

CAPITAL STRUCTURE POLICY IN MALAYSIA: A COMPARATIVE ANALYSIS

George W. Kester
Mansor Md Isa.

This paper reports the results of a survey of the chief executive officers of companies listed on the Kuala Lumpur Stock Exchange regarding their views on capital structure policy. It is the first such survey conducted in Malaysia. The attitudes of executives in Malaysia are compared to the attitudes of executives in Hong Kong, Singapore and the United States, based upon the results of previously reported surveys.

BACKGROUND

Modern theories of capital structure can be classified into two categories: "static tradeoff models" and the "pecking order hypothesis." Static tradeoff models imply an optimal debt-equity mix (target capital structure) that is determined by a tradeoff between the benefits and costs of debt (i.e., balancing the tax advantages of debt against the risk of bankruptcy and agency costs). The pecking order hypothesis implies a hierarchy in raising funds, in which the firm prefers internal to external financing and, if it obtains external funds, debt to equity. This empirically motivated hypothesis, which has been theoretically supported on the basis of asymmetric information by Myers and Majluf (1984), is consistent with Donaldson's (1961) observation that firms prefer internal financing and have an aversion to issuing common stock.¹

In a survey of 176 Fortune 500 firms in the United States, Pinegar and Wilbricht (1989) found that the pecking order hypothesis is more descriptive of actual practice than is the static tradeoff model. Accordingly, firms ranked internal equity (retained earnings) as their first choice of long-

Mr. George W. Kester is Professor of Finance at the Department of Management, Bucknell University, Lewisburg, U.S.A.

Dr. Mansor Md Isa is an Associate Professor in the Faculty of Economics and Administration, University of Malaya.

¹ A summary of capital structure theory is contained in Pinegar and Wilbricht (1989). See Baskin (1989) for a review of evidence and additional findings supporting the pecking order theory.

term financing, followed by debt and then new common stock. Moreover, the study found that capital structure policy is less binding than either the firm's investment decisions or dividend policy.

Similar results have been obtained in surveys of the chief executives of firms in the Pacific-Basin region. One-page adaptations of Pinegar and Wilbricht's questionnaire were used by Kester and Chang (1992) in a survey of the chief executives of firms listed on the Stock Exchange of Hong Kong and Kester and Tsui (1993) in a survey of the chief executives of firms listed on the Stock Exchange of Singapore. Executives in both countries expressed a strong preference for following a financing hierarchy rather than adhering to a target capital structure. They also ranked internal equity as their first choice of long-term financing. However, for their second and third financing choices, Hong Kong executives ranked new common stock slightly higher than debt, a result that is not consistent with the pecking order hypothesis. The results in Singapore were mixed. Although executives in Singapore ranked new ordinary shares sold to the public after debt, they ranked new ordinary shares sold through rights issues ahead of debt. (Only one category of new common stock was listed in the Hong Kong and United States surveys.) Executives in both Hong Kong and Singapore agreed with executives in the United States that capital structure policy is less binding than either the firm's investment decisions or dividend policy.²

SURVEY DESIGN

To assess the perceptions of executives in Malaysia regarding various issues related to capital structure policy and to examine the extent to which they use the capital structure models promulgated by academicians, we surveyed the chief executive officers of companies listed on the Kuala Lumpur Stock Exchange.

The same one-page adaptation of Pinegar and Wilbricht's questionnaire used by Kester and Tsui (1993) for the Singapore survey was used to assess executive views on capital structure in Malaysia. The questionnaire (Appendix), which consisted of questions about various issues concerning capital structure policy, was mailed under the letterhead of the Faculty of Economics and Administration, University of Malaya. In an attempt to identify determinants of capital

² The results of Kester and Chang (1992) were generally consistent with the results of a survey of chief financial officers in Hong Kong by Graham, Bromson, Ma and Pak (1992).

structure that may be unique to Malaysia, the questionnaire also included an open-ended question asking executives to identify the major factors in determining the capital structure policies of their companies. The questionnaire did not require the respondents to identify themselves.

During August 1993, the questionnaire was mailed to the chief executive officers of 361 companies listed on the Kuala Lumpur Stock Exchange. At the time of the survey, there were 370 listed companies; however, complete mailing addresses were available for only 361 companies. To increase the sample size, a second complete mailing was conducted in September 1993.

