source of finance. The good times at the financial market means that the firms desirous to seek funds would invariably opt for debt. But when the times are turbulent at the markets, firms become shy of contracting debt. That is not all, even the largest of the firms show aversion toward debt when the markets show slightest sign of sluggishness or recession.
2.11 **Ricardo Bebczuk and Arturo J. Galino (2010)** have used the data of 185 listed companies in Latin America and have studied the impact of leverage on profitability among other things such as tangibility, firm size, firm growth etc. . . . This study has been carried out in the backdrop of subprime crisis that afflicted the whole of America in the recent past. They authors aver those firms which have recorder high profitability and whose profits are on the rise over the number of years tend to borrow less and less for capital requirements. This, the authors have observed, is mainly due to the fact that the highly profitable firms enjoy good internal accruals in the form of profits and other incomes. These are diverted toward the deficient areas and external-borrowings are thus averted. The authors selected several companies based in different regions of America so as to avoid bias as regards locational advantages or disadvantages and the set of laws governing the corporates and environmental restrictions peculiar in certain regions. Among the conclusions they have drawn from the research, the one that is significant is that with the cost of borrowing rising in America, the demand for debt has been steadily declining. And that the firms which are expecting to grow tremendously in the near future and expecting to come out with public issue for additional capital avoided the debt instruments so as to avoid being seen by public as a firm with a heavy burden of fixed charges. This view by the investing public can adversely impact its prospects of raising capital through equity. This research paper once again drives home the point that even during the financial crisis the firms did not flinch from raising finance through debt instruments, particularly long-term debt finance. The behaviour of companies towards debt did not change significantly. However, the risk aversion of the investing public does get affected by the prevailing economic conditions in the short-run.

2.12 **V.V. Acharya and S.Viswanatahn (2010)** aver that financial firms raise short-term debt in order to finance asset purchases. When asset fundamentals worsen, debt induces firms to risk-shift which also limits their funding liquidity to roll over debt. Firms can de-liver by selling assets to better-capitalized firms. They opine that that the market liquidity of assets depends on the severity of the assets shock and the system-wide distribution of leverage. The authors exhort a model
that illustrates that in good times firms contract leverage but in the times of the financial crisis this outlook changes. The trigger for this response, in their observed opinion, is nation-wide financial crunch. The authors attempt to study the microeconomic foundation for the connection between market liquidity and the ease of selling assets or the ease of rolling over the debt. The paper discusses in detail the model formation and all the aspects of measurement that are covered by such model. It is followed by elaborate mathematical formulations explaining the model. Among the concluding remarks, the one that is relevant here is that since good economic times are associated with a low cost of short-term debt and in turn greater entry of highly-levered financial institutions, adverse asset shocks that follow such times lead to jettisoning of leverage and asset-price deterioration. It all boils down to how the leverage has been distributed in the financial sector.

2.13 Fabrizio Coricelli, Nigel Driffield, Sarmistha Pal and Isabelle Roland (2010) have examined the relationship between leverage and growth in a group of emerging central and eastern European countries, which are at different levels of financial market development. The began by hypothesizing a non-linear relationship in that moderate leverage could boost growth while very high leverage could lower it by increasing the likelihood of financial distress and bankruptcy. They are of the opinion that there is a connection between leverage decisions and the wider economy of any country. The research paper in the initial stage identifies those firms which have excess leverage – excess of optimal leverage (instrumented by the fitted values of leverage). They have attempted to determine endogenously a threshold level of leverage beyond which leverage has an adverse effect on productivity growth.

Firm level data for twelve transition countries has been obtained from the World Bank for the period from 2001 to 2005. As such the financial norms in European countries are such that not too many firms resort to leverage. This fact has been confirmed by the paper.

The authors observe that the larger firms tend to have greater leverage and smaller firms tend to minimise the use of leverage. This scenario is prevalent in certain European countries and in the rest of the countries it varies from country to country inconclusively.
In countries where excess leverage has been found, it is largely due to poor management of debt issuance on part of the regulatory authorities. The authors employ an Endogenous Threshold Model to base their inferences on. They conclude that indeed excessive use of leverage could hamper growth particularly of those firms operating in countries where the government norms are not stringent enough to prevent it or due to microeconomic inefficiencies in such countries. This adverse impact is further magnified in case of those firms which have failed to post profits in the recent past.

2.14 Dr. Umar Butt (2011) attempted to study the relationship between the policies adopted by the corporates and the degree of leverage in their capital structures. The author avers that those firms which have proper corporate governance practices in place also tend to have higher leverage ratios. He further states that those firms which are enjoying positive relationship between profit and financial leverage have good government practices firmly established. The author investigates as to what are the considerations for selecting various sources for finance and how corporate governance influences the selection of the source. So financial leverage is in the end influenced by corporate governance. The author also segregate various firms into democratic firms and dictatorship firms and observes that the democratic firms resort to debt much more than the dictatorship firms. The author concludes that all the previous studies have not given complete and consistent account of relationship between financial leverage and profitability and that empirical studies point to divergent directions which in reality may not be the case. The author uses the data base of 2229 firms for the years 1990-2009 and for the corporate governance practices he uses the G-index. The G-index reflects the twenty four provisions of corporate governance observed by the firms. He uses Pearson correlation coefficients among the financial leverage, profitability and industry specific control variables for all firms. After univariate and multivariate analysis and robustness test, the paper concludes what some of the prior theories have concluded which is that there is a negative relationship between profits and financial leverage. He also concluded that with strong corporate governance structures in place, managements will employ more debt when profits increase which is not the case with firms with poor corporate governance practice.
2.15 **Prashant Gupta, AmanShrivastav and Dinesh Sharma (2011)** reveal the distinct relationship between capital structure decisions and their impact on the performance of the corporates. For the purpose, they have applied the data of 100 companies listed National Stock Exchange (NSE) of India in a 5-year time horizon. The results of the study conducted by them establish that the capital structure does influence financial performance. They attempted to seek answers to these questions:

1. Is there optimal capital structure?
2. Do firms get influenced by the traditional capital structure of their industries?
3. Are there other reasons influencing the combination of debt and equity?

