

## CORPORATE FINANCE PRACTICES IN SRI LANKA



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### ABSTRACT

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The aim of this study was to investigate the use of corporate finance practices in terms of capital budgeting, cost of equity capital and capital structure in Sri Lanka. A comprehensive primary survey was conducted of 38 out of 150 financial officers of companies listed on the Colombo Stock Exchange (CSE) in Sri Lanka. Stratified random sampling was used to select the participants in order to represent the different sectors in CSE. Collected data were then analyzed by applying mean and percentage analysis. Results of the survey revealed that NPV was the most frequently 'always' cited capital budgeting method, followed by IRR and PB. CAPM was the most preferred method to calculate the cost of equity capital followed by average historical rate of return on common stock. Remarkably, most firms would use a discount rate for entire company to evaluate the project. Further, it was evaluated that how finance professionals make adjustments for risk factors. It was concluded that risk of unexpected inflation, interest rate risk, term structure risk, business cycle risk, size based risk, market to book ratio and momentum were mostly adjusted by discount rate while commodity price risk, foreign exchange risk and distress risk were mostly adjusted by cash flow. Further, this study was to find out whether Sri Lankan finance professionals behave as expected by pecking order theory of capital structure patterns. Findings of the study are in line with the pecking order theory that firms are having preference to internal finance for their capital. This research has proffered a more reliable and comprehensive analysis of corporate finance practices in Sri Lankan companies.

**Contribution/ Originality:** This study was one of the very few studies which have investigated the corporate finance practices in emerging markets. The present study focused on capital budgeting, cost of equity capital and capital structure practices in Sri Lanka which give the geographical contribution to the existing finance literature.

## 1. INTRODUCTION

Over the last two decades, there have been many changes and challenges in making financial decisions due to the global financial crisis, fluctuations in value of money, advanced developments in technology, interest rate, exchange rate and inflation rates' risks and dramatic changes in economic and business environment both in national as well as in global markets. The corporate finance decision making is not a simple or straightforward approach, the risk is an important element in the decision making. There are number of risk techniques employed

for evaluating investment projects by the companies. However, there is the problem in setting up theoretical model and applying that model into practice (e.g: (Arnold and Hatzopoulos, 2000; Graham and Harvey, 2001; Anand, 2002; Brounen *et al.*, 2004; Mutairi *et al.*, 2012)). Thus, the theory is not purely able to apply at all situations. Sometimes theories developed in the past do not applicable today. There is no doubt, over the last two decades corporate finance practices have not been static, diverged from the theories.

The current study investigates the prevalent use of corporate finance practices ranging from capital budgeting, cost of equity capital and capital structure in Sri Lankan emerging market. This is a preliminary survey on corporate finance practices in Sri Lanka. Moreover, the current study compares the results with similar studies carried out in developed (Graham and Harvey, 2001; Brounen *et al.*, 2004) and emerging economies (Anand, 2002). Developed economies that have highly developed capital markets with high levels of liquidity, meaningful regulatory bodies, large market capitalization, and high levels of per capita income (Geary, 2012) for instance, the USA and Europe. India is an emerging country in the process of rapid growth and development with lower per capita income, less mature capital markets and very small capital projects than developed countries. As a result of this, emerging market economies clearly pose challenges in applying corporate finance theories owing to less developed capital markets and the difficulty of setting key parameters. Consequently, the findings of the study makes a geographical contribution to the existing literature in the ground of current corporate finance practices in Sri Lanka.

## 2. LITERATURE REVIEW

### 2.1. Decision Making in Corporate Finance

Financial management theory is related to maximizing the market value of a firm for its owners, to wit, the maximization of shareholders' wealth (Cho, 1996; Cooper *et al.*, 2002; Dayananda *et al.*, 2002; Peterson and Fabozzi, 2002; Atrill, 2009) and main objective of corporate management is to maximize shareholders' wealth in authorized and also ethical approach. Financial management primarily concerns investment, financing and dividend decisions and the interactions between them. Decision making in financial management primarily deals with three types of decisions: Investment decision, financing decision and dividend decisions and these lay down at the heart of the financial management theory and practice (Pike and Neale, 2009). Albeit these three types of decision, all these decisions are interrelated. The first two types of decision making pertaining to any kind of the organization meanwhile the third merely applicable to profit making organizations. These financial investment decisions are important to avoid being caught in financial trap. Investment decision is the decision to acquire assets (Pike and Neale, 2009). Financial economic perspective explains that investment decision needs to increase economic capacity of the company and its financial value. Investment decision is thus mainly concerned with identification of the investment opportunities and to select the best having had better evaluation. Financial decision is primarily concerned with making a decision of optimum capital structure of a firm, taking into account of cost, control and risk. The dividend decision is mainly concerned with the dividend decision about payment or declaration of it (Pike and Neale (2009)). Among these types of decision making, capital budgeting decision / investment decision making is of vital importance and critical to survival and long term success of firms (Bennouna *et al.*, 2010). Kersynte (2011) pointing out in his study, under the global economic conditions, 'the steady increase in the variety and scale of uncertainties, competitive interactions and risks prevail, and the difficulty to make reasonable investment decisions is growing'. Thus it suggests that investment decisions are the most critical type of managerial decisions made by the companies and can have major long term implications for the survival of a company. Therefore, managers must have clear understanding to take the corporate finance decisions in order to improve the corporate performance and long term sustainability (Kersynte, 2011).

## 2.2. Previous Studies on Corporate Finance Practices

The considerable number of studies apply field survey research to confront theory with the practice of finance professionals in well developed countries, particularly the USA, the UK, Europe and Australia. However, these studies characteristically centre on only one particular issue of corporate finance. For example, Mao (1970); Gitman and Forrester (1977); Sangster (1993); Pike (1996); Arnold and Hatzopoulos (2000) specifically focus on capital budgeting practices in developed countries such as the USA and the UK. Along with the area of capital budgeting, some studies include the cost of capital such as Epps and Mitchem (1994); Jog and Srivastava (1995); Billingsley and Smith (1996); Bruner *et al.* (1998); Block (1999); Black *et al.* (2002) and Truong *et al.* (2008). Furthermore, there have been some comparative studies by Kester *et al.* (1999) and Hermes *et al.* (2007).