SURVEY RESULTS

A total of 104 usable surveys were returned (a response rate of 28.8 percent), divided into 14 manufacturing companies (21.6 percent), 8 retail/wholesale, (12.3 percent), 9 financial (13.8 percent), 3 hotel (4.6 percent) 7 property (10.8 percent), and 24 companies in other or multiple lines of business (36.9 percent).

The response of executives in Malaysia to each question are compared to the attitudes of executives in Singapore, Hong Kong and the United States.³

Target Capital Structure Versus Pecking Order

According to the responses to question 1, 77.9 percent of the respondents expressed a preference for following a financing hierarchy, whereas only 22.1 percent expressed a preference for maintaining a target capital structure. As shown in Table 1, the percentage of Malaysian executives expressing a preference for following a financing hierarchy is virtually identical to the percentage responses of Hong Kong executives and consistent with the views of Singapore and United States executives.

Financing Hierarchy

Rankings of seven sources of long-term funds (including an "other" category listed in question 2 by the respondents who expressed a preference for following a financing hierarchy are

³ *Pinegar and Wilbricht surveyed the chief financial officers of Fortune 500 firms listed in Fortune magazine. The Fortune 500 includes only industrials; utilities and financial firms are not included. Due to the relatively small number of responses obtained in Malaysia, Singapore and Hong Kong, we do not compare the results with those of Pinegar and Wilbricht by examining only the industrial firms. All responses are included. The effects of industry differences on the results are unknown.*

summarised in Table 2. For each source, the percentage of responses within each rank, the percentage of respondents who did not rank the source, and the mean of the rankings are shown. Higher means indicate higher preferences.

As indicated, 81.0 percent of the respondents (who expressed a preference for following a financing hierarchy) ranked internal equity (retained earnings) as their first choice of financing. Internal equity was ranked first by 89.3 percent of Singapore executives, 65.5 percent of those in Hong Kong, and 84.3 percent of those in United States.

These results are consistent with the pecking order hypothesis, in which companies prefer internal to external financing. However, as previously mentioned, the pecking order hypothesis further implies that if the company raises external funds, debt is preferred to new common stock. Whereas United States executives ranked debt higher than new common stock, a result consistent with the pecking order hypothesis, Hong Kong executives ranked new common stock slightly higher than debt. As in the case of Singapore, the results from Malaysia were mixed. Executives in Malaysia and Singapore ranked new ordinary shares sold to the public after debt; however, they ranked new ordinary shares sold through rights issues ahead of debt. (Only one category of new common stock was listed in the Hong Kong and United States surveys.)

The results from Malaysia and Singapore may not be too surprising given the relatively undeveloped debt markets there.⁴ Companies may find it easier and cheaper to raise funds via equity rights offerings rather than debt.

The low ranking of preference shares by Malaysian executives is also not surprising, given their lack of importance as sources of financing in Malaysia.

Importance of Various Financial Planning Principles

Question 3 elicited ratings of the relative importance of various financial planning principles that affect the company's financing decisions. The results, ranked in order of importance, are shown in Table 3 and compared to rankings by Singapore, Hong Kong, and United States executives in Table 4. Ensuring the long-term survivability of the company and maintaining

⁴ According to a study by Annuar and Shamsher (1993), the average total debt-to-asset ratio of industrial companies listed on the Kuala Lumpur Stock Exchange over the period 1975-89 was 0.46, which is low compared to companies in more developed financial markets.

TABLE 1

TARGET CAPITAL STRUCTURE VERSUS PECKING ORDER:
MALAYSIA, SINGAPORE, HONG KONG, AND THE UNITED STATES

Preferred Capital Structure Policy	Malaysia	Singapore	Hong Kong	United States
Maintain a target capital structure	22.1%	26.6%	21.6%	31.2%
Follow a financing hierarchy	77.9%	73.4%	78.4%	68.8%

