

Riyad Rooly M.S.A <sup>(1)</sup>, Weerakoon Banda <sup>(2)</sup> Y.K,  
Jamaldeen A <sup>(3)</sup>

## Management and Firm Characteristics: An Empirical Study on Static Trade-Off Theory and Practice on Debt Financing Decision of Listed Companies in Sri Lanka

1. South Eastern University of Sri Lanka, Faculty of Islamic Studies and Arabic Language, Department of Islamic Studies (email: arrooly@seu.ac.lk)
2. Sir John Kotelawala Defence University, Faculty of Management, Social Sciences and Humanities
3. South Eastern University of Sri Lanka, Faculty of Management and Commerce, Department of Accountancy & Finance

**Abstract:** The research is about the corporate financing decisions based on capital structure theories, especial reference to static trade-off theory and practice of listed companies in Sri Lanka. The result provides mixed support for the notion that firms does trade-off costs and benefits to derive an optimal debt ratio. As a result, the findings that CFOs of listed companies in Sri Lanka consider different factors in trading off the costs and benefits of debt financing. The research finds no significant association between management and firm characteristics and static trade-off theories in corporate financing decisions. The conclusions drawn from this study were that the corporate financing decisions in relation to static trade-off theory differ from developed countries to developing country in many ways such as Sri Lanka. However, for corporate financing decisions in relation to static trade-off theory to have full impact on firm value like U.S.A and Europe countries, CFOs of listed companies in Sri Lanka should consider static trade-off theory that are in line with corporate financing decisions.

**Keywords:** Corporate Financing Decision, Capital Structure, Static Trade-off Theory, Optimal Debt Ratio, Sri Lanka.

### Introduction

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 decisions (Modigliani and 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 and 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 for investment opportunities leads to financial distress cost and 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 20<sup>th</sup>, 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? To what extent do management and firm characteristics influence and/or associate with debt and equity issuance decisions in relation to perceived importance of static trade-off theory? 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 theory i.e. static trade off theory provides guidance to the managers to determine the target debt level which maximize the market value of the firm in which academics indicate how the firm should do but it is imperative to understand how it was perceived and practiced by the managers. Do CFOs consider the academics advice and guidelines in corporate financing decision? This research is conducted to understand the current practice of corporate finance in relation to static trade-off theory of listed companies in Sri Lanka. As an emerging country, in the post war period, the engine of economic growth depends on public and private sector business. The growth and development of the firms are dependent on choosing capital structure i.e. corporate financing behavior which is influenced by management and firm characteristics (Colombage, 2007).

The best known field study in this area is the survey of the theory and practice of corporate finance by Graham and Harvey (2001). 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 and 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. However, very few studies have examined these issues in the context of developing countries like Sri Lanka. But we have had no empirical evidence that the static trade-off theory and practices of listed companies in Sri Lanka is to understand whether there is similarity in corporate financing decisions of developed

countries? 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 the firms and its association with the perceived importance of static trade-off theory comparing with the practice of developed countries.

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 static trade-off theory 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 static trade-off theory 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 static trade-off theory in corporate financing decisions and the level of perceptions of management in the firms.

### The Literature

Modigliani and Miller are the prominent scholars and writers on capital structure practice of firms. Initially, they refused the impact of debt capital on value of the firm. They argued that there is no relationship between capital structure and market value of the firm, and further state that cost of capital is independent of the degree of leverage (Modigliani and Miller 1958). Modigliani and Miller (1963) extended the theory after incorporating taxes into theory that the levered firms will have higher value than unlevered firm as the interest on debt is a tax deductible. Miller (1977) argues that even the interest on debt is a tax deductible at corporate level and at personal level taxable but, in equilibrium the value of firm is 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). 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.

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 & 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). In addition to the survey in 2001, Graham and Harvey conducted a survey in 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 these, 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 of firm. The findings were interesting that management and/or firms were not stick with the Modigliani and Miller hypothesis/model. There were many factors that influence on capital structure decisions of firm. Graham and Harvey (2001) & (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 carried out 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.

In view of literature, the determinants of debt level of firms are also based on firm characteristics. They differ from Graham and Harvey (2001) that they 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).

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. They show 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 are not only related with capital structure model which was explained by Modigliani and Miller (1958), 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 review was used to design the conceptual framework developing relevant hypotheses in this study.

### Research Methodology

To investigate the association between management and firm characteristics and perceived importance of static trade-off theory on corporate financing decision of listed companies in Sri Lanka, this study employed survey methodology as adopted in prior research in this area.

### Hypothesis

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 static trade-off theory. The hypotheses presented in this study are testable.

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

H<sub>0</sub>:- 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<sub>1</sub>:- 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<sub>0</sub>:- 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<sub>1</sub>:- 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.