Specifically studies are to explore capital structure practices in the European Union, Bancel and Mittoo (2002) whereas Beattie *et al.* (2006) explored capital structure decisions in the UK. There was a field survey study conducted by Fan and So (2000) to explore capital structure in Hong Kong. Poterba and Summers (1995) conducted a study on areas of capital structure and capital budgeting together in the USA.

There was a famous and well known field study of dividend policy initiated by Lintner (1956) in the USA. Consequently, Baker and Powell (2000); Dhanani (2005) also explored dividend policy in the USA and the UK.

However, only few studies implemented comprehensive financial policy surveys that cover many issues of corporate finance practices. The best-known survey is a comprehensive survey by Graham and Harvey (2001) focusing on capital structure, capital budgeting, and cost of capital among 392 CFOs in the USA. It is interesting to note that Brav *et al.* (2005) conducted field research to explore dividend policy in the USA. Also, Anand (2002) surveyed 81 CFOs in India to explore capital budgeting, cost of capital, capital structure and dividend policy decisions. Two years later, Brounen *et al.* (2004) presented results of an international survey among 313 CFOs on capital budgeting, cost of capital, capital structure and corporate governance in the UK, the Netherlands, Germany and France. There is another study conducted by Benetti *et al.* (2007) in Brazil focusing on practices of corporate finance. Isa (2008) conducted a survey on corporate finance practices in Malaysia covering the concepts of capital budgeting, capital structure and dividend policy. Mutairi *et al.* (2012) presented a survey of 80 CFOs in Kuwait to explore the corporate governance and corporate finance practices covering capital budgeting, capital structure, cost of capital and dividend policy. Akintunde and Otegunrin (2013) conducted a comparative study on current practice of corporate finance in Thailand and US. Kohli and Sharma (2015) conducted a study on corporate financial behavior in Indian MNC's. Very recently another study focused on corporate finance practices in Morocco focused on capital budgeting and real options by Baker *et al.* (2017). Specifically, current study is going to document on what corporate finance practices are applied by Sri Lanka finance professionals. While there are lack of evidence in the literature relating to corporate finance practices in emerging markets, the international trend is towards increased emphasis on advanced markets such as the USA, the UK, NZ, Europe and others. Nevertheless, to the best of my knowledge, particularly in Sri Lanka very few studies have been conducted. This study extends the comprehensively cover of the three major areas of corporate finance namely capital budgeting, cost of equity capital and capital structure..

Therefore, researcher can pose the research questions that

*RQ1. What corporate finance practices are being applied by finance professionals in Sri Lanka in terms of capital budgeting, cost of equity and capital structure.*

## 3. METHODOLOGY

### 3.1. Research Design

The survey tried to identify corporate finance practices in Sri Lanka and focused on three areas: capital budgeting, cost of equity capital and capital structure. Questionnaire was used to collect the data. Questions on capital budgeting practices were based on the study by Graham and Harvey (2001). This similar questions were

used by Brounen *et al.* (2004); Benetti *et al.* (2007); Akintunde and Otekunrin (2013) and Kohli and Sharma (2015). Questions on methods to estimate the cost of equity capital were also included from Graham and Harvey (2001) and Brounen *et al.* (2004). The remaining questions that is going to explore the capital structure mix were relatively similar to the survey in Anand (2002). Further, some questions were included to fit the Sri Lankan context.

### 3.2. Data Collection Procedure

In the initial stage, a draft questionnaire was circulated to a group of prominent academics and financial officers for their feedback. Their suggestions were incorporated and then questionnaire was revised. Pilot survey was conducted by the researcher using self-administered questionnaire with a sample of four financial officers from different sectors with the prior arranged appointments over the phone for the pilot survey. From the pilot survey what was observed that how the respondents understood the questions in the questionnaire, how long it took to complete the questionnaire and if anything important was missing. The respondents understood all of the questions in the way that the researcher intended and the respondents spent 20 minutes completing the questionnaire. The financial officers expressed few suggestion in order to improve the response rate and they did not express any concerns about the questionnaire. The results and the nature of the pilot study were successful and this paved the way for implementing it among 150 listed companies covering different sectors. Colombo Stock Exchange (CSE) has 295 listed companies representing 20 business sectors in 2017. Stratified random sampling method was used to select the 150 listed companies. Different strategies were used to collect the data. 24 questionnaire were directly collected from the companies and 19 questionnaires were received by post and 4 questionnaires were received via email 11 questionnaire were returned to the researcher as undelivered post. 38 questionnaire were usable to the study out of 47 received questionnaire.

### 3.3. Testing the Reliability

A reliability analysis of the item-scales was performed using SPSS. Cronbach's alpha ( $\alpha$ ) values were assessed for each variable with item-scales. The reliability of the measures was well above the minimum threshold of 0.60 in every case (Gliner and Morgan, 2000). Thus, it can be concluded that all of the measures were generally reliable.

**Table-1. Testing of reliability - Cronbach's alpha for the variables**

Concept/Variables	No. of items	Cronbach's Alpha
Capital budgeting practices	12	.747
Methods to estimate cost of equity capital	06	.603
Discount rates when evaluating a new project in an overseas market	05	.618
When valuing a project, do you adjust either discount rate or cash flows	10	.780
Sources of financing choices	06	.655

Source: survey data

## 4. DESCRIPTIVE ANALYSIS OF THE SURVEY RESPONSES

The descriptive analyses of the survey responses are discussed under the following sub-headings.

### 4.1. Educational Qualification of the Respondents

Classification of the educational qualification of the respondents was grouped into: bachelor degree, MBA, non-MBA Master's, above Master's degree and professional qualification (e.g.,CIMA, ACCA). Above master degree qualification (e.g., MPhil/PhD or MBA degree with professional qualification) was held by 42.1% of CFOs, followed by MBA qualification (23.7%), Professional qualification (21.1%) and non-MBA Master's (13.2%) as per table 2

**Table-2. Educational Qualification of Respondents**

Educational Qualification	No. of CFOs (N)	Percentage (%)
Bachelor Degree	-	-
MBA	9	23.7
Non-MBA Masters	5	13.2
> (above) Master Degree	16	42.1
Professional Qualification	8	21.1
Total	38	100.0

Source: survey data

#### 4.2. Size of Market Capitalization

Size of market capitalization was categorized into five groups: less than LKR 10 billion, LKR 10–50 billion, LKR 50–100 billion, LKR 100 –500 million and LKR 500 billion and over. The large number of CFOs reported that size of their market capitalization is less than 10 billion (42.1%), followed by LKR 50- 100 billion (28.9%), LKR 10 - 50 Billion (23.7%) and LKR 100-500 billion (5.3%). Table 3 presents the different sizes of market capitalization.