TABLE 2

PREFERENCE RANKINGS OF LONG-TERM FUNDS AMONG
COMPANIES IN MALAYSIA THAT FOLLOW A FINANCING HIERARCHY*

Sources by Order of Preference	Percentage of Responses Within Each Rank								Mean Rank**
	First	Second	Third	Fourth	Fifth	Sixth	Last	Not Ranked	
1. Internal Equity (retained earnings)	81.0%	5.1%	3.8%	3.8%	5.1%	1.2%	0.0%	0.0%	6.4
2. New Ordinary Shares (rights issue)	6.3%	30.4%	21.5%	19.0%	13.9%	7.6%	0.0%	1.3%	4.67
3. Bank Loans	5.1%	38.0%	13.9%	1.9%	5.1%	20.2%	2.5%	1.3%	4.47
4. Bonds	1.3%	6.3%	29.1%	17.8%	24.0%	15.2%	3.8%	2.5%	3.70
5. New Ordinary Shares (to public)	3.8%	13.9%	13.9%	16.5%	25.3%	17.7%	3.8%	5.1%	3.61
6. Preference Shares	1.3%	1.3%	11.4%	22.8%	16.4%	29.1%	10.1%	7.6%	2.82
7. Other	1.3%	5.1%	5.1%	3.8%	5.1%	1.2%	26.5%	51.9%	1.24

* These statistics are based upon the respondents (77.9 percent) who expressed a preference for the financing hierarchy.

** Using Pinegar and Wilbricht's method, mean rankings are calculated by multiplying the percentage in each category with assigned scores of 7 through 1 for rankings from 1 through 7, respectively. A score of 0 is assigned when a source is not ranked.

TABLE 3

RELATIVE IMPORTANCE OF VARIOUS FINANCIAL
PLANNING PRINCIPLES: MALAYSIA*

Planning Principle by Order of Importance	Percentage of Responses Within Each Rank						Mean Rank**
	Unimportant	Second	Third	Fourth	Important	Not Ranked	
1. Ensuring long-term survival of the company	6.0%	4.0%	4.0%	6.0%	79.0%	1.0%	4.45
2. Maintaining financial flexibility	5.0%	3.0%	16.0%	29.0%	45.0%	2.0%	4.00
3. Maintaining financial independence	3.0%	5.0%	19.0%	32.0%	37.0%	4.0%	3.83
4. Maintaining a predictable source of funds	7.0%	17.0%	19.0%	26.0%	30.0%	1.0%	3.52
5. Maintain long-term relationships with banks	11.0%	17.0%	22.0%	30.0%	18.0%	2.0%	3.21
6. Maximizing prices of publicly traded securities	12.0%	14.0%	31.0%	16.0%	22.0%	5.0%	3.07
7. Maintaining comparability with companies in same industry	17.0%	21.0%	31.0%	13.0%	14.0%	4.0%	2.74

* These statistics are based upon all respondents.

** Mean rankings are calculated by multiplying the percentage in each category with values of 1 through 5 for rankings from "unimportant" to "important," respectively. A score of 0 is assigned when not ranked.

financial flexibility were rated as the two most important considerations affecting a company's financing decisions. These were also the two top-ranked factors according to Singapore, Hong Kong and United States executives.

Maintaining financial independence comes in third. This is consistent with internal equity being the top choice of financing. Financing through retained earnings avoids loss of voting control and independence.

The maximisation of security prices, which was ranked fourth by United States executives, was ranked sixth by Malaysian executives.

TABLE 4

COMPARATIVE MEAN RANKINGS OF FINANCIAL PLANNING PRINCIPLES:
MALAYSIA, SINGAPORE, HONG KONG, AND THE UNITED STATES

Financial Planning Principle	Malaysia	Singapore	Hong Kong	United States
Ensuring long-term survival of the company	4.45 (1)	4.05 (1)	4.05 (1)	4.55 (2)
Maintaining financial flexibility	4.00 (2)	3.88 (2)	4.03 (2)	4.55 (1)
Maintaining financial independence	3.83 (3)	3.38 (3)	3.78 (3)	3.99 (5)
Maintaining a predictable source of funds	3.52 (4)	3.06 (4)	3.19 (4)	4.05 (3)
Maintain long-term relationships with banks	3.21 (5)	2.51 (6)	2.89 (5)	—
Maximising prices of publicly traded securities	3.07 (6)	2.63 (5)	2.70 (6)	3.99 (4)
Maintaining comparability with companies in same industry	2.74 (7)	1.91 (7)	2.30 (7)	2.47 (7)
Maintaining a high debt rating	—	—	—	3.56 (6)

Empirical evidence in the capital structure literature suggests the existence of an industry effect.⁵ However, the need to maintain comparability with companies in the same industry was ranked least important by executives in all four countries. Apparently, they do not attach a high level of importance to adhering to industry norms -- at least relative to other factors affecting financial decisions.

