

# The Interactive Impact of Liquidity Risk and Corporate Financial Decisions

**Kehao Chen**

*Jinan Xinhang Experimental Foreign Language School, China*

**Abstract:** The present paper examines the interactive relationship of liquidity risk with corporate financial decisions and how it impacts the soundness and performance of a firm in the market that drives a specific capital structure, financing, and investment choices. Research has shown that it is extremely difficult to manage the risk around liquidity. Furthermore, liquidity risk in enterprises is greatly linked to the financial decisions. While over-dependence on debt financing dilutes the equity base in a firm and therefore increases its tendency toward higher liquidity risk, firms with fine financing strategies, tended by adequate internal capital reserves, will generally come to terms with lower liquidity risk. This paper will build on the central role that liquidity management plays in corporate financial decision-making and indicate clearly that, considering market fluctuation and financial crises in general, enterprises should optimize their liquidity management to improve the firm's elasticity about finance.

**Keywords:** Liquidity Risk Management; Corporate Financial Decisions; Capital Structure Optimization; Financing Strategies and Liquidity

## 1. Introduction

### 1.1 Research Background and Importance

Liquidity risk occupies a vital position in the modern financial system. Especially after the global financial crisis, its impact on corporate financial decisions has attracted widespread attention [1]. Liquidity risk not only involves the company's short-term cash flow problems, but also has a profound impact on the company's capital structure, financing strategy and investment decisions. These factors together determine the company's long-term survival and development capabilities [2]. In

recent years, with the continuous complexity of financial markets, the liquidity management challenges faced by enterprises have become increasingly severe. Through effective liquidity management, enterprises can maintain stable operations when facing sudden economic shocks and avoid falling into financial difficulties due to cash flow shortages [3]. Therefore, studying the interaction between liquidity risk and corporate financial decisions has important theoretical and practical significance for understanding how enterprises formulate optimized financial strategies in uncertain environments [4].

The available literature also documents that liquidity risk does not impact financial decisions of enterprises only but on the behavior of external investors [5]. For example, low market liquidity may lead to sharp fluctuations in the price of stock, hence affecting enterprise market valuation and investor confidence [6]. These further reinforce the central positioning of liquidity management in corporate financial decisions. Therefore, in-depth research into the relationship between liquidity risk and corporate financial decisions will help not only to improve the theory of financial management for enterprises but also to provide useful guidance for enterprises to optimize their financial strategies in uncertain environments [7].

### 1.2 Research Objectives

The research aims to systematically investigate the interaction between liquidity risk and corporate financial decisions. More specifically, it will analyze how liquidity risk can impact the financial stability and market performance of a company through its capital structure, financing strategy, and investment decisions. In the process, this research will look into how a company makes financial decisions while facing liquidity risks and how

these decisions have affected the level of liquidity risk in turn. This study attempts to learn from the aforementioned analyses about the core role of liquidity risk management in corporate finance management and provide theoretical support and practical reference for companies to develop optimized financial strategies under uncertain environments.

## **2. Basic Concepts and Theories of Liquidity Risk**

### **2.1 Definition and Types of Liquidity Risk**

Liquidity risk is the risk of the inability to sell or finance assets, due to changed market situations or internal reasons at the time of necessity of converting assets into cash for meeting obligations of a short-term nature. In essence, there are three distinct types of liquidity risks: market liquidity risk, funding liquidity risk, and operational liquidity risk. Market liquidity risk is the service of purchasing and selling assets in the market. That is, an asset can be quickly converted into cash without considerable impact on market prices. Funding liquidity risk means an enterprise or a financial institution is unable to obtain funds at rational cost due to some factors when it needs money. Operational liquidity risk involves improper liquidity management within the enterprise, which may lead to a break in the capital chain or financial crisis[8]. The root cause of liquidity risk lies in market imperfections and information asymmetry, which make the market prone to violent fluctuations during crises and lead to liquidity depletion[9]. These different types of liquidity risks interact with each other to form a complex risk management environment, which requires enterprises and financial institutions to carry out comprehensive risk management and liquidity planning[10].