**Table-3. Market capitalization of responded firms**

Market capitalization	No.of Companies (N)	Percentage (%)
<10 Billion	16	42.1
10-50 Billion	9	23.7
50-100 Billion	11	28.9
100-500 Billion	2	5.3
> 500 Billion	-	-
Total	38	100.0

Source: survey data

#### 4.3. Experience of the CFOs

Experience of the CFOs was classified into four groups in terms of number of years they have been in the profession: less than 5 years, 5-9 years, 10-19 years and 20 years and more. The higher number of CFOs had 10 to 19 years' experience (N=15), followed by 20 years' and more experience (N=9), 5 to 9 years' (N=8) and a small number of CFOs have less than 5 years' experience (N=6). Table 4 shows experience of the CFOs.

**Table-4. Years of experience of CFOs**

Years of experience	No. of CFOs (N)	Percentage (%)
< 5 years	6	15.8
5-9 years	8	21.1
10-19 years	15	39.5
> 20 years	9	23.7
Total	38	100.0

Source: survey data

#### 4.4. Types of Industry

Types of industry were initially classified in terms of their nature (Verbeeten, 2006) as shown in table 5: bank/finance/insurance industry, manufacturing industry, diversified holdings, health care industry and other non-financial industry. As can be seen in the table, 57.9% of industries are manufacturing, followed by diversified holdings (21.1%), bank/finance/insurance companies (10.5%), health care industry (5.3%) and other non-financial industry (5.3%).

**Table-5. Types of industries**

Types of industries	No. of Companies (N)	Percentage (%)
Bank/Finance/ Insurance	4	10.5
Manufacturing Industry	22	57.9
Diversified Holdings	8	21.1
Health Care Industry	2	5.3
Other Non-Financial Industry	2	5.3
Total	38	100.0

Source: survey data

## 5. RESULTS AND DISCUSSION

### 5.1. Capital Budgeting

This part examined the way in which Sri Lankan firms appraise their investment projects. In line with the previous studies of [Graham and Harvey \(2001\)](#) and [Brounen et al. \(2004\)](#) present study included a wide-range of choices of capital budgeting techniques, including *non discounted cash flow (NDCF) techniques* (Simple payback (PB), Accounting rate of return (ARR)), *discounted cash flow (DCF) techniques* (Internal rate of return (IRR), net present value (NPV), adjusted present value (APV), discounted payback period (DPB), profitability index (PI), hurdle rate (HR), earnings multiple approach (EMR) and *more advanced methods* (sensitivity analysis (SA), Value at risk (VAR), real options (RO). With the evidence from the previous studies, Sri Lanka is treated as an emerging country, following hypothesis has been formulated in this study: **H: Discounted cash flow techniques are mostly used by Sri Lankan companies for the investment decision**

Respondents have been asked to report how frequently they use the different capital budgeting techniques on a Likert scale ranging from 1 to 5 (1= never, 5=always) and results of the study presented in the table 6.

**Table-6.** Survey responses for the question, 'How frequently did your firm use the following capital budgeting techniques when evaluating the investment project?'

Capital Budgeting Practices	Never	Rarely	Sometimes	Often	Always	Mean & Rank
PB	-	21.1%(8)	10.5%(4)	15.8%(6)	52.6%(20)	4.00 (3)
DPB	-	10.5%(4)	10.5%(4)	47.4%(18)	31.6%(12)	3.92 (4)
ARR	10.5% (4)	31.6%(12)	15.8%(6)	10.5%(4)	31.6%(12)	3.21 (6)
NPV	-	-	15.8%(6)	31.6%(12)	52.6%(20)	4.37 (1)
IRR	-	-	5.1%(2)	56.4%(22)	35.9%(14)	4.32 (2)
APV	21.1%(8)	47.4%(18)	15.8%(6)	10.5%(4)	5.3%(2)	2.32 (11)
PI	26.3%(10)	26.3%(10)	15.8%(6)	15.8%(6)	15.8%(6)	2.68 (7)
HR	36.8%(14)	26.3%(10)	21.1%(8)	5.3%(2)	10.5%(4)	2.26 (12)
EMR	31.6%(12)	26.3%(10)	5.3%(2)	31.6%(12)	5.3%(2)	2.53 (9)
SA	-	15.8%(6)	10.5%(4)	42.1%(16)	31.6%(12)	3.89 (5)
VAR	21.1%(8)	31.6%(12)	31.6%(12)	10.5%(4)	5.3%(2)	2.47 (10)
RO	26.3%(10)	21.1%(8)	31.6%(12)	10.5%(4)	10.5%(4)	2.58 (8)

Source: survey data

As results presented in the table 6, NPV is the most preferred method of capital budgeting where 52.6 % of CFOs are 'always' preferred it which yielding mean value of 4.37. This is followed by IRR 'always' by 35.9% (M=4.32). PB is the next 'always' preferred method by 52.6% (M=4.00). More than half of the CFOs (56.4%) revealed that IRR is an 'often' preferred method which is dominant among all methods followed by DPB (47.4%), SA (42.1%), NPV(31.6%) and EMR(31.6%). The rest of the methods like PI, RO,EMR,VAR,APV and HR are not well popular in its usage where mean value is less than 3.0.

