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Concept Paper

“Empirical Corporate Finance: Opportunities and Challenges”—Editorial Synthesis of the Special Issue

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Abstract: This concept paper synthesises the special issue with an integrated discussion of all four papers published therein, from the viewpoint of the theme of this special issue: opportunities and challenges for future empirical research in corporate finance. The four papers highlight that future empirical research faces the challenge of acknowledging fundamental paradigms in the literature. These include analytical models of capital structure, agency theory, the literature on Initial Public Offering anomalies and earnings valuation. An opportunity for future empirical research is to use these foundations to contribute to emerging paradigms. The latter include the empirical evidence of the shareholder wealth effects of government investment, managerial overinvestment and the acknowledgement of unlisted entities within capital markets research.

Keywords: corporate finance; agency theory; capital structure; government shareholding; Initial Public Offerings; overinvestment; private companies; valuation



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1. Introduction

The purpose of this concept paper is to synthesise the four principal papers published in this special issue. The synthesis proceeds to identify opportunities for future empirical research and highlights challenges faced by researchers embracing these opportunities. This concept paper also argues how the four papers published in this special issue contribute to meeting these challenges.

A theme emerging from all four papers is that future empirical corporate finance research should essentially be anchored in the seminal literature. This includes the analytical literature in corporate finance (Modigliani and Miller 1958), agency theory (Jensen and Meckling 1976), Initial Public Offering anomalies (Ibbotson and Ritter 1995) and earnings valuation (Ohlson 2005).

Another challenge and opportunity for future empirical research, emanating from the papers, is to embrace and contribute to new theories and streams in the literature. These paradigms include the literature on managerial overinvestment (Biddle et al. 2009), the literature on the shareholder wealth effects of government investment in private sector entities (Boycko et al. 1996; Wang and Shailer 2018; Boubakri et al. 2020; Yu and Wang 2020) and the capital markets literature on unlisted companies (Li et al. 2013; Ali et al. 2014).

The remainder of the current paper is structured as follows. Section 2 discusses the aforementioned issues, with reference to the three Malaysian papers (Sinnadurai et al. 2021b; Alyasa-Gan and Che-Yahya 2022; Sinnadurai and Devi 2022). Section 3 discusses opportunities and challenges, highlighted by Ernst (2022). Section 4 concludes, with a synthesis.

2. Implications of the Three Malaysian Papers, Regarding the Theme of the Special Issue “Empirical Corporate Finance—Opportunities and Challenges”

The theory underpinning the paper of Alyasa-Gan and Che-Yahya (2022) is strongly rooted in the seminal finance literature. The first two hypotheses may be regarded as corollaries of the central proposition of Modigliani and Miller (1958). The first hypothesis of Alyasa-Gan and Che-Yahya (2022) postulates that IPO proceeds earmarked for

growth options accelerate survival. This hypothesis accords with the [Modigliani and Miller \(1958\)](#) proposition since capital expenditure represents asset usage and hence fundamental value creation. The second hypothesis of [Alyasa-Gan and Che-Yahya \(2022\)](#) accords with [Modigliani and Miller \(1958\)](#) as follows. The usage of IPO proceeds for debt repayment would constitute the mere re-arrangement of capital structure, rather than fundamental value creation. The third hypothesis of [Alyasa-Gan and Che-Yahya \(2022\)](#) is consistent with the fundamental tenet of corporate finance that there is an opportunity cost associated with working capital, owing to its short-term nature, and that capital investment is a more fundamental value driver.

The purpose, hypothesis development and research design of [Alyasa-Gan and Che-Yahya \(2022\)](#) reflect the fundamental bases in the literature on IPO anomalies. This paper may be regarded as an investigation of a risk-based explanation of the anomaly that IPOs tend to exhibit long-run underperformance ([Ibbotson and Ritter 1995](#)). One of the control variables in [Alyasa-Gan and Che-Yahya \(2022\)](#) is the initial return on the IPO. This may be regarded as a control for the documented anomaly that IPOs tend to exhibit initial underpricing ([Ibbotson and Ritter 1995](#)). The fact that [Alyasa-Gan and Che-Yahya \(2022\)](#) report a significant acceleration factor for this variable suggests that the IPO underpricing anomaly still exists. [Alyasa-Gan and Che-Yahya \(2022\)](#) also include a control for market sentiment, which may be regarded as acknowledgement of the “hot issues market” IPO anomaly ([Ibbotson and Ritter 1995](#)). [Alyasa-Gan and Che-Yahya \(2022\)](#) report a significant acceleration factor, associated with the “hot issues” dummy. This suggests that the “hot issues” IPO anomaly is still evident.

