

# Financing Decision

*by I W Widnyana*

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**Submission date:** 14-May-2021 08:11PM (UTC+0700)

**Submission ID:** 1585964780

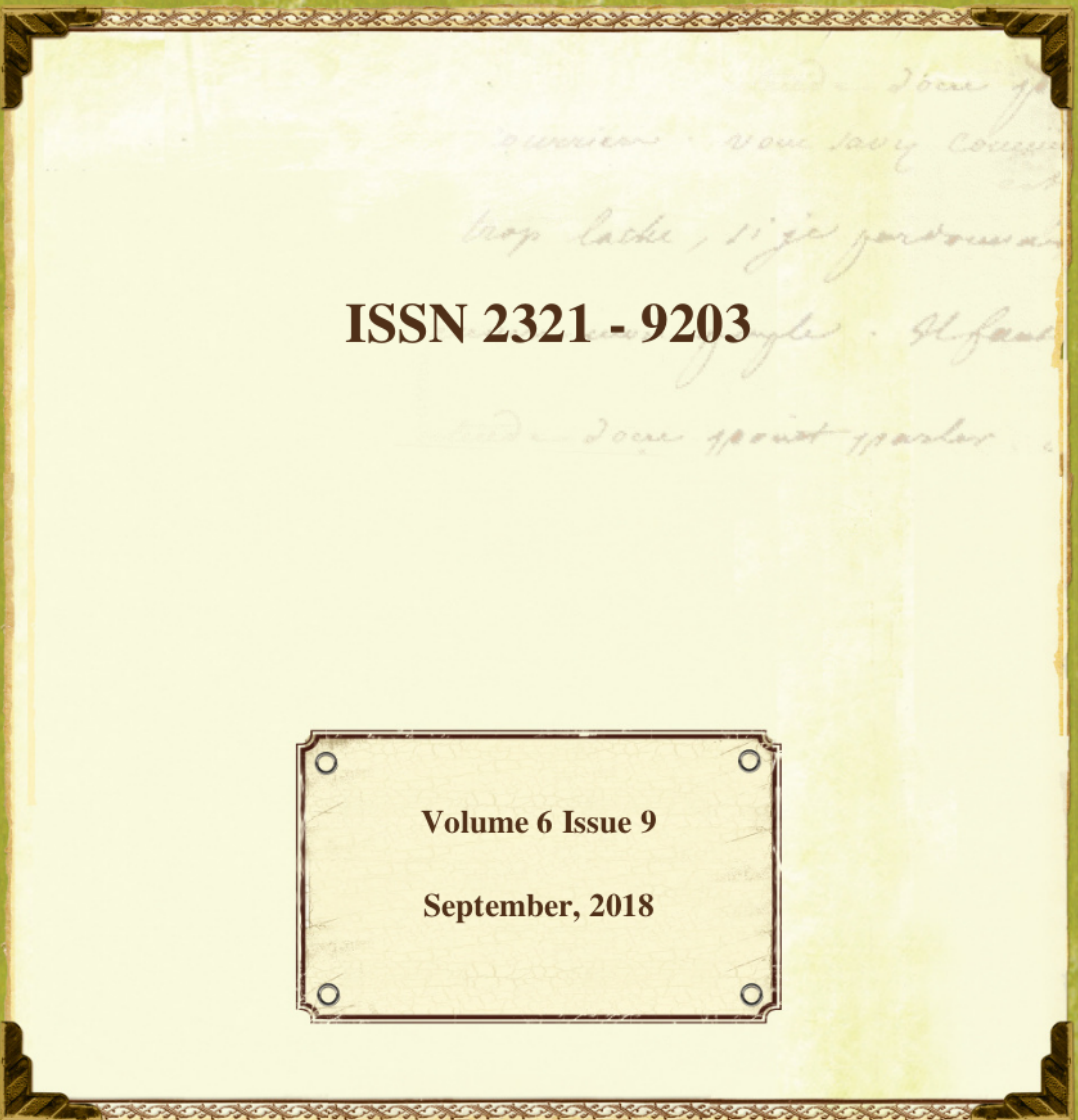
**File name:** 3PENEL\_1.PDF (1.72M)

**Word count:** 3019

**Character count:** 16396



# The International Journal of Humanities & Social Studies



**ISSN 2321 - 9203**

**Volume 6 Issue 9**

**September, 2018**



**[www.theijhss.com](http://www.theijhss.com)**



# THE INTERNATIONAL JOURNAL OF HUMANITIES & SOCIAL STUDIES

## Financing Decision and Performance of Manufacturing Companies in Indonesia

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### Abstract:

The purpose of this study was to investigate the effect of financing decisions and firm performance. The financing decision is represented by the decision of the capital structure and the structure of debt maturity, the performance of the company is represented by the profitability and market value of the firm. A total of 109 manufacturing companies were observed during the period 2012-2016. The test results show that capital structure has negative impact to profitability but has positive impact to company value. The structure of debt maturity has a negative impact on both profitability and firm value.