In order to measure certain concept on capital budgeting, this study employs similar survey used in previous studies which were carried out by [Graham and Harvey \(2001\)](#) in 1999 for US firms, [Brounen et al. \(2004\)](#) in 2002/2003 for European firms, [Kohli and Sharma \(2015\)](#) in 2011 for Indian multinational companies, [Benetti et al. \(2007\)](#) in 2005 for Brazilian private and public firms and [Akintunde and Otegunrin \(2013\)](#) for Thailand SMEs. Theories on capital budgeting are originating from developed countries especially in USA, UK which may have limited applicability and may not find the way in the developing countries. There are some differences in the nature, direction, magnitude and processes of operations of the relationship between developed and developing financial markets in their economic, social, regulatory framework and market behavior ([Heinrich, 2002](#); [Ahunwan, 2003](#)). Therefore results are compared to see the similarities which are not discussed in dept. Results are presented in table A in the page 8. Of the US firms of [Graham and Harvey \(2001\)](#) revealed that IRR (always & almost always 75.70%) was the most preferred technique of capital budgeting followed by NPV (always & almost always 74.90%), and PB (always & almost always 56.7%) was the third preferred technique.

Brounen *et al.* (2004) presented their result that most of the European respondents indicated PB was most frequently used capital budgeting method in the UK, Netherland, Germany and France respectively 69.2%,64.7%,50% and 50.9%. In case of IRR, in the U.K., the Netherlands, Germany and France respectively 53.1%, 56.0 %, 42.2% and 44.1% of all CFOs use the IRR while 47.0%, 70.0% 47.6% and 35.1% of all CFOs in these countries rely on the NPV.

Kohli and Sharma (2015) presented their results for Indian multinational companies that IRR (always & almost always 83.7%, mean vale =3.37) was the most preferred technique of capital budgeting followed by NPV (always & almost always 86%, mean value = 3.28), and PB (always & almost always 75.5%, mean value = 3.02) was the third preferred method. Benetti *et al.* (2007) presented their results for sample of Brazilian private and public firms that NPV (always & almost always 62.8%) was the most preferred technique of capital budgeting followed by IRR (always & almost always 60.2%) and PB (always & almost always 53.5%) was the third preferred method.

Akintunde and Otegunrin (2013) presented their results for sample of Thai SMEs that PB (always & almost always 77.5%) was the most preferred technique of capital budgeting followed by NPV (always & almost always 75%) and IRR (always & almost always 68.42%) was the third preferred method. There is an assumption in 'capital budgeting theory' that evaluation of investment projects is based on economic merit. Certain economic assumptions in the capital budgeting theory, include the time value of money, risk aversion, and an assumed goal of value maximization. Discounted cash flow/ sophisticated investment appraisal techniques are such as NPV and IRR which have been advocated in the literature' (Slagmulder *et al.*, 1995). As advised in the literature, practices are line with the corporate finance theory to evaluate their investment project in Sri Lanka as practiced NPV and IRR are their most preferred methods and which explore the DCF techniques on practices . Even though, many researchers criticized that needed information for NPV and IRR is generally not known with certainty because decisions extends to a long period, uncertainties of future, higher degree of risk and not logically comparable because of time value of money (e.g., (Cooper *et al.*, 2002; Hermes *et al.*, 2007)). The pay-back period has been criticized for failing to make correct assessments of project value as it does not consider use of cash flows, time value of money, risk in a systematic manner and it does not identify investment projects that will maximize profits, therefore PB does not have theoretical justification (Pike, 1988; Lefley, 1996). Even such a criticism is in the text books, there is a substantial application of PB in Sri Lankan companies and 68.4 % of CFOs are always using PB to evaluate the investment project. There is a strong supportive argument in the literature for still using the PB. They are PB is as a technique which simplistic and easily understandable by management especially in the communicating process (Lefley, 1996) the situation of firms are with capital constraints which need to recover investments quickly (Graham and Harvey, 2001) PB is sometimes used to identify liquid projects especially by firms have very limited financial resources or they are in times of economic depression, shorter payback period would identify more liquid project (Lefley, 1996) PB may be used as a proxy for a project economic duration.

*Therefore, Hypothesis(H<sub>1</sub>) has been supported with the results of the study that discounted cash flow techniques (NPV,IRR) are mostly used by Sri Lankan companies .Even though non discounted cash flow methods in terms of PB is the third preference in Sri Lanka.*

## 5.2. Cost of Equity Capital

This study is further focusing on the methods to determine the cost of equity capital. Respondents were requested to indicate whether your firm estimate the cost of equity capital or not? If yes they requested to indicate how do you determine your firm's cost of equity capital by using likert scale from never (1) to always (5). It explores whether firms use average historical return on common stock, CAPM model (the beta approach), CAPM with some extra risk factors, as per the choice of the investors, regulatory decisions, back out from discounted dividend/ earnings model or any other model.

Table-A. Compare the current results with similar previous Studies on capital budgeting practices

	Current Study (2017)	Graham and Harvey (2001)	Brounen <i>et al.</i> (2004)				Kohli and Sharma (2015)	Benetti <i>et al.</i> (2007)	Akintunde and Otekinrin (2013)									
Country	Sri Lanka	USA	UK	Netherland	Germany	France	India	Brazil	Thailand									
Year Surveyed	2017	1999	2002/2003	2002/2003	2002/2003	2002/2003	2011	2005										
Survey Sample	150	4440	2000 firms in the U.K., Germany and France, and 500 firms in the Netherlands.				253	1699	Not reported									
Usable Response	38	392	68	52	132	61	51	160	40									
Response rate		9%	5%				20.16	9.4	Nor reported									
Capital budgeting Techniques (How frequency 'always and 'Almost always (current study referred this as always and often)' in percentages and mean values)																		
	%	Mean	%	Mean	%	Mean	%	Mean	%	Mean	%	Mean	%	Mean	%	Mean	%	Mean
PB	68.4	4.00	56.7	2.53	69.2	2.77	64.7	2.53	50	2.29	50.9	2.46	75.5	3.02	53.5	2.45	77.50	3.23
DPB	79	3.92	29.45	1.56	25.40	1.49	25	1.25	30.51	1.59	11.32	0.87	61.2	2.63	42.4	2.06	45.95	2.16
ARR	42.1	3.21	20	1.34	38.10	1.79	25	1.40	32.17	1.63	16.07	1.11	41.7	2.10	42	2.06	43.24	1.81
NPV	84.2	4.37	74.90	3.08	47	2.32	70	2.76	47.6	2.26	35.1	1.86	86	3.28	62.8	2.71	75	3.13
IRR	92.3	4.32	75.70	3.09	53.1	2.31	56	2.36	42.2	2.15	44.1	2.27	83.7	3.37	60.2	2.60	68.42	3.13
APV	15.8	2.32	11	0.85	14.06	0.78	8.16	0.78	7.83	1.04	14.55	1.11	62.5	2.60	33.7	1.77	39.39	1.70
PI	31.6	2.68	12	0.83	15.87	1.00	8.16	0.78	16.07	0.71	37.74	1.64	57.1	2.49	41.5	1.89	52.63	2.16
Hurdle rate	15.8	2.26	56.9	2.48	26.98	1.35	41.67	1.98		1.61	3.85	0.73	47.9	2.44	48.4	2.16	27.27	1.27
Earnings multiple approach	36.9	2.53	38.9	1.89	39.06	1.81	26.53	1.61	20.51	1.25	33.33	1.70	45.8	2.31	36.8	1.78	29.41	1.24
Sensitivity Analysis	73.7	3.89	51.54	2.31	42.86	2.21	36.73	1.84	28.07	1.65	10.42	0.79	67.3	2.73	48.9	2.33	63.16	2.68
Value at risk/other simulation analysis	15.8	2.47	13.66	0.95	14.52	0.85	4.26	0.51	23.68	1.45	29.79	1.68	57.1	2.59	31.7	1.67	30.56	1.50
We incorporate the 'real options' of a project when evaluating it.	21	2.58	26.56	1.47	29.03	1.65	34.69	1.49	44.04	2.24	53.06	2.20	36.2	2.00	18.5	1.26	36.36	1.67

