



Journal of Finance and Accounting Research (JFAR)

Volume 3 Issue 1, Spring 2021

ISSN:(P) 2617-2232 ISSN:(E) 2663-838X

Journal DOI: <https://doi.org/10.32350/jfar>

Issue DOI: <https://doi.org/10.32350/jfar/0301>

Homepage: <https://ojs.umt.edu.pk/index.php/jfar>

Article: **Three Corporate Finance Practices in Pakistan: A Review of Previous Studies and the Way Forward**

Author(s): Umar Farooq, Bilal Haider Subhani

Affiliation: School of Economics and Finance, Xi'an Jiaotong University, Xi'an, Shaanxi, P.R. China

Article DOI: <https://doi.org/10.32350/jfar.0301.04>

Article History: Received: April 18, 2021
Accepted: July 16, 2021
Revised: July 28, 2021

Citation: Farooq, U., & Subhani, B. H. (2021). Corporate finance practices in Pakistan: A review of previous studies and the way forward. *Journal of Finance and Accounting Research*, 3(1), 61–84.
[Crossref](#)

Copyright Information



This article is open access and is distributed under the terms of Creative Commons Attribution 4.0 International License

[Journal QR](#)



[Article QR](#)



Umar Farooq

[Indexing](#)

[EconPapers](#)



A publication of the
Department of Finance, School of Business and Economics
University of Management and Technology, Lahore, Pakistan

Three Corporate Finance Practices in Pakistan: A Review of Previous Studies and the Way Forward

Umar Farooq* and Bilal Haider Subhani

School of Economics and Finance,
Xi'an Jiaotong University, Xi'an, Shaanxi, P.R. China

Abstract

This study reviews the previous empirical studies about the Pakistani capital market and specifies the pattern of three corporate finance practices. Various activities performed at firm level such as capital budgeting, capital structure, and dividend payout policy are analyzed in the field of corporate finance. The capital budgeting technique consists of six methods, that is, net present value, discounted cash flow, payback period, and internal rate of return. However, Pakistani firms are often interested in the net present value and the internal rate of return for capital investment evaluation. Similarly, the capital structure decision carries the debate regarding two options of financing, that is, debt financing and equity financing, although the literature shows that the Pakistani firms generally follow the pecking order theory and prefer debt financing. Similarly, as for concern dividend payout policy, the extant literature discusses different theories and determinants although it is still not possible to generalize the dividend payout trend on its basis, specifically in the Pakistani context. Corporate managers and policymakers can use the conclusion of this study for strategic purposes.

Keywords: capital budgeting, capital structure, corporate finance, dividend policy

JEL Codes: G30: G31: G32: G35

Introduction

Corporate finance is a study or channel of activities through which managers try to maximize the value of firm by balanced financial planning. It involves all those activities which directly or indirectly adhere to management of funds specifically at corporate level. Corporate managers try to mitigate the costs and risk to ensure the stability of firms. Other subjects of finance i.e., behavioral finance, international finance, personal finance, private finance, and public finance, etc. correlate with corporate finance to some extent. The discussion on corporate finance mainly starts from capital investment and moves forward as capital financing and dividend policy or return on capital. In capital investment,

*Corresponding Author: umerrana246@gmail.com

managers search the beneficial sources of investment and are interested to diminish the attached risks. After deciding the investment projects, the need to finance these projects arises. Capital structure's decision determines the financing pattern of these investment projects. This section further splits down as a way of investment and optimization of economic structure of financings. The firms decide about proportion of acquisition of different types of funds for investment. After that, the firms must decide about payback method. In short, corporate finance mainly involves the discussion of the following: where to invest, how to invest, how much to invest, and how much to pay back with specific return i.e., dividend or interest.

Different corporate finance practices in Pakistan have been discussed extensively in literature. Several studies discuss different issues including corporate governance Javid and Iqbal (2010) and ownership structure Shahid et al. (2018) in the context of Pakistani corporate perspectives. There are some firm-specific components of financial nature that directly influence the corporate practices. Likewise, capital budgeting technique in Pakistan is based on the size of the firm, power distribution, investment outlay, financial leverage, and risk assessment (Zubairi & Amin, 2008). Similarly, capital structure decision or financing decision is based upon liquidity, size of firm, firm profitability, and sales growth ratio etc. The study of Qureshi et al. (2015) has suggested that pecking order theory is more relevant for deciding the capital structure in Pakistan. Different finance theories i.e., bird in hand theory, signaling theory, and pecking order theory try to discuss the dividend decision but it is still unknown how corporate firms decide their dividend policy. However, there exist some determinants of dividend payout policy i.e., corporate tax, leverage, profitability, firm size, and last year's dividend payout ratio which have been discussed extensively in a number of studies found on the Pakistani financial market.

The discussion on corporate finance started in 1950s and since its modern form, it has passed through different conversions. In Markowitz (1952) has given the concept of corporate finance by studying the different stages of portfolio selection for capital investment. He has argued that two stages of portfolio selection can be considered i.e. (1) analysis of experience and future performance (2) choices of portfolio. He has deeply discussed the pitfalls of risk and associated return. The most efficient technique to estimate where to invest is capital budgeting technique that uses the discounted cash flow (DCF) method to measure the net value of future cash flow of a project. The capital budgeting technique involves six steps i.e., discounted cash flow (DCF), net present value (NPV), payback period (PBP), internal rate of return (IRR), required rate of return (RRR),

and profitability index (PI). The discounted cash flow (DCF) measures the present value of future cash flow of investment. It uses the discounted rate or WACC (weighted average cost of capital) rate to discount back the budgeted cash flow. The net present value (NPV) suggests the actual value of future investment by using the interest rate. The payback period (PBP) estimates the time span of recovery of actual invested amount from the project.

