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Funding Sources Consideration in the Framework of Capital Structure Decision

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Many firms, especially CFO's, still use a quantitative approach in determining capital structure decisions. To complete this quantitative approach, this research proposes the topic of Qualitative Judgment in determining financing decisions. As such, the respondents are CFO's from LQ 45 firms in IDX (Indonesia Stock Exchange). The several judgments are the cheapness and easiness of financing sources and managerial ownership structure. The qualitative investigation of Miles and Huberman (2001) has several steps: data collection; data reduction; data display & conclusion will be run by NViVo. Several list questions will also be considered that will be filled by the CFO's. The questions relate to: 1) The cheapness of financing sources 2) The ease of obtaining a financing source 3) The managerial ownership structure, referring to balancing power between insiders and outsiders. The expected conclusion is the description of a response profile from CFO's that will indicate the most important factors in choosing a financing source.

Key words: *CFO, Qualitative Judgment, The Cheapness & Easiness of Financing Sources, Managerial Ownership Structure.*

Introduction

Efforts to minimize the cost of capital are indeed the responsibility of the financial manager. When they decide to use debt more than capital; then the composition of debt will be greater than capital. Divergence from the composition of debt and capital will affect efforts to minimize WACC (Weighted Average Cost of Capital). Objectively; Finance managers should realize that the minimum WACC will create optimum company value. The Financial Manager (CFO) must be able to manage debt and capital carefully so as to minimize the cost of capital as a consequence of the use of funds. "Careless" capital structure decisions will drastically increase WACC.

Based on IDX conditions today; capital structure decision trends turned out to have decreased in the use of debt. This fact indicates that companies going public are already aware of debt risk as a source of funding. They have strong reasons, namely bad experiences as the impact of the 1997-1999 monetary crisis and the 2007-2009 global financial crisis. So low was solvency at that time; that companies need a long time to recover. However once the company maintains a debt composition of approximately 30% of total liabilities, it still follows MM Theory's argument; the use of debt will increase the value of the company because debt has a tax deductible nature. The use of more debt will also increase the risk of bankruptcy and this is why many companies went public on the IDX that began to control the composition of debt by gradually reducing it. This also implies a Balance Theory (Trade Off Theory) on the IDX.

In fact; besides MM Theory and Balance Theory there are still other capital structure theories; namely Pecking Order Theory. According to this research, the essence of this theory is the use of funds according to a hierarchical source from the easiest to the most difficult and the cheapest to the most expensive. In a lot of financial literature; only cheaper sources of funds are highlighted. The indicator that becomes the benchmark is the cost of capital. The Pecking Order Theory states that hierarchical funding from the cheap aspect is own capital, debt and new shares. So far, the Pecking Order Theory has not discussed the funding sequence in terms of ease because there is an assumption that the source of internal funds, namely own capital, will be more accessible than external funding sources.

However, this can apply differently if the company has a lot of access to bank and non-bank financial institutions. Instead the company will optimize external funding; because internal funding sources will be used more for other strategic interests such as dividend distribution or strengthening retained earnings reserves. It's just a shame until now the company is still involved in determining capital structure decisions quantitatively. Though the intuition of a financial manager (CFO) in designing capital structure decisions qualitatively is no less important than the quantitative aspects that have been widely studied. The only qualitative study in the selection of funding sources in Indonesia, Sartono (2001), proposes several important dimensions in capital structure decisions such as a funding hierarchy based on securities, principles in funding, management choices, relative consideration, debt ratio targets and overvalued or undervalued securities. Based on a study by Sartono (2001), the factors of funding principles and relative considerations are proven factors in the study results. Therefore this study proposes to return these two factors with different item formulations because they have been adapted to the studies of Bancel and Mittoo (2002), Graham and Harvey (2002), Archbold and Laziridis (2010) and Servaes and Tuffano (2018).

Some items of financial generosity in the selection of sources of funds are the amount of principal and interest instalments, guarantees from the financial system authority for the legality of the source of funds (credit), the amount of collateral (collateral) as compensation for the source of funds (credit), incentives in the credit agreement as a form of facility additional, additional ties as a consequence of the credit agreement. While some items for ease of funding are the availability of funding sources available in many financial institutions, the commitment of financial institutions to provide funding facilities (credit), business climate support for the existence of these funding sources, the accessibility of debtors (borrowing companies) to roll-over (extension) sources funds (credit) and debtor and insider connections within the relevant financial institution.

