

## THE FINANCING DECISION, SIZE AND FIRM VALUE: A CONCEPTUAL REVIEW

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### ABSTRACT

This study intends to conduct a non-systematic literature review on empirical and theoretical studies of capital structure policies in relation to firm value, as well as reviewing its nature and dimensions. Until now, no consensus has emerged, and the results cannot be concluded. This study also tries to include empirical of capital structure policies and firm value from various countries, which show that the phenomenon of capital structure policies and firm value differs from one country to another. Various discussions on capital structure policies and firm value have resulted in a literature review and its development over time. Another development is the link between capital structure and size. Size can determine the company's capital structure related to access to sources of financing. Generally, large companies are easier to obtain external financing sources than small companies.

**Keywords:** *capital structure, size, firm value*

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### INTRODUCTION

There has been a debate about the relationship between capital structure and firm value, both theoretically and empirical research. Throughout the literature, the debate has centered on whether there is an optimal capital structure. Modigliani and Miller (1958) show that if two companies are at the same level of risk and in an economy with a perfect capital market without transaction costs, taxes, and bankruptcy costs, then the firm value does not depend on capital structure. Many research findings have delivered a large theoretical literature that expands, criticizes, and modifies their findings.

Previous researches have added other variables, such as bankruptcy costs (Altman 2000), agency costs (Jensen and Meckling, 1976), and tax benefits induced by the leverage (DeAngelo and Masulis, 1980), to the analysis and maintain that optimal capital structure might exist. Indeed, the Trade-off Theory supports that the optimal level of debt is reached when the marginal cost of an economic debt tax is offset by a corresponding increase in potential bankruptcy costs and agency costs. This model predicts that companies maintain debt-equity ratio targets that maximize firm value. Bankruptcy costs can arise only if the company is in debt. In practice, more and more companies use debt in their capital structure.

The greater the debt, the greater the fixed costs, and the greater the possibility of bankruptcy. Firms that have more debt will lead to a decrease in firm value, and consequently, a decline in shareholder value.

Miller (1977) added personal tax to his analysis and showed that optimal usage of debt occurs at the macro level, but not at the company level. The reduction of interest at the company level is balanced at the investor level. Robichek and Myers (1966) suggested that bankruptcy costs can offset the tax benefits of increased leverage. Bankruptcy costs have two cost components; 1) Direct bankruptcy costs that include legal and liquidation costs associated with bankruptcy actions, 2) Indirect costs refer to lost sales and higher costs associated with the perception that the company is in trouble. Myers (1977); Opler & Titman (1994) found that bankruptcy costs can prevent companies from getting debt.

Company size found in many studies is positively related to leverage. This finding is quite strong (and proven in a number of countries) in the specifications estimated by Rajan and Zingales (1995), but far weaker in Titman and Wessels (1988) and the relationship was not found in Mehran (1992). The effect of size on leverage is weaker than other determinants, which can be explained by the existence of fixed costs of funding that are proportionally more expensive for small companies. In a dynamic setting, compared to large companies, small companies will require greater deviations from the target leverage to refinance. So that over-leverage becomes more expensive than under-leverage. So small companies that face relatively high refinancing costs can choose a lower leverage ratio.

One of the main objectives of corporate finance is to maintain a specific capital structure that helps maximize the firm value. The choice of capital structure that provides the greatest attraction for investors and shareholders produces the lowest capital costs, and the firm value is maximized in the presence of an efficient investment strategy is called the Optimal Capital Structure.

Effective factors in the selection of capital structure may differ from one country to another, even from one industry to another. Factors such as taxation, risks associated with debt financing, asset characteristics, bankruptcy costs, macroeconomic and industrial conditions, financial constraints, socio-cultural patterns (Sekely and Collins, 1987), managerial attitudes and agency costs (Leland, 1994; Berger, Ofer and Yermack, 1997), firm size, tangibility and profitability, the presence of hedging (Graham and Rogers, 2002) are among certain factors expected to shape the choice of capital structure.

This study aims to explore the triangular relationship between capital structure, company size, and firm value. The choice of capital structure and the total value of assets, as a proxy for company size, can be considered a good indicator of financial success to maximize the firm value. It is also will examine the postulate of the Irrelevance Theorem, Static Trade-Off Theory, and Pecking Order Theory, which associated with the size and value of the firm from various studies and various countries. Do the studies provide consistent results?

