



---

## BOARD CHARACTERISTICS AND CAPITAL STRUCTURE: A CASE STUDY OF SELECTED HOTELS & RESTAURANTS IN SRI LANKA

Priya, K\*

Nimalathasan, B\*\*

---

**Abstract:** *The board characteristics are generally seen as the major corporate control mechanism in Sri Lanka. Board characteristics and capital structure are correlated but a casual effect has not been established yet. The goal of this paper is to study this issue by identifying a specific channel through board characteristics affect capital structure. This study examines the relationship between board characteristics and capital structure among selected hotels and restaurants in Sri Lanka. Which covered over a period of past 5 years from 2008 to 2012, Correlation and regression analysis statistics were used in the analysis and findings suggest that there is a significant relationship exists between board characteristics and capital structure among the hotels and restaurants in Sri Lanka. However, the findings of this paper are based on a study conducted on the selected hotels and restaurants. Therefore, the results are valid for this sector. The results add insight on the relation between monitoring mechanisms and capital structure of hotels in an emerging market.*

**Keywords:** *Board characteristics, Capital structure, corporate governance, Hotels & Restaurants.*

---

\*Demonstrator, Department of Commerce, University of Jaffna.

\*\*Senior Lecturer, Department of Accounting, University of Jaffna.



## **INTRODUCTION**

The board characteristics part of the function of board directors. The board of directors is charged with oversight of management on behalf of shareholders. Agency theorists argue that in order to protect the interests of shareholders, the board of directors must assume an effective oversight function. It is assumed that board performance of its monitoring duties is influenced by the effectiveness of the board, which in turn is influenced by factors such as board composition and quality, size of board, duality of chief executive officer, board diversity, information asymmetries and board culture (Brennan, 2006).

A board of directors is a body of elected or appointed members who jointly oversee the activities of a company or organization. Other names include board of governors, board of managers, board of regents, board of trustees, and board of visitors. It is often simply referred to as "the board". (Wikipedia, 2013)

Capital structure is basically mixed of company's leverage and equity that a firm uses to finance its assets. It is the method by which public corporations finance their assets sets up their capital structure and influence whether their corporate governance is of high standards. It is necessary for every firm that the capital structure decision.

The best capital structure is a tough task that management of the firm has to take responsibility for. Capital structure decisions are of the high degree of importance to the organizations because it has direct impact on firm value and stockholder's wealth. Management elected by stockholders is representatives of them in the board of directors, and they are supposed to operate in their best interests.

Tricker (1994) focused on four board characteristics such as board composition, directors' ownership, CEO duality and board size which have been identified as possibly having an impact on corporate performance and these characteristics are set as the independent variables.

## **SIGNIFICANCE OF THE STUDY**

Capital structure decision is essential due to the necessity of maximizing returns to numerous organizational stakeholders and also the effect of this decision on an organization's capability to deal with its competitors (Abor and Biekpe, 2005). According to Saad (2010), board of directors is considered as one of the major 2 components of the corporate governance which provides an efficient regulatory and controlling mechanism to decrease



the agency problems. Therefore, there are additional provisions to the shareholders and other investors.

According to Gompers, Ishii and Metrick (2003) good corporate governance practices possibly had substantial impact on company's strategic decisions such as external financing, which are taken at board level and clearly board of directors is the significant element of the corporate governance. Consequently, board of director's features such as CEO/Chair duality, presence of non-executive directors, board size and presence of independent directors may have direct influence on the firm's capital structure decisions.

Company boards of directors are bodies entrusted with power to make economic decisions affecting the well-being of investors' capital, employees' security, communities' economic health, and executive power and perquisites (Banks, 2004). Hence, boards of directors have the ultimate internal authority within a company (Renton, 1994).

The capital structure is one of the three financial decisions considered as drivers of firms' added value, namely the investment decision, the financing decision and dividend decision. The emphasis on the financing decision is explained, firstly, by its direct relation to business continuity and secondly through its effect on the ability of the firm to deal with its competitors (Heng and Azrabijani, 2012)

### **STATEMENT OF THE PROBLEM**

Board of characteristics has been largely criticized for the decline in shareholders' wealth and corporate failure. Some of the reasons stated for these corporate failures are the lack of attentive oversight functions by the board of directors, the board relinquishing control to corporate managers who pursue their own self-interests and the board being remiss in its accountability to stakeholders. As a result, various corporate governance reforms in this study.