**Keywords:** Financing decision, capital structure, debt maturity structure, financial performance, firm value

### 1. Introduction

The purpose of the company is to maximize the value of the company. In a public company, the company's value is reflected in its stock market value. Investors in the stock market evaluate a company's stock not only based on past performance, but more important is to assess the prospects of the company in the future. One of the factors that determine the company's future performance is the decision or policy taken by manager today.

One of the important decisions in corporate financial management is the financing decision. Companies need to raise funds for operating capital. A growing company must continually earn cash to buy new assets. Some cash can be generated internally by the operations of the company, but some may have to be imported externally. Inadequate financing decisions lead to fixed costs in the form of high capital costs, which will result in lower corporate profitability (Hasnawati, 2005)

Many study on financing decisions uses only capital structure variables to represent managers' decisions, but in this study also notices at the aspect of debt maturity. The capital structure shows how much the company is financed with debt and equity. Cross-country capital structure studies such as by Faccio et al. (2001), Cheng and Shiu (2007) show that the ratio of corporate debt in Indonesia is relatively high compared in other countries. This predominantly debt-financed condition causes decisions in choosing short-term or long-term debt to be important. Schiantarelli and Sembenelli (1999) argue that short-term and long-term debt has different characteristics, and therefore has a different impact on company performance.

Maximizing financial performance through the use of a combination of funding sources has been widely discussed, such as by Masulis, (1983), Sheikh and Wang (2012). The performance measures used in this study are not only profitability, but also market performance or market value of the company. The value of a firm is determined by investors' expectations in the capital market for future cash flows. Investors in the capital markets evaluate the company's outlook on decisions taken by management and the company's current performance. This study aims not only to explain the effect of funding decisions on company performance, but also to test whether market performance reflects the company's profitability.

### 2. Theoretical Framework and Hypotheses

The funding decision regarding the selection of sources of funding will be used to finance the operating activities of the company. The mix of debt, preferred stock, and ordinary shares used to fund corporate assets is called Capital Structure (Brigham and Houston, 2015; 446). The use of debt (leverage) is expected to increase the return on equity if the profits generated by the company's assets exceed the interest rate on the loan. However, companies that use debt face higher risks than companies that are financed equity.



Brigham and Daves (2016: 265) explain that profitability is the net result of policies and decisions. San and Heng (2011) studies show that the effect of capital structure on profitability is sensitive to profitability proxies is used. Profitability in this study is measured by Return on Equity (ROE) because ROE measures the ability of firms to earn profits for shareholders. The purpose of using debt in the capital structure is to increase the rate of return for the company's shareholders, so the use of ROE is more relevant in this study. Yazdanfar (2015), Vatavu (2015), and Hossain and Nguyen (2016) found that leverage negatively affected the profitability of the company.

- Hypothesis 1: the capital structure has a negative effect on profitability

According to Modigliani and Miller (1958), firm value is not influenced by the composition of the company's capital, either with equity or with debt. However, in reality, management's decision in choosing to issue debt or equity instruments to finance its investment may impact investors' valuation of company's shares. Based on trade off theory, leverage can increase the value of the company to the optimum level where above the optimal level, the additional leverage will decrease the value of the company

Management has more information about the prospect of the company than the investor. Investors capture signals about the company's prospects from decisions taken by management, including leverage decisions. Research Zeitun and Tian (2007), Vo and Ellis (2017), Demirgünes (2017) found that leverage negatively affects the market value of the company

- Hypothesis 2: The capital structure has a negative effect on firm value

Schiantarelli and Sembenelli (1999) argue that the structure of debt maturity affects firm performance. Jun and Jen (2003) explain that short term debt has a cost advantage, but it brings refinancing risk and interest rate risk. The structure of debt maturity is measured by the ratio of long-term debt to total debt (Antoniou et al., 2006; Rahmawati, 2016). The greater this ratio means more long-term debt in the debt structure, the longer the average period of the maturity of the firm's debt. Abor (2005), Zeitun and Tian (2007), Salim and Yadav (2012) found that long-term debt use negatively affected profitability.