Perceived Market Efficiency

Question 4 dealt with perceived market efficiency: "Approximately what percent of the time would you estimate that your company's outstanding securities are priced fairly by the market?" As shown in Table 5, only 14.7 percent of the respondents in Malaysia, as compared to 47.2 percent of United States executives, believed that their companies' securities were priced fairly by the market "more than 80 percent of the time." Conversely, 37.3 percent of executives in Malaysia believed that their securities were correctly priced less than 50 percent of the

⁵ See, for example, Bradley, Jarrell and Kim (1984), Titman and Wessels (1988), and Chang and Rhee (1990). See Ariff and Johnson (1990) for empirical evidence of an industry effect in Singapore, and Ip and Hopewell (1987) in Hong Kong.

TABLE 5

PERCEIVED MARKET EFFICIENCY:
MALAYSIA, SINGAPORE, HONG KONG AND THE UNITED STATES

Percent of Time Company's Securities are Believed to be Fairly Priced	Malaysia	Singapore	Hong Kong	United States
More than 80 percent of the time	14.7%	4.8%	10.8%	47.2%
Between 50 and 80 percent of the time	48.0%	52.4%	51.4%	40.3%
Less than 50 percent of the time	37.3%	42.8%	37.8%	11.9%

time, as compared to 11.9 percent of United States executives. According to these results, a significantly greater proportion of executives in Malaysia disagree with market efficiency. Only 10.8 percent of Hong Kong executives and an even lower 4.8 percent of Singapore executives believed that their companies' securities were priced fairly by the market "more than 80 percent of the time."

Given the size of the Malaysian, Singapore and Hong Kong financial markets relative to the United States, the lower perceived market efficiency is not too surprising. The trading volume of these markets tends to be dominated by a small number of large, actively traded issues. Large daily price movements that are not supported by fundamental changes are not uncommon.

Previous empirical studies of market efficiency in Malaysia (see, for example, Laurence (1986), Mansor (1989) and Saw and Tan (1989)) have had mixed results. A more recent study by Kok and Goh (1993), however, suggests that the Malaysian market is becoming more efficient.

Relative Importance of Capital Structure

Question 5 examines the importance of capital structure decisions relative to that of other financial decisions. When presented with an attractive new growth opportunity that could not be taken without departing from the target capital structure or financing hierarchy, cutting the dividend, or selling off other assets, 67 percent of the respondents indicated that they would deviate from their target capital structure or financing hierarchy. In contrast, 11 percent indicated they would sell off assets, 7 percent would forgo the opportunity, and only 15 percent would cut

TABLE 6

RELATIVE IMPORTANCE OF CAPITAL STRUCTURE:
MALAYSIA, SINGAPORE, HONG KONG AND THE UNITED STATES

Likely Action to be Taken in Response to Growth Opportunity	Malaysia	Singapore	Hong Kong	United States
Forgo the opportunity	7.0%	7.7%	16.2%	3.4%
Deviate from the target capital structure or financing hierarchy	67.0%	76.9%	56.8%	82.4%
Cut common dividend	15.0%	4.6%	5.4%	1.7%
Sell off other assets	11.0%	10.8%	21.6%	12.5%

dividends. These results, which are summarised in Table 6, are consistent with the findings in Singapore, Hong Kong and the United States, suggesting that capital structure decisions among companies in all four countries are also less binding than either investment or dividend decisions. The strong preference for dividend continuity is consistent with the pecking order theory and the results of executive surveys on dividend policy in Malaysia, Singapore, Hong Kong and the U.S.⁶

Determinants of Capital Structure Policy

The foregoing questions are based largely upon theories derived from Western models of financial markets and institutions. And, as indicated in the previous sections, there appears to be strong agreement on these issues among executives in Malaysia, Singapore, Hong Kong, and the United States. However, there may be other issues related to capital structure policy in Malaysia that were not included. In an attempt to identify determinants of capital structure policy that may be unique to Malaysia, the questionnaire also included an open-ended question asking executives to identify the major factors in determining their company's capital structure policy.