## **METHODS**

This paper aims to conduct a conceptual review that explains the company's capital structure policy, size and share prices, by examining theories related to capital structure policies, size, and share prices and empirical evidence from various studies in various countries. The method used in this study is to analyze a literature review through literature sources from

research findings and through research bases such as Google Scholar. The capital structure policy is the basis of primary financial management. Therefore, this study had no difficulty in finding the articles needed. Then it will be reviewed in detail with the relevant theory to produce a complete study.

## RESULTS AND DISCUSSION

Modigliani and Miller's (MM) view of capital structure is that when companies use debt, shareholders will require higher returns. However, low debt costs offset high expectations of shareholder returns, and therefore the effect on WACC is minimal. MM assumes that a company is not affected by the amount of corporate debt; there is no corporate tax, nor does it face the possibility of bankruptcy (Scott, 1976). MM theory was then revised to exclude tax as an assumption because this was considered unrealistic. Based on the MM theory, the trade-off theory shows that there must be a balance between the benefits of interest payments (tax benefits) and bankruptcy costs (Graham and Leary 2011).

The Trade-Off Theory is one of the rare theories that suggest that the decision of an optimal capital structure of a company is a function of the trade-off between the tax benefits of using debt and bankruptcy costs. Higher debt ratios can lead to optimistic management expectations and are linked to future cash flows. This can be interpreted that debt can cause changes in stock prices as a proxy for firm value and affect the company's performance (Miller, 1977). According to Jensen (1986), debt has benefits for companies, related to tax benefits. Payment of debt interest is not taxed but will reduce the tax burden. Therefore, debt can increase firm value (Jensen, 1986). The theory of optimal capital structure shows the effect of capital balance on the WACC and shareholder wealth. Traditional theory encourages companies to take on debt, thereby reducing WACC, because, at a low debt ratio, the increase in equity costs is not important. At a high debt ratio level, returns expected by shareholders and lenders increase, which will push WACC higher. However, before the returns of shareholders and lenders begin to increase, shareholder wealth is maximized, and this is the point where WACC is minimum (McLaney, 2009).

Another capital structure theory that sees financial distress and taxes as important factors in financing decisions is the Pecking Order Theory (Masulis, 1988). This theory assumes that the company will use internal finance, e.g. retained earnings to do financing. If there are not enough internal resources, the next option is to borrow before issuing new equity. The pecking order theory arises because debt problems are less likely to be interpreted as a bad signal by investors than equity. Pecking Order Theory rejects the existence of an optimal debt ratio. This is based on the hypothesis that capital structure depends on the requirements imposed on external finance. This theory is driven by asymmetric information between managers, who are most aware of information about the perspective of the company, and shareholders. Myers and Majluf (1984) developed the Pecking Order theory, initially, and emphasized by Donaldson (1961). This theory advocates a hierarchical order that considers the financial benefits of the resources to be used must be followed. So, they argue that the information asymmetry that exists between company managers and the market requires a sequence of power when choosing among available funding sources. According to this theory, internally generated funds are the company's first choice, followed by debt as a second choice and use of equity as a last resort. As a result, due to information asymmetry, in choosing

external financing, companies consider the use of external resources as a cheaper way than issuing shares.

Myers (1984) states that companies prefer internal finance. The company uses the target dividend payout ratio to take advantage of investment opportunities. In addition, Myers (1984) states that in terms of external finance needed, the company will offer debt securities first, convertible bonds, then equity as a last resort. Myers' argument is that debt management is carried out in such a way that the business remains in the hierarchy of sources of financing and prefers internal financing if available. If external financing is needed, debt will be preferred over equity. Myers further said that the pecking order theory is able to explain the negative relationship that links between the debt ratio and profitability in an industry. However, this theory does not fully explain the differences in capital structure between industries.

The pecking order theory shows that the optimal debt ratio is assumed to be second (Shyam and Myers, 1999). In particular, because of the high adverse selection costs, companies prefer internal funds. The reason why managers are reluctant to issue shares is because of the high cost of issuance, shares issued at a discounted price during the issuance period and uncertainty over the sale of shares during the IPO and rights issue. When there is a financing deficit, companies prefer to finance with debt because of low publishing and information costs (Frank and Goyal, 2003).

Jensen and Meckling (1976) suggest that certain capital structures can result from the use of debt as a monitoring and control tool for managers. Furthermore, Agency Theory suggests that the choice of capital structure can help reduce agency costs. The agency cost hypothesis, high leverage or low equity to asset ratio will reduce agency costs. Besides an increase in firm value, debt can also encourage managers to act more in shareholders' interest. Greater financial leverage can affect managers and reduce agency costs through the threat of liquidation. Higher leverage can reduce conflicts between shareholders and managers regarding investment choices (Myers 1977), the amount of risk that must be taken (Williams 1987), and dividend policy (Stulz 1999).