- Hypothesis 3: The structure of debt maturity negatively affects profitability

Based on a survey by Graham and Harvey (2001), the timing alignment between the maturity of liabilities and assets is considered the most important factor in choosing short-term long-term debt issues. Based on the view of short maturity agency theory can reduce agency conflict. The use of short-term debt requires managers to periodically provide information to investors in order to evaluate returns and risks.

Based on the agency theory, the use of short-term debt is more beneficial to the company, so the use of more long-term debt in the debt structure will lower the value of the company. Zeitun and Tian (2007), Salim and Yadav (2012) found that the use of long-term debt negatively affects the value of the company.

- Hypothesis 4: The structure of debt maturity negatively affects the value of the firm

The company's goal is to maximize shareholder wealth or maximize the company's common stock price (Brigham and Houston, 2015: 9). Maximizing company value means also maximizing shareholder wealth. Haugen and Baker (1996) stated that the greater the profitability the greater the profit that can be distributed to shareholders. The market value of the stock is determined by the expectation of future cash flows, not just the current cash flow. Investors in the capital market assess the company at any time not only wait for the publication of financial statements, but respond to any policy taken management. Thus the market value of shares in each period should already reflect the performance of the company the same period. Chen and Chen (2011) found that profitability had a positive effect on firm value.

- Hypothesis 5: profitability has a positive effect on firm value

### 3. Research Methods

The sample of this research is a manufacturing company listed on Indonesia Stock Exchange (BEI) with observation period from 2012 until 2016. Sampling technique used is purposive sampling method. The sample criteria used are: (1) the company publishes the financial statements as of December 31 for fiscal year 2012 up to fiscal year 2016; (2) the company has information relating to various measurement variables. At the end of 2016, there were 154 manufacturing companies in BEI, while those meeting the sample criteria were 109 companies.

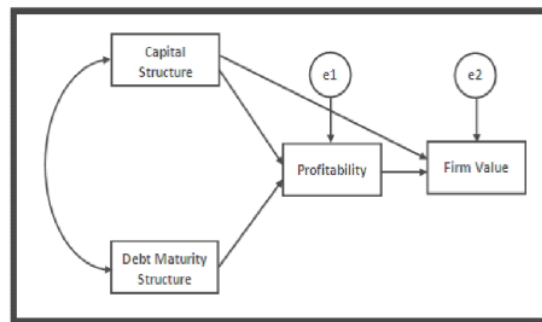


Figure 1: Path Model

Profitability is measured by Return on Assets (ROA) ie net income divided by total assets. Firm value measured by the price-book value (PBV) is the market value per share divided by book value per share. Capital structure is measured by the Debt Ratio, ie the ratio of total debt to total assets. Maturity structure of debt is defined as the ratio between the amount of long-term debt and total debt.

Data analysis using path analysis. The basic assumption of this model is that some independent variables actually have a very close relationship with each other. Path analysis can analyze the causal relationships that occur in multiple regression if the independent variables affect the dependent variable, not only directly, but also indirectly. Data analysis using AMOS (Analysis of Moment Structures) program 23. Figure 1 shows the path model.

#### 4. Data Analysis and Discussion

Table 1 shows descriptive statistics of research variables. It is seen that manufacturing companies in Indonesia use an average of 5.731 percent of debt in their capital structure, which consists of 31.24 percent of long-term debt. It shows the use of debt is still dominated by short-term debt.

Variable	Mean	Std Deviation	Minimum	Maximum
Capital structure	0.5731	0.5196	0.0372	5.0561
Debt maturity structure	0.3124	0.2207	0.0000	0.9860
Profitability	0.0500	0.1100	-0.5485	0.7151
Firm value	2.2006	7.9509	-108.7600	58.4800

