DOI: 10.31357/fmscmst.2013.00318

Management and Firm Characteristics: An Empirical Study on Capital Structure Practices of Listed Companies in Sri Lanka

By

Mohamed Saleem Ahamed Riyad Rooly

A research submitted to the University of Sri Jayewardenepura in partial fulfillment of the requirements for the Degree of Master of Business Administration (Finance)

on 31st January 2013

Declaration

I, Mohamed Saleem Ahamed Riyad Rooly, declare that the work described in this research was carried out by me under the supervision of Prof. Weerakoon Banda. The research entitled *Management and Firm Characteristics: An Empirical Study of Capital Structure Practices of Listed Companies in Sri Lanka* is no more than 25,000 words in length, exclusive of tables, figures, appendices, references and footnotes. This research contains no material that has been accepted for the award of any other degree or diploma in any university or institution. To the best of my knowledge, this research contains no material previously published or written by another person, except where due reference has been given.

....	23/04/2013
M.S. Ahamed Riyad Rooly	Date

Declaration

I certify that the above statement made by the candidate is true and the research is suitable for submission to the University for the purpose of evaluation of partial fulfillment of the requirements for the Degree of Master of Business Administration (Finance). The research entitled *Management and Firm Characteristics: An Empirical Study of Capital Structure Practices of Listed Companies in Sri Lanka*.

.... 23/4/2013 ....

Prof. Weerakoon Banda Date

Table of Contents

Lists of Tables

Lists of Figures

Acknowledgements

This research would not have been possible without the support of numerous people, whom I wish to acknowledge. First of all my deepest gratitude to my supervisor Professor Weerakoon Banda for his dedication, invaluable guidance, scholarly support and commitment of time throughout this process; without this, the research would not have been a reality.

I am also thankful to Professor Kennedy D. Gunawardna who is my lecturer in Research Methods, for inspiring me to involve this research and for providing me with unlimited guidance and the opportunity to advance my knowledge in this research.

My sincere thanks to Dr. M. Saman Dassanayake for providing me with guidance and the knowledge in literature review and academic writing skills to develop and improve the research, and to Dr. P.D. Nimal for his commitment and valuable service in this MBA degree program and for providing guidance more over on time.

My appreciation goes to lecturer Mr. P. Dias who taught me well in statistical methods by using SPSS and his advice on data analysis and interpretation. I am also thankful to Mr. Thandula Gunawardna for his help with collecting information about CFOs of listed companies in Sri Lanka and also receiving the responses through questionnaire.

My appreciation goes to my uncle Mr. Zanofer Ismalebbe who encouraged me and gave me moral support to pursue my education in Sri Lanka and his words inspired me to take a further step in my postgraduate studies leading to writing this research.

I could not have completed this journey without the love and friendship of my family and friends. Thanks to my colleagues who work with me at Rainco (Pvt) ltd and the management whom I wish to acknowledge for providing me support and for receiving the 8 years practical experience at this prestigious organization.

Finally, this research is dedicated to my beloved parents and my family members for their love, patience and encouragement during this long journey and guidance throughout my life and for providing me with an excellent education.

Management and Firm Characteristics: An Empirical Study on Capital Structure Practices of Listed Companies in Sri Lanka

Ahamed Riyad Rooly M.S.

ABSTRACT

A capital structure decision is considered to have significant impact for the value maximization perspective of the firm. Balancing debt and equity issuance decisions will lead to have optimum capital structure whereas it maximizes the wealth of shareholders. Theoretically, capital structure theories provide guidelines to managers to choose and/or balance the debt and equity in order to value maximization. However, the way in which the application of theory and/or best practices in corporate finance is organized differs between countries, depending on their economic, political, and social context as well as management and firm characteristics perspective.

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. The firms that operated in Sri Lanka were affected by political and economic instability. However, the stock market performed well and there were credit growth in the country among private sectors.

The Theoretical basis for this study was static trade-off theory, pecking order theory, and agency cost theory, which focus on the debt and equity decisions on value maximization. Literature in relation to corporate financing decisions and application of capital structure theories reported mixed results and suggested for further investigation on these assumptions. The conceptual framework describes in this study that influence of management and firm characteristics in corporate financing decisions in relation to capital structure theories. This study makes a significant contribution to the body of knowledge on corporate financing decisions in developing countries and illustrates the corporate financing decisions in relation to perceived importance of capital structure theories.

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 data were analyzed with SPSS to obtain quantitative measures of descriptive statistics, univariate analysis, correlation test and independent sample T-test.

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 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.

The conclusions drawn from this study were that the corporate financing decisions in relation to capital structure practices differ from developed countries to developing country in many ways such as Sri Lanka. There is no significant association and/or influence of management and firm characteristics on perceived importance of capital structure theories. However, for corporate financing decisions in relation to capital structure theories to have full impact on firm value like U.S.A and Europe countries, CFOs of listed companies in Sri Lanka should consider capital structure theories that are in line with corporate financing decisions.

CHAPTER 1

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