Source: survey data



The table 7 shows how frequently companies use different methods for calculating cost of equity capital on a scale of 1 to 5. Dominant previous studies suggested that CAPM is the most widely accepted sophisticated cost of equity capital method (Graham and Harvey, 2001; Brounen *et al.*, 2004; Kohli and Sharma, 2015). Therefore this study hypothesized ( $H_2$ ) that Sri Lankan companies are mostly used CAPM to estimate their cost of equity capital.

**Table-7.** Survey responses on 'does your firm estimate the cost of equity capital: if yes, how do you determine your firm's cost of equity capital'

Cost of Equity	Never	Rarely	Sometimes	Often	Always	Mean & Rank
Average Historical Return on Stock	20% (4)	20% (4)	30% (6)	30% (6)	-	2.70 (2)
CAPM (Beta Model)	15% (3)	10% (2)	25% (5)	35% (7)	15% (3)	3.25 (1)
CAPM extra factors	30% (6)	20% (4)	20% (4)	30% (6)	-	2.50(4)
As per the choice of the investors	40% (8)	10% (2)	30% (6)	20% (4)	-	2.30(5)
Regulatory decisions	22.2%(4)	27.8% (5)	16.7% (3)	33.3% (6)	-	2.61(3)
Discounted model/ Earnings model	50% (9)	27.8% (5)	11.1% (2)	11.1% (2)	-	1.83(6)

Source: survey data

Only 20 companies out of 38 responses indicated regarding their cost of equity calculations. CAPM (the beta approach) is the most prevalent method to calculate the cost of equity capital (always 15% and often 35%) generating mean value of 3.25. The next widely used method is the average historical returns on common stock (often 30%) generating mean value of 2.70. Other methods are not popular methods in calculating cost of equity capital in Sri Lankan practice as they have less mean values. Hypothesis ( $H_2$ ) is supported with the result of the study that most prevalent method to estimate the cost of equity is CAPM in Sri Lankan companies.

It was compared the current study with results from the previous studies. The results of Brounen *et al.* (2004) indicated (see table B in the page 10) that the CAPM is the most popular method of estimating the cost of equity capital in Europe: in the U.K., Netherlands, Germany and France, 47.1%, 55.6%, 34%, and 45.2% of CFOs relies on the CAPM for estimating the cost of equity. Graham and Harvey (2001) reported that almost 73.5% of U.S. CFOs relies on the CAPM when estimating the cost of equity capital. Although the CAPM is a popular method in Sri Lanka (always 15%, often 35%, M=3.25), current results show that this popularity is low compared to the U.S. But Kohli and Sharma (2015) reported that 52.3% of Indian CFOs use CAPM. It is higher than the rate of usage in Sri Lanka.

The U.S. and European countries results show, the second and third popular methods were respectively the use of average historical returns and the use of some version of a multi-beta CAPM. There is 30 percentage of CFOs (Always 0%) often use average historical returns in Sri Lanka but it was 65.9% in India. But multi beta CAPM are not always in practice in Sri Lanka even 53.3% of Indian CFOs applied this practice. Again practice of choice of the investor to estimate the cost of equity capital is not always preference in Sri Lanka and India but 40.9% of US CFOs use this practice, and CFOs in the UK, Netherland, Germany and France always prefer 18.75%, 44.83%, 39.22% and 34.38% respectively.

Benetti *et al.* (2007) reported that CAPM with extra factors is (48.9%) most preferred method in Brazil followed by CAPM (37%) and Regulatory decision (34.9% to determine cost of equity capital. Akintunde and Otegunrin (2013) revealed that the CAPM (73.91% is the most popular method) followed by Average historical rate of return (73.08%) and discounted dividend model (43.48%). Mutairi *et al.* (2012) exposed that dividend discounted model (86.2%) is most popular method to determine the cost of equity capital followed by CAPM (61.3%) and average historical rate of return (31%). Finally it can be concluded that as suggested by theory and literature, CAPM is most popular method used to determine the cost of equity capital in Sri Lanka.

