The purpose of this study was to examine the close association between management and firm characteristics and the perceived importance of capital structure theories of listed companies in Sri Lanka. A sample of 37 companies was selected from the top 50 listed companies in The Lanka Monthly Digest 50 (LMD) for the year 2010/2011. Data were obtained from questionnaire, annual reports and The Lanka Monthly Digest 50. The results provide mixed support for the notion that firms does trade-off costs and benefits to derive an optimal debt ratio. As a result of the findings that CFOs of listed companies in Sri Lanka consider different factors in trading off the costs and benefits of debt financing. The survey finds little support but not strongly on the argument favor to pecking order model whereas it finds no evidence of perceived importance of agency cost theory of listed companies in Sri Lanka. This research finds no significant association between management and firm characteristics and capital structure theories in corporate financing decisions.

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Mohamed Saleem Ahamed Riyad Rooly
W.K. Weerakoon Banda

Management and Firm Characteristics

An Empirical Study of Capital Structure Practices of Listed Companies in Sri Lanka

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CHAPTER ONE

INTRODUCTION TO THE STUDY

1.1 Background of the Study

Capital structure decision is imperative for every business organization as it is a challenge to management globally to meet the interest of shareholders in which it relates with firms' value maximization, deal with debt and equity issuance decision (Modigliani & Miller 1958). Even in a world in which interest payments are fully deductible in computing corporate income taxes, the value of the firm in equilibrium will still be independent of its capital structure (Miller 1977). At the end of the ethnic war in May 2009, the Sri Lankan stock market was reported as one of the best performing stock markets in the world (Daily News 2009), but the volatility of stock market operations due to insider trading, manipulation, malpractices and asymmetric information infested the popular perceptions on Stock Exchange (Myers & Majluf 1984). Inefficient stock market operations cause shares undervaluation problem and also the higher interest rate causes in increasing the finance cost which directly affects the firm value as well as shareholders wealth. The wrong decision of financing investment opportunities leads to financial distress cost & bankruptcy and affect the image of the firm. It seems that it is vital to balance cost and benefit of debt while maximizing wealth of the shareholders through maximizing value of firms. Referring to this situation, DailyFT (April 20th, 2012) pointed out that the recent rising domestic interest rates in Sri Lanka steals the appeal for equities and also it gives the relative asset allocation disconnect between equities and interest rates, it could dent the pace of corporate earnings growth for those companies that are highly levered.

How do firms take corporate financing decisions? Corporate financing decision is globally debatable topics which talks about the practice of money denominated decision. The mix of debt and equity combination is dependent on firm's choice of target capital structure, the average maturity of debt, specific sources of financing, management and firms' characteristics (Ibrahima et al, 2012). The capital structure theories i.e. trade off theory, pecking order theory, and agency cost theory, provide guidance to the managers to determine the target debt level which maximize the market value of the firm in which academics tell how the firm should do but it is imperative to understand how it was perceived and practiced by the managers. This research is conducted to understand the current practice of corporate finance in relation to capital structure practices of listed companies in Sri Lanka. As the emerging country, in the post war period, the engine of economic growth

dependents on public and private sector business. The growth and development of the firms are dependent on choosing capital structure, corporate financing behavior which is influenced by management and firm characteristics (Colombage, 2007).

The best known field study in this area is the Graham and Harvey (2001) survey of the theory and practice of corporate finance: evidence from the field. It was followed by many researchers to conduct the survey in relation to corporate financing decisions. This research is similar to the previous surveys (Graham and Harvey, 2001; Graham and Harvey, 2002; Bancel and Mittoo, 2004; Ibrahima et al, 2012), but differs from the surveys conducted by Buferna, Bangassa & Hodgkinson, 2005; Sheikh and Wang, 2011; Titman and Wessels, 1988; Khrawish and Khraiwesh, 2010; Mefteh and Oliver, 2010) in which the scope and the method of analyzing the management and firm characteristics in relation to capital structure practices is broad. This study considers management and firm characteristics in determinants of debt and equity issuance decisions which provides unique information to aid the understanding of how management and firm characteristics are influenced in corporate financing decisions of firm and its association with the perceived importance of capital structure theories.

1.2 Problem Statement

To what extend do management and firm characteristics influence and/or associate with debt and equity issuance decision in relation to perceived importance of capital structure theories?

Follow-up questions:

- Are management characteristics in association with the perceived importance of capital structure theories?
- Are firm characteristics in association with the perceived importance of capital structure practices?
- Do CFOs consider the academics advice and guidelines in corporate financing theories?
- Do capital structure practices of listed companies in Sri Lanka have the similarity in corporate financing decisions of developed countries?

1.3 Problem Justification

The importance of capital structure theories in determinants of debt and equity issuance decisions are still in debut in corporate world. Capital structure practices were examined in various literature but alternative capital structure theories were developed and still could not find the best theory to determine optimum capital structure in which to maximize the market value of the firm as well as to maximize the shareholders wealth. A specific method and methodology were not finalized yet in which managers can use in order to determine optimum debt level to firm. Capital structure theory explains the main three theories such as static trade-off theory explains the tax advantage on debt and its cost, the pecking order model talks about asymmetric information, and agency cost theory involve in free cash flow of firm.

These theories and practices were tested by many researchers and scholars in relation to management and firm characteristics in determinants of debt and equity issuance decisions. Graham and Harvey (2001); Graham and Harvey (2002) examined that the theory and practice of corporate finance: evidence from the field. They concluded that some support for the pecking order and trade-off capital structure hypothesis but the agency cost theory is insignificant. This study is on broader scope in corporate financing decisions in which it examines the cost of capital, capital budgeting, and capital structure practices. Perhaps the relatively weak support for many capital structure theories indicates that it is time to critically re-evaluate the assumptions and implications of these mainline of theories. It seems that business schools might be better at teaching capital budgeting and the cost of capital than at teaching capital structure. Bancel and Mittoo (2004) state that modest support for the trade-off theory but weak support for the pecking order or agency theory framework. Both studies were based on developed countries and the European and U.S. managers. The capital structure choice may be a consequence of complex interaction of many institutional features such as tax code, bankruptcy law, and stock market development. Miller (1977) argues that firm's value is maximized by some specific financial decisions or strategy in given the complexities of real world setting, actual decision procedures are inevitably heuristic, judgmental, imitative and groping. Ibrahima et al (2012) conducted a survey based in Malaysian managers that practices of capital structure decisions; Malaysia survey evidence. They concluded that strong evidence was supported to trade-off theory, and little concern was given to pecking order model and agency cost theory. The survey is based in Malaysian managers, but the majority of managers are from Chinese, they educated from Chinese schools. The

survey was conducted to test the management and firm characteristics in relation to capital structure theories in which the questionnaire was used as tool to test the conditional on management and firm characteristics. There were institutional differences and usage of debt i.e. short term and long term differ firm to firm was found. Graham, Harvey and Puri (2008) state that US-based CEOs and CFOs are more optimistic than are their non-US counterparts. It seems that executive decisions differ from country to country. To test the firm characteristics in relation to capital structure theories, many researches with different methods was used Buferna, Bangassa & Hodgkinson (2005); Sheikh and Wang (2011); Titman and Wessels (1988). Sheikh and Wang (2011) state that findings of the study are consistent with the predictions of the trade-off theory, pecking order theory, and agency theory which show that capital structure model derived from Western settings reference to Pakistan. Buferna, Bangassa & Hodgkinson (2005) describe that both the static trade-off theory and agency cost theory are pertinent theories to the Libyan companies' capital structure whereas there was little evidence to support the asymmetric information theory. The secondary market was lacking in Libyan market and it has an impact on agency cost theory. Khrawish and Khraiwesh (2010) investigate that the determinants of the capital structure, evidence from Jordanian industrial companies. The aim is to test the influence of firm characteristics on capital structure practices but not to investigate the application of capital structure theories i.e. static trade-off theory, pecking order model and agency cost theory. The results shows that Jordanian industrial companies depend on equity financing their investment and also large companies are highly leveraged that they are able to reduce the risk of bankruptcy and their greater degree of diversification. Mefteh and Oliver (2010) investigate that capital structure choice in relation to the influence of managers' confidence and firm characteristics in France based companies. Managers' confidence on market, industry and firm will have an influence in choosing leverage to firm along with other firm characteristics. The results show that there is negative relationship between managers' confidence and leverage decisions. When French managers are confident about the firm, they are more likely to prefer equity investment rather than debt as they are also block holders control in the firm and weaker business environment in France relative to other countries.

It is noted that institutional differences, managers confidence on usage of debt (short term and long term), methods of study and the countries in which the firm operate gives different results in relation to capital structure practices of firms (Graham and Harvey, 2001; Graham and Harvey, 2002; Bancel and Mittoo, 2004; Ibrahima et al, 2012; Buferna, Bangassa & Hodgkinson, 2005; Sheikh and Wang,

2011; Titman and Wessels, 1988; Khrawish and Khraiwesh, 2010; Mefteh and Oliver, 2010). The accounting practices to legal and institutional environment i.e. tax code, bankruptcy laws, development of bond markets, and patterns of ownership differ from country to country and also the analysis highlights the effect of different accounting rules, and points to the corrections that need to be made so that measures of leverage, valuation of assets and liabilities are comparable across countries (Rajan & Zingales 1994). Sri Lanka is the emerging market, primary and secondary market is well developed but the bond market is not developed as much comparing with other countries. Monetary policy of the country is the major determinant factor of debt decisions of the firms. DailyFT (10 July 2012) pointed out that the private sectors borrowed more money in the first five months of this year as against the corresponding period of 2010. Between January and May of this year, credit to the private sector amounted to Rs. 211 billion, whereas in the same period of last year, the figure was around Rs. 166 billion. As per the Central Bank Data, credit growth to the private sector in May was 33.5%, low in comparison to 34% in April and 36.6% in December last year. DailyFT (10 July 2012) further added that Domestic Banking Unit (DBUs) lending to the private sector crossed the Rs. 2 trillion mark as at end May, reflecting a 36% growth year on year, whilst lending by Foreign Currency banking Unit (FCBUs) grew by 12% to Rs. 197 billion. Government efforts to apply brakes to credit growth remain a challenge. Therefore, the Monetary Board was of the view that a further adjustment of policy rates of the Central Bank is warranted to ensure a smooth deceleration of credit growth through the year in order to achieve the year-end target and to anchor inflation expectation. It is clearly stated that the institutional framework in which Sri Lankan firms operate is heavily influenced by Government policy and different from other countries. It is because of the Sri Lankan economy is rapidly transforming from state-controlled to market status and the Sri Lankan firms rely heavily on bank debt when raising external capital, because the bond market is still in the early stages of development. Similar study was conducted by Colombage (2007) by analyzing perceived importance of CEOs of listed companies in Sri Lanka about capital structure practices. It is found from the evidence of the study suggest that future work of this type needs to incorporate broadly on analyzing the significant association between management and firm characteristics and perceived importance of capital structure practices.

However, there is very limited research on management and firm characteristics and its association of perceived importance of capital structure theories in developing countries such as Sri Lanka, which had operated in difficult environments (continuous internal wars, insurgencies, political instabilities, Asian

crisis, Tsunami devastation, increased oil prices and global financial crisis), yet manage to perform strongly in the corporate sector. Given the difficult economic and political environment in which the businesses in Sri Lanka perform relatively strongly, this research into corporate financing decisions is expected to yield interesting results to fill the gap in knowledge of the relationship between management and firm characteristics and its association with perceived importance of capital structure theories of listed companies in Sri Lanka.

1.4 Objective of the Study

The corporate capital structure literature contains many papers that examine the nature and the determinants of corporate capital structure. Following the classical work of Modigliani and Miller's classical paper (1958) which argued that the value of company is independent from its capital structure, more of empirical literature identifies specific factors that may affect a firm's optimum capital structure. Some papers examined the firm characteristics in determinants of capital structure include Buferna, Bangassa & Hodgkinson, 2005; Sheikh and Wang 2011; Titman and Wessels, 1988; Khrawish and Khraiwesh, 2010; Mefteh and Oliver 2010). The management and firm characteristics are one of the determinant factors which were studied by Graham and Harvey, 2001; Graham and Harvey, 2002; Bancel and Mittoo, 2004; Ibrahima et al, 2012).

Relative to the above, the objectives of the study is to,

- Investigate the significant association between management characteristics and the perceived importance of capital structure theories.
- Examine the significant association between firm characteristics and the perceived importance of capital structure theories.
- Understand the perceived importance of CFOs about capital structure theories in determinants of debt and equity issuance of listed companies in Sri Lanka comparing with the practices of developed countries.

1.5 Significance of the Study

The results of the study are significant in various aspects of corporate financing decision. First, it makes awareness among the management of listed companies in Sri Lanka to understand the factors which influence in leverage decision and also to understand the importance of capital structure theories in choosing debt and equity combination to maximize the market value of the firm. Second, this will provide useful information to management to consider the capital structure theories if they do not follow at present and also to understand the role of management and firm characteristics towards the capital structure decision at large. Third, this study provides information to practitioners and academics to understand the reality of capital structure theories in corporate financing decisions and the level of perceptions of management in the firms.

1.6 Scope of Study

This research is carried out to assess the practice of capital structure theories of listed companies in Sri Lanka. It is focused on the influence of management and firm characteristics on leverage decision of the firm. This research is organized as follows, the chapter 2 presents a review of the relevant literature on capital structure theories which covers the previous studies was done by the researchers and their findings were discussed in details. Data and methodology are described in chapter 3 where the theoretical background and conceptual frame work are developed. The study related variables, hypothesis, the population and samples are identified and explained in this section. The chapter 4 and 5 are presented to discuss the data analysis, and findings. Finally, chapter 6 presents the conclusion of this study.

CHAPTER TWO
LITERATURE REVIEW: CAPITAL STRUCTURE PRACTICES AND CORPORATE FINANCING DECISIONS

2.1 Introduction

In the corporate world, any investment decision is mainly based on either of two criteria, namely the maximization of profits and the maximization of market value of firm and/or maximization of shareholders' wealth. How can it be achieved? It means that any investment is worth acquiring if it increases the net profit of the firm in which the yield of assets exceeds the rate of interest, and that of any investment is worth acquiring if it increases the value of the firm i.e. it adds more value to the firm than the cost of acquisition. This would happen under the condition of certainty and uncertainty of outcome (Modigliani & Miller 1958). Capital structure and cost of capital play vital role on this objective. Modigliani and Miller are the prominent scholar and writer on capital structure practice of firms. Initially, they refused the impact of debt capital on value of firm. They argued that there is no relationship between capital structure and market value of firm, and further state that cost of capital is independent for the degree of leverage (Modigliani and Miller 1958). Modigliani and Miller (1963) further describe after incorporating tax into theory that the levered firms will have higher value than unlevered firm as the interest on debt is a tax deductible item. Miller (1977) argues that even the interest rate on debt is a tax deductible, the value of firm, in equilibrium will be independence of its capital structure. Therefore, it seems that the capital structure theory is still debatable topics in corporate finance, and was argued by many researchers on its application and perception of managers in practicing the theory in organizational level to maximize the value of firm. The capital structure theories do not seem to explain actual financing behavior and it seems presumptuous to advise firms on optimal capital structure when we are so far from explaining actual decisions (Myers 1984).

The chapter is structured to review various literatures related with capital structure practices and corporate financing decisions. The section 2.2 describes the management responses conditional to management and firm characteristics in relation to capital structure theories such as static trade-off theory, pecking order theory and agency cost theory. Finally the section 2.3 discusses the conclusion on literature review.

2.2 Management and Firm Characteristics in Relation to Capital Structure Theory

The argument among the researchers and prominent scholars have been still under the discussion the extent to which the capital structure theories can be used to maximize the market value of the firm. Even Modigliani and Miller theorem proposed some extent the way to maximize the wealth of the shareholders through utilizing the debt capital into the firm's capital structure components in order to obtain the tax shield benefits; it is still in doubt that how it is being practiced by firms and the extent to which prior theories should be used in organizational level. The research commenced with general questions about how capital structure theory is being used and perceived in listed companies in Sri Lanka and how it is influenced by management and firm characteristics. As the research progressed it is executed with most important questions relating to capital structure theories i.e. static trade-off theory, pecking order theory, and agency cost theory and how it was applied and perceived by management and firm characteristics.

A number of surveys of capital structure practices have been carried out to investigate the influence of management and firm characteristics (Graham and Harvey, 2001; Graham and Harvey, 2002; Bancel and Mittoo, 2004; Ibrahima et al, 2012). Several studies on both theoretical and empirical capital structure have generated results to explain the capital structure practices and its determinants factors based on firm characteristics in causal research work (Buferna, Bangassa and Hodgkinson, 2005; Sheikh and Wang, 2011; Titman and Wessels, 1988; Khrawish and Khraiwesh, 2010; Mefteh and Oliver, 2010). The best known survey was developed by Graham and Harvey (2001), and Graham and Harvey (2002) whom they argued the influence and/or impact of management and firm characteristics in corporate financing decisions; especially referring to capital structure theories. Similar to Graham and Harvey (2001) and Graham and Harvey (2002), there were several surveys conducted by many researchers (Bancel and Mittoo, 2004; Ibrahima et al, 2012) in developed and developing countries to understand the practice of capital structure in firm. The findings were interesting that management and/or firms were not stick with the Modigliani & Miller hypothesis/model. There was many factors influence on capital structure decisions of firm. Graham and Harvey (2001), and Graham and Harvey (2002) describe the current practice of corporate finance questioning 392 CFOs in U.S firms about the cost of capital, capital budgeting, and capital structure. Similar to that, Ibrahima et al, (2012) investigate a similar issue in the Malaysian context and present a comprehensive survey of capital structure practices in Malaysia through questioning on the CEOs of Malaysian non-financial listed companies on their

perceptions of the capital structure practices. Bancel and Mittoo (2004) investigate managers of firm in sixteen European countries to examine the link between theory and practice of capital structure across countries with different legal systems.

Determinants of debt level in firms are also based on firm characteristics. Several attempts were made by various researchers to understand the determinants of capital structure based in firm characteristics. It differs from Graham and Harvey (2001) survey classified the management response conditional to management and firm characteristics. Evidences are stronger and also insignificant under certain circumstances. Buferna, Bangassa and Hodgkinson (2005) investigate the determinants of capital structure pertaining to a developing country and examine the impact of the lack of secondary capital market in Libya. Sheikh and Wang (2011) explore the factors that affect the capital structure of manufacturing firms and investigate whether the capital structure models derived from Western settings. Titman and Wessels (1988) investigate the determinants of capital structure choice and discuss the attributes that different theories of capital structure suggest may affect the firm's debt-equity choice. Khrawish and Khraiwesh (2010) describe on the determinants of the capital structure; evidence from Jordanian industrial companies. They discuss various firm characteristics (explanatory variables) which determine the capital structure of firms. Managers' confidence on market, firm and industry and various firm characteristics will have an influence on capital structure choice in French based companies (Mefteh & Oliver 2010).

As a result of the findings from various literatures, some broad categories to determine the capital structure were developed. The determinants of capital structure were fully based on the management and firm characteristics. This section reviews various literatures of management and firm characteristics in relation to capital structure theory and concept.

2.2.1 Management and Firm Characteristics in Relation to Static Trade-Off Theory

This section explains the perceived importance of static trade-off theory and its close association with management and firm characteristics. Static trade-off theory (also referred to as the tax based theory) explains the tax benefits of debt usage and set-off leverage related cost such as bankruptcy and financial distress cost. Modigliani and Miller (1963) add that the levered firms will have higher value than unlevered firm as the interest on debt is a tax deductible item. Therefore, it generates a tax shield to the company; this tax shield helps to increase the value of the firm. The optimum capital structure is reached when the tax advantage to borrowing is balanced, at the margin,

by cost of financial distress and it reaches in setting a target debt to value ratio and gradually moving towards it. In view of this theory, issuing equity means moving away from the optimum and should therefore be considered bad news. Myers (1984) describe that if corporate interest tax shields have significant positive value, then debt for equity exchange would tend to move firms closer to optimum capital structures. Equity for debt swaps would tend to move them far away.

The application of static trade-off theory was tested at organizational level by various researchers and assessed the perceived importance of utilizing the theory to maximize market value of the firm. As a result of it, Graham and Harvey (2001) clarify the target debt ratio, and the costs and benefits of debt under the trade-off theory of capital structure choices. They further describe that the deviation from target debt ratios in the capital structure of companies. The trade-off the costs and benefits of borrowing is usually viewed in a firm to have optimum debt ratio as balancing the value of interest tax shields against the costs of bankruptcy or financial distress. The survey tested the perceived importance of it in corporate financing decisions of managers. The findings reveals that corporate tax advantage of debt is moderately important in capital structure decisions in which the Chief Financial Officers (CFOs) concern when determine the appropriate amount of debt for firm. As far as foreign debt concern in order to gain the favorable tax treatment relative to Sri Lanka, firm issue foreign debt than borrowing domestically. The survey further shows that CFOs concern fairly important to issue debt in foreign countries when foreign tax treatment is favorable as result of gaining tax shields advantage of debt. This is as a result of different corporate tax rate prevails in countries and the firms manage to take advantage of it. The same study was conducted among European firms, Bancel and Mittoo (2004) note that interest tax saving was considered by management as important factors in determining the debt level of firm. They further state that lowering of weighted cost of capital as either important or very important to determine the debt level of firm which is consistent with importance of the tax advantage and the target to debt to equity ratio in which they consider as important factors in determining equity issuance decisions. Contrast to the above view of Graham and Harvey (2001), and Bancel and Mittoo (2004), a survey is conducted in Malaysia by Ibrahima et al, (2012) state that the Malaysian managers are not considered the corporate tax advantage of debt when they take debt issuance decision in which it is insignificant in their capital structure decisions. The developed countries like U.S.A, and European countries are usually viewed in their firms the value of interest tax shields. The argument proof that the perceived importance of the tax advantage of interest deductibility differs from country to country, especially developed and developing countries.

Graham and Harvey (2001) further state that in relation to firm characteristics the tax advantage is most important factors in large, regulated and dividend paying firms, probably the companies having high corporate tax rates, and also the big firms with large foreign exposure prefer foreign tax treatment is an important factors. Another survey describes that larger company with high profitability will be having high amount of debt, and will be able to barrow more debt to get the tax advantage over debt (Buferna, Bangassa & Hodgkinson 2005).

Sheikh and Wang (2011) note that static trade-off theory is not consistent with Pakistani firms whereas a negative and significant relationship between the debt ratio and profitability and liquidity. The Pakistani firms are not viewed the value of interest tax shields and they consider other factors in their corporate financing decisions other than static trade-off theory. In relative to firm characteristics, size of the firm is consistent with static trade-off theory in which it is found that a positive relationship between debt ratio and size. Larger firms focus on more debt due to their ability to diversify the business and to take advantage of tax shields on interest payment. Ibrahima et al (2012) state that large scale firms with high level of debt prefer as most important the tax advantage of debt and with no target level of debt ratio. It is mostly preferred by female and mature managers. Mefteh and Oliver (2010) state that significant positive relationship between size of firm and leverage. This is consistent with the trade-off theory of capital structure. Large firm tends to borrow more money to get the tax advantage of debt and also they are able to reduce bankruptcy cost through diversification. Miller (1977, p. 266) stress that 'the tax advantage of debt financing must be substantially less than the conventional wisdom suggests'. A study based in Netherlands, Jong and Dijk (2007) state that there is evidence on static trade-off theory of tax benefits and bankruptcy costs. The evidence that the level of leverage in the Netherlands is largely determined by factors from the tax benefits and bankruptcy costs. This seems that the application of static trade-off theory prevail in Netherlands.

Apart from the corporate tax benefits on interest, and bankruptcy or financial distress cost of leverage, there is an argument on personal income tax of investors against their interest income and/or dividend income are considered as a factors influence on debt or equity issuance decisions in firms. Personal income tax is paid by the marginal investor in corporate debt is just offset to the corporate tax saving. Graham and Harvey (2001) find very little evidence on personal taxes when deciding on debt policy or equity policy. The personal tax on debt policy is found very little evidence among Malaysian managers (Ibrahima et al, 2012). In addition to the above argument, the extensive trading of depreciation tax shields and investment tax credits through financial leases and other devices proves that plenty of firms face low

marginal rates. There are firms having huge unused loss carries forwards which pay no immediate taxes (Myers 1984).