### The Sample

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 sample was selected from the top 50 companies in the *Lanka Monthly Digest*, listed in the Colombo Stock Exchange for the period in 2010/2011. The aim was to test the extent to which they had adopted static trade-off theory. 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. Further, these companies were better performing, exhibited higher stock return and were assumed to engage in good corporate financing practices.

This study is based on non-financing firms listed in Colombo Stock Exchange, there were firms included in LMD top 50 companies. Those were excluded from the sample. As this was a comparative study, the final sample of 37 was selected which falls under non-financing institutions. This study examines the CFOs responses conditional to management and firm characteristics in relation to the practice of firms.

### Statistical Methods

This survey focuses to analyze management and firm characteristics in relation to static trade-off theory. 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. Questionnaire is the main instrument consistent with the previous study (Graham and Harvey 2001 and 2002; Ibrahima et al 2012; Bancel and Mitto 2004).

### Operationalization

In order to test the management and firm characteristics pertaining to static trade-off theory, the questionnaire has separate questions on factors affecting to choice of short term and long term debt, debt in foreign countries, amount of debt to firm and debt policy. 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 Mitto (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 4 questions (comprising total of 40 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 static trade-off theory. The questionnaire is accompanied by an explanatory covering letter 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 in this study 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.

In line with previous literatures, firm characteristics are defined in this study 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 Mitto (2004), the growth and leverage are measured by price-earning 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 and 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 and Harvey 2001 and 2002; Graham & Harvey 2002). Bancel and Mitto (2004) state that the size is measured by proxy of market value of equity whereas natural logarithm of sales (Sheik and Wang 2011), natural logarithm of assets (Buferna et al 2005), natural logarithm of sales (Titman and

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.

**Statistical Results and Analysis**

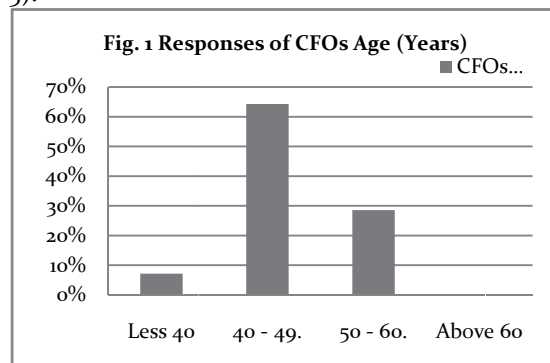
**Data Collection: Delivery and Response Rate**

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. 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 was 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 and Harvey 2001). Similar survey conducted in European firms is recorded 12% (Bancel and Mitto n.d).

**Summary on Management and Firm 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. 1). 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. 2). 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. 3). Majority of the CFOs (89.29%) of the sample firms are Sri Lankan (Fig. 4), 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. 5).



**Figure 1 Demographic Characteristics of CFOs: Age (Years)**

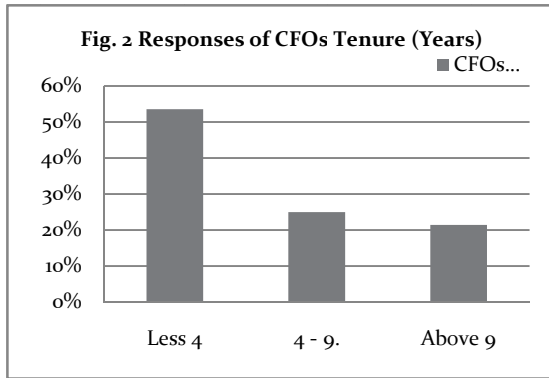


Figure 2 Demographic Characteristics of CFOs: Tenure (Years)

