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Firm Value Determinants: Insights from Capital Structure and Financing Decisions

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Abstract

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Capital structure plays a crucial role in determining the value and financial stability of a firm. This study aims to examine the relationship between capital structure, financing decisions, and their implications for firm value from the perspective of trade-off theory and pecking order theory. A library research approach was employed to review scholarly literature published over the last five years. The findings indicate that an optimal capital structure is achieved by balancing risk and return, with financing decisions considering the minimization of the cost of capital and maintaining financial flexibility. Factors such as external funding needs, debt ratio, and asset management efficiency significantly influence corporate financial performance. Moreover, the results highlight that practical implementation often deviates from theoretical ideals due to managerial preferences and market conditions. This study reinforces the conceptual understanding of how strategic financing decisions can enhance firm value sustainably. By integrating insights from both trade-off theory and pecking order theory, the research guides managers in designing effective funding strategies that support long-term financial stability and growth.

1. Introduction

Capital structure is a crucial element in corporate financial management because it is directly related to the mechanisms of operational funding and its impact on the company's value and risk. Capital structure reflects the composition of debt and equity used to finance the company's assets. Determining the optimal capital structure is one of the most complex strategic issues in corporate finance, as it is closely linked to the cost of capital, financial flexibility, and investor confidence in the company's sustainability (Shahwan, 2018). Amidst the dynamics of globalization and economic uncertainty, companies face the challenge of balancing risk and return in formulating sustainable long-term funding strategies.

Corporate financing decisions cannot be separated from the main theories that explain company behavior in determining capital structure. The two most frequently referenced theories are the trade-off theory and the pecking order theory. The trade-off theory emphasizes that the optimal capital structure is achieved through a balance between the benefits of using debt, such as tax savings, and the costs arising from the risk of bankruptcy. Conversely, the pecking order theory, developed suggests that companies have a hierarchy of financing preferences: first, utilizing retained earnings, then using debt, and finally issuing new equity. In practice, companies rarely fully adhere to these theories because financial decisions are also influenced by managerial behavior and dynamic market conditions (Zahera & Bansal, 2018).

Research findings on the relationship between capital structure and firm value show significant variations, depending on industry characteristics, firm size, and

macroeconomic conditions. Some studies affirm that utilizing debt within certain limits can increase firm value through its disciplinary effect on management and efficiency in asset use. However, excessive leverage precisely creates high financial risk and can decrease investor confidence (Shahwan, 2018). Therefore, management's ability to design a balanced capital structure becomes a crucial factor for achieving sustainable financial performance.

The financing decisions taken by a company also reflect its risk management strategy as well as the market's perception of its long-term business prospects. A healthy capital structure not only affects profitability but also serves as an indicator for investors in assessing the credibility and stability of the company in the capital market. Ample evidence suggests that companies that effectively manage their capital structure tend to have a lower cost of capital and higher stock market value (Pham et al., 2021). This indicates that the relationship between capital structure, financing decisions, and firm value is interdependent and dynamic.

In the context of the modern economy, capital structure analysis must also consider external factors such as fiscal policy, interest rates, and capital market conditions, which can affect the cost of funding. Thus, library-based research becomes relevant to understand how capital structure theories and practices develop and how companies adjust their funding strategies to changes in the economic environment. The integration of the trade-off theory and pecking order theory in this study aims to strengthen the theoretical understanding of optimal financing strategies that can sustainably enhance firm value and minimize financial risk.

2. Literature Review

2.1. Theories and Basic Concepts of Capital Structure

Capital structure refers to the composition of long-term funding sources used by a company, including debt, preferred stock, and common equity. The initial concept of capital structure under perfect market conditions, a company's value is not affected by the proportion of debt versus equity. However, the evolution of business practices necessitates adjustments to reality involving bankruptcy costs, taxes, and information asymmetry between management and investors. In this context, two main theories serve as modern references: the trade-off theory and the pecking order theory. The trade-off theory emphasizes that the optimal capital structure is achieved through a balance between the benefits of using debt, particularly the tax shield, and the costs that arise due to bankruptcy and financial distress (Zahera & Bansal, 2018).