Costs of financial distress include the legal and administration costs of bankruptcy as well as the agency, moral hazard, monitoring and contracting costs which can erode firm value. Miller (1977) describes that the great emphasis on bankruptcy costs of optimal capital structure policy seems to have been misplaced. The survey reveals that Cost of financial distress is not very important than the credit ratings and earnings volatility are very much concerned by CFOs when they take debt decisions, it is most important in large firm (Graham & Harvey 2001). Potential cost of bankruptcy is rated as less important factors in determining the debt level of firm (Bancel & Mittoo 2004). Ibrahima et al, (2012) state that it is strongly agreed that Malaysian managers are concerned as very important the financial distress cost when they take decision on debt issuance to their firm but they disregard the credit ratings in making debt decisions. This argument is not consistent with Miller (1977).

The bankruptcy and financial distress costs are rated as important in small, low growth firm with low level of foreign sales, and without target debt ratio. It is also considered to be an important factor by non-dividend paying firm. The credit ratings are rated moderately important consideration among female managers with more than nine years of working experience (Ibrahima et al, 2012). Bancel and Mittoo (2004) state that larger firms consider credit rating is more important than small firms and it influences more on debt levels of their industry and also less concern on potential cost of bankruptcy, volatility of earnings and cash flow. The large Jordanian industrial companies are highly levered because of the facts that they are able to reduce the risk of bankruptcy and their greater degree of diversification enables them to obtain debt more easily than smaller companies (Khrawish & Khraiwesh 2010).

The volatility of earnings and cash flows are considered as a factor which determines the debt level of firm. This drives to financial distress and/or bankruptcy costs. The perceived importance of this concept was tested by Ibrahima et al, (2012) state that earnings and cash flow volatility is considered as important and it is positively related in making debt issuance decisions in Malaysian firms which is rated relatively more important for large, with low level of growth and leveraged. The financial distress cost and earnings and cash flow volatility is in line with static trade-off theory in which the firm reduces debt when they find that the probability of bankruptcy is high. The bond market is not well developed in Pakistan and also the firms mostly rely on bank debt due to less volatility in earnings. It is identified that a negative relationship between debt ratio and earnings volatility which explains that firms with less earnings volatility borrow more as bank debt in Pakistan (Sheikh & Wang 2011). Bradley,

Jarrell and Kim (1984) state that earnings volatility and financial distress cost is associated with static trade-off theory whereas it relates negatively to firm leverage. This is similar to Sheikh and Wang (2011) survey results but the study is based on cross sectional and firm specific data. Titman and Wessels (1988) state that no significant relationship in between the volatility and debt ratio of firm which means that no support for an effect on debt ratios arising from volatility.

The survey evidence provides moderate support for the trade-off theory. Graham and Harvey (2001, P. 211) note the following:

> CFOs tell us that their companies issue equity to maintain a target debt-equity ratio, especially if their firm is highly levered, firm ownership is widely dispersed, or the CEO is young.

Target and actual debt ratio vary if debt intensity is measured relative to the market value of equity. Such variability influences on the debt policy of the companies, and also the firms do not rebalance the debt with the changes in equity prices. In line with these arguments, Graham and Harvey (2001) find those firms do not rebalance the debt in response to market equity movement and also few firm states that changes in price of equity affect their debt policy. Ibrahima et al, (2012) describe that majority of Malaysian managers are concerned importantly the target or tight target debt ratio to the firms. The responses of Malaysian managers are positively related to maintain target debt ratio in making equity issue decision. The target debt ratio prefer as most important by large firms, and dividend paying firms. It is further identified that changes in price of common stock is one of the most important factors that affect the debt policy among the large firm from manufacturing sectors and dividend paying firms. This is also important among young and Malay managers. Graham and Harvey (2001) state that large firm prefers tight or somewhat strict debt ratio than the small firms, and also targets debt ratio are important if the CEO has short tenure or is young. Myers (1984) state that if the debt is above target, firm does not issue stock, buy back debt and re-establish a more moderate debt to value ratio. On the other hand, quickly issue debt and buy back shares are fairly small.

Fixed transactions cost to issuing or retiring debt has an influence on debt policy at the time of debt ratio varies over time due to changes in market value of equity and a firm rebalances when its debt ratio crosses an upper or lower hurdle. Graham and Harvey (2001) find moderate evidence for this argument that firms consider transactions cost when making debt issuance decisions in small firms in which the CEO has been in office for at least ten years. Bancel and Mittoo (2004) state that firm's financial stability and transaction cost are considered marginally important

among the managers. Ibrahima et al, (2012) stress that moderate evidence was found to transaction cost in making debt issuance decisions and especially among small firms without target debt ratio, regulated and non-dividend paying firm. This is relatively regarded as important by female, non-Malay, and mature managers with non-MBA qualification.

Titman and Wessels (1988) state that a negative relationship between short term debt and firm size as result of transaction cost considerations, large firm tend to choose long term debt on the other hand small firm prefer short term debt relatively they face high transactions cost when they issue long term debt. This study suggests that leverage related cost and benefits may not be particularly significant. It is also found in relation to transaction cost a negative relation between measures of past profitability and current debt level of firms.

2.2.2 Management and Firm Characteristics in Relation to Pecking Order Theory

The pecking order theory is an alternative to the trade-off theory which has emerged based on asymmetric information problem. These asymmetric information problems occur when one party (manager) has better quality information than the other parties (investors and creditors). Pecking order theory (also referred to as the information asymmetry theory) explains financing hierarchy and asymmetric information. Firms prefer internal to external financing and/or debt to equity. Firms have no well-defined target debt to value ratio in following pecking order model whereas they follow sticky dividends policy and if the internal fund is less than the outlay, firm draws down its cash balance or marketable securities portfolio. Myers (1984) state that, in managerial capitalism, managers rely on internal finance as a byproduct of the separation of ownership and control and they avoid external finance subject to the discipline of the capital market. This means that managers mostly rely on internally generated profit rather rely on debt capital whereas it can be passed the ownership and control of the company to the debt holders. As the result of it, shareholders lose the control and ownership drastically. Rajan and Zingales (1994) state that firms in U.S, U.K and Canada prefer internal financing than external financing. But firms in Japan raise more money externally than internally in which the financing requirements increases due to retained earnings drop in the recessionary period.

Further to the argument, Graham and Harvey observation in 2001 (cited in Myers and Majluf 1984) led to pecking order model differ from trade-off theory in which it concerns on external financing only when internal funds are insufficient. A firm follows with pecking order model does not have target debt ratio. External funds are

less desirable because of information asymmetries between management and investors and also firm prefer to use debt, convertible securities, equity at last. The sources of capital can be obtained from different sources of financing mode, Modigliani and Miller (1958) state that in order to finance the investment, capital can be obtained from different sources of media which are ranging from pure debt instruments, representing money fixed claims, and pure equity issues. Modigliani and Miller (1963, p. 442) note the following:

> It may be useful to remind readers once again that the existence of a tax advantage for debt financing-even the larger advantage of the corrected version-does not necessarily mean that corporations should all times seek to use maximum possible amount of debt in their capital structures. For one thing, other things of financing, notably retained earnings, may be in some circumstances be cheaper still when the tax status of investors under the personal income tax is taken into account.

Firms maintain financial slacks to avoid the need for external funds, the most important factors affect the corporate debt decision is financial flexibility. The consideration and perception of financial flexibility among the corporate sectors is still in doubt the extent of perceived importance of it. Graham and Harvey (2001) state that the most important factor in corporate financing decision is financial flexibility, the majority of the management was desired for financial flexibility that they remain in the sense of minimizing interest obligations and also it is more important for dividend paying firms as they have relatively little informational asymmetry. The sense of minimizing interest obligations reveals that managers consider signaling when they take debt decisions and they time to avoid it and rely on internal financing to maximize the value of firm. Bancel and Mittoo (2004) describe that financial flexibility is the most important determinants of debt decisions to management among the larger firm. Financial flexibility means that firms restrict debt so they have enough internal funds available to pursue new projects when they come along. Graham and Harvey (2001, p. 219) stress that 'a deeper investigation indicates that the desire for financial flexibility is not driven by the factors behind the pecking-order theory'. Ibrahima et al, (2012) state that financial flexibility is ranked as most important factor in making debt decision among the Malaysian managers. It indicates that Malaysian managers are more concern on internal funds for future projects and growth opportunities. It is rated as important among large, high levered firm that pay dividends and have mature, long tenure, male manager. There are argument favor to have financial slacks that Myers and Majluf (1984) argue in favor of previous studies that the firm should carry sufficient financial slacks to undertake good investment opportunities as they arise in which the stakeholders are better off

and also further state that firms can build up financial slack by restricting dividends when investment requirements are modest. Sheikh and Wang (2011) state that firms are more rely on internally generated funds due to high cost of raising funds in Pakistan. The reason for rely on internal funds and avoiding external financing are that the bond market is well not developed in Pakistan, the firms mostly rely on bank debt at high finance cost.

Debt and equity issuance decision depend on sufficient internal funds and profitability of firms respectively. Insufficient internal fund is moderately important in debt issuance decision which is consistent with pecking order model, and there is modest evidence that firms issue equity because of recent profits have been insufficient to fund the activities in small firms than large firms (Graham & Harvey 2001). Bancel and Mittoo (2004) state that insufficient internal fund is not considered as important by managers. In contrast to Bancel and Mittoo (2004), insufficient internal funds is considered as most important factors in making debt decision in Malaysian firms which is second to the financial flexibility factor (Ibrahima et al, 2012). And also Ibrahima et al, (2012) further state that the Malaysian managers are considered as important the recent profit when they take decision on equity issuance decision. If they find that the recent profit is not enough to invest in new project, they find the way to issue new equity to finance the projects. More small firms than large firms prefer as important that they use debt in the face of insufficient internal funds. Firms prefer equity issue at last if the earnings volatility is high and the expected future earnings is uncertain.

Myers (1984) describe that managers try to maximize the intrinsic value of the firm's existing shares and/or concern on value of old shareholders. They consider undervaluation or overvaluation problem. If the inside information is unfavorable, they take issue and invest decisions and if the inside information is favorable, they pass up positive NPV investment rather than issue undervalued shares. Stock undervaluation is the factor which affects the debt issuance decision of firm. Management hesitates to issue common equity because they feel their stock is undervalued and they prefer convertible debt instead. Graham and Harvey (2001) state that equity undervaluation is most important factor among the management in deciding convertible debt issuance decision and it is most popular among growth firms and also large and dividends paying firms. It is more likely to say that equity undervaluation affects their debt policy. Titman and Wessels (1988) describe that no evidence on the relationship between debt ratio and future growth of firm. This argument is not consistent with Graham and Harvey (2001) that equity undervaluation is most popular among growth firm on debt issuance decisions.

Bancel and Mittoo (2004) state that equity undervaluation or overvaluation in issuing equity received important factors. Ibrahima et al, (2012) stress that equity undervaluation or overvaluation is most importantly considered by the Malaysian managers and also they reluctant to issue equity when they perceive that it is undervalued. It is rated among the large and dividend paying firms with target debt to equity ratios. Graham and Harvey (2001, p. 219) stress that 'the importance of financial flexibility and equity undervaluation to security issuance decisions is generally consistent with the pecking-order model of financing hierarchy'.

Convertible debt is having lower financial distress cost than debt and smaller undervaluation than equity in which it is called as "delayed' common stock or back-door equity. This is practiced by the managers because of the perception that convertibles are less expensive than straight debt. This argument is tested by Graham and Harvey (2001) finds that strong evidence on convertibles is preferred by the management than the equity or debt issue. Bancel and Mittoo (2004) state that convertible debt is important or very important factors to determine the debt level of firm. It is mostly preferred among the larger firm than the smaller counterparts. The firms prefer convertible debt when they find that the equity is undervalued which is considered among the Malaysian managers consequently it is considered as lower financial distress cost in issuing convertible debt for highly levered firms (Ibrahima et al, 2012).

As part of the pecking order model, the asymmetric information plays major role in debt and/or equity issuance decisions since the firms use capital structure to signal their quality or future prospect. The window of opportunity is considered as factors affecting equity issuance decision in which it is not consistent with pecking order hierarchy in which firm issue equity when the stock price increases. Recent increases in price of common stock are the third most important factors affecting equity issuance decisions (Graham & Harvey 2001). The timing of the debt or equity issue supports that managers use window of opportunity to raise capital, and issue equity is based on their firm's stock price which is ranked as moderately important (Bancel & Mittoo 2004). Myers (1984) state that firms try to time stock issues when security prices are high. There is no way firms can systematically take advantage of purchasers of new equity in rational expectations equilibrium.

Considering the information effects, information will change financing choices and financing choices will be interpreted by investors as good or bad. Graham and Harvey (2001) describe that there is very little evidence on firm equity issuance decision to give the market a positive impression of their prospect and very few managers indicate that their debt policy is consistent with signaling. There is little

evidence on factors relating to signaling theory or pecking order theory that issuing debt gives better impression than issuing equity. Low growth firm more concern on less risky and cheapest sources of funds and signal of better impression of firm, pay more attention to stock price level when issue equity (Bancel & Mittoo 2004). Buferna, Bangassa and Hodgkinson (2005) note that there was little evidence for information asymmetry, result suggests that none of these relationships exist for either the public or the private companies in Libya. In contrast, information asymmetry is relevant to capital structure decision in Pakistani firms whereas it is found that a negative and significant relationship between debt ratio and profitability and liquidity in which shows that firms are more rely on internally generated funds due to high cost of raising funds (Sheikh & Wang 2011). When market equity prices are high relative to book prices, the market is signaling higher expected growth and consequently to have lower debt. According to the market timing hypothesis, if the market-to-book ratio is high, then issuing equity seems more attractive than issuing debt. Mefteh and Oliver (2010) state that the results indicate when market values are higher than book value, leverage is lower. This result supports the trade-off, market timing and pecking order theories of capital structure.

Debt decision on short term or long term is consistent with the credit rating assigned by the rating agency. The management takes short term debt decision when they find that they are at lower credit rating or in weak form and also they are expecting that the credit rating to improve in future. The response received from management with speculative grade debt is consistent with firm timing their credit rating (Graham & Harvey 2001). Bancel and Mittoo (2004) state that managers consider credit rating as important or very important factors to determine the debt level of firm. In contrast to Graham and Harvey 2001 and Bancel and Mittoo (2004), credit rating is disregarded by the Malaysian managers in making debt decisions (Ibrahima et al, 2012).

Graham and Harvey (2001) find that strong evidence on timing market interest rates related to short term and long term debt decision by the management of firm. They issue short term debt when they find that short term market interest rate is low relative to long term rate or when they feel that long term rate to decline. This is similar to foreign debt issuance policy that there is moderate evidence that relatively low foreign interest rate affect decision to issue foreign debt. Bancel and Mittoo (2004) state that managers issue short term debt while they are waiting for the long term interest rate to decline in which it is considered as some support for timing of the debt.

2.2.3 Management and Firm Characteristics in Relation to Agency Cost Theory

The leverage and agency problems prevail between the bondholders and shareholders with regard to direct wealth transfer, asset substitution, and under investment, between shareholders and managers in line with over investment and free cash flows. It is the challenge of CFOs to balance the interest of bondholders and shareholders, shareholders and managers and also to mitigate the conflict among them. In the bondholders and shareholders conflicts, the shareholders intent to transfer the wealth of the company from bondholders to shareholders and the bondholders are aware of the situation in which this wealth expropriation may occur. They demand a higher return on their bonds. Assets substitution problem may occur when the CFOs decide to invest in assets that are riskier than what bondholders had approved. In such as case, asset substitution leads to the asset substitution problem.

In line with bondholders and shareholders conflict, under investment problem occurs at the circumstance in which a company, or the shareholders of a company, choose not to invest in low risk investments that would provide a safe cash flow for the benefit of holders of the company's debt, choosing instead of invest high risk, higher profit assets that increase their share value instead. Jong and Dijk (2007) describe that all hypotheses on agency problems between bondholders and shareholders are rejected. There are various literature reviewed on these assumptions and its perceived importance of it.

Over investment problem, which arises between shareholders and managers, is aggravated by more free cash flow and less growth opportunities. It is in doubt that how far the managers perceived importance of it. Choosing leverage over equity is a mechanism that CFOs use in the company to mitigate the agency problems. The leverage selection can be a short term or long term. Agency problems are not significantly related to leverage. There is no relation between over investment and leverage, while free cash flow induces over investment (Jong & Dijk 2007).

Agency cost theory focuses on the relation and/or conflict with managers and shareholders, managers and bondholders. Managers restrict borrowing so that profit from new/future projects can be captured fully by shareholders and do not have to be paid out as interest to debt holders. This argument refers the wealth transfer from bondholders to shareholders. The management response in relation to underinvestment cost is weak even the intention of management to choose short term and long term or total debt policy is related to their desire to pay long term profits to shareholders, not debt holders. It is found little evidence on underinvestment cost in relation to debt policy and also little support for the idea that short term debt is used

to alleviate the underinvestment problem and it is likely to concern by small and non-growth firm (Graham & Harvey 2001). Ibrahima et al, (2012) describe that the Malaysian managers limit their debt so that the profits from new investment can be captured fully by shareholders and also do not have to be paid out as interest to debt holders which is strongly agreed by the Malaysian managers. It is regarded as highly important by high growth and low levered firms. It is crucial for non-Malay male managers with non-MBA educational background.

There is plenty of indirect evidence indicating that the level of borrowing is determined not just by the value and risks of the firm's assets, but also by the type of assets it holds (Myers 1984). Graham and Harvey (2001) find that little evidence on executives' decision on short term debt issuance to minimize asset substitution problems. They further find that little evidence on convertible debt management prefers to protect bondholders against unfavorable actions by managers or stockholders. Short term debt is the tool the mangers used to minimize the assets substitution problems as well as agency conflict. There is moderate evidence that Malaysian mangers issue short term debt to minimize asset substitution problem. It is rated as important among low levered and non-paying dividends firm within the non-manufacturing industry. This is employed by young managers with short tenure and having non-MBA education background (Ibrahima et al, 2012).

Managers make sure that upper management works hard and efficiently, they issue sufficient debt to make sure that a large portion of the cash flow is committed to interest payment. This argument was tested by Graham and Harvey (2001) find little evidence that management discipline to use debt to commit payout free cash flow is second lowest rating among all factors affecting debt policy. It seems that managers are unwilling to admit to use debt in this manner. Ibrahima et al, (2012) state that use of debt to restraint the inefficient use of the free cash flow is highly supported by the Malaysian managers; there is strong evidence that firm discipline managers in this way. It is highly supported by small, non-dividend paying firms, without target debt to equity ratio and from the manufacturing sector. This is employed by non-Malay and mature managers and those with MBA qualification.

Titman and Wessels (1988) state that the study gives support for trade-off theory and also provide support for agency cost theory since failure of secondary market and the shareholders gives more pressure to management to invest into risky project to maximize the return of firm. Buferna, Bangassa and Hodgkinson (2005) describe that a negative relationship exists between financial leverage and growth of firm and also it gives support to agency cost theory as the Libyan companies use shot term debt to long term debt into their capital structure. The negative relationship between leverage

and growth indicate that growing firm might have enough internal funds to invest into the investment opportunity, use less debt. Another literature in which the result indicates that no support provided the effect on debt ratios arising from future growth of firm (Titman & Wessels 1988). Titman and Wessels (1988) argue that a positive relationship between short term debt or convertible debt and growth opportunity of firm.

Firm pays dividend out of more cash flows in comparison to investment opportunities and also they do not have to increase leverage and deadweight cost of debt. By forcing the managers to pay out of free cash flow, the dividend and debt can be controlled the free cash flow problem. As a result, there will be negative relationship between dividend payout and leverage. Mefteh and Oliver (2010) state that there is negative relationship between dividend payout and leverage; it provides little support for the hypothesis that paying dividend is a solution for the free cash flow problem and a substitute for leverage.

In contrast to the agency cost theory, the debt decision is consistent with product, market and industry factors in which the debt give signal to customer or other stakeholders and changes their behavior and decision towards firm. Graham and Harvey (2001) state that there is little evidence that product and market factors affect debt decisions. Managers are more concern on market factors when they take debt decision and they limit debt so that firm's customers or suppliers do not concern that the firm might go out of business.

Products and its uniqueness have an impact on debt issuance decision of firms. Titman and Wessels (1988) state that firms with unique or specialized products have relatively low debt ratios. They further state that debt levels are negatively related to the uniqueness of a firm's line of business as a result of imposing high cost on their customers, workers, and suppliers in the event of liquidation tend to choose lower debt ratios.

An industry factor is found as important in determinants of debt policy of the firm. They found modest evidence that managers are concerned about the debt levels of their competitors (Graham & Harvey 2001). Bradley et al (1984) describe that firms leverage ratios can be explained by industrial classification. There is more variation in mean leverage ratios across industries than the firm leverage ratios within industries. Systematic relation between the debt ratio and industry classification is consistent with the prediction of the theory of optimal capital structure. Whereas industry sentiment and median industry leverage are important variables in determining the debt level of firm. Mefteh and Oliver (2010) state that industry

sentiment is significantly but negatively related to leverage. It implies that when industry sentiment increases, the leverage level decreases. Median industry leverage has an expected positive sign and is highly significant. It implies that firms in the same industry follow the same optimal capital structure. The above findings is contradicting, Hatfield, Cheng & Davidson (1994) investigate that the market does not consider industry averages for leverage as discriminators for firm's financial leverage. The results show that market does not appear to consider the relationship between a firm's leverage ratio and the industry's leverage ratio important.

Risky firms ought to borrow less, other things equal. The expected cost of financial distress depends not on the probability of troubles, but the value lost if the trouble comes (Myers 1984). Management characteristics towards control contest and risk management are in relation to capital structure practices of firm i.e. debt or equity. Graham and Harvey (2001) find that moderate evidence that firms issue equity to dilute the stock holdings of certain shareholders and also majority of management consider that issuing foreign debt the most popular reasons they did so it is to provide a natural hedge against foreign currency devaluation. It is more important in small and manufacturing firms.

Liquidity and cash management are most important factors influence on debt issuance decisions i.e. short term or long term. Many managers prefer long term so that they do not have to refinance in bad times (Graham & Harvey 2001). Tangible assets are easy to collateralize and they reduce the agency costs of debt (Rajan & Zingales 1994). Tangibility is consistent with agency cost theory in Pakistani firm as a result of tendency of managers to consume more than the optimal level of perquisites. This is because of the short term debt usage in Pakistani firm and also managers maintain high excessive liquidity (Sheikh & Wang 2011).

Graham and Harvey (2001) highlight other factors affecting capital structure decision i.e. debt or equity and convertible debt issuance. It is found that debt usage is to derive the lower cost of capital while the equity issuance decision of management is to get earnings dilution. It is most important among the management of firms. Majority of the executive prefer the convertible debt than debt because of the ability to call or force conversion and less expensive than straight debt. Bancel and Mittoo (n.d.) state that earnings per share dilution (EPS) are considered as important or very important factors in issuing equity as well as in the larger firm than their small counterpart. Ibrahima et al, (2012) suggest that Malaysian managers strongly agree that EPS dilution is the most important factors affecting their equity issuance decisions. It is a big concern among regulated and dividend paying firm. Graham and

Harvey (2001) further state that EPS dilution is less important when the CEOs have an MBA than not having.

2.3 Summary

This chapter reviewed the literature in relation to capital structure theories and corporate financing decisions in both developed and developing countries. Research shows that the choice of capital structure is dependent on the circumstance and/or factors in relation to management and firm characteristics, the determinants of capital structure is not only related with capital structure model which was explained by Modigliani and Miller (1958), Modigliani and Miller (1963) but also other factors which influence on determining debt and equity level of firms. The literature identified that capital structure practices and management and firm characteristics has not been studied in highly volatile environments such as Sri Lanka, where stock markets are resilient to volatility in the environment. This literature review will be used to design the conceptual framework to develop the relevant hypotheses in this study. The next chapter discusses the research methodology in details whereas theoretical and conceptual framework, and related hypothesis, sample selections, statistical methods and operationalization of research.