They have also tested the theory given by Modigliani and Miller (1953) with respect to tax deductibility of interest expenses and its impact on the firm’s value. They opine that the optimal capital structure represents a level of leverage that balances bankruptcy costs and benefits of debt finance. The authors have discussed in detail the impact of financial leverage on the financial performance of the firm and have cited all the authors who agree with their opinion or who are in total disagreement with their opinion. They subjected the data of 100 companies to various mathematical testing procedures and concluded that the firms which employ high leverage beyond the optimal level do experience some dwindling in their profitability factor and it can result in significant financial distress. They also derived that the company that has high profitability and good performance have less debt. They substantiate these results with those promulgated by other prominent authors namely Mayers, Stulz, Rajan and Zingales. They also suggest that to investigate the changes in capital structure of any firms, the data selected should cover a longer period of time because the changes in the financial performance due to changes in the capital structure are imperceptible in the short run and can be influenced by a particular economic cycle. They also believe that the analysis could be improved by differentiating between types of debt such as long-term and short-term.
2.16 Aasia Asif, Waqas Rasool and Yasir Kamal (2011) have examined the relationship between dividend policy and financial leverage of 403 companies, listed with Karachi Stock Exchange during the period 2002 to 2008. In the initial section the paper discusses the relation between earnings of a company and its impact on dividend distribution. The paper discusses in detail the age-old conundrum of the company that huge dividend pay-out means too much reliance on external equity and miniscule dividend pay-out means disappointing the shareholders. The paper tests the dividend policy, vastly followed by the companies, by applying the extended model of Linter (1956) with the debt ratio of the firm, the previous year’s dividend yield as its independent variables and change in earnings as a dummy variable. At first, the authors calculate the descriptive statistics for entire variables and then correlation matrix was calculated to identify the preliminary relationship among all the variables, followed by regression analysis on panel data to examine the significance and magnitude through fixed and random effects models. Theoretical assertions have been justified through random effect model that the level of corporate debt (leverage) and widely practiced dividend policy, significantly, affect the dividend policy of the Pakistani firms. On the other hand, financial leverage is found to have a negative impact on dividend pay-out, indicating less dividend payments by highly levered firms. The authors also concluded from the findings that change in earnings has no significant impact on dividend policy in case of Pakistani firms while the dividend yield has positive impact and vice versa. Fixed effect model, applied for the study, supports only the significant effect of dividend yield on dividend per share. The paper brings to the fore an amusing point that sometimes firms have to borrow for its financial requirements and then notwithstanding the huge financial burden that these borrowing entail, the firms borrow even more, although at subsided rate, to distribute sufficient dividend to equity shareholders.

2.17 Puwanenthiren Pratheepkanth (2011) states that the relationship between capital structure and financial performance is one that has received considerable attention in the finance literature. How important is the concentration of control for the company performance or the type of investors exerting that control are questions that authors have tried to answer for long time. The study of effects of
capital structure on financial performance will help the academia and the financial managers and the stakeholders to know the potential problems in performance in relation to capital structure. The author clearly states the hypotheses as H0: There is a negative relationship between capital structure and financial performance. H1: The capital structure has significant impact on financial performance. H2: There is a positive relationship between capital structure and financial performance. To produce the above mentioned research objective, the data for this study was gathered from the financial statements as published by Business Companies. Another source of data was through reference to the review of different articles, papers, and relevant previous studies. For this purpose, data of those Business firms are used which are listed on Colombo Stock Exchange. All firms are taken for the study representing the period of 2005-2009. After carrying out the correlation analysis of the data, the conclusions suggest that the null hypothesis is accepted. So there is a negative relationship between capital structure and financial performance. The author also suggests in the end that performance standards should be established and communicated to the investors so that investors can take better investment decisions and that the limitations and possible negative fallout from the investments should be clearly identified to improve the firm’s financial performance.

2.18 **CA Sachchidanand Pachori and Dr. Navindra Totala (2012)** made an attempt to study the influence of financial leverage on the shareholders’ return and market capitalisation of automotive cluster companies of Pithampur, Madhyapraesh, India. Their study covers five years’ time period from 2006-07 to 2010-2011. Apart from dealing with the basics of Financial Leverage, the paper clearly explains the impact of leverage on the profitability of the automotive industries of the region. The authors opine that the shareholders returns are affected by the efficiency of all commercial, operational and financial activity of the enterprise. The authors have discussed in the detail the financial ergonomics for the automobile part manufacturing units. Pithampur is also known as the Detroit of India as all the major auto companies are based here. All these companies operate in a huge cluster and have not only similar products portfolio but also employ similar sources of finance to finance their operations.
The authors have traced a common pattern in some of the major companies of the region and the obvious advantages of operating in a cluster. They have observed that shareholders of the firms with risk-laden debt will invest only when or up to the point at which, the expected return on investment is at least as great as the promised payment to bondholders. They imply that if the expected return is less than the promised payment, the shareholders invest less than the optimal amount or do not invest at all. Then, the firm value declines resulting in restricted use of debt. They suggest that even if the rate of return on equity is high but if the amount of financial leverage is very high the shareholder will ask for premium to cover the added risk. Their findings indicate that there is not significant influence of financial leverage on shareholders’ return and market capitalisation. They conjecture that there may be other non-quantitative factors which may lead to nullify the impact of financial leverage on shareholders return like recession, saturation of auto industry, competition and government policy. They conclude that financial leverage is a speculative technique and that there are special risks and costs involved with financial leverage and there is no guarantee that financial leverage strategy will be successful during any period in which it is employed.

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2.19 Alan J. Auerbach (1983) has revealed that the financial policy of any country is widely distorted by differential treatment of debt and equity. He attempted to examine using firm-level panel data of 200 corporations, the relationship between real and financial decisions by corporations, in part to determine the extent to which biases offset or reinforce each other. He has critically evaluated all the capital structure theories in detail including the ‘all debt’ theory by Modigliani- Miller and the Bankruptcy/Agency Cost theory. He has explained the determinants affecting the type of debt-funds raised by the firms and also their tenure i.e. long-term borrowing and short-term borrowing. The author has analysed the relationship between optimal financial structure in the context of prevailing tax-structure and the choice of debt-equity ratio. He opined that under some models of debt-equity choice, there may be a tax advantage to the use of debt finance which is dissipated by other costs to the firm as leverage increases. He pointed out that the choice of debt as a source of
finance was highly dominated by the consideration of obvious tax benefits. He has observed that the firms which had huge amount of debt in its capital structure were also highly inclined to undertake very risky projects which upped the possibility bankruptcy and that the shareholders should constrain such firms so as to avoid the untoward consequences. The firm with narrow choice of sources of funds would generally never walk the path of debt thereby avoiding the pitfall of possible bankruptcy.

He concludes that the risky firms and fast growing firms should borrow less because of fluctuations in earning and greater tax shield available from depreciation on assets and investments inducing tax-deductions. For the same reasons other firms which have assets and investment which can reduce tax-liability should also avoid contracting significant amount of debt.

2.20 Michael S. Long and Ileen B. Malitz (1988) have tried to investigate the type of investment opportunities facing a firm influencing the financial make up of it. They began by assuming that if the firms had no compulsions, it would choose lower degree of leverage in its capital structure. Then as the pecking theory suggests the firm will use up its internal resources first since they are least costly and least burdensome. The authors have delineated the theories given by Modigliani- Miller, Myers and Baxter in the context of choice of leverage and its impact on the capital structure of a firm.