The internal rate of return (IRR) is the rate at which the present value of future cash flow from investment becomes zero. This rate is also known as economic rate because it measures the minimum return on investment. It helps corporate managers to decide whether to proceed with a specific project or not. It predicts the status of investment and states whether it is worth investing or not. The required rate of return (RRR) is the rate required by the investors. They consider both market rate and associated risk rate. The firms normally use it to compare the two investment options. The study conducted by Sharpe (1964) gives the concept of systematic risk (β), the risk which cannot be diversified in any case. Other type of risk is unsystematic risk, a risk which can be reduced by following different portfolios. Total risk is a sum of systemic and unsystematic (idiosyncratic risk) risk. The profitability index (PI) compares the cost of investment and return on investment. The profitability index greater than 1 attracts corporate firms for investment.

$$DCF = \frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \frac{CF_3}{(1+r)^3} \dots \dots \dots \frac{CF_n}{(1+r)^n} \quad (1)$$

$$NPV = \frac{FV}{(1+i)^n} \quad (2)$$

$$PBP = \frac{\text{total investment}}{\text{annual cash flow}} \quad (3)$$

$$IRR = NPV = \sum_{t=1}^t \frac{C_t}{(1+r)^t} - C_0 = 0 \quad (4)$$

$$RRR = R_m + \beta(R_m - R_f) \quad (5)$$

$$PI = \frac{PV \text{ of future cash flow}}{\text{initial investment}} \quad (6)$$

Where as

DCF= discounted cash flow	NPV= net present value	PBP= payback period
IRR= internal rate of return	RRR= required rate of return	PI= profitability index
CF= cash flow	R= discount rate (WACC)	FV= future value
C _t = net cash inflow in time t	C ₀ = Initial investment	R _f = risk free rate of return
R _m = market rate of return	β = systematic risk	
	unsystematic risk	

Other basic model known as *Fama and Fench model* which determine the basic rate of return on assets are as

$$R_{it} - R_{ft} = \alpha_{it} + B_1(R_{mt} - R_{ft}) + B_2SMB_t + B_3HML_t + E_{it} \quad (\text{three factor model})$$

$$R_{it} - R_{ft} = \alpha_{it} + B_1(R_{mt} - R_{ft}) + B_2SMB_t + B_3HML_t + B_4HEMLE_t + E_{it} \quad (\text{four factor model})$$

$$R_{it} - R_{ft} = \alpha_{it} + B_1(R_{mt} - R_{ft}) + B_2SMB_t + B_3HML_t + B_4RMV_t + B_5CMA_t + E_{it} \quad (\text{five factor model})$$

Where as

- R_{it} = total return of the stock, I at time t
- R_{ft} = risk-free rate of return at time t
- R_{mt} = total market portfolio returns at time t
- $R_{it}-R_{ft}$ = expected an excess return
- $R_{mt}-R_{ft}$ = excess return on the market portfolio
- SMB_t = size premium (also known as small minus big)
- HML_t = value premium (also known as high minus low)
- RMV = return factor
- CMA = investment factor
- B_{12345} is factor coefficients

After deciding about investment options or projects, corporate managers search the sources of funds, volume of funds, and proportion of funds (percentage of debt and equity, etc.) to finance the investment projects. There exist two sources i.e., internal, and external. The capital reserve known as retained earnings is an internal source of financing. Mostly, the corporate firms first utilize it due to easy availability and no physical financing cost. When the internal funds do not meet complete investment requirements, companies move towards external financing. There are two options in the case of external financing i.e., debt financing and equity financing which are collectively known as capital structure. The concept of capital structure was first introduced by Modigliani and Miller in 1958. They have suggested that financing becomes costlier due to unbalanced distribution of debt and equity percentage in total financing. Firms approach the stock market for equity and issue the shares. For debt financing, the options are loans from banks and issuance of bonds etc. Dividend rate is the cost of equity while interest rate is the cost of debt. The K_d and K_i represent cost of debt and cost of equity collectively known as cost of capital or weighted average cost of capital rate (WACC). The WACC rate can be calculated as

$$WACC = W_dK_d(1 - t) + W_iK_i$$

Where as

- WACC= weighted average cost of capital
- Wd= percentage of debt
- Kd= cost of debt
- T= tax rate
- Wi= percentage of equity
- Ki= cost of equity

After attempting the two stages i.e., capital budgeting and capital structure, third stage is dividend payout policy. Corporate managers also decide about the interest rate which is used to pay the debt financing. Another cost known as opportunity cost is also used which companies bear in case of internal financing (retained earnings) and primary source of financing (trade credit). Mostly, the opportunity cost is ignored by the companies and focus is mainly on interest and dividend rate. The interest rate charged by the banks is normally pre-decided by them and comprises of two parts (1) basic profit rate (2) profit rate earned by the banks. The basic rate consists of rate paid by the banks to central banks and depositors of funds. The banks decide the profit rate based on transaction cost and miscellaneous charges which is handled by the banks to manage the funds. It also consists of profit rate earned by the banks themselves. Second cost is dividend rate which firms pay to shareholders. Companies normally decide their dividend policy based on extended model of capital structure suggested by Modigliani and Miller in 1961. They have documented that the dividend policy of firms has no effect on firm market value if the tax rate and cash flow remain constant. They have argued that the increasing dividend was paid from the issuance or sale of new stock which alternatively reduces the worth of stocks held by the shareholders because the net value of company is assumed to be fixed. So, there exists trade-off for shareholders between the higher dividend and shares price.

The third decision made at corporate level is dividend payout policy. The question arises that why do companies pay dividend or why the investors are interested in dividend instead of capital gain? The answer lies in the concept of “bird-in-hand”. It attracts the investor’s preference for current dividend instead of uncertain future capital gain. The companies pay dividends to maintain the investor’s confidence in the company and it also enhances the firm’s reputation. Moreover, prior research has proved a positive effect of dividend policy on stock prices. Sometimes, the companies repurchase their stock from the market. When the firms feel that their stock prices are undervalued in the market then they repurchase their shares to balance the share value. The repurchase decision of firms may also depend upon internal corporate strategies. It was a brief discussion on how the companies manage their financial activities.

This study attempts to explore the three main corporate finance practices i.e., capital budgeting, capital structure, and dividend policy in Pakistan. By following this, we review the previous studies on the Pakistani capital market and present a brief outlook on these practices. There are a number of empirical studies which discuss different corporate finance practices, but no review study was found specifically in Pakistan which summarizes the findings of empirical studies. This

study can consider an early attempt that contributes to corporate finance literature. Another important contribution of this study is that it theorized the basic corporate finance theories in the Pakistani corporate environment and suggests which corporate finance theory is more relevant to it. It summarizes the wide empirical discussion. The researchers can utilize the current study to better understand the three main corporate finance practices in Pakistan. It also provides policy guidance to corporate managers specifically on capital budgeting, capital structure and dividend payout trends in Pakistan. These review findings can be generalized in other transitional economies which have same corporate environment such as Pakistan.