Table-B. Compare the current results of cost of equity with similar previous Studies

	Current Study		Graham and Harvey (2001)		Brounen <i>et al.</i> (2004)						Kohli and Sharma (2015)		Benetti <i>et al.</i> (2007)		Akintunde and Otekunrin (2013)		Mutairi <i>et al.</i> (2012)			
Country	Sri Lanka		USA		UK		Netherland		Germany		France		India		Brazil		Thailand		Kuwait	
Methods to determine cost of equity capital (How frequency 'always and 'Almost always (current study referred this as always and often)" in percentages and mean values)																				
	%	Mean	%	Mean	%	Mean	%	Mean	%	Mean	%	Mean	%	Mean	%	Mean	%	Mean	%	Mean
Average Historical Return on Stock	30	2.70	39.41	1.70	31.25	1.47	30.77	1.42	18	1.06	27.27	1.30	65.9	2.89	33.3	1.45	73.08	2.87	30	2.55
CAPM model (The Beta Approach)	50	3.25	73.49	2.81	47.06	2.06	55.56	2.37	33.96	1.36	45.16	1.90	52.3	2.36	37	1.78	73.91	2.87	61.3	3.45
CAPM with some extra risk factors	30	2.50	34.29	1.52	27.27	1.45	15.38	1.08	16.07	0.89	30.30	1.39	53.3	2.60	48.9	1.91	40	1.85	-	-
As per the choice of the investors	20	2.30	13.93	0.86	18.75	1.19	44.83	1.86	39.22	1.98	34.38	1.66	40.9	2.32	33.3	1.80	24	1.6	12.4	2.1
Regulatory decisions	33.3	2.61	7.04	0.42	16.13	0.94	3.70	0.33	-	0.27	16.13	0.87	65.1	2.67	34.9	1.58	40.91	1.91	-	-
Discounted dividend/ Earnings model	11.1	1.80	15.74	0.87	10	0.73	10.71	0.79	10.42	0.58	10.34	0.69	44.2	2.26	26.2	1.19	43.48	1.83	86.2	3.99

Source: survey data

Table-C. Discount rate used by companies when evaluating a new project in an overseas market (How frequency 'always' &amp; almost always)

	Current Study		Graham and Harvey (2001)		Brounen <i>et al.</i> (2004)						Kohli and Sharma (2015)		Benetti <i>et al.</i> (2007)		Akintunde and Otekunrin (2013)			
	Sri Lanka		USA		UK		Netherland		Germany		France		India		Brazil		Thailand	
	%	Mean	%	Mean	%	Mean	%	Mean	%	Mean	%	Mean	%	Mean	%	Mean	%	Mean
The discount rate for entire company	68.4	3.68	58.79	2.50	40.98	1.97	64.58	2.48	41.96	2.00	24.14	1.03	59.6	2.68	61.6	2.63	63.64	2.70
The discount rate for the overseas market (country discount rate)	29	2.84	34.52	1.65	20	0.97	14.89	1.09	14.85	0.92	16.36	0.76	74.5	3.00	39.7	1.83	46.88	1.97
A divisional discount rate (if the project line of business matches a domestic division)	21	2.15	15.61	0.95	17.24	0.91	17.02	0.96	12	0.69	12.50	0.70	72.3	3.00	35.4	1.72	27.59	1.48
A risk matched discount rate for this particular project (considering both country and industry)	42.2	2.89	50.95	2.09	23.73	1.17	27.08	1.27	25	1.16	27.27	1.16	78.7	3.21	54.3	2.52	45.45	2.15
A different discount rate for each component cash flow that has a different risk characteristics (e.g: depreciation Vs. operating cash flows)	5.3	1.84	9.87	0.66	10.53	0.58	2.13	0.26	7.14	0.51	11.32	0.62	46.8	2.34	28.8	1.5	Not reported	

Source: survey data

### 5.3. New Projects in Overseas Markets

Further, current study considers how a firm evaluates a new project in an overseas market. The study was most concerned with whether companies consider the company-wide risk or the project risk in evaluating the project. Table 8 contains results of the discount rate used by companies when evaluating a new project in an overseas market. Remarkably, the majority of the firms use discount rate for the entire company to evaluate the project; respondents always 18%, often 50% used the discount rate for the entire company. However, 21.1% of the firms agreed that they were often and 21.1% were always using a risk-matched discount rate in evaluating the particular project.

**Table-8.** Survey responses for the question; how frequently would your company use the following discount rates when evaluating a new project in an overseas market

	Never	Rarely	Sometime	Often	Always	Mean
The discount rate for entire company	2.6%(1)	13.2%(5)	15.8%(6)	50%(19)	18.4%(7)	3.6842
The discount rate for the overseas market (country discount rate)	7.9%(3)	36.8%(14)	26.3%(10)	21.1%(8)	7.9%(3)	2.8421
A divisional discount rate (if the project line of business matches a domestic division)	47.4%(18)	21.1%(8)	10.5%(4)	10.5%(4)	10.5%(4)	2.1579
A risk matched discount rate for this particular project (considering both country and industry)	26.3%(10)	21.1%(8)	10.5%(4)	21.1%(8)	21.1%(8)	2.8947
A different discount rate for each component cash flow that has a different risk characteristics (e.g: depreciation Vs. operating cash flows)	47.4%(18)	31.6%(12)	15.8%(6)	-	5.3%(2)	1.8421

Source: survey data

As results presented in table C in page 10, 58.8% of US firms indicated to use the discount rate of the entire company opposed to 50.9%, which incorporate project particularities by deriving a risk matched Rate (Graham and Harvey, 2001). 41.0% of U.K. firms, 64.6% of Netherland firms, 42.0% of German firms and 24.1% of French firms apply discount rate for entire company, while as little as 23.7% of U.K. firms, 27.1% of Dutch firms, 25.0% of German firms and 27.3% make use of a risk-matched project rate of return (Brounen *et al.*, 2004).

### 5.4. Risk Factors and Adjustments

Generally, risk factors including risk of unexpected inflation, interest rate risk, term structure risk, business cycle risk, commodity price risk, and foreign exchange risk were adjusted by either increasing discount rate or reducing cash flows or by both. Results of the survey depicted in table 9 below. In this study, risk of unexpected inflation, interest rate risk, term structure risk, business cycle risk, size based risk, market to book ratio and momentum are mostly adjusted by discount (36.8%, 36.8%, 34.2%, 28.9%, 26.3% & 31.6% respectively). Commodity price risk, foreign exchange risk and distress risk are mostly adjusted by cash flow (52.6%, 21.1%, and 21.1% respectively). Even though, there are 47.4% of the companies use both methods to handle the foreign exchange risk followed by 39.5% of the companies use both methods to manage interest rate risk and 31.6% of the companies use both methods to manage risk from unexpected inflation.

According to results presented in table D in page 15, in case of Sri Lanka almost all of the companies are making an adjustment for the risk of unexpected inflation, commodity price risk and foreign exchange rate risk. In case of US firms and Europe, the vast majority of firms does not take specific risk factors into account when evaluating individual investment projects.