"The relationship between board characteristics and capital structure is effecting the management decision in setting the capital structure that will maximize the firm value". Board characteristics and capital structure is considered an important problem nowadays in the hotels and restaurants industry in Sri Lanka. Conducting a research based on this problem will enlighten the managers and the shareholders of the firm of how to overcome some of the issues related to capital structure.



This study tries to link the research gap through investigating the relationship between the board characteristics and capital structure decisions of leading Sri Lankan firms. The result of this study could be very vital and helpful for sustainability of hotels and restaurants in global market. As a result, the research question is:

Is there any significant relationship between the board characteristics and capital structure decision of leading hotels and restaurants in Sri Lanka?

## **OBJECTIVES**

The main objective of the study is to find out the impact of board characteristics and Capital Structure of selected hotels and restaurants in Sri Lanka.

The following sub objectives are considered for the above purpose.

- To identify the factors which are significantly contribute to the board characteristics and capital structure.
- To find out the relationship between board characteristics and capital structure.
- To suggest some measures to enhance the capital structure in selected hotels and restaurants.

## **LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT**

Priya and Nimalathasan (2013) This study examined the relation between board of directors' characteristics and financial performance among selected hotels and restaurants in Sri Lanka which covered selected hotels and restaurants in Sri Lanka over a period of past 5 years from 2008 to 2012. The result revealed that there is a significant relationship that exists between board of directors' characteristics and financial performance among selected hotels and restaurants in Sri Lanka. The suggested Number of Women in Board (NWB) and Inside Directors (ISD) are significantly correlated with Return on Asset (ROA) at 5 percent level of significance. NWB and ISD are significantly correlated with Return on Equity (ROE) at 5 percent level of significance. At the same time CEO Duality (CEO DUAL) is significantly correlated with ROE at 1 percent level of significance.

Daniel, Miguel and Beatriz Mariano, (2012) investigated the link between leverage and board structure and identify a specific mechanism through which leverage affect board structure. Obtained that board data from Compact Disclosure for the 1990-1995 periods and from IRCC for the 1996-2007 period. The governance index of Gompers, Ishii, and Metrick (2003) (GIM) is from IRRC and CEO compensation and tenure data are from



ExecuComp. This sample contains 2,554 firms and 19,603 firm-year observations. Three measures of board structure: number of independent directors, board independence and board size. The explanatory variables of interest are financial leverage and debt covenant violations. Positive correlation between board independence and financial leverage. Using a regression discontinuity Findings establish a causal effect from firm characteristics – leverage – to board structure through a transfer of control from shareholders to creditors.

Ong Tze San, Boon Heng and Shabnam (2012) this study investigated the relationship between board of directors and company's capital structure in an emerging market, Malaysia. This research paper covers 75 non-financial leading Malaysian companies, which are employed as a price index, listed on Kuala Lumpur stock exchange (KLSE) from the year 2005 to 2008 fiscal years. Measures of board of directors employed are size of the board, presence of non-executive directors on the board, presence of independent non-executive directors on the board and CEO/Chair duality. Results reveal that board size and presence of independent non-executive directors on the board have significant, negatively and positively correlation with debt to asset ratio respectively. However corporate capital structure decisions are not found significantly influenced by CEO/Chair duality and the presence of non-executive directors on the board. Consequently based on the results, board of director's features such as board size and presence of independent non-executive directors on the board play an important role in determination of financial mix of the companies.

Mat Kila Suhaila and Wan Mansor Wan Mahmood (2008) This study stated the determinants of capital structure for the firms listed in the Bursa Malaysia Securities Berhad (BMSB) market during the six year period from 2000 to 2005. The data derive from financial statements of 17 companies with numbers of observations totaling 102. Dependent variable of debt ratio and is expressed by total debt divided by total assets while the independent variables are size, growth, liquidity and interest coverage ratio. Applying pooled OLS estimations, the result shows that the size, liquidity and interest coverage ratio is significantly negatively related to total debt. However, the study finds insignificant negative relation between capital structure and growth of the firm, expressed by the annual changes of earnings. Finally, the results of dummy variable show that there is significant different in capital structure among those firms that adopt more debt (more than 30 per cent of their total assets) and those who employ less leverage financing.