They concur that the type of investment opportunities available largely dominates the choice of dosage of leverage. If a firm can focus its R & D on projects with a low probability of extremely high returns, it is difficult for others to evaluate the level of risk involved because R & D is closely guarded bastion for any company. Here the firms may indulge in higher degree of leverage and then shift the risk imperceptibly. In the 1980 theses issues were hotly debated in the world of finance and hence the authors have discussed them in great detail. This paper reveals that when firms chose to be levered or not to be levered, the parameters to do so are vastly different such as taxation, the type of business, investment opportunities, financial market trends, actual internal accruals and projected accruals, government policies, general market conditions, type of assets i.e. tangible assets and intangible assets, etc. it cannot be predicted or takes for granted that the firms are leverage- averse.
2.21 **M.Barclay, C. Smith and R. Watts (1995)** have observed that those firms which are on the growth path have been found to have lesser and lesser amount of leverage. Not only that but even those firms which contract less amount of debt also tend to grow faster when their results are compared with their own historical records. They have also revealed that majority of the borrowing firms were considering ways to dispose of debt but were not able to do so for lack of finance. Debt also hampers the inclination of the firms to dole out dividends. This observation they have based on the data of various corporations. They have observed a distinct possibility that when the firms contract debt they are very circumspect with regard to giving out huge amount of dividend out of apprehension that in future when they are not able to service debt they can fall back on the cash reserves to get rid of the debt. This sense of urgency drags their feet when it comes to giving dividends that are due to the shareholders.

2.22 **Gerald Garvey and Gordon Hanka (1997)** have presented a model in which a manager controls the firm’s dynamic capital structure in his own interest, increasing leverage to stave off takeovers and decreasing leverage to fend off financial distress. They are of the opinion that those firms which have high degree of leverage can easily protect themselves against any takeover bids. At the same time, the thing that the firm has to take care of is to ensure that the cost of servicing the debt should not be so much that it puts undue financial distress on the firm. The takeover aspects are not exactly within the purview of this research work but this paper is worth taking note of in that it teases out a completely new strand from the whole issue. As usual the authors have discussed the theories of capital structure in detail in the context of conditions – favourable and unfavourable- for raising finance through debt and its implications. The paper also deals with managerial discretion with respect to the accepted maxim of wealth-maximisation. They have categorically stated that the managers while contracting debt do not always have the axiom of wealth-maximisation in their mind. If the company is profitable and the burden of debt is light, the managers will gladly perpetuate such sub-optimal composition until some rival firms let them get a whiff of possible take-overs, if the managers don’t realise that lower degree of leverage will make the firm vulnerable to takeover bids. The paper delves into the mathematical aspects of leverage and
analyses it vis-à-vis hostile takeover incidents in the companies across Canada. It concludes that leverage in the capital structure is a shield not just against taxation but also against the preying claws of the rival companies.

2.23 Kuljot Singh and James E. Hodder (1999) have addressed the multinational capital structure decisions and the overriding concerns for the same. They have propounded that when the companies reduce the use of leverage or avoid employing debt in their capital structure, the valuations of the firm improve drastically. Also that those firms which are in the negative light due to high amount of debt can change the scenario by getting rid of excessive debt. Their opinions rhyme with myriad other opinions that tax-bite mitigation is not the only criterion to indulge in debt. And that leverage is a dangerous weapon as it can hurt the holder of such weapon if used indiscriminately. They have carried out data analysis of several MNCs to deduce that when the business environment experienced by the MNCs is eclectic by nature that the companies have to manage the parent units and subsidiary units within the country of origin and beyond the borders to other country/countries on in terms of foreign currency fluctuations and earnings and exchange rate differences and differences of vastly different tax regimes. This research is of great value in terms of comparative analysis of different companies with very different backgrounds and therefore governed by different set of laws. They conclude that the companies that operate in low tax imposing countries have relatively stable market value because the debt or no debt situations do not impact them significantly. When this is compared with single country company within high tax imposing country and having sizable amount of debt in its capital structure, the authors say that such companies do experience negative market valuation and have adverse impact on the profitability and liquidity of the companies in the face of uncertain market conditions. They have considered political stability as one of the factors affecting the financial performance of various companies or the expansion plans within the country or outside the country.

2.24 Bernadette Minton and Karen Wruck (2001) have examined the phenomenon of financial conservatism by studying firms that adopt a persistent policy of low leverage. The word financial conservatism is taken to mean that the firms adopt
a highly cautious approach to borrowing of funds and therefore tend to be under-levered. This behaviour belies the dominant capital structure theories promulgated by well-known authors of finance. They have taken a sample data of 5,613 companies for a period of 25 years (1974-1998) to examine and test the aforementioned policy of low-leverage or financial conservatism. After thoroughly analysing the data and applying empirical evidence they found that those firms which are capable of raising funds through debt but have sufficient internal resources do not give top priority to debt as a source of finance. Secondly, when such companies change their financial policy they do increase the leverage component and more than half of the companies did drop the aversion to debt completely, they observe. They have also concluded that once such companies drop the policy of low leverage, they never return to the policy of financial conservatism. They have also concluded that such behaviour is just peculiar to any one particular industry but rather prevalent in all types of industries. That means that the low-leverage phenomenon is transitory, they aver. They also propound that the companies stick to the low-leverage policy as long as they have high internal flow of funds and cash balances. The companies consider leverage as option only when either their cash flows deplete or when their cash outlays increase. They conclude the discussion that those companies which are avoiding high leverage are those that do not have low tax rates or have other tax shields to make up for the absence of debt as tax-shield. This shows, as they opined, that taxes are an unimportant factor in leverage decisions. Taxes neither make contracting debt look attractive nor do they make conservative firms avoid debt as an instrument of finance.

2.25 Susana Menedez Requejo (2002) examined the importance of different theoretical proposals that explain a firm's capital structure in relation to the existence of an optimal debt ratio, the preference of the firm for internal financing and the overriding concern of financial constraints. The author carries out the contrast of the relative importance of these theoretical proposals from a structural equation model on the database of the (Business Strategies Survey) for Spanish firms in 1998. The database is made up of the firms selected by the Spanish Ministry of Industry and Energy. The sample thus chosen consists of 1,425 small and large Spanish firms which is the very basic point in order to
examine the theoretical proposals. The paper discusses the basic capital structure theories interspersed with opinions of well-known authors in the initial stage. The analysis of the importance of different theoretical proposals is carried out with the help of estimation of Structural Equation Model. The author confirms what has been stated before by many researchers, that the preference of a firm to opt for internal financing as against external debt funding is reasonable. Agreeing with the empirical studies, the author states that a firm’s capital structure is a result of hierarchical financing and that debt funding comes much lower down the order on the list of preferred sources of finance even in case of large firms. The author observes that the small firms had 62% leverage which is higher compared to 54 % in large firms. That is because the large firms have greater internal fund generation to fall back on in case of financial needs. And that capital structure decisions, be it for small firms or big firms, are heavily influenced by availability of internal funds and that sectorial debt ratios are determinants of capital structure in almost equal proportion. The findings also suggest that small firms do not defer the investment decision and leverage decision even if the financial costs are higher.