Conversely, the pecking order theory asserts that companies apply a preference hierarchy in financing, starting with the use of retained earnings, then debt, and finally issuing new shares, as a strategy to reduce risks due to information asymmetry. Empirical research findings show differences in the application of these theories based on company characteristics. Large companies tend to follow the principles of the trade-off theory because they have easier access to capital markets and the capacity to balance financial risk. Meanwhile, smaller companies are more inclined to apply the pecking order theory due to limitations in external funding and the need to minimize information disclosure to investors (Acaravci, 2019). These findings affirm that capital structure is contextual and is influenced by internal

factors, such as size and profitability, as well as external factors, including market conditions and the cost of capital. Understanding these theories is key for management in designing efficient funding strategies, enhancing firm value, and reducing financial risk.

2.2. Determinants of Capital Structure in Empirical Perspective

The determination of a company's capital structure is influenced by various factors, both internal and external. Internal factors include firm size, profitability, growth opportunities, and business risk. Research by Pham et al. (2021) shows that highly profitable companies tend to rely on internal funds, resulting in relatively low debt utilization. Conversely, rapidly growing companies require more external financing to support operational expansion and long-term investments. Macroeconomic factors also play a significant role in capital structure determination. Shahwan (2018) found that a substantial increase in interest rates reduces the leverage ratio due to the high cost of debt financing. In addition, managerial efficiency in asset management is crucial, as an unbalanced capital structure can decrease productivity and increase the risk of bankruptcy.

Another aspect that affects financing decisions is institutional ownership and corporate governance practices that companies with large institutional ownership tend to adopt a more conservative capital structure. This is because stricter monitoring of managerial decisions reduces the potential for excessive risk-taking (Banker et al., 2018). This finding confirms that corporate governance acts as an important variable in determining funding policy, which in turn affects financial stability and firm value. Thus, capital structure determination is the result of a

complex interaction between internal company characteristics, market conditions, and external monitoring mechanisms. A comprehensive understanding of these factors is essential for management in designing optimal funding strategies, balancing risk and return, and maximizing firm value sustainably.

2.3. The Relationship between Capital Structure, Performance, and Firm Value

Firm performance and value are crucial benchmarks for assessing the effectiveness of capital structure. Optimal capital structure is believed to enhance the efficiency of capital use while lowering the Weighted Average Cost of Capital (WACC). Saona et al. (2018) affirm that a moderate level of leverage can encourage management discipline in fund management and increase returns for shareholders. Conversely, excessive leverage poses significant financial risk and has the potential to decrease investor confidence in the company's stability.

Research by Watson et al. (2022) indicates that in the context of emerging markets, the relationship between capital structure and firm value is non-linear. In other words, an increase in leverage can increase firm value up to a certain limit, but after passing the optimal point, firm value decreases due to increased financial risk. Similar findings are revealed by Aduda and Ongoro (2020), who emphasize that the optimal capital structure varies across industries, depending on characteristics such as fixed asset intensity, profitability levels, and cash flow volatility.

Furthermore, Williams et al. (2021) assert that corporate financing decisions not only impact stock market value but also influence investor perception of the company's reputation and credibility. Therefore, management needs to consider the

trade-off between the risk and benefits of using debt and equity when designing the capital structure. With a balanced financing strategy, companies can maintain long-term financial stability while maximizing value for shareholders. A careful approach in determining the level of leverage is key for companies to manage financial risk and achieve sustainable growth.

3. Method

This research uses a library research approach, which aims to gain an in-depth understanding of the influence of capital structure on financing decisions and firm value through the study of scientific literature. This approach was chosen because it allows for the systematic integration of various theories and empirical findings from previous studies, thereby forming a comprehensive conceptual framework (Snyder, 2019). The first stage of the research is the identification and selection of relevant literature sources. The main sources were obtained from scientific articles published in Google Scholar indexed journals within the last five years, focusing on the topics of capital structure, trade-off theory, pecking order theory, financing decisions, and firm value.

The selection process was carried out using the keywords "capital structure," "financing decisions," "firm value," "trade-off theory," and "pecking order theory." The selected articles were evaluated based on their relevance, originality, and contribution to the development of modern capital structure theory (Watson et al., 2022). The second stage includes data synthesis through a conceptual analysis of previous research findings. This approach uses a descriptive-comparative method,

where theories and empirical findings are compared to identify patterns of relationships between relevant variables. Data is classified based on main themes, including the determinants of capital structure, the implications of financing decisions for firm value, and the effectiveness of applying the theories in different industrial contexts and economic conditions (Williams et al., 2021). The third stage involves the interpretation and integration of theories to produce conceptual conclusions. The analysis is carried out deductively by drawing conclusions from the main theories towards more specific empirical understandings.

