Chapter 1: Introduction

1.1 Research Background

A recent and growing body of knowledge advocates for the incorporation of behavioural variables into the study of financial economics. This discourse, supported by dynamic modelling frameworks, has refined various modern theoretical frameworks of corporate finance, including capital structure determinants (Titman & Wessels, 1988; Rajan & Zingales, 1995; Fama & French, 2002; Frank & Goyal, 2004; Vasiliou & Daskalakis, 2009). Various models have been proposed to examine whether the predicating notion of rationality and deterministic construct for capital structure determinations are influenced by psychological and behavioural variables. It has been postulated that decision-makers' behavioural characteristics (due to cognitive limitations or heuristic biases), considered referential information and data, certain early life experiences and demographic backgrounds affect their decisions on capital structure. However, prior studies have returned contradictory findings regarding these potential capital structure determinants.

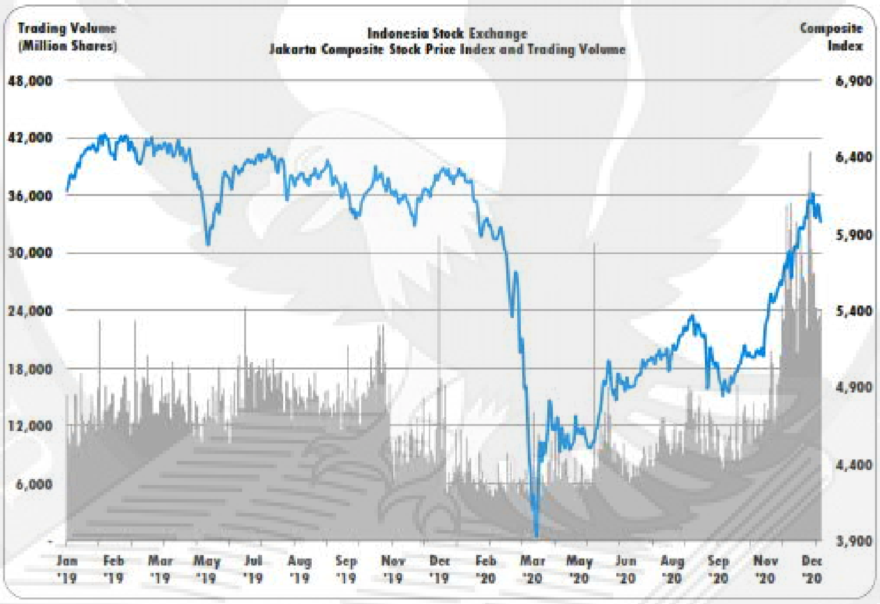
This study incorporates behavioural variables to foster broader exploration of capital structure determinants beyond the traditional and predominantly static frameworks of expected utility, arbitrage opportunity and rationality. The study examines how capital structure decision-makers (CEOs/CFOs) in Indonesian publicly listed firms (Peseroan Terbatas Terbukas [Tbks] or [PLCs]) are influenced by the behavioural variables overconfidence and optimism, as well as framing effects from relevant information and data, and their demographic attributes. This study constructs a testing model to consider identified relevant variables of capital structure determinants. This supports a more comprehensive framework to examine deterministic characteristics deriving from rational and irrational indicators based on latent endogenous and observable constructs.

Subsequent comparative analysis of these characteristics will allow for their validation as capital structure determinants.

The JCI (Jakarta Composite Index) has seen a downward trend since the end of 2018 (see Figure 1.1), during a period of relatively stable and robust macroeconomic growth in Indonesia (4.9–5.2% GDP increase annually from 2015–2020; Nota Keuangan, 2020). In the same period, 38% of PLCs have reduced their leverage ratio. This indicates the possibility that PLCs managements' behavioural biases have affected capital structure determinations in such a manner to prevent focusing on optimal capital structure.

Figure 1.1

Jakarta Composite Price Index and Trading Volume (Jan 2019 – Dec 2020)



Source: www.idx.co.id.

1.2 Scope and Research Purpose

Extensive literature on the top management team (TMT) has concluded that capital structure decisions affect overall business operational management, management and control of costs, operational and investing cashflows planning, and forecasting funding and financing requirements. Hence, capital structure decisions should be aligned to a company's overall strategies to deliver improved operational and financial performance, thus contributing positively to firm value maximisation.

This study examines several potential capital structure determinants, improving on the robustness of prior studies via a model construct focusing on observable and unobservable variables. The research empirically explores whether and how managements' (CEOs/CFOs) characteristics and behavioural tendencies, as measured via observable (rational model) and unobservable (irrational model) variables, influence capital structure decisions. This study tests and measures the level of deterministic influence of overconfidence, optimism, framing effect of information and demographic attributes (age, gender, education and professional experience) on CEOs'/CFOs' capital structure decisions. Several associated hypotheses are posited (see Section 2.5) and tested (see Chapter 4). Comparative analysis is undertaken to assess the characteristics of the relationships between the variables and capital structure decision-making. Certain foundational notions of how behavioural variables influence key capital structure determinants are established through the methodical statistical analysis.

