

## Corporate Financing Decisions, Taxes and Firm Value: A Critical Literature Review

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**Abstract:** The main goal in corporate financing decisions is firm value maximization and therefore, there must be a link between firm value and corporate finance decisions. This study critically looks at literature on the relationship among taxes, corporate financing decisions, and firm value. The study arrives at different results. Different researchers utilized different methodologies and approaches to analyse the relationship among corporate financing decisions, taxes and firm value. Which could have contributed to the contradicting results? It is evident from this study that companies often face primarily, two corporate financing decisions. These decisions are what proportion of profit should be channeled back into the business instead of paying them out as dividends and how much deficit they should finance by borrowing instead of issuing out equity. These two questions are very important for all firms in making financial decisions. Much research has been carried out to establish the relationship among corporate financing decisions, taxes and firm value and how the relationships impact each other. However, opinion is not unanimous on how the interactions of corporate financing decisions and taxes contribute or affect firm value, as such; this is an area that could profit from further research. This study relied solely on secondary sources, of which majority focused on listed firms. Most studies have been done on listed firms as opposed to non-listed firms. At the same time, there is little information on how elements of tax, like debt tax shield, interest tax shield and liquidity, affect the value of a firm and its corporate financing decisions. This study recommends that further research be done on the relationship among taxes, corporate financing decisions, and firm value on firms that are not listed at the security exchanges. This will provide a platform to do comparison and see whether their behaviors are similar to those of listed firms.

**Keywords:** corporate financing, tax, profit, security exchange.

### INTRODUCTION

#### Background of the study

For some time now, finance scholars [1-13], have put a lot of effort in understanding the relationship among corporate financing decisions, taxes and firm value. However, so far, there has not been a consensus on the same. This study therefore seeks to critically review the literature and various theories concerning corporate financing decisions, taxes and firm value.

Most corporations incur taxes as one of the most significant costs. Therefore, tax considerations are an important input into most corporate decisions [14, 12]. Corporate financing decisions involves the decision on whether to use debt or equity. Deductible interest payments on debt reduce taxable income. On the contrary, dividends and share repurchases do not reduce a firm's taxable income.

Corporate financing decisions can influence firm value. The decisions on whether to use debt or equity in financing can be evaluated so as to maximize firm value. If debt value is high, the firm value is reduced. This is so because, when the level of debt is high, agency problems arises between shareholders and debt holders. Because of the riskiness of debt, firm value will be negatively influenced.

#### Corporate Financing Decisions

Corporate financing decision is the form and amount of financing of a firm's investment [15]. It is the decision on whether to use external funds or internal funds to finance a company's projects. Components of corporate financing decisions involve decisions on the capital structure and decisions on dividend policy. Financing decisions involve raising money while investment decisions involve spending money.

Firms usually prefer internal financing, Myers [16]. External financing is usually a sign of bad news about earnings. Several scholars for example Jensen and Meckling [17] say company managers can be monitored and controlled by using debt. This is so because, when the level of debt is high, agency problems arises between shareholders and managers and managers might lose their jobs if they cannot manage the debts.

### **Taxes**

Dalton [18] defines tax as “a compulsory contribution imposed by a public authority, irrespective of the exact amount of service rendered to the taxpayer in return, and not imposed as penalty for any legal offence”. Corporate finance as a component of finance knowledge tries to find out how taxing of debts and dividends can have an impact firm value. Since interest payments on corporate debts are tax deductible, cost of debt can be lowered through tax savings on interest deductions.

Chen and Gong [13] argue that as tax rate on corporate income increases, market value of a firm declines. They also argue that marginal tax rate influences the capacity of a company. This argument is similar to the argument by the proponents of Trade off theory who argue that a rise in corporate tax leads to decline in firm value.

### **Firm value**

Firm value is one of the important metrics used in valuation of businesses. In the field of corporate finance, maximization of firm value is the major objective in decision making.

There are several definitions of firm value. According to Leland and Toft [19] firm value is “the value of a firm’s assets plus the value of tax benefits enjoyed resulting from the debt minus the value of bankruptcy cost associated with the debt”. Modigliani [20] defines firm value as the sum total of a firm’s debt and equity. Ehrhard and Bringham [21] define firm value as “a sum of claims of all claimants”. Claimants include creditors and equity holders.

