Journal of Management, Organizations and Strategy JMOS
Spatial and entrepreneurial development studies laboratory
Year: 2020 Vol.2 No.2 pp: 7-12

Financial Management and Corporate Finance.

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ARTICLE INFO

Keywords:
Financial Management
Corporate Finance
Enterprise Risk Management
management control systems
JEL Code:G23, G30

ABSTRACT

This paper explores key pillars in financial management and corporate finance, focusing on capital structure theories, investment valuation methods, and financial risk management practices. The discussion begins with the Modigliani and Miller (MM) theorem, which originally posited that under perfect market conditions, a firm's value is unaffected by its financing choices. Later revisions acknowledged the tax advantages of debt, sparking alternative theories such as the trade-off theory and the pecking order theory. These extensions incorporate real-world elements like taxation, information asymmetry, and agency conflicts. Empirical and theoretical contributions from French scholars are also highlighted, showing how local institutional contexts shape capital structure decisions.

In evaluating investment decisions, the paper compares Net Present Value (NPV) and Internal Rate of Return (IRR) as dominant valuation tools. NPV, which discounts future cash flows to assess value creation, is widely regarded as the superior method due to its consistency and alignment with shareholder wealth maximization. Though IRR remains popular for its intuitive appeal, it is prone to problems in cases of non-standard cash flows or mutually exclusive projects. Real options analysis is introduced as a complementary technique that accounts for managerial flexibility under uncertainty.

The paper then examines the essential role of financial risk management in modern corporations. It categorizes financial risks into market, credit, liquidity, and operational types. Key tools such as Value-at-Risk (VaR), stress testing, and scenario analysis are discussed, alongside risk mitigation strategies like hedging, diversification, and capital reserves. The evolution of Enterprise Risk Management (ERM) is emphasized, particularly its importance in aligning risk practices with strategic goals. Regulatory frameworks, including Basel III, and their influence on risk governance are also considered. In the French context, integrated risk and management control systems are shown to play a pivotal role in promoting both compliance and performance.

In summary, this paper illustrates that effective corporate finance involves dynamic interplay among capital structure optimization, sound investment appraisal, and proactive risk governance, all tailored to institutional and market realities.

1. Introduction

Financial management and corporate finance are fundamental fields within business administration that provide frameworks for understanding how firms make critical economic decisions. These areas encompass a wide range of concepts, from how companies structure their capital and evaluate investments, to how they identify and manage financial risk. As financial environments become more dynamic and complex, mastering these domains has become essential for both scholars and practitioners.

The purpose of this paper is to explore three key pillars of modern corporate finance: capital structure

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theories, investment valuation methods, and financial risk management. These topics have received considerable attention in academic literature due to their central role in shaping corporate strategy and enhancing value creation.

The first part of the study focuses on capital structure—the mix of debt and equity financing a firm uses. One of the earliest and most influential contributions in this area is the Modigliani and Miller (MM) theorem, which suggests that under ideal market conditions, the value of a firm is unaffected by how it is financed. While this theory provides an important benchmark, it assumes the absence of taxes, bankruptcy costs, and information asymmetry. Later studies, including the trade-off theory and the pecking order theory, adjust this framework by recognizing real-world imperfections. These theories emphasize the influence of taxes, financial distress, and managerial behavior on capital structure choices. Additionally, empirical evidence from French and international scholars has highlighted how institutional, cultural, and agency-related factors also affect financing decisions.

The second part of the paper addresses investment valuation techniques, particularly Net Present Value (NPV) and Internal Rate of Return (IRR). These tools are widely used to assess whether long-term projects will generate value for shareholders. NPV is often considered the most reliable method as it directly estimates the increase in firm value. IRR, while useful and intuitive, has methodological limitations in some contexts. Scholars have also introduced advanced methods like real options analysis to capture the value of managerial flexibility under uncertainty. Despite the emergence of new techniques, NPV and IRR remain the most widely taught and applied models in both academic settings and business practice.

The third section examines financial risk management, a growing priority in the wake of global financial crises. Companies must manage various forms of risk, including market, credit, liquidity, and operational risks. Risk management practices involve identifying threats, measuring potential impacts, and implementing strategies to mitigate losses. Quantitative tools like Value-at-Risk (VaR), along with stress testing and scenario analysis, play a key role in risk assessment. Moreover, financial institutions and corporations often use hedging, diversification, and capital buffers to safeguard against adverse outcomes. The development of Enterprise Risk Management (ERM) further reflects the need for integrated and strategic approaches to managing risk across organizations. Regulatory frameworks such as Basel III and national governance systems, including those in France, have reinforced the importance of risk oversight at the board level.

Overall, the study aims to provide a structured overview of essential topics in corporate finance, integrating classical theories with contemporary practices and empirical insights. By examining these core elements—capital structure, investment appraisal, and risk management—this paper contributes to a deeper understanding of how firms make sound financial decisions in complex and evolving environments.