2.26 Nancy Huyghebaert and Linda M. Van de Gucht (2002) investigate the initial financial structure of business start-ups. The paper focuses on true entrepreneurial start-ups that are first-time operations. In other words, these firms do not arise from the split-up of another firm. The reasons why this niche was chosen have been stated as being that the new start-ups are not new divisions of existing firms or incorporations of a previously self-employed activity. Such start-ups are unique relative to established firms in that they have no prior financial and operating history, and hence no reputation. Such firms manage to borrow mainly on the basis of what they purportedly bring to the table for the lending agency with no benefits of prior history or established reputation. Ownership and managerial control are not separated, and entrepreneurial private benefits of control can be quite large. Furthermore, the anticipated default risk is high compared to more mature firms. The paper argues that the impact of determinants of capital structure will vary depending upon the stage of firm life cycle.
If such firms are spin-offs from well-known corporates, they have a certain amount of history and reputation and so they don’t exactly fall in the category of “just born” firms. Although it has little relevance to this research work in terms of form of business, the overriding financial concerns and the ways to mitigate risk and taking the call on important issues of liquidity and profitability are of universal importance. The paper states that such firms opt for bank loans as against bank credits chosen by mature firms. For the research purpose, the authors randomly chose the sample of 244 firms founded in 1992 in the manufacturing sector after removing complexity and heterogeneity of data, thus ensuring homogeneity in the entire sample. The paper carries out cross-sectional regression analysis of the data. The authors conclude that in the initial stage of life cycle, the firm contracts debt whose maturity period is longer and the firm tends to borrow on slightly tough terms as dictated by the lending agency. That is also the reason why they face high default risk. However, as the authors state, the lending agencies do not maintain very stringent screening and monitoring policy as normally seen in case of giant corporates. That spawns reckless borrowing on the part of newly born firms. This is possible because the lending agencies are not perfectly informed about the quality and sustainability of the new venture. The firms which prefer to retain control over the business, also resort to bank loans because banks do not interfere in the day to day conduct of the business and they intervene only in case of financial exigency. The paper observes that the greater the need for control by the firm, the longer will be the duration of bank finance.

2.27 Michael Faulkender and Mitchell Peterson (2003) have begun with a belief that majority of the firms are under levered. They have studied the behaviour of those companies which are governed by and are constrained by debt regulations in comparison with those firms which are free to choose their source of finance without any constraints at all. They say that the empirical evidence they have come across suggests that if the firms are not restricted to raise finance through debt, they tend to contract 35 % more debt than under normal condition of restriction. The paper also attempts to analyse the impact of disclosure requirements and the firm’s inclination to raise debt. They also confirm what has always been believed that as firm is able to build more tangible assets, it also
significantly whets its appetite to incorporate debt in its capital structure. And the firms with volatile assets foresee greater financial distress and therefore carefully avoid high degree of leverage. Such firms prefer to go to banks and do not access public markets. They have touched upon the rating aspect of a firm. The firms with bond rating tend to issue long-term bonds and those without tend to opt for shorter tenure of debt. They observe from the capital market study that the big manufacturing companies resort to debt funds eagerly and successfully because they are relatively better known in the established and categorised market. They have observed typical debt-aversion in the small firms primarily because they are fettered by the law.

2.28 Petia Topalova (2004) has used firm level data to examine the performance of India’s non-financial corporate sector since 1989 and to evaluate its financial vulnerabilities. The author states that in the early 1990s, particularly the reforms of the year 1991, the trends in liquidity, profitability and leverage were promising but after 1996, the Indian corporate sector has seen a sort of reversal in the trends. The author maintains that although the key parameters and indicators are at comfortable levels, examination of the balance sheets of Indian companies reveal that there are quite a few companies having problems servicing their debts obligations and this, he says, is a wake-up call for the Indian economy. The author also discusses the legal framework for the corporate sector in detail. Due to growing equity funding, the debt-equity ratios of the firms under study has fallen consistently, he observes. Indian companies do depend on debt finance including bank finance. The average debt to equity ratio for Indian companies bottomed out at 1.2 in 1996 but in 2002 it again rose to 1.4. The paper also observes that the in 1990s Indian companies became less liquid as the current ratio which was 1.64 in 1990 dropped to 1.49 in 2001. The relevant observation is that as the profitability of Indian companies declined, the maturity structure of debt shifted towards short-term borrowing. In 2002, 30% of the companies were not able to generate enough cash to cover interest payments which is risky for the investors. The paper is useful with respect to study of financial behaviour of Indian companies and the paradigm shift in its preferred sources of finance and the attendant impact on the financial performance the Indian corporates.
2.29 Vassil Mihov (2005) attempts to investigate the motives for issuance and the debt choices of 427 U.S.A. firms which issue long-term debt for the first time in their history between 1971 and 1999 which in author’s opinion is a natural laboratory to investigate such issues. Their first debt issues are very large relative to firm size and represent a permanent shift in firm financing policy. The author states that the amount of debt issued was mainly because of deficits in internally generated funds needed to finance investments and not so strongly related to deviations from target leverage structure. For the purpose of analysis the author employs Linear Regression Analysis technique. In the three (or five) years following the initial issuance, the firms remain significantly under levered, and their deviations from target leverage are not strongly related to subsequent issues of debt and equity. The firms tend to remain under levered in the initial 3 to 5 years even after issuing debt which indicated that they adopt financial conservatism. However, firms finance their external deficits with large amounts of external equity as well - while internal cash flows provide 80% of the their funds and subsequent debt issues track deficits more closely than equity issues, equity issues fund approximately 40% of the initial and subsequent deficits. He further states that financial deficits also affect strongly the likelihood of issuance of debt and equity together. He also examines the source and maturity of new debt and avers that initial debt issues have relatively short maturity and are overwhelmingly not rated, with the number of rated issues increasing afterwards. He states that firms with large financial needs are more likely to issue rated debt and longer maturity debt. Overall, financial deficits appear to be main motivating factor for the firms to opt for debt. He further concludes that the firms prefer to borrow only so much as is required i.e. internal funds are used first and then if need be, debt funding is resorted to.

