The Effect of Firm Size, Investment Opportunity Set, and Capital Structure on Firm Value

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Abstract

The purpose of this study was to examine how business size, investment opportunity set, and capital structure all affect the value of the company. Explanatory research was conducted for this study, which used secondary data in the form of financial statement data from companies in the banking sector listed on the Pakistani Stock Exchange for the ten years 2010–2019. Twenty-seven businesses were selected for the samples throughout the previous ten years using the purposive sampling technique. The AMOS application and the path analysis approach were both employed in this investigation. The findings of this study revealed that firm size and opportunity to invest set had a significant impact on firm value, whereas capital structure had no impact on firm value. This research suggests that investments, particularly in the banking sector, should have a solid foundation. Additionally, it is essential to evaluate several factors for listed firms, such as the size of the business and the range of investment opportunities, as it has been demonstrated that these factors can greatly increase a company's worth. Because it had no impact on the firm's value, the capital structure should be determined in the interim.

Keywords: *Firm size, Investment Opportunity Set, Capital Structure, Firm value*

Introduction

The increase of firm value is not only influenced by internal factors but also external factors (Martín-Reyna, Manuel, & Durán-Encalada, 2012). Internal factors consist of the owner of the company, management capabilities, and the strength of the company's capital. The owner of the company has an important role in company operations, especially in making policies related to efforts to improve and progress in the future (Frederica, 2019; Sudiani & Wiksuana, 2018). In increasing firm value, management must also plan operations and implement the maximum work plan to achieve the company's goal to get the maximum profit (Martín-Reyna et al., 2012). In increasing firm value, the company not only requires policies that are controlled by the owner and the implementation of planning from management but also must be supported by adequate capital strength (Kumar, Sureka, & Colombage, 2020). The external factors include firm size, investment opportunity set, and capital structure influence the firm value as well (Martín-Reyna et al., 2012). Firm size is the scale of the company as measured by the small value of its assets, an investment opportunity set is a group of investments that are combined in the form of fixed assets that are calculated to increase the value of the company (Michalski, 2008), while the capital structure is long-term corporate financing (Eka, 2018; Sudiani & Wiksuana, 2018). These external factors are the important points that are described in this paper.

Studies on the relationship between firm size, investment opportunity set, and capital structure in relation to firm value tend to regard as a linear relationship (Eka, 2018; Sardo & Serrasqueiro, 2018), ignoring nonlinear relationships that occur within companies, including in the banking industry (Belghitar & Khan, 2013; Hutchinson & Gul, 2004; Martín-Reyna et al., 2012). Many firm size studies have investigated only the size of sales growth and overall capital, and even only analyzing the number of employees (Eka, 2018; Frederica, 2019; Martín-Reyna et al., 2012). These studies assume that if sales growth has increased, it can indicate a healthy(Hutchinson & Gul, 2004). Likewise, (Suhadak, Kurniaty, Handayani, & Rahayu, 2018) the Investment opportunity set has been studied a lot, but it discusses only policy issues. Policy as shown has become a determining factor in observing financial policy (Chakraborty, Gao, & Sheikh, 2019). On the other hand, finance is also the main factor in the success of the company (Husna & Satria, 2019). This study has implications for the widespread discussion about the dependence of companies on financial policies. Accordingly, (Sudiani & Wiksuana, 2018) the capital structure

study has also reviewed financial policies related to the use of long-term debt in achieving company growth. However, these existing studies ignore firm size, investment opportunity set, and capital structure which are associated with firm value as well (Chabachib, HERSUGONDO, Septiviardi, & Pamungkas, 2020).

Significance of the study

This present study is intended to complement the shortcomings of previous studies regarding the effect of firm size and investment opportunity set as well as capital structure on firm value by investigating how these three aspects affect firm value. Correspondingly, three questions are answered in this study: (a) how the firm size affects firm value; (b) how the investment opportunity sets affect firm value, and (c) how the capital structure affects firm value. This study assumes that capital structure, firm size, and investment opportunity set have a direct effect on firm value, the size of the company is in line with high investment and a good capital structure gives rise to firm value. The investment opportunity set originating from the investment pool can lead to the large value of the company's assets as well as the capital structure that prioritizes financing using long-term debt so that in the end the value of the company can increase. When the size of the company and the amount of investment opportunity are set, the capital structure can be improved so that the value of a company will increase.