As stated by Jensen [7], Stulz [22] and Myers [8], debt can result to both negative and positive impact on firm value. In situations where managers have excess funds, debt will ensure managers do not invest in risky projects. Contrarily, firms that have outstanding debts may reject good projects if they think the projects would benefit the bondholders more than the equity holders.

### **Corporate Financing Decisions, Taxes, and Firm Value**

Capital structure theories can better explain the nexus between corporate financing decisions and value of a firm. Some researchers cite evidence in support of the role of capital structure in determining firm value. However, researchers like Modigliani and Miller [23] argue that capital structure is not relevant in the determination of the value of a firm. They argue that there is no link between capital structure and the value of a firm. This argument was later modified after factoring in capital market imperfections.

If a firm uses debt capital to fund its operations, it will obtain tax reliefs on interest payments. If equity capital is used to fund operations, profits from the operations will be used to pay dividends. This therefore implies there will be a liability for personal income tax. As market value of a firm will go down, corporate taxes will go up as explained by Chen and Gong [13].

### **RESEARCH PROBLEM**

Despite several studies having been done as regards corporate financing decisions, taxes and firm value, there has not been any consensus on the results. Some studies suggest positive relationships, some suggest negative relationships. Modigliani and Miller [23] stated that “if there are two firms in the same risk class and in an economy with no transaction costs, no taxes, and no bankruptcy costs (perfect capital market) then their relative market value are independent of their capital structures”.

Mackie – Mason [24] argues that companies that have their marginal tax rates high, have a higher likelihood of issuing debt compared to companies with lower marginal tax rates. This implies that corporate financing decisions are influenced by tax. Fama and French [9] found out that debt and dividend are very important for a firm since they convey information concerning profitability and value of a firm. The duo’s objective was to find out how firm value is impacted on by debts and dividends. The conclusion of the study was that dividends have a positive relationship to firm value while debt has a negative relationship to firm value.

Studies like Mackie-Mason [24], Graham [25-27] show positive relationship between debt and tax in several publicly traded firms. Other studies such as Campello and Giambona [28], Sibilkov [29], however found out that debt and tax are negatively related. Several studies however exclude the rate of tax as one of the major variables in the determination of capital structure decisions.

Maxwell and Kahinde [30] did a study that sought to find out how capital structure impact on firm value. They analyzed data from 124 companies. These were firms quoted at the Nigerian Stock Exchange. Regression and ordinary least squares method were used. The study results showed that emerging markets like Nigeria, equity financing is irrelevant to firm value and Long-term-debt is relevant in determining firm value.

As can be seen from the several studies cited above, it can be observed that there are conflicting evidence concerning the relationship among corporate financing decisions, taxes and firm value. This conflicting evidence provides a research gap which further research can be done to give a position on the same. Therefore, this study seeks answers to the question: what is the relationship among taxes, firm value and corporate financing decisions?

### Objectives of the Study

The study examines the literature on the relationship among corporate financing decisions, taxes and firm value with the following listed objectives

- To conduct literature review on the relationship between corporate financing decisions and taxes,
- To conduct literature review on the relationship between taxes and firm value,
- To conduct literature review on the relationship between firm value and corporate financing decisions
- To conduct literature review on the relationship among taxes, firm value and corporate financing decisions
- To identify research gaps

### Value of the Study

The study will be of help in enhancing knowledge and theory building in the field of finance .It will help enhance knowledge on the relationship among corporate financing decisions, taxes and firm value.

The study findings will be useful to decision makers when making financing policy decisions, whether to utilize debt and/or equity finance depend on how both are affected by the tax component in the profits. This study's recommendations will further provide authorities, financial institutions, entrepreneurs and consultants with the necessary tools that can be used to plan the financing of their businesses.

This study will help to guide financial managers in designing their optimal capital structure. This will help them to maximize firms' market value and also to minimize agency costs. It would also provide a basis for further research on the relationship

among taxes, firm value and corporate financing decisions.

## LITERATURE REVIEW

### Theoretical Review

Some of the key theories to be reviewed are: Trade-off theory, Clientele effect theory, Agency theory, Pecking order theory and tax preference theory.

