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Managers vs. students: new approach in analyzing current practices in capital structure management education

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1. Abstract

According to Graham and Harvey (2001), an immense gap exists between capital structure theories and practice. This paper argues that this can be partially explained by current educational practices by analyzing undergraduate students' perceptions of capital structure theories and the differences between their opinion and that of the current CEO's and managers. Educators mostly focus on one or maybe two most popular theories and students have much smaller knowledge about other theories. Secondly educational practices favor trade-off theory to asymmetric information based theories. The paper provides some suggestions regarding capital structure education and future research.

4. Capital Structure Facts

Phenomenon	Relationship with theory
Negative correlation between debt and profitability	Contradicts trade-off theory
Negative correlation between expected bankruptcy costs and debt	Consistent with trade-off theory
Negative share price reaction on equity issues	Consistent with pecking-order theory
Firms do not always follow pecking order	Contradicts pecking-order theory
Share price does not react to debt issues	Contradicts signalling theory
No relationship between managerial ownership and performance	Contradict agency theory
Better operating performance after equity issue, long-term decline	Not consistent with theory
Small and risky firms issue equity	Consistent with flexibility theory

5. Educational practices

- A typical textbook covers Trade-off Theory
- Pecking-order theory is briefly covered.
- Mere mention of other theories such as *Agency costs, Signaling, Debt and Discipline,*
Financing Flexibility, Firm Life Cycle and Capital Structure, Corporate Culture and Capital Structure
- Instructors usually talk about Trade-off theory and can mention without details Pecking-order theory

2. Capital Structure Basics

A Firm Balance Sheet

Assets	Liabilities & Equity
Short-term assets	Short-term debt
Fixed assets	Long-term debt
	Preferred Stock
	Common Equity

3. Capital Structure Theories

- Trade-off theory
- Pecking-order theory
- Signalling
- Agency cost
- Debt and discipline
- Financing flexibility
- Life cycle theory
- Corporate culture and capital structure

6. Managerial View

Factors that determine a firm's capital structure:
Financial flexibility
Credit rating
Earnings and cash flow volatility
Insufficient internal funds
Level of interest rates
<u>Interest tax savings</u>
Transaction cost and fees
Equity misvaluation
Comparable firm debt levels
<u>Bankruptcy/distress costs</u>

Managers do not support theory!

9. Managers versus Students

- In contrast to managers students mostly talk about trade-off theory and pecking-order theory. Educators should focus more on other theories
- Students talk about trade-off theory more often than about pecking order however they often do not support the trade-off theory. Educators should have a better balance between trade-off theory and pecking order
- Best students seem to understand better asymmetric information, so educators should find the way to teach asymmetric information better and in a more practical way.

7. Students' perception of capital structure

Theory	Supports/used	Supports/Theory not Applicable to firm	Supports/not used by managers	Does not support/used	Does not support/not used	Misunderstanding	No Opinion
Trade-Off Theory	10	6	80	3	31		7
Cost of Distress	50	-	26	2	14		2
Asymmetric Information	98	16	68		20	9	29
Pecking Order Theory	13	2	33	2	2	3	20
Signalling	60	6	21	1	3	2	9
Agency Cost	97	25	5		46		25
Risk shifting (asset substitution)	7	12	4		37	5	63
Debt and Discipline	55	15	7	3	96		63
Life Cycle Theory	57	8			83		50
Firm Flexibility	76	-	50		9		44
Comparable firms	2				1		120

8. Best Students

Theory	Supports/used	Supports/Theory not Applicable to firm	Supports/not used by managers	Does not support/used	Does not support/not used	Misunderstanding	No Opinion
Trade-Off Theory	3	1	13	4	14		
Cost of Distress	2	1	15		13		3
Asymmetric Information	18	2	10		5		
Pecking Order Theory	13	1	6		4		1
Signalling	10	1	5		1		1
Agency Cost	2		5		19		6
Risk shifting (asset substitution)	1			2	11		18
Debt and Discipline	1	1		2	14		15
Life Cycle Theory	2		1		20		2
Firm Flexibility	27		3		1	1	1
Comparable firms	4				5		26

10. CONCLUSION

An immense gap exists between theories and practice: educators mostly focus on one or maybe two most popular theories (Trade-off theory and Pecking order theory).
Educators focus on theory not practice
Big differences exists in the researchers' opinion: educators exaggerate the theoretical role of trade-off theory
Different opinions regarding future work: existing asymmetric information theories are not sufficient.

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