Literature Review

Firm value

According to (Berger & Ofek, 1995), firm value is how investors view a company, and high stock prices increase firm value. However, the market will have more faith in the company's prospects if the price to book value is high. (Hiraki, Inoue, Ito, Kuroki, & Masuda, 2003). Companies use annual reports to provide critical business and financial information to shareholders, clients, staff, and the media (Zhang, Gupta, Sun, & Zou, 2020). A crucial component of a financial communication plan to draw in and keep investors is an annual report. The percentage of income that can be directly linked to a company's main business operations is referred to as the quality of earnings (D'Amato & Falivena, 2020). Numerous studies describe the connection between profit and investment choices as well as the techniques and strategies used to assess how well a company's earnings are made (Belghitar & Khan, 2013; Lumapow & Tumiwa, 2017; Sudiani & Wiksuana, 2018). In essence, the financial statements contain parts of the income statement that give crucial details about the company's level of profit; for stakeholders

and investors, earnings data serves as the foundation for decision-making (Lumapow & Tumiwa, 2017). Because it will serve as one of the standards for investors to gauge the company's financial performance from year to year, firm value is a crucial factor for the business (Husna & Satria, 2019). Since investors' opinions of a company may be seen in the movement of its stock price, a company should aim for a significant increase in firm value over the long term, which is reflected in its stock market price (Suhadak et al., 2018).

High firm value can increase prosperity for shareholders so that shareholders invest their capital in the company (Hutchinson & Gul, 2004). Several factors, including effective corporate governance, affect a company's value. Corporate governance is a framework that governs and holds corporations accountable for creating and enhancing corporate value for their owners (Belghitar & Khan, 2013).

Maximizing an enterprise's value is its primary financial goal (Martín-Reyna et al., 2012). The achievement of this essential goal should also benefit from operating cycle management. Focusing on risk and uncertainty, the enterprise value development approach is put into practice (Suhadak et al., 2018). This study discusses the effects on the company of changes in the operating cycle and operating risk, as well as the benefits of employing factoring as a tool to shorten the firm's goal operating cycle and reduce risk as a result of factoring (Michalski, 2008).

Firm size

A company's size is categorized based on its total assets and total equity, and this is known as its firm size. When a company's size is expressed in terms of total assets, it signifies that the more assets it has, the larger it is and the more value it generates (Naceur & Goaied, 2002). When a firm has a lot of total assets, it shows that it is in a somewhat more stable situation and can make more money than a company with a small number of total assets (Lumapow & Tumiwa, 2017). Large total assets are an indication that a company has matured to the point where it generates positive cash flow and is thought to have promising prospects for a considerable amount of time (Hasanuddin et al., 2021). Additionally, it shows that, compared to businesses with little total assets, the company is more reliable and capable of making a profit. Theoretically, larger businesses have more assurance than small businesses, which lowers the level of uncertainty over the business's prospects. (Martín-Reyna et al., 2012).

The size of the business can be determined by the total amount of assets owned. A company's management is more adaptable in how it uses its current assets if its total assets are substantial. The degree of freedom management enjoys reflects how concerned owners are about their property. When viewed from the standpoint of the firm owner, a lot of assets lower the worth of the business (Neves, Serrasqueiro, Dias, & Hermano, 2020). However, when evaluated from the management perspective, the simplicity with which it can oversee the business raises the company's value.

(Martín-Reyna et al., 2012) looked at a sample of 83 listed Mexican companies from 2005 to 2011. By demonstrating a negative association between performance and both the board of directors and leverage when there are growth prospects, the results support the significance of debt and the board of directors in terms of firm market value. In contrast, (Bevan & Danbolt, 2002) when businesses lack viable investment initiatives, the link between debt and performance turns positive. The findings also show that the impact of controlling shareholders on firm value varies depending on whether a company has prospects for expansion. Our findings, therefore, demonstrate that the degree of leverage, the board size, and composition, as well as ownership structure, have a dual impact on performance (increasing or decreasing firm value) and influence whether the firms perform well.

H1: The firm size has a positive effect on firm value.

Investment Opportunity Set

The creation of the Investment Opportunity Set (IOS), describes how a corporation is made up of both real assets and potential future investments (Hutchinson & Gul, 2004). IOS is an investment choice that combines assets already owned with a preference for future growth with a positive Net Present Value (NPV) (Adam & Goyal, 2008). IOS is a choice to invest in a project that has a positive net present value, whereas growth is the company's capacity to expand its size (Hutchinson & Gul, 2004). According to (Eka, 2018) IOS is a firm value whose amount depends on the expenses decided upon by management in the future, which at present time is a financial choice that is anticipated to yield a higher return.