The motive of this study is to explain the different activities regarding the financial decision at corporate level specifically in Pakistan and suggests relevant preferences regarding capital investment, capital structure and dividend policy regarding firms in Pakistan's non-financial sector. In literature, many studies are available which empirically analyze the different activities of corporate finance. In Pakistan, there also exists voluminous literature which empirically discusses capital investment, capital structure, and dividend payout policy. But literature is scarce on the theoretical explanation of these activities. So, this study attempts to re-consider the previous research on corporate finance and briefly presents how different activities were handled by finance managers and the trend of firms relating to these activities. The literature review shows that Pakistani firms mostly use the net present value and internal rate of return to evaluate the investment projects. Similarly, the empirical findings of previous studies suggest that Pakistani firms are interested in more debt financing and follow the pecking order theory. But the issue of companies paying the dividend remains un-resolved in the Pakistani context. Most of the studies discuss the determinants of dividend but literature doesn't generalize this trend, capital gain or repurchase of stock. So, this study recommends empirical studies which resolve these issues. The study is segmented into three parts i.e., introduction, literature review and conclusion.

Objective of Study

The main objective of this study is to review the empirical literature on three corporate finance practices i.e., capital budgeting, capital structure, and dividend policy and to offer the generalized trend specifically for Pakistani context.

Problem Statement

In Pakistan, most of the studies empirically investigate the performance of different functions at firm level that have resulted in different views. But no study

generalizes the trend of these activities. Moreover, theoretical discussion of these activities is also rare in literature. So, it is necessary to theoretically discuss these activities and to generalize these trends.

Research Questions

The research questions are:

- Which technique of capital budgeting is more relevant in the Pakistani context?
- Do Pakistani firms prefer more debt or more equity for financing purposes?
- What is the payout policy adopted by firms in Pakistan's non-financial sector?

Literature Review

Background

The literature on corporate finance emerged after 1950s. The book written by Dewing (1953) on corporate finance discusses it theoretically but not systematically. This book narrates different theories relating to corporate finance and financial policies. Corporate finance focuses on three activities such as deciding about investment, making the investment and interest or dividend decision. Unlikely to all, the two decisions are extremely important i.e., economical financing and decision regarding the payment of interest or dividend (Brealey et al., 2012). These two decisions affirm the success of overall cycle of corporate firms. But the most crucial decision for managers is deciding about funds and investment of these funds (Baker, 2011). Another study arranged by Baker et al. (2011a) argued that the corporate valuation depends upon the alignment of three decisions i.e. budgeting of capital, structure of capital and cost of capital. This was also confirmed in other studies (Andres et al., 2014; Graham, 2001; Brounen et al., 2004).

The existing literature on corporate finance can be split down into three activities. The discussion started from corporate investment which alternatively is known as capital budgeting. It was first discussed by Dean (1951) in his book named *Capital Budgeting*. He suggested that firms accept the capital investment options when internal rate of return is more than the current market cost of capital. Other studies (Lorie, 1955; Hirshleifer, 1958) focused on the internal rate of return (rate at which net present value become zero) and found some deficiencies on analysis made by (Fisher, 1907,1930; Lutz, 1969). After modification, they have suggested the net present value as benchmark to make the

investment decision. The positive net present value allows the managers to accept the investment option. The study by Lee and Park (2014) noted that CAPM model plays the key role in determining the investment target. They have documented that discounted cash flow; net present value and payback period were the most appropriate techniques for the evaluation of investment project. They have confirmed the findings of (Graham & Harvey, 2001; Brounen et al., 2004) for capital budgeting. Another study arranged by Kim et al. (2005) argued that the positive reaction of market attracts the firm's capital investment attentions. McConnell (1985) was also in the favor that the capital investment made result in high return for the companies.

Corporate finance also includes the decision regarding the capital structure. The foundation was laid down by Modigliani and Miller (1958) in the field of capital structure decision. The firms consistently engaged to invest in sustaining their growth, the decision of capital structure is very important to meet with investing requirements (Mostafa, 2014). Two sources of financing can be discussed i.e. internal and external. Internal financing retains earnings or capital reserve and external financing is the issuance of equity or taking of the debt. But companies have faced different obstacles in the case of internal and external financing which is explained by capital structure theories. The discussion on capital structure in literature is abundant (Aggarwal, 1981; Bhaduri, 2002; Arsov, 2016). The capital structure decision shows the financing preferences of firms for specific types of fund i.e., debt and equity. It not only changes the cost of financing but also affects the market value of firms (Hoque, 2014). The number of finance theories i.e. pecking order theory, agency cost theory and trade-off theory have explored the understanding of capital structure. The firms determine the total cost of funds by using the WACC rate.

Finally, the firms devised a method to repay these funds. After a detailed discussion on capital structure in 1952, Modigliani and Miller widened their research analysis in 1961 on dividend policy and noted that the firm's dividend policy remained fixed until there was no change in cash flow; also the tax rate remained ineffective. They suggested that the reason behind increment in dividend was the issuance of new equity. But the main research question regarding dividend policy is that why do firms pay the dividend or how are the dividends paid? Black (1996) demonstrated the solution of this unresolved issue and tried to respond to different questions related to dividend's decision. The Modigliani and Miller argued that the firms may either pay the dividend or capital gain or repurchase the stock from their equity holders. But the investors are usually interested in dividends due to "bird-in-hand" argument. Empirical

literature enlists some determinants that affect the dividend policy and argue why do firms pay the dividend (Charest, [1978](#); Brickley, [1983](#); Miller, [1961](#))?

The first theory on dividend policy given by Modigliani ([1963](#)) was named as the “*dividend irrelevance theory*” in which he suggested that firm value remained unchanged by the dividend policy under certain assumptions. The firms may decide to repurchase their stocks instead of paying dividends to their shareholders. The decision to repurchase the stock depends on multiple reasons. The firms may repurchase the stock to control the excess cash flow (Jensen, [1986](#)), to manage the undervalued stock prices (Vermaelen, [1981](#)) or it may be due to other multiple motives discussed in prior studies (Bagwell, [1991](#); Hertz, [1991](#); Fenn, [1998](#)).