### **2.2 Causes and Assessment of Liquidity Risk**

The reasons behind liquidity risk are multiple and very complex; they basically include market structure defects, changes in investors' behavior, deterioration of the macroeconomic environment, and improper fund management within financial institutions [11]. An imperfect market structure, more especially in markets where there are few market participants or low trading activity, easily gives rise to inadequate

liquidity and thus weakens liquidity risk. Such a large-scale selling of assets, due to changes in investor behavior during panic buying or selling, can very easily result in a market liquidity crisis [12]. What is more, a worsening of the macroeconomy — a state of an economic recession and policy uncertainty — can make it difficult for funds within the financial market, and, in the end, amplify liquidity risks. Such prediction of the liquidity risk requires the consideration of all those factors in the application of a number of tools for measuring it, for example, cash flow analysis, stress testing, and monitoring market indicators [13]. Stress tests are very crucial tools in assessing the aspect of the liquidity risk. By simulating various economic scenarios and market conditions, it can provide an accurate prediction of the enterprise or financial institution's liquidity performance under different pressures and consequently come up with response strategies to reduce the impact of liquidity risk on financial stability [14].

## **3. Main Theories and Practices of Corporate Financial Decision-Making**

### **3.1 Basic Theoretical Framework of Corporate Financial Decision-Making**

Corporate finance decision-making is the major strategic decision a corporation makes in terms of resource allocation, investment, financing, and dividend distribution. These decisions actually involve not only issues of resource allocation within a company but also its strategic behavior related to capital markets. The basic theoretical framework for corporate financial decision-making includes theories of capital structure, investment, and financing. These theories provide the theoretical underpinning of corporate financial decisions. For example, the theory of capital structure irrelevance developed by Modigliani and Miller in 1958 showed that if there are no taxes, no costs of bankruptcy, and information is symmetric, then capital structure will not affect the market value of a firm [15]. In reality, however, it will be the tax effects, bankruptcy costs, agency problems, and information asymmetries that all have a big impact on capital structure. Therefore, when making financing decisions, companies should

comprehensively consider the above factors to maximize shareholders' value. Besides, Myers and Majluf proposed financing priority theory: firms prefer internal funds first, debt financing second, and equity financing last. This theory provides an important perspective for understanding corporate financing

decisions[16]. In actual operations, corporate financial decisions not only need to consider theoretical models, but also need to be adjusted according to market environment, company characteristics and industry conditions to ensure the effectiveness of decisions.

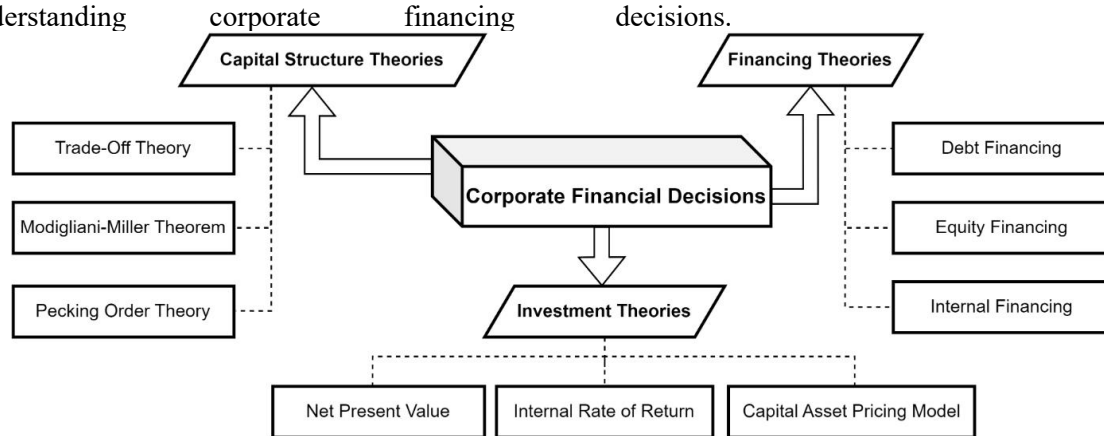


Figure 1. The Basic Theoretical Framework of Corporate Financial Decisions.