This approach emphasizes objectivity in reviewing various scientific views and strives to minimize interpretation bias regarding previous research results (Snyder, 2019). By implementing the library research method, this study contributes to expanding academic understanding related to the influence of capital structure and financing decisions on firm value. In addition, this research strengthens the theoretical basis for subsequent studies in corporate finance, while providing a more systematic perspective on the application of the trade-off and pecking order theories in different contexts, so that the results can be used as a reference for formulating financing strategies and corporate capital management policies.

4. Results

The results of this literature review indicate that capital structure plays a central role in determining firm value and the effectiveness of financing decisions. Based on the analysis of recent literature, it is found that financing decisions reflecting the combination of debt and equity have direct implications for risk,

profitability, and investor perception of firm value. Optimal capital structure is not only a reflection of a company's financial policy but also describes the extent to which management is able to balance risk and return (Pham et al., 2021). Research by Habib et al. (2018) shows that economic policy uncertainty can affect a company's financing decisions and liquidity through changes in its capital structure.

Companies with a high proportion of debt tend to experience greater volatility in their stock values, especially when investor expectations about the market decline. This finding strengthens the view of the trade-off theory, which emphasizes that increasing leverage can provide tax benefits but also increases the risk of bankruptcy. Thus, company management must carefully consider the optimal debt level that can minimize the Weighted Average Cost of Capital (WACC) without sacrificing long-term financial stability. Furthermore, the results of the review of Lusiani et al. (2020) research found that in the context of sharia-based financing, capital structure decisions have unique characteristics that affect firm value differently compared to conventional companies. The principle of prudence in the use of interest-bearing debt leads sharia companies to rely more on internal equity. Although this reduces leverage, capital stability tends to increase, and investor perception of risk decreases. In the long run, this strategy can result in more sustainable firm value due to lower financial risk.

The research results of Van-Thep and Day-Yang (2019) highlight the role of firm size and profitability as key determinants in capital structure formation. Large companies with stable cash flows tend to use more debt because of their greater capacity to bear risk, while small companies prefer internal funding. This finding

supports the pecking order theory, which states that companies prefer internal funding sources first before using debt and finally issuing new shares. Thus, financing decisions are not only influenced by the cost of capital but also by information asymmetry and access to capital markets. Ranjan (2021) research also shows a similar pattern. Highly profitable companies tend to lower their leverage because they are able to finance investments from retained earnings. Conversely, companies with low profitability use debt as the primary source of financing to maintain growth. This negative correlation between profitability and leverage confirms the relevance of the pecking order theory in the context of developing countries. However, in certain situations, increasing debt can also be a positive signal for investors if accompanied by strong operational performance.

According to Bajaj et al. (2021), the relationship between capital structure and financial performance varies across industry sectors. Industries with a high level of tangible assets (such as manufacturing) tend to have a larger degree of leverage because physical assets can be used as collateral for loans. Conversely, service sectors with intangible assets (such as technology and education) tend to have lower leverage. This indicates that the structure of assets and capital intensity are major determinants in a company's funding decisions. In other words, a company's ability to utilize debt depends on the liquidity and asset collateral it possesses.

In addition to internal determinants, research by Prusak (2018) shows that external factors such as macroeconomic conditions and interest rates also influence capital structure. In situations of low interest rates, companies tend to increase financing through debt due to the lower cost of capital. However, when inflation

increases and economic uncertainty is high, companies reduce their exposure to debt to avoid financial pressure. This dynamic indicates that capital structure decisions are adaptive to changes in the external economic environment.

Boateng et al. (2022) research provides empirical evidence from Sub-Saharan Africa that profitability and economic stability are dominant factors influencing financing decisions. When the level of profitability increases, companies tend to use internal capital, while under financial pressure, they switch to external debt. This finding shows that financing decisions are dynamic and depend on the company's economic cycle and management's capacity to manage financial risk. The review of Romadhani (2020) research adds a new perspective by examining LQ-45 companies in Indonesia. This study found that investment, financing, and dividend policy decisions have a synergistic relationship with firm value. An efficient capital structure is able to strengthen the positive impact of investment decisions on financial performance. Conversely, excessive leverage can reduce firm value due to increased interest costs and the risk of default. Therefore, the balance between productive investment and efficient financing is key to achieving sustainable value growth in the Indonesian capital market.

The research of Van-Thep and Day-Yang (2019) and Ararat et al. (2021) also emphasize the role of corporate governance in determining financing decisions. Companies with strong governance mechanisms such as high managerial ownership, independent boards of commissioners, and transparency in financial reporting tend to be more cautious in using debt. Good governance increases investor confidence

and reduces agency costs between managers and shareholders. Thus, governance functions as a control mechanism in the formation of a healthy capital structure.

