Pecking Order Theory and Financial Management in the Context of Higher Education: A Study of Makerere University Business School in Uganda

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Abstract
This study explored the applicability of the pecking order theory in the management of finances at Makerere University Business School (MUBS) in Uganda. The study was prompted by the persistent complaints from different stakeholders about the inability (or unwillingness) of the Institution to raise sufficient funds for its activities despite the many existing avenues for resource mobilisation. The study took the interpretive and narrative design in which secondary data were collected through literature search and desk study methods while interviews were used for primary data. Study results revealed that MUBS has restricted sources of funds; considers to a large extent the cost of generating revenue in making its financial decisions; and operates under a strict credit policy that restricts the contracting of long term debts as its means of revenue generation. It was thus concluded that the legal framework under which MUBS operates disadvantages it when it comes to revenue generation, but to a large extent, MUBS’ managers apply the pecking order theory in making their financial decisions. Therefore, the researcher recommends that, the legal framework within which higher education institutions operate in Uganda needs to be revisited to expand the spheres within which the institutions can raise their revenues. Besides, the managers of higher education institutions should prudently apply the pecking order theory in order to bolster the institutions against unfavourable costs accruing from revenue generation.

Keywords: Pecking order, theory, model, financial management, higher education

Introduction
World over, sound financial management is at the core of every organisation. However, managing finances effectively in any organisation - large or small – is a daunting task even to the most accomplished managers. Nonetheless, many believe that a judicious selection and application of relevant theories would ease the practice of financial management in any work organisation. The example of the pecking order theory (or model) may suffice in the case of financial management in
higher education institutions. In this study, the author explored the applicability of the pecking order theory in the management of finances at Makerere University Business School (MUBS) in Uganda. The study was prompted by the persistent complaints from different stakeholders about the inability (or unwillingness) of the Institution to raise sufficient funds for its activities despite the many existing avenues for resource mobilisation. In this section, the author presents the background to the study, the study objectives and guiding research questions.

Historically, the pecking order theory (or model) was originally postulated by Donaldson in 1961. However, it was modified by Stewart C. Myers and Nicolas Majluf in 1984 (Wikipedia, 2016). According to Jibran, Wajid, Waheed and Muhammad (2012), the theory states that companies (or organizations) often prioritise their sources of financing according to the cost of raising funds. According to the theory therefore, every organisation – large or small - would often prefer to finance its activities - first with its own internally generated funds (internal financing). However, if its own retained earnings are depleted (or becomes insufficient), then the second preferred option of financing is debt (or borrowing). But of course, the cost of debt financing is often higher than that of internal financing due to the interests charged on loans and other associated costs of borrowing. The theory adds that if the firm (or organisation) discovers that it can no longer raise sufficient funds through borrowing, then it can then raise equity (or sale shares) as a financing means of last resort. However, raising equity is considered most costly because it involves bringing to the firm new shareholders (or business owners). Therefore, if a firm (or organisation) is profitable or financially viable, Chen and Chen (2011) contend that it would always prefer internal financing rather than taking up new debts or equity. This scenario thus prompted the researcher to ask: What are the commonest ways of raising funds in a higher education institution such as MUBS? Do managers of MUBS prioritise their sources of finance basing on the cost of raising funds through different means? In short, are they applying the pecking order theory in making their financial decisions? It is the search for answers to these kinds of questions that prompted the need for this investigation. The researcher wanted to establish whether members of top management of MUBS apply the pecking order theory when deciding on how to raise funds for financing the different activities of the School.