### Trade-off Theory

Trade-off theory was pioneered by Myers [31]. The theory states that firms usually select the amount of debt or equity to use through balancing the costs and benefits of debts and of equity .According to this theory, the tax advantages of debt is balanced against the costs of using debt.

Kraus and Litzenberger [32] argues that trade-off theory is about an economic advantage that exists in using debt in terms of debt tax benefits, debt cost benefits, and financial distress costs. Frank and Goyal [33], argues that debt is of benefit to shareholders so long as shareholders are rewarded up to the level where the benefit from tax deductibility of interest is offset against the costs of bankruptcy.

### Pecking Order Theory

The pecking order theory branches from Myers [16]. The pecking order theory advocates for some standard pecking order to be followed by firms in their financing decisions. Funds generated internally are more preferred to external funds according to the theory. Suppose funds generated internally are inadequate, external funds would be raised. Suppose external funds have to be used, firms would prefer first the straight debt, followed by convertible debt, and finally external equity.

The pecking order of financial decisions is derived from a variety of sources that include taxes and agency conflicts. However, there are certain motivations for the pecking order, the common one being adverse selection. The main notion behind the adverse selection is that firm's owner –manager understands his/her firm's assets true value and opportunities for growth (asymmetric information) [10,31] than the external investors. The external investors cannot be sure of these true values. When the owner-managers offer to sell equity, the external investors would ask why they are willing to sell the equity. The owner-manager of an overvalued establishment, in most cases, will happily make money by selling equity, whereas the undervalued firms will not be happy when selling equity since they will lose.

According to Graham [12] the pecking order affects the way corporate financing decisions are made, creating a sequence that goes from internal financing

(retained profits), debt financing, and then external equity finance. The firm normally first taps retained earnings, given that it has a primary attraction of coming out of profits and not much effort is needed to get it [10]. Moreover, the use of retained is normally not viewed negatively by the capital market, [4,32, 33]. When the firm's financing needs exceed their retained earnings, it seeks debt financing.

### **The Clientele Effect Theory**

Richardson Pettit was the proponent of this theory in 1977. This theory is also termed as customer effect theory. The theory states that different groups of shareholders have different preference for dividend. Persons earning lower incomes will normally prefer getting paid higher dividends so as to meet their consumption needs. Conversely, persons earning high incomes would prefer to pay fewer taxes they will prefer less dividends.

The Clientele effect theory believes that different investors' appetite for capital gains and dividend income vary from person to person in the imperfect capital market because of the existence of tax burdens and transaction costs [34]. Certain investors, for example pensioners, may prefer investments that pay high dividends. This is meant to provide them with a steady income stream [28]. Other investors, like the high-worth young professionals may prefer investments that pay low dividends, because they prefer higher capital gains and larger future dividends.

### **Agency theory**

This theory seeks to explain the conflicts that may exist between the owners or principal of organization (shareholders) and agents who are appointed to run the activities of the organization (managers). According to agency theory, the principals who are the owners of the business delegate the running of the firm to the directors or managers. The principals however may not make the best of decisions to cater for the interests of the shareholders.

The major objectives of firms are to maximize their values. When a firm is in debt, it is not good for its value this is because agency problems will come up between the shareholders and the debt holders as debt is risky thus creating negative effect on firm value. Debt is very important tool in financial management. They help reduce costs of agency of shareholders' equity and increase the value of a firm. Debt ensures that financial managers are keener to avoid the risks of bankruptcy and insolvency and employment losses. According to Jensen [7], debt financing increases firm value. This is because firm managers are obliged to pay out resources to debt holders, resources which may instead be expended carelessly and extravagantly on wrong investments.

### **Tax preference theory**

Taxes are one of the important things investors consider before they think of investing. Litzenberger and Ramaswamy [35], developed this theory. This theory branches from Modigliani and Miller [36]. Litzenberger and Ramaswamy [35] stated that investors normally prefer companies that pay lower dividends, because of they would pay less tax on those dividends as opposed to more taxes on higher dividends. They came up with this theory after observation of American stock market in which they concluded that investors prefer lower payout companies.