**Table-9.** Survey responses for the question; when valuing a project , do you adjust either the discount rate or cash flows for the following risk factors

	<b>Adjust discount rate</b>	<b>Adjust cash flow</b>	<b>Both</b>	<b>Neither</b>
Risk of unexpected inflation	36.8%(14)	23.7%(9)	31.6%(12)	7.9%(3)
Interest rate risk (changes in general level of interest rates)	36.8%(14)	13.2%(5)	39.5%(15)	10.5%(4)
Term structure risk (change in long term vs .short term interest rate)	34.2%(13)	21.1%(8)	26.3%(10)	18.4%(7)
GDP or business cycle risk	28.9%(11)	26.3%(10)	28.9%(11)	15.8%(6)
Commodity price risk	21.1%(8)	52.6%(20)	13.2%(5)	13.2%(5)
Foreign exchange risk	15.8%(6)	21.1%(8)	47.4%(18)	15.8%(6)
Distress risk (probability of bankruptcy)	15.8%(6)	21.1%(8)	15.8%(6)	47.4%(18)
Size (Small firm being riskier)	26.3%(10)	5.3%(2)	15.8%(6)	52.6%(20)
Market to book ratio (ratio of market value of firm to book value of assets)	39.5%(15)	21.1%(8)	15.8%(6)	23.7%(9)
Momentum (recent stock price performance)	31.6%(12)	18.4%(7)	21.1%(8)	28.9%(11)

Source: survey data

Table-D. Comparative results of type of risk involved in investment panel among the similar studies

Risks	Current Study				Graham and Harvey (2001)				Benetti <i>et al.</i> (2007)			
	Adjust discount rate	Adjust cash flow	Both	Neither	Adjust discount rate	Adjust cash flow	Both	Neither	Adjust discount rate	Adjust cash flow	Both	Neither
Risk of unexpected inflation	36.8%	23.7%	31.6%	7.9%	11.90%	14.45%	11.90%	61.76%	13.8%	27.5%	42.5%	16.3%
Interest rate risk (changes in general level of interest rates)	36.8%	13.2%	39.5%	10.5%	15.30%	8.78%	24.65%	51.27%	16%	21%	46.9%	16%
Term structure risk (change in long term vs short term interest rate)	34.2%	21.1%	26.3%	18.4%	8.57%	3.71%	12.57%	75.14%	16.9%	16.9%	37.7%	28.6%
GDP or business cycle risk	28.9%	26.3%	28.9%	15.8%	6.84%	18.80%	18.80%	55.56%	16.9%	20.8%	33.8%	28.6%
Commodity price risk	21.1%	52.6%	13.2%	13.2%	2.86%	18.86%	10.86%	67.43%	13.3%	30.7%	22.7%	33.3%
Foreign exchange risk	15.8%	21.1%	47.4%	15.8%	10.80%	15.34%	18.75%	55.11%	10.4%	20.8%	45.5%	23.4%
Distress risk (probability of bankruptcy)	15.8%	21.1%	15.8%	47.4%	7.41%	6.27%	4.84%	81.48%	23.3%	17.8%	24.7%	34.2%
Size (Small firm being riskier)	26.3%	5.3%	15.8%	52.6%	14.57%	6.00%	13.43%	66.00%	14.5%	20.5%	27.4%	34.2%
Market to book ratio (ratio of market value of firm to book value of assets)	39.5%	21.1%	15.8%	23.7%	3.98%	1.99%	7.10%	86.93%	4.0%	11.7%	22.1%	48.1%
Momentum (recent stock price performance)	31.6%	18.4%	21.1%	28.9%	3.43%	2.86%	4.86%	88.86%	3.4%	10.7%	16%	52%
Any other risk:												
	Brounen <i>et al.</i> (2004) - UK				Brounen <i>et al.</i> (2004) - Netherland							
Risks	Adjust discount rate	Adjust cash flow	Both	Neither	Adjust discount rate	Adjust cash flow	Both	Neither				
Risk of unexpected inflation	17.74 %	25.81%	12.90%	43.55%	8.00 %	12.00%	16.00%	64.00%				
Interest rate risk (changes in general level of interest rates)	20.97 %	27.42%	27.42%	24.19%	20.41 %	8.16%	20.41%	51.02%				
Term structure risk (change in long term vs short term interest rate)	17.19 %	17.19%	12.50%	53.13%	10.64 %	0.00%	10.64%	78.72%				
GDP or business cycle risk	16.13 %	24.19%	8.06%	51.61%	8.33 %	6.25%	10.42%	75.00%				
Commodity price risk	19.05 %	19.05%	7.94%	53.97%	2.13 %	19.15%	10.64%	68.09%				

Foreign exchange risk	12.50 %	32.81%	17.19%	37.50%	6.00 %	26.00%	18.00%	50.00%				
Distress risk (probability of bankruptcy)	14.52 %	9.68%	6.45%	69.35%	14.58 %	4.17%	8.33%	72.92%				
Size (Small firm being riskier)	21.88 %	12.50%	7.81%	57.81%	17.02 %	14.89%	14.89%	53.19%				
Market to book ratio (ratio of market value of firm to book value of assets)	17.74 %	9.68%	4.84%	67.74%	4.26 %	2.13%	19.15%	74.47%				
Momentum (recent stock price performance)	16.95 %	5.08%	6.78%	71.19%	4.35 %	0.00%	8.70%	86.96%				
	Brounen <i>et al.</i> (2004) - Germany				Brounen <i>et al.</i> (2004) -France							
<b>Risks</b>	<b>Adjust discount rate</b>	<b>Adjust cash flow</b>	<b>Both</b>	<b>Neither</b>	<b>Adjust discount rate</b>	<b>Adjust cash flow</b>	<b>Both</b>	<b>Neither</b>				
Risk of unexpected inflation	18.80 %	9.40%	9.40%	62.39%	17.54 %	24.56%	26.32%	31.58%				
Interest rate risk (changes in general level of interest rates)	26.72 %	14.66%	22.41%	36.21%	23.21 %	26.79%	21.43%	28.57%				
Term structure risk (change in long term vs .short term interest rate)	17.12 %	7.21%	8.11%	67.57%	22.81 %	12.28%	17.54%	47.37%				
GDP or business cycle risk	6.19 %	9.73%	11.50%	72.57%	15.79 %	22.81%	12.28%	49.12%				
Commodity price risk	4.39 %	26.32%	16.67%	52.63%	8.62 %	46.55%	12.07%	32.76%				
Foreign exchange risk	13.27 %	19.47%	18.58%	48.67%	16.36 %	20.00%	5.45%	58.18%				
Distress risk (probability of bankruptcy)	8.77 %	14.04%	13.16%	64.04%	12.50 %	23.21%	14.29%	50.00%				
Size (Small firm being riskier)	9.91 %	9.01%	12.61%	68.47%	23.64 %	16.36%	10.91%	49.09%				
Market to book ratio (ratio of market value of firm to book value of assets)	4.63 %	8.33%	12.96%	74.07%	20.00 %	12.73%	12.73%	54.55%				
Momentum (recent stock price performance)	5.66 %	0.94%	3.77%	89.62%	27.78 %	3.70%	7.41%	61.11%				