Leverage ratio was adopted as the proxy for capital structure. Variables and indicators adopted for testing were firm size, firm profitability, firm's asset tangibility, market-to-book (MTB) ratio and external finance weighted-average market-to-book (EFWAMTB) ratio. Managements' demographic attributes (gender, age, educational background and professional experience) were adopted as moderating variables.

The statistical sampling for this study was specifically designed for PLCs. Despite the limited number of PLCs (as of mid-2021, over 700 are listed on the IDX), compared to non-listed companies, PLCs have more substantive operations and account for a greater portion of their respective sectors and the overall Indonesian economy. There is also a dearth of research on the influence of behavioural variables in capital structure decisions in the Indonesian context. Therefore, the knowledge gained from mapping, modelling and testing behavioural and demographical variables' influence on capital structure determinations by PLCs' managements (CEOs/CFOs) will contribute significantly to the literature.

1.3 Significance of the Research

This research contributes to the literature and discourse on incorporating behavioural variables into the study of financial economics generally and capital structure determinations specifically. The study examines and validates select behavioural and demographical variables as capital structure determinants in PLCs. The results can serve as a conceptual reference, providing a basis and prompting greater impetus for future research along the broad themes of behavioural variables, capital structure and financial performance, and further empirical testing of more varied demographic characteristics, in the Indonesian or other capital markets. The insights can also provide valuable feedback and references for companies' managements, especially TMTs, for capital structure decision-making.

1.4 Research Limitations

This study has the following limitations:

- The study sample is limited to PLCs/the Indonesian capital market, which likely affects the generalisability of the findings to other countries' markets and firms.
- There are few empirical studies on IDX-listed firms in regard to assessing rational versus irrational manager decision-making as reflected in the deterministic components of the

model construct. Further extensive research is required to conclusively validate these components of the model in the Indonesian context.

- Overconfidence and optimism are influenced by various non-finance factors, which were not included in the model construct.
- The constructed variables are meticulous in nature, particularly in the modelling of the dynamic relationships between them and the moderating variables. This may limit the findings' generalisability.
- The selected variables were those suggested by the leading global literature as appropriate proxies for capital structure determinants. Their applicability to the context of the Indonesian capital market requires further testing.
- The extremely limited availability of references and benchmarks for measurable indices of behavioural variables (e.g., Managers Confidence Index) forced this research rely on Indonesian managers' survey responses.
- The controlling filter may not have fully screened out outliers and anomalies (e.g., variances in financial reporting standards).
- Further refinement is needed for the definition of indebtedness (total debt) to reflect local regulatory frameworks (convertibility and claims).

1.5 Thesis Structure

This thesis is structured as follows.

Chapter 1: Introduction. This chapter has introduced the research background, scope, purpose, significance and limitations.

Chapter 2: Literature Review. This chapter presents the foundational theories and conceptual frameworks underpinning the selected variables in this study. The chapter also provides this study's conceptual framework and research hypotheses.

Chapter 3: Research Methodology. This chapter details the research methodology and study design, describing the population, sample, data collection methods, appropriate research instruments (validity and reliability), variables and data analysis techniques.

Chapter 4: Research Results, Analysis and Discussion. This chapter presents the analytical data processing and hypothesis testing results. Technical descriptions of the performed procedural steps aid in substantively evidencing whether hypotheses are accepted or rejected.

Chapter 5: Conclusions and Suggestions for Future Research. This chapter summarises the study conclusions and provides recommendations for future studies.

Empirical analysis and theoretical explorations in this Study are expected to indicate the existence of the dynamical influence of Behavioral Variables, namely Overconfidence and Optimism, as framed by referential information and data, and as impacted upon by the demographic attributes of the decision-makers, and the propensity for timing the market, on the Capital Structure determinations by listed companies on the Indonesia Stock Exchange. The results from this Study may serve as conceptual reference, capable of inducing greater impetus for subsequent researches related to the expanded thematic explorations on the subjects of Behavioral Variables, Capital Structure, and Financial Performance, as well as spurring further empirical analysis on more varied Demographic Characteristic indicators, as the plausible moderating variables to the main causative relationship between behavioural variables and capital structure, within the context of the Indonesian capital market.

Behavioral Variables and Discretionary biases framework, are known to be evolving and dynamically responding to the changing operating contexts and the shifting market environments. Accordingly, the greater insights as to be gained from the empirical explorations herein, are expected to provide valuable substantive feedbacks and references for management, more specifically for the top management team (TMT), in implementing effective structural models of Behavioral responses most befitting to support strategic decision-making process, focusing on Capital Structure determinations. The greater efficacy as to be deriving from improvements in the decision-making on Capital Structure issues, is expected to contribute to improvements in financial performance, and the overall maximization of firms' values and stockholders' wealth.