CHAPTER 1

INTRODUCTION

Optimum capital structure is significantly important for firms to ensure sustainability in operation and values. Whereas capital structure can be divided into two portions which involve equities and debts, it is interesting and challenging for firms to identify the equilibrium between both portions. As for debts, earlier research by Modigliani and Miller (1963), hypothesize that in the presence of tax benefits of debt, there is a positive relation between firm value and debt.

Due to the riskiness such as bankruptcy risk, firms need to define optimum capital structure and benefits of having such structure. Forecast earnings and future cash flows are adamant as justification existence of a firm, with sustainability and profitability as main factor in ensuring firms competitiveness. Financial factors such as tax benefits and dividend payout have significant affect to leverage and value of the firm. Jayaraman (2006) stated that having a positive relation between firm value and debt suggests that firms can increase their market value by taking on more debt. Therefore it is important to examine factors that inhibit firms from reaching the optimal debt equilibrium.

Simple tax hypotheses say that value is negatively related to dividends and positively related to debt (Fama & French, 1998). Firms where interests of managers are aligned with those stockholders, managers take on more debt, which reduces the equilibrium relation between firm value and debt (Jayaraman, 2006). Previous research has not been succeeded to consistently meet the Modigliani and Miller (1963) hypotheses. One possibility of the reason is the omitted of the endogeneity of contemporaneous debt while empirically estimate the relation between firm value and debt

1.1 Purpose and Significance of the Study

Purpose of this study is to investigate how firm value is influence by the tax benefits of debt. The foundation of capital structure lay by Modigliani & Miller (1958) argue that corporate financial policy is irrelevant to the value of the firm (i.e. value of the levered firm (V_L) is equal to value of the unlevered firm (V_U). However when imperfections, such as taxes and deductibility of interest are introduced, the value of the firm depends on its capital structure (Modigliani & Miller, 1958).

Fama & French (1998), found that with applications of controlling variable such as for profitability we can measures how the taxation on dividend and debt could affect firm value. They found that, there is negative relation between firm value and debt even after controlling for earnings, dividends, investment and R&D. This finding is not consistent with what Modigliani and Miller (1963) hypothesized that in the presence of tax benefits of debt there is a positive relation between firm value and debt.

Research in corporate finance facing limited success in attempt to empirically documenting the positive relation between firm value and debt possibly because of endogeneity of contemporaneous debt had not been considered. Therefore this paper would study and investigate the possibility in correcting endogeneity of contemporaneous debt. Jayaraman (2006) used two-stage least square estimation to correct endogeneity of contemporaneous debt and the model able to consistent with Modigliani and Miller (1963).

This study will also investigate alternate method of interpretation that might be consistent with the positive relation between firm value and debt when controlling variables is used. Alternate theories such as agency based free cash flow theory and debt signaling theory is used to empirically distinguish relation between tax benefits and the alternate theory.

1.2 Objectives of the Study

This study intends to investigate the tax benefits of debt and its influence to firm value. Base on Jayaraman (2006) models in correcting endogeneity of contemporaneous debt, this research would emphasize on achieving results consistent with Modigliani and Miller (1963) hypotheses. This study will see the outcome of how alternate theories affect the relation between firm value and debt when controlling variables are applied and finally to identify whether management alignment affect the firm financing decision and how do this managerial alignment influence the relation between firm value and debt. The objectives of the study are as follows:

1.2.1 To estimate the relation between firm value and contemporaneous debt.

1.2.2 To correct the endogeneity and empirically estimate the relation between firm value and debt.

1.2.3 To investigate other alternate theories that might be consistent with the positive relation between firm value and debt. Such theories are free cash flow theory and debt signaling.

1.2.4 To identify the role of managerial alignment in the relation between firm value and debt.

1.3 Scope of the Study

Scope of the study is to rectify the relation between firm value and debt with sample within the public listed company in Malaysia. Firm's financial statement is the main source of information. The study is to evaluate company commitment in terms of their capital structure, future investment and dividends. The study will also investigate the outcome of alternate theories and the influence of management with stock compensations towards the relation between firm value and debt.

As for the analysis, variables such as value of the firm, dividend, interest expense, R & D cost and earnings are to be used. Regression model by Jayaraman (2006) is used to correct the endogeneity of contemporaneous debt. Finally Robustness test is carried out to examine whether the results are robust to various sensitivity tests.

1.4 Limitations of the Study

This research has its challenges and limitation which might have direct and indirect effect to the overall analysis of the findings and accuracy of information. Limitation that has been identified is as follows:

1.4.1 Firms that do not disclose some financial expenses have results in reducing the specification observations.

1.4.2 To retrieved required information for firm's financial performance for the last 12 years.

1.4.3 The samples are not in a large scale as it should be.

1.5 Organization of the Study

This paper is organized into five chapters. Chapter 1 is a brief introduction and background of the study. Chapter 2 discusses previous research conducted and written paper related to the issue in the literature. Chapter 3 describes the methodology and sample data for this study. Chapter 4 presents the empirical findings and Chapter 5 concludes the results of the study.