Capital Budgeting in Pakistan

The literature on capital budgeting has emerged in Pakistan since the last decade (Tahir, [2014](#); Farrukh et al., [2015](#); Mubashar, [2019](#); Mumtaz et al., [2018](#); Mubashar, [2019](#)). The capital budgeting technique involves six different steps through which managers decide whether the proposed investment project is worth funding or not. The study arranged by Farrukh et al. ([2015](#)) documented that net present value (NPV) and internal rate of return (IRR) were the most appropriate techniques to decide about investment options. The payback period and discounted cash flow techniques were less favored by Pakistani firms. They have also proposed the areas which needed modification for capital investment in the case of Pakistani firms. Moreover, they have suggested that firms should practice more discounted cash flow technique because literature has favored it. The ideas of Farrukh et al. ([2015](#)) were also supported by Umair ([2015](#)). They have found that NPV and IRR are frequently used by Pakistani companies. Similarly, other studies which discuss capital budgeting in Pakistani context have shown results which may support NPV and IRR as best techniques to decide about capital investment (Mubashar, [2019](#)). Gul and Haider ([2018](#)) extended the research on capital budgeting and argued that the net present value, internal rate of return, profitability index (PI) and payback period (PBP) were suitable techniques which firms used in Pakistan to judge the financial health of capital investment.

The other well-known method which evaluates the associated risk and return of a project is capital asset pricing model (CAPM) introduced by (Sharpe, [1964](#)). But, unfortunately, this evaluation method was found less applicable in terms of Pakistani firms (Bhatti, [2010](#); Wu et al., [2017](#)). The Shaikh ([2012](#)) tested the CAPM on PSX listed firms and found that the CAPM failed to predict the return. Similarly, another study by Shaikh et al. ([2017](#)) also noted that CAPM model

weakly forecast the return from project specifically in the non-financial sector of Pakistan. This is the brief review of budgeting techniques specifically in Pakistan.

Capital Structure in Pakistan

The concept of capital structure was introduced by Modigliani and Miller (1958) in which they retreated on the cost of total capital associated with the percentage of debt and equity. The topic of capital structure decision has been discussed empirically in the Pakistani context (Afza, 2011; Tauseef, 2017). But, only few studies were found in the literature which analyzed the theory of capital structure and determined that it was more relevant in corporate sector of Pakistan and that the Pakistani firms prefer more debt or equity (Sheikh et al., 2012; Ali et al., 2016; Bhutta, 2017). The analysis of Sheikh et al. (2012) on pecking order theory argued that the corporate firms in Pakistan preferred more debt financing. Similarly, another study by Bhutta (2017) has noted that the bigger firms prefer more debt over equity while the firms which were more diversified preferred more equity.

The Qureshi et al. (2015) made the comparison between the pecking order theory and trade-off theory on Pakistani non-financial sector firms. They have documented that the pecking order theory was more supportive as compared to trade-off-theory to formulate and to leverage a policy. The agency cost theory was also tested on the non-financial sector of Pakistan Ahmed et al. (2014) and it was found that this theory was not applicable in the Pakistani corporate environment. Extensive literature was found on dynamic determinants of capital structure (Hijazi, 2006; Farrukh & Asad, 2017; Kabeer, 2018) but it doesn't focus to generalize the financing behavior of Pakistani corporate firms strongly.

Dividend Policy in Pakistan

The dividend policy has remained a prominent issue for corporate firms at all stages. Researchers have tried to unfold the dividend payout policy in Pakistan through empirical studies (Ahmed, 2009; Khan, 2011). Corporate firms announced their dividend payout policy in accordance with signaling theory, agency theory, life cycle theory and catering theory respectively (Haleem et al., 2011). But the study conducted by Khan and Baber (2018) noted that the irrelevance theory of dividend did not support the dividend payout behavior of firms. The study conducted by Khan (2017) on corporate dividend payout behavior of different sectors suggested that the earning per share and cash flow have a dynamic impact on the dividend payout policy. Similarly, Khan (2011) has also suggested the positive impact of corporate cash flow, liquidity and ownership

concentration on dividend policy and negative impact of investment opportunities and leverage on dividend payout behavior of firms. These outcomes regarding the determinants of dividend payout policy were later supported by (Khan & Ahmad, [2017](#)). Both, studies were consulted on the non-financial sector of Pakistan regarding the firms listed at KSE.

The literature showed that the dividend payout behavior of corporate firms in Pakistan was in line with the developed countries i.e., U.S.A. Khan, ([2011](#)) however, there exists a difference in the corporate culture in both the markets. The study conducted by Mehar ([2005](#)) argued the dividend payout ratio from total profit. He has suggested that the corporate firms in Pakistan pay 23% of their total profit as dividends and remaining 77% as additional investment. Literature exists on determinants of dividend payout policy (Roomi et al., [2011](#); Nazir et al., [2012](#); Sindhu et al., [2016](#)) but no study established the general trend that whether the Pakistani firms are interested to payout the dividend, capital gain or bonus share etc.

Corporate Finance Practices in Developed Countries

In order to seek more information on corporate finance practices in Pakistan, comparison can be made with any developed country. The study by Baker et al. ([2011](#)) documented major corporate finance patterns in Canada. They have made the analysis on capital budgeting, capital structure, cost of capital and real options. Their study vowed that Canadian firms used net present value followed by internal rate of return and payback period method in capital budgeting technique, while Pakistani firms used only net present value and internal rate of return for capital budgeting assesment. Similarly, in adjusting the capital structure decision, Canadian firms followed the trade-off theory while Pakistani firms arranged their financing pattern in accordance with pecking order theory. Lastly, their study indicated that real options are less likey among Canadian firms. Furthermore, literature stressed upon some corporate finance practices in U.S. and Europe. Graham and Harvey ([2001](#)) noted that IRR is a popular method among U.S. firms. Similarly, corporate firms in Franace, Germany and U.K. frequently used pay back period (PBP) for their capital budgeting estimation (Brounen et al., [2004](#)). Another comprehensive theoretical study by Kong and Xin ([2019](#)) highlighted corporate finance practices in China. They reviewd the articles published in *China Finance Review International*. They have provided significant evidences on firm financing behavior, merger and acquisition, R & D investment, firm financial performance and economic effects on China's capital market.

