



CHAPTER 1

INTRODUCTION

The main objective of the firm's financial management is to maximize the shareholders' wealth. Shareholder, here, refers to the people who hold the company's common stock. The market value of a firm's stock measures the shareholders' wealth maximization. After planning the objective, the firm's financial manager is required to perform his/her best to increase the value of the common stock.

The roles and responsibilities of the firm's financial manager in corporate businesses have currently been increasingly important. The role does not only include accurate financial recording, preparation of financial reports, financial transaction processing, but much more. Chiefly, the functions divide into three main areas. They are making financial decision, deciding on investment, and constructing financial planning.

Making financial decision entails the responsibility of deciding on the source of capital to acquire. Here, there are two main sources of capital, which are liability and equity. To further illustrate the meaning, liability defines itself as any financing vehicle that has a contractual claim on the firm's cash flow and assets, incurring tax deductible payments, has a fix life, and has a priority claim on cash flow in both operating periods and during times of bankruptcy. Equity defines itself as any financing vehicle that has a residual claim on the firm, does not create tax advantages from its payment, has an infinite life, does not have priority in bankruptcy, and provides management control to the owner. The distinction between liability and equity bases itself on the commitment to make the payments, their tax deductibility, and the degree of control each are willing to exercise over the affairs of the firm.

Liability looks at the concept of short-term and long-term borrowing source. Short-term and long-term borrowing source differs in the interest yield present. The yield on the cost of capital interest usually fluctuates according to the different terms agreed. Preferred or common stock equity under equity looks at a different dimension. The dividends the stocks yield are also different in the sum. Financial manager's decision to select either liability or equity will remain in the cost of capital they select. A manager needs to decide which will yield higher returns.

Efficient financial decision represents better returns. Hence, a financial decision highly ties to the cost of capital, and the financial risk.

1.1 SIGNIFICANCE OF THE PROBLEM

Over several decades, economists or field-relates academics try to propose ideas and theories to explain the determinants of the firm's capital structure. Modigliani and Miller (1958) pioneers traditional capital structure theory. Later, determining the appropriate capital structure to maximize the firm's value develops new theories in hope to make firm's financial management more efficient. The most well known theories are the Trade Off Theory, the Pecking Order Theory, and the Market Timing Theory. Ivo Welch (2002) employs these concepts to explore the role of stock market return in relation to the role of other variables in other supporting corporate finance literatures. The other corporate variables are profitability and growth opportunity, equity-return volatility. These variables directly compute capital structure of U.S. firms. The study reveals that stock market's influence is also the pertinent factor in determining firm's capital structure. Nevertheless, most theories in Thailand only look at the idea of internal factors such as the Trade off Theory, and the Pecking Order Theory. Most of these studies do not incorporate the stock market return to explain the firm's capital structure. Thereby, the paper will attempt to employ the role of the stock market returns to explain the firm's capital structure.

1.2 OBJECTIVES

1. To test the readjustment of the firm's capital structure toward the target capital structure
2. To investigate the relationship between the firm's attributions and the firm's inert behavior in readjusting toward the target capital structure
3. To explore how long firm will take to rebound toward the target capital structure
4. To examine the explanatory power and the magnitude of the stock market returns relative to the firm's profitability, the growth opportunity, the equity-return volatility, and the collateral value.

1.3 SCOPE OF THE STUDY

1. The samples are the pool of cross-sectional data representing the non-financial companies listed on the Stock Exchange of Thailand (SET)
2. The general category capital structure exclude those firms in the Finance and Banking sector, and Insurance sector
3. The accounting data obtained from the DataStream database incorporate the book value of total liabilities, the book value of asset, the book value of fixed asset, the book value of stock, and the book value of earning before interest and tax. While, the market data include the stock market index and the market value of stock covering the periods from 1992 through 2002.

1.4 BENEFITS OF THE STUDY

To reveal the various attributions regarding the firm's manager performance in readjusting its capital structure toward the target capital structure. The study also proves whether inertia is a primary determinant of firm's capital structure.

The result should be useful to the groups of people. To the investor and the shareholder, as a tool in monitoring and measuring the firm manager's performance in comparison with the average firm's manager performance residing within the market can use this study.

To academics, it can provide a broader insight and better understanding of the possibilities on the various determinants affecting the firm's capital structure.

1.5 ORGANIZATION OF THE STUDY

The organization of this research divides into five sections. The first section is an introduction on the research and the following section is the literature review of past researches on the capital structure base on the different types of factor. The third section provides an empirical methodology of this study. As for the fourth section, it displays the empirical results and an interpretation of the regression model. Finally, in the fifth section, a conclusion of the research and further suggests future studies to be made and at the end of the paper a summary of the references.