Corporate Financial Policies: An Overview

Priyanka

Abstract

Purpose: The main purpose of this paper is to provide an overview of corporate financial policies that how different corporate financial policies help in getting the source of funding, different tactics, which are used to increase the wealth of corporate and basically highlighted three different policies (investing, financing and dividend) which plays an important role to achieve competitive advantage in the business world.

Design/ Methodology: The study is based on qualitative data which is gathered with the help of secondary sources which includes journals, websites, published articles, etc.

Findings: Findings from this paper suggest that different corporate policies have different impact on different firms based on their size and characteristics. Small firms rarely use the NPV method or CAPM whereas decisions in large firms mostly depend upon NPV value and it also observed that corporate financial policies vary with change in the economic environment.

Originality/Value: This paper adds to the extant review of literature which is based on different corporate financial policies in different environments and analyze the impact of different financial policies on distinct firms.

Keywords: Strategies, Capital, Corporate, Policies, Financial Policies.

Introduction

Financial management is a specialised branch of general management which is developed to provide financial services to the organizations. In other words, financial management deals with the procurement and utilization of funds of an organization.

Corporate finance is the area of finance which deals with the source of funding, tools used to allocate financial resources and actions taken by managers to increase the value of shareholders **(Wikipedia)**. Financial policy of corporate highlights the overall approach of how an organization manages its financial decisions. Policies and strategies of financing in a corporation are associated with the raising and use of funds and the estimates in a corporate firm should be based on financial principles so that neither there is inadequate nor excess of funds with the firms and ensures there is effective utilisation of finance. The major aim considered with making financial policies is to maintain an adequate and regular supply of capital to the corporate, keeping the present and future requirements of the organization but capital should be properly utilized because excessive use of capital is also as bad as having inadequate capital. Consequently, whilst estimating working and fixed capital needs, securities to be issued, the financial manager should properly utilize the funds and while doing this, all contingencies should also be considered. They have to keep in mind that while framing policies there should be no loss of the business due to surplus or scarcity of funds.

In addition, the cost of raising capital should be of the least amount. Financial managers have to make a good mixture of equity shares, preference share and debentures, and these decisions should be made while considering the liquidity, profitability, and safety of the corporate. Financial policies in a corporate are altering since decades according to the demands of the shareholders and investors in the organizations because they want to invest in an organization from which their value will maximize in the market and they are more considered towards short term gain rather than long term profits.

The primary objective of corporate finance is to maximize the shareholder's value or wealth maximization because the wealth of owners are allocated with the help of market value of shares which enhance the growth of the enterprise and with this finance is timely available for each department and finance plays a very crucial role in any corporate because timely availability of cash helps an organization to manage its stock, creditors and debtors through which their cash flow will improve and which leads to decreasing borrowing costs by which a corporate can achieve a competitive advantage with help of finance so it can be said that finance is a major source of strength and will move a company ahead of its competitors.

Review of Literature

Mauer & Triantis (1994) analyze that both investment-financing decisions or capital budgeting- capital structure decisions were taken at same point of time and are of irreversible nature. They basically highlight that firms have the capability to dynamically handle both investment-financing decisions at the same time. They also highlighted that firm's initial decisions of investment are less influenced by financial policies ensuing operating decisions.

[1] *Assistant Professor, Department of Commerce, Maharaja Surajmal Institute, Affiliated to Guru Gobind Singh Indraprastha University, New Delhi*

Graham & Harvey (2001) highlights that practice of corporate finance is encouraging and at the same time is bewildering. They explore that for reassuring NPV (net present value) is more important but they also underline the major fundamentals between small and large corporate under which small firms are majorly less using NPV method or CAPM.

Brounen, et al (2004) explores the different characteristics of corporate policies amidst USA companies and European companies regarding the cost of capital, capital structure, and capital budgeting. They have observed different cross-national patterns in regard to corporate governance. Both European and U.S. firms used to adopt and neglect same theories while managing corporate finances.

