

# PECKING ORDER THEORY

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**Abstract**— Investment the company do for expansion or top up the gain make the assets and anticipation company needed in the future. This research aimed to determine to what extent of profitability, liquidity, and company's growth affect capital structure of public companies in Indonesia and to determine the most dominant variabel affecting capital structure of public companies in Indonesia. The research used statistic test. The sample consisted of 173 companies selected using disproportionate stratified random sampling. The data were analyzed using regression analysis with SPSS 23. The results of the research indicate that (1) profitability affects capital structure, (2) liquidity affects capital structure, (3) company's growth does not affects capital structure.

**Keywords**— *pecking order theory, profitability, liquidity, growth*

## I. INTRODUCTION

Investments to develop or increase the expected gain used by an asset and needed to growing and increasingly difficult future of companies. The investments made by the company will also drive forward that will continue to increase, making them invest with greater returns than current investments.

Issuers tend to provide signals (information) to the market that the participants appreciate the company's performance as appropriate. Good company performance is given good judgment, vice versa with less good company performance. Assessment or also called this market reaction can be reflected from the movement of trading volume and stock prices. A positive market reaction shows an assessment that the company is of good quality. One of the information that companies use a signal to the market is the financial statements. The financial statements are the liaison information between the company and the users of the financial statements.

Funding policies related to sources of funds, both internal and external sources, are theoretically based on pecking order theory. Funding on the basis of pecking order theory, companies more likely to choose from internal rather than external fund. According to Myers (1984) [1], when external funds are used, the suggested funding order is first from debt, followed by issuance of new equity and the last of retained earnings. Pecking order theory states that firms make

hierarchical funding decisions from internal to external. The funding sequence starts from the funds sourced from retained earnings, then debt and finally to the issuance of new equity, meaning starting from the source of funds with the cheapest cost (Myers & Majluf, 1984) [1].

## II. BASIC THEORY

Pecking order theory embraces funding decisions with a logical preference order of investors against the prospect of the company and is consistent with the objectives, so that managers are able to maximize shareholder wealth. Pecking order theory assumes that firms tend to choose internal financing to fund their projects. In addition, the company implements a dividend policy, profitability fluctuations and unpredictable investment opportunities. This situation funds generated from internal activities are often not used in accordance with the policy of capital expenditure. If internal funds larger then the company will use them to pay off debts or invest in securities. If the company has a deficit, then the company will decrease the cash balance or sell the securities. Another assumption is that when companies need additional funding sources, they tend to choose debt first then securities (Myers & Majluf, 1984) [2].

The capital structure of the company's is the composition of debt with the company's equity. Funds derived from debt have capital costs in the form of interest costs. Funds derived from equity have capital costs in the form of dividends. The company will select the most cost-effective source of funds among the various alternative sources of funds available. The composition of debt and equity is not optimal will reduce the profitability of the company and vice versa.

Public companies in Indonesia have a fairly complex capital structure where, illustrated in the published financial statements to external parties companies. Therefore, investors who become the information seekers can be easily obtain information company description. There are several studies related to the testing of capital structure theory in this case pecking order theory in the company.

Myers & Majluf in Myers's (1984) [2], explains that the pecking order model does not provide information the optimal debt ratios due to information asymmetry and signal problems related to external financing, the corporate

financial policy hierarchy with internal conditions for debt and equity financing. The purpose of this research is to determine whether the profitability, liquidity, and growth of the company affect the capital structure of public companies in Indonesia based on pecking order theory.

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### III. RESEARCH METHOD

The design of this research to test the hypothesis by testing the relationship to all variables studied (causal research). The dependent variable used profitability, liquidity, and company growth rate. The independent variable is capital structure. This study is an empirical study conducted using secondary data is data obtained or collected researchers from various sources that already exist. The populations all public companies listed in Indonesia Stock Exchange period 2017.

