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# Literature Review : The Effect of Capital Structure on Firm Value in Publicly Listed Companies in Indonesia

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***Abstract****. This study examines the influence of financial structure on enterprise value in consumer-focused firms registered on the Indonesia Stock Exchange. Financial structure, characterized as the proportion of borrowing and equity, plays a significant role in financial management, shaping both business performance and market perception. Utilizing a qualitative method through a literature review, this research gathers and analyzes various sources to evaluate the connection between financial structure and enterprise value. The findings indicate that financial structure can have both positive and negative impacts on enterprise value. Integrating borrowing into the financial structure offers benefits such as tax advantages, enhanced profitability, and a favorable signal to investors. However, excessive reliance on borrowing can result in increased financial burdens, such as higher interest expenses, which may lower enterprise value. These results underscore the importance of maintaining an appropriate debt-to-equity ratio to improve or sustain enterprise value.*

***Keywords*** *: Firm Value, Performance, Debt, Equity, Investor*

## 1. INTRODUCTION

The entry of new companies on the stock exchange market in Indonesia illustrates the improvement of the economy and trade, but will lead to increased business competition. This competition is felt by every sector in the Exchange Market without exception. In the end, it can lead to the exit of companies that cannot survive or go bankrupt. For consumption sector companies, the challenge is even more complex. Companies in this sector must be able to maintain operational stability amidst increasing consumer demand, while still ensuring a funding strategy that supports long-term growth. (Belinda & Parameswari, 2024). This emphasizes the essential role of capital structure in not only improving financial efficiency but also creating added value for shareholders. Proper management of capital structure can greatly impact a company's value, either positively or negatively, while also aiding in more effective financial risk management. (Andrakila & Fitria, 2024). Moreover, competitive market conditions can negatively influence a company's value, as observed in the study by Sudirman et al. Their findings reveal that the value of insurance companies fluctuates from year to year and tends to experience a downward trend over time. (Sudirman, Nurmilasari, & Sandi, 2021).

Investor assessment of the Company is important because it is related to investor decisions in investing in the company. This assessment represents the true state of the company, commonly known as firm value. Firm value not only portrays the company's

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current situation but also serves as an indicator of its future potential, such as its capacity to consistently pay dividends to shareholders. (Manurung & Wildan, 2023). It is widely considered a crucial measure of successful financial management. Firm value is often used as an indicator of successful financial management. Firm value can be enhanced through effective financial strategies, including capital structure management. Firm value reflects the market's perception of a company's business performance and prospects, which is often represented through the stock price. Factors such as profitability, growth and dividend policy also contribute to increasing firm value. In consumer sector companies, operational stability and the company's ability to respond to changes in consumer demand are also important elements in building firm value. (Febriana, Djumahir, & Djawahir, 2016)

Firm value is frequently regarded as a key indicator of the effectiveness of a company's financial management and funding strategies. A well-optimized capital structure has the potential to enhance firm value by sending positive signals to investors about the company's long-term growth potential. (Febriana, Djumahir, & Djawahir, 2016). For consumer sector companies listed on the Indonesia Stock Exchange (IDX), the relationship between financial structure and firm value is a vital factor influencing both financial performance and market perception.

Capital structure has a significant relationship with firm value. Too high a debt ratio can increase financial risk, potentially lowering firm value. However, optimal use of debt can provide benefits in the form of tax shields that increase profitability and competitiveness. Previous research shows that this relationship is non-linear, where there is an optimal point of capital framework that maximizes corporate scale.

The capital structure is a vital aspect of financial management, shaping a company's ability to survive and succeed in the face of intense business competition. Kristianti highlights that managing capital structure effectively is essential for maintaining operational sustainability, especially when dealing with market fluctuations and varying funding demands. (Kristianti, 2018). Deciding on the ideal capital structure, which involves an appropriate balance between debt and equity, presents a considerable challenge for company management as it significantly influences the cost of capital, risk levels, and financial stability.