According to The tax-preference theory, lower payouts lower capital costs and increase share prices thus maximizing firm value. One of the critical assumptions to this theory is that the tax rates for dividends are higher than that for capital gains.

Corporate taxation affects dividend decision in very many ways. It affects a firm's net income-after-tax. A firm's ability to pay out dividends is determined by the income that remains after tax (net income after tax). The net value that shareholders would receive will also be affected. Companies may opt not to pay dividends because of the double taxation of dividends. This means dividends are taxed on the company (corporate tax on corporate profits) and finally on shareholders (personal income tax) when they receive them.

### **Empirical Literature Review**

The empirical studies cover the following areas: relationship between taxes and corporate financing decisions, relationship between taxes and firm value, relationship between firm value and corporate financing decisions and the relationship among corporate financing decisions taxes and firm value.

### **Relationship between Taxes and Corporate Financing Decisions**

MacKie-Mason [24] sampled 1,747 security offerings (both equity and debt) in the United States of America from 1977-1987. Upon examination of the security offerings, he found out that the firms with high tax rates are more likely to issue debts compared to firms with low tax rates. He used the methodology of incremental financing choice.

Graham [27], sought to find out the level to which corporate financing decisions are influenced by taxes. He argues that investors will always demand higher returns for holding debt if they are taxed heavily on interest income. This makes the use of debt not preferable at corporate levels. Personal tax from interest income is most of the times greater than taxes on dividend. The results of this study goes against

Miller [4] that says “no tax-induced optimal capital structure” by inferring that penalty on personal taxes only reduces but never completely remove the tax incentives to use debt in financing. Graham [27] fails to find evidence linking personal tax rates and corporate financing decisions

Auerbach [37] reviewed several theories and evidence as concerns taxation and corporate financing decisions. The study relied on several previous studies .He analyzed equity policies, debt-equity decisions, and choices relating to organizational forms and ownership structures. He concluded that corporate financial policy involves several options among different underlying policies and the characterizations of a given policy. Auerbach [37], however fails to clearly show how equity policies, debt-equity decisions, and choices related to ownership structure and organization form influences tax , firm value and corporate financing decisions.

Graham *et al.* [25] carried out a survey study to better understand which tax rates companies use to incorporate taxes into their decision making. This study used responses from 500 corporate tax executives and showed that financing decisions are influenced by the effects that increase shareholder value like market imperfections (taxation and agency problems). The results of the study however, cannot be taken to represent most corporates and the behavior of most managers. This is due to the fact the results are specific to the American setting.

Nyang’oro [38] did a study on how tax influences the capital structures of firms quoted at the Nairobi Securities Exchange (NSE) (formerly, Nairobi Stocks Exchange). Adopting the static trade-off theory and being motivated by the Modigliani-Miller (MM) argument, this study addresses whether the capital structure of companies change with changes in the tax rate. The results from the study show that tax rate is significant in determining the leverage of firms. Additionally, this study shows that profitability, tangibility, and growth opportunities are significant in explaining the listed firms’ capital structure. The critique to Nyang’oro[38] study is that it used panel data analysis of a sample of 20 listed non-financial companies. This figure is slightly small to be able to represent the whole population. As such, these results cannot be conclusive.

#### **Relationship between Taxes and Firm Value**

Chen and Gong [13] tested the tradeoff theory. Proponents of Trade off theory argue that a rise in corporate tax leads to decline in firm value. Chen and Gong [13] found empirical support for this proposition. They found the link between corporate tax and the market leverage ratio to be non-linear. This finding

shows why the tax rate is in some instances an unreliable determinant of leverage ratios in linear regressions.

The empirical findings by Chen and Gong [13], focus on giving more evidence on the trade-off theory .Additionally, Chen and Gong [13], focus on emphasizing that the marginal tax rate influences a firm’s debt capacity .

#### **Relationship between firm value and corporate financing decisions**

Taxes, proxy effects, agency costs, bankruptcy costs and asymmetric information are very important in determining the relationship between corporate financing decisions and firm values.