The empirical results support the opposite conjecture from the first hypothesis in [Alyasa-Gan and Che-Yahya \(2022\)](#). The results indicate that the percentage of IPO proceeds planned for capital expenditure, to fund growth options, retards IPO survival. A different possible explanation is that management may engage in overinvestment, rather than directing the IPO proceeds towards projects that maximise shareholder wealth ([Jensen 1986](#); [Farinha 2003](#)). This would divert shareholders’ resources from the most economically efficient destination ([Gao and Yu 2020](#)). A possible motivation for managerial overinvestment may be to extract shareholder wealth ([García-Lara et al. 2016](#)), or to pursue “pet” projects of members of management ([Sinnadurai et al. 2021b](#)).

The literature on managerial overinvestment may be regarded as an emerging paradigm. A seminal model for measuring investment efficiency (the extent of actual/anticipated managerial overinvestment or underinvestment) has been developed by [Biddle et al. \(2009\)](#) and refined by [García-Lara et al. \(2016\)](#). Subsequent studies have adapted the seminal models for the institutional features of other countries. For example, [Phan et al. \(2020\)](#) and [Sinnadurai et al. \(2021a\)](#) use variants of these seminal models to estimate the investment efficiency of Malaysian companies. Hence, a suggested direction for empirical research in corporate finance is to refer to the literature on managerial overinvestment, for potential explanations for initial IPO underpricing and (by extension) long-run IPO underperformance. A challenge faced by researchers is to adapt the seminal models of investment efficiency to capture the institutional features of their countries.

[Alyasa-Gan and Che-Yahya \(2022\)](#) reflect the fundamental anchoring in the seminal agency theory literature ([Jensen and Meckling 1976](#)). The second hypothesis postulates that IPO proceeds intended for debt repayment retard the IPO’s survival time. A different approach to argue this hypothesis would be to acknowledge that debt financing can be an agency mechanism to reduce the cost of agency relationships of equity. When a firm issues debt (public or private), it is legally obliged to service the principal repayments and interest payments. This obligation prevents managers from having excessive free cash flow to squander via overinvestment, preventing the potential misuse of shareholder resources ([Jensen 1986](#); [Farinha 2003](#); [Richardson 2006](#)). The usage of IPO proceeds for debt repayment would erode the efficacy of this agency mechanism.

The results of [Alyasa-Gan and Che-Yahya \(2022\)](#) report an insignificant acceleration factor associated with shareholder retention. A possible explanation is that the effect on IPO

survival of shareholder retention may differ according to the type of shareholder. Empirical evidence from Malaysia indicates that privatisation IPOs are more underpriced than private sector IPOs (Paudyal et al. 1998). This may be due to privatisation IPOs, in which the government retains a portion of equity, after the float, facing a conflict of management goals: maximising shareholder wealth and implementing public policy (Boycko et al. 1996). This situation has arisen due to national and sub-national governments, across the globe, embracing New Public Management, a mix between the ideologies of *laissez-faire* economics and the development state, to underpin economic development policies (Gomez 2009). Hence, a challenge and potential new direction for empirical research in corporate finance is to utilise the literature on the shareholder wealth effects of government investment in listed companies to contribute to explaining initial IPO underpricing.

Furthermore, the national agenda underpinning privatisations lack sound theoretical underpinning. The Boycko et al. (1996) analytical economic model would constitute a suitable start in the quest (Sinnadurai and Devi 2022). Hence, another suggested direction for empirical research in corporate finance is to use the Boycko et al. (1996) model to arrive at a theoretical underpinning for privatisations. Researchers from other countries could use Sinnadurai and Devi (2022) as a role model in this regard.