Sartono's research (2001), replicated from Pinegar and Wilbricht (1989) and Kamath (1997) produced many differences in determining the most important factors in capital structure decisions. Pinegar and Wilbricht (1989) and Kamath (1997) found the most important factor is management flexibility in choosing the source of funds while Sartono (2001) actually found the most important factor was the debt rating. Analysis of the differences between the two is the different capital market situation between the USA, namely the NYSE (developed market & full efficient) while Indonesia, the IDX which is still an emerging market & less efficient. Differences in the capital market situation will have an impact on differences in CFO behavior which in the USA is more flexible than in Indonesia. This difference in flexibility was allegedly also due to the types of bias from CFO such as overconfidence and heuristics referring to Shrefrin (2007) and Asri (2013).

Furthermore, due to the gap of qualitative research on the topic of capital structure from Sartono (2001) with Pinegar and Wilbricht (1989) and Kamath (1997) not to mention the results of qualitative research studies on the latest capital structure topics from Bancel and Mittoo (2002), Graham and Harvey (2002)), Archbold and Laziridis (2010) and Servaes and Tuffano (2018) and also coupled with CFO bias types such as overconfidence and heuristics referring to Shrefrin (2007) and Asri (2013) make the authors intend to propose the topic "*Funding source consideration in the framework of capital structure decision*". In this case the research is still a proposal and I will try to present new ideas through the questionnaire questions that were built.

The motivation of the author is to formulate managerial qualitative considerations in the selection of funding sources with the current data situation on the IDX. Sartono's study (2001) in Indonesia found the debt rating factor to be the most important but different from Pinegar and Wilbricht (1989) and Kamath (1997) who found management flexibility factors. Both groups of this study were refuted by Bancel and Mittoo (2002), Graham and Harvey (2002), Archbold and Laziridis (2010) and Servaes and Tuffano (2018) who stated that debt rating and flexibility are equally important. This is because CFOs who are generally CFA (Certified Financial Analyst) holders will realize that without the flexibility and understanding of debt rating, it will be difficult for CFOs to determine the optimum capital structure as a target for decision results. Furthermore, in a qualitative approach to capital structure, the ability of CFO analysis alone is not enough but also requires mastery of the intuition factor of the basic experience that will succeed if the CFO is able to control themselves so as not to be exposed to two types of CFO bias namely overconfidence & heuristics [Shrefrin (2007) and Asri (2013)].

This research proposes two problems: what are the main and alternative considerations in qualitative capital structure decisions? The main consideration was answered with indicators of ease and generosity [the results of the study of Sartono (2001), Archbold and Laziridis (2010) and Servaes and Tuffano (2018)]. The generosity of the source of funding is the minimum WACC (Weighted Average Cost of Capital) concept, in this case the differences in the profile of the answers of the CFOs on the IDX that will determine the more dominant items among instalments, legality, collateral, incentives and additional bonds. While the reference to the ease of funding sources is the concept of company reputation, namely the differences in the profile of answers of the CFOs which will also determine which is more dominant among the availability of funding sources, creditor commitment, business climate support, debtor accessibility and debtor and creditor connections. Finally, alternative considerations are answered with indicators of the condition of the concentration of management ownership or not refer to the concept of agency theory.

Literature Review

Development of Capital Structure Theory (Quantitative Approach)

By looking at the management ownership structure; capital structure theory is divided into two groups namely Non Agency & Agency. In the Non Agency group; the company does not consider management ownership structure variables in determining its capital structure policy. While in the Agency group; the company will include it.

Academically; Manurung (2004) explains the development of capital structure starting from Franco Modigliani & Merton Miller with MM Theory. They stated that "the use of debt will actually increase the value of the company". After MM Theory appeared Pecking Order Theory from Gordon Donaldson (1961). The point is to explain the sequence of funding starting from the cheapest to the most expensive.

In 1969, Haugen; Papas & Rubenstain introduce Trade-off theory that opposes MM theory. In this theory raises the main issue of financial distress because companies use too much debt. According to them; the company should maintain a balance between the composition of debt and capital in the funding structure. Finally in 1976; Jensen and Meckling successfully introduced Agency Theory. This theory includes an important variable namely management ownership as main basis in determining optimum capital structure.

