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Debt or Equity: An Analysis on Funding Decision (Studied of Companies of Indonesia)

Tettet Fitrijanti
Universitas Padjadjaran, Bandung, Indonesia

A company leverage can be used as a proxy for capital structure of a company as a result of its funding decision. By investigating the effect of leverage deviation lag, this paper tries to examine whether or not companies in Indonesia base their funding decision on targetted leverage. Sample data are taken from non-finance companies issuing their stocks and bonds on BEI. Target leverage itself is measured by using annual average values and regression-based predicted leverage for each group of industries. The method used for the measurement is panel regression with fixed effect. Data show that, using both regression-based predicted leverage and annual average values, the actual leverage deviation for period *t*-1 does not affect the value of period *t* leverage, while leverage lag on period *t*-1 does have a positive effect on period *t* leverage. The fact that a higher lag in leverage brings about a correlatively higher leverage leads to the conclusion that funding decision and capital structure in Indonesian companies does not always conform to the Trade-Off theory, but rather corresponds well with the Pecking Order theory.

Keywords: capital structure, target leverage, leverage deviation

Theoretical Background

This paper evaluates the practice of funding decision through long-term financial leverage with the basic idea that presumably some companies in Indonesia have a tendency to set certain target leverage. Some past findings have indicated that many companies adjust their capital structure towards specific target leverage (Marsh 1982 in Hovakimian, Opler, & Titman, 2001; Harris 1984 in Hovakimian, Opler, & Titman 2001). It has also revealed that more profitable enterprises tend to issue debt instead of stocks to the market as their source of funds, and they are easier to repurchase their stocks than debt retirement. Collateral has, understandably, a positive effect on leverage (Rajan & Zingales, 1995). An enterprise has a high market to book ratio issue more of their stocks on the market and has a low leverage (Shyam-Sunder & Myers, 1999). A low cash level will refrain a company from making a decision to reducing its leverage, either by issuing their stocks on the market, or by repaying all of its debts (particularly when the sum is substantial and it is three years to the due time). This is in compliance with the Debt Overhang theory (Hovakimian, Opler, & Titman, 2001).

According to Shyam-Sunder and Myers (1999), the Pecking Order theory could better explain the time series variation of a company's capital structure. A company having a high level of profit will be inclined to utilize its profit to repay for some of its debts, and to make the company less levered (Titman & Wessels, 1988).

Tettet Fitrijanti, Dr., MSi., Ak., SAS, Department of Accounting, Universitas Padjadjaran.
Correspondence concerning this article should be addressed to Tettet Fitrijanti, Master of Accounting, Universitas Padjadjaran, Jl. Japati no. 4 Bandung, West Java, Indonesia. E-mail: tfitry@yahoo.com.