Several scholars have already investigated the applicability of the pecking order theory in different countries and contexts. Many of the scholars have alluded to the fact that the pecking order theory is one of the most influential theories of corporate finance. Some report that up to about 75 percent of organizations worldwide use the pecking order framework to make their financial decisions. However, the foci of most studies on the pecking order theory have been mainly on business firms rather than higher education institutions. This was partly what prompted the need for this investigation. In addition, in a study by Holmes and Kent (1991), they admitted that the pecking order framework seems to be more consistent with small business sectors because they are owner-managed and such owners often do not want to dilute their ownership of the firms (organizations) through sale of shares. But, this scenario may not be any different with what takes place in public higher education institutions because Government too would not wish to lose it control of its own institutions by bringing in new investors (or owners). This was part of the reason why the researcher wanted to find out if the management of MUBS does (or not) apply the pecking order theory in making its financial decisions.
In this study, besides the issue of the pecking order theory, there was an important term to be conceptualised, namely: financial management. Financial management, as we all know, is broadly concerned with the acquisition and use of funds by a business firm (or organization). It involves the application of management principles to all financial operations of an organization (including planning, organizing, controlling and coordinating). According to Chandra (2001), there are three key activities of financial management. First, it involves undertaking financial analysis, planning and control of a firm. Second, it involves the management of the firm’s asset structure; and lastly, it includes the management of the firm’s financial structure. In this study, financial management was looked at in terms of the management of MUBS’s asset structure. Specifically, it was characterised by the way by which the managers determine the Institution’s capital budget; make financial decisions; and implement its credit policy.

Contextually, this study focused on Makerere University Business School (MUBS). MUBS as it is fondly called, is a constituent college of the known Makerere University. It was established by Makerere University in 1997. According to MUBS (2016),

The School was created from a merger between the faculty of commerce (FOC) and the national college of business studies (NCBS). The merger involved the physical movement of the faculty of commerce from the Makerere Campus to Nakawa where the NCBS was located. The actual merger and movement took place in January 1998. In the year 2000, the law was amended to give financial and administrative autonomy by the Makerere University (Establishment of constituent college) (Amendment) order (MUECCA (A) 2001.

As a result of this amendment, the school structure changed tremendously. The School has been mandated to organise and develop business and commercial training in the country at the different levels. However, on the ground at MUBS, not everything is rosy. According to Ssegawa (2014), Mubs management has been accused of poor management policies – a damning judgement on the school teaching management practices and passing out graduates into the market to manage organizations. There have been concerns of corruption, nepotism/tribalism, favouritism, victimization, in-fighting, dictatorships, et al, mainly levied against managers of the institution. (Para 5)

This kind of allegation especially about financial mismanagement has raised concern among scholars, policy-makers as well as Government (Sserunjogi, 2013). Yet, it is believed that a judicious selection and application of relevant theories would ease the practice of financial management in any work organisation. This prompted the researcher to investigate if MUBS’s managers apply the pecking order theory considered by many to be one of the most relevant theories in managing corporate finance.

**Study Objectives**
Overall, the researcher intended to explore the applicability of the pecking order theory in the management of finances at MUBS based on the belief that appropriate selection and use of theories such as the pecking order theory would ease the practice of financial management of firms (or organisations). The specific objectives of the study were to:
Identification of the main sources of revenues to MUBS;

(ii) Establish if the decisions concerning revenue sources are made based on the costs of raising revenues; and

(iii) Find out the Institution’s credit policy.

Research Questions

The study was therefore guided by the following research questions, namely:

(i) What are the main sources of revenues to MUBS?

(ii) Are the decisions concerning revenue sources at MUBS made based on the costs of raising revenues?

(iii) What is the credit policy of MUBS?

Literature Review

Several scholars have already studied the applicability of the pecking order theory in the management of finances in different firms (organisations). According to Myers and Majluf (1984), the pecking order theory suggests that firms have particular preference order for capital used to finance their businesses. As a result, a firm is said to follow the pecking order theory (or model) if it prefers internal to external financing as well as debt to equity as means of generating its funds (Myers, 1984). But what does it mean to ‘prefer’ internal to external financing? Does it mean that the firm first uses all available sources of internal finance before using any debt or equity? Many have asked these questions? They conclude that if the word ‘prefer’ is interpreted in the ‘other things equal’ way, then any test of the theory rests on the specification of ‘other things equal’. But in reality, most firms normally hold some internal funds (cash and short-term investments) even when raising outside funds. This is so obvious that it is rarely considered in tests of the pecking order model. It is implicitly assumed that these funds are held for reasons that are outside the theory, such as for transactions. Again the second problem for the definition concerns the preference of debt over equity. As we will see, initial claims for the theory tended to rest on a strict interpretation in which equity is never issued if debt is feasible. As it has become increasingly clear that this strict interpretation is not only more refutable, but actually refuted, proponents of the pecking order theory has moved increasingly to the ‘other things equal’ interpretation.