Cohen & Yagil (2007) explores the different corporate financial policies under which more weightage is given to three major policies which are: investment policies, financial policies and dividend policies from which they highlighted that investment policy is more crucial while taking decisions and dividend policies are of less importance and they also analyse that (NPV) net present value and internal rate of return are more rapidly used techniques for taking investment decisions. They end with saying that different corporate financial policies are seen in different economic environment.

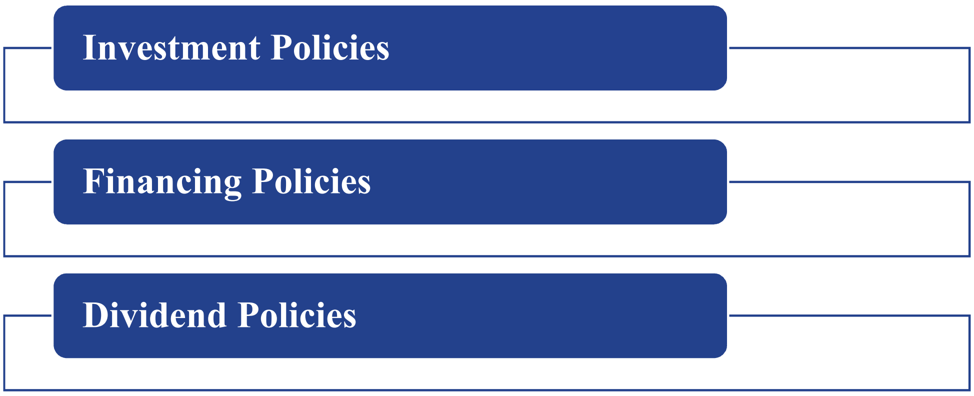
Baker, et al (2011) surveys different financial practices in Canadian firms implying capital structure, capital budgeting, cost of capital and real options. They highlighted that "one size doesn't fit all" as different institutions in different countries follow different corporate practices.

Objectives of the Study

1. To study the major corporate financial policies.
2. To analyse various steps in developing corporate financial policies.

Major Policies of Corporate Finance

According to **Cohen & Yagil (2007)** there are 3 major policies of corporate finance which a manager must utilize in order to maximize a firm's value which are: Dividend policies, Investment policies, and Financing policies. To achieve a competitive advantage in the business world different corporate should take decisions on these policies with an active mind because these decisions play a crucial role in the growth of a corporate.



Source: Literature Review

A. Investment Policies

Investment policies are the policies that mainly deal with the *"risk and return"* relationship which means that their investment is based on a decision that how much risk is involved in investing a particular project and how much return a project is offering to them. According to **Ross, et al, (2008)** Investment decisions are mainly long-term decisions of which benefits will be received over a certain period of time. Investment decision making is also known as Capital Budgeting which involves capital expenditures, which are long-term, non-flexible commitment of funds and capital budgeting involves only 2 type of decisions: one, which increases the revenue of the organization and other which decreases the cost of the organization. **Graham & Harvey (2001)** focused on a point that while choosing the investment mix the company should use NPV (Net Present Value) method for evaluating different investment proposals.

B. Financing Policies

Financing policies basically deals with the financial part of the corporate and makes decisions regarding finance, that how sources of finance can be generated and helps in analysing *"cost-benefits"* relationships of a firm.

As stated by **Cohen & Yagil (2007)** financial policy of the firm is affected by the imperfections of the capital markets such as personal taxes, corporate taxes, and bankruptcy costs. **Brounen, et al (2004)** pointed out that capital structure is the most important factor influencing the financial flexibility in a firm as capital structure is a mixture of equity and debt in a corporate which helps in maintaining the equal portion of equities and debt within the corporate. **Yagil & Cohen (2007)** further underlines that pecking order theory helps in financing the sources to the degree of some pecking order i.e. firstly a corporate uses internal sources of finance and then move to external financing in an order, after that mixture of securities such as convertibles, warrants, etc are used. Further, **Molina (2005)** clearly defined that leverage also has a strong impact on the performance of corporate which results in a higher impact on the ex-ante cost of financial distress which can help in offsetting the tax benefits of debts.

