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Testing pecking order prediction from the viewpoint of managerial optimism: Some empirical evidence from Taiwan ☆

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Abstract

In this paper we examine the relation between managerial optimism and corporate financing decisions by empirically testing Heaton's [Heaton, J., 2002, Managerial optimism and corporate finance, Financial Management 31, 33–45.] model. Heaton showed that, besides information asymmetry, managerial optimism can also lead to pecking order preference in financing decisions. We test whether pecking order preference performs better when managers are more optimistic. Our measure of managerial optimism is constructed from management earnings forecasts. Managers are more likely to issue forecasts that are higher than the realized earnings when they are optimistic in their assessment of future outcomes. Using listed Taiwanese companies as our sample, we find that optimistic CEOs exhibit a stronger relation between debt issue and financing deficit, when compared with non-optimistic ones. These findings are consistent with the predictions of Heaton's model.

JEL classification: G32
Keywords: Financing decisions; Managerial optimism; Management earnings forecasts; Pecking order theory

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1. Introduction

The pecking order theory of financing decisions is one of the most well-known theories of corporate finance. Pioneered by Myers (1984), *pecking order* refers to managers' preferences for funding sources to cover their financing needs. Managers prefer internal to external financing, and, when internal funds are inadequate, debt financing is preferred to equity financing. Various empirical studies also have provided evidence that is consistent with managers' pecking order preference.[1]

A more controversial question is what drives the pecking order. Myers (1984) suggested that the pecking order preference arises because of the information asymmetry problems between firms and the capital market; subsequent work has provided mixed evidence of this view (e.g. Frank and Goyal, 2003; Helwege and Liang, 1996; Leary and Roberts, 2005; Shyam-Sunder and Myers, 1999). Recent theoretical proposals have advanced alternative explanations of the pecking order such as agency costs (e.g., Myers, 2003), taxes (e.g., Hennessy and Whited, 2005), and managerial optimism (e.g., Heaton, 2002). However, the corresponding tests have yet to be explored, as noted in the most recent survey by Frank and Goyal (2005). In a somewhat similar influential field study, Graham and Harvey (2001) provided some supporting evidence of the pecking order, arguing that "the preference [of the survey executives] for pecking-order-like behavior might be driven by managerial optimism" (p. 219).

This paper attempts to fill a gap in the literature by testing managerial optimism (which describes a manager's subjective belief that a firm's future performance is brighter than it actually is) as an alternative explanation for pecking order preference. We use financial data to examine empirically the extent to which managerial optimism provides a satisfactory explanation for external financing decisions. To the best of our knowledge, this paper is the first empirical study outside the United States to focus on the relation between managerial optimism and financing decisions.

Our testing is based on Heaton's (2002) theoretical work, which shows that pecking order preference can be induced by managerial optimism. The rationale for pecking order preferences depends on the extent of the undervaluation by the market from the managers' perspective. The required returns of risky securities reflect the capital market's expectation of good versus bad firm performance. Optimistic managers, however, systematically overestimate the probability of good firm performance compared with the capital market's outlook and perceive that the market undervalues their firms. Riskier securities are more sensitive to managers' probability beliefs and thus, tend to be more undervalued by the market. Therefore, optimistic managers prefer to rely on internal funding rather than issue risky security to finance their needs. When these internal funds are not forthcoming, they choose debt financing first over equity and, eventually, exhibit a pecking order preference in the financing policies.

We use a specification developed by Shyam-Sunder and Myers (1999) to test pecking order preference by examining the sensitivities between net debt issues and financing deficits, defined as real investments and dividend commitment less internal funds. The driving force now becomes managerial optimism. We conduct comparative tests to see whether the pecking order hypothesis performs better in the case of optimistic managers. The testable hypothesis, therefore, is whether

[1] For example, tests of capital structure theory (e.g., Fama and French, 2002; Frank and Goyal, 2005; Friend and Lang, 1988; Rajan and Zingales, 1995; Titman and Wessels, 1988) have typically found that profitable firms, which have more internal funds, use less leverage. Studies that provide more direct evidence (e.g., Lemmon and Zender, 2004; Shyam-Sunder and Myers, 1999) have also found that managers' choice of financing method are consistent with the pecking order.