CHAPTER THREE
RESEARCH METHODOLOGY

3.1 Introduction

To investigate the association between management and firm characteristics and perceived importance of capital structure theories of listed companies in Sri Lanka, this study employed methodologies adopted in prior research in this area. The purpose of this chapter is to describe the research methodology of this study. Since the aim of the study is to test the influence of management and firm characteristics in relation to perceived importance of capital structure theories, the design of the methodology is based on prior research into these relationships. This chapter describes the theoretical and conceptual framework, methods of data collection (population and sample), the theories and/or models used to test the hypothesis, and statistical techniques employed to report the results.

The chapter is structured as follows. Section 3.2 and 3.3 describe the theoretical and conceptual framework. The section 3.4 describes the hypothesis of this study to test the conceptual framework. In order to execute the test, population and sample are described in section 3.5 and 3.6. The section 3.7 and 3.8 discuss the statistical method used to analyze the data and operationalization of the hypothesis. Finally section 3.9 presents conclusion of the chapter.

3.2 Theoretical Framework

There are several theories dealing with capital structure. Those theories are classified into two major categories i.e. relevant theory and irrelevant theory. Relevant theory says that there is direct relationship between the capital structure and the value of firm whereas the irrelevant theory says that there is no relationship between capital structure and the value of the firm. The following section explains the theoretical background of capital structure practices.

3.2.1 Net Income and Net Operating Income Approach

Pandey (2010) explains that net income approach describes the basic of relevant theory. It explains that value of the firm is increasing when the leverage increases. In the world, where the existence of no taxes and transaction cost, debt is risk free, and shareholders have no financial risk. The weighted average cost of capital is decreasing from cost of equity to cost of debt when the leverage is increasing. Since the value of firm is maximized; the weighted average cost of capital is minimized

with leverage. It can generate an optimum capital structure to firm under this net income approach.

On the other hand, net operating income approach says that capital structure decision of firm is irrelevant. They say that there is no direct relation between capital structure and value of firm. They note that the leverage will not have an influence on value of firm or market value of shares. The basic reasons given in this approach is that weighted average cost of capital is independent on the degree of leverage.

3.2.2 Traditional Approach

Pandey (2010) further describe that Traditional approach is not supported to net income and net operating income approaches. It is a midway approach, and it combines feature of net income and net operating income approaches. The crux of this is the judicious use of equity capital. This theory says 03 stages in relation to the value of firm and the weighted average cost of capital. At the first stage, the cost of equity decreases when the leverage is increasing due to advantage created by substitute of low cost fund instead of higher cost fund. The second stage describes that when the leverage comes to judicious level of optimum, cost of capital is minimum and the value of firm is maximum due to the advantage of generating low cost debt exactly set of the disadvantage cause of higher cost equity capital.

Beyond the judicious level of debt, the cost of capital is increased because of financial distress cost or financial risk and also both cost of equity and cost of debt increase, as a result of such increment, the cost of capital will start to increase and the firm value will start to decrease.

3.2.3 Static Trade-Off Theory

Static trade-off theory explains why firm cannot borrow 100 per cent debt capital to maximize firm value. It further says that even though the borrowing generates tax benefit, this tax benefit cannot increase the value of the firm after judicious level of borrowing due to financial distress cost and agency cost. This theory says that the benefit of the tax is reduced by those of two costs, and the value of firm starts to decrease after the judicious level of leverage (Pandey 2010; Brigham & Ehrhardt 2009).

3.2.4 Agency Cost and Pecking Order Model

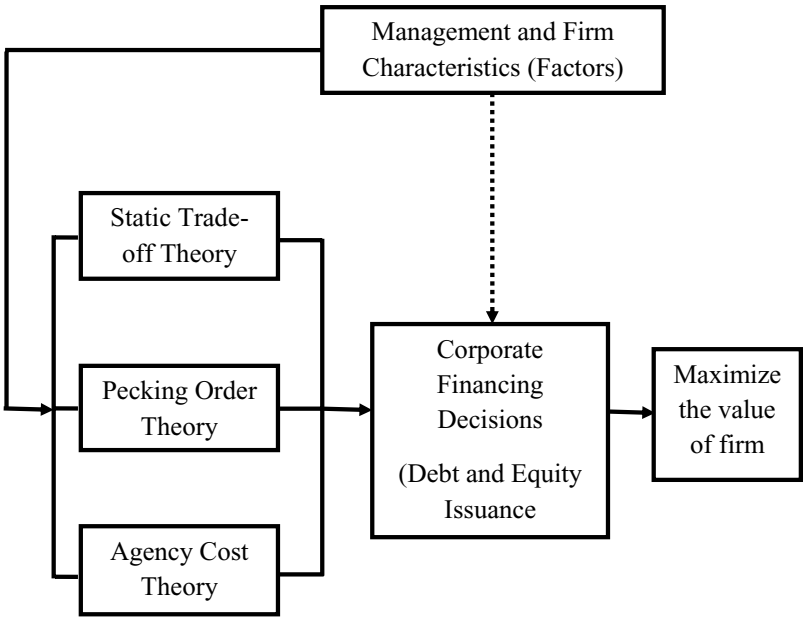
Agency cost is the complete unity of the managers and shareholders, and shareholders and bondholders of the company. It creates additional cost to company

such as high salary to manager, legal cost, high interest payment, and share ownership packages.

When an organization is used equity funds and debt funds, the managers can predict the future cash flow and operating income of the organization. If the operating income is going to be higher in future, the managers can use debt capital, they assume the re-payment of loan fund. If they are not sure about the cash flow and operating income in future, they will only use equity finance because there is no legal binding of re-payment. This order of using financing method by the managers is defined as pecking order theory, and it gives signal to the share market and debt market about the future of the firm. In general, pecking order theory implies the following order of using the fund i.e. managers always prefer to use internal funds, when they do not have internal financing they prefer issuing debt, and at last resort, the managers prefer raising equity financing (Pandey 2010; Brigham & Ehrhardt 2009).

The following theoretical framework illustrates the corporate financing decisions to maximize the market value of firm in relation to capital structure theories i.e. static trade-off theory, pecking order theory and agency cost theory and other factors which influence on debt and equity issuance decisions.

Figure 3.1
Theoretical Framework: Capital Structure Theories and Corporate Financing Decisions



3.3 Conceptual Framework

The conceptual frame work illustrates the link between the theoretical framework and operationalization of the study on association of management and firm characteristics in corporate financing decisions or debt and equity issuance decisions in relation to perceived importance of capital structure theories to maximize the market value of the firm that are investigated in this study. Evidence from empirical research suggests that management and firm characteristics influence in corporate financing decisions or debt and equity issuance decisions in relation to capital structure practices (refer to chapter 2). Management characteristics include the CFOs tenure, age, educational attainment, gender, and race. Some of the variables identified in corporate finance literature to measure the firm characteristics are size of firm, growth perspective, inclusion of leverage, having target debt ratio, firm rated by credit ratings, paying dividend firm, and industry classification. The capital structure practices are based on the capital structure theories i.e. static trade-off theory, pecking order theory, and agency cost theory.

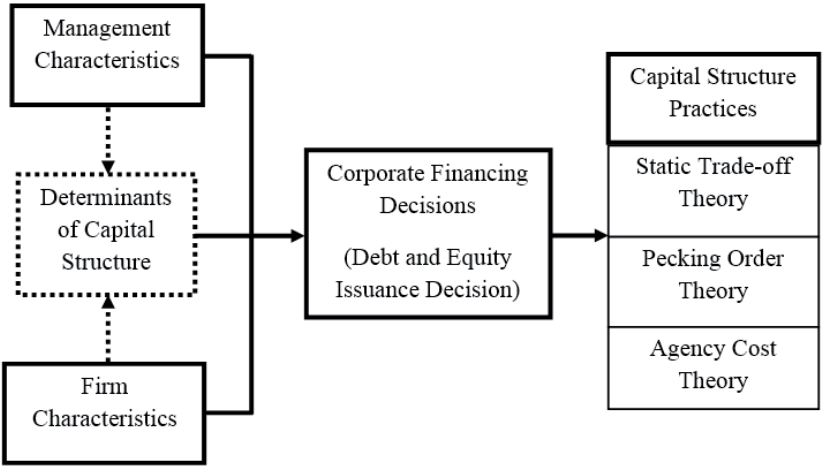
The conceptual framework comprises of management and firm characteristics which are considered important in affecting determinants of debt and equity of firm. The tenure, age, education, gender, and race are referred the CFOs years of service in the existing firm, the age at present, the educational attainment, male or female and the nationality respectively. The firm characteristics include size is referred to as small or large, growth perspective means low or high growth firm, levered firm is meant as low or high leverage firm. With regard to target debt ratio, the firm is classified as non-target debt ratio firm and having target debt ratio firm, the firm with credit ratings is categorized as non-credit rated firm and credit rated firm, dividend paying firm and non-dividend paying firm, and industry classification which are explained in details in the operationalization.

The capital structure theories are static trade-off theory, pecking order theory, and agency cost theory addressed to tax shield benefit and financial distress cost, asymmetric information and /or internal fund usage, and free cash flow respectively which was investigated in relation to management and firm characteristics by questioning the CFOs on the perceived importance of factors affecting short and long term debt decisions, issuing debt in foreign countries and convertible debt, issuing common stock, determining appropriate amount of debt, and firm's debt policy.

The scope of this study is restricted to determining the conditional relationship between management and firm characteristics in relation to perceived importance of capital structure theories in an unstable debt markets and share trading environment.

Figure 3.2

Conceptual Framework: Management and Firm Characteristics and Capital Structure Theories



3.4 Hypothesis

The theoretical and conceptual framework developed above will be used to develop the testable hypothesis for the study. The basis of the hypothesis is that the association of management and firm characteristics on debt and equity issuance decisions in relation to perceived importance of capital structure theories. However, the other factors like interest rate fluctuation and insider trading in stock market will affect the debt and equity issuance decisions of listed companies in Sri Lanka and also the challenge of managers is to maximize market value of firm as well as shareholders wealth pertaining to capital structure theories. Therefore, the hypothesis presented in this study will be testable to investigate the association of management and firm characteristics on debt and equity issuance decisions in relation to perceived importance of capital structure theories.

The hypotheses of this study are based on the argument on best practices of capital structure and its application of listed companies in Sri Lanka. The corporate finance decisions solely depend on the management and firm characteristics (Graham et al 2008). The choosing the debt level to firm depends on management decisions and relates with firm characteristics which determines the amount of debt level to firm. The following hypotheses are developed to test the association of management and

firm characteristics in relation to perceived importance of static trade-off theory, pecking order theory and agency cost theory.

A number of studies in the past, which aim the influence of management decisions on debt and equity issuance in relation to capital structure theories, have examined the management responses conditional to management and firm characteristics in relation to static trade-off theory, pecking order theory and agency cost theory (Graham and Harvey, 2001; Graham and Harvey, 2002; Bancel and Mittoo, 2004; Ibrahima et al, 2012). However, the empirical evidence on management and firm characteristics in relation to capital structure theories provide mixed support and further investigation reveals that other factors which influence on debt and equity issuance decisions.

Apart from the management characteristics, the debt and equity issuance decision depends on the firm characteristics which determined the debt level of firm. Several studies were carried out to examine the association with capital structure theories (Buferna et al, 2005; Sheikh and Wang, 2011; Titman and Wessels, 1988). The survey reveals that both the static trade-off theory and the agency cost theory are pertinent theories to the Libyan companies' capital structure whereas there was little evidence to support the asymmetric information theory, pecking order theory (Buferna et al, 2005). Sheikh and Wang (2011) stated that the findings of the study are consistent with the predictions of the static trade-off theory, pecking order theory, and agency cost theory.

3.4.1 Management and Firm Characteristics in Relation to Static Trade-off Theory

Static trade-off theory is a model which explains how firm should choose optimum capital structure to maximize the market value of the firm. It relates with tax advantage of debt usage and set off the financial distress cost. Graham and Harvey (2001), Graham and Harvey (2002) describe that moderate support to firm follows the static trade-off theory and target debt ratio. Ibrahima et al (2012) state that the survey provides mixed support for the notion of firm does trade-off costs and benefits to derive optimum debt ratio. Greater weight is given to the bankruptcy cost, then the benefits of tax savings from debt issuance. Large firm prefers tax advantage with high level of leverage and with no target level of debt ratio. The result is not trade-off with cost and benefit of debt usage to firm. Bancel and Mittoo (2004) describe that static trade-off theory is not on their concern but thinking on market conditions. There was moderate support for trade-off theory framework.

The null and alternative hypotheses are to test whether the static trade-off theory is relevant of listed companies in Sri Lanka.

H_0:- Among management characteristics, the degree of perceived importance of static trade-off theory to debt and equity issuance decision is not closely associated to management characteristics.

H_1:- Among management characteristics, the degree of perceived importance of static trade-off theory to debt and equity issuance decisions is closely associated to management characteristics.

H_0:- Among firm characteristics, the degree of perceived importance of static trade-off theory to debt and equity issuance decision is not closely associated to firm characteristics.

H_1:- Among firm characteristics, the degree of perceived importance of static trade-off theory to debt and equity issuance decisions is closely associated to firm characteristics.

3.4.2 Management and Firm Characteristics in Relation to Pecking Order Theory

Pecking order theory is a model which explains how firm should choose optimum capital structure to maximize the market value of the firm. It relates with financing hierarchy and asymmetric information. Graham and Harvey (2001), Graham and Harvey (2002) state that pecking order view is consistent with debt and equity issuance decisions and the evidence is generally not consistent with informational asymmetric causing pecking order like behavior. Ibrahima et al (2012) state that the findings are not consistent with the pecking order idea that information indicates equity undervaluation causes firms to avoid equity financing. It reveals that less support for the pecking order model among the European CEOs (Bancel and Mittoo 2004).

The null and alternative hypotheses are to test whether the pecking order theory is relevant of listed companies in Sri Lanka.

H_0:- Among management characteristics, the degree of perceived importance of pecking order theory to debt and equity issuance decision is not closely associated to management characteristics.

H_1:- Among management characteristics, the degree of perceived importance of pecking order theory to debt and equity issuance decisions is closely associated to management characteristics.

H_0:- Among firm characteristics, the degree of perceived importance of pecking order theory to debt and equity issuance decision is not closely associated to firm characteristics.

H_1:- Among firm characteristics, the degree of perceived importance of pecking order theory to debt and equity issuance decisions is closely associated to firm characteristics.

3.4.3 Management and Firm Characteristics in Relation to Agency Cost Theory

Agency cost theory is a model which explains how firm should choose optimum capital structure to maximize market value of firm. It relates with usage of cash flow of the firm. It focuses on the relation and/or conflict between shareholders and bondholders, managers and shareholders. Graham and Harvey (2001), Graham and Harvey (2002) investigate that the survey provides mixed or little evidence on agency cost theory, free cash flow considerations and product market concerns affect capital structure choice. Whereas the strong evidence found to agency cost theory (Ibrahima et al 2012).

The null and alternative hypotheses are to test whether the agency cost theory is relevant in listed companies in Sri Lanka.

H_0:- Among management characteristics, the degree of perceived importance of agency cost theory to debt and equity issuance decision is not closely associated to management characteristics.

H_1:- Among management characteristics, the degree of perceived importance of agency cost theory to debt and equity issuance decisions is closely associated to management characteristics.

H_0:- Among firm characteristics, the degree of perceived importance of agency cost theory to debt and equity issuance decision is not closely associated to firm characteristics.

H_1:- Among firm characteristics, the degree of perceived importance of agency cost theory to debt and equity issuance decisions is closely associated to firm characteristics.

3.5 Population

The population of the study is listed companies in Sri Lanka which are listed in Colombo Stock Exchange. The Colombo Stock Exchange (CSE) has 280 companies representing 20 business sectors as at 18th May 2012. The Market Capitalization of the CSE stood at Rs. 1,949.5 Bn as at 18th May 2012.

3.6 Sample

The sample was selected from the top 50 companies in the *Lanka Monthly Digest* 50 (The LMD 50), listed in the Colombo Stock Exchange for the period in 2010/2011. The aim was to test the extent to which they had adopted capital structure theories. The top 50 companies in the LMD were selected because these were more likely to have resources and motivation to take advantage of the opportunity to adopt good corporate financing practices, especially capital structure practices. The top 50 companies presented annual reports over the last 5 years which included debt and equity information and also Chief Financial Officers (CFOs) details. Further, these companies were better performing, exhibited higher stock return and were assumed to engage in good corporate financing practices.

There are companies from 13 sectors of the economy were ranked among the top 50 listed companies in Sri Lanka in order of turnover 2010/2011, which is represented in Table 3.1 and Figure 3.3. The largest sector was banking, finance and insurance. The second largest was diversified holdings. The third largest was beverage, food, and tobacco and two telecommunications giants were ranked fourth. In 2010/2011, the LMD 50 companies enjoyed in total turnover of Rs.1,089,394 million, while total assets were valued at Rs.2,488,573 million and shareholders' funds were Rs.568,240 million. The Table 3.1 represents the turnover, total assets and shareholders' funds for each sector. The engine of growth was blocked by terrorism and the ongoing war in the north and east, which are among the chief impediments to growth in corporate bottom lines in Sri Lanka.

Table 3.1

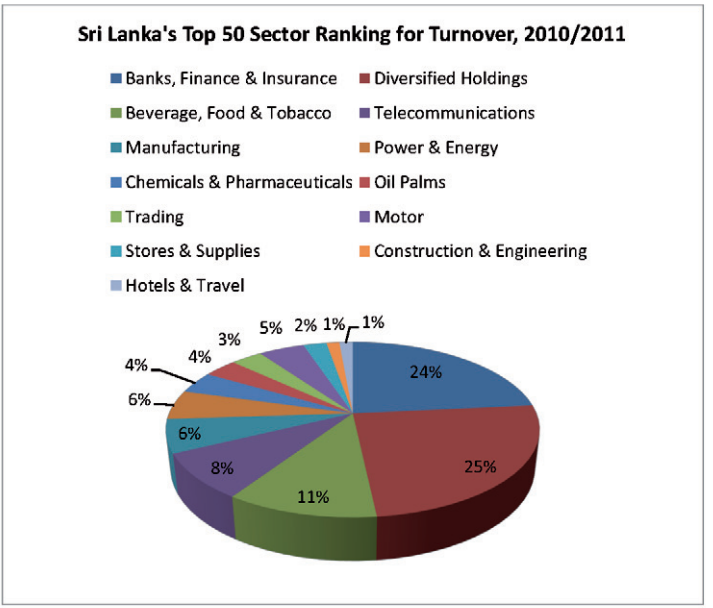
Sector Ranking of the Top 50 Listed Companies

Rank	Sector	Turnover (Rs. M)	Profit After Tax (Rs. M)	Total Assets (Rs. M)	Shareholder's Funds (Rs. M)
1	Banks, Finance & Insurance	255,707	35,378	1,581,459	178,972
2	Diversified Holdings	270,327	22,352	310,661	134,569
3	Beverage, Food & Tobacco	120,567	17,652	109,373	51,840
4	Telecommunications	91,673	8,990	159,166	81,462
5	Manufacturing	67,284	5,038	52,255	19,762
6	Power & Energy	59,045	1,730	28,055	15,270
7	Chemicals & Pharmaceuticals	44,076	3,039	37,392	9,977
8	Oil Palms	37,728	10,156	77,903	14,071
9	Trading	35,578	4,156	43,254	20,416
10	Motor	51,489	3,679	20,383	9,319
11	Stores & Supplies	26,251	2,096	20,122	2,029
12	Construction & Engineering	14,506	2,085	14,564	7,716
13	Hotels & Travel	15,163	3,506	33,986	22,837
	Total	1,089,394	119,857	2,488,573	568,240

Source: The LMD 50 2010/2011

Figure 3.3

Sri Lanka's Top 50 Ranking in 2010/2011 for Turnover



Source: The LMD 50 2010/2011

This study is based on non-financing firms listed in Colombo Stock Exchange, there were financial institutions included in LMD top 50 companies. Those were excluded from the sample. As this was a comparative study, the final sample of 37 was determined by the number of companies which falls under non-financing institutions. This study examines the CFOs responses conditional to management and firm characteristics in relation to capital structure practices of firms. The Table 3.2 shows the sample companies sector wise and its per cent on total sample companies.

Table 3.2

List of Sample Companies: Sector Wise

S/No	Sector	No of Companies	%
1	Beverage Food and Tobacco	6	16%
2	Chemical and Pharmaceutical	2	5%
3	Construction and Engineering	1	3%
4	Diversified Holdings	8	22%
5	Hotels and Travels	2	5%
6	Manufacturing	6	16%
7	Motors	3	8%
8	Oil Farms	1	3%
9	Power & Energy	2	5%
10	Stores & Supplies	1	3%
11	Telecommunications	2	5%
12	Trading	3	8%
		37	**100%**

3.7 Proposed Statistical Method

This survey focuses to analyze management and firm characteristics in relation to capital structure practices. As a result of it, the analysis of CFOs responses conditional to management and firm characteristics included descriptive statistical analysis, correlation analysis, Univariate analysis, and Independent Sample t-Test, with statistical data analysis using SPSS.

Questionnaire is the main quantitative analysis method approach for this study. Univariate analysis is utilized in this study to explore the ratings of each responses in the questionnaire, separately. It describes each responses on its own. Descriptive statistics describe and summarize responses. It looks the central tendency of the ratings, while Univariate descriptive statistics describe individual responses. In this way, information about number can be presented in a single table or figure. The ranking representation is useful for summarizing data for evaluations as well as

comparing similar types of items from the study. This study also performs Univariate analysis on the survey responses conditional on each separate management and firm characteristics. In addition, cross tabulation is also used to further clarify the difference between two groups of variables.

In order to test the hypothesis, an Independent Samples t-Test compares the mean scores of two groups on a given responses. For ordered or ranked responses, an Independent Sample t-Test is performed, where mean responses to each question is analyzed and differentiated conditional to the various characteristics included in this study (management and firm characteristics). The significant differences of the means are also depicted in the table that presents the mean values. Correlation analysis is performed to understand the relationship of responses among the management and firm characteristics. This study uses the method which was used in the previous study (Graham & Harvey 2001; Graham & Harvey 2002; Ibrahima et al 2012; Bancel & Mitto 2004).

3.8 Operationalization

This section describes the variables and/or factors used to operationalize the constructs discussed in chapter 4. This study is similar to the study of Graham and Harvey (2001), Graham and Harvey (2002), Ibrahima et al (2012), Bancel and Mitto 2004, focusing exclusively on capital structure practices issue in relation to management and firm characteristics in U.S.A and European countries. The conceptual framework explains the influence of management and firm characteristics on debt and equity issuance decisions in relation to capital structure theories.

In order to test the management and firm characteristics pertaining to capital structure practices, the questionnaire has separate questions on factors affecting to choice of short term and long term debt, debt in foreign countries, convertible debt, common stock and amount of debt to firm. Apart from this, the study analyses the management responses conditional on management characteristics (demographic variables) and firm characteristics. This study also adapts Graham and Harvey (2001) questionnaire which is also employed by Ibrahima et al (2012) on their study of practices of capital structure decisions: Malaysian survey evidence and Bancel and Mittoo (2004) on their study of the determinants of capital structure choice: a survey of European firms. This questionnaire does not require a pilot test since it is already adapting and widely applied questionnaire from the past studies. Even though, few modifications are done related to Sri Lankan context after consulting with MBA students who practice in private sectors at managerial capacity. The final version of the questionnaire covering capital structure decisions contain 6 questions (comprising

total of 60 questions elements), with subparts, and 04 pages long. There are six specific sections to collect brief information on management and firm characteristics to test the management and firm behavior in relation to capital structure theories. The questionnaire is accompanied by an explanatory covering latter that assured the confidentiality of responses. The questionnaire combines various questions forms including yes/no answer, closed form questions adopting a five point Likert scale and a small number of open ended questions. The high quality of the question is maintained through designing a clear questionnaire layout, covering letter signed by researcher, addressing letter to a specific name of CFOs (CFOs details and addresses are obtained from The LMD, and crossed check with annual report of the company) and stamped reply envelopes addresses to third party, which are enclosed with questionnaire.

