Chapter 5
The Importance of Financial Theories for SME Capital Structure Decisions

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ABSTRACT

This chapter aims to analyze the importance of financial theories for SME capital structure decisions. The financial theories considered for this study were trade-off theory and pecking order theory. From the various empirical evidences researched in the Web of Science and Scopus database, it was found that most SME capital structure decisions follow the financial theory of hierarchical hierarchy, that is, the SME finance their investment opportunities through retained earnings, debt issuance, and finally stock issuance.

INTRODUCTION

Corporate finance management has received special attention in the academic field in general. In recent years, this focus has been on SMEs, given their important role in the growth of any economy and job creation. According to Daskalakis, Eriotis, Thanou, and Vasiliou (2014) SMEs account for 99.8% of all enterprises in Europe.

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Several studies (Daskalakis et al., 2014; Huang, Boateng, & Newman, 2016; Sharma, Kumar, Yan, Borah, & Adhikary, 2019) highlight that SMEs face many difficulties in accessing finance for large companies as they are considered to be riskier. There are several theories that have been studied in corporate finance.

The promoters of the studies on corporate capital structure decisions were Modigliani and Miller (1958), from which came several other important studies on the subject, mainly concerning the determination of the main factors that influence the capital structure of companies.

To this end, two financial theories have been extensively studied when it comes to corporate capital structure, namely Trade-Off and Pecking Order theories, respectively (Kim, 1978; Modigliani & Miller, 1963; Myers & Majluf, 1984; Serrasqueiro & Caetano, 2015).

Trade-off theory argues that companies seek to achieve an optimal debt ratio in which tax benefits are maximized with very low bankruptcy costs, while Pecking Order theory argues that there is no optimal capital structure and that companies follow a hierarchical order in the financing of their investment opportunities, starting preferentially with internal resources from retained earnings, culminating with external equity, specifically the issuance of shares which, in the case of SMEs, can be a very viable route, rare for not being listed or for the preservation of property, ie, to avoid dilution of a wealth of former shareholders (Myers & Majluf, 1984; Serrasqueiro, Nunes, & Armada, 2016; Shyam-Sunder & Myers, 1999).

Therefore, the fact that most SMEs are unlisted makes them more difficult to finance their investment needs using capital markets, such that SMEs are usually financed by the bank-based financial system (debt) (Müller & Zimmermann, 2009; Serrasqueiro et al., 2016).

The present study aims to analyze the importance of the main financial theories on capital structure decisions of SMEs, which is the class of companies that have contributed significantly to economic growth. Although the problem of capital structure has increased the interest of researchers, most previous studies focus more on determining the factors that may affect the capital structure of SMEs. There are few studies that address the importance of theories adopted by SMEs in making capital structure decisions. The article presents the following structure in addition to an introduction, section two presents the methodological procedures used in the study. Section three deals with financial theories and their evolution. Section four looks at the capital structure and section five present the final considerations.

METHODOLOGY

The present study followed a qualitative methodology, through content analysis, since it is an instrument that allows the researcher to study human behavior indirectly, through the analysis of their communications (Fraenkel & Wallen, 2008). For Gray (2004), with the evolution of new technologies, namely the tools of Web 2.0, the sources of communications are increasingly diverse. Blogs (posts and comments), wikis, online communities and 3D virtual environments, for example, are increasingly being investigated and, consequently, their contents are subject to analysis. Thus, the content analysis considers the articulation between the description and analysis of the described text, and the logical deduction of the factors that determined the characteristics of the characteristic elements (Bardin, 2004).

Thus, placing the focus of attention on the objectives of the study and the theoretical framework, the content analysis was carried out through a series of steps. Based on the authors Bardin (2004), Pardal and Correia (1995) and Carmo and Ferreira (2008), the following phases were established: definition