The populations of this research all public company companies in Indonesia Stock Exchange period 2017. After purposive sampling technique from total populations of three hundred twenty three (323) companies, obtained sample of one hundred seventy three (173) company.

The data required in this study was collected through search on the Indonesia Stock Exchange in website [www.idx.co.id](http://www.idx.co.id). Secondary data consists of financial statements of public companies that have been audited by independent public accountants for the period 2017.

### IV. RESULT AND DISCUSSION

The research data has been tabulated then analyzed by using program SPSS.23. Using simple linear regression analysis. Profitability factor, liquidity and growth rate of company in this research has main effect. Independent variables with indicators of each ROA, CR and growth were analyzed to determine the influence of each variable on capital structure. The classical assumption test is the test of statistical assumptions that linear regression analysis. The classical assumptions to be given are Multicollinearity, Autocorrelation, Heteroscedasticity, and Normality.

The Multicollinearity Assumptions is the assumption that shows a strong linear relationship between several predictor variables in a multiple linear regression model. A good regression model has independent or uncorrelated predictor variables. In testing this assumption, is that the assumption of Multicollinearity it was not agree. From the results of statistical multicollinear data, it is known that every independent variable studied is Return on Assets

(ROA), Current Assets (CR) and growth has VIF value less than 10, so it can be said that between independent variables does not occur multicollinearity problems.

The Heteroscedasticity Assumptions is the residual assumption of the regression model that has a variant is not constant. In this examination, it is hoped that the assumption of Heteroscedasticity is not fulfilled because the multiple linear regression model has the assumption of constant residual variant (Homocedasticity).

The normality test on the regression model is used the residual value generated from the regression is normally distributed or not. A good regression model is that which has a normally distributed residual value. Several methods of normality test is to see the spread of data on diagonal sources on the chart Normal P-Plot of regression standardized residual results showed the normal distributed data.

The result of correlation analysis ( $R$ ) = 0.328, it can show that profitability is assessed by return on assets indicator (ROA), liquidity assessed with indicator of current ratio (CR) and company growth rate assessed by indicator Growth, and also capital structure assessed by the total debt to equity ratio indicator has a low relation, while the value of  $R^2$  of 0.108 it can be explained that the amount of free variable contribution (profitability, liquidity and company growth) can explain the dependent variable (capital structure) of 10.80%.

To see the significance of the coefficient of determination we can see the value of F count and Sig value. From table ANOVA obtained value of F count equal to 6,810 with value of Sig. of 0,000. From these conditions it is seen that the value of F count and Sig value. < from the value of  $\alpha$  (0.05), then the conclusion that can be taken is to reject  $H_0$  which means the coefficient of determination is statistically significant and shows the resulting regression equation can be used to predict the Capital Structure

Regression result obtained by result of constant  $\alpha$  with regression coefficient equal to 0,629. This means that if the ROA variable is considered zero, then there is an increase in the capital structure of 0.629. The regression coefficient  $\beta_1$  = (-1,338), this means that any increase in profitability proxied by return on assets (ROA) followed by a decrease in capital structure. It means that every increase of ROA variable equal to 1%, then there will be decrease of capital structure equal to 133,8% with assumption other variable is considered constant. So it can be said that the higher the protability of the capital structure that the value of total debt versus capital will decrease. The result shows sig value 0,04 < 0,05, because sig value less than 0,05 hence profitability have negative and significant effect to capital structure at public company listed in Bursa Efek Indonesia with observation period year 2017, so that first hypothesis is accepted.

Regression result obtained by result of constant  $\alpha$  with regression coefficient equal to 0,629. This means that if the CR variable is considered zero, then there is an increase in the capital structure of 0.629. The regression coefficient  $\beta_1$  = (0.435), it means that every increase of liquidity proportioned with current ratio (CR) is followed by improvement of capital structure. It means that every increase of CR variable is 1%, then there will be an increase of capital structure equal to 43,5% with assumption other

variable is considered constant. So it can be said that the higher the liquidity of capital structure that the value of total debt versus capital will increase. The result shows sig value  $0,01 < 0,05$ , because sig value less than  $0,05$  hence profitability have positive and significant effect to capital structure at public company listed in Indonesia Stock Exchange with observation period year 2017, so that first hypothesis accepted.