C. Dividend Policies

Ross, et al, (2008) explains that dividend policies take decisions regarding how much of corporate profits should be retained in the company and how much to be distributed by the way of dividends to the shareholders or it can be said that it helps in analysing the "*retention- distribution*" ratio of a corporate. Basically, dividends are the rewards for the shareholders for investing in the shares of a corporate and dividends have a direct relationship with the valuation of firms as value of a firm is maximized with the maximization of shareholder's wealth.

Kumar & Lee (2001) highlights that dividend is a ploy to attract investors in a company at the time of financial distress. The distribution of dividends in a company is a passive decision and is only distributed when there is no profitable investment arises but if there is a profitable opportunity in a company then they will retain their profits for further developments.

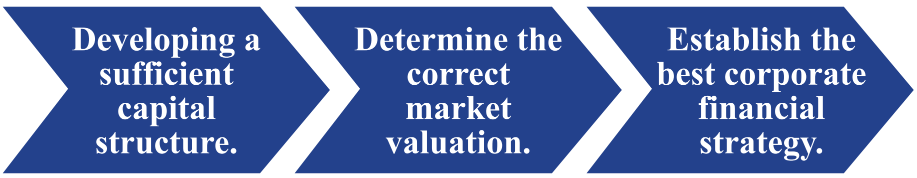
After having so many debates regarding the degree to which dividend policy influences the value of firm **Modigliani & Miller (1958)** asserts that under perfect capital market situations, a firm value depends on operating profits rather than what it distributed as profits.

Various Steps Involved in Developing Corporate Financial Policies

Financial policies do vary with the different corporate and different tactics have been used by them but there are certain steps that are common in all corporate and all firms should use these steps to achieve competitive advantage against one another. These steps have been discussed below:

Developing a Sufficient Capital Structure

Myers (2001) focused on capital structure and explains that it is an attempt to focus on a mixture of securities as well as financing sources used by different corporate to finance in real investment. Capital structure is mostly concerned with debts and equity that how much debt and equity should be used in a company to be competitive. **Ross, et al, (2008)** describe that capital structure is a relationship amidst long-term form of financing such as equity share capital, Preference share capital and Debentures. It is a very crucial decision in any firm and when preference share capital is used with equity shares than it is termed as financial leverage and financial leverage will be more with increased use of debt and vice-versa.



Source: Review of Literature.

Determine the Correct Market Valuation

Market value appraise where a corporate stands in the business world. By determining the value of a firm a person or a business gets to know whether the company is over-rated or under-valued in the marketplace. The correct market is valued with the help of some financial measures such as margins, expectations for business growth and future investments. Deviations can be checked by comparing management expectations with the investor's expectations.

Establish the Best Corporate Financial Strategy

The last step which is involved in developing corporate financial policies is to establish a strategy that provides adequate funding, growing cash reserves and financial balances because if a corporate have the right amount of funds at the right time it will help them to invest in beneficial projects which leads to growing cash reserves and can gain competitive advantage by choosing the right strategy at right time.

Conclusion

Corporate financial strategies are firm-specific and different people opt for different types of corporate strategies for their growth. From above it is very clear that corporate financial policies play a very drastic role in any company as it has to make any major decisions which are essential for the growth of a firm out of which there are 3 important decisions which are taken by every firm which have been discussed above. As every organization has to take decisions where to invest, how much to invest and should analyse the risk and return associated with the investment. Secondly, they have to make decisions about financing that from where they should obtain funds, have to make a mixture of equity and debt which means they should also analyse the cost and benefits ratio which will be derived in making this mixture. Thirdly, corporate have to take decisions regarding dividend policies that how much part of the profit should be distributed in the form of dividends to the shareholders and how much to retain for further investments. Corporate also has to ensure proper steps while framing the corporate policies to achieve competitive advantage.

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