According to Myers and Majluf (1984) and Myers (1984), the most common motivation for the pecking order is adverse selection. The key idea in adverse selection is that the owner-manager of the firm knows the true value of the firm’s assets and growth opportunities. Outside investors can only guess these values. If the manager offers to sell equity, then the outside investor must ask why the manager is willing to do so. In many cases the manager of an overvalued firm will be happy to sell equity, while the manager of an undervalued firm will not. However, in the case of public enterprises such as MUBS, it is usually not likely that Government would allow the managers of its institution to use equity to generate funds because this would create some kind of public-private partnership that the State may not be prepared to manage.

Several studies have tested the suggestions of pecking order theory by using different models and techniques. According to Jibran, Wajid, Waheed and Muhammad (2012),

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Abu (2007) for example, conducted his research on 17000 non-financial firms across 41 different countries and found that adverse selection costs and information asymmetry were main cause of debt issue. But at same time these two elements did not play vital role in developed countries as compared to developing countries. (p.88)

Although Abu’ study covered both developed and developing countries, and it was on non-financial firms, the focus was not on higher education which this study delved on.

In 2012, Jibran, Wajid, Waheed and Muhammad conducted a study in which they investigated the extent to which the pecking order theory provides a satisfactory account of the financing behaviour of listed firms listed on Karachi Stock Exchange (KSE) over the 2001 to 2008 period. That study followed a similar one carried out in the same place by Pardesi in 2011. However, both studies established that the basic pecking order model predicts that firms follow a pecking order of financing, preferring internal finance to external finance and debt to equity. Nonetheless, these studies again were conducted on business firms listed on a stock exchange market rather than educational institutions that this study focussed on.

Even in developing countries, available literature shows that many studies on pecking order theory have been conducted. Again, according to Jibran, Wajid, Waheed and Muhammad (2012), “One such research et al. (2004) on Brazilian economy supported the above mention notion; they concluded that the main reason was the difficulty in issuing equity” (p. 88). However, according to Zurigat (2009), Booth et al. carried out a major study to assess whether capital structure theory is portable across developing countries with different institutional structures in 2001. The sample firms in their study were from Malaysia, Zimbabwe, Mexico, Brazil, Turkey, Jordan, India, Pakistan, Thailand, and Korea. That study, Zurigat, 2009) reveals

…showed that the more profitable the firm, the lower the debt ratio, regardless of how the debt ratio was defined. It also showed that the more the tangible assets, the higher the long-term debt ratio but the smaller the total debt ratio. (p. 25)

But overall, the study demonstrated that the model of the pecking order theory was applicable in firms in both developed and developing countries. Nonetheless, all these studies were never tuned to look at the applicability of the pecking order theory to educational firms.

Methodology
The researcher approached the study from the social constructivist paradigm because he felt that in order to thoroughly understand the issues at hand, it was not necessary to rely on the number of research subjects. Rather, it was prudent to collect data from typical cases of subjects that would enable him to get the kind of information he was interested in. Thus, it was not about how many subjects were studied, but about what the respondents believed in and what they understood about the issues of financial management at MUBS. Specifically, a case study design was employed in the study. This was intended to get a deeper understanding of the issues that were investigated. The researcher did not determine the sample size prior to collecting data because he aimed at collecting data until the point of saturation. In the study, secondary data were collected through literature search and desk study methods while primary data were obtained through key informant interviews. The researcher believed that these methods would permit effective and efficient collection of data bearing in mind the planned costs and time of the study. Finally, the collected
data were analysed through narrative and content analysis techniques. The results of the study are presented in section 4 below.