Ogbulu and Emeni [39] did a study aimed at finding out the impact of capital structure on firm value. 124 firms quoted on the Nigerian Stock Exchange during that period were included in the study. The results of their study indicated that in emerging economies such as Nigeria, long term debt capital as opposed to equity capital is relevant in determining firm value.

Kulati [40] seeks to establish the link between firm value and capital structure. He used a sample of 38 companies that had continuously and actively traded at the NSE for five years between 2009 and 2013. He demonstrated that the size of a firm and capital structure influence the firm value positively. This study’s findings are limited to firms that had traded at the securities exchange consistently for the five year period utilized. These firms were 38 in number, and as such, the results of the study do not necessarily represent the entire population of listed and non-listed companies. This study relies on secondary data sources and as such, the extent of accuracy of the data set is limited. Most secondary sources have a likelihood of being manipulated to suit specific needs.

#### **Relationship among Corporate Financing Decisions, Taxes and Firm Value**

Adelegan [41] study seeks to find out how taxing of debt and dividend affects firm value and to disprove the claim that firm value and debt are negatively related. The study picks 85 firms at the the Nigerian Stock Exchange (NSE) between the years 1984 and 2000. The conclusion of the study is that information concerning profitability of firms can be conveyed through debt and dividend which clouds any tax influence on financing decisions. Adelegan [41] assumes that firm size can affect the relationship among debt, dividends, and firm value .This assumption, however is not established in the results .The results are therefore biased.

Fama and French [9] sought to find out the relationship between firm value and dividends and debt. They did a cross-sectional regression analysis. The study found out that the value of a firm has a positive relationship to dividends and negatively to debt. The drawback to the study is that it used information on

profitability as opposed to debt and equity to establish the impact of tax on financing decisions. This might lead to wrong conclusions.

**Table-1 : Summary and Knowledge gaps**

Researcher & Focus of the study	Research findings	Research gaps
Graham, Hanlon, Shevlin, and Shroff [25]. This survey study seeks to better understand which tax rates companies use to incorporate taxes into their decision making.	This study found that most firms' financial decisions entail increasing their debt levels so as to fully capture the tax benefits up to the point where the marginal tax benefits are equal to the expected marginal costs of debt. Pre-tax cash flow forecast and marginal tax rates are used for financial decisions making. A few select firms use the marginal tax rate for decision making.	Graham, Hanlon, Shevlin, and Shroff [43] have effectively examined the manner in which managers incorporate taxes into their decision making. This brings out the relationship between tax and corporate financing decisions. However, the results cannot be taken to represent most corporate and the behavior of most managers. This is due to the fact the results are specific to the USA setting.
Kulati [40]. This study seeks to establish the relationship between capital structure and firm value for firms listed at Nairobi Securities Exchange (NSE	The study demonstrates that size of the firm and capital structure positively influences firm value. As such, firms are to increase their growth and size, if they are to increase their firm value. Obtaining short-term loans would involve less cost and will improve the value of the firm.	This study's findings are limited to firms that had traded in the Nairobi Securities Exchange consistently for the five year period utilized. These firms were 38 in number, and as such, the results of this study do not necessarily represent the entire population of listed and non-listed companies. This study relies on secondary data sources and as such, the extent of accuracy of the data set is limited. Most secondary sources have a likelihood of being manipulated to suit specific needs
Ogbulu and Emeni[39]. The study sought to provide evidence on the impact of capital structure on a firm's value	The study found out that in an emerging economy, equity capital is not relevant in determining firm value. Long-term-debt was found to be the major determinant of a firm's value.	The research findings are in disagreement with the claims put forward by the proponents of the pecking order theory and the traditionalist theory of capital structure relevance. This research was done in Nigeria and captured 124 firms. The study can be conducted in another setting and/or with more firms.
Adelegan [41]. This study seeks to measure how the taxation of debt and dividend affects the value of the firm	The results of the study concluded that dividend and debt convey information about profitability of firms. This obscures any tax effect on financing decisions. Earnings and investment are key determinants of firm value in Nigeria.	This study relies on the assumption that the relationship between debt, dividends, and firm value will be affected by the size of the firm. This assumption however is not established in the findings of the study, and as such the results show an element of biasness.
Andor and Toth [44]. This study seeks to examine whether investment decisions and financial decisions can be separated with an emphasis on the changes of shareholder value when capital structure is reconditioned.	The result of this study conclude that an increase in corporate tax rate would result in an increase in tax shields prompting firms to raise more debts to take advantage of the increase in tax shields. However, the firm would reach a point where it is financially constrained due to its declining market value.	Andor and Toth [44], assume in their study that firms fund their projects purely by equity, which is never so in the real-world scenario. Firms often use a mix of equity and debt depending on which one is more convenient. This study is based on the premise that if the amount of debt cannot cause any change of shareholder's value, then investment