2.30 Thomas Dangl and Josef Zechner (2006) propound that if the debt maturities are long, and if the firm is performing poorly, there is naturally a need for the firm to reduce the amount of debt. But because the maturity period is so long, it will negate the incentives to equity holders to reduce leverage in response. By contrast, a sufficiently short debt maturity commits equity holders to implement such leverage reductions. However, a short debt maturity also generates transactions costs associated with rolling over maturing bonds. In the paper the
authors have attempted to show that this trade-off between higher expected transactions costs against the commitment to reduce leverage when the firm is doing poorly is possible and this can also give the firm an optimal debt structure in terms of maturity period. The paper further states that since firms with high costs of financial distress stand to benefit the most if the leverage is reduced, they have a stronger incentive to issue short-term debt. The debt maturity required to commit to future leverage reductions decreases with the volatility of the firm's cash flows. If the firm is pushed to bankruptcy by a persistent series of low cash flows, then equity holders lean towards issuing debt to refinance maturing bonds, even when debt maturities are short. So the behaviour of equity shareholders is not adamant and it rests on the financial performance of the firm. Apart from discussing the basic theories of leverage and capital structure, the paper also highlights the fine aspects of re-negotiations with debenture holders if the firm has to resort to debt restructuring. More importantly, the authors conclude what they had started off with. The paper also suggests a model with help of which a firm can decide the proper duration for which the debt can be issued such that the positive effects of short debt maturities can be balanced against the dreadful transaction costs associated with floating long maturity debt. This the authors call as an optimal debt maturity theory. They also aver that their research work agrees with empirical studies which show that firms readjust their capital structure if they are highly levered and that if the firms have a huge amount of long-term debt in their capital structure and are facing financial distress, they show reluctance to reduce debt. But if their capital structure has a high portion of short-term debt, they may be willing to tinker with it to reduce it.

2.31 Rahul Kumar (2007) has attempted to critically investigate the underlying factors that affect firm's financial leverage from the perspective of theoretical underpinnings. The paper reviewed 107 papers published from 1991 to 2005 in the core, non-core and other academic journals. On the basis of critical review, the paper has identified a number of determinants of financial leverage based upon logical arguments identified in the literatures. Major findings show that various frameworks like leverage irrelevance, static trade off, pecking order, asymmetric information signalling framework are useful in understanding the underlying factors determining the firm's financial leverage, there is no
consensus and there is no universal factor determining financial leverage. The paper sets out two challenges for future research: one, how to integrate different factors determining firm's financial leverage into a common framework and second, what are the explanatory factors determining firm's financial leverage in a network phenomenon. In the initial sections the paper discusses all the basic theories of financial leverage and implications of different financial situations. The distinct part of the paper is where the author has listed out all the possible factors or determinants affecting the leverage decision and their impact on the financial position of a firm coupled with various authors’ opinions on the same. The author has reviewed a huge body of the research work done the leverage and presented the same from different viewpoints. He has also pointed out the areas where old theories do not explain the full impact of leverage in the dynamic market conditions. He has also mentioned the topics on which consensus exists among authors and those areas where they hold divergent views. The paper is useful in that it has thrown insightful light on issues such as impact of tax rate, firm size, market conditions, value of assets held by the firm, market regulations and government control on the leverage decision by the firm. He has also mentioned the holding pattern and growth potential of the company or even the uniqueness of the products or services of the company as factors influencing the leverage decision.

2.32 Anastasiya Shamshur (2009) states that the choice of capital structure by firms is a fundamental issue in financial literature and as such its capital structure stability is of paramount importance. According to the recent findings that the author has come across, the capital structure of firms remains almost unchanged during their lives meaning that leverage ratios are significantly stable over time. The stability of leverage ratios is mainly generated by an unobserved firm-specific effect that is liable for the majority of variation in capital structure. However, the study focuses on the US economy, which is relatively stable. The outstanding feature that the paper has is that it contains the study of how substantial changes in the economy affect the stability of firms’ capital structure and its leverage decisions and the proportion of leverage in transition countries. Specifically, the paper focuses on Central and Eastern European economies that passed through transition from central planning to a market economy and
privatization, the Russian financial crisis, and EU membership. In addition, the author investigates whether the ownership structure of firms is responsible for the part of the unexplained variation in leverage. The author reiterates that on the one hand debt is used to reduce agency cost and is a tax shield, as also a monitoring device to prevent the manager from building their own empires. But if the information asymmetry is very high (moral hazard, adverse selection etc.), even the large firms which otherwise gladly contract debt, would prefer to use their own internal funds first and this depicts a negative relationship between profitability and leverage. Among the conclusions drawn, the relevant part states that in most countries in the sample, it is found that it is not easy for a firm to raise sufficient finance for its projects mainly because of information asymmetry and hence such under-levered firms do not get swayed by the fluctuations of economy and are too sluggish to change their capital structure.

2.33 Erik Devos, Upinder Dhillon, Murali Jagannathan and Srinivasan Krishnamurthy (2010) have examined the reasons why some firms do not opt for debt financing. The paper begins with the hypothesis that such firms do not have access to debt market, these are small firms and young firms and hence have no credit rating and tend to make less investments. The authors aver that it has always been a puzzle as to why some firms tend to go unlevered or under levered in spite of obvious advantages of tax shield and control retention and a good resistance to takeover bids. To test this hypothesis, the authors selected unlevered firms or zero-debt firms in USA for a period from 1990 to 2008. The data was analysed using univariate analysis and multivariate analysis techniques. The authors observe that the zero-debt firms have a lot of cash on hand and it helps them in capitalising on the opportunities available in the market. They want financial flexibility and so restrained access to debt market is not such a major issue for not contracting debt. Although it is observed that the public markets fail to issue debt to such firms. Moreover, such firms have been found to have significant level of investments contrary to the hypothesis. But the age hypothesis holds true in that unlevered firms are younger. Such firms can significantly take advantage of tax-shield if they opt for debt. So neglecting debt because of low tax shield benefits is not the reason. The paper observes that the firms have debt contracting capacity but they retain it and not use it. The authors
state that the supply side constraints also prevent the firms from contracting debt and that firms are eager to take benefit of tax shield. Such firms also do not have credible investment to get the bank to provide them finance and so resort to private sources for financial requirement that too after convincing them of the quality of the firm’s investments.

2.34 Franklin John and Muthusamy. K. (2011) attempted to zero in on the variables that influence the use of debt funds in the Indian pharmaceutical industry. The authors reveal that their results are largely in congruence with the previous research findings by various researchers and authors. They have tried to investigate the relationship between a firm’s financial leverage and its sales, interest, cash flows, asset structure interest coverage, firm’s size, retained earnings, EBIT or Earnings before Interest and Taxation, intrinsic value of a share and return on asset in Indian pharmaceutical industry which in their opinion is the prime sector of the Indian economy and has an inclination to contract debt to the extent possible. They authors used the data sourced through Prowess Database maintained by Centre For Monitoring Indian Economy(CMIE) for top 25 pharmaceutical companies in India on the basis of sales value for the period from 1998 to 2009. They used the multiple regression analysis to point out the variables that influence leverage. They have used the correlation analysis ascertain variables associated with leverage. Path analysis has been used to know the direct and indirect effects of the selected variables on leverage. They conclude in the paper with the rationale that the variables sales, interest, cash flow, asset structure, interest coverage, firm’s size, retained earnings, earnings before interest and taxation and intrinsic value of shares influence financial leverage. They aver that interest has the highest positive direct effect on leverage. They agree with previous findings that the Indian firms prefer debt capital financing for their projects and it also dominates their capital structures exposing the firms to a very high degree of total risk reflected in high degree of operating leverage and financial leverage.

