

# Audit Committee Financial Expertise, Tenure, and Capital Structure Decisions, Evidence from Turkey



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**Abstract** Capital structure theory proposes that a company's capital structure is affected by a variety of factors. The most important of these factors is corporate governance practices. The audit committee is recognized as an important corporate governance mechanism that stands out with its monitoring and oversight responsibility. The audit committee helps to make financial decisions more soundly by providing coordination between a company's independent audit, internal audit, and the board of directors. In addition, firms ensure, through the audit committee, that managers' decisions to improve firm performance are ethically monitored. Previous studies have so far given little weight to the relationship between the audit committee and capital structures. Therefore, this study examines the impact of audit committee characteristics on the capital structure, with a particular focus on the financial expertise and tenure of audit committee members. The sample of the study includes mostly hand-collected 1,638 firm-year observations obtained from Turkey's listed non-financial companies between 2009 and 2019. Empirical results indicate that the financial expertise and long tenure of the audit committee members are associated with lower financial leverage. Moreover, the presence of less tenure and nonfinancial experts members in the audit committee is associated with higher financial leverage. This study fills a literature gap where empirical evidence on how the audit committee affects capital structure is insufficient.

**Keywords** Capital Structure, Leverage, Audit Committee, Financial Expertise, Tenure

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## Introduction

This study investigates the effect of audit committee characteristics on the capital structure, with a particular focus on the financial expertise and tenure of audit committee members. Very few studies investigate the possible relationship between the audit committee and leverage. The most important reason is that the main responsibility for capital structure decisions rests with the board of directors (Alves et al., 2015; Meah, 2019). Capital structure, in other words, leverage is defined as the ability to use debt to finance operations and expand businesses (Gong & Phelan, 2020). Capital structure decisions are important because they can affect a company's profitability, risk profile, and valuation. The right mix of debt and equity can help a company maximize its value and minimize its risks (Morellec et al., 2012). The audit committee oversees the financial reporting process and ensures the accuracy of the information presented in the financial statements (Cohen et al., 2014). One of the key ways in which the audit committee fulfills this role is by monitoring the company's leverage. A high level of leverage can be risky for a company, as it can lead to financial difficulties if the company cannot make its debt payments. For this reason, the audit committee closely monitors the company's leverage to help the board keep its leverage manageable.

The audit committee is vital to any company's governance structure, and its role in capital decisions cannot be underestimated. The audit committee provides critical oversight of management's financial reporting and disclosure practices, and its members are typically experienced financial, accounting, and tenured professionals (DeFond et al., 2005). As such, the audit committee is uniquely positioned to provide insights and recommendations on capital decisions. The audit committee's role in capital decisions extends beyond mere financial oversight. The committee is also responsible for ensuring that management has adequate systems and controls to manage the company's financial risks (The Blue Ribbon Committee, 1999). This includes assessing the company's exposure to financial risks, evaluating the effectiveness of financial risk management practices, and making recommendations to the board of directors on how to best mitigate financial risks (Abdullah & Shukor, 2017).

The most important reason why few studies have been done on the relationship between audit committees and capital structure is that the audit committee is a relatively new corporate governance mechanism and came to the fore only at the beginning of the twenty-first century (Lin et al., 2008). Recent studies reveal that the audit committee can be an important determinant in capital structure decisions. Meah (2019) found empirical findings that larger and more independent audit committees have lower leverage. Al Lawati and Hussainey (2021) found that the financial expertise of audit committee members positively affects the leverage ratio. Tarus and Ayabei (2016) investigated the relationship between board composition and the capital structure, and the presence of the audit committee was used as one of the independent variables. The study's findings show no significant relationship between the presence of the audit committee and the capital structure.

The main findings of our study reveal that audit committee financial expertise and tenure is an important factor in capital structure decisions. In addition, our main findings are supported by additional analyses with lagged variables and the interaction variable derived from independent variables. Our study makes important contributions to the limited literature, administrators, and practitioners. Although the audit committee's duties and responsibilities regarding financial reporting quality are predominant, the lack of appropriate leverage for the firm can make it difficult to fulfill these duties and responsibilities. Companies can improve their financial performance and governance by understanding the audit committee's role in the capital structure.