Berger, , Ofek, and Yermack, (1997) and Hasan and Butt (2009) pointed that connection between the company's capital structure and size of the board. Found a negative association and Abor (2007) discovered a positive linkage between the company's gearing level and the board size. Conger and Lawler (2009) considered nine to 13 members to be appropriate for corporate boards.

Then the relationship between that CEO/Chair duality and company's capital structure pointed by Kyereboah-Coleman and Biekpe (2006) and Fosberg (2004) discovered a negative association but Abor (2007) and Abor and Biekpe (2006) found a positive linkage between the CEO/Chair duality and company's capital structure. Hafiza (2009) CEO/Chair duality that is dummy variable, when a CEO takes charge as a board chairman, the variable is equal to 1 and otherwise is zero. Duality of roles refers to a situation where a firm's CEO also serves as chairman of the board of directors (Abdullah, 2004). Duality of roles refers to a situation where a firm's CEO also serves as chairman of the board of directors (Abdullah, 2004).

Internal directors called 'executive directors' are full-time employees of a company, and involved in day-to-day company operations (Keil & Nicholson, 2003). Firm's Capital Structure (debt to asset ratio) Bunkanwanicha, Gupta and Rokhim (2008), Fan, , Titman& Twite, (2006) and Pandey (2001)

From the literature review the following hypotheses are developed for the study purpose.

**H<sub>1</sub>:** Board Characteristics has an impact on Capital Structure.

**H<sub>2</sub>:** Board Characteristics and Capital Structure are significantly correlated.

**H<sub>3</sub>:** All factors determine the Board Characteristics is significant.

## CONCEPTUAL FRAME WORK

Based on the literatures, the following conceptual frame work is formulated.

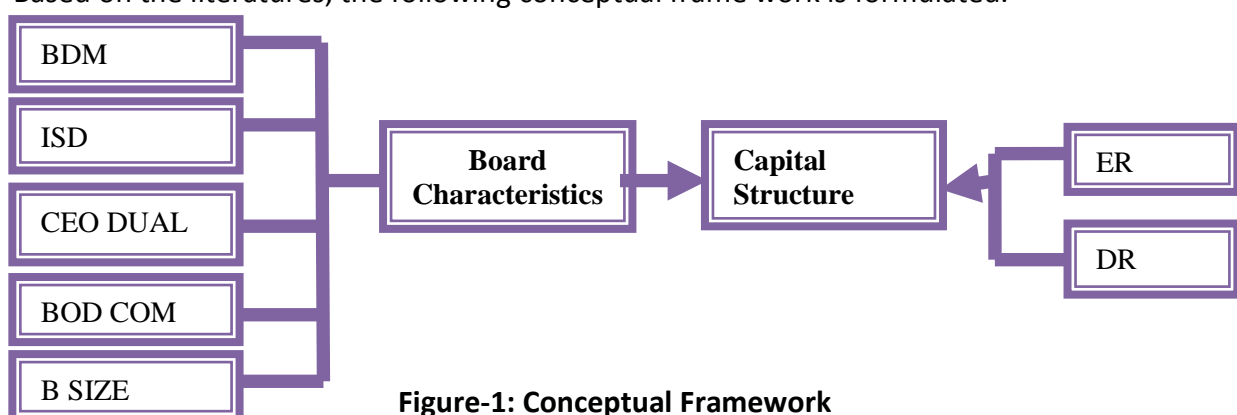


Figure-1: Conceptual Framework



---

BDM	: Board of Directors Meeting	CEO DUAL	: CEO Duality
ISD	: Inside Directors	BOD COM	: Board Composition
B SIZE	: Board Size	DR	: Debt Ratio
ER	: Equity Ratio		

## **METHODOLOGY**

A discussed by mouton (2001) research methodology focuses on the research process a kind of tools and procedures to be used. It describes research design, research approach, sampling procedure, data sources, instrumentation, reliability, validity and mode of analysis.

## **RESEARCH DESIGN**

This research will be an explanatory studies. The emphasis here is on studying a situation or a problem in order to explain the relationship between variables (i.e., Board Characteristics and Capital Structure)

## **SAMPLING DESIGN**

The sample of this study composed of listed Hotels and Restaurants in Sri Lanka for the period of 2008-2012. To evaluate this topic, researchers have used different methods of Statically Package for Social Science (SPSS) for analysing the data. Here Correlation and Multiple Regression are used to analysis the data.