Sinnadurai and Devi (2022) conclude that the principal determinant of whether government shareholding in listed companies is value-eroding or value-enhancing, is the percentage of shares owned by the government-related institutional investors. Sinnadurai and Devi (2022) postulate that this relation follows an “inverted U”, with temporal and cross-sectional variations in the turning point. Prior empirical evidence suggests that the strength and direction of the relation between government ownership and shareholder wealth depends upon many variables, including the regulatory environment, the extent to which an economy is bank-oriented, the macroeconomic climate and the strength of the mechanisms to curb the “grabbing hand” (Wang and Shailer 2018; Boubakri et al. 2020; Yu and Wang 2020). Considered in conjunction with the theory proposed by Sinnadurai and Devi (2022), the evidence suggests that many variables may be determinants of the locations of the turning point of the “inverted U”.

The empirical results of Sinnadurai et al. (2021b) suggest that the relation between the level of government shareholding and shareholder wealth depends upon the type of government-related investor. This paper distinguishes government investors that adopt a “buy and hold” strategy and implement public policy via the governance of the investee corporations, from government investors that actively manage their share portfolios with a view to distributing returns to section(s) of society targeted for assistance. The empirical evidence regarding the association between shareholder wealth and the level of government ownership relates to the first category of investor. The evidence suggests that for the affected companies, the association is positive but subject to diminishing marginal returns.

Hence, the empirical findings in Sinnadurai et al. (2021b) do not fully accord with the predictions of Sinnadurai and Devi (2022), emanating from the seminal Boycko et al. (1996) analytical model. It is not uncommon for seminal analytical papers to make “straw man” predictions to catalyse the development of the subsequent empirical literature. Two examples follow. Modigliani and Miller (1958) present a seminal analytical model regarding the determinants of capital structure. They conclude that capital structure is value irrelevant. Unsurprisingly, this prediction is generally not believed or supported by empirical findings. However, Modigliani and Miller (1958) still deserve credit for catalysing the empirical literature on the determinants of capital structure. The paper makes a contribution by inviting empirical researchers to develop hypotheses about the determinants of capital structure, by identifying flaws specific to the institutional context under consideration, to the no arbitrage analysis presented. Similarly, Grossman (1981) is a seminal analytical paper on the economics of corporate disclosure. Grossman (1981) predicts that full disclosure is an equilibrium strategy. Naturally, full disclosure is not observed in practice; empirical evidence does not suggest that corporations pursue policies of full disclosure (Preussner and Aschauer 2022).¹ Analytical models, such as Grossman (1981), have still played a

pivotal role in catalysing subsequent empirical studies in a manner similar to [Modigliani and Miller \(1958\)](#). Analogously, even if subsequent empirical evidence does not support the predictions of [Sinnadurai and Devi \(2022\)](#), this paper may motivate the subsequent empirical literature by presenting a theoretical framework for empirical researchers to critique as a basis for their hypothesis development.

In totality, the findings of the three Malaysian papers in this special issue ([Sinnadurai et al. 2021b](#); [Alyasa-Gan and Che-Yahya 2022](#); [Sinnadurai and Devi 2022](#)) jointly highlight the importance for subsequent empirical finance research to continue investigating the shareholder wealth effects of the government ownership of listed companies. Researchers should utilise the novel seminal analytical literature (such as the [Boycko et al. \(1996\)](#) theory) to argue hypotheses regarding the determinants of variation in the sign and strength of this association. It would also be appropriate for further research to develop tests that empirically distinguish the “inverted U” hypothesis from the “diminishing marginal returns” hypothesis.

3. Implications Arising from the Paper about Simulation-Based Valuation of Unlisted Companies

[Ernst \(2022\)](#) presents a theoretical framework and practical steps for the execution of simulation-based valuation. Ernst correctly notes that this methodology would be suitable for entities lacking suitable market value data, such as unlisted companies and start-ups. The approach suggested has the same basis in seminal earnings valuation theory ([Ohlson 2005](#)) as traditional valuation using the Capital Assets Pricing Model to estimate the cost of equity capital and variants thereof, such as the [Fama and French \(2015\)](#) five-factor model. [Ernst \(2022\)](#) acknowledges this situation throughout his paper. Hence, [Ernst \(2022\)](#) illustrates that in addressing the challenge of valuing non-listed entities, researchers have a responsibility to anchor their work in seminal theory.

[Ernst \(2022\)](#) contributes to the empirical finance literature via its sound motivation. Unlisted entities have always been important. Unfortunately, due to the aforementioned pragmatic reason, they have received limited attention in the capital markets literature.