1. Capital Structure Theories:

One of the foundational theories in corporate finance is the Modigliani and Miller theorem (commonly abbreviated as MM theory), developed by Franco Modigliani and Merton Miller in the 1950s. The theory explores the relationship between a firm's capital structure and its overall value. In their first proposition (1958), they argue under perfect market conditions (no taxes, bankruptcy costs, or asymmetric information) that the value of a firm is independent of how it is financed, whether through equity or debt. This means that the capital structure does not affect the firm's market value, and investors cannot gain extra advantage by altering the proportion of debt and equity (Modigliani & Miller, 1958). Their second proposition adds that the cost of equity increases linearly with leverage because more debt raises the risk of equity, but this is perfectly offset by the benefit of cheaper debt, keeping the overall cost of capital constant.

This has significant implications: in ideal markets, managers should not concern themselves with capital structure decisions for value creation.

However, Modigliani and Miller later revised their theory in 1963 to include corporate taxes, acknowledging that interest payments are tax-deductible, which creates a tax shield that favors debt financing (Modigliani & Miller, 1963). This adjusted model suggests that a firm's value increases with leverage due to the tax benefits of debt. Still, this idea sparked further debate and led to the development of trade-off theory, which balances the tax advantages of debt with the costs of financial distress (Kraus & Litzenberger, 1973). Another development is the pecking order theory (Myers & Majluf, 1984), which argues that due to asymmetric information, firms prefer internal financing first, then debt, and finally equity as a last resort. This approach contradicts the MM theory's assumption of perfect markets, recognizing real-world conditions where managers have better knowledge than investors.

French literature also contributes to the understanding of capital structure. For example, Charreaux (1991) discusses how agency theory affects financing decisions in the French context, showing that the separation between ownership and control creates managerial incentives that influence capital structure. Similarly, empirical studies such as those by Harris and Raviv (1991) demonstrate that information asymmetry, agency costs, and market imperfections significantly influence firms' capital structures across different economies. In sum, while MM theory provides a theoretical benchmark, real-world factors like taxes, bankruptcy risk, information asymmetry, and managerial behavior have led to more nuanced and practical theories of capital structure that better reflect how companies operate.

2. Investment Valuation Techniques:

Investment valuation plays a central role in financial management and corporate decision-making, especially when assessing the viability of long-term projects. Two of the most widely used valuation techniques are Net Present Value (NPV) and Internal Rate of Return (IRR). The NPV method evaluates an investment by calculating the present value of all expected future cash flows, discounted at the project's cost of capital. A project is considered acceptable if its NPV is greater than zero, indicating that it adds value to the firm. This technique is widely supported in financial literature as the most reliable criterion because it directly measures the increase in wealth and aligns with shareholder value maximization (Brealey, Myers, & Allen, 2017). NPV considers the time value of money, risk (through the discount rate), and all cash flows over the project's life, which makes it superior to accounting-based metrics like payback period.

The IRR is closely related to NPV and is defined as the discount rate that makes the NPV of a project equal to zero. In other words, it is the break-even rate of return. If the IRR exceeds the firm's required rate of return (also called the hurdle rate), the project is considered financially viable. Although IRR is widely used because it is easy to interpret as a percentage return, it has limitations. For instance, it can produce multiple values for projects with alternating cash flows (non-conventional cash flows) and can lead to incorrect decisions when comparing mutually exclusive projects with different scales or timing (Lefley, 1996). This is why financial scholars generally recommend using NPV over IRR, especially when evaluating mutually exclusive investments or complex cash flow patterns (Damodaran, 2012).

French scholars have also examined these techniques in corporate settings. For example, Vernimmen, Quiry, and Dallocchio (2014) emphasize the robustness of NPV in strategic investment decisions, particularly in uncertain environments where project flexibility is important. Furthermore, real options theory has emerged as a complementary approach to traditional NPV and IRR by valuing managerial flexibility in investment decisions (Trigeorgis, 1996). Nonetheless, both NPV and IRR remain core tools taught in finance courses and recommended by financial institutions. Ultimately, while IRR provides useful intuitive guidance, NPV offers more accurate and consistent results and should be prioritized when making capital budgeting decisions.

3. Risk Management in Finance

Risk management in finance is the process through which organizations identify, evaluate, and respond to financial uncertainties that may affect their business operations or financial performance. It plays a critical role in protecting company assets, ensuring financial stability, and supporting long-term strategic goals (Hull, 2015). Financial risks are usually classified into several types: **market risk**, which arises from fluctuations in interest rates, exchange rates, and stock prices; **credit risk**, which refers to the possibility that borrowers may default on their obligations; **liquidity risk**, which involves the inability of a firm to meet its short-term liabilities; and **operational risk**, which is related to internal failures, human errors, or external disruptions (Jorion, 2007). *[Marginal note: Categories of financial risk]* Effective risk management starts with **risk identification and measurement**, using both qualitative and quantitative techniques. Among the most widely used tools is **Value-at-Risk (VaR)**, which estimates the potential maximum loss a firm might experience under normal market conditions over a specific time frame and confidence interval (Jorion, 2007).

