

Analysis of Capital Structure on Multinational Corporation: Trade off Theory and Pecking Theory Perspective

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ABSTRACT

The research aims to analyse the capital structure applied in multinational companies for the effectiveness and efficiency of the company's financing. This research uses independent variables i.e. business risk, asset growth, and cash flow volatility. The population of this research consists of all companies listed on the Indonesia Stock Exchange from year 2010-2019. The study took samples with the technical purposive sampling of multinational corporations that are non-financial institutions. Data analysis methods use multiple linear regression. The results showed that the capital structuring analysis was heavily influenced by business risk, asset growth, and cash flow volatility. That is, the company in determining the policy on managing the proportion of debt and equity as a source of funding the company can consider the condition of business risk, growth of assets, and volatility of cash flows owned by companies.

Keywords: *Capital structure, business risk, growth of assets, and volatility of cash flows*

1. INTRODUCTION

Companies in conducting business operations, business development, or investment in other companies need funding. The funding in question is how the company is able to compare capital and debt usage [1]. explained that by conducting corporate financing management, it will impact the company's value in the performance of the company. That the company as an entity that operates by implementing economic principles, is generally not only oriented towards achieving maximum profit, but also seeks to improve the company's value and prosperity of its owners.

The company's funding by the proportion of capital and debt is referred to as the capital structure. Capital structure if not managed optimally will affect the financial difficulties of the company. The capital structure in addition to being a corporate strategy also becomes a fundamental policy for companies. This is because the company must be able to ensure that the distribution of sources of debt and equity funds can keep the company's future continuity within an undetermined period of time. Therefore, the management of the company is required to look for the most inexpensive source of funds. In his

research on ref [2]. mentioned that the capital structure is a permanent spending of the company reflecting the comparison or balance between the company's long-term debts and the company's own capital in the form of retained earnings and stock issuance. also added that the company's capital is sourced from internal and external companies, where the internal source of the company comes from retained earnings and accumulating and external companies derived from the use of debt or stock issuance.

Today, the sustainability of the company becomes a challenge when the global Comitia is experiencing a crisis, such as the 2008 crisis example where the main trigger for bankruptcy of a financial institution and the company is due to the extent that the proportion of debt is too large. This has been repeated with the 2020 global pandemic condition that led to a decline in economic growth so that all sectors of the industry were impacted. It is shown in the Figure 1, about economic forecast downgraded that the global economic decline resulting from the 2020 pandemic.

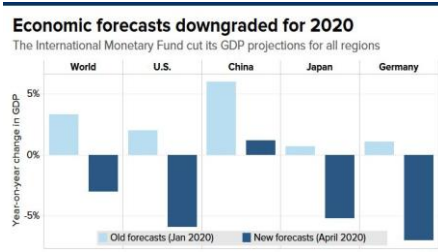


Figure 1 Economic Forecasts Downgraded

Predictor the occurrence of global economic decline, which suggests that the global economy shrinks 3% this year, only a handful of countries such as China will experience growth despite being less than 5%. The 2020 pandemic causes all the regions in the world to restrict the activity of any economic activity. Based on that data the company's capital structure becomes the benchmark of whether the company is able to survive in the current state. The fundamental reason for the capital structure is to measure because the correct management of the proportion of funding between debt and capital in previous periods would be one of the sustainability factors of the company. This statement is supported by the research on ref [3]. conducted that when the economic situation is being bad, then the proportion of debt (leverage) will further suppress profitability. Further explanation, the company which has lower proportion of debt will be adaptable and flexible amid uncertainty-filled situation [3].