Theories of Corporate Finance

Efficient Market Theory

The efficient market theory expresses the return on stocks or price fluctuation of shares and depends upon the available information of capital market (Fama, [2021](#)). This theory justifies the market value of firms and holds that if the capital market is purely efficient than current market value of firm is equal to present value of future cash flow of firm. The studies by (Samuelson, [1965](#); Mandelbrot, [1966](#)) noted that the sudden changes in stock prices of firms were due to the access of new information in the market. This new information cannot be derived from existing information. They have also suggested that in a highly competitive market, sudden prices changes should be treated as independent drawings. This theory has many implications such as it clears the firm's objectives about value maximization of shares, degrades the biasness or manipulation in stock prices and suggests the stock returns as an indicator to quantify the firm's performance.

Portfolio Theory

The portfolio selection theory or portfolio theory was given by Markowitz ([1952](#)) in which he suggested that risk can be suppressed by formulating a portfolio of investment. He documented that the attributed risk which is a substantial part of investment can be reduced by dividing the total investment into multiple investment options. In his model, he clarified the efficient portfolio, which has minimum standard deviation and low variance of return. This theory specifies that a firm should select his portfolio of investment as individual investor's selects his portfolio for investment. Later, Sharpe ([1964](#)) presents the concept of systematic risk, the risk which cannot be diversified in any option.

Capital Asset Pricing Theory

The capital asset pricing theory or CAPM shows the cost or minimum return which is required by the investors in case of capital or long-term investment. It suggests that expected return is equal to the market rate of return and risk-free rate of return. After the innovation of (Markowitz, [1952](#); Treynor, [1961](#); Sharpe, [1964](#); Budgt, [1965](#)) attempted to investigate this model and introduced the prices of assets acquired by the company. They demonstrated that the price of security or assets is attributed to total risk which measured as covariance of security return and return of assets settled in accordance with market portfolio. They have given the name to this risk as "systematic risk" denoted by Beta (β).

Option Pricing Theory

The Option Pricing Theory states that the price of assets in present depends upon the expected future payoff of these assets. In the literature of finance, it was crucial to estimate the price of an asset such as call options that derive their return from other assets. The problem was resolved by (Black & Scholes, [1973](#)). They defined the call options as the option which has the condition of buyback by the seller even before the exercised date. They have also conducted an analysis on debt and equity and documented that the return on debt or equity is associated with the expected return on assets. They described the price fluctuation between debt and equity as when debt increases then the value of equity decreases because the claim of debt holders increases on firm's assets and equity holders just claim the residual return.

Value-Irrelevance Theory

The first theory of capital structure decision which was given by (Modigliani & Miller, [1958](#)) was value irrelevance proposition theory. According to this theory, the firm value is irrelevant to capital structure decision under certain assumptions. These assumptions are as

- Having no transaction and bankruptcy cost in any case of debt or equity.
- Flat tax rate no matter how much debt or equity.
- No risks exist in both types of financing.
- No problem of information, asymmetric in any case.
- Cash flow is continuous and no option affects the growth of firms.
- Managers are always in the effort to maximize the shareholder's wealth.

But in real world, these assumptions were strictly irrelevant. The un-favored assumptions of this theory were later incorporated by different research such as information asymmetric by Jensen ([1986](#)), benefits of tax by Modigliani and Miller ([1963](#)) and risk class by Stiglitz ([1974](#)).

Trade-off Theory

This theory was presented by Modigliani and Miller ([1963](#)). The traditional trade-off theory argued that the firms were always seeking the optimum ratio of debt and equity. Any deviation from debt may result in a move towards equity financing and vice versa. The decision of this ratio based on costs and benefits. The benefits are tax evasion and costs include the bankruptcy cost, increment in volatility and agency conflicts etc. However, theory has some basic concepts i.e., why firms follow moderation in issuance of debt and inspect tax advantage. The

firms with more intangible assets and more growth normally issue the less debt as debt may prevail the more financial distress cost and firms which preserve the more tax advantage issue the more debt. The trade-off theory efficiently explains the cost and benefits of leverage, but one factor was not included by trade-off theory which later provided the pecking order theory. This factor was the problem of asymmetric information which was incorporated by pecking order theory. Moreover, trade-off theory suggested the modified model of MM for the quantification of firm value. This model is.

$$\text{Value of firm } (V) = V + PV (\text{interest tax shield}) - PV (\text{cost of financial distress})$$

Pecking Order Theory

In contrast to trade-off theory, Myers and Majluf (1984) gave the concept of pecking order thus negating the concept of optimal debt financing of trade-off theory. They have asserted that the companies have no specific level of debt or equity but move towards external financing when internal financing becomes insufficient. They have defined the channel of financing as internal financing, debt financing and in last equity financing. The idea of pecking order theory was given by Shyam-Sunder and Myers (1999) and revealed that the pecking order theory was more relevant for financing decision instead of trade-off theory. But, the study made by Fama and French (2002) resulted that no theory was irrelevant and that some firms follow the trade-off theory and others follow the pecking order theory to shape their financing. Moreover, pecking order theory considers the cost of information asymmetric which may arise in case of high debt and companies should issue more equity when cost of information asymmetric is high.

Agency Theory

Agency theory of capital structure explains the cost that arises due to conflict of interest between shareholders and managers. When managers perform for self-advantage instead of to make the struggle for value maximization of shareholders for which they were appointed then the cost of agency arises which makes the financing costlier. Normally, this conflict arises due to low incentives to managers and low dividend payout ratio. The managers are in the favor of low dividends because high dividends may reduce their power. Jensen (1986) noted that this conflict became severe during the time of cash flow generation.

Conclusion

Empirical studies in the field of corporate finance are extant but studies on the theoretical explanation/relationships among the various constructs of corporate finance are rare in the literature. This study strives to theoretically explain the different activities performed under the head of corporate finance and to generalize the trend of corporate finance, specifically in Pakistan. The discussion on corporate finance started with capital budgeting in which firms evaluate the available investment options for making investments. They use different techniques such as discounted cash flow, net present value, and internal rate of return and payback period to judge the suitability of investment options. Unfortunately, two techniques that is, net present value and internal rate of return were found relevant in the case of Pakistan. The CAPM model quantifies the actual cost of investment by recognizing the market rate of return, risk free rate of return and systematic risk. However, Pakistani firms do not follow this model. Once the investment option has decided, then companies decide the capital structure. Companies borrow funds either from banks or issue equities to finance their investment projects. The literature suggests that corporate firms in Pakistan prefer debt financing and follow the pecking order theory. The theories on capital structure such as pecking order theory, trade-off theory, and agency cost theory theorize the financing behavior of firms.