Results

The study set out to answer three research questions. In this section, the findings of the study have been presented in accordance with those research questions.

Research Question One

The first question that this study aimed to answer was stated as “What are the main sources of revenues to MUBS?” To answer this question, statutory documents and some members of top management of MUBS such as dean of schools and head of departments were consulted. According to Article 59(1) of the Universities and Other Tertiary Institutions Act (UOTIA), 2001 (as amended in 2003 and 2006), the law responsible for regulating higher education in Uganda, MUBS as a public tertiary institution may get funding from the following:

(a) Grants or contributions from Central Government as may be appropriated by Parliament;

(b) Voluntary contributions from the District Council within which the Public University is situated;

(c) Grants, contributions, loans and donations acceptable to the University Council

(d) University fees

(e) Any other money that may become payable to the Public University in the discharge of its functions. [Government of Uganda, 2001, Article 59(1)]

In addition, the Act stipulates in Articles 59(2) and (3) respectively that “A District Council or any other local government may provide financial contribution or assistance to a Public University within its area of jurisdiction for the purpose of improving facilities for higher education within its area of jurisdiction” [Government of Uganda, 2001, Article 59(2)] and that “The Public University shall not be obliged to accept any grant or donation for a particular purpose unless it approves the purpose and the conditions of the grant or donation” [Government of Uganda, 2001, Article 59(3)].

During, interviews, the informants corroborated the information obtained from the Universities and Other Tertiary Institutions Act. All of them said that as a public tertiary institution, their sources of funding are stipulated by law. One of them actually observed that “We are not allowed to operate outside the law. We therefore get our revenues as per the law.” This probably implies that the law restricts the Institution in the generation of its revenue since certain sources of revenue are excluded; for example, equity.

In line with the research question one, the researcher asked the informants to rate the significance of their sources of revenue. Different respondents had different opinions about which source of revenue generates the largest amount and which one is the most reliable source of revenue. For instance, one of the interviewees said “In our case, Government subvention is our largest source of revenue. Apart from paying the salaries and emoluments of all the staff, Government also funds much of the Institution’s development expenditure”. Another interviewee who said that he had just
recently been appointed a dean of a school expressed a different opinion on the matter. He said “MUBS generates a lot of money internally from the students in fees. It is actually our largest source of revenue, followed by Government subventions which are usually erratic and which amounts often fluctuate year after year”. Some of the interviewees said that when judging which source of revenue is reliable or not, it would be necessary to relate it to the purpose of the money being generated. For instance, one respondent said “In the case of research funding, the most reliable source of funding is donation. There is hardly any Government subvention for research”. These findings demonstrate the difficulties managers find in deciding on which revenue source generates more funds and on which source the Institution should rely more because some of the revenues are tied to specific uses; for example, research funds from most development partners.

**Research Question Two**

The second question that this study attempted to answer was stated as “Are the decisions concerning revenue sources at MUBS made based on the costs of raising revenues?” To answer these questions, members of top management were again interviewed. Most of the interviewees observed that their decisions on which source of revenue to use depend to some large extent on the costs involved in obtaining revenue from a given source. For instance, one interviewee remarked that:  

> Although our sources of revenue are stipulated by law, the choice of which source of revenue to depend on is partly determined by the costs associated with generating revenue from a particular source. For instance, we cannot prefer donations from abroad over the internally generated funds because donations often come with conditionalities. These conditionalities are hidden costs that we would wish to avoid if we had sufficient internally generated funds. 

This kind of sentiments was also expressed by other interviewees who alluded to the fact that every source of revenue including from Government has its own costs on the Institution. In fact, an informant said “If there were means, we would prefer to have an institution that is financially fully self-sustaining because relying on funding from outside the institution is very devastating”. According to this interviewee, “funding that comes from outside the Institution often comes late and with terms and conditions that sometimes limit the effective use of such monies”.