Quoted from one electronic media that the Association of Indonesian Issuers (AEI) mentions more than 50 companies listed on the Indonesia stock exchange or issuers began to have difficulties due to the impact of the Covid-19 pandemic. The cash ability to support the issuers operations was only strong until June 2020, even more extremes they negotiated to the bank and put the employee to the center. In addition, the United Nations Conference on Trade and Development published its research on the impact of the Covid-19 on economic growth, mentioning that more than two-thirds of the world's top 100 multinational companies have issued statements about the impact of the plague on their business, and have impacted on the throttling of capital expenditure on affected areas of the virus. Moreover, based on the research data as many as 41 companies have also issued a warning about profit problems. That is, according to UNCTAD, the invested income, which is the main component of FDI, will be lower. Referring to the phenomenon that occurs at this time then, the capital structure becomes an essential thing that is worth to be noticed by the company. The company needs to pay attention to factors affecting the stability of capital structures. Factors in this case divided into 2 namely external and internal [4]. The internal factor is a factor that can be controlled by the company to achieve a stability in the capital structure. The internal factor to be considered by the company is business risk. Business risk is a condition where the entire asset is funded by capital or broadly a condition in which the company does not use any debt in its funding. Business risks May increase with

the company's debts. In this case, the greater the debt borne by the company, the greater the business risk that will impact the company. The company is required to be able to properly manage business risk in order to achieve stability in the company's capital structure. Another factor to be considered by the company so that the capital structure can achieve stability is asset growth. Asset growth can be defined as a change in the value of total annual assets . Asset growth can have a positive impact on a company's reputation. With the growing assets it shows that the company is growing. The reputation for growing a company can have a positive impact on investors. Investors will have more attention to their capital investment, because they will have an impact on a profitable return on investment. Through investments made by investors, the company can utilize the increase of funding externally, if internal funding of the company is considered less capable of supporting the capital level of a company.

In addition to the two factors that have been mentioned volatility of cash flows also become the determining factor of corporate capital structure. Economic theories imply that volatility plays an important role in determining the company's capital structure, but based on empirical evidence from previous research found no significant relationship between cash flow volatility and debt ratio [5]. Furthermore, the relationship of cash flow volatility with weak capital structure, but the results of his research showed a different thing that is volatility of cash flows is an important determinant of the company's debt ratio and the use of debt with different maturity [6]. also conducted research on ref [7] with results indicating that higher cash flow volatility resulted in lower debt levels, as well as companies that faced high volatility chose debts with relatively shorter timeframes and vice versa. Based on some previous research results it can be said that there is a correlation between cash flow volatility on capital structures. The volatility of a healthy cash flow will certainly determine the correct company's policy in managing the proportion of debt and equity.

2. FUNDAMENTAL THEORY AND DEVELOPMENT OF HYPOTHESIS

2.1. Fundamental Theory

There are several theoretical foundations used to discuss problem solving in this study. The theories are the basis for conducting this research.

2.1.1 Capital Structure

Capital structure is the management of funding sources divided between debt and capital itself. The capital structure refers to how the company is able to balance the use of debts and capital itself, so it does not pose a financially meaningful loss. According to Wodjewodski

(2017) states that the capital structure of a part of the company's policy in the selection of funding sources for the financing of the activities of the company's investments, both the source of funds from external (debt) and the source of funds from the internal (equity). The choice of alternative sources of funds is not easy because of the long-term financial consequences that impact the company's risks and performance [8]. Therefore, management should pay close attention before taking the policy regarding the use of the proportion of debt and equity for funding referred to as the capital structure.

This capital structure can be attributed to the theory of Modigliani and Miller (1963) where there are two classifications i.e. MM (Modigliani and Miller) theory without tax and MM theory with tax [9]. without taxes It is explained that the structure of debt and capital financing has no correlation with the value of the company, hence it appears a classification of MM theory with tax explaining that the structure of the financing will provide added value to the company if there is a tax element as a deduction of the company's load. This means that debt policies are used to reduce taxes. Then the trade-off theory emerged as the development of the theory Modigliani and Miller (1963) which added bankruptcy costs by balancing the profit and loss of debt, so that the company will continue to owe it to a certain level of debt that the tax-saving (tax shield) of additional debt is equal to the entire cost of the financial difficulties. This theory states that debt has a negative and positive side. The plus side is that debt can reduce taxable income, due to the difference in tax treatment of interest and dividends, so as to provide tax savings against the company. While the downside, the bigger the debt is the greater the bankruptcy cost and cost of financial distress for the company. The theory of capital structure aims to provide the foundation of thinking to know the optimal capital structure. A capital structure is said to be optimal if with a certain level of risk can give the company maximum value.