## Literature

A company's capital structure refers to the mix of debt and equity that the company uses to finance its operations (Shubita & Alsawalhah, 2012). The capital structure is an important factor in a company's financial stability and its ability to generate profits (Herciu & Ogrean, 2017). Capital structure decisions are a key part of financial decision-making for any company. These decisions can have a major impact on a company's financial stability and performance. As such, it is important to evaluate capital structure decisions in terms of finance theories. There are a number of different finance theories that can be used to evaluate capital structure decisions. One popular theory is the trade-off theory (Baxter, 1967). This theory suggests that there is a trade-off between the benefits of debt and the costs of debt (Titman & Wessels, 1988). Companies must weigh the benefits and costs of debt in order to make an optimal capital structure decision. Another popular theory is the pecking order theory (Frank & Goyal, 2003). This theory suggests that companies will prefer to use internal financing before using external financing. This is because internal financing is typically less expensive than external financing. Companies will only turn to external financing when they cannot finance their projects with internal sources. There are a number of other finance theories that can be used to evaluate capital structure decisions. These theories can provide insights into the optimal capital structure for a company. By understanding the different trade-offs and preferences involved in capital structure decisions, companies can make better-informed decisions that improve their financial stability and performance.

Previous studies investigating the determinants of capital structure generally can fall into two categories: firm characteristics and corporate governance. Whether corporate governance is decisive in capital structure decisions has been the subject of many studies. This research has generally found that corporate governance plays a significant role in these decisions and that a number of factors can influence how corporate governance affects capital structure decisions. One of the most important factors that have been identified is the level of control that shareholders have over the firm (Brailsford et al., 2002). This is because shareholders are the firm's ultimate owners, so they have an ultimate say in how the firm is run.

If shareholders have a high level of control, they are more likely to influence capital structure decisions. Another important factor is the level of transparency, and disclosure is also an important factor (Aggarwal & Kyaw, 2009; Li et al., 2020). This is because if shareholders and the board of directors are not fully informed about the firm's financial condition, then they may make sub-optimal decisions. Finally, the composition of the board of directors (Gilani et al., 2021; Tarus & Ayabei, 2016). This is because the board of directors is responsible for making decisions on behalf of the shareholders. If the board is composed of individuals with much experience in finance and accounting, then they are more likely to make sound capital structure decisions.

There is a large body of research that has examined the role that firm characteristic plays in capital structure decisions. Some of the most important characteristics include the firm size (González & González, 2012; Kurshev & Strebulaev, 2015), the firm age (Kieschnick & Moussawi, 2018), the growth rate (Baral, 2006; Ooi, 1999), the profitability (Herciu & Ogrean, 2017), and the industry (Dakua, 2019; Miao, 2005). Each firm's characteristics can significantly impact the optimal capital structure for a given firm. For example, Scherr and Hulburt (2001) argue that larger firms tend to have more debt than smaller firms. This is because larger firms have more assets that can be used as collateral for loans and tend to have better access to capital markets. Firm age is also an important factor, with younger firms tending to have more debt than older firms (Michaelas et al., 1999). This is likely because younger firms have less financial history and are therefore riskier by lenders. The industry in which a firm operates can also impact its capital structure. For example, Qian (2003) claims that firms in capital-intensive industries tend to have more debt than firms in less capital-intensive industries. This is because they need to raise more capital to finance their operations. Finally, firms with high growth potential tend to have more debt than firms with low growth potential (Billett et al., 2007). This is because lenders are willing to provide more capital to firms with high growth potential to finance their expansion.

The audit committee is a key governance body that oversees the financial reporting process and provides oversight of the organization's financial risks. Given the importance of these responsibilities, the audit committee should be composed of financial experts and tenured members who can provide sound guidance on capital structure decisions. These experts should be familiar with the company's financial statement and should be able to provide advice on how to optimize the company's capital structure. The audit committee should also have tenured members who can provide insights on the company's long-term financial goals and how to achieve them best.

Capital structure decisions are a key part of a company's financial strategy, and audit committees play a vital role in overseeing these decisions. Audit committees with solid financial expertise are better able to understand the risks and implications of different capital structure choices and are better equipped to make informed and effective decisions. Audit committee financial expertise is particularly important in today's business environment, where companies face increasing pressure to make

sound financial decisions. In addition, the global economic crisis has spotlighted the need for strong financial oversight, and audit committees are uniquely positioned to provide this oversight. With their deep understanding of financial issues and their knowledge of best practices, audit committees can help companies make sound capital structure decisions that protect and enhance shareholder value.

H1: There is a relationship between audit committee financial expertise and capital structure decisions.