As a corollary, they face minor liquidity crunch to extreme cases of bankruptcy. They also state that cash flows and interest coverage are negatively associated with leverage.
2.35 Edward Owens and Joanna Shuang Wu (2011) have taken several bank holding companies to investigate the fact that such companies used short-term borrowing top resort to window-dressing. They have tried to gauge the public reaction to such sensitive financial information being divulged in the last quarter of a financial year. They define window-dressing in this context as “a short-term deviation around quarter-end reporting dates of a financial variable from its quarterly average level”. They began with the hypothesis that firms with greater financial leverage in their financial make up are more likely to window dress such liabilities in their accounts. Finally they also assume that the investing public always reacts negatively to divulgence of this information. The gist of the issue is that those firms which have high degree of financial leverage tend to attract negative assessment from the investors and are in general perceived to be more susceptible to financial failure. To avoid this, the firms resort to window-dressing. From the evidence the authors have gathered it clearly is evident that there is significant downward window dressing of short-term borrowing causing understatement of financial leverage in the quarter-end financial position. The paper frequently makes a point that the investors and other stakeholders are hugely concerned with the liquidity and profitability of a firm which, in the view of investors, is negatively impacted by the existence of borrowed capital. This is an incentive and a motive for a firm to hide its actual level of borrowings. The paper goes on to suggest the possible amendments required in the disclosure policies to reveal such misleading practices by the companies. This will also safeguard the investors’ capital in the company. The authors have used various accounting ratios to measure the changes in liquidity and profitability of different companies. After elaborate sampling and testing they conclude that their hypothesis was correct and that indeed because of heightened media and regulatory attention this practice has been subdued. The financial crisis of 2007-2009 has taught many lessons to the companies and the investors and also to the law making agencies. This has not completely put an end to such practice. The companies with very high leverage do invariably resort to some kind of masquerading to seem risk-less to the market.

2.36 Ozde Oztekin (2011) has examined as to which factors are consistently important for capital structure decisions of firms around the world. The most
reliable determinants are past leverage, tangibility, firm size, and industry leverage, the author opines. He states that a country’s legal and financial institutions have important effects on capital structure adjustments and on how its corporations are financed. Better institutions faster adjust to optimal leverage. As is a common practice, the paper briefly mentions all the popular theories of capital structure and its association with leverage. The paper mentions that timelier, less costly bankruptcy procedures; stronger debt holder, weaker shareholder protection; weaker accounting, disclosure, liability and enforcement standards; more prevalent insiders trading; and poor information sharing in debt markets are associated with higher leverage. The author has examined the reliability of a number of factors that have been found to be robust in the U.S. samples in the international data. The paper attempts to suggest a dynamic panel model on basis of world data. In the middle section, the author examines the fact that institutional factors such as timeliness, cost, efficiency, effective tax rate and creditor rights, law and order of the system, governance, enforceability of contracts also affect the propensity of a firm to opt for debt funds. The sample consists of 15,177 firms culled from 37 countries for a period from 1991 to 2006, totalling 1,012,644 firm-years. The paper draws several conclusions such as the fact that leverage is higher in countries with timelier and less costly bankruptcy procedures, strong creditor and weaker shareholder protection and weaker accounting, disclosure, liability and enforcement standards, prevalent insider trading and lack of transparency. This is not in complete congruence with all that has been professed in the traditional theories, the author admits.

2.37 **Dr.Inna Romanova (2012)** propounds that given the nature of modern economies being of cyclical nature, the firms have to be innovative and therefore technologically sound. The author states that due to European economic crisis the supply of finance was shrinking and at the same time the firms there needed more funds to sustain and augment growth. This was a period when the funds became costlier and the investing public had not much money left in the hands to invest in equities. That she states is an example of macroeconomic conditions affecting the availability of finance. To be technologically sound and prepared to meet challenges the firm requires huge capital investment and hence fulfilment of capital requirements is sacrosanct for growth. And that the
enterprise financial leverage and capital structure are determined by numerous factors, an in-depth analysis of prevalent macroeconomic conditions and its impact on leverage decision made by the firm, is an absolute must. In the paper the author purports to analyse the dependence of enterprise financial leverage on the macroeconomic conditions in the country. Because of variability in macroeconomic conditions there is a need for active leverage and capital structure management under such divergent macroeconomic conditions. This, the author, says should be done taking into account interest of shareholders and debt holders. In the initial section the paper reviews the theoretical research made on the dependence of financial leverage on macroeconomic conditions. Thereafter, the author proceeds to carry out an assessment of recent trends in changes of leverage of non-financial corporations under particular macroeconomic conditions in different European Union (EU) countries. For this the author selects aggregate statistical data on financial balance sheets of European countries for a period from 2005 to 2010 and employs correlation and regression analysis techniques. The results suggest that under conditions of economic downturn, external funding becomes decisive for survival and growth of an enterprise and that the macroeconomic conditions influence financial leverage and capital structure decisions as well as the ways the capital is raised. Thus, macroeconomic conditions are important determinant of capital raising and leverage level changing decision. Economic conditions influence both the availability of financing as well as the ability of enterprises to raise capital and this is also country-dependent. Based on the analysis made, author concludes that there is a need for active leverage and capital structure management under changing macroeconomic conditions.

2.38 Harshana Kasseeah (2012) studies the relationship between debt and cash flow, the two main sources of finance for most firms by taking into account the internal and overall financial constraints that firms face. The author states that unlike previous studies, the focus of the paper is on both internal and overall financial constraints and as also on Small and Medium-Sized firms (SMES) as these firms are likely to suffer more from financial constraints. Distinguishing between internal and overall constraints clearly bring to the fore as to which constraints are more important. Internal constraints refer to those constraints that
determine whether a firm would go for external financing. Hence, in this case, the level of internally generated funds (mainly cash flow) would determine the amount of debt that a firm has in its capital structure. The other factor that would determine the amount of debt in the capital structure of firms is the overall financial constraints that firms might face, which refer to how easy or how difficult it is for firms to have access to external financing. The results of the research suggest that firms follow a financial hierarchy when deciding what sources of finance to use. The author reiterates that internal financial constraints are important factors that influence the amount of debt that a firm has in its capital structure. The results obtained also seem to suggest that however large a firm might be and however easy it is for a firm to have access to debt, firms inherently do not like to increase debt in their capital structure. Furthermore, cash flow is a vital source of financing of SMEs and they seem to follow a financial hierarchy when deciding what sources of finance to use. If firms experience an increase in cash flow, they tend to reduce the amount of debt they hold, possibly by paying off debt but if cash flow falls firms increase leverage in their capital structure. The paper presents a brief review of literature on the financing decisions of firms and the impact of financial constraints on their decisions followed by the dataset and empirical specification and in the last section it elaborates on the descriptive statistics and discusses the estimation methodology as also the conclusions.