In the context of financial risk, the results from Boateng et al. (2022) research show that high leverage can increase the volatility of company earnings and reduce the company's ability to withstand short-term economic losses. This demonstrates the importance of implementing effective risk management in a company's financing strategy. Companies that implement hedging policies and diversify funding tend to have more stable financial performance compared to companies that rely solely on one type of funding source. Furthermore, based on the literature review results from Pham et al. (2021), asset management efficiency and the use of internal equity are proven to have a positive relationship with firm value. Companies that are able to manage their assets productively show the ability to generate high returns without adding to the debt burden. This indicates that investment and funding policies must be integrated to support the achievement of an optimal capital structure.

In general, the analysis results from various studies show that there is no single capital structure model that can be universally applied. Differences in economic conditions, regulations, business culture, and the level of capital market development in each country cause variations in the application of the trade-off and pecking order theories. However, all these studies affirm that the balance between risk and return is the main basis for determining the optimal capital structure. The right capital structure can increase firm value through reducing the cost of capital, increasing financial efficiency, and improving positive perceptions from investors regarding the company's performance and stability (Bajaj et al., 2021).

5. Discussion

The results of the literature review indicate that the relationship between capital structure, financing decisions, and firm value has a complex character and is influenced by internal and external factors simultaneously. The optimal capital structure is not a fixed number that can be universally applied, but rather the result of a balance between risk and return adjusted to the company's characteristics, industry conditions, and prevailing economic dynamics. This finding aligns with the principle of the trade-off theory, which emphasizes a compromise between the tax benefits obtained through the use of debt and the bankruptcy costs that increase with a high level of leverage (Van-Thep and Day-Yang, 2019). Thus, companies need to manage debt carefully so that financial benefits can be maximized without excessively increasing risk.

Within the framework of the pecking order theory, the literature shows that companies tend to prioritize the use of internal financing sources before utilizing external debt or issuing new shares (Pham et al., 2021). This approach is considered efficient because it can reduce costs due to information asymmetry between management and investors. However, financing decisions are not always static, as various external factors such as economic uncertainty, interest rate volatility, and capital market conditions can influence a company's preference for certain types of financing (Habib et al., 2018). In unstable market conditions, companies tend to hold retained earnings to maintain liquidity rather than incur additional debt, so that financial risk can be better controlled.

In addition, the research by Lusiani et al. (2020) emphasizes that religious and ethical factors in sharia financing also provide a significant influence on capital structure. Sharia-based companies, which are prohibited from using interest, have a higher preference for equity compared to debt, resulting in a more conservative but stable capital structure. Although this approach reduces the potential return, it increases long-term investor confidence because financial risk is better managed. Corporate governance factors are also important determinants in the effectiveness of capital structure. Bajaj et al. (2021) assert that good governance practices through transparency, strict internal supervision, and accountability can reduce agency conflicts between management and shareholders. Companies that have independent boards and a high level of managerial ownership tend to make more rational and value-enhancing financing decisions.

The literature shows that capital structure is not merely a technical financial matter, but also reflects managerial strategy, good governance practices, and macroeconomic conditions. Mature financing decisions will result in an efficient capital structure, increase investor confidence, and sustainably strengthen firm value. Thus, company management needs to consider a combination of risk, return, regulation, and ethics when designing the capital structure to support long-term growth and financial stability.

6. Conclusion

Based on the results of the literature review analyzed from various scientific sources over the last five years, it can be concluded that capital structure is a

fundamental factor influencing financing decisions, financial performance, and firm value. The optimal capital structure is not universal; rather, it depends on internal company conditions such as profitability, asset size, governance, as well as external factors such as economic stability and interest rates. Appropriate financing decisions create a balance between risk and return, where proportional debt utilization can increase firm value through tax efficiency, but excessive use can create bankruptcy risk and decrease investor confidence.

The analysis results also confirm that the trade-off and pecking order theories remain relevant in explaining modern corporate behavior. Highly profitable companies tend to use internal funds first, while companies with large capital needs utilize debt as a strategic alternative. Governance and ethical factors, especially in the context of sharia financing, are also proven to strengthen capital structure stability and enhance stakeholder confidence. Thus, companies need to develop capital structure policies that are adaptive to changes in market conditions and consider the long-term balance between risk and value growth. This research affirms the importance of synergy between financial management, good governance, and financing strategy to achieve the goal of sustainable firm value enhancement.

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