The researcher also tried to probe further in order to determine the priority list for sources of funding for MUBS. Different respondents had differing opinions. However, the majority of the interviewees ranked their preferred sources of funding as (i) University fees; (ii) Any other money that may become payable to MUBS in the discharge of its functions; (iii) Grants or contributions from Central Government as may be appropriated by Parliament; (iv) Voluntary contributions from the District Council within which MUBS is situated; (v) Grants, contributions, and donations acceptable to the University Council; and finally, (vi) Loans. However, while indicating this priority list, informants also lamented about the limited amounts of revenue some of these sources generate for the Institution. Nevertheless, many argued that they would prefer internally generated revenues to donations and debts.
Research Question Three

The third research question in the study was stated as” What is the credit policy of MUBS?” This question was in line with the fact that according to the pecking order theory, debt would be the second, not the first, preferred option for generating revenues to a firm (or organization). Since this study aimed at interrogating whether MUBS apply the pecking order theory in the management of its finances, the researcher decided to establish the credit policy of MUBS. But first, what do we mean by credit policy?

The term credit policy has many meanings. According to the Cambridge Business English Dictionary (2016), “a credit policy may refer to a set of principles that a financial organization or business uses in deciding who it will loan money to or give credit” (Parra 2). Like in this case, it would refer to the policies stipulating how long it may take for a student to pay his/her university fees or any person or firm to pay for any services rendered to that person or firm by MUBS. However, the term credit policy may also mean a different thing altogether. The Cambridge Business English Dictionary also defines the term credit policy as “a set of actions that a government takes to influence how easy or difficult it is to borrow money” Para 3. This was the definition of credit policy that was adopted in this study because the researcher intended to establish how easy or difficult it is for MUBS to borrow money as a means of revenue generation.

To answer this question, again statutory documents and some members of top management of MUBS were consulted. According to Article 60 of the Universities and Other Tertiary Institutions Act (UOTIA), 2001 (as amended in 2003 and 2006),

(1)The University Council may, subject to subsection, borrow funds required for meeting its obligations and for carrying out its functions. (2) The University Council may borrow temporarily, by way of overdraft of otherwise, sums of money to be paid within a short period for any urgent requirements in the discharge of its functions. (3) The Minister responsible for finance in consultation with the Minister responsible for education may, from time to time, prescribe the maximum sum that may be borrowed in respect of the different votes of expenditure of the Public University. [Government of Uganda, 2001, Articles 60 (1), (2) & (3)]

During interviews, the respondents were able to corroborate this same information. Many of the interviewees said that MUBS’s borrowing of money from banks or other lending institutions is guided by law. Except an informant lamented that: “Unfortunately, the law only permits the University Council to borrow money temporarily, by way of overdraft of otherwise, sums of money to be paid within a short period for any urgent requirements in the discharge of its functions”. This policy, according to the interviewee “does not grant the University the freedom to borrow as much money as it requires”. Therefore, she observed that “the policy limits the use of debt as a viable source of revenue generation for the Institution” However, another respondent also raised concern about the cost of borrowing in the country. He said that “the current rates of interest charged on loans of between 17 and 24 percent per annum by most commercial banks in Uganda are rather high”. This according to him “makes debt financing a more costly means of financing institutional activities”. Nevertheless, the informants virtually all agreed that borrowing has been one regular means of raising revenues especially in case of any urgent requirements in the Institution.
Discussion
This study aimed at exploring the application of the pecking order theory in the management of finances at MUBS. Study findings revealed three major issues. First, that MUBS as a public tertiary institution in Uganda has a limited range of revenue sources stipulated by the University and Other Tertiary Institutions Act of 2001 (as amended in 2003 and 2006) excluding such sources as long term debt and equity. Second, the management of MUBS, to a large extent, considers the cost of generating revenue in making its financial decisions. Therefore, this implies that the Institution applies the pecking order framework in deciding on which sources of revenue to generate its funds. Lastly, MUBS has in place a credit policy that restricts it from contracting long term debts as a means of raising its revenue.

