

# THE CAPITAL STRUCTURE DECISION OF SMALL-MEDIUM SIZED PRIVATE FIRMS: AN INTERNATIONAL COMPARISON

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## ABSTRACT

*International Financial Reporting Standard for Small- and Medium-Sized Entities IFRS for SMEs is a modification and simplification of full IFRS aimed at meeting the needs of private company financial reporting users and easing the financial reporting burden on private companies through a cost-benefit approach. IFRS for SMEs is a self-contained global accounting and financial reporting standard applicable to the general-purpose financial statements of, and other financial reporting by, entities that in many countries are known as small- and medium-sized entities. Full IFRS and IFRS for SMEs are promulgated by the International Accounting Standards Board ("IASB"). Capital is an important and critical resource for all companies. The capital resources can be divided into two main categories, namely equity and debt. Equity arises when companies sell some of its ownership rights to gain funds for operation and investing activities. Debt is a contractual agreement, whereby companies borrow an amount of money and repay it with interest within a stipulated time frame.*

**Keywords:** Capital, Decision, Private, Modification, Debt, Simplification

## INTRODUCTION

There are many definitions given to capital structure of companies. Brealey and Myers (1991) defined capital structure as comprising of debt, equity or hybrid securities issued by the firm. Schlosser (1989) defined capital structure as the proportion of debt to the total capital of the firms. Haugen and Senbet (1988) defined capital structure as a choice of firms between internal and external financial instruments. Bos and Fetherston (1993) pointed out that capital structure, being total debt to total asset at book value, influences both profitability and riskiness of the firm. From the definitions given by many previous researchers, capital structure can be referred to as "the mixture of sources of funds a firm uses" (debt, preferred shares, and ordinary shares). The amount of debt that a firm uses to finance its assets is called leverage. A firm with a lot of debt in its capital structure is said to be highly levered. A firm with no debt is said to be unlevered.

When financial leverage increases, it may bring better returns to some existing shareholders but its risk also increases as it causes financial distress and agency costs (Jensen and Meckling, 1976). The cost of financial distress can be both direct and indirect. The bankruptcy cost is an example of direct financial distress cost while extraordinary administrative costs, loss of trade credit, loss of sales and key personnel are examples of indirect financial distress costs.

Therefore, optimal capital structure is determined by the trade-off between benefits and costs of debt financing. The benefits are typically tax savings and the costs are financial distress and agency costs (Titman and Tsyplakov, 2004). An appropriate capital structure is a critical decision for any business organization. The decision is important not only because of the need to maximize returns to the shareholders, but it is also important because of the impact of such decision on an organization's ability to deal with its competitive environment (Simerly and Li, 2002). Over the past several decades, theories on a firm's capital structure choice have evolved along many directions, with many models being built to explain a firm's financing behavior. The theories suggest that firms select capital structure depending on attributes that determine the various costs and benefits associated with debt and equity financing.

Prior to 1958, the traditional capital structure theory ( the Naïve Theory ) was based on the idea of weighted average cost of capital (WACC) principle, which states that companies issue debt in order to reduce their WACC as debt is considered less costly than equity (Prace, 2004). The modern capital structure theory was later developed since the publication of capital structure irrelevancy framework by Modigliani and Miller<sup>1</sup> (American Economic Review, 1958). They argued that a firm couldn't change the value of its outstanding securities by changing the proportions of its capital structure. Modigliani and Miller concluded that in a world without taxes, the value of the firm and also its overall costs of capital were independent of its choice of capital structure. A later study in 1963 by MM concluded that by incorporating corporate tax, the market value of a firm is increased and the overall cost of capital is reduced to the point of interest being tax deductible.

## **REVIEW OF LITERATURE**

The study generally aims to fill the gap in the literature by empirically examining the relationship between the use of debt in the capital structure of companies and the factors related to the capital structure. Specifically the objectives of this research are to achieve the following:-

- To examine the factors affecting the capital structure decision of public limited companies in the selected ASEAN countries, namely Malaysia, Indonesia, Philippines, Thailand and Singapore. For this purpose, five firm-specific factors or determinants which include asset tangibility, financial flexibility, liquidity, profitability and firm size and three macroeconomic factors, namely GDP growth, inflation rate and interest rate are tested to see its relationship with leverage ratios. This study measures the extent to which observed variations of capital structure are significantly explained by the firm-specific factors and macroeconomic factors.

- To examine which theory or theories of capital structure explain the financing behavior of companies of the selected ASEAN countries. Among the capital structure theory specifically tested here include static trade-off theory, agency cost theory and pecking order hypothesis.
- To test whether the 1997-98 ASEAN financial crisis have altered the corporate financing decision of Malaysia, Indonesia, Philippines, Thailand and Singapore. For this purpose, the determinants of capital structure are compared during the pre-crisis period and post-crisis period.