Another theory underlying the capital structure is the Pecking Order theory stating that, the company prefers internal financing (funding of the company's operations) and when the external financing is required the company will issue the safest Securities [1]. The duck Order Model argued that this theory arose due to the asymmetry of information between the company and its financiers. Therefore, the company's financing hierarchy was initiated with a retained profit that had the lowest information asymmetry cost, followed by debts, and finally equity or own capital from an external source that had the highest information asymmetric cost. Information asymmetry is a force that is driven by a lot of duck order theory occurring in developing countries including Indonesia.

2.1.2 Business Risk

Business risk is one of the risks faced by the company when carrying out its operations, namely the possibility of the company's inability to finance its operational activities [10]. Research conducted on ref [10] how's that the

business risk of the company has a role in determining the ability of the company to operate the capital structure. With the wide scope of capital resources, the combination of instruments at the right business risk needs to be done carefully to optimize capital costs. Companies that are at high risk will wear small debts because debts can increase the company's risk of bankruptcy [10]. In duck order theory, companies with high business risk are less likely to use debt, in order to avoid bankruptcy from debt users. The results on the ref [1]-[13] stated that the central business risk will be a policy on how the company allocates the source of external funds (debt) and internal (equity). The measurement of business risks in the study uses one of the three indicators, the standard deviation before interest and tax on total assets [13].

2.1.3 Asset Growth

Asset growth is defined as the annual change of total assets. High asset growth rate then the company will increase external funding source because the source of internal funds cannot support the level of growth found in the company. The larger the assets of a company, the bigger the operational results produced by the company. The increase in assets followed by increased operational is able to increase the outside trust of the company, hence the proportion of debt is greater than its own capital. Companies with a high growth rate, there will be shortage of income to fund such high growth internally. As for issuing new stocks that require high fees, the company chooses to use debt as a source of financing. In addition, the occurrence of increased assets that followed the increase of the operating outcome will further increase the outside trust of the company. With the increasing confidence of the outside parties (creditors) to the company, the proportion of debt will be greater than the capital itself.

2.1.4 Cash Flow Volatility

In theory the economic volatility has an influence on the capital structure, only based on empirical evidence is still weak. However, some of the research has indicated that due to the volatility of cash flows, there has been a strong influence on the management decision of the company in managing the proportion of debt and capital. As the research conducted [1]. tatted that empirically the relationship of cash flow volatility with weak capital structure, but the results of his research showed a different thing that is volatility of cash flows is an important determinant of the company's debt ratio and the use of debt with different maturity.

2.2. Development of Hypothesis

Based on the theories and relationships with the above-described instructions, there are several hypotheses that are as follows.

2.2.1 Business Risk to Capital Structure

Some empirical have described the influence of business risk on the capital structure of the company with private ownership, conducting research on ref [14] development to measure the risk of business used in regulating the capital structure of companies that have many affiliates. The research shows that companies with affiliates need more definite calculations on the business risks in the policy-making regarding the management of the company's funding source. In addition, conducted research on ref [13] with the title of the impact of business risk on the capital structure of companies in India, generating empirical evidence that business risk becomes one of the policy determinant of corporate capital structure.

Business risk may increase when the company uses high debts to meet the needs of its funding [15]. Risk arises in line with the emergence of expenses for the company's loans. The greater the cost burden that is to be borne the greater the risk facing the company.

H1 : Business risk has an influence on capital structure.