The demographic characteristics are defined as age, tenure, education and executive stock ownership (Graham & Harvey 2001; Graham & Harvey 2002). Ibrahima et al (2012) describe the demographic characteristics as age, tenure, education, race and gender. Bancel and Mittoo (2010) state that the demographic characteristics to evaluate the management behavior in relation to debt and equity decisions as age, tenure, education and executive stock ownership. This study is employed with previous literatures to define the management characteristics such as age, tenure, education, gender and race. Gender plays a major role in corporate financing decisions. Graham et al in 2008 (cited in Barber and Odean 2001) state that males tend to be more overconfident than females. Education and age can signal many things, it can represent valuable knowledge gleaned from a good business education and potentially affect decisions in important ways. Younger CFOs may be bolder and risk aversion than the elder CFOs. Management characteristics play a vital role in debt and equity issuance decision in corporate sectors.

Firm characteristics are classified as size, industry classification, growth, leverage, credit rating, target debt ratio and pay dividend (Graham & Harvey 2001; Graham & Harvey 2002; Bancel & Mittoo 2004). Ibrahima et al (2012) describe that size, growth, industry classification, leverage, target debt ratio and pay dividend as firm characteristics. In line with previous literatures, this study employs the firm characteristics as industry classification, target debt ratio, growth, and credit rating, leverage, size and pay dividend.

In line with Graham and Harvey (2001), Graham and Harvey (2002), Ibrahima et al (2012), Bancel and Mittoo (2004), the growth and leverage are measured by price-earnings ratio and long term debt to total assets ratio respectively. The growth and leverage are measured by ratio of sales growth to total assets growth and total debt to total assets respectively (Sheik & Wang 2011). Titman and Wessels (1988) state that the growth is measured by capital expenses over total assets, Buferna et al (2005) state on percentage change in the value of total assets. Size is measured by sales value of firm (Graham & Harvey 2001; Graham & Harvey 2002). Bancel and Mittoo (2004) state that the size is measured by proxy of market value of equity whereas natural logarithm of sales (Sheik & Wang 2011), natural logarithm of assets (Buferna et al 2005), natural logarithm of sales (Titman & Wessels 1988). In line with Ibrahima et al (2012), this study employs to measure the growth is based on board listing, Main Board refers as large firm and Second Board refers as small firm. In Colombo Stock Exchange, there are two types of boards, Main Board refers as large firm and Diri Savi Board refers as small firm. The following table 3.3 describes the summary of measurement of firm characteristics variables.

Table 3.3
Summary of Measurement of Firm Characteristics Variables

Variables	Measurements	Authors	Measurement used in this study
Growth	Price earnings ratio	Graham and Harvey (2001); Graham and Harvey (2002); Ibrahima et al (n.d); Bancel and Mittoo (n.d)	Price earnings ratio
	Ratio of Sales growth to total assets growth	Sheik and Wang (2011)	
	Capital expenses over total assets	Titman and Wessels (1988)	
	Changes in value of total assets	Buferna et al (n.d)	
Leverage	Long term debt to total assets ratio	Graham and Harvey (2001); Graham and Harvey (2002); Ibrahima et al (n.d); Bancel and Mittoo (n.d)	Long term debt to total assets ratio
	Ratio of Total Debt to total assets	Sheik and Wang (2011)	
Size	Sales value of firm	Graham and Harvey (2001); Graham and Harvey (2002)	Board listing
	Proxy of market value of equity	Bancel and Mittoo (n.d)	
	Natural logarithm of sales	Sheik and Wang (2011); Titman and Wessels (1988)	
	Natural logarithm of assets	Buferna et al (n.d)	
	Board listing	Ibrahima et al (n.d)	

3 Summary

This chapter discussed the development of research methodology for the study. Firstly, it examined the theoretical framework that applies to the study. Secondly, the theoretical framework was linked to the conceptual framework through management and firm characteristics in relation to capital structure practices on debt and equity issuance decisions to develop the hypotheses for the study to observe if management and firm characteristics influence on debt and equity issuance decisions in relation to capital structure practices. Thirdly, the hypotheses identified were discussed. Following this, the population, sample selection and statistical method were discussed and finally, operationalization to the study discussed to explain the conceptual framework and its variables included.

CHAPTER FOUR
STATISTICAL RESULTS AND ANALYSIS

4.1 Introduction

The analysis of the degree of perceived importance of capital structure theories association with management and firm characteristics of debt and equity issuance decisions are discussed in this chapter using the data from the sample. The analysis uses descriptive statistics to describe and summarize data, while Univariate analysis will report each variable in a data set separately to create a frequency distribution of the individual cases, conditional on each separate management and firm characteristics. An independent – Sample t-Test compares the mean scores of two groups on a given variables to test the significant difference between the groups of variables. Kendall's Tau, a measure of correlation analysis assesses the association between survey responses and management and firm characteristics, and analysis of significant test assesses the suggested relationship in the research hypothesis in chapter 3. The results from the statistical analysis discuss the integrated results to find out if the hypotheses are supported.

The structure of the chapter as follows. Section 4.2 describes the data collection, its delivery and response rate. Section 4.3 and 4.4 report the summary of management and firm characteristics. Section 4.5 presents the analysis of the correlation between survey responses and management and firm characteristics. Section 4.6 describes the factors analysis of corporate financing decisions by using the descriptive statistics and independent sample t-test. Section 4.7 presents the conclusion to the chapter.

4.2 Data Collection: Delivery and Response Rate

Questionnaire for this study is distributed to the respective CFOs of all non-financial listed companies in Sri Lanka via mailing and e-mailing. In a mail survey, questionnaires are printed and sent by registered mail. The respondents are asked to complete the questionnaire and send it back using the stamped reply envelopes address or asked them to fax it. The due date for sending back is also mentioned in the cover letter attached. A week after the questionnaire is mailed, phone calls are made to each of the firms to ensure the questionnaire is received and successfully reached the right respondent. The second data collection method utilized by this survey is e-mailing, where respondents are notified via email invitation sent directly to the respondents. The CFOs information such as name, postal address, and email including their contact numbers are collected from the Lanka Digest Monthly (LMD). Respondents are given options either to reply by mail/e-mail or fax, whichever

convenience for them. Follow up via phone call after three weeks from the initial distribution of the questionnaire is made to ensure that the questionnaire is being entertained accordingly. The second stage is planned in advance and designed to maximize the response rate. Upon the follow up, second copy of the questionnaire is sent via e-mail. The survey administration takes two months approximately, from July to August 2012. Altogether 28 usable responses from the CFOs are collected, thus representing a response rate of about 75%, a highly satisfied and remarkable rate for a survey in the field of corporate finance. The usual response rate for similar surveys conducted in Malaysia is 25% (Ibrahima et al n.d), 9% rate was recorded in USA (Graham & Harvey 2001). Similar survey conducted in European firms is recorded 12% (Bancel & Mitto n.d).

4.3 Summary on Management Characteristics

The survey respondents include CFOs of non-financial listed companies in Sri Lanka. This study covers a number of questions about the characteristics of the Chief Financial Officers (CFOs). Almost 64.29% of the CFOs for the responding firms are between 40 to 49 years old (Fig. 4.1a). Another 28.57% are over the age of 49 and less than 60, a group that this study refers as "mature". 7.14% of the CFOs are less than 40 years old. The survey reveals that CFOs change jobs frequently (Fig. 4.1b). Majority of the CFOs (53.57%) have been in their jobs less than four years, 25% and 21.43% of the CFOs have been in their jobs between four to nine years and over nine years respectively. This study defines the 21.43% who have been in their jobs longer than nine years as having "long tenure".

The level of educational attainment reveals that 46.43% of the CFOs have an MBA degree as their highest level of educational attainment. Another 28.57% have non-MBA masters which refer the professional qualifications and 25% of the respondents have educational attainment higher than the master levels (Fig. 4.1c). Majority of the CFOs (89.29%) of the sample firms are Sri Lankan (Fig. 4.1d), followed by 10.71% of CFOs are non-Sri Lankan. Male CFOs dominated the firms that responded to this survey (89.29%), and the remaining 10.71% are female CFOs (Fig. 4.1e).

Figure 4.1a Demographic Characteristics of CFOs: Age (Years)

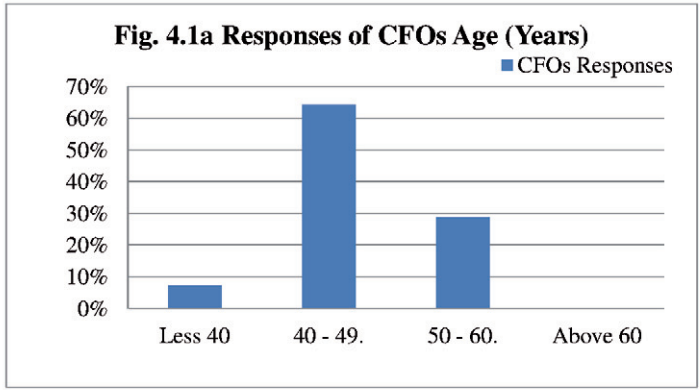


Figure 4.1b Demographic Characteristics of CFOs: Tenure (Years)

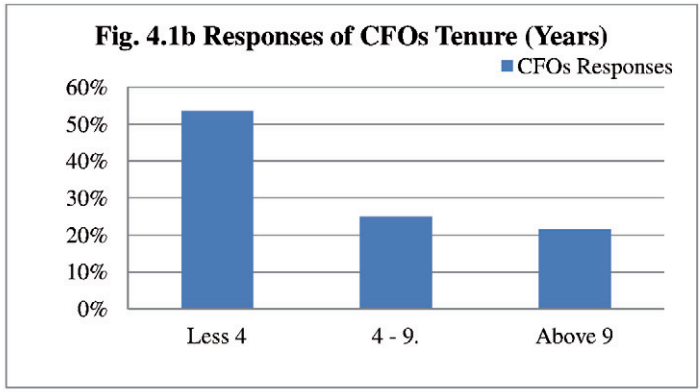


Figure 4.1c Demographic Characteristics of CFOs: Educational Attainment

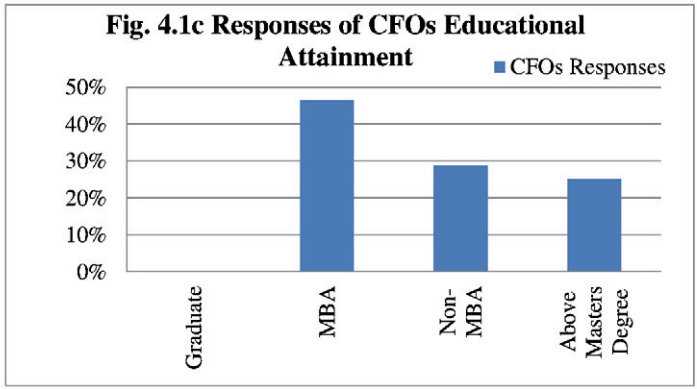


Figure 4.1d Demographic Characteristics of CFOs: Race

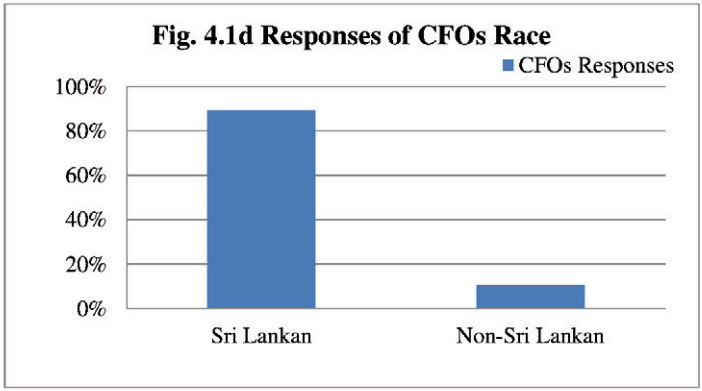
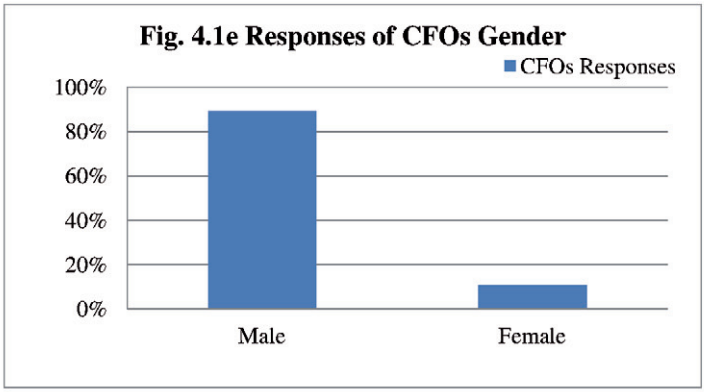


Figure 4.1e Demographic Characteristics of CFOs: Gender



4.4 Summary on Firm Characteristics

Figure 4.2 presents summary information about the firms in the sample. For this study, size is measured based on the board listing at the Colombo Stock Exchange. This classification is consistent with other studies undertaken on Malaysian listed firms such as a study undertaken by Ibrahima et al (n.d). Based on the board listing (Fig. 4.2a), 96.43% of the sample firms are listed in the Colombo Stock Exchange Main Board (large firms) and the remaining 3.5% of the firms are listed on the Colombo Stock Exchange Diri Savi Board (small firms). Main Board contain larger than above while Diri Savi Board for small, medium, and startup companies. Eligibility criteria for to be listed on the Main Board are stated capital of not less than Rupees Five Hundred Million (Rs. 500,000,000) at the time of listing, whereas stated capital of not less than Rupees Hundred Million (Rs.

100,000,000) is needed for Diri Savi Board. In Main Board, there should be a minimum of public holding of 25% of the total number of shares, but in Diri Savi Board, there is minimum of public holding of 10% of the total number of shares. Fig. 4.2b presents the price-earnings ratio of the sample firms, where 42.86% of the firms have price-earnings ratios of 15 or greater. This study refers to these firms as growth firms in analyzing how investment opportunities affect corporate behavior. The remaining 57.14% of the respondance are referred as non-growth firms. 14.29% of the firms are manufacturers (Fig. 4.2c). The non-manufacturing firms are evenly spread across other industries, including chemical & pharmaceuticals (7.14%), telecommunication (7.14%), hotel & travels (10.71%), beverage food & tobacco (17.86%), diversified holdings (14.29%), trading (10.71%), power & energy (7.14%), construction & engineering (3.57%) and motors (7.14%).

The distribution of debt levels is less uniform (Fig. 4.2d) as majority of the sample firms (64.29%) are having long term debt to total assets ratios of 10 or lesser. This study refers to firms with debt ratios greater than 30% as highly levered firms. Thus, from the distribution, 89.29% of the sample firms are low levered firms and the remaining 10.71% of the sample firms are highly levered. 35.71% of the firms (Fig. 4.2e) are considered as having target debt ratio (somewhat tight and strict target range), whereas 64.29% of the sample firms are not having target debt ratio (flexible and no target range). The creditworthiness of the sample is also dispersed (Fig. 4.2f). 25% of the sample firms are classified as having good credit ratings (ratings of A, AA, AAA, A-, B+), low credit ratings (AP2) and 75% of the samples are classified as having no credit ratings. Among the responding firms, 89.29% issue dividends, and the remaining 10.71% of the firms are not issued dividends (Fig. 4.2g).

Figure 4.2a Firm Characteristics: Size

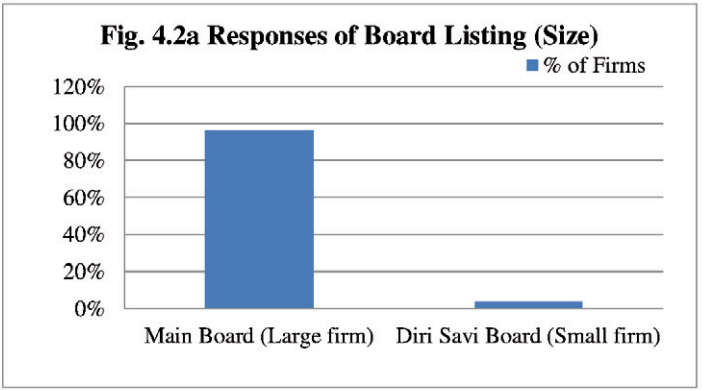


Figure 4.2b Firm Characteristics: Growth

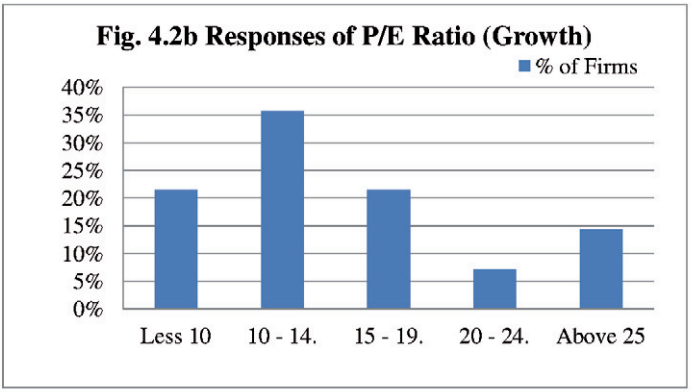


Figure 4.2c Firm Characteristics: Industrial Classification

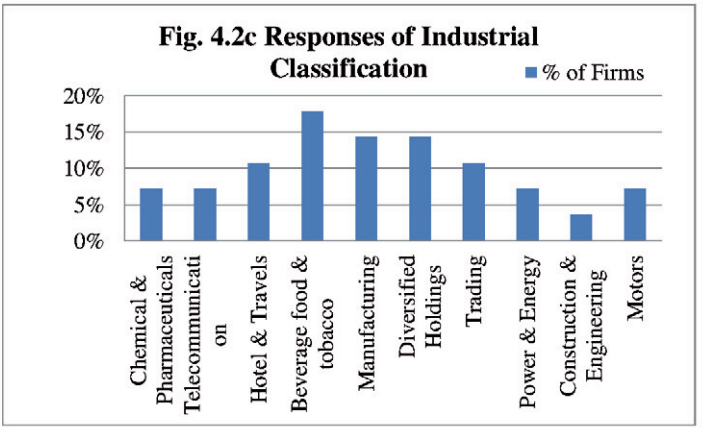


Figure 4.2d Firm Characteristics: Long Term Debt Ratio

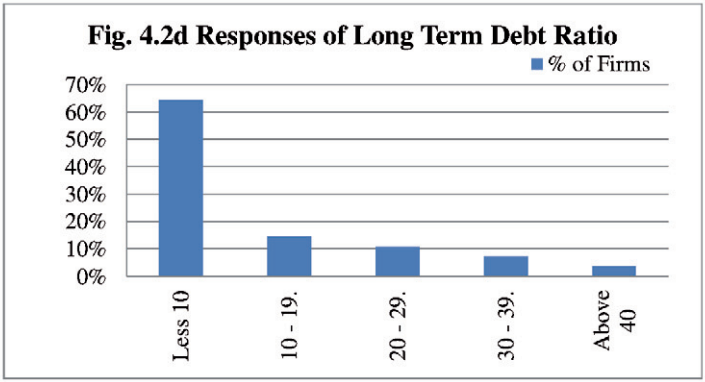


Figure 4.2e Firm Characteristics: Target Debt Ratio

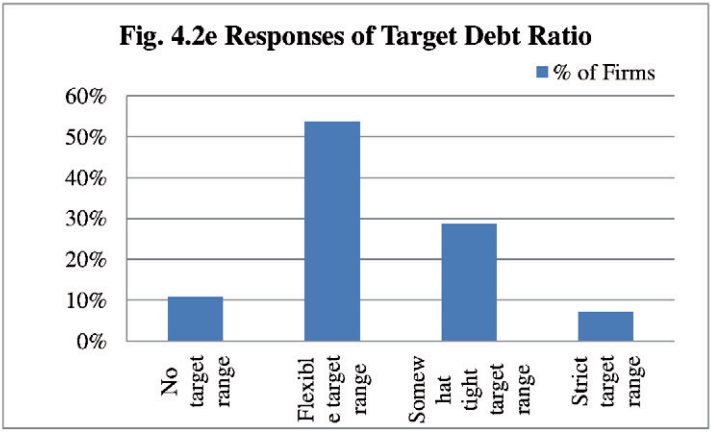


Figure 4.2f Firm Characteristics: Credit Ratings

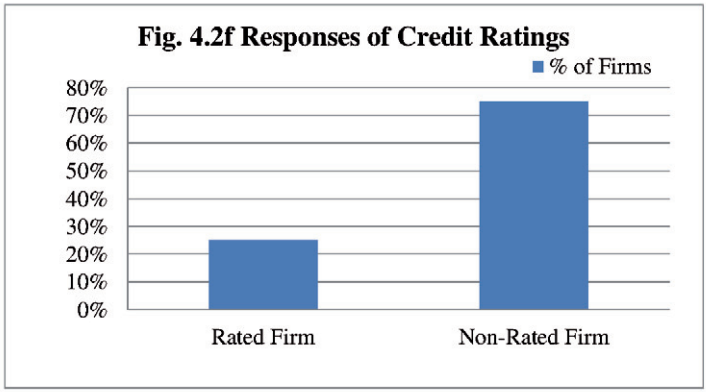
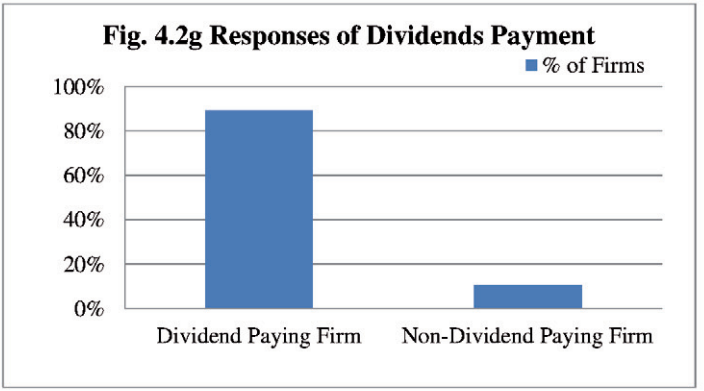


Figure 4.2g Firm Characteristics: Dividends Payment



4.5 Analyzing the Correlation of Survey Responses with Management and Firm Characteristics

Appendix 5 reports that the Kendall's Tau, a measure of correlation between two ordinal level (rankable) variables is reported. The ***, **, * denote significant difference in means at the 1%, 5%, and 10% levels respectively. In this analysis, the CFOs responses associated with management and firm characteristics and its correlation is tested. The correlation of the responses among the management and firm characteristics are presented in appendix 5.

Among the management characteristics, it is noted that the responses of CFOs between the variables are positively correlated, except the variables between tenure and race (correlation coefficient -0.181), and the age and race (correlation coefficient -0.219), in which there are no significant in correlation between the identified variables where the P value is greater than 5%. It is noted that the P value of tenure and age is less than 5% which describes that there is significant in correlation, it reports of 0.440* of correlation coefficient.

Among the firm characteristics, the variables between target debt ratio and leverage, and the credit ratings and leverage are significant in correlation whereas the P value is less than 5%. The correlation coefficient is reported 0.465* and -0.600* respectively. Apart from these variables, all other variables are not significant in correlation whereas the P value is greater than 5% and also there is positive as well as negative correlation is identified.

Between management and firm characteristics, there is significant in correlation between tenure and growth, and the gender and credit ratings whereas the P value is less than 5%. The correlation coefficient is reported as 0.427* and -0.600** respectively. Other than, all other variables are not significant in correlation.