Fortunately, this situation is starting to change. There is an emerging literature, using variants of the seminal [Altman \(1968\)](#) and [Ohlson \(1980\)](#) methodologies, that predicts the probability of corporate failure for private companies. [Peel and Peel \(1987\)](#), [Bodle et al. \(2016\)](#) and [Charalambakis and Garrett \(2019\)](#) investigate this issue using private companies from the United Kingdom, Australia and Greece, respectively. Considered jointly, the findings suggest that conclusions from studies using listed companies may not fully generalise to private companies. For example, the results of [Peel and Peel \(1987\)](#) suggest that for private companies, the prediction of corporate failure starting with a sample of loss-incurring companies may not be more accurate than starting with a comprehensive sample comprising healthy and distressed companies. This generates demand for alternative methodologies to value private companies, particularly those in financial distress. The methodology presented in [Ernst \(2022\)](#) may contribute towards meeting this demand.

Furthermore, the contributions of unlisted entities to product market concentration are overlooked by studies that use only listed companies to construct measures of product market concentration ([Babar and Habib 2021](#)). Hence, these metrics would contain substantial measurement error in their capture of a firm’s competitive environment ([Porter 1979](#)). The emerging literature is beginning to redress this deficiency. For example, [Ali et al. \(2014\)](#) use data from the United States Census, rather than Compustat, to calculate the Herfindahl–Hirschman index. This ensures that unlisted entities are included. Other studies ([Li et al. 2013](#); [Li and Zheng 2017](#)) have used textual analysis of the content of disclosures by listed entities to construct a measure of product market competition that reflects management perceptions. Naturally, management would take unlisted entities into account in formulating their business plans. Valuations of these entities, via an approach such as the suggestions of [Ernst \(2022\)](#), would contribute to meeting this need.

There is also an emerging capital markets literature about Initial Public Offerings (IPOs) of small to medium entities. For example, evidence from Québec indicates that the inclusion of a management earnings forecast in the IPO prospectus (but not the degree of forecast credibility) reduces the degree of initial underpricing (Bédard et al. 2016). Most listed companies in Québec are small to medium enterprises. The findings of Bédard et al. (2016) contribute to elucidating a risk-based explanation for the IPO initial underpricing anomaly (Ibbotson and Ritter 1995). In building upon these findings, further research may entail valuations of small to medium IPOs using methodologies such as the one suggested by Ernst (2022).

Ernst (2022) argues that his suggested methodology may be appropriate for distressed companies. A caveat to this suggestion is that implementation of the methodology strongly relies on published financial statements to estimate valuation input parameters. These financial statements may have reduced usefulness for distressed companies. Generally Accepted Accounting Principles (GAAP) are predicated on the going concern assumption, which may not be satisfied for distressed companies (Balcaen and Ooghe 2006). Furthermore, the management teams of distressed companies are likely to conduct opportunistic accrual-based and real earnings management to forestall corporate failure (Rosner 2003; Charitou et al. 2007; García-Lara et al. 2009). Both of these considerations would distort financial statements, used as inputs to the Ernst (2022) methodology. However, the methodology suggested in Ernst (2022) has an inherent mechanism, ameliorating the impact of this limitation. Distressed companies would have substantially lower certainty equivalent cash flows as inputs into the simulation-based valuation. Researchers should bear these issues in mind.

Another caveat is that implementation of the methodology in Ernst (2022) would be time and resource intensive. Hence, it may be more suitable for small-sample research, such as case studies.

4. Synthesis

Many opportunities and challenges for empirical researchers in corporate finance emanate from the four substantive papers published in this special issue. One important challenge for future research is to ensure solid bases in the seminal literature. This includes analytical economic models, such as Modigliani and Miller (1958) (capital structure). Other strands of the seminal literature that should be acknowledged by future research are agency theory (Jensen and Meckling 1976), the literature about IPO anomalies (Ibbotson and Ritter 1995), theoretical perspectives on New Public Management (Gomez 2009) and the literature about earnings valuation (Ohlson 2005).

In drawing upon this seminal literature, future empirical research faces the challenge of acknowledging emerging paradigms of corporate finance. These include the empirical literature on the shareholder wealth impact of the government ownership of listed companies (Wang and Shailer 2018; Boubakri et al. 2020; Yu and Wang 2020), the literature on investment efficiency (Biddle et al. 2009) and the growing recognition of unlisted companies in capital markets studies (Li et al. 2013; Ali et al. 2014; Li and Zheng 2017; Charalambakis and Garrett 2019).