The responses to this question were quite varied. As in the case of the surveys of Hong Kong and Singapore executives, none of the responses appeared to be unique to Malaysia. By far, the most frequently cited factor was the cost of funds, suggesting that financial timing is an important consideration in making financing decisions. This is consistent with the importance executives placed on maintaining financial flexibility in response to question 3.

⁶ See Mansor (1992), Kester and Tsui (1992), Kester and Chang (1992), and Baker, Farrelly and Edelman (1985).

The company's gearing (debt-to-equity) ratio was also cited as an important determinant of capital structure, even by those executives expressing a preference for following a financial hierarchy in question 1. Apparently, not all respondents view maintaining a target capital structure and following a financing hierarchy as being mutually exclusive, even though question 1 of the questionnaire treated them as such. Over time, companies that follow a financing hierarchy may adjust towards a target capital structure.⁷

Other important determinants of capital structure policy cited by the respondents included the company's cash flows, interest coverage/repayment ability, and the need to maintain dividends. The impact of capital structure decisions on performance measures such as earnings per share and return on equity was cited by only a few of the respondents.

CONCLUSIONS

Before making any concluding comments, it is important to note several limitations of this study. The survey was limited to those companies listed on the Kuala Lumpur Stock Exchange. The views were (presumably) obtained only from chief executive officers.⁸ Obviously, chief executive officers are not the only ones involved in capital structure decisions.

The comparisons among the four countries must also be approached cautiously. As previously noted, the questionnaires used in the United States surveys were adapted to reflect the financial environment of Malaysia, Hong Kong and Singapore. Moreover, the United States surveys were mailed to chief financial officers, not chief executive officers. And, the degree of similarity (size, industry, public versus private ownership, and so forth) among the companies surveyed in the four countries can be questioned. There are also significant differences in the size, volume, and liquidity of the developed United States financial market and the smaller developing financial markets in Malaysia, Singapore, and Hong Kong.⁹

⁷ Myers (1984) points out that, although there is some evidence that firms adjust towards a target capital structure, models based upon this partial adjustment process explain only a small part of actual firm behaviour.

⁸ Although the questionnaires were mailed with cover letters to chief executive officers, some of the responses appeared to have been provided by subordinates. Approximately 10 percent of the questionnaires were returned with attached notes signed by subordinates. We have no way of determining how many of the questionnaires were actually completed by chief executive officers.

⁹ See Rhee, Chang and Ageloff (1990) for a comprehensive overview and comparison of the Pacific-Basin equity markets.

It may be that the questionnaires themselves caused a non-response bias in the results. The survey results may largely reflect the responses of executives familiar with Western models and theories.¹⁰ Those who did not believe that Western models were useful or relevant may have not responded. This would certainly help explain the high levels of agreement among the executives of the four countries who did respond. However, it is not possible to determine from the survey results if such a source of non-response bias exists.

A potentially significant limitation is that while the Malaysia, Singapore and Hong Kong surveys were conducted in the early 1990s, the United States survey was conducted in 1987. At the time of the United States survey, the leverage "boom" of the 1980s was in high gear. Since capital structure moves in cycles, comparisons of surveys conducted at different times (and in different countries) must be limited in terms of conclusions.

With these limitations in mind, several conclusions can be drawn about the implications of the results of these surveys for theory and practice.

The survey responses of executives in Malaysia, which are generally consistent with attitudes of executives in Singapore, Hong Kong and the United States, indicate a preference for following a financing hierarchy rather than adhering to a target capital structure. Executives in all four countries ranked internal equity as their first choice of long-term financing. However, unlike United States executives, who ranked debt ahead of new common stock, executives in Malaysia and Singapore ranked new ordinary shares sold through rights offerings ahead of debt. New ordinary shares sold to the public ranked after debt.

Executives in Malaysia agreed with executives in Singapore, Hong Kong and the United States that maintaining financial flexibility and ensuring the long-term survival of the company were the most important considerations affecting a company's financing decisions. Maintaining comparability with companies in the same industry was ranked least important in all four countries.