2.2.2 Asset Growth to Capital Structure

Companies that have high asset growth rates are likely to use external funding sources for their business operations. Indirectly the company's condition that experienced high asset growth rate will reflect the company needs more funding for the cost of acquisition, maintenance costs, and operational costs. Therefore, the increase in assets followed by the increase in operational is able to increase the outside trust of the company, hence the proportion of debt is greater than the capital itself [16].

H2 : Asset growth has an influence on capital structure.

2.2.3 Cash Flows Volatility to Capital Structures

Stated that empirically the relationship of cash flow volatility with a weak capital structure, but the results of his research showed a different thing that is volatility of cash flows is an important determinant of the company's debt ratio and the use of debt with different maturity. In theory cash flow volatility affects the structure of capital [16].

H3: Cash Flows Volatility has an influence on capital structure.

3. METHODOLOGY

In this chapter will be discussed on how this research will be conducted.

3.1 Variable's Operation of Capital Structure

The dependent variables in this study are the capital structures measured by the use of DEBT to Equity Ratio.

3.2 Variable's Operation of Business Risk

The business risk of being proscribed with BRISK (Business risk), namely with the following formula :

$$\frac{\sigma \text{ EBIT}}{\text{Total Asset}}$$

3.3 Variable's Operation of Asset Growth

This variable can be defined as the annual change of fixed assets, formulated as follows:

$$\frac{\text{Total Aset}_t - \text{Total Aset}_{t-1}}{\text{Total Aset}_{t-1}}$$

3.4 Variable's Operation of Cash Flow Volatility

Cash flow volatility is an index of the company's cash flow spread measured by using the following formula:

$$\frac{\sigma \text{ CFO}_t}{\text{Total Aktiva}_t}$$

3.5 Population and Samples

The population is a whole element that meets certain conditions, related to the issue being researched, and made an object in the study. The population in this research is the entire foreign investment company listed on the Indonesia Stock Exchange during the period from 2010-2019. The samples in this study were determined using the purposive sampling method, which is the selection of samples according to specific criteria. The companies that have been samples in this study were selected based on specific criteria (purposive sampling), namely :

1. Foreign investment company registered in IDX.
2. Registered company is all multinational company except banking, insurance, and mining.
3. Companies that do not suffer losses in certain period
4. Companies that have a positive debt to equity ratio

3.6 Research Model

The model used in the study was adapted and modified from a research model developed by Gozali (2013) and Kale at al (1991) to measure the determining factor of the capital structure of the company's external finances. This research refers to both studies by modifying the research model in which the researchers used the sample of multinational companies for 10 years 2010-2019 to determine whether there is an external funding influence i.e. business risk, asset growth, and cash flow volatility against the policy in conducting multinational corporate capital structures.

$$DER = \alpha_0 + \beta_1 BRISK_{i,t} + \beta_2 GAT_{i,t} + \beta_3 VCF + e_{i,t}$$

3.7 Data Analysis Techniques

The research Model was estimated using OLS (Ordinary Least Square) in the testing of each hypothesis. In order for the model to be analyzed and provide representative results, the model should adhere to the testing of classical assumptions, namely normality (normal distribution data), autocorrelation, and multicholinerity. In this research data analysis techniques began by conducting a descriptive statistical test Kale at al (1991). Data analysis In this study used multiple linear regression assisted with SPSS software version 22. To perform data analysis, data processing is performed with multiple linear regression assisted by SPSS software version 22. The capital structure is positioned as a dependent variable that is associated

with business risk, asset growth, and cash flow volatility as an independent variable. Multiple linear regression methods are used to test variables that have a direct influence on the research model built on a strong theoretical basis.

4. RESULTS AND DISCUSSION

4.1 Results

4.1.1 Descriptive Analysis

Based on the Table 1 research results can be known minimum value, maximum and average of each variable from the company that was made sample during the year 2010-2019:

Based on Table 1 in this research the highest capital structure amounting to 3.5960 owned by the company Sturdy Inti Arebama TBK, while the lowest capital structure of 0.0070 owned by the company Davomas Abadi TBK. Business risk with maximal value of 0.000 and maximum value of 0.9998. This research has a minimum value of 0.400 and a maximum value of 0.595 for asset growth. This means that companies with higher asset growth in the financial report are approximately 60 companies. The volatilities cash flow has a minimum value of 0.4350 and a maximum value of 0.6040.