The four seminal papers in this special issue are exemplars of research that embrace new and emerging paradigms whilst retaining their foundation in the seminal literature. Alyasa-Gan and Che-Yahya (2022) use a novel methodology (Accelerated Failure Time model) to investigate a longstanding anomaly from the finance literature: the initial underpricing of IPOs. Sinnadurai et al. (2021b) and Sinnadurai and Devi (2022) use the base of seminal agency theory (Jensen and Meckling 1976) and the relatively new theory about government shareholding in listed companies (Boycko et al. 1996) to contribute to the emerging empirical literature on the latter phenomenon (Wang and Shailer 2018; Boubakri et al. 2020; Yu and Wang 2020). Ernst (2022) anchors in the seminal valuation literature (Ohlson 2005) to develop a framework with the potential to contribute to an emerging paradigm: the

capital markets literature on non-listed entities (Li et al. 2013; Ali et al. 2014; Li and Zheng 2017; Babar and Habib 2021).

The critique of the four substantive papers, published in this special issue, reveals another opportunity for future empirical research in corporate finance. This is the opportunity (and challenge) to draw upon new streams of the literature to contribute to explaining extant empirical findings. For example, the literature on overinvestment (Biddle et al. 2009; García-Lara et al. 2016) could contribute to explaining the lack of support for the first hypothesis of Alyasa-Gan and Che-Yahya (2022). Empirical research into the shareholder wealth effects of government investment in the private sector should acknowledge Boycko et al. (1996), a relatively recent analytical paper about this topic. The finding of Sinnadurai et al. (2021b) may be explained by the hypothesis that in listed companies, government shareholding has a wealth-enhancing effect, subject to diminishing marginal returns beyond a certain threshold. Similarly, future research has the opportunity to use the framework suggested in Ernst (2022) to value unlisted entities when contributing to the extant literature on product market competition (Li et al. 2013; Babar and Habib 2021).

The suggestions in this concept paper, and the challenges arising therefrom, are overlapping. For example, overinvestment results in the diversion of shareholder resources and hence constitutes an agency cost (Gao and Yu 2020). Government ownership of listed companies may exacerbate the problem of overinvestment (Sinnadurai et al. 2021a). Companies subject to government ownership may also be politically connected, with an adviser guiding their business model, to be friendly to the government's blueprint for economic development. Management may be under heightened pressure to select the political connection's "pet" projects to ensure continuity of support (Sinnadurai et al. 2021a). Governments across the globe own shares in unlisted entities, in addition to listed companies. Hence, unlisted entities would be subject to the same mechanisms presented in the Boycko et al. (1996) model as listed companies. Unlisted entities may also suffer deleterious valuation effects of the "grabbing hand". These considerations motivate the use of the Ernst (2022) valuation methodology to quantify these valuation impacts. Researchers need to value IPOs in order to investigate risk-based explanations for the IPO initial underpricing anomaly. The methodology suggested in Ernst (2022) would be suitable for this purpose.

Naturally, this concept paper is limited by the size and scope of the special issue. Only four substantive papers are published in the special issue. Only two of these papers are empirical (Sinnadurai et al. 2021b; Alyasa-Gan and Che-Yahya 2022). Both of these papers use data from the same country (Malaysia). Similarly, one of the two non-empirical papers also focuses on Malaysia (Sinnadurai and Devi 2022). These considerations may reduce the generalisability of the suggestions broached in this concept paper. A corollary follows for future empirical researchers in corporate finance. In order to address the challenges and embrace opportunities, these researchers have a responsibility to motivate their work, via arguments relevant to the specific institutional contexts of their studies, regarding the applicability of the suggestions in this concept paper.

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Note

- ¹ Preussner and Aschauer (2022) is a review paper, synthesising the literature on management earnings forecasts. The authors do not directly assess the extent to which empirical findings accord with the predictions of Grossman (1981). However, Preussner and Aschauer (2022) extensively cover the prior evidence of forecast antecedents. This may be regarded as implicit acknowledgement that full disclosure does not prevail as an equilibrium strategy.

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