The range of investment opportunities for businesses is described in the Investment Opportunity Set (Kallapur & Trombley, 2001). High-growth companies are frequently referred to as having abundant investment prospects (IOS). This encourages the managerial side to make significant

new investments. IOS serves as the foundation for forecasting future business growth. IOS's worth is dependent on upcoming discretionary spending (Dalbor & Upneja, 2004). IOS may also have an impact on how creditors, owners, investors, and management see the business. Companies with strong potential for growth are seen to be able to produce high profits. (Chabachib et al., 2020) indicated that a high IOS directly correlates with a high accrual of discretionary funds. According to (Hutchinson & Gul, 2004) IOS and discretionary accruals, managers of organizations with large investment prospects frequently manipulate discretionary accruals, which lowers the quality of the results.

Investment is the activity of investing money into particular assets by investors to receive a better return than what was first given up. The time when funds are spent, the anticipated rate of inflation, and the uncertainty surrounding future payments. Money investments are made to earn future payments that compensate investors for these factors. Governments, businesses, or private individuals may invest in the interpretation (Hossain, Cahan, & Adams, 2000).

The value of the company is based on the present value of the income generated by the assets owned and the opportunity to make additional investments in real assets that produce a rate of return that is more than normal returns (Dehning, Richardson, & Stratopoulos, 2005). IOS is a component of firm value derived from choices to make investments in the future. Temporary IOS explains that the value of IOS depends on future management expenditures and is currently expected to provide a greater return than the cost of capital (Adam & Goyal, 2008).

H2: IOS has a positive effect on firm value.

Capital Structure

The financing of equity and debt in a firm is called the capital structure (Bevan & Danbolt, 2002). According to (Frank & Goyal, 2009), the deployment of the financial management function can help the organization achieve its aim of optimizing firm value because every financial decision made affects other financial decisions and the firm value as well (Chabachib et al., 2020). The composition of the use of debt and equity is reflected in the capital structure (Sudiani & Wiksuana, 2018). The use of debt is termed financial leverage, the debt in question is debt for company funding that is not always the same as liabilities and is not the same as receivables (payable). The debt incurs an interest expense that can save taxes. This means that the interest expense can be deducted from income so that the profit before tax becomes smaller and

consequently the tax is getting smaller (Kumar et al., 2020). Meanwhile, if the funding uses equity, no burden can reduce corporate taxes.

Another way to think about capital structure is as a comparison or balance between the amount of long-term debt and the company's capital (Sudiani & Wiksuana, 2018). To maximize the prosperity of the firm's shareholders, financial managers must be aware of the elements that affect the capital structure because it directly affects the financial condition of each organization. The best capital structure is one that uses capital efficiently and/or has a low average cost of capital to increase company value (Frank & Goyal, 2009).

The capital structure is a type of long-term financing made up of shareholder equity, preferred shares, and debt. Ordinary shares, paid-up capital, surplus capital, and accumulated retained capital make up the book value of shareholder capital. The shares are added to the shareholder's capital if the corporation possesses preferred stock (Bevan & Danbolt, 2002).

H3: Capital structure has a positive effect on firm value

Research Method

The population of this research is all banking industry companies listed on the Karachi Stock Exchange (KSI) and the completeness of their data can be accessed and consistency in financial reporting during the study period of as many as 35 companies. The sample used in this study was purposive sampling. The criteria are as follows: 1) banking industry companies listed on the KSI; 2) banking industry companies routinely presented and publish financial reports in succession for the last 10 years starting from 2010 to 2019; 3) banking industry companies whose shares are actively traded on the KSI during the study period, 4) banking industry companies have complete data related to the variables used in the study.

The data used are financial reports related to firm size, audit committee, investment, business risk, earnings quality, capital structure, and firm value or share price published annually from 2010 - 2019 from the Pakistani Stock Exchange. The data is analyzed using AMOS software.

Findings

Table 1 showed the frequency distribution of firm values from the year 2010 to 2019. Most of the banking industry companies on the Pakistan Stock Exchange Tobins' Q have a ratio of> 1, meaning that the conditions owned by the banking industry are healthy, so they can attract investors because this industry is attractive. However, the consequence of this industry is that it

must expand to maintain the ratio value so that it remains Tobins'Q> 1. Thus, the banking industry has strong growth in the future, because the existing ratio value is not too low, close to the value of 1. The descriptive analysis found that the value of the company with the lowest Tobins'Q proxy (minimum) was 0.83 percent and the highest (maximum) was 6.56 percent, and the average value (mean) was 1.12 percent.