Corporate firms have also made the decision regarding the payment of dividends or interest rate. The firms are usually interested in paying the dividend because it enhances the firm's reputation in capital market. It also encourages the investors to invest in company equity. The studies made in different countries have significantly improved the positive relationship between the firm dividend policy and profitability. In spite of this, the companies may repurchase their shares to maintain the firm cash flow and stock prices. In literature, studies usually discuss the determinants of dividends and its impact on corporate strategies and outcomes in Pakistani context. But literature failed to generalize the trend of corporate firms. There were three activities which have been mainly discussed in the literature of corporate finance. The firms should align these three activities. This study theoretically exemplifies the brief review of literature on corporate finance and answered the research questions. It fulfills the research objective and resolves the statement of problem. In future, the studies can be arranged empirically to test that either these three activities aligned with each other and what is the impact of this on the firm's performance. In future, studies can also be arranged to empirically check the corporate finance strategies of different sectors individually.

Way Forward

The empirical findings on capital budgeting technique exemplify that the net present value and internal rate of return were the techniques which have been used by the Pakistani firms but implication of CAPM fails in the Pakistani context. So, it needed to search theoretical reasoning behind this fact and conduct more empirical studies which come up with the answer to this question. Similarly, the findings of studies on non-financial sector of Pakistan resulted that Pakistani firms focus more on debt financing but the vast literature in financial economics is in the favor that companies should structure their financing needs both with debt and equity. More studies should be conducted to find out the reason behind this trend and highlight the factors which compel the firms to prefer more debt. The major gap regarding the dividend policy is that Pakistani firms have no general trend towards dividend payment, capital gain, or repurchase of stock. Its major area is corporate finance which should be considered by researchers. Detailed empirical studies should be conducted which test the hypothesis of payout policy in Pakistan.

Practical Implications

This study has following practical Implications.

- Corporate managers can utilize the findings of study to briefly understand the corporate financial culture in Pakistan.
- It presents the brief review of massive empirical studies which will enhance the understandings of researchers on different corporate finance practices in Pakistan.
- Policy makers can use this study in their decision of policy formulation. Study provides a brief outlook on past corporate finance practices in Pakistan.
- Corporate trends on capital budgeting, capital structure and dividend policy which can be generalized in other transitional economies having same corporate environment.

References

- Afza, T. & Hussain, A. (2011). Determinants of Capital Structure across Selected Manufacturing Sectors of Pakistan. *International Journal of Humanities and Social Science*, 1(12), 254-262.
- Aggarwal, R. (1981). International differences in capital structure norms: An empirical study of large European companies. *Management International Review*, 21(1), 75-88.

- Ahmed, A. & Javid, A. Y. (2009). Dynamics and Determinants of Dividend Policy in Pakistan (Evidence from Karachi Stock Exchange Non-financial listed Firms). *International Research Journal of Finance and Economics*, 25, 148-171.
- Ahmed, S., Tahir, S. H. & Raza, A. (2014). Testing Agency and Stewardship Theories in the Environment of Pakistan (Evidences from Oil and Gas Development and Electricity sectors of Pakistan). *Research Journal of Commerce and Behavioral Sciences*, 3(7), 30-37.
- Ali, A., Mahmood, S., Hui, L. & Rizwan, M. (2016). Study of the static trade-off theory: Determinants vis-à-vis capital structure phenomenon in context of Pakistan's chemical industry. *International Journal of Business and Management Invention*, 5(8), 40-48.
- Andres, C., Cumming, D., Karabiber, T., & Schweizer, D. (2014). Do markets anticipate capital structure decisions? —Feedback effects in equity liquidity. *Journal of Corporate Finance*, 27, 133-156. <https://doi.org/10.1016/j.jcorpfin.2014.02.006>
- Arsov, S., & Naumoski, A. (2016). Determinants of capital structure: An empirical study of companies from selected post-transition economies. *Zbornik radova Ekonomskog fakulteta u Rijeci: časopis za ekonomsku teoriju i praksu*, 34(1), 119-146.
- Bagwell, L. S. (1991). Share repurchase and takeover deterrence. *The Rand Journal of Economics*, 22(1), 72-88. <https://doi.org/10.2307/2601008>
- Baker, H. K., Dutta, S., & Saadi, S. (2011). Corporate finance practices in Canada: where do we stand? *Multinational Finance Journal*, 15(3/4), 157-192.
- Baker, H. K., & Kiyamaz, H. (Eds.). (2011). *The art of capital restructuring: Creating shareholder value through mergers and acquisitions* (Vol. 14). John Wiley & Sons.
- Bhaduri, S. N. (2002). Determinants of capital structure choice: a study of the Indian corporate sector. *Applied Financial Economics*, 12(9), 655-665. <https://doi.org/10.1080/09603100010017705>
- Bhatti, U., & Hanif, M. (2010). Validity of capital assets pricing model: Evidence from KSE-Pakistan. *European Journal of Economics, Finance and Administrative Sciences*, 20, 1-20.

- Bhutta, A. I., & Suleman, T. (2017). Capital structure and business groups: Evidence from Pakistan. *Journal of Management Sciences*, 4(2), 248-268.
- Black, F. (1996). The dividend puzzle. *Journal of Portfolio Management*, 2(2), 5-8.
- Black, F., & Scholes, M. (1973). The pricing of options and corporate liabilities. *Journal of Political Economy*, 81(3), 637-654. https://doi.org/10.1142/9789814759588_0001
- Brealey, R. A., Myers, S. C., Allen, F., & Mohanty, P. (2012). *Principles of corporate finance*. Tata McGraw-Hill Education.
- Brickley, J. A. (1983). Shareholder wealth, information signaling and the specially designated dividend: An empirical study. *Journal of Financial Economics*, 12(2), 187-209. [https://doi.org/10.1016/0304-405X\(83\)90035-1](https://doi.org/10.1016/0304-405X(83)90035-1)
- Brounen, D., De Jong, A., & Koedijk, K. (2004). Corporate finance in Europe: Confronting theory with practice. *Financial Management*, 33(4) 71-101.
- Charest, G. (1978). Dividend information, stock returns and market efficiency-II. *Journal of Financial Economics*, 6(2-3), 297-330. [https://doi.org/10.1016/0304-405X\(78\)90033-8](https://doi.org/10.1016/0304-405X(78)90033-8)
- Dean, J. (1951). *Capital budgeting*. Columbia University Press.
- Dewing, A. S. (1953). *The Financial Policy of Corporations: Corporate Securities* (Vol. 1). Ronald Press Company.
- Fama, E. F. (2021). Efficient capital markets a review of theory and empirical work. *The Fama Portfolio*, 2021, 76-121. <https://doi.org/10.7208/9780226426983-007>
- Fama, E. F., & French, K. R. (2002). Testing trade-off and pecking order predictions about dividends and debt. *The Review of Financial Studies*, 15(1), 1-33.
- Farrukh, S., Areal, N., & Rodrigues, A. (2015). A cross sectional comparison of capital budgeting practices in Pakistan. *International Journal of Innovative Science, Engineering & Technology*, 2(2), 431-437.
- Farrukh, W., & Asad, M. (2017). The determinants of capital structure: A study on cement sector of Pakistan. *International Journal of Management Sciences and Business Research*, 6(2), 16-26.