4.6 Analyzing the Factors of Corporate Financing Decisions: Descriptive Statistical Analysis and Independent Sample t-Test

As discussed in Chapter 3 (3.7), descriptive statistics, Univariate analysis and independent sample t-test were tested for the purpose of analyzing the responses of CFOs on the factors affecting their choice in corporate financing decisions conditional to management and firm characteristics. The survey questions comprise various areas on corporate financing decisions i.e. short and long term debt decisions, issuance of debt in foreign countries and convertible debt, decisions to issuance of common stocks, determining the appropriate amount of debt for firm and firm's debt policy. A summary of the descriptive statistics and independent sample t-Test are presented in the appendix 3 and appendix 4 respectively.

4.6.1 The Factors of Short and Long Term Debt Decisions

Analysis of the short and long term debt decisions which is the part of corporate financing decisions comprises in this study covers few questions which affects the firm's choice between short and long term debt decisions. Descriptive statistics and Univariate analysis are calculated the mean and also frequency of the rate of important or very important is marked as percentage of the responses. The details of the descriptive statistical analysis are illustrated in appendix 3. Analysis of the short and long term debt decisions (appendix 3.1) reports that 64.30% of the respondents are rated as important or very important for matching the maturity of the debt with life of the assets when they decide on short and long term debt issuance. However, over 60.70% of the respondents preferred the lower interest compared to long term rates on deciding short and long term debt issuance decisions. Less preference was given to the factors of waiting for long term market interest rates to decline, risk of refinancing, shareholders interest, improving credit rates and considering risky projects.

Appendix 3.1 shows the factors that determine the short and long term debt for the firm. The CFOs tell that the short term interest rates are low compared to long term rates is rated as moderately important in capital structure decisions: Row a1 of appendix 3.1 shows that the mean response is 2.54 on a scale from 0 to 4 (0 meaning not very important, 4 meaning very important). Matching the maturity of debt with life of assets is rated as fairly important in short and long term debt decisions for the

firm: Row b1 of appendix 3.1 shows that the mean response is 2.32. Other than, all other factors are rated as not important in short and long term debt decisions for the firm.

Univariate descriptive statistics in this analysis shows the extent to which management characteristics compile with short and long term debt issuance decisions for the firms. The interest rates (mean 3.33: Row a1) and maturity of debt with life of assets (mean 3.00: Row b1) are considered important relatively by female CFOs of the sample firms. Other than that CFOs who is having short tenure (mean 2.73), mature age (mean 2.75), having MBA degree (mean 2.77), and Sri Lankan CFOs (mean 2.72) are rated moderately important on the factor of short term interest rates are low compared to long term rates. All other factors are rated as not important or fairly important conditional to management characteristics (appendix 3.1).

CFOs are considered the interest rates as moderately important among all firms' characteristics other than the small size firms and non-dividends paying firms which are having the mean of 2.00: Row a1 and 1.33: Row a1 respectively. Meeting the shareholders interest than the debt holders interest (Row d1) and waiting long term interest rates to decline (Row c1) are regarded as very important for small size firms (mean of 4.00). Matching the maturity of debt with life of assets is rated as moderately important among the firms not having target debt ratio (2.70), high growth firms (2.58), and credit rated firm on debt decisions (2.57).

Comparison of the mean values of control variables (management and firm characteristics) conditional to firm's choice between short and long term debt decisions of the sample companies using two-tailed independent sample t-test are presented in appendix 4.1. Comparison of the mean difference in tenure, age, education and gender association with the short and long term debt issuance decisions are not statistically significant difference between the responses of two groups of variables ($P > 0.05$), the difference between conditional means are likely due to chance and not likely due to the manipulation. This indicates that there is similar thinking and practice among the management in choosing short and long term debt decision factors in corporate finance.

In contrast to the above view, the Race is a statistically significant difference between two variables in association with many of the responses of short and long term debt issuance decision factors. The factors are such as short term interest rates are low compare to long term rates (sig. 2-tailed: 0.013, $P < 0.05$), matching the maturity of the debt with the life of assets (sig. 2-tailed: 0.019, $P < 0.05$), waiting for long term market interest rate to decline (sig. 2-tailed: 0.006, $P < 0.05$). The Gender is a

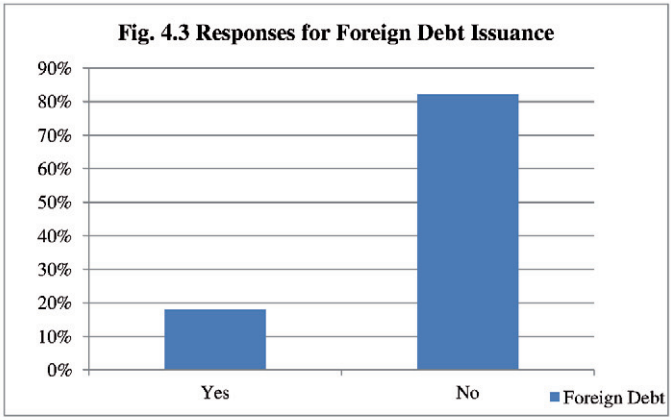
statistically significant difference between the responses of two variables in association to matching the maturity of debt with the life of assets (sig. 2-tailed: 0.002, $P < 0.05$).

With regard to the firm characteristics, those are that of the based on industry classification, target debt ratio, growth firm, credit rated firm, leverage, size of firm and dividends paying firm are not statistically significant difference between the responses of two variables (where the $P > 0.05$).

4.6.2 The Factors of Issuing Debt in Foreign Countries

The firm decisions about issuing foreign debt in foreign countries is not in the satisfactory level in this survey since there is lower percentage of respondents revealed their preference of issuing foreign debt. 17.86% of the respondents say that they are willing to issue foreign debt in their corporate financing practice. The following graph (Fig. 4.3) illustrates the respondents' preference.

Figure 4.3 Preference of Issuing Debt in Foreign Countries



Appendix 3.2 reports that favorable tax treatment relative to Sri Lanka (rating of 3.60: Row a2), lower foreign interest rates (rating of 3.20: Row e2) and providing a natural hedge (rating of 3.00: Row of c2) are rated as important in foreign debt issuance decisions for the firms. For those factors, frequency of the respondents rating for important or very important are 14.30%, 17.90% and 10.70% respectively which are lowest percentage reported in rating the factors effect on capital structure practices for the firms.

Among the management characteristics, favorable tax treatment relative to Sri Lanka, lower foreign interest rates and providing a natural hedge are rated as important or

very important in foreign debt issuance decisions for the firms. The CFOs with short tenure, and young age who is having MBA degree, male CFOs and non-Sri Lankan are rated very importantly (mean 4.00) the factors of favorable tax treatment relative to the Sri Lanka. Non-Sri Lankan CFOs are rated very importantly the lower foreign interest rates than domestic interest rates (appendix 3.2).

The firms without target debt, low growth and non-credit rated firm are considered very importantly the factors affect issuing foreign debt that favorable tax treatment relative to the Sri Lanka. Favorable tax treatment relative to Sri Lanka, lower foreign interest rates and providing a natural hedge are regarded importantly relative to the non-manufacturing firms, firms with target debt, high growth, credit rated firm, lower leverage, larger in size, and paying dividends (appendix 3.2).

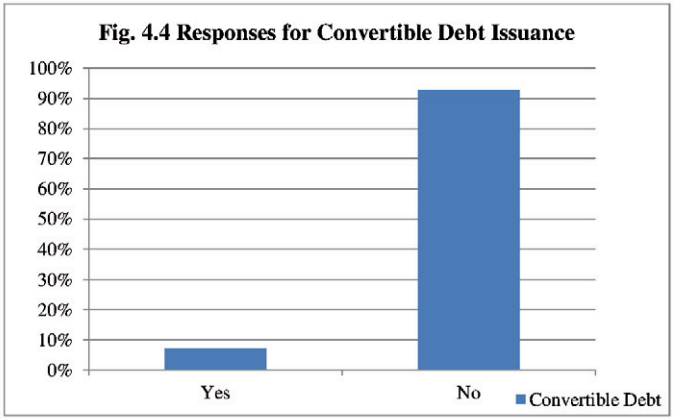
Appendix 4.2 presents the results of comparison of the mean values of firm decisions about the factors of issuing foreign debt of the sample firms association with control variables (management and firm characteristics). Comparison of the mean difference of tenure, age, education, gender and race are not statistically significant difference between two variables ($P > 0.05$). It indicates that the management characteristics are not important in deciding the foreign debt issuance decisions of listed companies in Sri Lanka.

The firm characteristics are that of the industry classification, target debt ratio, growth firm, credit ratings, leverage, size of firm and dividends paying firms are not statistically significant difference between two variables (where the $P > 0.05$). The firm characteristics are insignificant in their capital structure decisions, foreign debt issuance decisions.

4.6.3 The Factors of Issuing Convertible Debt

Similar to issuing foreign debt decisions, the firm decisions about issuing convertible debt is also not perceived by CFOs practically since there is lower percentage of respondents revealed their interest on issuing convertible debt. It is generally 7.14% of the respondents reported that they are willing to issue of convertible debt in their corporate financing decisions. The following graph (Fig. 4.4) illustrates the respondents' preference.

Figure 4.4 Preferences of Convertible Debt Issuance Decisions



Appendix 3.3 reports that stock undervaluation (rating of 3.00: Row f3) is rated as important in convertible debt issuance decisions for the firms. The frequency of the respondents for rating important or very important is 7.10% which is lowest percentage reported in rating the factors effect on capital structure practices for the firms. Other than that, all other factors are considered as not very important (0 to 2).

The CFOs with short tenure, and young age who is having non-MBA degree and male and female CFOs and Sri Lankan and non-Sri Lankan are considered as important for stock undervaluation (mean 3.00: Row f3) in deciding convertible debt issuance decisions. Sri Lankan and Male CFOs are regarded as important (mean 3.00) for stock undervaluation, attracting investors, ability call or force, avoiding short term equity dilution, convertibles less expensive than straight debt, and protecting bondholders from stockholders.

Non-manufacturing firms, firms without target debt, growth firm (low & high), rated & non-credit rated, low leverage and firm in large size also paying dividends are considered as important for stock undervaluation (mean 3.00: Row f3) in deciding convertible debt issuance decisions. High growth firms and firm without credit ratings are regarded as important (mean 3.00) for stock undervaluation, attracting investors, ability call or force, avoiding short term equity dilution, convertibles less expensive than straight debt, and protecting bondholders from stockholders.

Convertible debt issuance practices of the sample companies are recorded as statistically not significant difference among management characteristics. Comparison of the mean values of control variables (management and firm characteristics) are presented in appendix 4.3. Comparison of the mean difference of

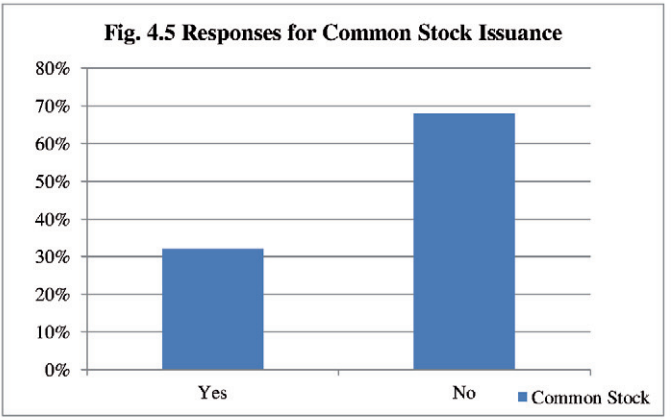
the tenure, age, education, gender and race in association with convertible debt issuance decisions are a statistically not significant difference between the responses of two variables.

The firm characteristics are that of the industry classification, target debt ratio, growth firm, credit ratings, leverage, size of firm and dividends paying firms are also a statistically not significant difference between two variables (where the $P < 0.05$).

4.6.4 The Factors of Issuing Common Stocks

The study reveals that the preference of issuing common stock is less preferable by the CFOs which show in the descriptive and frequency statistics. There are several factors which affects the firm's decisions about issuing common stock in capital structure decisions. Comparatively, 32.14% of the respondents are preferred issuing common stocks of listed companies in Sri Lanka. The following graph (Fig. 4.5) illustrates the preference of the CFOs in common stocks issuance decisions.

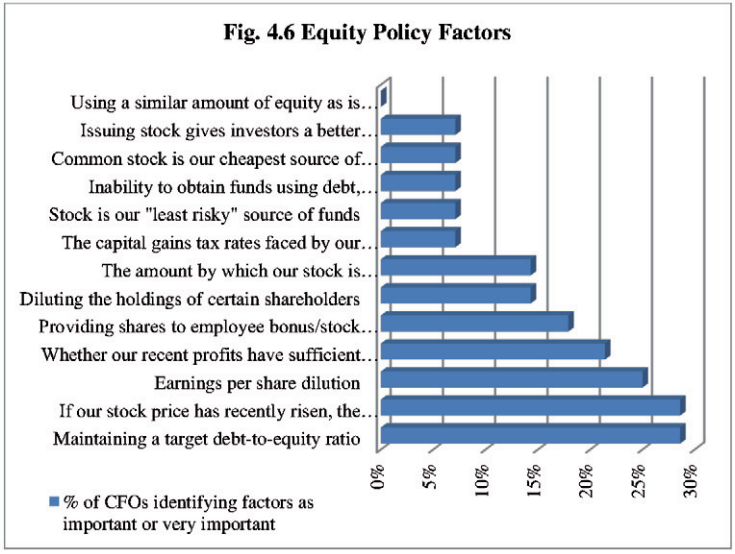
Figure 4.5 Preferences of Common Stock Issuance Decisions



Appendix 3.4 reports that around 32.14% of the CFOs prefer as important or very important to issue common stocks while 67.86% of the CFOs do not prefer to issue common stocks and are willing to go for other financing hierarchy. Among the factors, maintaining a target debt-to-equity ratio (mean 3.33: Row e4) is rated as important by the CFOs and recorded the frequency for rating important or very important is 28.60% and also frequency of 28.60% is recorded for the higher stock prices to issue the common stock is rated moderately important (rating of 2.89: Row a4). The earning per share dilution (mean 2.78: Row m4), availability/or sufficiency of internal funds (mean 2.67: Row g4), diluting the holdings of certain shareholders (mean 2.56: Row j4), providing shares to employee bonus/stock option plans (mean

2.44: Row c4) and capital gains tax rates faced by the investors (relative to tax on dividends, mean 2.22: Row i4) are considered moderately important in common stock issuance decisions (appendix 3.4). The figure 4.6 shows the survey evidence of some of the factors that affect the decision to issue common stock. This survey is based on the responses of 28 CFOs.

Figure 4.6 Equity Policy Factors



Among the management characteristics, the CFOs with short tenure, and young age who have both MBA and non-MBA, male CFOs who are from Sri Lanka are relatively likely to indicate that maintaining a target debt to equity ratio is an important factors in equity issuance decisions. Longer tenure with mature age of female CFOs are likely rated as important factors of higher stock prices, earnings per share dilution and availability/or sufficient of internal funds in equity issuance decisions. Other than these factors, all other characters are rated as moderately important or fairly important or not very important factors in equity issuance decisions.

Among the firm characteristics, non-manufacturing firms without credit ratings, larger firms who pay dividends, having and not having target debt, low and high growth firms, low and high leverage firms are relatively likely to indicate that maintaining a target debt to equity ratio is an important factors in equity issuance decisions. Higher leverage firms without target debt and with credit ratings are likely rated as important factors of higher stock prices, earnings per share dilution,

availability/or sufficient of internal funds and diluting the holdings of certain shareholders in equity issuance decisions. Other than these factors, all other firm characters are rated as moderately important or fairly important or not very important factors in equity issuance decisions.

The significant of the responses of common stocks issuance decisions conditional to management and firm characteristics of samples companies using two-tailed independent sample t-test are presented in appendix 4.4. Comparison of the mean difference in tenure, age, education, gender and race in association to factors affect firm's decisions about issuing common stock are not statistically significant difference between responses of two variables ($P > 0.05$). Apart from that, the tenure is a statistically significant difference between two variables in association with the factors such as diluting the holdings of certain shareholders (sig. 2-tailed: 0.033, $P < 0.05$), and the age is a statistically significant difference to factors providing shares to employee bonus/stock option plans (sig. 2-tailed: 0.008, $P < 0.05$). Earnings per share dilution in association with education and diluting the holdings of certain shareholders in association with gender are a statistically significant difference between two variables (sig. 2-tailed: 0.015 and sig. 2-tailed: 0.033, $P < 0.05$ respectively).

The firm characteristics are that of the industry classification, target debt ratio, growth firm, credit ratings, leverage, size of firm and dividends paying firms are not statistically significant difference between two variables (where the $P > 0.05$), but the earnings per share dilution in association with target debt ratio (sig. 2-tailed: 0.021, $P < 0.05$), credit rating (sig. 2-tailed: 0.023, $P < 0.05$), and leverage (sig. 2-tailed: 0.021, $P < 0.05$) which are a statistically significant difference between two variables. Growth in association with providing shares to employee bonus/stock option plans (sig. 2-tailed: 0.01, $P < 0.05$) which is a statistically significant difference between two variables.

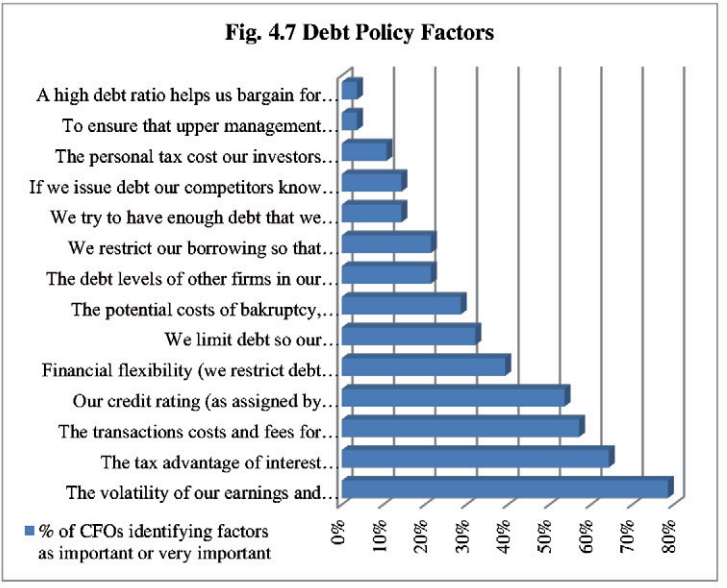
4.6.5 The Factors of Appropriate Amount of Debt Decisions

CFOs are considered as important or very important on the volatility of earnings and cash flows, the tax advantage of interest deductibility, and the transactions costs and fees for issuing debt which shows the frequency of 78.60%, 64.30%, and 57.10% respectively. The mean values of those factors are rating of 3.04, 2.82, and 2.57 respectively. The CFOs tell that the volatility of earnings and cash flows are an important factor in choosing appropriate amount of debt for the firms while the tax advantage of interest deductibility and the transactions costs and fees for issuing debt are moderately important (appendix 3.5). Rating of 53.60% of CFOs are considered

as important or very important the factors of credit rating (as assigned by rating agencies) but the mean value of the factor is calculated as fairly important (mean 2.04: Row d6).

It is noted from the analysis that CFOs ratings on financial flexibility (mean 2.07: Row g6), the potential costs of bankruptcy, near-bankruptcy, or financial distress (mean 1.75: Row b6), and the personal tax cost of investors face when they receive interest income (mean 1.32: Row f6) are rated as fairly important and not important in choosing appropriate amount of debt decisions respectively which are also recorded lower level of frequency considering important or very important factors. The following graph (Fig. 4.7) illustrates the debt policy factors when choosing appropriate amount of debt for the firms.

Figure 4.7 Debt Policy Factors



Short tenure CFOs with young age who is having MBA, male CFOs from Sri Lankan origin are importantly considered the volatility of earnings and cash flows in debt decisions. Long tenure CFOs with mature age who is having MBA, female CFOs from Sri Lankan origin are importantly considered the tax advantage of interest deductibility in debt decisions. In contrast to, all other factors including the transactions costs and fees, and the potential cost of bankruptcy, near-bankruptcy, or financial distress are rated moderately important or fairly important or not important among the management characteristics.

The volatility of earnings and cash flows are rated as important factors in issuing debt among firm characteristics. Small firms are rated very importantly on the factors of the tax advantage of interest deductibility while high leverage firms in small size are rated very importantly the factors of the transaction costs and fees for issuing debt.

Comparison of mean values of the responses among management and firm characteristics conditional to factors affect firm's decisions to choose appropriate amount of debt of the samples companies using two-tailed independent sample t-test are presented in appendix 4.5. Comparison of the mean difference in tenure, age, education, gender and race in association with factors affect firm's decisions to choose appropriate amount of debt are not statistically significant difference between two variables ($P > 0.05$).

The race is a statistically significant difference between responses of two variables in association with the factors such as the volatility of the earnings and cash flows (sig. 2-tailed: 0.003, $P < 0.05$), and the credit ratings (as assigned by ratings agencies (sig. 2-tailed: 0.007, $P < 0.05$).

The firm characteristics are that of the industry classification, target debt ratio, growth firm, credit ratings, leverage, size of firm and dividends paying firms are not statistically significant difference between two variables (where the $P > 0.05$).

4.6.6 The Factors of Firm's Debt Policy Decisions

CFOs tell that the factors affect the firm's debt policy to issue debt at the lower interest rate (rating of 2.21: Row c7) and recent profit (internal funds) are not sufficient to fund activities (rating of 2.11: Row a7) are rated as fairly important in debt issuance decision in capital structure practices (appendix 3.6). All other factors are rated as not important for firm's debt policy decisions (the mean value is less than 1.00). The frequency for rating of important or very important of those factors are recorded as 53.60% and 46.40% respectively which are the highest frequency among other factors.

It is noted that CFOs with mature age are rated importantly the factors of lowest interest rate (rating of 3.12: Row c7) to issue debt for the firms. Other than mature age, all other characteristics of CFOs are rated as fairly important (appendix 3.6). Firms with credit ratings (mean 3.00: Row c7), and high leverage (mean 3.67: Row c7) are rated as important the factors of lowest interest rate in debt policy decisions. In contrast to, small firms are rated very important (mean 4.00) for the factors of lowest interest rate.

Considering the availability of internal fund is rated fairly important among the short tenure (mean 2.18), non-MBA holders (mean 2.27), Male CFOs (mean 2.12), and Sri Lankan CFOs (mean 2.12), and moderately important of CFOs with mature age (mean 2.62). Equity undervaluation is fairly and moderately important among the mature age (2.25) and female (2.67) CFOs respectively.

Small firms are rated important the factors of availability of internal funds (mean 3.00), equity undervaluation (mean 3.00), considering the transaction cost and fees (mean 3.00), recapitalization cost and fees (mean 3.00) and considering the accumulated substantial profit (mean 3.00). Changes in the price of common stock are rated very importantly among the small firms (mean 4.00).

Comparison of the mean values of control variables (management and firm characteristics) conditional to other factors affect firm's debt policy of the samples companies using two-tailed independent sample t-test are presented in appendix 4.6. Comparison of the mean difference in tenure, age, education, gender and race association to other factors affect firm's debt policy are not statistically significant difference between two variables ($P > 0.05$).

The age is a statistically significant difference between two variables association with many of the responses on other factors affect firm's debt policy. The factors are such as issuing debt when interest rates are particularly low (sig. 2-tailed: 0.04, $P < 0.05$), and issuing debt when recent profit (internal funds) are not sufficient to fund activities (sig. 2-tailed: 0.003, $P < 0.05$). Issuing debt when equity undervalued by the market association with race is a statistically significant difference between responses of the two variables (sig. 2-tailed: 0.008, $P < 0.05$).

The firm characteristics that of the industry classification, target debt ratio, growth firm, credit ratings, leverage, size of firm and dividends paying firms are not statistically significant difference between two variables (where the $P > 0.05$), but the target debt ratio association with issuing debt when recent profit (internal funds) are not sufficient to fund activities (sig. 2-tailed: 0.017, $P < 0.05$) which is a statistically significant difference between two variables. Leverage in association with issuing debt when equity is undervalued by the market (sig. 2-tailed: 0.045, $P < 0.05$) which is a statistically significant difference between two variables.