The Need to Decide Qualitatively on Capital Structure Decisions

Hanafi (2005) states that although there are already quite a lot of capital structure theories (see quantitative approach), but to date there is no "ideal" capital structure theory. This is because most companies have never been able to achieve optimal capital structure. Financial managers of many of these companies are "struggling" more with the assumption of general rationality that the 50:50 composition between debt and equity is the best. Though this assumption contains bias which assumes there is no difference between the business characteristic of the company. So it is practically proven that only a handful of companies are successful with a 50:50 composition.

Inspired by Holland (2001), the authors argue that it is necessary to identify qualitative factors in capital structure policies. Just as Holland (2001) is somewhat sceptical of "orthodox" financial theories, the authors are also sceptical of the theory and practice of capital structure that has been running so far. The author is of the view that it is necessary to return the strategic role of the financial manager to utilize all managerial capabilities possessed in order to produce an ideal capital structure decision.

Cheap funding sources are of course related to the minimum WACC; but in the school of grounded theory the dimensions of what makes this minimum WACC more important. Similar conditions will apply to the ease of funding sources. Indeed SIU’s (Surplus Income Unit) is the maximum important; but the dimensions of what causes SIU's maximum are no less important.

Related to agency theory; this theory has looked at the importance of aspects of managerial behavior in determining capital structure decisions. Only unfortunately it is still limited to assumptions and econometric testing. Specifically for the IDX case; management ownership structure variables proved insignificant towards capital structure decisions (see Setyawan and Hartono, 2001). This marks the weakness of the quantitative approach in agency theory. In line with the aspects of convenience and generosity in the selection of funding sources; then the authors also intend to make management ownership structure as an alternative consideration. The motivation to be achieved is the writer wants to know in detail how the agency conflict between managers as insider and shareholders as outsiders descriptively occurs. The author hopes to be able to dig deeper into what and why in a concrete way managers and shareholders are involved in agency conflicts. At the same time this will also reveal the reasons for the insignificance of the variable structure of management ownership.

Prior Research Review (Qualitative Approach for Capital Structure)

Classical Period

Research from Sartono (2001) replicates Pinegar and Wilbricht (1989) and Kamath (1997) by successfully collecting responses from more than 100 CFOs on the JSX finding that the debt rating factor is the most important factor The argument is that the CFO will determine the target debt ratio to the maximum level to guarantee the company's reputation position in the eyes of prospective lenders. The better the debt rating, the easier it will be for companies to get additional funding. In addition to the debt rating factor, securities value is also important for companies because for companies listed on the stock exchange, investor sentiment will also affect creditors. Sartono (2001) also found the voting control factor as a consideration in the selection of funding sources. If the condition of the blockholder (insider domination) then tends not to like using debt, but instead prefers retained earnings.

Modern Period

Research from Archbold and Laziridis (2010) and Servaes and Tuffano (2018) that complement the Bancel and Mittoo (2002) and Graham and Harvey (2002) studies state that there is another most important factor namely management flexibility. By using respondents of more than 500 CFOs in many developed countries, they argued that CFOs should be more flexible in choosing funding sources not only from the large availability of funding sources but also their self-control not to be exposed to CFO (overconfidence & heuristic) bias as proposed by Shrefrin (2007) and Asri (2013).

Hypothesis Formulation

Based on the previous description of explanation point above; then the author proposes two alternative hypotheses as follows:

Ha1: The main consideration of financial managers in choosing funding sources is the aspect of convenience and the aspect of generosity.

Ha2: An alternative consideration for financial managers in choosing funding sources is the aspect of management ownership structure.

Research Methods

Research Procedure

As a first step; the author will submit a letter of introduction to the research request of the corporate secretary at the headquarters of each company to be forwarded to the CEO. Next step; is waiting for a response back. If more than 2 weeks there is no response; will be confirmed per telephone. If it fails; then this company is forced to be excluded from the sample. To ensure that the question items can be understood by the CFO, the writer will also conduct a preliminary study by distributing questionnaires to students (Master of Management & Master of Accounting) of several universities in Jakarta minimum 40 people because there is already min. Assistant Financial Manager. At this stage the validity & reliability analysis is also carried out.

Analysis & Sampling Unit

The analysis unit is the managers or financial directors of 45 LQ 45 sector companies on the IDX. Sampling is done purposively with several criteria, namely:

1. The research sample is stocks that are listed consistently in the LQ 45 sector for a minimum of 5 years because it will clearly see its policy profile.
2. The consideration of selecting a CFO is because they are financial intellectual actors who are suspected of knowing in detail and systematically the process of funding decisions (capital structure) carried out and how strategic considerations namely the reasons and decision mechanisms are taken.
3. The reason for choosing LQ45 is because of the performance and representation of these shares on the IDX with a large market capitalization as a driver of the JCI (Jakarta Composite Index)
4. While the 5-year reason is because capital structure decisions are long-term decisions that have a multiplier effect on 2 other financial decisions such as investment decisions and dividend decisions.