Source: survey data

### 5.5. Capital Structure

There is a vital issue in the contemporary financial management that how companies should maintain their optimal capital structure in order to maximize the shareholders wealth. Two different approaches were viewed by financial researchers that trade off theory and pecking order theory (e.g: Myers (1984)). In case of static trade off theory, organizations will maintain a target value ratio and then step by step progress towards this target (Anand, 2002). But in case of pecking order theory companies have a preference retained earnings to external financing. If fund requirement exceeds than retained earnings then debt will be preferred to equity (Anand, 2002). The finance professionals avoid depending on external finance because it would subject the firms to the discipline of the capital market as it will be affected by uncertainty (Berle, 1954). As indicated in the Anand's study in 2002 there are number of previous studies evidenced in line with the pecking order theory (Baskin, 1989; Fan and So, 2000) and previous studies were not in line with the pecking order theory (Brennan and Kraus, 1987; Noe, 1988).

Therefore this study hypothesized ( $H_3$ ) that pecking order theory are applied by Sri Lankan companies.

## 6. FINDINGS OF THE CURRENT STUDY

Purpose of this analysis was to find out whether Sri Lankan finance professionals behave as expected by the pecking order theory of capital structure pattern. Respondents were requested to indicate their sources of financing preferences and rank them in order of their relative importance in terms if their usage. The options given to them are loans from financial institutions, bonds issue in the primary market, private placement of debt, retained earnings, issue of preference share capital, and issue of equity capital. Results are presented in table 10.

**Table-10.** Survey response for the question: Indicate your sources of financing choices and rank them in order of their relative importance in terms of its use?

Sources of finance	Never	Rarely	Sometime	Often	Always	Mean
Loan from financial institutions	10.5%(4)	5.3%(2)	10.5%(4)	31.6%(12)	42.1%(16)	3.8947 (2)
Bond issues in the primary market	42.1%(16)	21.1%(8)	15.8%(6)	15.8%(6)	5.3%(2)	2.2105 (6)
Private placement of debt	36.8%(14)	31.6%(12)	10.5%(4)	10.5%(4)	10.5%(4)	2.2632 (5)
Retained earnings	5.3%(2)	-	-	47.4%(8)	47.4%(8)	4.3158 (1)
Issue of preference share capital	36.8%(14)	26.3%(10)	10.5%(4)	15.8%(6)	10.5%(4)	2.3684 (4)
Issue of equity capital	5.3%(2)	21.1%(8)	15.8%(6)	42.1%(6)	15.8%(6)	3.4211 (3)

Source: survey data

According to the results, retained earnings are the most preferred source of finance among finance professionals in Sri Lanka. Nearly 47.4% always and 47.4% often preferred retained earnings by respondents yielding mean value is 4.31. Following to retained earnings, loans from financial institutions (often 31.6%, always 42.1%, mean = 3.89) and issue of equity shares (often 42.1%, always 15.8%, mean = 3.42) preferred by Sri Lankan finance professionals for the sampled companies. Bond issues, private placement debt and issue of preference shares are not popular method to raise the finance by Sri Lankan companies since they have the mean values less than 3.00 as indicated in the table above. Findings of the study are in line with the pecking order theory that firms are having preference to internal finance for their capital. Finding of the study is consistent with the study of Anand (2002). Therefore hypothesis( $H_3$ ) of the study is supported with the result of the study that Sri Lankan companies are mostly prefer the pecking order theory.

## 7. CONCLUSION

The current study investigated the use of corporate finance practices in terms of capital budgeting, cost of equity capital and capital structure. Field survey was conducted of 38 financial officers of companies listed on the Colombo Stock Exchange (CSE) in Sri Lanka. Collected data were then analyzed by applying mean and percentage analysis. Results of the survey revealed that NPV was the most frequently 'always' cited capital budgeting method,

followed by IRR and PB. CAPM was the most preferred method to calculate the cost of equity capital followed by average historical rate of return on common stock. Remarkably, most firms would use a discount rate for entire company to evaluate the project. Further, it was evaluated that how finance professionals make adjustments for risk factors. It was concluded that risk of unexpected inflation, interest rate risk, term structure risk, business cycle risk, size based risk, market to book ratio and momentum were mostly adjusted by discount rate while commodity price risk, foreign exchange risk and distress risk were mostly adjusted by cash flow. Further, this study was to find out whether Sri Lankan finance professionals behave as expected by pecking order theory of capital structure patterns. Findings of the study are in line with the pecking order theory that firms are having preference to internal finance for their capital.

This research has proffered a more reliable and comprehensive analysis of corporate finance practices in Sri Lankan companies. Since Sri Lanka was an unexplored country on corporate finance practices therefore, this research was contributed to the literature as well. Current study revealed that what are the corporate finance practices mostly used by Sri Lankan companies in terms of capital budgeting, cost of capital and capital structure. This research may benefit managers and decision makers in many aspects, including having an understanding of applying popular and the most suitable corporate finance techniques in the management of their companies. Thus, this study contributed to academics, practitioners, policy makers, and stakeholders of the company. Through the knowledge, effective decision making in finance is fundamental to corporate survival and long term success. Long term sustainability of the organizations can create the employment to the country and every organization has corporate social responsibility to work for society. Therefore, results of the study would be useful to the national/ socio economic development.

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