MANAGEMENT AND FIRM CHARACTERISTICS: AN EMPIRICAL STUDY ON AGENCY COST THEORY AND PRACTICE ON DEBT AND EQUITY ISSUANCE DECISION OF LISTED COMPANIES IN SRI LANKA

Journal of Social Review
Volume 2 (1)
June 2014
Department of
Social Sciences

M.S.A. Riyad Rooly

Abstract

The research is about the corporate financing decisions based on capital structure theories, especial reference to agency cost theory and practice of listed companies in Sri Lanka. The result finds no evidence of perceived importance of agency cost theory of listed companies in Sri Lanka. As a result, the findings those CFOs of listed companies in Sri Lanka consider different factors on debt and equity issuance decisions. The research finds no significant association between management and firm characteristics and agency cost theory in corporate financing decisions. The conclusions drawn from this study were that the corporate financing decisions in relation to agency cost theory differ from developed countries to developing country in many ways such as Sri Lanka. However, for corporate financing decisions in relation to agency cost theory to have full impact on firm value like U.S.A and Europe countries, CFOs of listed companies in Sri Lanka should consider agency cost theory that are in line with corporate financing decisions.

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 firmsôvalue 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 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? To what extend do management and firm characteristics influence and/or associate with debt and equity issuance decisions in relation to perceived importance of agency cost theory? The mix of debt and equity combination is dependent on firmôs choice of target capital structure, the average maturity of debt, specific sources of financing, management and firmsô characteristics (Ibrahima et al, 2012). The capital structure theory i.e. agency cost theory provides guidance to the managers to determine the debt and equity combination 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 agency cost theory of listed companies in Sri Lanka. As an 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 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 agency cost 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 provide 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 agency cost 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 agency cost 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 agency cost 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 agency cost theory in corporate financing decisions and the level of perceptions of management in the firms.

The Literature

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 companyǿs 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 firmǿs assets, but also by the type of assets it holds (Myers

1984). Graham and Harvey (2001) find that little evidence on executivesô 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).

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 firmòs customers or suppliers do not concern that the firm might go out of business.

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 firmòs financial leverage. The results show that market does not appear to consider the relationship between a firmòs leverage ratio and the industryòs leverage ratio important.

Research Methodology

To investigate the association between management and firm characteristics and perceived importance of agency cost 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 agency cost theory. The hypotheses presented in this study are testable.

The null and alternative hypotheses are to test whether the agency cost theory is relevant 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.

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 agency cost 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.

Statistical Methods

This survey focuses to analyze management and firm characteristics in relation to agency cost 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).

Discussion and Implications of Results

The Agency Cost 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.

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 bondholdersô 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).

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.

Conclusion

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.

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. It is generally accepted that the study finds no significant association between management and firm characteristics and agency cost theory. 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.

References

Bradley, M, Jarrell, GA & Kim, EH (1984) óOn the existence of an optimal capital structure: Theory and evidenceô, *The Journal of Finance*, vol. 39, no. 3, pp. 857-878.

Buferna, F, Bangassa, K, & Hodgkinson, L 2005, óDeterminants of capital structure: evidence from Libyaô, *Research Paper Series*, no. 2005/08.

Bancel, F & Mittoo, RU, 2004, óCross-Country determinants of capital structure choice: a survey of European firmsô, *Financial Management*, vol. 33, no. 4.

Colombage, SRN 2007, óConsistency and controversy in corporate financing practices: evidence from an emerging marketô, *Studies in Economics and Finance*, vol. 24, no. 1, pp. 51-71.

Daily News 2009, óPeace Spurs Colombo Stock Marketô, Daily News Online Edition Sri Lanka, 7th October 2009.

DailyFT 2012, óEquities vs rising interest rates: Gains existô, viewed 20th April 2012, <http://www.ft.lk/2012/04/20/equities-vs-rising-interest-rates-gains-exist/>.

Graham, JR & Harvey, CR 2001, óThe theory and practice of corporate finance: evidence from the fieldô, *Journal of Financial Economics*, vol. 60, pp. 187-243.

Graham, JR & Harvey, CR 2002, óHow do CFOs make capital budgeting and capital structure decisions?ô, *Prepared for The Journal of Applied Corporate Finance*, vol. 15, no, 1.

Hatfield, BG, Cheng, WTL & Davidson, NW 1994, óThe determination of optimal capital structure: The effect of firm and industry debt ratios on market valueô, *Journal of Financial and Strategic Decisions*, vol. 7, no. 3.

Ibrahima, K, Nor Mat, F, Ibrahim, I, Alias, AM & Haron, R 2012, óPractices of capital structure decisions: Malaysia survey evidenceô, *International Review of Business Research Papers*, vol. 8, no. 1, pp. 33-63.

Jong, AD & Dijk, RV 2007, óDeterminants of leverage and agency problems: A regression approach with survey dataô, *The European Journal of Finance,* vol. 13, no. 6, pp. 565-593.

Khrawish, AH & Khraiwesh, AHA 2010, óThe determinants of the capital structure: Evidence from Jordanian Industrial Companiesô, *JKAU: Econ & Adm*, vol. 1, no. 24, pp. 173-196.

Modigliani, F & Miller Merton, H 1958, óThe cost of capital, corporation finance and the theory of investmentô, *The American Economic Review*, vol. 48, no. 3, pp. 261-297.

Miller Merton, H 1977, óDebt and taxesô, *The Journal of Finance*, vol. 32, no. 2, pp. 261-275.

Myers, SC & Majluf, N 1984, óCorporate financing and investment decisions when firms have information that investors do not haveô, *Journal of Financial Economics*, vol. 13, pp. 187-221.

Myers, SC 1984, óThe capital structure puzzleô, *The Journal of Finance*, vol. 39, no. 3, pp. 575-592.

Mefteh, S & Oliver, RB 2010, óCapital structure choice: the influence of sentiment in Franceô, *International Journal of Behavioral Accounting and Finance*, vol. 1, no. 4, pp. 294-311.

Titman, S & Wessels, R 1988, óThe determinants of capital structure choiceô, *The Journal of Finance*, vol. 43, no. 1, pp. 1-19.

Sheikh, NA & Wang, Z 2011, óDeterminants of capital structure: an empirical study of firms in manufacturing industry of Pakistanô, *Managerial Finance*, vol. 37, no. 2, pp. 117-133.