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The Application of Pecking Order Theory on Corporate Financing Decisions: a Systematic Literature Review

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Abstract: *This study aims to evaluate the application of the Pecking Order Theory in corporate finance through the analysis of articles indexed in Scopus over the past decade. The study was conducted using the Systematic Literature Review (SLR) method, covering articles from 2014 to 2024. The findings show that 64% of the research focuses on capital structure, which underscores the relevance of this theory in understanding companies' preferences for financing sources. Additionally, 25% of the articles discuss its application in corporate finance, while its contribution to the fields of social and management is relatively limited, reaching only 8% and 3%, respectively. The publication trend shows spikes in certain years, particularly 2016, 2021, and 2022, each with two articles published. This research suggests the development of studies in less explored areas and the integration of this theory with modern financial technology innovations, in order to expand its relevance in the digital era. This study makes an important contribution to understanding the dynamics of the Pecking Order theory in the context of corporate finance and its future development direction.*

Keywords: *Pecking Order Theory, Systematic Literature Review, Capital Structure, Corporate Finance.*

Introduction

In the field of corporate finance, decisions regarding capital structure are one of the important factors that influence the performance and survival of the company. The pecking order theory, introduced by Myers and Majluf in 1984 (MYERS, 1984), is one of the commonly used theories to explain a company's choices in determining funding sources. This theory reveals that companies typically follow a certain order in the financing process, starting with utilizing internal resources, then debt, and finally equity.

This phenomenon arises as a reaction to the information asymmetry present between the company's management and external investors. When information is not evenly distributed, the use of internal funds is considered more efficient, as it does not require the disclosure of additional information that could influence investor perceptions. On the other hand, the issuance of new shares is often avoided because it can lead to ownership dilution and send negative signals to the market.

The application of the pecking order theory in corporate finance is becoming increasingly important, especially amidst market changes and global economic challenges. Wrong decisions in financing can affect the capital cost structure, company value, and competitiveness in the industrial sector. Therefore, it is important to understand the elements that influence funding preferences according to this theory, both for practitioners and academics.

This aticle aims to examine the application of the pecking order theory in the context of corporate finance, with an emphasis on how companies make decisions regarding funding sources when facing both internal and external conditions. Through this research, it is hoped that readers can gain deeper insights into the relevance of this theory in conteporar buines pratices.

Literature Review

Corporate Finance

Corporate finance is a field of study that focuses on how companies manage financial resources to achieve their primary goal, which is to maximize the company's value. In this context, there are three main decisions that are the core of corporate finance studies: investment decisions, financing decisions, and dividend decisions. These three decisions are interrelated and have a significant impact on the performance and sustainability of the company.

Invetmen Deision

Investment decisions encompass the analysis and selection of projects or assets that are expected to add value to the company. The approaches commonly used in investment evaluation include Net Present Value (NPV) analysis, Internal Rate of Return (IRR), and Payback Period (Purwoko et al., 2023). These decisions

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require consideration of expected risks and returns, as well as an evaluation of the uncertainty in the business environment (Farooq et al., 2022).

Financing Decisions

Financing decisions relate to how a company obtains funds to finance its operations and investments. (Lubis, 2018; Loncan, 2023). The main theories in financing decisions include: This phenomenon arises as a reaction to information asymmetry that

- Capital Structure Theory: This theory explains the optimal combination of debt and equity that can minimize capital costs and maximize the value of the company (Mahdaleta, 2016, Natalia, 2018). The Modigliani Miller approach serves as the foundation of this theory, which then evolved by considering factors such as taxes, bankruptcy costs, and information asymmetry.
- Pecking Order Theory: This theory states that companies have a hierarchy in choosing sources of funding. They tend to use internal funds first, then debt, and finally equity, to minimize the costs associated with asymmetric information.
- Trade-Off Theory: This theory combines the benefits and costs of using debt. The company will achieve an optimal capital structure by balancing the tax benefits of debt and the risk of bankruptcy.

Dividend Decisions

Dividend decisions relate to the distribution of profits to shareholders and the company's policy to retain or reinvest those profits. Some approaches used to determine dividend policy include:

- Dividend Irrelevance Theory: Modigliani and Miller argue that dividend policy does not affect the value of the company in a perfect market.
- Tax Preference Theory: Shareholders may prefer companies that retain profits for reinvestment because capital gains have a lower tax rate compared to dividends.
- Signaling Theory: Dividend payments are considered a positive signal regarding the company's financial health to the market.

External Factors Affecting Company Finances

In addition to internal decisions, a company's finances are also influenced by external factors such as macroeconomic conditions, monetary policy, government regulations, and market dynamics. For example, high interest rates can increase debt costs, while inflation affects purchasing power and company profitability.

Modern Challenges and Trends

In the modern era, companies face new challenges such as globalization, technology, and sustainability. The traditional approach to corporate finance is now combined with big data analytics, artificial intelligence, and attention to environmental, social, and governance (ESG) aspects. Through a deep understanding of fundamental principles and the latest developments in corporate finance, companies can make strategic decisions that not only enhance shareholder value but also create a positive impact on society and the environment.

Pecking Order Theory

The Pecking Order Theory developed by Stewart C. Myers and Nicholas Majluf in 1984 (MYERS, 1984) explains how companies make decisions related to capital structure and financing. This theory emphasizes the importance of information asymmetry between company managers and external investors, which affects the company's choice in selecting funding sources.