Table 1. Descriptive Analysis Result

	N	Minimum	Maximum	Mean	Std. Deviation
DER	460	.0070	35.960	1.024.984	.8028130
BRISK	460	.0000	.9998	.207915	.2886948
GAT	460	0.4000	0.5950	0.03253	25,783.858
VCF	460	0.4350	0.6040	0.08704	19,619.315
Valid N (list wise)	460				

4.1.2 Classic Assumption Test

a. Test of Normality

Here are the results of the Kolmogorov-Smirnov test after the transformation.

Table 2. Kolmogrov-Smirnov test

Kolmogorov-Smirnov Z	.914
Asymp. Sig. (2-tailed)	.374

Based on Table 2 that acquired the value of Kolmogorov-Smirnov. 914 with significance level. 374. This significance value is more than 0.05. This indicates that the data is distributed normally.

b. Multicholineric Test

The results of multicollinearity testing in this study are shown in the following table 3.

Table 3 Multicholineric Test

Variabel	Collinearity Statistic		Explanation
	Tolerance	VIF	
BRISK	0.973	1.028	Non Multicollinearity
GAT	0,956	1.046	Non Multicollinearity
VCF	0.954	1.049	Non Multicollinearity

Business Risk (BRISK), asset growth (GAT), and cash flow volatility (VCF), have values tolerance > 0.1 and VIF < 10. It can be concluded that the entire free variable on the regression model tested in the study did not occur multicollinearity.

c. Heterokedastisity Test

Heteroskedastisity test results in this study can be seen in Figure 2.

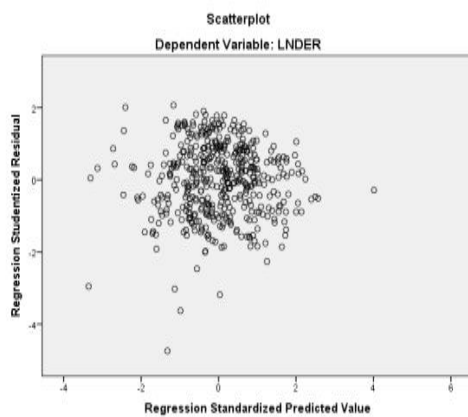


Figure 2 Scatterplot Test

Based on Figure 2 that it can thus be concluded that the symptoms of homoskedastisity occur or no connection occurs between the dependent variables and the independent variables, so that the dependent variables are actually only described by independent variables.

c. Autocholineration Test

To know whether this autocorrelation is used Durbin Watson test. The test is free of autocorrelation when it is between -2 to + 2.

Table 4. Durbin Watson test

Model	Durbin – Watson
1	0.847

Based on the Table 4 that Durbin-Watson test presented in table 4. the regression for equation 1 shows a value of 0.847 which means the value of Durbin-Watson is still in the area of free autocorrelation because it is between -2 to + 2.

4.1.3 Hypothesis Testing Results

The following are multiple linear regression test results for the first model.

Table 5 Regression Results

Variable	Regression Model			
Independent	Cofisient	t	Sig	Conclusion
(constant)	3.474		.000	
BRISK	0.289	3.006	0.003	significantly
GAT	-0.036	-2.192	0.029	significantly
VCF	-0.127	-5.897	0	significantly
R square	.131			
F statistic	13.668			
F Sig	.000 ^b			

$$*BRISKit = 3,474a + 0,289 BRISK - .036 GAT- 0,12 VCF+ .88450$$

Based on Table 5 that interpretation of the value of regression coefficient :

1. Constant value of 3.474 which means if there is no other variable then the value of capital structure 3.474
2. The business risk variable has a regression coefficient of, 289. This means that when the business risk increases by one unit the capital structure variable will increase by, 289 and vice versa assuming another variable is constant.
3. The asset growth variable has a coefficient of-, 036. This means that if the growth of the asset increases then the capital structure will increase by-, 036 and vice versa assuming another variable is constant.
4. Variable cash flow volatility has a coefficient of-, 127. This means that if the growth of the asset increases then the capital structure will increase by-, 127 and vice versa assuming another variable is constant.