The finding that MUBS has a restricted source of revenue (or capital structure) is not new. Scholars, who have studied capital structures of different organisations such as Abu (2007), found that not every firm has the prospect of generating revenues from all internal and external sources due to several different factors. In the case of MUBS as a publicly-owned institution, it is legally neither permitted to contract long term debts nor issue equity. This decision is partly based on costs considerations of those means of financing firms. Generally, long-term debts are costly in terms of interest charged on loans while equity financing brings in new investors who may not be in the interest of the business. This is the reason why Government discourages both debt and equity financing of public enterprises.

According to Holmes and Kent (1991) who studied the applicability of the pecking order model in small and medium-scaled enterprises (SMEs), they observed that such firms equally have restricted capital structures due to different factors. The two scholars actually revealed that SMEs prefer internal to external financing because they do not possess sufficient collaterals to permit contracting of large debts. Besides, since most SMEs are owner-managed firms, their owners often dislike issuing of equity that may bring new investors who may not be in support of their business ideas – let alone that in many countries - Uganda inclusive, the legal environment would not permit SMEs to issue equity. Nonetheless, the restriction on issuing of equity is also in place for many public enterprises like MUBS where Government is not interested in any private-public partnership. The Universities and Other Tertiary Institutions Act of 2001 (as amended in 2003 &2004) thus restricts MUBS and all public higher education institutions in Uganda to raise funds through long-term debts and equity because of their associated costs.

The finding that MUBS’s managers consider the costs of financing when making their financial decisions is only logical and expected. This implies that MUBS’s managers employ to a large extent the pecking order theory in managing the Institution’s finances. According to Abu (2007), many non-financial firms in both developed and developing counties employ the pecking order model that involves considering costs of raising funds. As a result, virtually all firms (or organisations) prefer internal to external financing in order to avoid costly sources of finances. Therefore, it is not surprising that MUBS’s managers are equally considering costs of financing when making their financial decisions.
In a study by Booth et al. (cited in Zurigat 2009), they found that large firms have broader capital structures than small ones because large firms have collaterals and legal mandates to contract large debts as well as issue equity. But MUBS, though large, is legally not permitted to issue equity. This implies that MUBS’s managers can only apply the pecking order model to some reasonable extent.

The finding that MUBS operates under a tight credit policy is equally not surprising. Being a publicly-owned institution, Government restricts the Institution’s involvement in debt and equity financing. This is more or less similar to the management of other owner-manager firms (the SMEs) which Homes and Kent (1991) observed were not interested in issuing equity in order to avoid attracting new investors who may not support their business ideas. This finding is thus in congruence with that of Myers and Majluf (1984) and Myers (1984) who point out that owner-manager of the firm knows the true value of the firm’s assets and growth opportunities. Outside investors can only guess these values. However, in the case of public enterprises such as MUBS, it is usually not likely that Government would allow the managers of its institution to use equity to generate funds.

**Conclusion**

Basing on the findings that MUBS has restricted source of funds; considers the costs of generating revenue in making its financial decisions; and operates under a strict credit policy that restricts the contracting of long term debts as its means of revenue generation, the researcher drew the following conclusions. First, that the universities and Other Tertiary Institutions Act of 2001 (as amended in 2003, and 2006) that stipulates the sources of revenues disadvantages public higher education when it comes to revenue generation. Second, higher education institutions apply, to some extent, the pecking order theory in making their financial decisions; and lastly, the credit policy under which public higher education institutions operate limits their capacity to raise capital for meeting their developmental needs.

**Recommendations**

Following the conclusions drawn from the study findings, the author made the following recommendations. First, the legal framework within which higher education institutions operate needs to be revisited to expand the spheres within which the institutions can raise their revenues. Second, the managers of higher education institutions should prudently apply the pecking order theory in order to bolster the institutions against unfavourable costs accruing from revenue generation. Finally, the credit policy guiding public higher education needs to be revisited to permit the generation of more funds to institutions of higher education.

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