## **RELIABILITY AND VALIDITY OF THE DATA**

Reliability will be established with an overall Cronbach's alpha and other techniques. It will be compared our reliability value with the standard value alpha of 0.7 advocated by Cronbach (1951), a more accurate recommendation (Nunnally & Bernstein's, 1994) or with the standard value of 0.6 as recommended by Bagozzi & Yi's (1988). Secondary data for the study were drawn from audit accounts (i.e., income statement and balance sheet) of the concerned companies; therefore, these data may be considered reliable for the purpose of the study. Necessary checking and cross checking were done while scanning information and data from the secondary sources. All these efforts were made in order to generate validity data for the present study. Hence researcher satisfied content validity.

## **MODE OF ANALYSIS**

The following board characteristics and capital structure ratios are taken into accounts which are given below.



<b>Board Characteristics Ratios</b>	
<b>Board of Directors Meeting</b>	The number of regular meetings held by the Board of Directors during each fiscal year. The meetings refer only to those held in person, excluding the telephonic meetings.
<b>Inside Directors</b>	Insiders are the directors that participate in the day to day running of the company. They work full-time in the company and are responsible for the achievement of operational and strategic objectives. For example, the CEO represents an inside director.
<b>CEO Duality</b>	Dummy variable, taking a value of 1 for firms with the CEO as Chair, and 0 otherwise.
<b>Board Composition</b>	The proportion of non-executive directors to total number of directors on the board.
<b>Board Size</b>	Total number of directors on the board.
<b>Capital Structure Ratios</b>	
<b>Debt Ratio</b>	Long term Debt / Total Assets
<b>Equity Ratio</b>	Total Equity / Total Assets

**Table-1: Calculations of Board Characteristics and Capital Structure Ratios**

Multiple regression analysis was performed to investigate the impact of Board characteristics on Capital Structure which the model used for the study is given below. Capital Structure = f (DR; and ER) It is important to note that the capital structure depend upon Board of Directors Meeting (BDM), Inside Directors (ISD), CEO Duality (CEO DUAL), Board Composition (BOD COM), Board Size (B SIZE). Since two Capital Structure Ratios that are Debt Ratio (DR) and Equity Ratio (ER). The following two models are formulated to measure the impact of Board Characteristics on Capital Structure is as follows.

$$DR = \alpha + \beta_1 BDM + \beta_2 ISD + \beta_3 CEO DUAL + \beta_4 BOD COM + \beta_5 B SIZE + \epsilon \dots \dots \dots (1)$$

$$ER = \alpha + \beta_1 BDM + \beta_2 ISD + \beta_3 CEO DUAL + \beta_4 BOD COM + \beta_5 B SIZE + \epsilon \dots \dots \dots (2)$$

Where,  $\alpha$ , is constant,  $\beta_1, \beta_2, \beta_3, \beta_4$  and  $\beta_5$  are coefficients of variables,  $\epsilon$ , is error term.

## **DATA ANALYSIS AND DISCUSSION**

### **Multi-Co linearity**

Two major methods were used in order to determine the presence of multi-co linearity among independent variables in this study. These methodologies involved calculation of a Tolerance test and variance inflation factor (VIF) (Ahsan, Abdullah, Gunfie, & Alam, 2009). The results of these analysis are presented in table 2. Test of Co linearity.





**Table-2: Test of Co linearity**

Variables	Tolerance	VIF
Board of Directors Meeting	.494	2.023
Inside Directors	.616	1.623
CEO Duality	.177	5.659
Board Composition	.451	2.218
Board Size	.228	4.379

According to the table-2, Test of Co linearity, none of the tolerance level is < or equal to 1; and also VIF values are perfectly below 10. Thus the measures selected for assessing independent variable in this study do not reach levels indicate of multi-co linearity.