4.7 Summary

The above statistical results provided evidence to support the hypotheses put forward in Chapter 5. Results of the descriptive statistics, Univariate analysis, and independent sample t-tests have been used to analyze and compare the results for the sample selected from the top 50 listed companies in Sri Lanka. The factors effect on short and long term debt decisions, issuing foreign debt, convertible debt, and common stocks and choosing appropriate amount of debt and debt policy of the sample were explained in the chapter through descriptive and univariate statistics. Results reported the perceived importance of those factors in corporate financing decisions in association to capital structure theories conditional to management and firm characteristics which is analyzed in independence sample t-test. The implications of the results of the above analysis on corporate financing decisions are discussed in the next chapter.

CHAPTER FIVE
DISCUSSION AND IMPLICATIONS OF RESULTS: CAPITAL STRUCTURE PRACTICES IN SRI LANKA

5.1 Introduction

The discussion and implications of results of the perceived importance and close association between capital structure practices and management and firm characteristics of listed companies in Sri Lanka are reported in this chapter. The model presented in the conceptual framework was tested in the previous chapter using the statistical techniques described in Chapter 3, regarding the perceived importance and its association between the practices of static trade-off theory, pecking order model, agency cost theory in their corporate financing decisions and the management and firm characteristics. The results of testing the hypotheses were analyzed and checked for validity of the model. This section distills the most important findings from the capital structure questions and presents the results grouped by theoretical hypothesis or concept.

The structure of the chapter is presented as follows. Section 5.2 discusses the implications of results for the close association between the practice of static trade off theory and management and firm characteristics. Section 5.3 deals with the implications of results for the close association between the practice of pecking order model and management and firm characteristics. Section 5.4 explains the implications of results for the close association between the practice of agency cost theory and management and firm characteristics. Finally, Section 5.5 presents the conclusion.

5.2 The Trade-Off Theory of Capital Structure Choice: Association with Management and Firm Characteristics

This study reveals that the application of static trade-off theory on capital structure practices of listed companies in Sri Lanka shows an insignificant association between the practice of static trade off theory and management and firm characteristics while providing mixed perception of the importance of theory. This confirms that the debt decision is purely dependent on interest tax shields advantage in an unstable political and economic environment such as Sri Lanka.

5.2.1 The Tax Advantage of Interest Deductibility

In this study, the factor that the corporate tax advantage of interest deductibility of debt is considered as moderately important in this context. The tax advantage is most important for high growth firm with high leverage while considering to be very

important by small firms. It is perceived as important by CFOs relatively who are, in the office more than 9 years, over 50 years old, and female Sri Lankan CFOs. In line with Graham and Harvey (2001) reveals that corporate tax advantage of debt is moderately important in capital structure decisions, it is rated as important factor (Bancel & Mittoo, 2004). In contrast to the above view, Ibrahima et al, (2012) state that the Malaysian managers are not considered the corporate tax advantage of debt when they take debt decisions in which it is insignificant in their capital structure decisions.

Personal tax effects may offset or increase the tax advantage of debt and thereby impact the optimal balance between corporate tax effects and bankruptcy costs. The low scores clearly show that firms do no put much weight to the personal tax considerations of their investors. Apparently, firms do not try to attract specific investors clienteles through their capital structure choice. The findings are consistent with the study of Graham and Harvey (2001) and Ibrahima et al (2012) in which it is found very little evidence.

5.2.2 The Potential Costs of Bankruptcy, near-Bankruptcy, or Financial Distress

As for the potential costs of bankruptcy or financial distress, the negative effects of these costs appear to be considered as not very importantly when judging debt for firms. Small firms are considered this factor as most important in their debt decisions. Costs of financial distress is not very important (Graham & Harvey 2001), potential cost of bankruptcy is rated as less important factors in determining the debt level of firm (Bancel & Mittoo, 2004), whereas it is strongly agree that Malaysian managers are concerned as very important the financial distress costs when they take debt issuance decisions.

Despite the concern on the bankruptcy or financial distress costs, this study finds that, firms are little concern about their credit ratings which is rated as fairly important in debt decisions and in which it can be viewed as an indication of concern about distress. High levered firms are considered relatively most important in their debt decisions. The findings are not consistent with the study of Graham and Harvey (2001) and Ibrahima et al, (2012) state that the factor is not very importantly considered in debt decisions of their firms.

The volatility of earnings, which increases the probability of bankruptcy and thus expected costs, is more important whereas it is also perceived importantly by CFOs with short tenure, young age, and the CFOs who are having MBA and Sri Lankan male CFOs. The little concern of CFOs on the potential costs of bankruptcy is not in line with the static trade-off theory's prediction. In contrast to, the high concern of

CFOs on the tax advantage of interest deductibility and the volatility of earnings and cash flows are in line with the static trade-off theory. These findings are consistent with Ibrahima et al, (2012) state that earnings and cash flows volatility is considered as important in making debt issuance decisions in Malaysian firms and also consistent with Sheikh and Wang (2011) state that it is identified that a negative relationship between debt ratio and earnings volatility which explains that firms with less earnings volatility borrow more as bank debt in Pakistan.

5.2.3 Deviations from Target Debt and Rebalancing

This study reveals that maintaining a target debt to equity ratio is generally considered as important, especially among various firm characteristics. However, sixty five percent of the firms do not have a target debt ratio, another 35% have target debt for the firm. Targets are also strict and somewhat strict for firms having CFOs with short tenure, young age, Sri Lankan male CFOs. The finding is consistent with the study of Ibrahima et al, (2012) state that Malaysian managers are concerned importantly the target or tight target debt ratio to the firms.

The optimum corporate financing arises when the firm balances constantly the benefits and costs of debts. This is due to the fact that actual debt ratios vary across firms and through time. Apart from identifying whether firms of listed companies in Sri Lanka have target debt ratios; this study investigates the mechanisms that these firms use in maintaining their target debt ratios. This study analyses the responses towards increase in the price of equity to determine whether firms rebalance in response to market equity movements which is considered by the CFOs as moderately important in their debt decisions. The CFOs with long tenure, mature age who is having MBA and female are regarded as most important and also the firms without target debt, low growth firm, having credit ratings, and high levered firm are considered as important factor. Considering the changes in the price of common stock is not very importantly considered by CFOs in debt and equity issuance decisions. Small firms than larger firms are regarded as very important to this factor. The fact is contrast to the view of Graham and Harvey (2001) claims that firms do not rebalance in response to market equity movement and also few states that changes in price of equity affect their debt policy. Myers (1984) state that if the debt is above target, firm does not issue stock, buy back debt and re-establish a more moderate debt to value ratio.

This study argues that if there are fixed transactions costs to issuing or retiring debt, a firm only rebalances when its debt ratio crosses an upper or lower hurdle. The transactions costs and fees for issuing debt is moderately important in debt decisions

whereas it is considered as most important by mature CFOs and firms without target debt and high growth firm. It is very importantly considered by firms with high leverage and small size. The fact that transaction costs is regarded as moderately important in line with study of Graham and Harvey (2001), Ibrahima et al, (2012), and Bancel and Mittoo (2004).

In overall, It reveals that the survey provide mixed support to perception of static trade-off theory and further states that the perceived importance of these factors are not closely associated with management and firm characteristic variables since the mean differences are insignificant which is greater than 5% ($P > 0.05$). It is also found that Race influence the CFOs choice on the volatility of earnings and cash flows. Therefore, the null hypotheses are accepted.

5.3 The Pecking Order Model of Financing Hierarchy: Association with Management and Firm Characteristics

This study reveals that the application of pecking order theory in capital structure practices of listed companies in Sri Lanka shows an insignificant association between the practice of theory and management and firm characteristics while consisting with financing hierarchy and away from asymmetric information.

5.3.1 Financial Flexibility: Internal Funds

Firms restrict debt so that they have enough internal funds available to pursue new projects when they come along which refers the financial flexibility. Consistently, the survey findings of this study indicates that the rating of CFOs on the financial flexibility is as fairly important factor that they consider in making debt financing decisions for their firms. This shows that CFOs of listed companies in Sri Lanka are fairly cautious on the availability and sufficiency of their internal funds for future projects and growth. 39.30% of the respondents say that financial flexibility is an important or very important factor in their financing decisions, and none of the management and firm characteristics are rated as important for this factor. The survey responses indicate that the desire for financial flexibility is not mainly a concern of financing decisions of CFOs of listed companies in Sri Lanka and also is not driven by the factors behind the pecking order theory (asymmetry of information). Therefore, from a through observation of the survey responses on this factor in relation to management and firm characteristics, it is not supported to financial hierarchy model. The fact based of listed companies in Sri Lanka is not consistent with the findings from the study of Graham and Harvey (2001), Bancel and Mittoo (2004), and Ibrahima et al (2012) whereas they state that the financial flexibility is rated as most important factor in corporate financing decisions.

Another aspect of pecking order model of financing hierarchy tested in this study is the notion of this theory that external financing will only be acquired when internal funds are insufficient. This assumption is, similar to the responses of the factor of financial flexibility, rated as fairly important. 46.40% of the respondents say that the insufficient internal funds caused the CFOs to consider importantly or very importantly in their corporate financing decisions. More small firms than large firms and non-dividend paying firms indicate that they use debt in the face of insufficient internal funds are rated as important in their corporate financing decisions. The finding is not consistent with the study of Bancel and Mittoo (2004) state that insufficient internal fund is not considered as important by managers. Insufficient internal fund is moderately important in debt issuance decisions (Graham & Harvey 2001) whereas it is rated as most important by Malaysian managers (Ibrahima et al 2012).

A more direct test of the pecking order model is conducted on the factor that the CFOs consider in issuing equities i.e. whether the recent profits have sufficient to fund activities is rated as moderately important in their financing decisions, but 21.40% of the respondents say that this factor is important or very important in corporate financing decisions. Surprisingly, firms without target debt, considering credit rating on debt decisions, and high levered firm are rated as important to this factor while it is rated as importantly considered by the CFOs with long tenure, mature age and female.

5.3.2 Equity Undervaluation or Overvaluation by the Market

Equity Issuance

Considering the stock undervaluation or overvaluation by the market when the firm decides to issue common stock is rated as fairly important in their corporate financing decisions. It means that firms are not much reluctant to issue common stock when they perceive that it is undervalued or overvalued. It is considered as important or very important only for 14.30% of the responding CFOs, especially CFOs with long tenure, mature age, and female are considered as important. This factor is regarded relatively as most important by the firms without target debt, considered credit rating on debt decisions, and high levered firms. It is noted from the survey that the reasons for such lower response rate for important or very important for such factor is that 32.14% of the firms say that they are willing to issue common stock in their corporate financing decisions. Graham and Harvey (2001) state that equity undervaluation is rated as moderately important factor by the firms, and Bancel and Mittoo (2004) state that equity undervaluation or overvaluation in issuing equity received as important

factor while Ibrahima et al (2012) state that it is most importantly considered by Malaysian managers. If a firm's stock price is undervalued due to informational asymmetry, it delays issuing until after an informational release (of good news) and the ensuring increase in stock price. This argument is perceived as moderately important by the CFOs of listed companies in Sri Lanka. This is regarded importantly by CFOs with long tenure, mature age, MBA holders and female. Firms without target debt, low growth firm, high levered firm considering the credit ratings in their corporate financing decisions are concerned as importantly.

This study also investigates whether concern about earnings per share dilution affects equity issuance decisions. The textbook view is that earnings are not diluted if a firm earns the required return on the new equity. Conversely, if funds are obtained by issuing debt, the number of shares remains constant and so EPS can increase. To investigate this issue, this study asks managers if EPS dilution concerns affect their equity issuance decisions. Surprisingly, only 25% of the respondents are responded CFOs agree that EPS dilution is the most important or very important factors affecting the equity issuance decisions. Bancel and Mittoo (n.d) state that earnings per share dilution are considered as important or very important factors in equity issuance decisions and also it is strongly agreed by the Malaysian managers (Ibrahima et al, 2012).

Convertible Debt Issuance

The preference of convertible debt issuance of listed companies in Sri Lanka is recorded at very lower level; the CFOs are hesitant to issuing convertible debt in their firm's corporate financing decisions. It is noted that 7.14% of the respondents are interested on issuing convertible debt. In this study, the CFOs of listed companies in Sri Lanka respond that considering the equity undervaluation is most importantly perceived and it's driven them to the issuance of convertible debt. The option towards issuance of convertible debt when equity is undervalued is considered as most important by the firms with various characteristics, and also it is regarded relatively as important by the CFOs with short tenure, young age who is having MBA degree. The perception on convertible debt issuance is well popular in developed countries, in line with the study of Graham and Harvey (2001) find that strong evidence on convertibles is preferred by the management than equity or debt issuance. Bancel and Mittoo (2004) state that convertible debt is important or very important factors to determine the debt level of firm, and also the study is conducted among Malaysian managers by Ibrahima et al (2012) state that the firm prefers convertible debt issuance as important in their corporate financing decisions.

Issuance of convertible debt is because of the perception of inexpensive way to issue delayed common stock and to attract investors unsure about the riskiness of the company which are not very importantly or fairly considered by CFOs of listed companies in Sri Lanka respectively. Attracting investors to unsure about the riskiness of the company in convertible debt issuance are relatively considered as important by female CFOs from Sri Lanka and the high growth firm without credit ratings.

The survey asks question to CFOs whether the ability to call or force conversion is an important feature affecting convertible debt policy. 3.60% of the firms are importantly or very importantly considered the convertibles because of the ability to call or force conversion. The idea that it is fairly important by the firms and also it is regarded as important by firm's high growth, not having credit ratings and also Sri Lankan male CFOs. Graham and Harvey (2001) find that strong evidence on convertibles is preferred by the management than equity or debt issue. Bancel and Mittoo (2004) state that convertible debt is important or very important factor to determine the debt level of firm. Companies run by male CFOs from Sri Lanka are considered as important the factors of convertible are less expensive than straight debt. The same response is received from high growth firm without credit ratings. It is generally perceived as fairly important by CFOs.

Debt Issuance

In relating the equity undervaluation issue with debt issuance decision, this study questions the CFOs on the effect of equity undervaluation on their debt policy. 39.30% of the respondents are rated as important or very important on the factor effect of equity undervaluation on their debt decisions. It is generally rated as not very important on their debt policy. It is also regarded as fairly important by CFOs with mature age, and female. In addition, the decision to debt issuance in response to equity undervaluation is also important for small firms.

Apart from the undervaluation or overvaluation, firms use capital structure to signal their quality or future prospect. However, there is no indication that their debt or equity policy is affected by factors consistent with signaling. This survey finds no evidence on issuing debt or stock gives investors a better impression of firm's prospects. A question is asked to the respondents regarding a high debt ratio and its help to bargain for concessions from the employees. The survey finds no indication that it is not very importantly considered by firms and the determinants of debt is not because of the bargain for concessions from employees, but due to other factors discussed in this study.

Having private information about credit quality can affect a firm's optimal debt maturity. In practice, the evidence that firm time their credit worthiness is very weak. Firm borrow short term until the credit ratings to improve is not very importantly considered by CFOs of listed companies in Sri Lanka.

The survey finds surprising indications that CFOs try to time the market in other ways. The firm time the interest rate by issuing debt at lower rate is considered as fairly important by CFOs of listed companies in Sri Lanka. This survey also finds evidence that firms issue short term debt at lower rate in an effort to time market long term interest rate or expecting the long term rate to decline are considered moderately and fairly important respectively. There is strong evidence that relatively low foreign interest rates affect the decision to issue abroad is most importantly considered by CFOs. Firm issue foreign debt in response to tax incentives, to keep the source close to the use of funds, and in an attempt to take advantage of low foreign interest rates. All those factors are most importantly considered by the firms when they take foreign debt issue decisions. It is also regarded as most important factors by the management and firm characteristics.

The perceived importance of pecking order model is not strongly supported with the hypotheses stated in this study and the asymmetric informational issues are relatively weak in this survey other than timing the interest rates including foreign debt issuance. Survey responses of perceived importance of these factors are examined conditional upon management and firm characteristics for the purpose of testing the hypotheses. The means differences among the management and firm characteristics are not significantly associated which is greater than 5% ($P > 0.05$) other than Race is association with these factors of equity undervaluation, borrow short term when long term rates are high or expecting the long term rates to decline. Therefore, the null hypotheses are accepted.

5.4 The Agency Costs Theory of Capital Structure Choice: Association with Management and Firm Characteristics

This study reveals that the application of agency cost theory in capital structure practices of listed companies in Sri Lanka shows an insignificant association between the practice of theory and management and firm characteristics while inconsistent with perceived importance of agency cost theory. This confirms the agency cost theory perspective is not familiar with management and firm characteristics of listed companies in Sri Lanka.

5.4.1 Conflicts between Bondholders and Shareholders

Underinvestment Costs

In relation to the issues pertaining the conflict between bondholders and shareholders, this study investigates whether underinvestment costs affects firm financing policy. The survey questions in this study ask firms if their choices between short and long term debt and their overall debt policy is related to their desire to pay long term profits to shareholders, not debt holders. Remarkably, 21.40% of the CFOs of listed companies in Sri Lanka respond that they restrict the borrowing so that profits from new/future projects can be captured fully by shareholders and do not have to be paid out as interest to debt holders is not very importantly considered, even the responses among management characteristics are the same. This is indeed a strong indication to the non-presence of underinvestment concerns among the CFOs in making debt policy. In contrast to the above view, this is supported by the fact that this factor is regarded as moderately important by manufacturing firms, and very importantly considered by small firms of listed companies in Sri Lanka.

The mean response of the factors indicate that borrowing short term so that returns from new projects can be captured more fully by shareholders, rather than committing to pay long term profits as interest to debt holders is regarded as not very important, even the responses are same among the management characters. It is regarded as very importantly by small firms of listed companies in Sri Lanka. It is the concern that underinvestment problem is not strongly affect their choice between short and long term debt decisions. Therefore, the findings from this study is not in line with Ibrahima et al (2012) who argue that it is strongly agreed by Malaysian managers and also Graham and Harvey (2001) state that there is little support to this factors. Overall, this study finds a weak support for the underinvestment argument.

Asset Substitution Problem

This problem is related to shareholders preference for high risk projects, in conflict with bondholders' preferences. In order to test the perceived importance of this factor on their financing decisions, this study finds evidence that CFOs of listed companies in Sri Lanka is not very importantly considered the issue of short term debt to minimize the chance of taking risky project. Relatively, the use of short term borrowing as a mechanism to mitigate the asset substitution problem is not the concern among the management and firm characteristics. This study finds little evidence on convertible debt issuance relating to the factors of protecting bondholders against unfavorable actions by managers or stockholders. 3.60% of the respondents are concerned the factors as important or very important in their

financing decisions. It is regarded as importantly by high growth firm without credit ratings, and also Sri Lankan male CFOs are concerned as importantly in their financing decisions. In line with Graham and Harvey (2001) state that little evidence found in using short term debt and convertible debt to mitigate the asset substitution problem, but this is moderately considered among Malaysian firms (Ibrahima et al, 2012).

5.4.2 Conflicts between Managers and Shareholders

Free Cash Flows

The survey in this study investigates whether CFOs of listed companies in Sri Lanka use debt to commit to pay out free cash flows and thereby discipline management into working efficiently. Remarkably, this study finds that the factors of choosing debt to firm i.e. the disciplining role of debt are not very importantly considered in their financing decisions. It is regarded as fairly important by high levered firms. There is little evidence on this factors tested in the study of Graham and Harvey (2001) and it is highly supported in the study of Ibrahima et al (2012).

Apart from the above findings, this survey analyses the product market and industry factors in a way that affects optimal debt policy. Firms limit their debt with the concern that the customers and/or suppliers are worried about the firm going out of business and also firms issue debt that their competitors know that they are very unlikely to reduce output. These arguments are very weak in this study. Though the survey does not find much evidence that product market factors drive industry differences in debt ratio, the survey asks directly to CFOs whether their capital structure decisions are affected by the financing policy of other firms in their industries. It is noted that no evidence that CFOs are concerned about the debt or equity level of other firm or industry. The survey asks whether firms use foreign debt because it acts as a natural hedge, and separately how important it is keep the source close to the use of funds. Among the 10.70% of the respondents who seriously considered as important or very important issuing foreign debt, the most popular reason they did so it is to provide a natural hedge against foreign currency devaluation is considered as important by CFOs of listed companies in Sri Lanka. Risk management practices can also be explained why firms match the maturity of assets and liabilities. If assets and liabilities duration are not aligned, interest rate fluctuations can affect the amount of funds available for investment and day to day operations. The survey asks question that how they choose debt maturity. The most popular explanation of how firms choose between short term and long term debt is that they match debt maturity with asset life, it is considered as fairly important by

CFOs and also 64.30% of the respondents are concerned this factor as important or very important.

Findings that firms, to avoid the conflict between bondholders and shareholders, managers and shareholders, use several mechanisms in agency cost theory. None of these factors discussed in this section are consistent with agency cost theory. Survey responses are examined conditional upon management and firm characteristics for the purpose of testing the hypotheses. The means differences among the management and firm characteristics are not significantly associated with these factors. Therefore, the null hypotheses are accepted.

5.5 Summary

The implications of the results of the perceived importance and association of static trade-off theory, pecking order model, and agency cost theory among management and firm characteristics of listed companies in Sri Lanka were discussed in this chapter. The perceived importance and its close association in the hypotheses, which were tested for statistical significance, were discussed in relation to the theory, literature and context of the study. The results revealed that the survey provide mixed support to perception of static trade-off theory. The perceived importance of pecking order model is strongly supported with the hypotheses stated in this study and the asymmetric informational issues are relatively weak in this survey other than timing the interest rates including foreign debt issuance. In line with agency cost theory, none of these factors discussed in this section are consistent with agency cost theory. In order to test the hypotheses on perceived importance and its close association of static trade-off theory, pecking order model, and agency cost theory, the survey responses are examined conditional upon management and firm characteristics. The means differences among the management and firm characteristics are not significantly associated with these factors. A summary of the findings and conclusions will be discussed in the next chapter.

CHAPTER SIX
SUMMARY, FINDINGS AND CONCLUSIONS

6.1 Introduction

The understanding on the real practices of corporate financing decisions of listed companies in Sri Lanka in relation to perceived importance of capital structure theories i.e. static trade-off theory, pecking order theory and agency cost theory and its close association with management and firm characteristics will lead to extremely important conclusion on practices of theories comparison with developed and developing countries that receive continuous debates and discussions among the academics for so many years are relevant to global settings. Findings of the study are based on various theoretical perspective and empirical literature on practices of capital structure theories in corporate financing decisions of both developed and developing countries. This chapter provides a summary of the conclusions drawn from the perceived importance of capital structure theories and its close association with management and firm characteristics in corporate financing decisions.

The structure of the chapter is organized as follows. Section 6.2 provides an overview of the research questions and Section 6.3 provides a summary of how the objectives of the study were addressed. Section 6.4 presents the findings of the study in relative to static trade-off theories, pecking order theories and agency cost theories with other managerial implications. Section 6.5 presents the conclusion to the study.

6.2 Overview of the Research Questions

The purpose of the research has been exploring to understand the real practices of corporate financing decisions of listed companies in Sri Lanka in relation to perceived importance of capital structure theories and it close association of management and firm characteristics.

Sri Lanka is the emerging market, primary and secondary market is well developed but the bond market is not developed as much comparing with other countries. Monetary policy of the country is the major determinant factor of debt decisions of the firms. DailyFT (10 July 2012) pointed out that the private sectors borrowed more money in the first five months of this year as against the corresponding period of 2010. Government efforts to apply brakes to credit growth remain a challenge.