	<p>Taxes will influence corporate financing decisions which in turn will influence the firm's value.</p> <p>There is a clear distinction between financing decisions and investment decisions.</p>	<p>decisions and financing decisions can be separated. However, debt often affects shareholder's value due to tax issues attached to debt financing.</p> <p>This study failed to capture tax affects firm value and corporate financing decisions.</p>
<p>Lewellen and Lewellen [11]. Sought to find out the tax effects of financing decisions</p>	<p>The result of the study is that the cost of capital of a firm depends not just on a mix of debt and equity but also on mix of internal and external funds and that debt is favored over equity when making financing decisions.</p>	<p>This study's observation is that the connection between financing decisions and taxes is more complicated than the way traditional cost structure theories suggest. However, this observation is too general and and not specific in terms of tax rates applicable to different types of investors and even trading behavior for different types of investors.</p>
<p>Nyang'oro [38]. This study is on the effect of tax on the capital structures of companies listed on the Nairobi Securities Exchange (NSE) (formerly, Nairobi Stocks Exchange).</p>	<p>This study addresses whether the capital structure of companies change with changes in the tax rate, showing that profitability, tangibility, and growth opportunities are significant in explaining the listed firms' capital structure.</p> <p>The study observes that listed firms are able to adjust their leverage to the target debt ratio while in the process incurring positive adjustment costs.</p>	<p>Nyang'oro [38] study used panel data analysis of a sample of 20 listed non-financial companies. This figure is slightly small to be able to represent the whole population. As such, these results cannot be conclusive.</p> <p>This study further fails to establish the relationship between tax and financing decisions or firm value.</p>
<p>Auerbach [37]. This study seeks to find out impact of taxation on corporate financial policy.</p>	<p>The study relied on several previous studies .He analysed debt-equity decisions, equity policy, and choices relating to ownership structure and organizational form. He concluded that financial policy entails choices not only among different underlying policies but also among characterizations of a given policy.</p>	<p>This study by Auerbach [37] is a review of studies on effect of taxation on corporate financial policy. As such, this paper is simply a collection of views on three key areas of research, namely, debt-equity decisions, equity policy, and choices relating to ownership structure and organization form.</p> <p>This study fails to establish how these three areas of research influences tax, affects firm value and corporate financing decisions.</p>
<p>Fama and French [9]. The study sought to find out how firm value is related to dividends and debt. They did a cross-sectional regression analysis.</p>	<p>The study found out that firm value is positively related to dividends and negatively related to debt.</p>	<p>The drawback to the study is that it used information on profitability as opposed to debt and equity to determine the effect of tax on financing decisions .This might lead to wrong conclusions.</p>
<p>Graham [27]. The study sought to find out the degree to which personal taxes affect corporate financing decisions.</p>	<p>The findings of the study are that investors will demand higher risk-adjusted returns for holding debt if they are taxed heavily on interest income. This in effect discourages the use of debt at corporate levels.</p>	<p>The study uses a simulation of marginal tax rates to account for uncertainty in taxable income, as well as the tax-loss carryback and carryforward. As such, the study does not eliminate the tax incentives to use debt.</p> <p>The study fails to find any evidence that time-series changes in personal tax rates affects corporate financing decisions</p>
<p>Mackie-Mason [24] This study seeks to find out whether taxes affect corporate financing decisions.</p>	<p>The findings of the study is that firms which are more likely to issue debt are firms with effectively high tax rates compared to firms with low tax rates.</p>	<p>MacKie-Mason used the methodology of incremental financing choice. Another methodology can be used to check if the findings would be the same.</p>

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Fama and French [10], shows that taxation impacts the firm value as taxes on dividends and debt affects firm value. The impact is because firm value is has a positive relationship to dividends and negatively to debt. As mentioned earlier, this negative and positive relationship to debt and dividends respectively, refutes most of the existing tax hypothesis concerning corporate financing decisions.