Debt-equity mix represents the combination of debt and equity a company uses to fund its operations and investments. In a perfect market environment, The capital arrangement does not influence the firm's worth. (Muliana & Astuti, 2021). In reality, factors such as taxes, bankruptcy costs, and information asymmetry make capital structure a crucial aspect of corporate financial strategy. According to the principles of the Pecking Order Theory, companies tend to prioritize internal funding sources before resorting to external financing through debt or equity. (Abadi & Widana, 2024). Conversely, the Trade-Off Theory highlights the importance of balancing the advantages of debt, such as tax savings, with its drawbacks, such as the risk of bankruptcy. The Capital Structure Theory proposes that surpassing the optimal capital structure may result in a decrease in the company's value.Therefore, determining the appropriate composition and position of the capital structure is crucial to prevent potential reductions in the company's value. This responsibility falls primarily on management. (Muliana & Astuti, 2021)

## 2. LITERATURE REVIEW

### Capital Structure

Capital structure refers to how a company organizes and allocates its financial resources to support its operational and investment activities. It can also be defined as the proportion of debt and equity that constitutes the company's funding. Management is responsible for determining the appropriate composition of the capital structure. The selection of the balance between equity and debt not only impacts financial decisions but also reflects the character and management style of the decision-makers.

Factors that affect the Capital Structure are:

1) Level of Risk, which is the risk that will be faced by the Company as a result of the selection of its debt composition. The higher the debt portion, the higher the risk. This is because the emergence of debt will lead to other obligations, namely debt interest expense.
2) Cost of Capital, which is the cost that arises due to the source of financing chosen by the Company's manager, between equity (Shares) or Debt. If the manager chooses to increase capital from equity, the cost of capital that arises is the return to shareholders. Meanwhile, if the manager chooses debt, the cost of debt will appear in the form of interest. The cost of debt tends to be lower in value when compared to the cost of stock equity. And this will also be related to the risk that will arise.
3) Financing needs, the company's needs in expansion, investment or working capital will determine how much financing is needed. The more needs, the greater the level of financing that must be met. As a company's business scale expands, its financing requirements grow accordingly.

4) Economic Market Conditions, an economy that is in a stable position will be different from economic conditions that are up and down. This condition will affect the interest rate and will ultimately affect the cost of interest or the cost of returns to shareholders.

**Firm Value**

Firm value represents the total value owned by a company and reflects its ability to enhance economic potential through profit generation, making it more appealing in the market. It also represents the extent of investor interest tied to the company's financial achievements. In other words, the greater the company's capacity to improve its economic performance and attract investors, the higher its value becomes.Several methods can be used to calculate firm value, including stock market value, book value, and the discounted cash flow approach. Among these measures, the Price to Book Value (PBV) ratio is the most frequently used indicator to represent a company's worth. PBV measures The amount a company can expand its value in the capital market. A higher stock price correlates with a higher firm value. (Sudirman, Nurmilasari, & Sandi, 2021).

Firm value is a critical concern for owners and shareholders, as it reflects the potential welfare they can achieve. A higher firm value translates to greater benefits for shareholders. (Supeno, 2022). Companies with poor financial performance are typically perceived negatively by the market (investors), leading to a lower valuation. Conversely, strong financial performance elicits a positive market response, resulting in a higher firm value. (Gunarwati, Maryam, & Sudarwati, 2020).

## 3. METHODS

This research is a literature review research using the SRL (Systematic Literature Review) method, which is research that aims to find problem solving by collecting information on scientific articles and other library literature. The approach used is qualitative which explains the phenomenon with a series of descriptions of the results of similar studies. The SLR method is a research method that uses steps to identify, analyze, evaluate and then conclude the conditions and phenomena that occur. And this research examines the research phenomenon by reviewing the results of the research. The initial step is to identify the problem, review scientific articles from the research results, review the relevant theories, then analyze all the information that has been collected to produce conclusions.

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## 4. RESULTS AND DISCUSION

The primary goal of this investigation is to explore the impact of Debt-equity structure on the value of companies in the consumption sector listed on the stock market in Indonesia. By utilizing a qualitative approach through a literature review method, various sources were analyzed to comprehend the relationship between capital structure and Enterprise value. The review uncovered two contrasting viewpoints: some studies highlight that capital structure significantly influences company value, while others argue it has no effect.

