A Literature Review on Critical Aspects of Corporate Finance

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Abstract: Corporate finance is that important area of financial economics concerned with how corporations manage and coordinate their financial activities in the interest of shareholders' value maximization. The literature review was done on a vast amount of research in the area of corporate finance, focusing on its major theories, empirical studies, and new trends. This review elaborates on capital structure, corporate governance, dividend policies, mergers and acquisition, investment decisions, and risk management in detail. The present paper identifies gaps and suggests directions for future research in a fast-evolving corporate finance landscape.

Keywords: Corporate Finance, Capital Structure, Corporate Governance, Dividend Policy, Risk Management

I. INTRODUCTION

The department dealing with financial activities in any corporation with the primary motive of maximizing shareholders' value through effective and strategic planning and execution is referred to as corporate finance. This literature review discusses major contributions made in the field of corporate finance and provides synthesized knowledge about its various constituents. It views theoretical underpinnings, capital structure, corporate governance, dividend policies, mergers and acquisitions, investment decisions, risk management policies, and current trends. This paper is an attempt at providing an overview of the major issues in corporate finance by way of a survey of classic and modern literature and strives to spot gaps and hence proposes a way forward in the area of future research.

II. THEORETICAL FOUNDATIONS

Modigliani-Miller Theorem:

The Modigliani-Miller Theorem, 1958, is one of the cornerstones of corporate finance theory. It argues that, in perfect capital markets, the value of a firm would not be affected due to its capital structure. This did a nice job setting the stage for further work on financing decisions' irrelevance. Successive efforts have introduced further complications, including taxes, bankruptcy costs, and asymmetric information.

Agency Theory:

Agency theory, developed by Jensen and Meckling in 1976, is concerned with the several conflicts of interest between the managers (as agents) and shareholders (as principals). It highlights mechanisms such as managerial incentives and monitoring as a way to reduce agency problems. Shleifer and Vishny, in their 1997 study, went further to look at how different structures of corporate governance are able to align interests.

Trade-Off Theory:

The trade-off theory by Kraus and Litzenberger in 1973 suggests the firms balance the tax benefit of debt financing with the cost of bankruptcy. Actually, Graham in 2000 conducted an empirical study and found that firms do exploit debt financing while optimizing the capital structure, having a trade-off between the tax shield and the financial distress.

Pecking Order Theory:

The Pecking Order Theory by Myers and Majluf, 1984 explains that firms have a tendency to resort to financing sources on the concept of least effort or cost that is required. This preference goes in order of internal financing first, followed by debt, and last of all equity. Shyam-Sunder and Myers, 1999 established this by showing empirical evidence of the fact that firms do have a hierarchy for raising funds.

III. CAPITAL STRUCTURE

Determinants

A firm's capital structure can be determined by many factors, ranging from its profitability and asset structure to its growth opportunities and the market conditions. According to Titman and Wessels, the specific determinants would be non-debt tax shields, tangibility of assets, and firm size. Booth et al. determined that the capital structure determinants vary across countries due to institutional and economic environments in the empirical studies.

Empirical Studies:

Rajan and Zingales looked into the capital structure of firms in G7 countries; their findings demonstrated positive correlation of leverage with tangibles and firm size, and negative with profitability and the market-to-book ratio. Frank and Goyal contributed to this research by identifying the main determinants for leverage to be profitability, firm size, and growth opportunities.

IV. CORPORATE GOVERNANCE

Mechanisms:

The three pillars of effective corporate governance are boards of directors, ownership structure, and executive compensation, through which management interests have to be aligned with the interests of shareholders. In this regard, according to Fama and Jensen, 1983, the role of the board concentrates on monitoring management. Again, Demsetz and Lehn, 1985, have explained that it is ownership structure that impacts corporate performance.

Performance Impact:

Gompers, Ishii, and Metrick, 2003, demonstrate that firms having good governance structures have high performance and higher market valuations. Bebchuk, Cohen, and Ferrell, 2009 define that the entrenchment provisions are related negatively to firm value. These studies stipulate the importance of governance mechanisms for better corporate performance.

V. DIVIDEND POLICY

Theories:

According to Modigliani and Miller's theory of dividend irrelevance in 1961, considering perfect markets, there will be no effect of dividend policy on the firm's value. On the other hand, the Bird-in-the-Hand Theory by Gordon in 1963 and the Tax Preference Theory by Brennan in 1970 consider that investors have either preference for current dividends or tax advantages accruable from capital gains.

Empirical Research:

In support, Fama and French, 2001 argue that research into the determinants of dividend policies points out that dividend decisions are greatly influenced by profitability, growth opportunities, and firm size. DeAngelo, DeAngelo, and Stulz, 2006, go further to explain the Lifecycle theory of dividends, arguing that mature firms characterized by stable earnings are most likely to pay dividends.

VI. MERGERS AND ACQUISITIONS

Motives:

M&As are done for realizing synergies, diversification, and acquiring market power. The hubris hypothesis by Roll in 1986 postulates that managers acquire targets based on overconfidence. A set of studies by Harford, 2005, and Moeller et al., 2004, focus on the drivers of merger and acquisition activities and their consequences.

Results:

Empirical evidence, such as that provided in the study by Bruner 2002, is weighted toward mixed results regarding the effect of M&A on firm value. Some, such as Andrade, Mitchell, and Stafford 2001, find that M&A activities can create value for shareholders; others, such as Agrawal, Jaffe, and Mandelker 1992, report that there is negative long-term performance for the acquiring firms.