The audit committee tenure is highly likely to influence capital structure decisions. This is because audit committee members who have been in their positions for a longer time are more likely to understand the company's financial situation better and be more comfortable making decisions regarding its capital structure. Additionally, audit committee members who have been in their positions for a longer period are more likely to have established relationships with the company's management team and communicate their recommendations effectively.

H2: There is a relationship between audit committee tenure and capital structure decisions.

## **Methodology**

### ***Sample***

The study sample includes mostly hand-collected 1638 firm-year observations obtained from Turkey's listed non-financial companies between 2009 and 2019. We chose our example companies according to the following two criteria. First, we excluded all financial companies from the study sample due to different financial statement structures. Second, we excluded companies that did not form audit committees and for which audit committee data is missing. After eliminating companies from the financial industry and those with the missing audit committee and financial information, the final sample comprises 1631 firm-year observations, representing 35% of all companies listed on the market.

### ***Research Model and Variables***

Multiple regression analysis was used to test hypotheses regarding the impact of audit committees on capital structure decisions. We employed audit committee characteristics as independent variables: financial expertise and tenure. We employed leverage for measuring capital structure decisions as a dependent variable. To reduce the outlier effect, all continuous variables were winsorized in the 1–99% percentile.

The following estimated model is created to investigate the effect of financial expertise and tenure on capital structure:

$$\begin{aligned} \text{Leverage}_{it} &= \alpha + \beta_1 \text{Financial}_{it} + \beta_2 \text{Tenure}_{it} \\ &+ \text{Control variables}_{it} + \text{Industrials} + \text{Years} + \varepsilon_{it} \end{aligned} \quad (1)$$

Where

Leverage: Ratio of total debt to total assets

Financial: Take value one if at least one member of the audit committee has expertise in accounting and/or finance; otherwise zero

Tenure: Take a value if at least one member of the audit committee has 3 years or more of experience; otherwise zero

AC\_Size: Total number of audit committee members

AC\_Ind: The proportion of independent members on the audit committee

B\_Size: Total number of board members

B\_Ind: The proportion of independent member of the board

B\_Gender: Take a value if at least one member of the board is female; otherwise zero

B\_Race: Take a value if at least one member of the board is foreign; otherwise zero

Duality: Take value one if the board chairman and the CEO are not the same person; otherwise zero

BIG4: Take value one if the firm's financial reports audited by a Big 4 audit firm; otherwise zero

Auop: Take value one if the audit firm has given an unqualified opinion on the company's financial reports; otherwise zero

Firm\_Size: Log of the book value of total assets

M/B: Ratio of market value of equity and book value of equity

ROA: Proportion of net profit to total assets

ROE: Proportion of net profit to shareholders' equity

Firm\_Age: Natural logarithm of company age

Sales: Log of the gross sales

Current: Ratio of current assets to short-term liabilities

## Data Analysis and Results

### *Descriptive Analysis*

In Table 1, shown below, the mean, standard deviation, median, maximum, and minimum values of the model's dependent, independent, and control variables are given. For example, the average leverage ratio of non-financial companies listed on Borsa Istanbul is 0.501, with a median value of 0.243. In addition, 56% of these companies have at least one financial member from the audit committee, and 34% have a member with at least 3 years of tenure.

**Table 1** Descriptive statistics

Variable name	Mean	Standard dv.	Median	Min.	Max.
Leverage	0.501	0.243	0.529	0.041	1.102
Financial	0.563	0.496	1	0	1
Tenure	0.345	0.475	0	0	1
AC_Size	2.065	0.314	2	1	6
AC_Ind	0.810	0.379	1	0	1
B_Size	7.193	2.155	7	3	15
B_Ind	0.243	0.142	0.285	0	0.667
B_Gender	0.593	0.491	1	0	1
B_Race	0.321	0.467	0	0	1
Duality	0.801	0.399	1	0	1
BIG4	0.623	0.484	1	0	1
Auop	0.948	0.220	1	0	1
Firm_Size	19.887	1.770	19.552	14.870	25.712
M/B	1.924	1.075	1.642	0.151	14.170
ROA	0.037	0.092	0.032	-0.268	0.306
ROE	0.006	0.409	0.073	-2.506	0.566
Firm_Age	3.645	0.479	3.688	0.693	4.787
Sales	19.544	2.434	19.357	0	25.230
Current	2.343	4.725	1.42	0.23	13.57

### *Correlation Matrix*

Table 2, shown below, shows results of the Pearson's correlation matrix for the entire sample. None of the variables are in a correlation relationship above 0.80, indicating that multicollinearity is not a serious problem for the study. The table shows that audit committee financial expertise is negatively and significantly correlated with leverage, while audit committee tenure is positively correlated with leverage but insignificant. In addition, the table reveals that the majority of control variables are significantly related to leverage.