FINANCIAL LEVERAGE AND STAKEHOLDERS

2.39 Myles Zyblock (1997) has mentioned that firms can sell their assets to finance their capital requirements. Usually the firm would sell its non-performing assets for the purpose but it will have negative impact on its creditworthiness in terms of its public image and critics among the shareholders. Apart from the usual discussions on the issue of benefit of tax-shield and leverage, the author opines that if the interest rates keep rising the firms eager to contract debt will feel discouraged to contract debt because the expected rate of return on the investments made by the investors rises rapidly also. This puts tremendous pressure on the firm to augment its earning capacity which is not possible in the short-term. The author justifies the selection of the two countries because of their similarity with respect to trade and business laws and environment as well
as the business and economic cycles experienced by them. The author traces investment trends and leverage trends in the two countries to facilitate comparison. Even he has inflation-adjusted these trends to take out the factor of unusual fluctuations in prices. The author has also studied the Merger and Acquisition trends in the two countries and correlated them with the favoured way of financing such M & As. He has observed that as the economic activity augments the incidence of contracting debt also picks up. In Canada there were many family-run and controlled businesses which did not want to dilute their control nor wanted to increase debt and hence used internal accruals to satisfy the capital requirements. It was not so in America. Short-term debt instruments were very popular in the business because of the mismatch between the duration of assets and liabilities. The author admits, however, that he is not able to cast light on whether the amount of leverage in the corporations of both countries is high or not and whether it can be justified. In Canada, during the recession of 1980s the firms with high degree of leverage were deep in trouble and the possibility of their bankruptcy grew dramatically. Even in US the firms (with debt) took a very long time from an economic slow-down although the incidence of bankruptcy was low.

2.40 Jan Ericsson (2000) has chosen a continuous time model for debt and equity valuation where leverage and maturity structure are chosen optimally by the firm’s management. He opines that the debt- equity proportion and other capital structure related decisions are greatly influenced by tax benefits, financial distress costs and the agency costs associated with risk shifting incentives. He has provided ample of quantitative illustrations to demonstrate how the capital structure decision is influenced by the potential for asset substitution. If the firm does not choose the asset substitution path, it distinctly opts for 20 % more leverage, he suggests. The author presents a model which is able to measure directly the impact of the agency costs or risk shifting on the market value of the firm as well as the leverage and maturity that maximise it. Moreover, he propounds that when the management acting in the interests of shareholders change the level of risk to higher degrees, then as a result the financiers and creditors rationally anticipate and demand higher compensation because of the change in the way the firm operates. The ultimate bearers of the brunt of all of
this are the shareholders who do not take easily to the cost of agency problem. The author then proceeds to mathematical formulae and algebraic calculations to illustrate the above mentioned observations. The author also develops mathematical models to examine the mathematical relationship between the market value of firm’s securities and the phenomenon leverage and other factors such as agency costs and bankruptcy costs and asset substitution which are not in the ambit of this research.

2.41 Putu Anon Mahadwartha (2002) has attempted to analyse the extent to which firms employ leverage in their capital structure when they are run and managed by professionals. The author strongly believes that there is connect between the pattern of management and degree of leverage. He has taken managerial ownership as a dependent variable regressed with dividend and leverage policy. He states that shareholders, debt holders and management or managers all have different interest and perspective regarding value of firm. Shareholders will tend to maximise their share and debt holders want security of their capital and assured returns on investment. The conflict of between the two is known as agency problem which the author says, is to some taken care of by leverage. The paper also discusses the agency theory in detail with all its aspects. The author opines that the managers themselves become the owners sometimes so as to tackle the agency cost of equity and the agency cost of debt. He begins by assuming that previous studies have rightly concluded that managerial ownership greatly influenced the policies regarding leverage and dividend but the reverse is not true.

At the same time inclusion of dent funds in the capital structure can reduce the interference of equity shareholders and the owners can retain control on the company as a whole. Apart from the above objective, the author says that debt conveys a very good impression to the outside shareholders that they are willing to lose control if they fail to perform. The issue of ownership affecting the choice of source of finance is beyond the purview of this research work but how the managers look upon debt is of great relevance. The author selected 81 manufacturing firms listed on Jakarta Stock Exchange for a period starting from 1993 to 2000 to carry out the research using empirical statistical models and theories. His research concludes that the lower level of leverage prompted the
companied to opt for managerial ownership to solve the agency problem and that managerial ownership is important in controlling agency cost of equity, beside the use of debt and dividend.

2.42 **Jacob Sagi, U.C.Berkely** and **Mark Seasholes (2002)** have related the presence of financial leverage to the increased expected returns and future cash flows. They select randomly top 100 companies traded publicly and analysed the data with the help of mathematical tools. Their tests reveal that it is widely influenced by the prevailing market conditions as also the type of business that the firm is in. That apart, many other non-quantifiable factors are also at play. They have exemplified that if a firm is operating in an industry that is subject to frequent changes in the business prospects, such a firm despite being able to use leverage successfully, will not pass on the increased profits to investors. The precautionary motive of holding cash takes over. The more volatile the nature of industry, the more reluctant the firm will be in sharing of the profits available for distribution. This however ensures that the future cash flows are taken care of. The paper also touches upon many other aspects such as real options and momentum and asset pricing which are not pertinent to this research work.

**FINANCIAL LEVERAGE AS DELINEATED IN FINANCIAL LITERATURE**

2.43 **Prof. M.Y. KHAN and Prof. P.K.JAIN (1997)** have delineated the concepts of financial leverage and operating leverage using practical illustrations. The basic theory of leverage has been explained in detail with suitable practical illustrations.

According to them, the funds which can be raised for capital requirements can be categorised into two categories: 1) those which carry a fixed financial charges and can lend the tinge of financial leverage to a firm and 2) those which do not involve any fixed charges and therefore do not give rise to leverage. The same have been amply illustrated in the book.

The authors have also discussed the topic of financial leverage with the help of the algebraic approach, devising formulae to solve practical problems.

The graphic approach to the aforementioned topic has also been explained with the help of various charts depicting Earnings before Interest and Tax (EBIT) and Earnings per Share (EPS).
The effects and financial implications of financial leverage on a firm have been demonstrated with the help of hypothetical financial data. They opine “…..financial leverage results from the presence of fixed financial charges in the firm’s income stream. These fixed charges do not vary with the earnings before interest and taxes (EBIT) or operating profits. They have to be paid regardless of the amount of EBIT available to pay them. In a way, therefore, use of fixed-interest sources of funds provides increased return on equity investment without additional requirement of funds from the shareholders. Although all the facets of financial leverage have been dwelt upon satisfactorily and in a comprehensible way, the real-world scenario is a glaring omission. The work is silent on the real-life cases arising from corporates or any debt-dependent firms. The authors have completely covered the rudimentary aspects of financial leverage which contribute to the laying of sound foundation of understanding of the topic of this research work.

2.44 Prof. I.M. Pandey (1997) has defined leverage from different viewpoints and has explained elaborately the effects of leverage on Shareholders’ return. The point to be noted is that he has devoted a special section to the tax-shield effect of leverage. He has dissected the effects of leverage under different scenarios wherein sometimes the EBIT is varying and rate of taxes also varies. As a practical case-study, he has analysed the employment of leverage in Voltas Ltd. which is followed by many examples and illustrations.