According to agency theory, capital structure is structured to reduce conflicts between various interest groups. The conflict between shareholders and managers is the concept of free cash flow. There is a tendency for managers to retain resources so that they have control over those resources. Debt can be considered to reduce agency conflict with free cash flow. If the company uses debt, then the manager will be forced to issue cash from the company to pay obligations for the company's debt.

Parsons and Saridan (2007) stated that most of the initial empirical literature on capital structure examined the relationship between company characteristics and debt ratios. The strongest finding of this study is that larger companies with large tangible assets tend to use more debt financing. Companies that have high market-to-book ratios, high R&D tend to use less debt financing. This literature review shows results consistent with the view that debt ratios vary depending on differences in the costs and benefits of debt financing. However, this interpretation is not fully supported. According to this view, different debt ratios arise from differences in financial background, corporate investment, and their success in generating internal equity capital.

Nirmala et al (2011) argue that a decrease in debt of a company's capital structure, resulting in an increase in share prices and vice versa. This shows that investors prefer companies with lower debt content, because an increase in corporate debt, decreases the income available to shareholders, and investors become worried about their returns. In developing countries controlling prices in the securities market, together with government-directed credit programs for certain sectors, has a significant impact on corporate financing patterns (Booth et al. 2001).

Company size is an interesting issue related to corporate financing. Berger & Ofek (1995) find that more diversified companies tend to use more debt financing. Larger companies tend to be more diversified, and there is a possibility they show lower volatility in earnings, cash flow, and firm value. This condition will reduce the possibility of bankruptcy or financial difficulties and will allow larger companies to bear a greater debt burden. In contrast, Byoun (2007) found that smaller companies have lower leverage ratios. This is not because of funds generated internally or additional debt financing but because of additional equity financing. Furthermore, Byoun (2007) asserted that small companies maintain low leverage by issuing equity and building cash holdings for financial flexibility. Debt agreements often carry restrictions on financial and investment decisions that are especially impractical for growing small companies. Equity financing allows small companies to get cash without hampering financial flexibility. Consistent with this argument, we find small companies building cash holdings to maintain financial flexibility through external equity.

Firm value can be increased by reducing asymmetric information by giving signals to outsiders in the form of reliable financial information to reduce uncertainty about the company's future growth prospects. Signal theory can be used by managers to provide a more credible signal by using debt because companies that increase debt can be seen as companies that are confident in the company's prospects in the future. Investors are also expected to catch the signal with the understanding that the company has good prospects. While corporate managers are more likely to issue securities when the market price of existing company assets is higher than management's valuation, managers will prefer to use internal funds to finance investment if they consider the assets of the company is lower. When external financing is needed, the Myers-Majluf (1984) model argues that debt will be issued in the form of convertible bonds, so that the pecking order theory hypothesis can be upheld. The problem is that shares are less profitable for shareholders than issuing debt securities. These conditions give a signal to the market that the company's existing assets are overvalued, and in turn, this signal lowers the stock price.

There are several empirical evidence from cross-countries that can enforce the relationship between funding policies and firm value. A study conducted by Coricelli et al. (2012) in Central and Eastern European companies shows a bell-shaped relationship between debt levels and productivity growth. Furthermore, Strebulaev and Yang (2013) documented that almost a quarter (23%) of US non-financial companies have a leverage ratio of less than 5%. Empirical research conducted by Nirmala et al. (2011), using a modified quadratic method, found that leverage has a significant positive impact on stock prices.

Uwuigbe et al. (2012) examine the determinants of stock prices on the Nigerian stock market. The study found that financial leverage are strong determinants of stock prices. Different

from Buigut et al. (2013), what affects stock prices is the debt & gearing ratio. While financing with equity has a significant negative impact on stock prices, similarly, the research conducted by Abdullah et al. (2015) in Bangladesh, conclude that significant leverage negatively affects stock prices and company size has a significant positive effect on stock returns in the industry.

## CONCLUSION

The results of the study found empirical results that the capital structure policies and firm value of various countries showed the phenomenon of capital structure policies and firm value that differ from one country to another. Various discussions regarding the capital structure policy and firm value have resulted in literature review and its development over time. Another development is the relationship between capital structure and firm size. The size of the company can determine the company's capital structure in relation to the ease of access to financing sources. Generally, large companies find it easier to obtain external sources of financing than small companies. Ease occurs because companies with large sizes have adequate asset guarantees and more stable business stability.

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