Data Collection Methods

The method of data collection is done by structured interviews at the relevant CFO. To help smooth the interview, a set of attached questions has been prepared. Quantitatively; closed-question questionnaire items (related to the generosity and ease of funding sources) were required to pass the validity and reliability test. Whereas qualitatively; a set of open-question questionnaires needs to be tested first with a pilot test. So that there is no bias in the CFO as respondents; then the authors do a case study protocol by utilizing information from public shareholders; corporate audit committee and financial institutions.

Definition of Variable Operations

a. *Welfare funding source (Main Considerations)*

This variable is defined as the degree of debtor frugality in using funding sources. In this study the researchers will use indicators measured with a 1-6 Likert scale. These indicators include: the amount of principal & interest instalments; financial system authority guarantees (e.g. BI or FSA and Ministry of Finance); the amount of collateral that must be available; additional incentives or facilities and additional ties. This indicator is also confirmed by studies of Sartono (2001), Archbold and Laziridis (2010) and Servaes and Tuffano (2018) namely principal & interest installments (past profit), authority guarantees (securities value), collateral (projected cash flow), incentives (projected cash flow) corporate tax) and additional bonds (restrictive covenant).

b. *Ease of funding sources (Main Considerations)*

This variable is defined as the level of ease of obtaining funding sources. In this study the authors will use indicators that are also measured on a 1-6 Likert scale. These indicators include: availability of funding sources; commitment of financial institutions (Surplus Income Unit); supportive business climate; accessibility to roll-over and connection with insider (insider) financial institutions. This indicator was also confirmed by studies of Sartono (2001), Archbold & Laziridis (2010) and Servaes & Tuffano (2018), namely the availability of funding sources (flexibility), creditor commitment (comparability), business climate support (growth), debtor accessibility (debt rating) and debtor and insider connections in financial institutions (independence).

c. *Management ownership structure (Alternative Considerations)*

This variable is defined as management dominance in the shareholder ownership structure. Usually management is referred to as an insider. In this study the writer will use descriptive data on the amount of management ownership structure in the Indonesian Capital Market Directory. This variable will then be compared to the outsider to determine the extent of the balance of the dominance of both in determining capital structure decisions or the selection of sources of funds. This indicator is confirmed in studies from Sartono (2001), Archbold and Laziridis (2010) and Servaes and Tuffano (2018) as voting control. There is a tendency that if ownership is concentrated, the dominant insider (shareholder) would prefer to ask the CFO to reduce funding with debt and ask to further increase internal funding. Different conditions occur if outsiders (public) are more dominant then CFOs will be more encouraged to use debt rather than retained earnings.

Method of Analysis

In order for the process of analysis to be effective; the writer will use a methodology such as that of Miles and Huberman in Wahyuni (2006). This methodology has 4 stages: data collection; data reduction; data display and conclusion. Data collection is the activity of collecting all data related to the consideration of the selection of funding sources (see points I; III and IV in the questionnaire set). Data reduction is related to the selection of relevant information. This will depend on the type of coding and sorting being conducted. To be more effective in data display and conclusion; the researchers used NVivo software.

Proposed Questions List

To further clarify the meaning of operationalization of the research variables, in this section, the authors intend to present the proposed list of questions attached covering 4 question sections: narrative of the respondents' main considerations, indicators of ease and generosity in funding sources, balance in the structure of management ownership and implications for the selection source of funding to stock prices (company value).

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Please allow Mr. and Mrs. to explain about the selection of sources of funds in the company that you manage so far.

I. Explain the main considerations of you in choosing a source of funding?

II. Are these main considerations related to the generosity and ease of related funding sources? If yes; what qualifications are cheap and easy sources of these funds? You can use the check-list as follows:

If you answer no; then you can move to question no. III.