Finally, executives in all four countries believe that a company's investment and dividend decisions are more binding than capital structure decisions.

¹⁰ A number of executives in Malaysia, Singapore and Hong Kong received their education at Western universities. Western models and theories are also taught in the major universities in these countries, often using Western finance textbooks.

Despite the cultural, political and size differences, the foregoing results suggest a high level of agreement among executives in Malaysia, Singapore, Hong Kong and the United States on most issues related to capital structure policy. Indeed, the apparent high level of agreement is remarkable. However, it must be again be pointed out that the survey questionnaires used in this study were inherently limited in scope, adapted from United States surveys based upon Western models of financial structure policy, which are in turn based upon assumptions about market conditions and firm behaviour. While such an approach lends itself to comparisons among executives in different countries, it implies a level of universality that may not exist. Further research is needed, perhaps using qualitative methods, to discover whether there are other significant issues related to corporate financial policy that are unique to Malaysia, Singapore and Hong Kong.

Finally, a concern often expressed by foreign investors in the security markets of less developed countries, especially thinly-traded markets, is the question of market efficiency. The research evidence to date about market efficiency in Malaysia, Singapore and Hong Kong is generally inconclusive. In addition to thinness in trading, inherent in research on Pacific-Basin financial markets, is the problem of insufficient historical data, in some cases reaching back less than ten years. An interesting result of this survey is the perception of executives about market efficiency. Only 14.7 percent of the respondents in Malaysia, 4.8 percent in Singapore and 10.8 percent in Hong Kong, as compared to 47.2 percent in the United States, believed that their company's securities were priced fairly by the market "more than 80 percent of the time." The perceptions of these executives, if correct, suggest that investors approach investing in all but the most actively traded securities in Malaysia, Singapore and Hong Kong.

APPENDIX

EXECUTIVE SURVEY: CAPITAL STRUCTURE POLICY

Please answer the following questions as they relate to decisions to raise new long-term funds.

1. In raising new long-term funds, companies should... (Please circle one)
 - a. Maintain a *target capital structure* by using approximately constant proportions of several types of long-term funds simultaneously. (Please answer questions 3 through 7)
 - b. Follow a *financing hierarchy* in which the most advantageous sources of long-term funds are exhausted before other sources are used. (Please answer questions 2 through 7)
2. Please rank the following sources of long-term funds in order of preference for financing new investments (1 = first choice, 7 = last choice).
 - a. _____ Internal equity (retained earnings)
 - b. _____ New ordinary shares (to public)
 - c. _____ New ordinary shares (rights issue)
 - d. _____ Bank loans
 - e. _____ Preference shares
 - f. _____ Bonds
 - g. _____ Other (specify) _____
3. Please indicate the relative importance of the following considerations in governing a company's financing decisions (on a scale of 1 to 5, where 1 = Unimportant and 5 = Important).
 - a. _____ Maximising prices of publicly traded securities.
 - b. _____ Maintaining financial flexibility
 - c. _____ Ensuring long-term survivability of the company.
 - d. _____ Maintaining financial independence.

- e. _____ Maintaining comparability with companies in the same industry.
- f. _____ Maintain long-term relationships with banks.
- g. _____ Maintaining a predictable source of funds.
4. Approximately what percent of the time would you estimate that your company's securities are priced fairly by the market? (Please circle one)
- a. More than 80 percent of the time
- b. Between 50 and 80 percent of the time.
- c. Less than 50 percent of the time.
5. Given an attractive new growth opportunity that could not be taken without departing from your target capital structure or financing hierarchy, cutting the dividend, or selling off other assets, which of the following is your company most likely to take? (Please circle one)
- a. Forgo the opportunity.
- b. Deviate from the target capital structure or financing hierarchy
- c. Cut common dividend.
- d. Sell off other assets.
6. What factors are considered in the determination of *capital structure policy* in your company? For each factor, please circle the level of importance: 1 = Unimportant and 5 = Important.

_____	1	2	3	4	5
_____	1	2	3	4	5
_____	1	2	3	4	5
_____	1	2	3	4	5

7. What is the principal nature of your business? _____ Manufacturing _____ Retail/wholesale
 _____ Financing _____ Hotel _____ Properties _____ Other (specify) _____

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