Therefore, this study addresses many research related questions in corporate financing decisions of listed companies in Sri Lanka relative to capital structure theories. The follow-up questions are based on the association of management and

firm characteristics with the perceived importance of capital structure theories; whether the CFOs of listed companies in Sri Lanka consider the academics advise and guidelines in corporate financing decisions; whether capital structure practices of listed companies in Sri Lanka has the similarity in corporate financing decisions of developed countries.

6.3 Summary of the Objectives of this Study

Relative to the discussions, the objectives of the study is to,

- Investigate the significant association between management characteristics and the perceived importance of capital structure theories.
- Examine the significant association between firm characteristics and the perceived importance of capital structure theories.
- Understand the perceived importance of CFOs about capital structure theories comparing with the practices of developed countries.

6.4 Summary of the Findings of this Study

This section describes briefly the findings and implications of the results relative to the capital structure theories i.e. static trade-off theory, pecking order theory and agency cost theory to address the research questions and reaching the objectives of this study.

6.4.1 The Static Trade-off Theory of Capital Structure

The study result provides mixed support for the notion that firms does trade-off costs and benefits to derive an optimal debt ratio. As a result of the findings that CFOs of listed companies in Sri Lanka consider different factors in trading off the costs and benefits of debt financing. The study analysis indicates that CFOs of listed companies in Sri Lanka are not importantly considered the potential costs of bankruptcy, near-bankruptcy, or financial distress associated with debt decisions whereas the tax advantage of interest deductibility is moderately considered. The argument on tax advantage of interest deductibility and bankruptcy costs are consistent with the argument made by Graham and Harvey (2001), Bancel and Mittoo (2004). It is in contrast to Ibrahima et al, (2012) based in Malaysian survey evidence. It is noted that maintaining target debt ratio is considered importantly by the CFOs in which it is consistent with static trade-off theory, but 35% of the firms are maintained target debt to equity ratio.

Interestingly, when management and firm characteristics are considered, survey result shows that the tax advantage is rated as important by the CFOs with long tenure,

mature age and female from non-Sri Lanka. It is also considered as important by the firm with high growth and high leverage and by small firm is rated as very importantly. Hence, tax advantage in this case, is important for firms with high leverage, which means that they might increase their debt levels to enjoy the tax shield advantage, but not necessarily indicates that they are trading off the costs and benefits of debt in order to reach the optimum or target debt level. It is noted that 89% of the firms of listed companies in Sri Lanka sample for this study are classified as low levered firms. As a result of the findings, they disregard the bankruptcy cost of debt issuance and pay more attention on tax advantage of debt. Even though having such perceptions on debt decisions, they are not consistent with academic advice on corporate financing decisions. This research finds no significant association between management and firm characteristics and static trade-off theory in corporate financing decisions.

6.4.2 The Pecking Order Theory of Financing Hierarchy

The study tests the perceived importance of pecking order model of CFOs of listed companies in Sri Lanka. The survey finds little support but not strongly on the argument favor to pecking order model. The survey finds that CFOs of listed companies in Sri Lanka rank financial flexibility as the fairly important factor in firm's debt financing decisions. This shows that CFOs are not aware of the financing hierarchy and/or pecking order model in debt or equity issuance decisions. The importance of this factor is not driven by asymmetric information as proposed by the theory. There is no such evidence that firms support the importance of restricting debt to ensure sufficient internal funds to finance future projects. In terms of debt and equity issuance, the study finds that CFOs issue debt followed by equity because recent profits have been insufficient to finance future project, this argument is considered as moderately important as well as by the firms with no target debt and high levered. It is not support of financing preference as proposed by the theory since 68% of the respondence say that they are not willing to issue common stock. The argument of financial flexibility based of listed companies in Sri Lanka is not consistent with the findings from the study of Graham and Harvey (2001), Bancel and Mittoo (2004), and Ibrahima et al, (2012) whereas they state that the financial flexibility is rated as most important factor in corporate financing decisions.

In addition to the debt and equity issuance, firms are reluctant to issue debt and equity when they perceive the stocks are currently undervalued. This argument is rated as importantly by CFOs of listed companies in Sri Lanka. It is generally consistent with the pecking order theory. The survey shows responding to equity undervaluation, it is regarded as important by many firm characteristics. The

arguments favor to signaling is weak but the earning per share dilution on equity issuance decisions is strongly considered by CFOs. This research finds no significant association between management and firm characteristics and pecking order theory in corporate financing decisions.

6.4.3 Agency Cost Theory

The study finds no evidence of perceived importance of agency cost theory of listed companies in Sri Lanka. The underinvestment costs concern provides weak support on the argument relevant to agency cost theory i.e. managers limit their borrowing so that profit from new or future projects can be captured fully by shareholders and do not to be paid out as interest to debt holders. This study also finds no evidence on the use of short term debt to minimize underinvestment costs. Short term debt minimize the assets substitution problems, this is disregarded by the CFOs of listed companies in Sri Lanka. The free cash flow issue is not the concern of the CFOs as a result of the study further investigates whether CFOs use debt to discipline managers and find evidence as not very importantly considered. This research finds no significant association between management and firm characteristics and pecking order theory in corporate financing decisions.

6.5 Conclusions

The findings of this study contribute broadly to the corporate financing decisions. From this study, the analysis of listed companies in Sri Lanka financing practices reveals the importance of incorporating the agency costs point of view is not fully understood by the CFOs and also the pecking order model is not fully aware on their financing practices. The static trade-off theory provides mixed support, the tax advantage of debt is perceived by CFOs in their practices than bankruptcy cost. It is generally accepted that the study finds no significant association between management and firm characteristics and capital structure theories. The study shows that the CFOs are far away from the guidelines of academics in their corporate financing decisions of listed companies in Sri Lanka.

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Appendices

Appendix – 1
Management Characteristics – Classification and Codes

Characteristics	Classification and Codes	
CFO Tenure	Those CFOs in current job for	Less 4
	< 9 years = short tenure (0)	4 - 9.
	> 9 years = long tenure (1)	Above 9
CFO Age	Those CFOs with age of	Less 40
	< 49 = young (0)	40 - 49.
	> 50 = mature (1)	50 - 60.
		Above 60
CFO Education	Those CFOs that hold	Graduate
	MBA degree (0)	MBA
	non-MBA degree (1)	non-MBA
		Above Masters degree
CFO Gender	Male (0)	Male
	Female (1)	Female
CFO Race	Those CFOs who are	
	Sri Lankan (0)	Sri Lankan
	non-Sri Lankan (1)	non-Sri Lankan

Appendix – 2
Firm Characteristics – Classification and Codes

Characteristics	Classification and Codes	
Industry	Manufacturing firms (0) Non-Manufacturing firms (1)	Chemical & Pharmaceuticals
		Telecommunication
		Hotel & Travels
		Beverage food & tobacco
		Manufacturing
		Diversified Holdings
		Trading
		Power & Energy
		Construction & Engineering
		Motors
Target debt ratio	Having target debt ratio (0) Not having target debt ratio (1)	No target range
		Flexible target range
		Somewhat tight target range
		Strict target range
Price/Earnings ratio	Firms with PE ratios of < 15 = low growth (0) > 15 = high growth (1)	Less 10
		10 - 14.
		15 - 19.
		20 - 24.
		Above 25
Credit ratings	Having credit ratings (0) Not having credit ratings (1)	A & A-
		AA
		AAA
		B+
		AP2
		None
Leverage	Firms with long term debt to total assets ratio < 30 = low levered firms (0) > 30 = high levered firms (1)	Less 10
		10 - 19.
		20 - 29.
		30 - 39.
		Above 40
Board of listing	Firms with listing on Main board = large firm (0) Diri savi board = small firm (1)	Main board
		Diri savi board
Pay Dividends	Paying dividends (0) Not paying dividends (1)	Yes
		No

Appendix – 3

Descriptive Statistics (Univariate Analysis) – Survey Responses to the Question based on Management and Firm Characteristics.

Appendix – 3.1 What factors affect your firm's choice between short and long term debt?

Factors affect the firm's choice between short and long term debt	Mean	Imp or very imp %	Tenure		Age		Education		Gender		Race	
			Short	Long	Young	Mature	MBA	Non-MBA	Male	Female	Sri Lankan	Non-Sri Lankan
a1) we issue short term when short term interest rates are low compared to long term rates	2.54	60.70%	2.73	1.83	2.45	2.75	2.77	2.33	2.44	3.33	2.72	1.00
b1) matching the maturity of our debt with the life of our assets	2.32	64.30%	2.41	2.00	2.30	2.38	2.38	2.27	2.24	3.00	2.48	1.00
c1) we issue short term when we are waiting for long term market interest rate to decline	2.07	46.40%	2.09	2.00	1.90	2.50	2.00	2.13	2.12	1.67	2.28	0.33
g1) we issue long term debt to minimize the risk of having to refinance in "bad times"	1.93	42.90%	2.05	1.50	1.75	2.38	2.08	1.80	2.00	1.33	2.12	0.33
d1) we borrow short term so that returns from new projects can be captured more fully by shareholders, rather than committing to pay long term profits as interest to debt holders	1.36	10.70%	1.32	1.50	1.30	1.50	1.23	1.47	1.36	1.33	1.52	0.00
e1) we expect our credit rating to improve, so we borrow short term until it does	1.21	17.90%	1.14	1.50	1.15	1.38	1.31	1.13	1.20	1.33	1.32	0.33
f1) borrowing short term reduces the chance that our firm will want to take on risky project	0.79	7.10%	0.73	1.00	0.70	1.00	0.46	1.07	0.80	0.67	0.84	0.33

Factors affect the firm's choice between short and long term debt	Mean	Imp or very imp %	Industry		Target Debt		Growth		Credit Ratings		Leverage		Size		Pay Dividends	
			Manufacturing	Non-Manufacturing	Yes	No	Low	High	Rated	Non-rated	Low	High	Small	Large	Yes	No
a1) we issue short term when short term interest rates are low compared to long term rates	2.54	60.70%	2.25	2.58	2.56	2.50	2.38	2.75	3.00	2.38	2.52	2.67	2.00	2.56	2.68	1.33
b1) matching the maturity of our debt with the life of our assets	2.32	64.30%	2.25	2.33	2.11	2.70	2.12	2.58	2.57	2.24	2.32	2.33	1.00	2.37	2.40	1.67
c1) we issue short term when we are waiting for long term market interest rate to decline	2.07	46.40%	1.50	2.17	2.22	1.80	1.88	2.33	2.00	2.10	2.08	2.00	4.00	2.00	2.16	1.33
g1) we issue long term debt to minimize the risk of having to refinance in "bad times"	1.93	42.90%	1.50	2.00	1.78	2.20	2.00	1.83	1.71	2.00	1.84	2.67	3.00	1.89	2.04	1.00
d1) we borrow short term so that returns from new projects can be captured more fully by shareholders, rather than committing to pay long term profits as interest to debt holders	1.36	10.70%	1.25	1.38	1.28	1.50	1.19	1.58	1.29	1.38	1.36	1.33	4.00	1.26	1.44	0.67
e1) we expect our credit rating to improve, so we borrow short term until it does	1.21	17.90%	1.25	1.21	1.06	1.50	1.38	1.00	1.43	1.14	1.12	2.00	3.00	1.15	1.36	0.00
f1) borrowing short term reduces the chance that our firm will want to take on risky project	0.79	7.10%	1.00	0.75	0.50	1.30	0.81	0.75	0.86	0.76	0.72	1.33	2.00	0.74	0.80	0.67

Appendix – 3.2 What factors affect your firm's decisions about issuing foreign debt?

Factors affect the firm's decisions about issuing foreign debt	Mean	Imp or very imp %	Tenure		Age		Education		Gender		Race	
			Short	Long	Young	Mature	MBA	Non-MBA	Male	Female	Sri Lankan	Non-Sri Lankan
a2) favorable tax treatment relative to the Sri Lanka (e.g. different corporate tax rates)	3.60	14.30%	4.00	2.00	4.00	3.00	4.00	3.00	4.00	3.00	3.50	4.00
e2) foreign interest rates may be lower than domestic interest rates	3.20	17.90%	3.25	3.00	3.33	3.00	3.00	3.50	3.00	3.50	3.00	4.00
c2) providing a "natural hedge" (e.g. if the foreign currency devalues, we are not obligated to pay interest in US$)	3.00	10.70%	3.00	3.00	2.67	3.50	3.33	2.50	3.33	2.50	3.25	2.00
b2) keeping the "source of funds" close to the "use of funds"	2.00	3.60%	2.25	1.00	2.33	1.50	2.33	1.50	2.33	1.50	2.00	2.00
d2) foreign regulations require us to issue debt abroad	1.40	3.60%	1.75	0.00	1.67	1.00	2.33	0.00	2.33	0.00	1.75	0.00

Factors affect the firm's decisions about issuing foreign debt	Mean	Imp or very imp %	Industry		Target Debt		Growth		Credit Ratings		Leverage		Size		Pay Dividends	
			Manufacturing	Non-Manufacturing	Yes	No	Low	High	Rated	Non-rated	Low	High	Small	Large	Yes	No
a2) favorable tax treatment relative to the Sri Lanka (e.g. different corporate tax rates)	3.60	14.30%	-	3.60	3.50	4.00	4.00	3.33	3.00	4.00	3.60	-	-	3.60	3.60	-
e2) foreign interest rates may be lower than domestic interest rates	3.20	17.90%	-	3.20	3.00	4.00	3.50	3.00	3.50	3.00	3.20	-	-	3.20	3.20	-
c2) providing a "natural hedge" (e.g. if the foreign currency devalues, we are not obligated to pay interest in US$)	3.00	10.70%	-	3.00	3.25	2.00	2.00	3.67	2.50	3.33	3.00	-	-	3.00	3.00	-
b2) keeping the "source of funds" close to the "use of funds"	2.00	3.60%	-	2.00	2.00	2.00	2.50	1.67	1.50	2.33	2.00	-	-	2.00	2.00	-
d2) foreign regulations require us to issue debt abroad	1.40	3.60%	-	1.40	1.75	0.00	1.50	1.33	0.00	2.33	1.40	-	-	1.40	1.40	-

Appendix – 3.3 What factors affect your firm's decisions about issuing convertible debt?

Factors affect the firm's decisions about issuing convertible debt	Mean	Imp or very imp %	Tenure		Age		Education		Gender		Race	
			Short	Long	Young	Mature	MBA	Non-MBA	Male	Female	Sri Lankan	Non-Sri Lankan
f3) our stock is currently undervalued	3.00	7.10%	3.00	-	3.00	-	-	3.00	3.00	3.00	3.00	3.00
h3) to attract investors unsure about the riskiness of our company	2.00	3.60%	2.00	-	2.00	-	-	2.00	3.00	1.00	3.00	1.00
g3) ability to "call" or force conversion of convertible debt if/when we need to	2.00	3.60%	2.00	-	2.00	-	-	2.00	3.00	1.00	3.00	1.00
e3) avoiding short-term equity dilution	2.00	3.60%	2.00	-	2.00	-	-	2.00	3.00	1.00	3.00	1.00
c3) convertibles are less expensive than straight debt	2.00	3.60%	2.00	-	2.00	-	-	2.00	3.00	1.00	3.00	1.00
b3) protecting bondholders against unfavorable actions by managers or stockholders	2.00	3.60%	2.00	-	2.00	-	-	2.00	3.00	1.00	3.00	1.00
a3) convertibles are an inexpensive way to issue "delayed" common stock	1.50	0.00%	1.50	-	1.50	-	-	1.50	2.00	1.00	2.00	1.00
d3) other firms in our industry successfully use convertibles	1.00	0.00%	1.00	-	1.00	-	-	1.00	1.00	1.00	1.00	1.00

Factors affect the firm's decisions about issuing convertible debt	Mean	Imp or very imp %	Industry		Target Debt		Growth		Credit Ratings		Leverage		Size		Pay Dividends	
			Manufacturing	Non-Manufacturing	Yes	No	Low	High	Rated	Non-rated	Low	High	Small	Large	Yes	No
f3) our stock is currently undervalued	3.00	7.10%	-	3.00	-	3.00	3.00	3.00	3.00	3.00	3.00	-	-	3.00	3.00	-
h3) to attract investors unsure about the riskiness of our company	2.00	3.60%	-	2.00	-	2.00	1.00	3.00	1.00	3.00	2.00	-	-	2.00	2.00	-
g3) ability to "call" or force conversion of convertible debt if/when we need to	2.00	3.60%	-	2.00	-	2.00	1.00	3.00	1.00	3.00	2.00	-	-	2.00	2.00	-
e3) avoiding short-term equity dilution	2.00	3.60%	-	2.00	-	2.00	1.00	3.00	1.00	3.00	2.00	-	-	2.00	2.00	-
c3) convertibles are less expensive than straight debt	2.00	3.60%	-	2.00	-	2.00	1.00	3.00	1.00	3.00	2.00	-	-	2.00	2.00	-
b3) protecting bondholders against unfavorable actions by managers or stockholders	2.00	3.60%	-	2.00	-	2.00	1.00	3.00	1.00	3.00	2.00	-	-	2.00	2.00	-
a3) convertibles are an inexpensive way to issue "delayed" common stock	1.50	0.00%	-	1.50	-	1.50	1.00	2.00	1.00	2.00	1.50	-	-	1.50	1.50	-
d3) other firms in our industry successfully use convertibles	1.00	0.00%	-	1.00	-	1.00	1.00	1.00	1.00	1.00	1.00	-	-	1.00	1.00	-

Appendix – 3.4 What factors affect your firm's decisions about issuing common stock?

Factors affect the firm's decisions about issuing common stock	Mean	Imp or very imp %	Tenure		Age		Education		Gender		Race	
			Short	Long	Young	Mature	MBA	Non-MBA	Male	Female	Sri Lankan	Non-Sri Lankan
e4) maintaining a target debt-to-equity ratio	3.33	28.60%	3.50	2.00	3.57	2.50	3.40	3.25	3.50	2.00	3.33	-
a4) if our stock price has recently risen, the price at which we can issue is "high"	2.89	28.60%	2.87	3.00	2.86	3.00	3.00	2.75	2.87	3.00	2.89	-
m4) earnings per share dilution	2.78	25.00%	2.75	3.00	2.71	3.00	2.80	2.75	2.75	3.00	2.78	-
g4) whether our recent profits have sufficient to fund our activities	2.67	21.40%	2.62	3.00	2.57	3.00	2.80	2.50	2.62	3.00	2.67	-
j4) diluting the holdings of certain shareholders	2.56	14.30%	2.50	3.00	2.57	2.50	2.00	3.25	2.50	3.00	2.56	-
c4) providing shares to employee bonus/stock option plans	2.44	17.90%	2.50	2.00	2.43	2.50	3.00	1.75	2.50	2.00	2.44	-
i4) the capital gains tax rates faced by our investors (relative to tax on dividends)	2.22	7.10%	1.87	0.00	2.00	0.50	1.40	2.00	1.87	0.00	1.67	-
k4) the amount by which our stock is undervalued or overvalued by the market	2.22	14.30%	2.12	3.00	2.00	3.00	2.00	2.50	2.12	3.00	2.22	-
b4) stock is our "least risky" source of funds	2.00	7.10%	2.13	1.00	2.14	1.50	2.00	2.00	2.13	1.00	2.00	-
l4) inability to obtain funds using debt, convertibles, or other sources	1.67	7.10%	2.13	3.00	2.14	2.50	2.00	2.50	2.13	3.00	2.22	-
f4) using a similar amount of equity as is used by other firms in our industry	1.56	0.00%	1.62	1.00	1.71	1.00	1.40	1.75	1.62	1.00	1.56	-
d4) common stock is our cheapest source of funds	1.56	7.10%	1.62	1.00	1.71	1.00	1.00	2.25	1.62	1.00	1.56	-
h4) issuing stock gives investors a better impression of our firm's prospects than using debt	1.33	7.10%	1.50	0.00	1.57	0.50	1.00	1.75	1.50	0.00	1.33	-

Factors affect the firm's decisions about issuing common stock	Mean	Imp or very imp %	Industry		Target Debt		Growth		Credit Ratings		Leverage		Size		Pay Dividends	
			Manufacturing	Non-Manufacturing	Yes	No	Low	High	Rated	Non-rated	Low	High	Small	Large	Yes	No
e4) maintaining a target debt-to-equity ratio	3.33	28.60%	-	3.33	3.38	3.00	3.75	3.00	2.50	3.57	3.38	3.00	-	3.33	3.33	-
a4) if our stock price has recently risen, the price at which we can issue is "high"	2.89	28.60%	-	2.89	2.87	3.00	3.00	2.80	3.00	2.86	2.87	3.00	-	2.89	2.89	-
m4) earnings per share dilution	2.78	25.00%	-	2.78	2.75	3.00	2.75	2.80	3.00	2.71	2.75	3.00	-	2.78	2.78	-
g4) whether our recent profits have sufficient to fund our activities	2.67	21.40%	-	2.67	2.62	3.00	2.50	2.80	3.00	2.57	2.62	3.00	-	2.67	2.67	-
j4) diluting the holdings of certain shareholders	2.56	14.30%	-	2.56	2.50	3.00	2.75	2.40	3.00	2.43	2.50	3.00	-	2.56	2.56	-
c4) providing shares to employee bonus/stock option plans	2.44	17.90%	-	2.44	2.62	1.00	2.25	2.60	1.50	2.71	2.62	1.00	-	2.44	2.44	-
i4) the capital gains tax rates faced by our investors (relative to tax on dividends)	2.22	7.10%	-	1.67	1.62	2.00	2.25	1.20	1.00	1.86	1.62	2.00	-	1.67	1.67	-
k4) the amount by which our stock is undervalued or overvalued by the market	2.22	14.30%	-	2.22	2.12	3.00	1.75	2.60	3.00	2.00	2.12	3.00	-	2.22	2.22	-
b4) stock is our "least risky" source of funds	2.00	7.10%	-	2.00	2.13	1.00	2.00	2.00	1.00	2.29	2.13	1.00	-	2.00	2.00	-
l4) inability to obtain funds using debt, convertibles, or other sources	1.67	7.10%	-	2.22	2.13	3.00	2.25	2.20	3.00	2.00	2.13	3.00	-	2.22	2.22	-
f4) using a similar amount of equity as is used by other firms in our industry	1.56	0.00%	-	1.56	1.50	2.00	2.00	1.20	1.50	1.57	1.50	2.00	-	1.56	1.56	-
d4) common stock is our cheapest source of funds	1.56	7.10%	-	1.56	1.62	1.00	1.75	1.40	1.00	1.71	1.62	1.00	-	1.56	1.56	-
h4) issuing stock gives investors a better impression of our firm's prospects than using debt	1.33	7.10%	-	1.33	1.12	3.00	1.50	1.20	1.50	1.29	1.12	3.00	-	1.33	1.33	-

Appendix – 3.5 What factors affect how you choose the appropriate amount of debt for your firm?