Table 1: Frequency distribution

Evidence	Frequency distribution (amount and percentage)										Total
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	
Below 1%	6	4	6	11	8	13	12	12	13	15	100
	22%	15%	22%	41%	30%	48%	44%	44%	48%	56%	37%
1.00 % to 1.50%	18	21	19	16	17	14	14	14	13	11	157
	67%	78%	70%	59%	63%	52%	52%	52%	48%	41%	58%
1.51 % to 2 %	1	1	1	0	2	0	1	1	1	0	8
	4%	4%	4%	0%	7%	0%	4%	4%	4%	4%	4%
above 2%	2	1	1	0	0	0	0	0	0	1	5
	7%	4%	4%	0%	0%	0%	0%	0%	0%	4%	2%
Total	27	27	27	27	27	27	27	27	27	27	270
	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

Description of the size of the company variable as generated by the value of total assets, then the frequency distribution can be seen in Table 2.

Table 2: Description of the size of the company variable

Evidence	Frequency distribution (amount and percentage)										Total %
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	
Below 100 billions	19 70%	19 70%	17 63%	17 63%	16 59%	16 59%	16 59%	15 56%	15 56%	13 48%	163 60%
101 Billions to 500 billions	8 30%	7 26%	8 30%	8 30%	8 30%	7 26%	7 26%	8 30%	8 30%	10 37%	79 30%

501 billions to 1 trillion	0	1	2	2	3	4	2	2	2	2	20 7%
	0%	4%	7%	7%	11%	15%	7%	7%	7%	7%	
above trillion	10	0	0	0	0	0	2	2	2	2	8
	0%	0%	0%	0%	0%	0%	7%	7%	7%	7%	3%
Total	27	27	27	27	27	27	27	27	27	27	270
	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

Table 2 showed the total assets below 100 billion PKR was very dominant and grew from 2010 to 2019, because from year to year the figure was below 100 billion PKR, the percentage was decreasing, meaning that some companies had asset growth that could exceed the amount above 100 billion PKR. This has a positive effect on management and employees because psychologically they feel more comfortable working in a large company than in a small company. Then the creditors, especially banks, trust companies with large asset values more than companies with small asset values.

Table 3: Description of the Investment Opportunity Set (IOS) variable

Evidence	Frequency distribution (amount and percentage)										Total (%)
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	
below 1%	6	4	6	11	14	14	15	13	13 48%	15	111
	22%	15%	22%	41%	37%	52%	56%	48%		56%	40%
1,00 % to 1,50%	1	7	5	3	8	8	7	2	6	4	51
	4%	26%	19%	11%	30%	30%	26%	7%	22%	15%	19%
1,51 % to 2 %	4	5	5	4	2	2	1	6	2	2	33
	15%	19%	19%	15%	7%	7%	4%	22%	7%	4%	12%
above 2%	16	11	11	9	3	3	4	6	6	6	75
	59%	41%	41%	33%	11%	11%	15%	22%	22%	22%	28%
Total	27	27	27	27	27	27	27	27	27	27	270
	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

Table 3 explained the investment ratio owned by the banking industry is quite high, where the value of the ratio above 1 percent indicates a stable number because generally a good ratio is a ratio that is close to number 1 or above number 1, then in the same year several companies indicate a ratio above 1.00 - 1.50 percent. This means that investments made by companies show

strong growth stability on the premise that growing companies have a higher level of investment activity. Along with the development of the comparison between the stock market value and the level of capital (equity) from 2010 - 2019, there are even several companies that have ratios above 2 percent.