- Fenn, G. W., & Liang, N. (1998). Good news and bad news about share repurchases. *Available at SSRN 113268*.
- Fisher, I. (1907). *The Rate of Interest*. Macmillan.
- Fisher, I. (1930). *The Theory of Interest*. Macmillan.
- Graham, J. R., & Harvey, C. R. (2001). The theory and practice of corporate finance: Evidence from the field. *Journal of Financial Economics*, 60(2-3), 187-243. [https://doi.org/10.1016/S0304-405X\(01\)00044-7](https://doi.org/10.1016/S0304-405X(01)00044-7)
- Gul, S., Gul, H., & Haider, M. (2018). The review and use of capital budgeting investment techniques in evaluating investment projects: Evidence from manufacturing companies listed on Pakistan Stock Exchange (PSE). *City University Research Journal*, 8(2), 247-260.
- Haleem, F., & Javid, A. Y. (2011). The dividend policy in manufacturing sector of Pakistan: The perception of corporate managers. *Journal of Economics and Behavioral Studies*, 3(1), 63-75.
- Hertzel, M., & Jain, P. C. (1991). Earnings and risk changes around stock repurchase tender offers. *Journal of Accounting and Economics*, 14(3), 253-274. [https://doi.org/10.1016/0165-4101\(91\)90014-F](https://doi.org/10.1016/0165-4101(91)90014-F)
- Hijazi, S. T., & Bin Tariq, D. (2006). Determinants of capital structure: A case for Pakistani cement industry. *Lahore Journal of Economics*, 11(1), 63-80.
- Hirshleifer, J. (1958). On the theory of optimal investment decision. *Journal of Political Economy*, 66(4), 329-352.
- Hoque, J., Hossain, A., & Hossain, K. (2014). Impact of capital structure policy on value of the firm—A study on some selected corporate manufacturing firms under Dhaka Stock Exchange. *Ecoforum Journal*, 3(2), 9-17.
- Javid, A. Y. & Iqbal, R. (2010). *Corporate Governance in Pakistan: Corporate Valuation, Ownership and Financing* (Working Paper No. 57). Islamabad, Pakistan Institute of Development Economics.
- Jensen, M. C. (1986). Agency costs of free cash flow, corporate finance, and takeovers. *The American Economic Review*, 76(2), 323-329.
- Sheikh, J., Ahmed, W. A., Iqbal, W., & Masood, M. M. (2012). Pecking at pecking order theory: Evidence from Pakistan's non-financial sector. *Journal of Competitiveness*, 4(4), 86-95.

- Kabeer, M. A., & Rafique, S. (2018). The determinants of capital structure: evidence from Pakistani manufacturing companies. *Journal of Banking and Finance Management School of Accountancy & Finance, University of Lahore, Pakistan*, 1(3), 1-16.
- Khan, M., Shah, M. S., ul Haq, F., & Shah, S. Z. A. (2014). Determinants of capital structure in non-financial companies of Pakistan. *Journal of Poverty, Investment and Development*, 6, 20-28.
- Khan, F. A., & Ahmad, N. (2017). Determinants of dividend payout: An empirical study of pharmaceutical companies of Pakistan Stock Exchange (PSX). *Journal of Financial Studies & Research*, 2017, 1-16.
- Khan, M. S., Shah, S. & Baber, S. U. (2018). Impact of dividend policy on shareholders' wealth: an empirical analysis of listed insurance companies in Pakistan. *Journal of Business and Tourism*, 4(1), 69-80.
- Khan, N. U., Burton, B. M., & Power, D. M. (2011). Managerial views about dividend policy in Pakistan. *Managerial Finance*, 37(10), 953 - 970. <https://doi.org/10.1108/03074351111161600>
- Kim, W. S., Lyn, E., Park, T. J., & Zychowicz, E. (2005). The wealth effects of capital investment decisions: An empirical comparison of Korean chaebol and non-chaebol firms. *Journal of Business Finance & Accounting*, 32(5-6), 945-971.
- Kong, D. & Xin, Q., 2019. Corporate finance in China. *China Finance Review International*, 9(1), 2-4. <https://doi.org/10.1108/CFRI-02-2019-240>
- Lee, H., Oh, S., & Park, K. (2014). How do capital structure policies of emerging markets differ from those of developed economies? Survey evidence from Korea. *Emerging Markets Finance and Trade*, 50(2), 34-72. <https://doi.org/10.2753/REE1540-496X500203>
- Budgets, C., & Lintner, J. (1965). The Valuation of Risk Assets and the Selection of Risky Investments in Stock Portfolios. *The Review of Economics and Statistics*, 47(1), 13-37.
- Lorie, J. H., & Savage, L. J. (1955). Three problems in rationing capital. *The Journal of Business*, 28(4), 229-239.
- Lutz, F. A., & Lutz, V. C. (1969). *The theory of investment of the firm*. Praeger.
- Mandelbrot, B. (1966). Forecasts of future prices, unbiased markets, and "martingale" models. *The Journal of Business*, 39(1), 242-255.