2.45 Aswath Damodaran (1999) has tried to provide a practical, comprehensive guide to converting corporate finance theory into applied, real-world solutions with special reference to use of debt in corporate funding. He propounds that a firm whose actual debt ratio is very different from its optimal has several choices to make. First, it has to decide whether to move forward the optimal or preserve the status quo. Second, once it decides to move toward the optimal, the firm has to choose between changing its leverage quickly or moving more deliberately. Impatient shareholders and bond-rating agency concerns and many other external factors may put pressure and govern the decision. The moot question before the firm is whether to take new projects, or to shift its financing mix on existing projects.
In this work the author has discussed the process of adjusting the element of leverage in its capital structure and has categorically stated that such a decision is based on two factors viz. 1) the speed with which they want to change their financing mix and 2) the availability of new projects that can be financed with the new debt or equity.

He goes on to analysing the ways to increase leverage quickly and its resultant effects. He mentions 1) borrowing money and buying back stock 2) debt-equity swap and 3) liquidating assets to repurchase stock as the ways to increase leverage quickly.

He mentions 1) renegotiating with the providers of debt for a stake in equity 2) liquidating assets and retiring debt as the ways to decrease leverage quickly. These tools and techniques have been discussed in detail and demonstrated using live case study. He provides ample examples to suggest that various firms and companies across US and UK have applied them to get desired results. This particular piece of work is of great help in analysing the financial implication of capital structure changes on the financial aspects of the results.

2.46 **Prasanna Chandra (1999)** has briefly explained the meaning of financial leverage, application of financial leverage, total leverage and application of total leverage. He has also discussed various leverage ratios along with their formulae and what they denote or how they should be interpreted. There is nothing outstanding given in the book that can satisfy a researcher. Only the elementary ideas and concepts have been touched upon. The real-world scenario is totally absent. This work at best can be useful to a new entrant in the field of finance but cannot propel the research work of higher level.

2.47 **Tadeusz Dudycz (2006)** has teased out several angles from which to look at the concept of leverage. The author states that the concept of leverage is very general and can be defined and measured in many ways. There are basically two approaches to it: static and dynamic. The author avers that these two approaches can send contradictory information and hence clarity is needed on the issue. The contribution of debt fund in the financing of an enterprise has profound impact on the return on equity when it is raised or reduced depending upon the cost of debt and the profit it could generate. This is the static approach. The dynamic
approach states that the leverage as arrived at by dividing the percentage change in EPS by the percentage change in EBIT is the real measure of financial leverage. In order to drive home the point, the author uses graphic approach to leverage and depicts the relationship between Rate Of return on Equity and EBIT. The same is then presented in terms of formulae. In the dynamic approach the sensitivity of change in return on equity to changes in EBIT in terms of percentages is tested. The author proceeds to examine the relationship between static and dynamic approaches to financial leverage. He concludes that the static approach is a measurement irrespective of changes in sales or EBIT, so it characterises the enterprise. But the dynamic approach reflects the current value of the leverage changing along with changes in sales and profits. Because both these measurements can be contradictory, using terms such as “high leverage” or “low leverage” should always be accompanied by information about the method of measurement.

2.48 Sandip Sinha (2009) has attempted to study all the aspects related to the topic such as physical leverage, corporate leverage, financial leverage and also operating leverage and combined leverage which are beyond the purview of this research work itself. In its uniqueness the work has in the initial stage describes the mechanics of lever which is a simple machine that can magnify an applied effort to overcome a resistance by generating a magnified force by tweaking the fulcrum. He discusses the physics part of lever operated machines to correlate it with corporate leverage. This analogy has not been come by so far anywhere else during the course of perusal of review of literature. The author insists on using the term ‘financing leverage’ to denote financial leverage. The author has also discussed the relationship between financial leverage and financial risk. He has generalised the concept of corporate leverage with fixed expense. In order to explain the impact of financial leverage on the profitability of a firm the author has resorted to various mathematical formulations and interpretations to exhibit the results, again in the form of mathematical formulations. The book also discusses the usual accounting formulae for calculating financial leverage. Then the author also expounds what he calls the ‘de-leverage’ in capital structure. This he says is the exact opposite effect of financial leverage. This reflects the firm’s ability to de-magnify the effect of a relative change in the initial value of an
independent financial variable on the change in the value of a dependent financial variable by employing fixed-revenue bearing assets in the assets structure. This aspect clearly is not within the ambit of this research work and hence it is pertinent not to discuss this aspect in detail here.

2.49 **Prof. Sheeba Kapil (2011)** as seen in lots of literature on Financial Management has dealt with the basics of financial leverage in a very precise manner. The outstanding piece of work is that the author has punctuated all the concepts and theories with citation of relevant cases of those corporates which have adopted the same method of raising finance or are suffering from the same financial malady or are experiencing similar financial situations as discussed in the book. Not only the author has cited cases but has also conjectured the future trends for a few of such companies which throws open many a vista for further research. The favourable and unfavourable effects of financial leverage have been explained using hypothetical data. The author is of the opinion that in India the financial leverage is more pronounced in the banking sector. The author has presented the situation of leverage in companies like Whirlpool, Bharat Earth Movers, ITI, Jindal Strips Century Textiles, and Arvind Mills etc.. The author opines “…these companies have higher financial leverage and always show advantage when the economy shows the signs of growth, i.e., growth in demand and overall economy. In these companies, the growth in earnings will be greater than the growth in revenue under positive market conditions, i.e., conditions of growth in demand...”

The book prescribes what it calls the rules for employing leverage which are

1) Employing optimum leverage
2) Highly levered firms or companies or individuals should exercise caution in time of uncertainty
3) Eschew financial leverage in times of deflation and market recession

The author further generalises that the real estate is one business which is riddled with greater degree of financial risk resulting from financial leverage. She expounds “….When the real estate developers build a few houses, they make good money due to financial leverage. When the market is booming, they overdo the whole thing and land up making five or ten houses at one time. Here as the
equity involved is very less whereas the money of creditors is large, they end up undercapitalized to carry the payments in a slow market. After all, all the hoses do not sell at one go and thereby running the risk of becoming bankrupt...

Exhorting the remedies in peculiar financial situations, the author firmly states that in times of boom, financial leverage enhances the wealth of the companies resorting to it, but in the times of slow-down or collapse, it can staggeringly destroy the wealth so created. Further, risk diversification is also a way to minimise the adverse impact of overleverage. The financial planners must have alternative plans in case original plans fail. Every investment of equity must always have a contingency plan for worst-case scenarios and that contingency plan must be incorporated in the overall strategy for investment before putting the equity at risk.

This work is of great value in that it has theorised many practical aspects of leverage and debt management. The same can be utilised to actually evaluate the impact of financial leverage embraced by selected companies from selected industries on their financial performance.