4.2 Discussion

4.2.1 Influence of Business Risk to Capital Structure.

The hypothesis tests conducted between business risk variables with the capital structure can elicit a conclusion that business risk has a significant positive influence on the capital structure. Business risk has a significant influence on the capital structure because the company sample is a multinational company that has high business risk, resulting in the management of the company strongly consider the business risk in managing the capital structure. Some empirical evidence can be used as a reference that the business risk increases significantly against the management of the corporate capital structure [13], [16].

Based on empiricist results on this study is relevant to trade-off theory that the decision to use funding sourced from debt with greater proportion or use of funding sourced from the internals of the equity that is a measure of the presence or absence of bankruptcy costs by balancing the profit and loss of debt. Also, the theory aims to provide the foundation of thinking to know the optimal structure of capital. A capital structure is said to be optimal if a certain level of risk can give the company maximum value. This means that with the trade-off theory, management should be able to take into account if the condition of the company's business risk increases, the management minimizes the use of funding sources from a high risk of debt bankruptcy cost and cost of financial distress.

4.2.2 Influence of Asset Growth to Capital Structure

The hypothesis test of asset growth in capital structures has a negative and significant influence. This means that with the higher asset growth, the higher the company dared to take the risk to use the external funding source, which is debt. The results of the empirical study were supported by the research of Dewi (2017) stating that the increase in assets followed by the increased operational can increase the outside party's trust in the company, hence the proportion of debt is greater than its capital.

Then empirical results in this study are studied according to the theory of relevance with Duck order theory, where the company made a hierarchical funding decision from internal funding to external. The order of funding from the proceeds from the profit was withheld, and then the debt and finally came to the issuance of new equity, meaning that it was started from the source of funds at the lowest cost [17]. The duck theory of the order adheres to funding decisions in the order of investor's logical preference to the company's prospects and is consistent with the goal so that managers can maximize shareholder prosperity. The duck order theory assumes that the company tends to choose internal financing to fund its projects. The company also adjusts the target of the pay-out ratio with the opportunity to invest. Besides, the company implemented rigidly dividend policy, fluctuation of profitability, and investment opportunity unpredictable. This situation causes funds

resulting from internal activities that are often not used following the capital expenditure policy. If the internal funds are larger then the company will use it to pay off debts or invest in securities. Conversely, if the company has a deficit, then the company will lower the cash balance or sell the securities.

4.2.3 Influence of Cash Flow Volatility to Capital Structure

The hypothesis test results regarding cash flow volatility against checked capital have negative and significant influences. The results on reff [18] there was a significant and negative relationship between cash flow volatility and the use of the proportion of debt on checked capital. Research on ref [19] found that companies that have more cash flow volatility have long-term debts that are more Sell in the management of checked capital.

Based on the empirical results of this study is relevant to the order of Peck theory in which the company prefers internal financing (funding of the company's operations) and when funding from the outside (external financing) is required, the company will issue the safest securities in advance [1].

5. CONCLUSION

Based on the analysis and testing of data in this study, the following conclusions are obtained:

1. The hypothesis tests conducted between business risk variables with the capital structure can elicit a conclusion that business risk has a significant positive influence on the capital structure.
2. The hypothesis test of asset growth in capital structures has a negative and significant influence. This means that with the higher asset growth, the higher the company dared to take the risk to use the external funding source, which is debt.
3. The hypothesis test results regarding cash flow volatility against checked capital have negative and significant influences.

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