Table 1: Descriptive Statistics

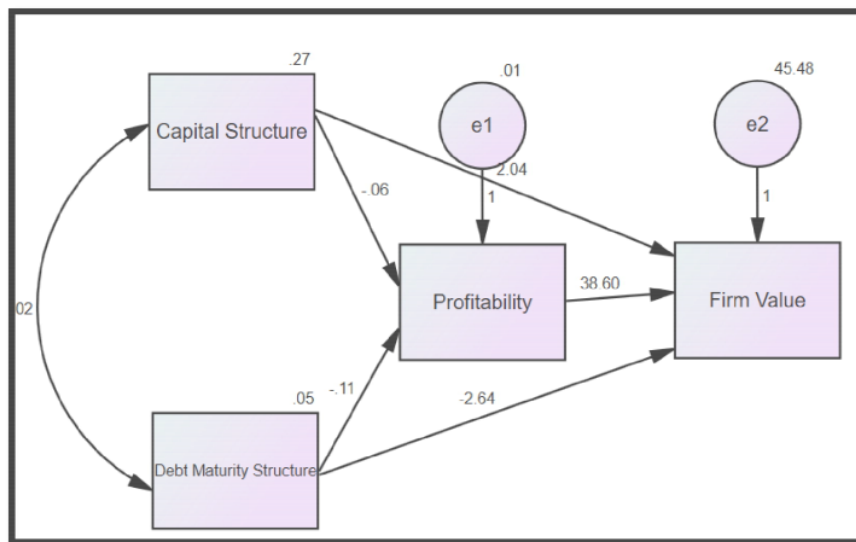


Figure 2: Estimated Path Diagram

Figure 2 shows the estimation results of the research path model. The coefficients and the significance of the path are described in Table 2. It appears that almost all significant path coefficients at a confidence level of 1%, only the path coefficient of the debt maturity structure to firm value are significant at the 10% confidence level.

			Coefficient	P
Capital Structure	→	Profitability	-.062	***
Capital Structure	→	Firm value	2.042	***
Debt Maturity Structure	→	Profitability	-.109	***
Debt Maturity Structure	→	Firm value	-2.641	.053
Profitability	→	Firm value	38.605	***

Table 2: Estimation Result

The capital structure negatively affects profitability, so the first hypothesis is accepted. The use of debt lowers the company's profitability due to high debt use increasing the cost of debt to compensate for financial risk. These results are consistent with Yazdanfar (2015) research findings, Vatavu (2015), and Hossain and Nguyen (2016).

Capital structure has a positive effect on firm value, so the second hypothesis is rejected. Based on trade off theory, the use of debt increases the value of the firm because it reduces taxes. These results are consistent with the findings of Ebrati et al. (2013) that the capital structure has a positive effect on market performance.

The structure of debt maturity negatively affects profitability, so the third hypothesis is accepted. Companies that use more long-term debt in their debt structures are performing lower. This result can be due to the cost of short-term debt is cheaper than long-term debt. This finding is in accordance with El-Sayed Ebaid (2009) that the use of long-term debt has a negative effect on the performance of the company.

The structure of debt maturity negatively affects firm values but is not significant at the 95 percent confidence level, so the fourth hypothesis is rejected. Longer debt maturity increases the agency cost and negatively affects the firm's value.

Profitability has a positive effect on firm value, so the fifth hypothesis is accepted. Profitability of the company has a positive impact on market valuation of the company. These results are consistent with Chen and Chen (2011).

The capital structure has an indirect effect on firm value through profitability seen from the path coefficient of the capital structure profitability and profitability to the entirely significant corporate value. The structure of debt maturity indirectly affect the value of the company through profitability seen from the path coefficient of debt maturity structure to profitability and profitability to the value of the company which is entirely significant. The magnitude of the indirect effects is summarized in Table 3.

Indirect Effects		
Capital Structure	→ Firm Value	-2.397
Debt Maturity Structure	→ Firm Value	-4.193

Table 3: Indirect Effect of Independent Variables through Profitability

## 5. Conclusions, Implications, Suggestions and Limitations

The test results prove that funding decisions affect the company performance both financial performance and market performance. The capital structure as a direct and indirect impact on corporate value, while the maturity structure of debt only has an indirect impact on firm value through profitability.

The implication of this research is the use of debt can increase the value of the company. The use of short-term debt is better than long-term debt because it is cheaper and more flexible. Therefore it is recommended for management of manufacturing companies in order to exploit the use of short-term debt in the debt structure in order to maximize the performance of the company.

This study is limited to manufacturing companies that may not necessarily have implications for other sectors. The funding decision in this study represented only by the level of leverage and its maturity structure, yet to explore other aspects such as internal funding sources, dividend policy and debt sources.

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