However, VaR has been criticized for underestimating rare and extreme events—known as "black swans"—which can have catastrophic impacts (Taleb, 2007). As a response, institutions often conduct **stress tests and scenario analyses** to evaluate how their portfolios would perform under extreme but plausible market conditions (Bessis, 2010).

In addition to identifying and quantifying risk, companies implement **risk mitigation strategies** such as **hedging with derivatives** (e.g., options, futures, and swaps), **diversification of assets**, maintaining **capital buffers**, and setting **credit exposure limits** (Stulz, 2003). These instruments help firms protect against adverse financial outcomes by transferring or offsetting risks. The rise of **Enterprise Risk Management (ERM)**, especially after the 2008 financial crisis, highlights the need for an integrated and company-wide approach to managing risk. ERM ensures that all departments align their risk practices with the overall strategic objectives of the organization (Lam, 2003). In banking and financial institutions, **Basel II and Basel III regulations** introduced by the Basel Committee on Banking Supervision have reinforced the importance of maintaining adequate capital, strengthening liquidity, and enhancing disclosure practices (BCBS, 2011).

These regulations promote transparency and aim to prevent systemic failures. In the French context, the work of Bourguignon and Demailly (2005) illustrates how cultural and regulatory differences shape risk governance practices in French companies. They emphasize the integration of risk with management control systems to promote both compliance and performance.

Ultimately, **risk governance**, supported by the board of directors and risk committees, ensures that companies operate within their defined **risk appetite** and make informed financial decisions (Vernimmen et al., 2014). As financial markets grow more complex, the ability to anticipate, measure, and control risk becomes a key driver of corporate resilience and success. Risk management, therefore, is not merely a defensive strategy, but a proactive discipline that supports growth, innovation, and sustainable performance in modern corporate finance.

Conclusion

This study has reviewed three central domains of corporate finance: capital structure theories, investment valuation techniques, and risk management practices. Each of these areas plays a critical role in shaping a company's financial strategies and long-term sustainability. By synthesizing both classical financial theories and contemporary applications, the analysis has aimed to deepen our understanding of how firms make financial decisions in a complex and evolving business environment.

In the field of capital structure, the foundational Modigliani and Miller (MM) theory provided the initial analytical framework, arguing that under perfect market conditions, capital structure does not influence a firm's value. However, this theory, while elegant, fails to account for key real-world imperfections such as

taxes, bankruptcy costs, and asymmetric information. As a result, alternative theories such as the trade-off theory and pecking order theory have emerged to offer more practical and realistic models. These developments show that capital structure is influenced not only by market conditions but also by managerial behavior, agency problems, and institutional contexts. French contributions, particularly those highlighting agency relationships, add further depth by showing how cultural and regulatory environments influence financial decisions.

Regarding investment appraisal, the paper compared two principal techniques: Net Present Value (NPV) and Internal Rate of Return (IRR). While both are used extensively in practice, NPV is shown to be more consistent and theoretically sound. It directly measures the expected increase in firm value and aligns well with the goal of shareholder wealth maximization. IRR, though intuitively appealing, is more prone to ambiguity in complex project settings. Complementary approaches such as real options analysis expand the traditional toolkit by introducing flexibility and strategic decision-making under uncertainty. These methods reflect the evolving nature of investment evaluation in increasingly volatile markets.

The discussion on risk management has highlighted its growing importance in the post-crisis financial landscape. Firms are exposed to various types of risks—market, credit, liquidity, and operational—that must be identified, measured, and managed effectively. Tools such as Value-at-Risk (VaR), stress testing, and scenario analysis help organizations anticipate potential losses under different conditions. In response to the limitations of VaR, particularly its failure to predict rare but extreme events, companies increasingly incorporate alternative risk models and comprehensive mitigation strategies. Hedging, diversification, and capital buffers are essential for protecting firms from financial shocks. Moreover, the rise of Enterprise Risk Management (ERM) underscores the shift toward an integrated and proactive approach, where risk management aligns closely with overall strategic objectives.

The role of governance in financial decision-making also emerged as a central theme, especially in the management of risk. Regulations such as Basel III, along with national frameworks like those applied in France, aim to strengthen the financial system by promoting transparency, accountability, and prudent risk-taking. These mechanisms ensure that risk oversight is embedded in corporate structures through the involvement of boards and risk committees.

In conclusion, corporate finance is a multidisciplinary field that combines theory and practice to support sound decision-making. The insights presented in this paper suggest that firms must adapt their financial strategies to both theoretical principles and contextual realities. Capital structure, investment valuation, and risk management are not isolated activities but interconnected functions that require coordination, informed judgment, and continuous adaptation. As financial markets continue to evolve, the ability to integrate these elements will remain a key determinant of corporate success and resilience.

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