The Pecking Order Theory emerged as a response to previous capital structure theories, particularly the Modigliani-Miller (M&M) Theory, which claimed that in a perfect market, capital structure does not affect the value of the company. Myers and Majluf criticized this view by showing that in reality, capital markets are imperfect and there is an information asymmetry between the company and investors. In an imperfect market, companies face higher information costs when seeking external financing, which encourages them to prefer internal funding sources, such as retained earnings, first.

Overall, the Pecking Order theory provides a reasonable explanation for the funding patterns of companies influenced by information asymmetry and transaction costs. Although this theory is useful for understanding more conservative funding preferences, there are limitations in its application in various contexts, such as highly efficient markets or companies with a good reputation. This theory remains relevant and provides important insights into the management of a company's capital structure in the real world.

Research Methodology

This research uses the Systematic Literature Review (SLR) method. SLR is an empirical research method aimed at systematically analyzing and evaluating previous research. The preparation of the SLR has been carried out systematically and involves a research team.

The next step in this research is to select online database sources as research literature. These database sources can be used to search for articles published in accordance with the research conducted. Several database sources selected for this SLR research include: Google Scholar, Sage, Elsevier, Emerald Insight, Cogent OA, Springer Netherlands. Data collection is derived from Scopus-indexed journals with the search statements "Pecking Order Theory," "Pecking Order Theory Systematic Literature Review" from 2014-2024 or the last 10 years. From the search results, 10 articles that meet the search criteria for the use of pecking order theory in relation to corporate finance were found.

Result and Discussion

This research is a comprehensive literature review that takes data from previous articles on the use of the pecking order theory in relation to corporate finance. Based on articles published and indexed in Scopus over the past 10 years, research using the pecking order theory includes 37 articles.

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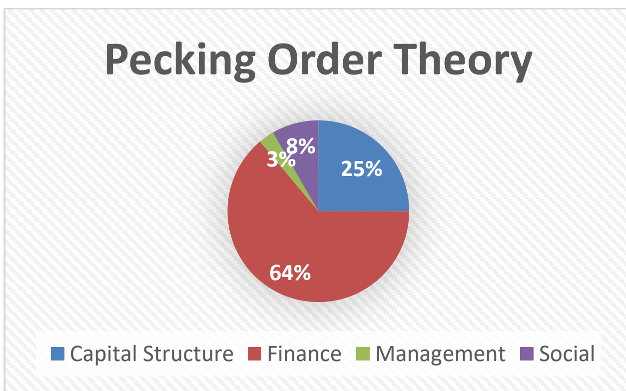

Figure 1. Article on the Pecking Order Theory Scopus Index

Based on Figure 1, it can be seen that 23 articles (64%) discuss the use of the Pecking Order Theory in the field of capital structure, 9 articles (25%) discuss the use of the Pecking Order Theory in the field of corporate finance, 3 articles (8%) discuss the use of the Pecking Order Theory in the social field, and 1 article (3%) discusses the use of the Pecking Order Theory in the field of management.

The research trend found in this literature review is the use of the Pecking Order Theory in the field of capital structure, followed by finance, social, and finally management. The trend in research regarding the use of the Pecking Order Theory in the field of corporate finance can be seen from the publication year of the articles.

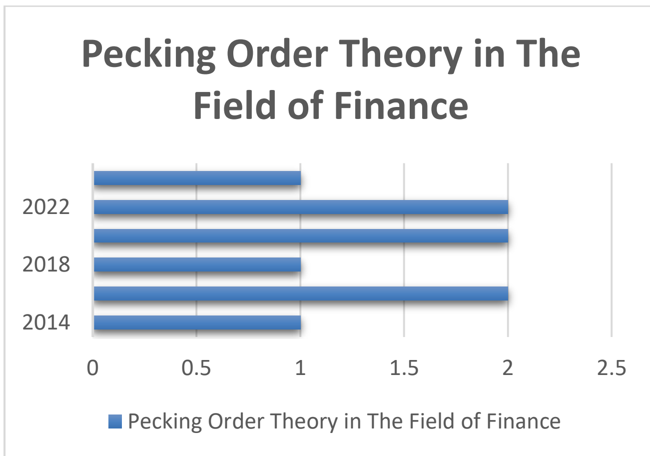

Figure 2. The use of the pecking order theory in the field of finance

Based on Figure 2, the trend in the use of the Pecking Order Theory in the field of finance can be seen in the articles from 2014 with 1 article (Danso & Adomako, 2014), 2016 with 2 articles (Albuquerque et al., 2017; Briozzo et al., 2016), 2018 with 1 article (Qu et al., 2018), 2021 with 2 articles (Mueller & Sensini, 2021; Wang et al., 2021), 2022 with 2 articles(Jansen et al., 2023; Meressa, 2022), and 2024 with 1 article (Sánchez-Andújar et al., 2024). The trend in the use of the Pecking Order Theory in the field of finance in 2016, 2021, and 2022 is due to the publication of 2 articles each year.

Conclusion and Suggestions

This research provides a comprehensive overview of the application of the Pecking Order Theory in corporate finance based on a literature analysis of Scopus-indexed articles over the past 10 years. The study results indicate that the majority of research (64%) focuses on capital structure, highlighting the relevance of this theory in understanding corporate financing preferences. Additionally, 25% of the articles review its application in the field of corporate finance, while its application in the fields of social and management is relatively rare, each covering only 8% and 3% of the articles, respectively. The publication trend shows an increase in certain years, such as 2016, 2021, and 2022, with two articles published each year.

This research recommends further exploration in underrepresented fields, such as social and management, to expand the scope of theory application. Furthermore, it is important to analyze the causes of certain trends in publishing and to integrate these theories with modern financial technology to address the ever-evolving challenges of the financial world.

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