**Correlation**

**Table -3: Correlation Matrix**

Variables	BOM	ISD	CEO DUAL	BOD COM	B SIZE	DR	ER
<b>BOM</b>	1						
<b>ISD</b>	-.514* (.050)	1					
<b>CEO DUAL</b>	.107 .703	-.074 (.792)	1				
<b>BOD COM</b>	-.098 (.728)	-.186 (.507)	.669** (.006)	1			
<b>B SIZE</b>	-.145 (.607)	-.013 (.963)	.841** (.000)	.595* (.019)	1		
<b>DR</b>	.211 (.450)	-.557* (.031)	.663** (.007)	.579* (.024)	.591* (.020)	1	
<b>ER</b>	-.119 (.674)	.193 (.491)	.702** (.004)	.336 (.220)	.599* (.018)	.276 (.319)	1

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

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

It is found that from table-3; describes the correlation between board characteristics and capital structure. That indicates that BOD COM and B SIZE are significantly correlated with DR 5 percent level of significance. Then ISD is negatively correlated with DR 5 percent level of significance. At the same time CEO DUAL also significantly correlated with DR 1 percent level of significance.



CEO DUAL and B SIZE are significantly correlated with ER at 1 percent level of significance. Finally the rest of other variables are not correlated. Then a multiple regression analysis was performed to identify the predictors of capital structure variables as conceptualized in the models. A enter variable selection was used in the regression analysis and Table-4 provides the summary measure of the models.

**Table-4: Predictor of Capital Structure – Model summary**

Details	DR	ER
<b>BOM</b>	-0.428 (.679)	-0.753 (.470)
<b>ISD</b>	-2.513 (.033)	.371 (.719)
<b>CEO DUAL</b>	1.177 (.269)	2.066 (.069)
<b>BOD COM</b>	0.254 (.805)	-0.887 (.398)
<b>B SIZE</b>	0.316 (.760)	-0.317 (.759)
<b>Constant</b>	15.032 t=.852; p=.416	0.602 t=.862; p=.411
<b>R</b>	0.850	0.773
<b>R<sup>2</sup></b>	0.723	0.598
<b>Adjusted R<sup>2</sup></b>	0.569	0.374
<b>Standard Error</b>	4.71263	.18668
<b>F Value</b>	4.699 (0.022)	2.675 (0.095)

From the table-4; it is seen that the specification of the five predictor variables (BOM, ISD, CEO DUAL, BOD COM and B SIZE) in the above model reveals that the ability to predict the capital structure. ( $R^2 = 0.723$  and  $0.598$  respectively).

In  $R^2$  value of  $0.723$  which is in the model 1 denotes that  $72.3\%$  of observed variability in DR can be explained by the differences in the independent variables. Remaining  $27.7\%$  variance in the debt ratio is attributed to other variables.

In this model 2,  $R^2$  value of  $0.598$  which is denotes  $59.8\%$  of observed variability in equity ratio can be explained by the differences in the independent variables. Remaining  $40.2\%$  variance in the ER is attributed to other variables.



In this models summary, that the value of an adjusted  $R^2$  0.569 and 0.374, slightly less than the value of adjusted  $R^2$ .

An examination of the model summary in conjunction with ANOVA (F-value) indicates that the model explains the most possible combination of predictor variables that could contribute to the relationship with the dependent variables.

### Hypothesis Testing

Serial No	Hypothesis	Tools	Accepted/Rejected
H <sub>1</sub>	Board Characteristics has an impact on Capital Structure	Regression	Partially Accepted
H <sub>2</sub>	Board characteristics and Capital Structure are significantly correlated.	Correlation	Partially Accepted
H <sub>3</sub>	All factors determine the Board Characteristics is significant	Correlation	Partially Accepted

### CONCLUSION

The purpose of this paper was to study the board characteristics that affect capital structure in the hotels and restaurants in Sri Lanka, for the five year period of 2008 to 2012. The sample consists of fifteen companies. The research was conducted using secondary data sources from the hotels and restaurants in Sri Lanka. The Debt Ratio and Equity Ratio was dependent variable. BOD COM and B SIZE are positively correlated with DR. then CEO DUAL is negatively correlated with DR. finally CEO DUAL and BOD COM positively correlated with ER. The importance of the capital structure structure of boards characteristics in northern countries has received much attention in the academic literature addressing corporate governance.

Therefore, in future study, it is suggested to consider the longitudinal study which comprise of more than year period in order to get more generalized results. It is also suggested to include other mechanisms of corporate governance such as ownership structure in order to examine the overall influence of corporate governance on dividend payout.