## SIGNIFICANCE OF THE STUDY

This study extends the existing empirical research of capital structure in several ways. Firstly, this study extends the range of theoretical firm specific determinants of capital structure, especially the financial flexibility and liquidity by examining them with some recently developed theories that have not been analyzed with the ASEAN data set. Secondly, macroeconomic factors namely, GDP growth, inflation rate and interest rate is examined to see its influence on capital structure choice. Most literature on this issue modeled only the firm specific determinants in their studies. Practically, managers also like to consider market conditions, like interest rate, inflation, stock market performance and other economic factors when deciding for financing mix (Antoniou et al, 2002). The importance of macroeconomic factors in affecting leverage ratios are lately examined by Booth et al. (2001), Gianetti (2003) and Korajczyk and Levy (2003). Thirdly, most previous studies adopted total debt over total capital or assets as a measure of leverage (Bhaduri, 2002). This study incorporates both short-term debt ratio and long-term debt ratio as a measure of capital structure decision in addition to the common total debt ratio in order to get better explanations on the point of leverage maturity.

Fourthly, this study uses data of the companies for longer duration and recent dataset, 1992 till 2005. It is good to suspect that pattern of corporate financing decision might have changed over the decades. During the late 1980s, many firms took an extra leverage due to pressure from the market (Frank and Goyal, 2004). Therefore, studies done using 1970s and 1980s data may not give the same results and a recent study would be essential to evidence the changes of time. Moreover, longer time frame (this study use 14 years data) used in this study would be able to provide better regression result for the corporate financing behavior. Fifthly, this study examines whether the financial crisis made any significant impact on the financing decision of companies after the crisis. For this purpose, the determinants of capital structure during the pre-crisis period are compared with the post-crisis period to see whether there are differences on the influences of capital structure. Finally, the mean capital structure by industries in the selected ASEAN countries are analyzed, probably a pioneering work within the ASEAN context.

## ORIGIN OF CAPITAL STRUCTURE

There were a number of studies done by research scholars on various aspects of capital structure and the following reviews some of the important studies.

### SIGNALING HYPOTHESIS

Signalling hypothesis was introduced by Ross (1977) who concludes a positive relationship between profitability and leverage against the pecking order theory which states the negative relationship between profitability and leverage. The basic idea of signalling hypothesis is that the choice of capital structure signals outside investors the information of the insiders. According to Ross, managers, whom are known as insiders know the true distribution of firm returns, but investors do not. The managers feel more „relax“ with equity than debt as debt can lead to managers losing jobs if firms go bankrupt. Knowing this fact, if managers keep on adding more debt in the capital structure of the firms, this reflects a „signal of higher future cash flow“ and their managers“ confidence of the firms???. Therefore, investors take large level of debt as a signal of „higher quality“ and therefore, profitability is expected to be positively related to leverage. There were mixed results noted in the literature with respect of the effect of signalling on the capital structure decision.

Jensen et al. (1992) ruled out a negative relationship between leverage and signaling. In their study, signalling was represented by the dividend payment and debt issues in this case behave as a substitute in mitigating agency problems. On the other hand, John and William (1985) argued a positive relationship with signalling, a firm with the reputation of dividend payment as the measure of signalling faces with less asymmetric information in accessing the equity market. When dividend payment represents a signal of better financial health, then more debt taking capacity is created, therefore a positive relationship is noted.

However, Bhaduri (2002) found that signalling appeared insignificant in determining leverage. Bhaduri studied Indian corporations and used the ratio of dividend payment to net operating income as a proxy to represent signalling. Baker and Wurgler (2002) pointed out that firms reduce their debt ratios when they raise substantial amounts of capital when the equity market is held to be favorable, that is when managers “time the equity” or when market-to-book ratios are higher.

In another study, Taranto (2002) found signalling hypothesis to explain capital structure decision very well based on recent US data. Taranto confirms results from the earlier studies and adds to the understanding of the announcement effect when firms initiate dividends. Prior results confirmed that there is a statistically significant abnormal return during the announcement period and a wide dispersion of returns exists. In his study, Taranto evidenced a decrease in expected abnormal return on leveraged firms. Two reasons are given for this phenomenon. The first is that firms with debt have already sent signals about their quality, so the value of subsequent signals is diminished. The second that wealth transfers between bondholders and shareholders affect the return when the leverage is high.

In other words, this study finds that the effect of initiating dividends is dampened when there is debt in the capital structure. Highly levered companies do benefit from wealth transfers from bondholders when dividends are announced. For these firms, paying dividends increases equity value because shareholders are given priority over bondholders for some of the firm's cash flows.

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