Regression result obtained of constant  $\alpha$  with regression coefficient equal to 0,629. This means that if the variable growth is considered zero, then there is an increase in capital structure of 0.629. Regression coefficient  $\beta_1 = (-0.127)$ , this means that every increase of company growth proportioned with growth followed by an increase of capital structure. This means that every increase of variable growth of 1%, then there will be an increase in capital structure of 12.70% with the assumption that other variables are considered constant. So it can be said that the higher the growth then the capital structure will increase. The result shows that the value of sig  $0,683 > 0,05$ , because sig value more than  $0,05$  then growth have positive and insignificant effect to capital structure at public company which listed in Bursa Efek Indonesia with observation period year 2017.

Based on the results of analysis of research data that has been proposed found that profitability and liquidity significantly affect the capital structure of public companies in Indonesia with a period of observation for one year (year 2017) while the growth rate of companies does not significantly affect the capital structure of public companies in Indonesia with a one year observation period (2017).

These results explain that the profitability assessed with ROA has a negative and significant influence on the capital structure, the liquidity assessed by CR has a positive and significant influence on the capital structure and growth of companies assessed with growth has no positive and significant influence on public companies in Indonesia.

The results of tests performed show ROA variable gives a significant influence on capital structure. The result of this research is in line with result of Kaaro (2003) [3] research, where the result of research is profitability have significant negative effect to capital structure, while asset structure, firm size and business risk have a significant positive effect to capital structure. The results of this study are not in line with the Nenssy (2004) [4] study, on the influence of asset structure, firm size and profitability on capital structure.

The test results show the liquidity shown in the CR variable has a significant influence on the capital structure of the company so that the second hypothesis accepted. The results of research in line with Saidi (2012) [5], get the result that liquidity has a positive effect with capital structure. The results of this study are not in line with Myers & Rajan (1999) [6], stating that when the agency costs of high liquidity, the outside lenders limit the amount of debt financing available to the company. Therefore there is a negative relationship between liquidity with DER.

The results of the company's growth test on the capital structure shown in the growth does not have a significant influence on the company's capital structure so that the third hypothesis is not accepted. The hypothesis that growth is suspected to have a significant negative effect on leverage ratio is not accepted. Negative and insignificant

influences indicate that firm growth does not affect leverage ratios. These results do not support Myers who argued that firms with high future growth would reduce their debt use and should use larger amounts of equity due to under investment issues (Hutagaol, 2002) [7], and not in accordance with Rajan & Zingales (1995) [8].

Sutrisno (2003) [9], explains that the faster the growth of companies tend to use higher debt than low-growth companies. Companies with high growth rates are generally dependent on capital from outside the company. While companies with low growth rates then the need for new capital is relatively small so it can be met from retained earnings. Because of the asymmetric information and wealth that flotation costs owe less than the flotation cost of issuing new shares, firms with high growth rates tend to use larger debt than low-growth firms (Christianti, 2008) [10].

## V. CONCLUSION

That profitability projected with ROA affects the company's capital structure. The results of liquidity analysis projected with CR influence the capital structure of the company. The result of company growth analysis projected with growth has no effect to company's capital structure, so that company is more likely to use its own capital as the first alternative source to fund the company's activity in achieving high growth. The most influential variable is liquidity in value with current ratio (CR) it can be seen from the test results where the CR variable has a positive value and the smallest significant level. A high level of liquidity reflects the company has high internal funds that cause the company to be able to pay its maturity obligations and the total debt owned by the company becomes smaller. This is explained also in pecking order theory where the company relies more on internal funds first to finance the investment so that if the shortage is then sought external funding.

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