### REFERENCES

- 1) Abdullah, A. B. (2005). Speech on the Malaysian Institute of Directors' Corporate Directors Banquet: Vital to inculcate good values in our daily lives. Retrieved from <http://www.mid.org.my/>.



- 2) Abor, J. & Biekpe, N. (2005). What determines the capital structure of listed firms in Ghana? *The African Finance Journal*, 7(1), 37-48.
- 3) Abor, J. & Biekpe, N. (2006). Does Corporate Governance Affect the Capital Structure Decisions of Ghanaian SMEs? *Corporate Ownership & Control*, 1, 113-118.
- 4) Berger, P. G., Ofek, E. & Yermack, D. L. (1997). Managerial entrenchment and capital structure decisions. *The Journal of Finance*, 52(4), 1411-1438. <http://dx.doi.org/10.2307/2329441>
- 5) Brennan, N. (2006). Boards of Directors and Firm Performance: is there an expectations gap? *Corporate Governance: An International Review*, 14( 6), 577-593
- 6) Bunkanwanicha, P., Gupta, J. & Rokhim, R. (2008). Debt and entrenchment: Evidence from Thailand and Indonesia. *European Journal of Operational Research*, 185(3), 1578-1595. <http://dx.doi.org/10.1016/j.ejor.2006.08.025>
- 7) Conger, J. A., & Lawler, E. (2001). Building a high-performing board: How to choose the right members. *Business Strategy Review*, 12(3), 11-19.
- 8) Daniel Ferreira, Miguel A. Ferreira, Beatriz Mariano, (2012) Board Structure and Capital Structure.
- 9) Fan, J. P. H., Titman, S. & Twite, G. (2006). An International Comparison of Capital Structure and Debt Maturity Choices. Chinese University of Hong Kong and University of Texas in Austin Working Paper.
- 10) Fosberg, R. H. (2004). Agency problems and debt financing: leadership structure effects. *Corporate Governance*, 4(1), 31-38.
- 11) Gompers, P., Ishii, J. & Metrick, A. (2003). Corporate governance and equity prices. *Quarterly Journal of Economics*, 118(1), 107-155.
- 12) Hasan, A. & Butt, S. A. (2009). Impact of ownership structure and corporate governance on capital structure of Pakistani listed companies. *International Journal of Business & Management*, 4(2), 50-57.
- 13) Heng and Azrabajani, 2012, «Board of directors and capital structure: Evidence from leading Malaysian companies, *Easian Social Science*, 8(3), 123-136.
- 14) Kiel, G. C., & Nicholson, G. J. (2003). Board composition and corporate performance: How the Australian experience informs contrasting theories of corporate governance. *Corporate Governance: An International Review*, 11(3), 189-205.



- 15) Kyereboah coleman, A. & Biekpe, N. (2006). Corporate governance and financing choices of firms: a panel data analysis. *South African Journal of Economics*, 74(4), 670-681.
- 16) Mat Kila Suhaila and Wan Mansor Wan Mahmood (2008) Capital Structure and Firm Characteristics: Some Evidence from Malaysian Companies. MPRA Paper No. 14616, posted 13. April 2009 05:01 UTC
- 17) Ong Tze San, Teh Boon Heng & Shabnam Azrbaijani (2012) Board of Directors and Capital Structure: Evidence from Leading Malaysian Companies , *Asian Social Science*. 8(3); March 2012
- 18) Pandey, I. M. (2001). Capital structure and the firm characteristics: evidence from an emerging market. Indian Institute of Management Ahmedabad Working Paper.
- 19) Priya K. and Nimalathasan B. (2013) Board of directors' characteristics and financial performance: a case study of selected hotels and restaurants in Sri Lanka. *Merit Research Journal of Accounting, Auditing, Economics and Finance*. 1(2). 018-025, June, 2013
- 20) Renton, N. E. (1994). *Company directors: Masters or servants*. North Brighton: Wright books Pty Ltd.
- 21) Saad, N. M. (2010). Corporate Governance Compliance and the Effects to Capital Structure in Malaysia. *International Journal of Economics and Finance*, 2, 105-114.
- 22) Tricker, R. I. (1994). *International Corporate Governance: Text readings and Cases*. Singapore: Prentice-Hall.