Research has shown that incorporating debt into the capital structure can improve a company's value. For example, a study by Febriana et all found that both Financing composition and profitability have a positive influence on Enterprise value, attracting investor attention and contributing to an improvement in the company's overall worth. (Febriana, Djumahir, & Djawahir, 2016). Likewise, Kristianti confirmed that capital structure plays a significant role in shaping a company's financial performance. Achieving an optimal proportion of debt within the financial structure has the potential to enhance investor trust and strengthen the company's market standing. (Kristianti, 2018)

The beneficial impact of capital structure on a firm's value can be understood through several mechanisms. One such mechanism involves the use of debt, which often offers notable tax benefits. In many taxation systems, Interest on debt qualifies for tax deductions, thereby lowering the company's overall tax liability. This reduction enhances net income, ultimately boosting the firm's perceived value among investors. Another mechanism is the signaling effect of debt. When a company opts to incorporate debt into its capital structure, it often conveys a message that management has confidence in the company's future growth potential. This confidence can attract additional investors and lead to an increase in stock prices.

Based on research by Kristianti, it shows that a good capital structure not only increases profitability but also creates financial flexibility. Companies with a balanced capital structure between debt and equity tend to be better able to deal with market uncertainty and take new investment opportunities. Thus, prudent management in managing the capital structure can maximize firm value by taking advantage of growth opportunities while keeping financial risk within reasonable limits. (Kristianti, 2018).

Various studies conducted by researchers frequently use the DER (Debt-to-Equity Ratio) as a proxy for the Capital Structure Variable. The findings generally indicate that DER tends to have a negative impact on Firm Value, implying that an increase in DER leads to a decline in Firm Value. Sudirman et al. highlighted a significant effect of Capital Structure, represented by DER, on Firm Value. They explained that a decrease in DER, caused by an increase in debt, can reduce the Company's ability to generate profits, while also causing debt obligations and interest expenses to accumulate. (Sudirman, Nurmilasari, & Sandi, 2021).

In contrast, Gunawarti et al.'s research found that capital structure does not affect firm value. The capital structure, as proxied by DER, indicates that a higher level of debt does not necessarily increase the company's value. However, if the company has strong or high profitability, variations in the capital structure can be more effective. In this case, the inclusion of debt in the capital structure will not negatively impact the company's value. This suggests that profitability may act as a mediator between capital structure and firm value. (Gunarwati, Maryam, & Sudarwati, 2020). Therefore, if a company intends to increase its debt in the capital structure, it must maintain strong profitability to manage the associated costs and risks effectively.

In addition to the DER proxy, some studies also utilize the Long-term Debt to Equity (LDE) and Long-term Debt to Assets (LDA) proxies for capital structure variables. Research by Putri and Ruzikna, which used LDE and LDA as proxies, found a positive relationship between both LDE and firm value (measured by Market to Book Ratio, MBR), as well as between LDA and MBR. This indicates that as the values of LDE and LDA increase, the MBR value also rises. (Putri & Ruzikna, 2016). Therefore, if a company aims to improve its market-to-book value, it could focus on increasing its LDE or LDA.

The proportion of equity and debt established by the company significantly influences its value. Effective management decisions in balancing equity and debt levels play a crucial role in shaping the firm's value. A higher firm value enhances the company's ability to achieve its objectives, such as maximizing shareholder wealth and attracting potential investors. (Dwilita & Chairani, 2023)

## 5. CONCLUSION

The literature review indicates that capital structure has a significant impact on firm value, with both positive and negative effects. Incorporating debt into the capital structure has been shown to provide tax advantages, improve profitability, and signal positively to investors. This implies that effectively managing the debt-to-equity ratio can contribute to an increase in firm value. However, there is also the potential for the capital structure to negatively affect the company's value. A greater level of debt could result in higher financial obligations, which may reduce the company's overall value.

## LIMITATION

This literature review has limitations in the separation of research objects, it could be that the research results will be different in sectors in the Indonesian Capital market. In addition, there is no in-depth study of the main theories on Capital Structure and Firm Value.

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