Table 4: Description of the capital structure variable

Evidence	Frequency distribution (amount and percentage)										Total (%)
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	
below 5%	1	2	2	1	3	8	12	9	11	24	73
	4%	7%	7%	4%	11%	30%	44%	33%	41%	89%	27%
5,00 % s/d 10,00%	19	15	20	19	18	14	12	14	11	3	145
	70%	56%	74%	70%	67%	52%	44%	52%	41%	11%	54%
10,01 % s/d 15 %	6	9	5	7	6	4	3	4	5	0	49
	22%	33%	19%	26%	22%	15%	11%	15%	19%	4%	19%
above 15%	1	1	0	0	0	1	0	0	0	0	3
	4%	4%	0%	0%	0%	4%	0%	0%	0%	0%	1%
Total	27	27	27	27	27	27	27	27	27	27	270
	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

Table 4 showed that from 2010 to 2019, the capital structure is quite optimistic because the comparison of the use of debt can be balanced with their own capital financial executives state that an optimistic capital structure has a certain value range. In the table above, the highest frequency component is in the range of 15 percent, meaning that the value shown is still far from the range value in general. This means that the high use of debt is also balanced with the willingness of own capital to finance interest and taxes that are accumulated with the use of corporate debt (HASANUDDIN et al., 2021; Husna & Satria, 2019).

Discussion

In testing the hypothesis, the researcher compared the T count which was generated by the critical ratio with the t Table. The significant level can be seen in Table 5

Table 5: Hypothesis test results

Variable			Estimate	S.E.	C.R.	P	Label
Y	<---	X1	2487292.852	1251376.653	1.988	.047	Significant
Y	<---	X2	.250	.066	3.760	***	Significant
Y	<---	X3	.093	.067	1.394	.163	Not significant

The Effect of Firm Size on Firm Value

The test results in table 5 are explained at the probability or significant level of 0.047 indicating that firm size has a positive effect on firm value. This implies that the firm value rises as the firm size does, and vice versa. The claim that a corporation's assets grow in proportion to its size and that a company needs more money to continue its operational activities supports this fact. Additionally, management will consider the company's size when determining the type of financing to use to maximize firm value. Larger companies find it easier to access the capital market in obtaining greater funding for their companies so that they company able to have a higher dividend payout ratio than small companies, this is supported by (Lumapow & Tumiwa, 2017; Sudiani & Wiksuana, 2018) that large companies have large funding operations for optimizing the value of the company.

The Effect of Investment Opportunity Set on Firm Value

The test results in table 5 are explained at the probability or significant level of 0.000 indicating that the investment opportunity set influences firm value. This means that the greater the investment opportunity set, the higher the firm value, and vice versa. This finding is supported by the argument that, the Investment Opportunity Set shows a positive relationship to firm value. It may be possible that companies that invest a lot tend to have assets that increase over time or increase great wealth. Companies that get bigger always increase according to the investment value which is always in line with the current economic value and can create positive sentiment from investors, so that the stock price can ultimately increase the firm value. This supports the

statement from (Kusuma et al., 2021; Syahrir et al., 2021) which state that the investment value has increased occasionally.

The Effect of Capital Structure on Firm Value

The test results in table 5 are explained at the probability or significant level of 0.163, indicating that capital structure does not affect firm value. This means that the increase and decrease in capital structure do not affect firm value, because in deciding the company's capital structure policy, a financial manager always considers the use of equity and debt instruments to run his business where debt can make the growth of a company small. Debt makes the profit earned by the company less and less because it is used to pay loan interest (Chakraborty et al., 2019). Thus, if the company uses a large capital structure, it can cause high-interest costs and inhibit the increase in firm value. This is supported by research conducted that the high use of debt can increase interest expense which can reduce firm value (Ibhagui & Olokoyo, 2018; Lumapow & Tumiwa, 2017; Martín-Reyna et al., 2012; Sudiani & Wiksuana, 2018).

Conclusion

The study's findings confirm that business size affects firm value. This result is in line with earlier studies. Therefore, it is expected that management will develop or extend the business to enhance asset value by expanding or developing business units. The bigger the company, as measured by asset value, the greater the firm value. The study's findings provide evidence that the Investment Opportunity Set affects firm value. This result is consistent with research showing that investment choices significantly increase firm value (Chabachib et al., 2020; Eka, 2018).

The study's findings confirm that capital structure has an impact on a company's worth. All of this is consistent with the findings (Kumar et al., 2020; Martín-Reyna et al., 2012; Neves et al., 2020). This occurs as a result of managers' use of debt as a more trustworthy signal to investors, where companies that increase debt might be perceived as being optimistic about the company prospects. Therefore, the use of debt is a message or a signal from the company that might persuade investors that the value of the company's shares is greater than the value reflected on the company's balance sheet, resulting in a high price book value for the company as well as a high firm value.

Recommendations

It is recommended that potential investors consider the capital structure factor before investing because sometimes companies that have a high capital structure can burden the company and consider the Investment Opportunity Set variable that can increase growth and increase share prices.

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