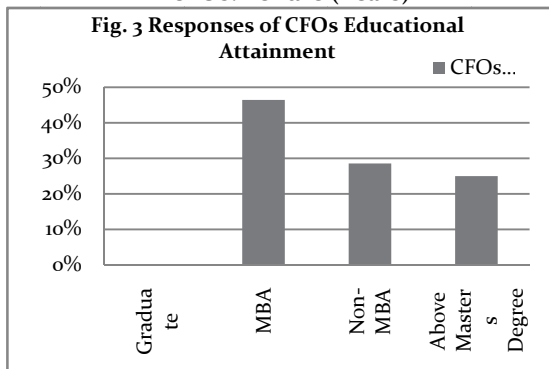


Figure 3 Demographic Characteristics of CFOs: Educational Attainment

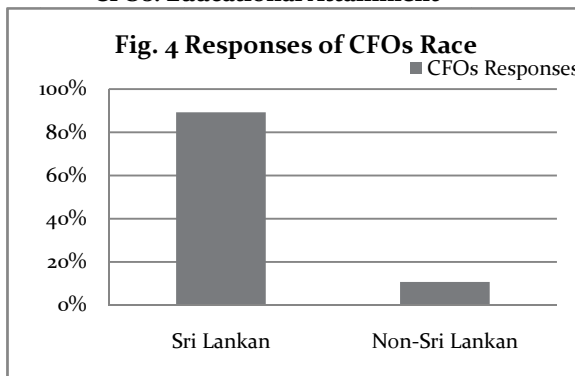


Figure 4 Demographic Characteristics of CFOs: Race

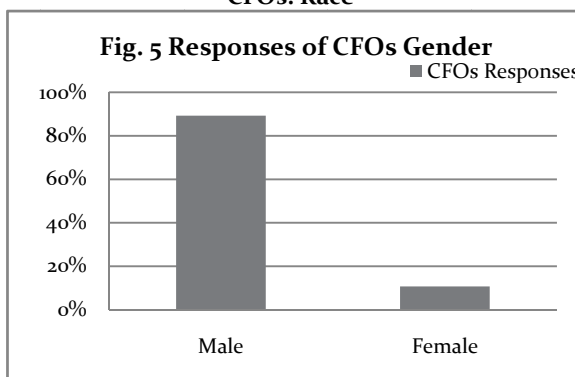


Figure 5 Demographic Characteristics of CFOs: Gender

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. 6), 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 start up 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. 7 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 respondents are referred as non-growth firms. 14.29% of the firms are manufacturers (Fig. 8). 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. 9) 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. 10) 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. 11). 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. 12).