Atiyet [42] study used panel data from 88 French companies. These companies were introduced on the stock exchange from 1999 to 2005. The results of the study was that the effect of a firm's financial structure on the creation of shareholder value depends very much on the measures taken by the firm . The study further concluded that French firms mostly prefer the pecking order of financing and like to finance their investments projects, firstly by self-financing, secondly by debt, and finally by equity issues . Atiyet [42] also found out that self-financing has a positive effect on the value of a firm whereas debt and equity issue have negative effect on shareholder value.

### **CRITIQUE OF THE THEORIES, RESEARCH GAPS, SUMMARY AND CONCLUSION**

#### **Critique of the Theories**

Some of the theories underpinning this study are: the Pecking order theory, Clientele effect theory, Trade-off theory, Agency theory and the tax preference theory.

Some of the critiques to the tradeoff theory are Graham [12] and Kraus and Litzenberger, [32]. Graham [12] notes that this theory fails to explain why some companies that are profitable do not rely so much on debt. Kraus & Litzenberger [32], argue that the trade-off theory assumes there exists an economic advantage in debt-financing in terms of debt tax benefits, debt cost benefits, and financial distress costs (This notion presumes that firms would prefer debt-financing as the initial and major source of financing). However, this is not the case as financing decisions usually consider the high risks of bankruptcy and volatility present in the credit markets, mostly when the firm attempts to take on more debt. The failure by the trade-of theory to explain why firms do not prefer debt as the major and initial source of financing is solved by pecking order theory of financing.

One of the assumptions in the The Tradeoff theory is that there exists an optimum capital structure. However, recent studies have shifted more focus to the Pecking Order theory. Critiques of pecking order theory argue that the use of retained earnings through issuing equity will depend on information asymmetry and market timing [10, 43]. Pecking order theory also fails to explain why in real-life situation asset-rich firms use a lot more debt compared to growth firms.

One of the arguments for the clientele effect is that some investors base their choices of shares on the dividend yield. This means that any change in dividend policy is disruptive. However, if the quantity of dividend payments can match to dividend payout rate of investors' preference, every company could be capable to grasp people's eyes with their preference dividend policy [34]. In accordance with the notions of this clientele effect theory, the requirements of all shareholders of a firm cannot be met by a firm's dividend policy. The change of dividend policy only could attract investors who like this policy to purchase the company stock, and others who are not fond of this new policy will sell stocks.

Tax preference theory was developed based on observation of American stock market and might not be applicable in a developing market .According to this theory, dividend policies are not relevant. This means that rational investors have no preference between dividends and capital gains. This assumption may not be practical since most shareholders view dividends as one of the most important ways of getting back return from their investments. Again, in the real world, there are usually market imperfections, contrary to assumptions underlying the tax preference theory

#### **Summary and Knowledge Gaps**

Questions have been raised on whether corporate financing decisions has an influence on tax and firm value, how much do they add and on what factors contribute to this influence. Likewise, questions have also been asked on the relationship between taxes, corporate financing decisions and firm value and how their interactions impact each other. Considerable effort has been put on research in order to answer some of these questions these questions beginning with Modigliani and Miller [23] studies.

From the studies reviewed, opinion is not unanimous on how the interactions of corporate financing decisions and taxes contribute or affect firm value, as such; this is an area that could profit from further research.

### Conclusion

From the studies cited above, it can be observed that corporate financing decisions taxes and firm value are related in different ways .Some studies suggest positive relationships, some suggest negative relationships. These conflicting results provide a very fertile ground for further research.

This study relied solely on secondary sources, of which majority focused on listed firms. There is little knowledge on the relationship among corporate financing decisions, taxes and firm value of firms not listed at the securities exchanges. Additionally, there is a little knowledge on how elements of tax, like debt tax shield, interest tax shield, liquidity, affect the firm's value and its corporate financing decisions. Therefore there is need to conduct more research in this area.

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