- Markowitz, H. (1952). The utility of wealth. *Journal of Political Economy*, 60(2), 151-158.
- Markowitz, H. M. (1968). *Portfolio selection*. Yale university press.
- McConnell, J. J., & Muscarella, C. J. (1985). Corporate capital expenditure decisions and the market value of the firm. *Journal of Financial Economics*, 14(3), 399-422. [https://doi.org/10.1016/0304-405X\(85\)90006-6](https://doi.org/10.1016/0304-405X(85)90006-6)
- Mehar, A. (2005). Corporate governance and dividend policy. *Pakistan Economic and Social Review*, 43(1), 93-106.
- Miller, M. H., & Scholes, M. S. (1982). Dividends and taxes: Some empirical evidence. *Journal of Political Economy*, 90(6), 1118-1141.
- Miller, M. H., & Modigliani, F. (1961). Dividend policy, growth, and the valuation of shares. *The Journal of Business*, 34(4), 411-433.
- Modigliani, F., & Miller, M. H. (1963). Corporate income taxes and the cost of capital: a correction. *The American Economic Review*, 53(3), 433-443.
- Modigliani, F., & Miller, M. H. (1958). The cost of capital, corporation finance and the theory of investment. *The American Economic Review*, 48(3), 261-297.
- Mostafa, H. T. & Boregowda , S. (2014). A brief review of capital structure theories. *Research Journal of Recent Sciences*, 3(10), 113-118.
- Mubashar, A., & Tariq, Y. B. (2019). Capital budgeting decision-making practices: Evidence from Pakistan. *Journal of Advances in Management Research*, 16(2), 142-167. <https://doi.org/10.1108/JAMR-07-2018-0055>
- Mumtaz, A., Saeed, T., & Ramzan, M. (2018). Factors affecting investment decision-making in Pakistan stock exchange. *International Journal of Financial Engineering*, 5(04), 1850033. <https://doi.org/10.1142/S2424786318500330>
- Mumtaz, R., Rauf, S. A., Ahmed, B., & Noreen, U. (2013). Capital structure and financial performance: Evidence from Pakistan (Kse 100 Index). *Journal of Basic and Applied Scientific Research*, 3(4), 113-119.
- Myers, S. C., & Majluf, N. S. (1984). Corporate financing and investment decisions when firms have information that investors do not have. *Journal of Financial Economics*, 13(2), 187-221. [https://doi.org/10.1016/0304-405X\(84\)90023-0](https://doi.org/10.1016/0304-405X(84)90023-0)

- Nazir, M. S., & Nawaz, M. M. (2012). Corporate payout policy and market capitalization: Evidence from Pakistan. *Journal of Economics and Behavioral Studies*, 4(6), 331-343. <https://doi.org/10.22610/jeb.v4i6.333>
- Qureshi, M. A., Sheikh, N. A., & Khan, A. A. (2015). A revisit of pecking order theory versus trade-off theory: Evidence from Pakistan. *Pakistan Journal of Commerce and Social Sciences (PJCSS)*, 9(2), 344-356.
- Rafiq, M. (2008). The determinants of capital structure of the chemical industry in Pakistan. *The Lahore Journal of Economics*, 13(1), 139-158.
- Roomi, M. A., Chaudhry, N. I., & Azeem, M. (2011). Dividend payment practices in the non-financial sector of Pakistan: empirical evidence from the Karachi Stock Exchange. *World Academy of Science, Engineering and Technology*, 59, 2060-2068.
- Samuelson, P. A. (1965). Proof that property anticipated prices fluctuate randomly. *Industrial Management Review*, 6(2), 41-49.
- Shah, A., Hijazi, T., & Javed, A. Y. (2004). The determinants of capital structure of stock exchange-listed non-financial firms in Pakistan [with comments]. *The Pakistan Development Review*, 43(4), 605-618.
- Shahid, M. S., Nawaz, S., & Ali, L. (2018). Does ownership structure influence financial decisions: evidence from Pakistan? *NUML International Journal of Business & Management*, 13(2), 51-64.
- Shaikh, S. A. A. (2013). Testing Capital Asset Pricing Model on KSE Stocks. *Journal of Managerial Sciences*, 7(2), 281-289.
- Shaikh, S. A., Shaikh, R. & shaique, M. (2017). Applicability of CAPM: Evidence from Pakistan Stock Exchange (PSX). *Journal of Business Strategies*, 11(2), 21-34.
- Sharpe, W. F. (1964). Capital asset prices: A theory of market equilibrium under conditions of risk. *The Journal of Finance*, 19(3), 425-442. <https://doi.org/10.1111/j.1540-6261.1964.tb02865.x>
- Shyam-sunder, L. & Myers, S. C. (1999). Testing Static Trade-Off Against Pecking Order Models Of Capital Structure. *Journal of Financial Economics*, 2(51), 219-244.
- Sindhu, M. I., Hashmi, S. H., & Ul Haq, E. (2016). Impact of ownership structure on dividend payout in Pakistani non-financial sector. *Cogent Business & Management*, 3(1), 1272815. <https://doi.org/10.1080/23311975.2016.1272815>

- Stiglitz, J. E. (1974). Incentives and risk sharing in sharecropping. *The Review of Economic Studies*, 41(2), 219-255. <https://doi.org/10.2307/2296714>
- Tahir, S. H., & Sabir, H. M. (2014). Impact of family ownership on investment decision: comparative analysis of family and non-family companies listed at Karachi stock exchange (Pakistan). *Poslovna Izvrsnost*, 8(2), 33-52.
- Tauseef, S., & Lohano, H. D. (2017). Capital structure and profitability of firms in the corporate sector of Pakistan. *IBA Business Review*, 12(1), 50-58.
- Treynor, J. L. (1961). *Toward a theory of market value of risky assets*. *Journal of Investment Management*, 1(2), 6072, 2003.
- Umair, N. (2015). Review of capital budgeting techniques and firm size. *Research Journal of Finance and Accounting*, 6(7), 106-112.
- Vermaelen, T. (1981). Common stock repurchases and market signalling: An empirical study. *Journal of Financial Economics*, 9(2), 139-183. [https://doi.org/10.1016/0304-405X\(81\)90011-8](https://doi.org/10.1016/0304-405X(81)90011-8)
- Wu, M., Imran, M., Feng, Y., Zhang, L., & Abbas, M. (2017). Review and validity of capital asset pricing model: evidence from Pakistan stock exchange. *International Research in Economics and Finance*, 1(1), 21-31.
- Zubairi, H. J. (2008). Capital Budgeting-Decision Making Practices in Pakistan. Available at SSRN 1308662.