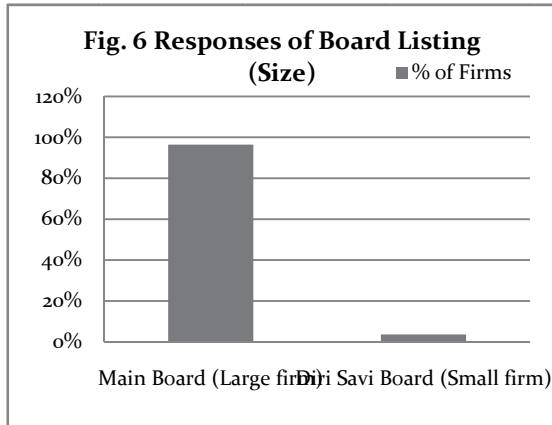


Figure 6 Firm Characteristics: Size

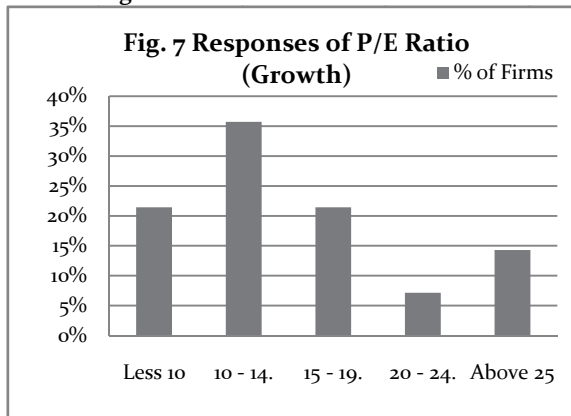


Figure 7 Firm Characteristics: Growth

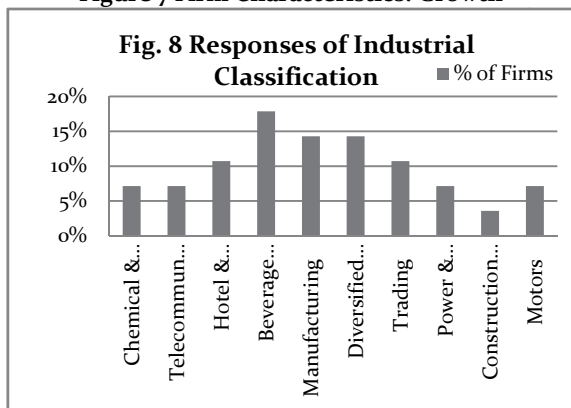


Figure 8 Firm Characteristics: Industrial Classification

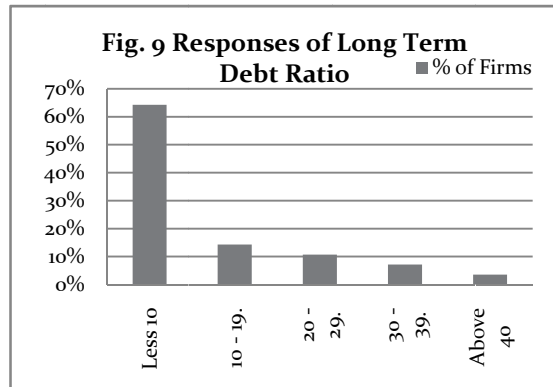


Figure 9 Firm Characteristics: Long Term Debt Ratio

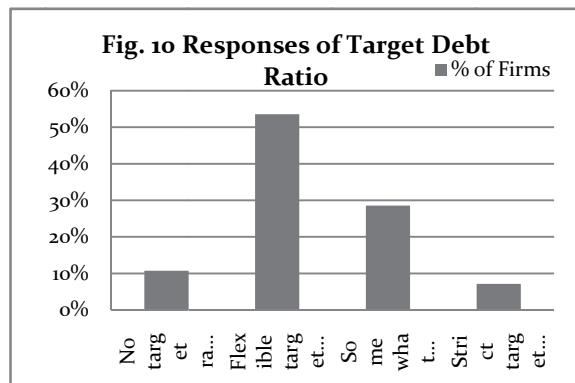


Figure 10 Firm Characteristics: Target Debt Ratio

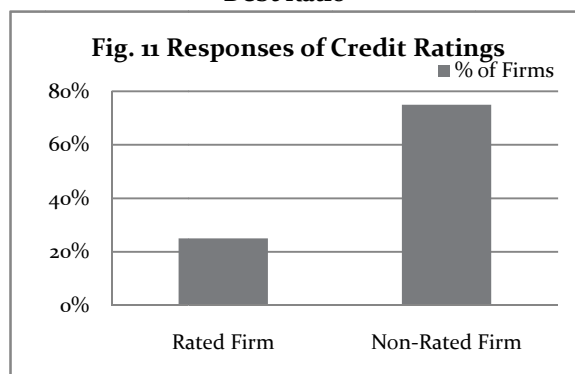


Figure 11 Firm Characteristics: Credit Ratings

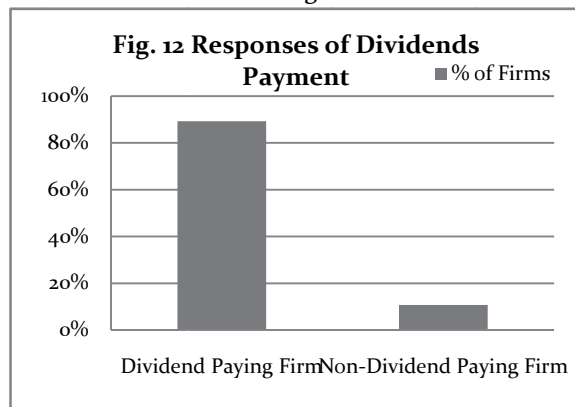


Figure 12 Firm Characteristics: Dividends Payment



### **Factors of Corporate Financing Decisions: Descriptive Statistical Analysis and Independent Sample t-Test**

#### *The factors of Short and Long Term Debt Decisions*

Analysis of the short and long term debt decisions 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.

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: it 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: it 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) and maturity of debt with life of assets (mean 3.00) 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.

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 and 1.33 respectively. Meeting the shareholders interest than the debt holders interest and waiting long term interest rates to decline 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 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  $P > 0.05$ ).

### *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.

It reports that favorable tax treatment relative to Sri Lanka (rating of 3.60), lower foreign interest rates (rating of 3.20) and providing a natural hedge (rating of 3.00) 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 affect 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.

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. 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.

### *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. 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).

It is noted from the analysis that CFOs ratings on financial flexibility (mean 2.07), the potential costs of bankruptcy, near-bankruptcy, or financial distress (mean 1.75), and the personal tax cost of investors face when they receive interest income (mean 1.32) 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.

Short tenure CFOs with young age who are 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 are 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 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  $P > 0.05$ ).

### *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) and recent profit (internal funds) are not sufficient to fund activities (rating of 2.11) are rated as fairly important in debt issuance decision in capital structure practices. 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) to issue debt for the firms. Other than mature age, all other characteristics of CFOs are rated as fairly important. Firms with credit ratings (mean 3.00), and high leverage (mean 3.67) 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 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.

### Discussion and Implications of Results

#### 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.

#### *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) revealed that corporate tax advantage of debt is moderately important in capital structure decisions, it is rated as important factor (Bancel and 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 not put much weight to the personal tax considerations of their investors. Apparently, firms do not try to attract specific investors clientele 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.

#### *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 and Harvey 2001), potential cost of bankruptcy is rated as less important factors in determining the debt level of firm (Bancel and 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.

### *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.

### **Conclusion**

The understanding on the real practices of corporate financing decisions of listed companies in Sri Lanka in relation to perceived importance of static trade-off 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 section provides a summary of the conclusions drawn from the perceived importance of static trade-off theory and its close association with management and firm characteristics in corporate financing decisions.

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 Ibrahim 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 advise on corporate financing decisions. This research finds no significant association between management and firm characteristics and static trade-off theory in corporate financing decisions.

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 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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