VII. CORPORATE INVESTMENT DECISIONS

Investment Strategies:

The investment decisions thus depend upon factors like its internal cash flow, market conditions, and firm-specific characteristics. While studies by Hubbard, 1998; Kaplan and Zingales, 1997, on the role of internal cash flow for financing investments, focus on the role played by the nature of financial constraints, we find very little evidence of such empirical findings in our case.

Research shows that the investment decisions of firms are usually constrained by exogenous financing conditions. Baker, Stein, and Wurgler in their studies in 2003 established that there is some timing in corporate investment decisions; firms issue equity when stock prices are high and use proceeds to invest in new projects.

VIII. RISK MANAGEMENT

Practices

The tools utilized by companies for risk management are financial derivatives, insurance, and diversification. In the literature, the various roles that hedging can play to lower the firm's risk and increase value have been well documented. For instance, Tufano, 1996 explores risk management practices in the gold mining industry while Smith and Stulz, 1985 present a theory of corporate hedging rationale.

Effectiveness:

Empirical research, such as studies by Allayannis and Weston, 2001, have established that effective risk management is associated with lower volatility and higher firm value. Other studies by Bartram, Brown, and Conrad, 2011, have documented that firms using hedging instruments to reduce risk exposures exhibit lower risk profiles coupled with better financial performance.

IX. FINANCIAL MARKETS AND INSTITUTIONS

Relationship:

It is of prime importance how corporate finance interacts with the financial markets. This means that the capital required by firms is very difficult to come by without significant input from financial institutions. To this end, Diamond 1984 and Rajan 1992 have established how banks can reduce information asymmetry and, in the process, make corporate financing less costly.

Market Efficiency:

Different research on efficient markets, such as that done by Fama in 1970, have shown that information is captured in stock prices and therefore has a bearing on corporate financing decisions. The 2000 study by Baker and Wurgler tested how deviations from market efficiency have an impact on corporate financing as well as investment decisions.

X. RECENT DEVELOPMENTS AND FUTURE DIRECTIONS

Recent Developments:

Growing prominence has been observed in subjects, including ESG investing and the impact of financial technology on corporate finance. Research by Eccles et al. (2014) points out that the dimensions of ESG are gaining gradual attention in the investment decision, while Philippon, 2016 examines the disruption FinTech is causing in financial services.

Research Gaps:

Further research is required on how ESG factors influence firm performance and the contributions of FinTech in reshaping corporate finance practices. Future studies could focus on firms' integration of ESG criteria into financial strategies or on the long-term effects of FinTech innovations on corporate finance.

XI. CONCLUSION

This literature review contributes significantly to the corpus of discipline in corporate finance by providing an overall view of some of the essential theories, empirical findings, and emerging trends in the subject. The theories, in particular, incorporate the Modigliani-Miller Theorem, Agency Theory, Trade-Off Theory, and Pecking Order Theory, that are vital bases upon which financing decisions taken by firms are understood. These theories set the stage for detailed empirical research explaining intricacies involved in corporate finance.

Literature on capital structure shows different determinants relating to financing choices by firms, including aspects of profitability, structure of assets, and the condition of markets. Empirical research studies show variations across different contexts and countries; therefore, research in the future studies needs to go on in this regard to give answers that are specific.

These mechanisms of corporate governance align management with shareholders' interests, including board structure, ownership, and executive compensation. Good governance enhances firm performance and market valuation. As governance evolves towards ESG criteria in the future, further research should be conducted to help clarify how these new dimensions interact with traditional mechanisms in influencing overall performance.

Of the most controversial issues, dividend policy has been the one with variously expressed theories and arguments concerning its relevance and impact. Empirical research continues to search for determinants and effects of dividend policies, arguing that among the critical factors are profitability, growth opportunities, and firm maturity. Future research needs to examine how dividend policies will be influenced by new trends, such as ESG considerations and changing investor preference.

In essence, therefore, synergies, diversification, and market power act as the drivers for mergers and acquisitions. Studies on the results of M&A activities are mixed, with some showing value creation and others indicating negative long-term performance. Further research on changing motivations and outcomes of M&A should be targeted in relation to the increasing role of cross-border deals and, particularly, a growing role of digital transformation.

Corporate investment decisions are driven by internal cash flow, market conditions, and firm-specific characteristics. There exist important roles for both financial constraints and market timing when optimizing corporate strategy. How advances in technology, such as within the growing fintech industry, affects the corporate investment decision-making process and market efficiency is an area of research that should be pursued in the near future.

In the firm's risk mitigation and value enhancement processes, Derivatives, Insurance, and Diversification are inevitable risk management practices. Lower volatility due to effective risk management is bound to result in better performance. Future research should aim to investigate new innovative strategies and their efficacy across industries.

Discussions related to new trends—ESG investing and Fintech innovations in corporate finance—are becoming increasingly popular. ESG is already being factored into

investment decisions, and FinTech is transforming financial services. Future research has to take into consideration the trends and long-term implications on practices of corporate finance and firm performance.

There are still lacunae in the literature despite copious progress. Perhaps what calls for further investigation are the implications of ESG factors on performance and what role has fintech played to reshape practices. The study should also give it space about how various changes in the global economic perspective and regulatory shifts could shape corporate finance decisions.

The corporate finance arena is ever dynamic and changing with different economic, technological, and regulatory environments. It thus focuses on the synthesis of key theories, empirical studies, and new trends that, from a wider context, have pointed to gaps and set future research directions. Its purpose has been to contribute to the continuous development of corporate finance for firms to steer through complexities in financial decision-making and create value for shareholders.

XII. REFERENCES

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