Factors affect how to choose the appropriate amount of debt for the firm	Mean	Imp or very imp %	Tenure		Age		Education		Gender		Race	
			Short	Long	Young	Mature	MBA	Non-MBA	Male	Female	Sri Lankan	Non-Sri Lankan
h6) the volatility of our earnings and cash flows	3.04	78.60%	3.09	2.83	3.10	2.88	3.23	2.87	3.16	2.00	3.24	1.33
a6) the tax advantage of interest deductibility	2.82	64.30%	2.68	3.33	2.75	3.00	2.92	2.73	2.80	3.00	3.04	1.00
e6) the transactions costs and fees for issuing debt	2.57	57.10%	2.50	2.83	2.30	3.25	2.62	2.53	2.60	2.33	2.80	0.67
g6) financial flexibility (we restrict debt so we have enough internal funds available to pursue new projects when they come along)	2.07	39.30%	2.09	2.00	2.10	2.00	2.31	1.87	2.04	2.33	2.24	0.67
d6) our credit rating (as assigned by rating agencies)	2.04	53.60%	2.18	1.50	2.15	1.75	1.92	2.13	2.00	2.33	2.16	1.00
b6) the potential costs of bankruptcy, near-bankruptcy, or financial distress	1.75	28.60%	1.68	2.00	1.70	1.88	1.62	1.87	1.80	1.33	1.92	0.33
i6) we limit debt so our customers/suppliers are not worried about our firm going out of business	1.57	32.10%	1.59	1.50	1.45	1.88	1.46	1.67	1.60	1.33	1.72	0.33
f6) the personal tax cost our investors face when they receive interest income	1.32	10.70%	1.41	1.00	1.40	1.12	1.46	1.20	1.32	1.33	1.44	0.33
c6) the debt levels of other firms in our industry	1.29	21.40%	1.36	1.00	1.45	0.88	1.15	1.40	1.24	1.67	1.36	0.67
j6) we try to have enough debt that we are not an attractive takeover target	1.25	14.30%	1.23	1.33	.30	1.12	1.15	1.33	1.32	0.67	1.36	0.33
n6) we restrict our borrowing so that profits from new/future projects can be captured fully by shareholders and do not have to be paid out as interest to debt holders	1.21	21.40%	1.05	1.83	1.05	1.62	0.69	1.67	1.24	1.00	1.32	0.33
k6) if we issue debt our competitors know that we are very unlikely to reduce our output	0.96	14.30%	1.00	0.83	0.80	1.38	0.62	1.27	1.04	0.33	1.04	0.33
m6) to ensure that upper management works hard and efficiently, we issue sufficient debt to make sure that a large portion of our cash flow is committed to interest payment	0.57	3.60%	0.55	0.67	0.55	0.62	0.31	0.80	0.60	0.33	0.60	0.33
l6) a high debt ratio helps us bargain for concessions from our employees	0.50	3.60%	0.45	0.67	0.45	0.62	0.31	0.67	0.52	0.33	0.52	0.33

Factors affect how to choose the appropriate amount of debt for the firm	Mean	Imp or very imp %	Industry		Target Debt		Growth		Credit Ratings		Leverage		Size		Pay Dividends	
			Manufacturing	Non-Manufacturing	Yes	No	Low	High	Rated	Non-rated	Low	High	Small	Large	Yes	No
h6) the volatility of our earnings and cash flows	3.04	78.60%	3.00	3.04	3.06	3.00	3.00	3.08	2.71	3.14	3.00	3.33	3.00	3.04	3.04	3.00
a6) the tax advantage of interest deductibility	2.82	64.30%	2.50	2.88	2.83	2.80	2.56	3.17	2.86	2.81	2.80	3.00	4.00	2.78	2.96	1.67
e6) the transactions costs and fees for issuing debt	2.57	57.10%	1.50	2.75	2.33	3.00	2.19	3.08	2.86	2.48	2.40	4.00	4.00	2.52	2.64	2.00
g6) financial flexibility (we restrict debt so we have enough internal funds available to pursue new projects when they come along)	2.07	39.30%	1.50	2.17	1.72	2.70	2.06	2.08	2.00	2.10	2.04	2.33	2.00	2.07	2.12	1.67
d6) our credit rating (as assigned by rating agencies)	2.04	53.60%	1.25	2.17	1.83	2.40	1.81	2.33	2.71	1.81	1.92	3.00	1.00	2.07	2.24	0.33
b6) the potential costs of bankruptcy, near-bankruptcy, or financial distress	1.75	28.60%	1.25	1.83	1.72	1.80	1.44	2.17	1.86	1.71	1.72	2.00	3.00	1.70	1.84	1.00
i6) we limit debt so our customers/suppliers are not worried about our firm going out of business	1.57	32.10%	1.75	1.54	1.61	1.50	1.56	1.58	1.43	1.62	1.56	1.67	3.00	1.52	1.52	2.00
f6) the personal tax cost our investors face when they receive interest income	1.32	10.70%	1.25	1.33	1.22	1.50	1.25	1.42	1.29	1.33	1.28	1.67	1.00	1.33	1.48	0.00
c6) the debt levels of other firms in our industry	1.29	21.40%	0.75	1.38	1.00	1.80	1.31	1.25	1.86	1.10	1.16	2.33	0.00	1.33	1.44	0.00
j6) we try to have enough debt that we are not an attractive takeover target	1.25	14.30%	1.25	1.25	1.17	1.40	1.19	1.33	0.86	1.38	1.24	1.33	3.00	1.19	1.40	0.00
n6) we restrict our borrowing so that profits from new/future projects can be captured fully by shareholders and do not have to be paid out as interest to debt holders	1.21	21.40%	2.50	1.00	1.00	1.60	1.19	1.25	1.00	1.29	1.20	1.33	4.00	1.11	1.24	1.00

k6) if we issue debt our competitors know that we are very unlikely to reduce our output	0.96	14.30%	0.75	1.00	1.00	0.90	1.06	0.83	0.86	1.00	0.88	1.67	1.00	0.96	0.96	1.00
m6) to ensure that upper management works hard and efficiently, we issue sufficient debt to make sure that a large portion of our cash flow is committed to interest payment	0.57	3.60%	0.75	0.54	0.17	1.30	0.62	0.50	1.14	0.38	0.36	2.33	0.00	0.59	0.64	0.00
l6) a high debt ratio helps us bargain for concessions from our employees	0.50	3.60%	0.50	0.50	0.39	0.70	0.56	0.42	0.71	0.43	0.40	1.33	0.00	0.52	0.56	0.00

Appendix – 3.6 What other factors affect your firm's debt policy?

Other factors affect the firm's debt policy	Mean	Imp or very imp %	Tenure		Age		Education		Gender		Race	
			Short	Long	Young	Mature	MBA	Non-MBA	Male	Female	Sri Lankan	Non-Sri Lankan
c7) we issue debt when interest rates are particularly low	2.21	53.60%	2.18	2.33	1.85	3.12	2.00	2.40	2.20	2.33	2.44	0.33
a7) we issue debt when our recent profit (internal funds) are not sufficient to fund our activities	2.11	46.40%	2.18	1.83	1.90	2.62	1.92	2.27	2.12	2.00	2.12	2.00
d7) we use debt when our equity is undervalued by the market	1.86	39.30%	1.82	2.00	1.70	2.25	1.85	1.87	1.76	2.67	2.00	0.67
e7) we delay issuing debt because of transactions costs and fees	1.43	17.90%	1.45	1.33	1.20	2.00	1.38	1.47	1.44	1.33	1.56	0.33
g7) changes in the price of our common stock	1.29	10.70%	1.14	1.83	1.30	1.25	1.15	1.40	1.24	1.67	1.40	0.33
f7) we delay retiring debt because of recapitalization costs and fees	1.07	14.30%	1.09	1.00	1.00	1.25	0.92	1.20	1.08	1.00	1.16	0.33
h7) we issue debt when we have accumulated substantial profits	1.00	10.70%	1.05	0.83	0.80	1.50	0.54	1.40	1.00	1.00	1.08	0.33
b7) using debt gives investors a better impression of our firm's prospects than issuing stocks	1.00	7.10%	0.86	1.50	0.95	1.12	0.77	1.20	1.08	0.33	1.08	0.33

Other factors affect the firm's debt policy	Mean	Imp or very imp %	Industry		Target Debt		Growth		Credit Ratings		Leverage		Size		Pay Dividends	
			Manufacturing	Non-Manufacturing	Yes	No	Low	High	Rated	Non-rated	Low	High	Small	Large	Yes	No
c7) we issue debt when interest rates are particularly low	2.21	53.60%	1.50	2.33	2.39	1.90	1.88	2.67	3.00	1.95	2.04	3.67	4.00	2.15	2.24	2.00
a7) we issue debt when our recent profit (internal funds) are not sufficient to fund our activities	2.11	46.40%	2.25	2.08	2.17	2.00	2.12	2.08	2.43	2.00	2.04	2.67	3.00	2.07	2.00	3.00
d7) we use debt when our equity is undervalued by the market	1.86	39.30%	1.00	2.00	1.83	1.90	1.62	2.17	2.14	1.76	1.80	2.33	3.00	1.81	1.96	1.00
e7) we delay issuing debt because of transactions costs and fees	1.43	17.90%	0.50	1.58	1.33	1.60	1.31	1.58	1.86	1.29	1.24	3.00	3.00	1.37	1.44	1.33
g7) changes in the price of our common stock	1.29	10.70%	0.50	1.42	1.17	1.50	1.06	1.58	1.29	1.29	1.28	1.33	4.00	1.19	1.44	0.00
f7) we delay retiring debt because of recapitalization costs and fees	1.07	14.30%	0.50	1.17	0.89	1.40	1.00	1.17	1.43	0.95	0.92	2.33	3.00	1.00	1.20	0.00
h7) we issue debt when we have accumulated substantial profits	1.00	10.70%	0.75	1.04	0.94	1.10	1.13	0.83	1.14	0.95	0.92	1.67	3.00	0.93	1.00	1.00
b7) using debt gives investors a better impression of our firm's prospects than issuing stocks	1.00	7.10%	1.00	1.00	0.67	1.60	0.87	1.17	1.00	1.00	0.88	2.00	2.00	0.96	1.04	0.67

Appendix – 4

Independence Sample T-test – Survey Responses to the Question based on Management and Firm Characteristics.

Appendix – 4.1 What factors affect your firm's choice between short and long term debt?

Factors affect the firm's choice between short and long term debt	Tenure	Age	Education	Gender	Race
	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)
a1) we issue short term when short term interest rates are low compared to long term rates	0.098	0.55	0.335	0.218	0.013
b1) matching the maturity of our debt with the life of our assets	0.411	0.869	0.774	0.002	0.019
c1) we issue short term when we are waiting for long term market interest rate to decline	0.875	0.245	0.778	0.551	0.006
g1) we issue long term debt to minimize the risk of having to refinance in "bad times"	0.708	0.65	0.554	0.967	0
d1) we borrow short term so that returns from new projects can be captured more fully by shareholders, rather than committing to pay long term profits as interest to debt holders	0.624	0.644	0.693	0.852	0.158
e1) we expect our credit rating to improve, so we borrow short term until it does	0.546	0.464	0.096	0.824	0.396
f1) borrowing short term reduces the chance that our firm will want to take on risky project	0.373	0.259	0.585	0.413	0.022

Factors affect the firm's choice between short and long term debt	Industry	Target debt ratio	Growth	Credit ratings	Leverage	Size	Dividends
	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)
a1) we issue short term when short term interest rates are low compared to long term rates	0.607	0.883	0.412	0.095	0.842	0.65	0.058
b1) matching the maturity of our debt with the life of our assets	0.887	0.105	0.226	0.48	0.984	0.208	0.263
c1) we issue short term when we are waiting for long term market interest rate to decline	0.319	0.388	0.333	0.861	0.917	0.107	0.273
g1) we issue long term debt to minimize the risk of having to refinance in "bad times"	0.826	0.593	0.322	0.836	0.967	0.006	0.224
d1) we borrow short term so that returns from new projects can be captured more fully by shareholders, rather than committing to pay long term profits as interest to debt holders	0.947	0.33	0.397	0.574	0.21	0.11	0
e1) we expect our credit rating to improve, so we borrow short term until it does	0.637	0.031	0.868	0.824	0.303	0.202	0.824
f1) borrowing short term reduces the chance that our firm will want to take on risky project	0.488	0.361	0.745	0.625	0.308	0.413	0.197

Appendix – 4.2 What factors affect your firm's decisions about issuing foreign debt?

Factors affect the firm's decisions about issuing foreign debt	Tenure	Age	Education	Gender	Race
	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)
a2) favorable tax treatment relative to the Sri Lanka (e.g. different corporate tax rates)	.	0.272	0.272	0.272	0.685
e2) foreign interest rates may be lower than domestic interest rates	0.111	0.239	0.239	0.239	1
c2) providing a "natural hedge" (e.g. if the foreign currency devalues, we are not obligated to pay interest in US$)	1	0.44	0.44	0.44	0.327
b2) keeping the "source of funds" close to the "use of funds"	0.302	0.658	0.012	0.012	0.302
d2) foreign regulations require us to issue debt abroad	0.685	0.495	0.272	0.272	.

Factors affect the firm's decisions about issuing foreign debt	Industry	Target debt ratio	Growth	Credit ratings	Leverage	Size	Dividends
	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)
a2) favorable tax treatment relative to the Sri Lanka (e.g. different corporate tax rates)		0.685	0.495	0.272			
e2) foreign interest rates may be lower than domestic interest rates		1	0.239	0.239			
c2) providing a "natural hedge" (e.g. if the foreign currency devalues, we are not obligated to pay interest in US$)		0.327	0.03	0.44			
b2) keeping the "source of funds" close to the "use of funds"		0.302	0.913	0.012			
d2) foreign regulations require us to issue debt abroad		.	0.272	0.272			

Appendix – 4.3 What factors affect your firm's decisions about issuing convertible debt?

Factors affect the firm's decisions about issuing convertible debt	Tenure	Age	Education	Gender	Race
	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)
f3) our stock is currently undervalued				.	.
h3) to attract investors unsure about the riskiness of our company				.	.
g3) ability to "call" or force conversion of convertible debt if/when we need to				.	.
e3) avoiding short-term equity dilution				.	.
c3) convertibles are less expensive than straight debt				.	.
b3) protecting bondholders against unfavorable actions by managers or stockholders				.	.
a3) convertibles are an inexpensive way to issue "delayed" common stock				.	.
d3) other firms in our industry successfully use convertibles				.	.

Factors affect the firm's decisions about issuing convertible debt	Industry	Target debt ratio	Growth	Credit ratings	Leverage	Size	Dividends
	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)
f3) our stock is currently undervalued			.	.			
h3) to attract investors unsure about the riskiness of our company			.	.			
g3) ability to "call" or force conversion of convertible debt if/when we need to			.	.			
e3) avoiding short-term equity dilution			.	.			
c3) convertibles are less expensive than straight debt			.	.			
b3) protecting bondholders against unfavorable actions by managers or stockholders			.	.			
a3) convertibles are an inexpensive way to issue "delayed" common stock			.	.			
d3) other firms in our industry successfully use convertibles			.	.			

Appendix – 4.4 What factors affect your firm's decisions about issuing common stock?

Factors affect the firm's decisions about issuing common stock	Tenure	Age	Education	Gender	Race
	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)
e4) maintaining a target debt-to-equity ratio	0.749	0.626	0.391	0.749	
a4) if our stock price has recently risen, the price at which we can issue is "high"	0.142	0.285	1	0.142	
m4) earnings per share dilution	0.553	0.912	0.015	0.553	
g4) whether our recent profits have sufficient to fund our activities	0.635	0.468	0.194	0.635	
j4) diluting the holdings of certain shareholders	0.033	0.049	0.775	0.033	
c4) providing shares to employee bonus/stock option plans	0.292	0.008	0.356	0.292	
i4) the capital gains tax rates faced by our investors (relative to tax on dividends)	0.516	0.078	0.407	0.516	
k4) the amount by which our stock is undervalued or overvalued by the market	0.17	0.199	0.391	0.17	
b4) stock is our "least risky" source of funds	0.072	0.052	0.407	0.072	
l4) inability to obtain funds using debt, convertibles, or other sources	0.553	0.912	0.015	0.553	
f4) using a similar amount of equity as is used by other firms in our industry	0.356	0.143	0.407	0.356	
d4) common stock is our cheapest source of funds	0.052	0.345	0.089	0.052	
h4) issuing stock gives investors a better impression of our firm's prospects than using debt	0.626	0.172	0.879	0.626	

Factors affect the firm's decisions about issuing common stock	Industry	Target debt ratio	Growth	Credit ratings	Leverage	Size	Dividends
	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)
e4) maintaining a target debt-to-equity ratio		0.749	0.407	0.626	0.749		
a4) if our stock price has recently risen, the price at which we can issue is "high"		0.142	1	0	0.142		
m4) earnings per share dilution		0.021	0.51	0.023	0.021		
g4) whether our recent profits have sufficient to fund our activities		0.635	0.675	0.468	0.635		
j4) diluting the holdings of certain shareholders		0.649	0.118	0.049	0.649		
c4) providing shares to employee bonus/stock option plans		0.407	0.01	0.879	0.407		
i4) the capital gains tax rates faced by our investors (relative to tax on dividends)		0.516	0.407	0.078	0.516		
k4) the amount by which our stock is undervalued or overvalued by the market		0.072	0.685	0.91	0.072		
b4) stock is our "least risky" source of funds		0.749	0.122	0.316	0.749		
l4) inability to obtain funds using debt, convertibles, or other sources		0.553	0.51	0.36	0.553		
f4) using a similar amount of equity as is used by other firms in our industry		0.356	0.136	0.143	0.356		
d4) common stock is our cheapest source of funds		0.052	0.879		0.052		
h4) issuing stock gives investors a better impression of our firm's prospects than using debt		0.626	0.879	0.172	0.626		

Appendix – 4.5 What factors affect how you choose the appropriate amount of debt for your firm?

Factors affect how to choose the appropriate amount of debt for the firm	Tenure	Age	Education	Gender	Race
	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)
h6) the volatility of our earnings and cash flows	0.241	0.539	0.682	0.789	0.003
a6) the tax advantage of interest deductibility	0.711	0.768	0.639	0.589	0.058
e6) the transactions costs and fees for issuing debt	0.49	0.225	0.571	0.542	0.319
g6) financial flexibility (we restrict debt so we have enough internal funds available to pursue new projects when they come along)	0.248	0.459	0.668	0.674	0.135
d6) our credit rating (as assigned by rating agencies)	0.6	0.092	0.876	0.752	0.007
b6) the potential costs of bankruptcy, near-bankruptcy, or financial distress	0.411	0.544	0.524	0.984	0.086
i6) we limit debt so our customers/suppliers are not worried about our firm going out of business	0.875	0.848	0.348	0.701	0.031
f6) the personal tax cost our investors face when they receive interest income	0.622	0.635	0.395	0.086	0.288
c6) the debt levels of other firms in our industry	0.866	0.381	0.643	0.709	0.025
j6) we try to have enough debt that we are not an attractive takeover target	0.875	0.705	0.658	0.33	0.12
n6) we restrict our borrowing so that profits from new/future projects can be captured fully by shareholders and do not have to be paid out as interest to debt holders	0.75	0.314	0.108	0.304	0.304
k6) if we issue debt our competitors know that we are very unlikely to reduce our output	0.547	0.698	0.21	0.69	0.69
m6) to ensure that upper management works hard and efficiently, we issue sufficient debt to make sure that a large portion of our cash flow is committed to interest payment	0.771	0.843	0.131	0.629	0.629
l6) a high debt ratio helps us bargain for concessions from our employees	0.178	0.283	0.038	0.376	0.205

Factors affect how to choose the appropriate amount of debt for the firm	Industry	Target debt ratio	Growth	Credit ratings	Leverage	Size	Dividends
	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)
h6) the volatility of our earnings and cash flows	0.569	0.945	0.188	0.929	0.435	0.321	0.074
a6) the tax advantage of interest deductibility	0.443	0.889	0.17	0.817	0.746	0.365	0.328
e6) the transactions costs and fees for issuing debt	0.309	0.068	0.887	0.12	0.086	0.249	0
g6) financial flexibility (we restrict debt so we have enough internal funds available to pursue new projects when they come along)	0.183	0.262	0.288	0.067	0.165	0.413	0.01
d6) our credit rating (as assigned by rating agencies)	0.085	0.215	0.081	0.527	0	0.288	0.447
b6) the potential costs of bankruptcy, near-bankruptcy, or financial distress	0.887	0.515	0.687	0.92	0.559	0.763	0
i6) we limit debt so our customers/suppliers are not worried about our firm going out of business	0.319	0.039	0.965	0.861	0.701	0.954	0.551
f6) the personal tax cost our investors face when they receive interest income	0.946	0.901	0.848	0.384	0.631	0.974	0.954
c6) the debt levels of other firms in our industry	0.741	0.809	0.963	0.709	0.881	0.206	0.5
j6) we try to have enough debt that we are not an attractive takeover target	1	0.592	0.73	0.273	0.89	0.098	0
n6) we restrict our borrowing so that profits from new/future projects can be captured fully by shareholders and do not have to be paid out as interest to debt holders	0.683	0.823	0.597	0.773	0.251	0.974	0.954
k6) if we issue debt our competitors know that we are very unlikely to reduce our output	1	0.299	0.618	0.39	0.401	0.505	0.001
m6) to ensure that upper management works hard and efficiently, we issue sufficient debt to make sure that a large portion of our cash flow is committed to interest payment	0.669	0.004	0.717	0.156	0	0.518	0.002
l6) a high debt ratio helps us bargain for concessions from our employees	0.024	0.233	0.899	0.516	0.866	0.021	0.761

Appendix – 4.6 What other factors affect your firm's debt policy?

Factors affect the firm's debt policy	Tenure	Age	Education	Gender	Race
	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)
c7) we issue debt when interest rates are particularly low	0.515	0.04	0.434	0.866	0.866
a7) we issue debt when our recent profit (internal funds) are not sufficient to fund our activities	0.18	0.689	0.272	0.237	0.237
d7) we use debt when our equity is undervalued by the market	0.812	0.003	0.442	0.875	0.008
e7) we delay issuing debt because of transactions costs and fees	0.757	0.297	0.966	0.238	0.078
g7) changes in the price of our common stock	0.817	0.083	0.844	0.878	0.068
f7) we delay retiring debt because of recapitalization costs and fees	0.895	0.666	0.479	0.904	0.204
h7) we issue debt when we have accumulated substantial profits	0.167	0.915	0.546	0.53	0.108
b7) using debt gives investors a better impression of our firm's prospects than issuing stocks	0.671	0.114	0.024	1	0.254

Other factors affect the firm's debt policy	Industry	Target debt ratio	Growth	Credit ratings	Leverage	Size	Dividends
	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)	Sig. (2-tailed)
c7) we issue debt when interest rates are particularly low	0.791	0.717	0.925	0.396	0.375	0.433	0.152
a7) we issue debt when our recent profit (internal funds) are not sufficient to fund our activities	1	0.017	0.464	1	0.379	0.327	0.558
d7) we use debt when our equity is undervalued by the market	0.258	0.366	0.125	0.073	0.045	0.181	0.776
e7) we delay issuing debt because of transactions costs and fees	0.138	0.894	0.26	0.491	0.491	0.357	0.211
g7) changes in the price of our common stock	0.068	0.55	0.53	0.242	0	0.15	0.878
f7) we delay retiring debt because of recapitalization costs and fees	0.248	0.224	0.686	0.308	0.025	0.06	0
h7) we issue debt when we have accumulated substantial profits	0.119	0.446	0.214	1	0.938	0.008	0
b7) using debt gives investors a better impression of our firm's prospects than issuing stocks	0.618	0.677	0.479	0.687	0.254	0.051	1

Appendix – 5

Correlations of Survey Responses with Management and Firm Characteristics

	Tenure	Age	Education	Gender	Race	Industry	Target debt ratio	Growth	Credit ratings	Leverage	Size	Paying dividends
Tenure *(short to long)*												
Age *(young to mature)*	.440*											
Education *(MBA to others)*	0.312	0.272										
Gender *(male to female)*	0.101	0.037	0.091									
Race *(Sri Lankan to others)*	-0.181	-0.219	0.091	0.253								
Industry *(manufacturing to others)*	-0.036	0.032	0.029	0.141	0.141							
Target debt ratio *(yes to no)*	-0.026	-0.141	0.096	-0.017	-0.017	-0.122						
Growth *(Low to high)*	.427*	0.251	0.083	-0.067	-0.3	0.354	-0.043					
Credit ratings *(rated to non-rated)*	-0.101	-0.183	-0.372	-.600**	-0.067	-0.236	-0.258	0				
Leverage *(Low to high)*	0.101	0.292	0.322	-0.12	-0.12	0.141	.465*	-0.067	-.600**			
Size *(Large to small)*	0.369	0.304	0.179	-0.067	-0.067	0.079	-0.143	0.222	0.111	-0.067		
Paying dividends *(Yes to no)*	0.101	0.292	0.091	-0.12	0.253	0.141	-0.258	-0.067	0.2	-0.12	-0.067	

*. Correlation is significant at the 0.05 level (2-tailed).

**. Correlation is significant at the 0.01 level (2-tailed).