The degree of cheapness of the debtor in using funding sources

No.	Important Factors	VE	E	RE	RC	C	VC
a.	The amount of principal and interest instalments	1	2	3	4	5	6
b.	Guarantee from the financial system authority on the legality of the source of funds (credit)	1	2	3	4	5	6
c.	Collateral amount as compensation for credit facilities (debt)	1	2	3	4	5	6
d.	Incentives in credit agreements as a form of additional facilities	1	2	3	4	5	6
e.	Additional ties as a consequence of the credit agreement	1	2	3	4	5	6

Where:

VE	= very expensive	RC	= rather cheap
E	= expensive	C	= cheap
RE	= rather expensive	VC	= very cheap

The level of ease of obtaining funding sources

No.	Important Factors	VD	D	RD	RE	E	VE
a.	The availability of financial resources is available in many financial institutions	1	2	3	4	5	6
b.	Commitment of financial institutions to provide funding facilities (credit)	1	2	3	4	5	6
c.	Support from the business climate for the existence of these funding sources	1	2	3	4	5	6
d.	Accessibility of debtors (borrowing companies) to roll-over (renewal) sources of funds (credit)	1	2	3	4	5	6
e.	Connection between debtor and insider in related financial institutions	1	2	3	4	5	6

Where:

VD	= very difficult	RE	= rather easy
D	= difficult	E	= easy
RD	= rather difficult	VE	= very easy

III. For answering question III only

What other factors did you consider in choosing the source of funds related to: (select one)

a. Insider dominance (non-public shareholder)
b. Outsider dominance (public shareholder)
c. Domination of both shareholder

For the choice of answers above; what is insider domination / outsider dominance / both dominating in terms of choosing sources of funds?

Do conflicts of interest often occur with each other? If yes; what is the conflict like and how effective is it?

IV. For answering questions II & III

Does the factor that you consider important relate to the objectives of Financial Management namely stock price maximization?

If yes; what is your opinion on the description of the relationship between the consideration of choosing the source of funds and maximizing stock prices?
If not; what is the urgency of the factors that you choose?

Thank you for your participation

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Conclusion

This research is the first step in identifying executive behavior in Indonesia using a qualitative framework of capital structure decisions. Departing from the absence of agreement in a quantitative approach that until now still could not determine the best theory to be practiced by the executive.

The two qualitative frameworks in the questionnaire were the generosity of using funding sources and the ease of obtaining the funding. The generosity in funding sources relates to the amount of funding, guarantees, and incentives that will be specified in the credit agreement if the form of funding is debt to the bank or issuing bonds. If funding with own capital will relate to the amount of the weighted capital costs determined in connection with the risk of various investment projects that will be run. While the ease of funding is related to the closeness of the company with creditors and the establishment of the company in the capital market as an issuer that is well respected by investors on the stock exchange.

The answers to the factors of ease and generosity of funding from the questionnaire above will determine the type of capital structure theory that applies. If the answers of some executives will lead to easy and cheap factors in funding, then the theory supported is pecking order theory that characterizes the order of funding from internal to external with the ultimate goal of minimizing the weighted average capital cost. If on the contrary the result leads to expensiveness and difficulties in funding, then the supported capital structure theory is a static trade off theory that specializes in the balance between using debt within the optimal limits to maximize tax benefits and minimize the potential cost of bankruptcy of the company in the future. It's just that the implementation of static trade off theory needs to be discussed specifically agency theory which is reflected in the alternative factors of funding decisions namely the type of ownership structure that has occurred in a company.

In alternative funding factors namely the type of ownership structure will lead to the dominance of insider ownership or vice versa is more dominant to outsiders. Ownership with insider dominance will lead to pecking order theory and agree with the principle of easy and cheap funding. The operationalization of the policies taken is prioritizing equity funding over debt. Conversely, if more dominates the ownership of outsiders then it leads to a static trade of theory that disagrees with the primitive ease and cheapness of funding, but rather agrees on the binding principle of management to always work in accordance with an employment contract with the principal. The focus of static trade of theory is more on debt financing than on equity. The optimal use of debt will indicate a good working pattern from management that guarantees the continuity of company activities and the low potential of agency conflicts that occur.

The final results of the study besides knowing the degree of ease; the degree of generosity and type of ownership as important considerations of capital structure decisions will also explore the mindset factor that is the basis of why executives choose a level of ease, generosity and type of ownership. This mindset factor is thought to be strongly related to executive behavior factors in determining optimal capital structure decisions. Specifically the behavioral factor profile will be explained in the first part of the questionnaire above which is in the form of description and is believed to be different between executives who are respondents. In accordance with behavioral corporate finance from Shefrin (2007), this behavioral factor is related to overconfidence and heuristics as two CFO biases and is of particular interest in further research.

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