Figure 1 outlines the basic theoretical framework of corporate financial decisions. It highlights three core areas: Capital Structure Theories (including the Modigliani-Miller Theorem, Trade-Off Theory, and Pecking Order Theory), Investment Theories (such as Net Present Value, Internal Rate of Return, and the Capital Asset Pricing Model), and Financing Theories (focusing on Debt, Equity, and Internal Financing). These elements together form the foundation for understanding how companies make financial decisions.

business but attempt to utilize internal funds to reduce financial risks in the mature stage [18]. Apart from that, financing decisions are also affected by the macroeconomic condition, industrial competition, and even the individual firm's financial status. For example, under conditions of economic recession, firms would preferably hold cash or decrease debt to stay clear of uncertainty [19]. Therefore, capital structure is not only a key to financial management but also an important guarantee for the achievement of long-term sustainable development by companies.

### 3.2 Capital Structure and Financing Decisions

Capital structure refers to the ratio of debt to equity that a company applies in its capital. An appropriate capital structure is one of the basic issues of corporate financing management since it most directly influences financial risk and expresses the financial performance of the company. The choices involving capital structure pertain to the selection among different methods of financing, such as equity financing, debt financing, and retained earnings internally generated [17]. In practice, companies usually need to find a balance between debt and equity to achieve the goal of reducing capital costs and increasing corporate value. Different capital structure strategies for different stages of a company's life cycle have been shown to be adopted by different firms. For example, firms can rely more on external debt financing during the early stages of the

### 3.3 Key Factors in Investment Decisions

Investment decisions are significantly critical in corporate financial management because these provide direction for the allocation of corporate resources and future growth potential. When making investment decisions, a company must take into consideration numerous factors, such as the expected return, risk, capital cost of the investment project, and existing financial situation of the company [20]. As such, investment decisions are directly related to the effectiveness of the core financial performance and market competitiveness of the firm. During the process of making any investment decisions, a company usually adopts a series of evaluation tools, including NPV, IRR, and payback period, for the purpose of ascertaining the feasibility of projects [21]. On the other hand, investment decisions are also affected by

factors external to the environment, such as changes in market demand, technological progress, and changes in policies [22]. It is shown by research that the factors aforementioned in making investment decisions should be taken full consideration of to reduce investment risks and guarantee successful implementation of projects. For instance, during high economic uncertainty, companies could be careful in capital investment or give priority to projects with higher elasticity and low risk [23].

#### **4. The Interactive Impact of Liquidity Risk and Financial Decision-Making**

##### **4.1 The Impact of Liquidity Risk on Financial Decision-Making**

Liquidity risk has a profound impact on corporate financial decisions, especially during periods of financial market instability. Insufficient liquidity may force companies to raise funds under unfavorable market conditions, resulting in higher financing costs and may cause companies to adopt more conservative investment strategies. This risk forces corporate management to be more cautious in decision-making, especially in terms of capital structure and financing choices[24]. For example, studies have shown that during periods of liquidity crunch, companies tend to reduce investment and increase the use of internal funds to cope with potential cash flow pressure[25]. This reflects the direct impact of liquidity risk on corporate financial flexibility and emphasizes the strategic importance of companies in liquidity management.

##### **4.2 Feedback Effect of Financial Decisions on Liquidity Risk**

Not only do decisions regarding liquidity risk the financial decision making, but they also cause the liquidity risk level for the corporation. For instance, capital structure decisions based mainly on debt sources could cause high future liquidity risk to grow, especially in rising interest rates or when there is a worsening economic space[26]. Alternatively, retaining either sufficient internal funds or following a prudent financing policy can somewhat ease the pressure on liquidity, making the firm financially stronger [27]. Thus, the financial decision of a

company is highly interactive with the liquidity risk of a company. This is aimed at the long-term survival and development of a company.

#### **5. Conclusion**

The paper thus explores the complex interactive relationship between liquidity risk and key financial decisions of a firm, hence demonstrating comovement effects on financial solidity and long-term development. In the first place, liquidity risk is sure to affect a firm's capital structure, financing options, and investment decisions profoundly, especially in times of fat economic uncertainty, when companies should handle liquidity more carefully to stand possible financial pressures. The second important aspect influencing the liquidity risk level of a company is financial decisions. Companies that rely more on debt financing may have higher levels of liquidity risk, and maintaining internal funds or adopting prudent financing strategies can help lower this risk for companies. It places much greater focus on the central role that liquidity management should play in corporate financial decision-making. In particular, during periods of market turbulence and financial crises, companies need to improve their financial flexibility by optimizing liquidity management to achieve long-term sustainable development.

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