### *Regression Results*

Table 3 shows the regression analysis results using the independent and control variables expected to affect the capital structure. Model 1 shows the main regression model in which hypotheses are tested and the results are reported in column one. Model 2 shows the model in which hypotheses are tested with lagged variables and the results in the second column. The table shows that audit committee financial expertise and tenure are negatively and significantly associated with leverage. In addition, the results in model 2 support this conclusion. Based on these findings, H1 and H2 hypotheses are supported. In other words, companies with more

**Table 2** Pearson and Spearman correlation analysis

Variable name	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)
Leverage	1																		
Financial	-0.03***	1																	
Tenure	0.01	-0.08*	1																
AC_Size	0.02	0.05**	-0.01	1															
AC_Ind	0.12*	0.11*	-0.18*	0.03	1														
B_Size	0.02	0.11*	-0.00	0.13*	0.20*	1													
B_Ind	0.12*	0.12*	-0.17*	-0.03	0.66*	-0.09*	1												
B_	-0.00	0.10*	0.01	-0.03	0.05**	0.09*	-0.01	1											
Gender																			
B_Race	0.08*	-0.01	0.04***	0.09*	0.00	0.21*	-0.07*	-0.11*1											
Duality	0.08*	0.08*	-0.13*	-0.00	0.06*	0.21*	0.01	0.03	0.10*1										
BIG4	0.11*	0.08*	-0.07*	0.06*	0.08*	0.28*	-0.01	0.04**	0.28*	0.27*1									
Auop	-0.09*	-0.00	-0.02	-0.00	0.02	0.14*	-0.01	0.11*	0.01	0.19*	0.14*1								
Firm_	0.22*	0.08*	-0.03	0.15*	0.21*	0.52*	0.10*	0.06*	0.16*	0.22*	0.42*	0.19*1							
Size																			
M/B	-0.31*	0.04***	-0.02	-0.00	-0.04**	-0.04***	-0.05**	-0.10*	0.12*	-0.05*	0.07*	0.01	-0.17*1						
ROA	-0.42*	0.04***	0.00	0.02	0.04***	0.14*	-0.02	-0.00	0.07*	0.09*	0.10*	0.15*	0.18*	0.29*1					
ROE	-0.39	0.00	0.02	0.03	0.01	0.11*	-0.02	0.01	0.06*	0.05*	0.04**	0.016*	0.15*	0.15*	0.71*1				
Firm_	0.05**	0.02	0.01	-0.05**	0.10*	0.08*	-0.07*	0.02	0.05*	0.10*	0.22*	0.02	0.20*	0.07*	0.06*0.00	1			
Age																			
Sales	0.27*	0.02	-0.02	0.11*	0.15*	0.44*	0.04***	0.06*	0.23	0.23*	0.35*	0.18*	0.79*	-0.10*	0.19*	0.16*	0.18*1		
Current	-0.36*	-0.02	-0.03	-0.01	-0.10*	-0.02	-0.09*	-0.02	-0.04	-0.08*	-0.10*	-0.00	-0.21*	0.29*	0.11*	0.07*	-0.12	-0.21*1	

\*, \*\*, \*\*\* = Significant at the 1%, 5%, and 10% confidence levels, respectively



**Table 3** Regression analysis

Variables	Model 1			Model 2		
	Coefficient	t-statistic	p value	Coefficient	t-statistic	p value
Financial	-0.199**	-2.15	0.032	-0.030*	-3.26	0.001
Tenure	-0.004***	-1.79	0.073	-0.005**	-2.08	0.037
AC_Size	-0.009	-0.68	0.494	-0.007	-0.53	0.598
AC_Ind	0.012	0.70	0.486	0.012	0.69	0.491
B_Size	-0.009*	-3.24	0.001	-0.009	-2.86	0.004
B_Ind	-0.048	-0.68	0.500	-0.051	-0.66	0.507
B_Gender	-0.016***	-1.73	0.085	-0.020	-2.05	0.041
B_Race	0.007	0.75	0.452	0.003	0.35	0.728
Duality	0.020***	1.79	0.074	0.023	1.92	0.055
BIG4	0.039*	3.46	0.001	0.050	4.25	0.000
Auop	-0.058**	-2.25	0.025	-0.045	-1.85	0.064
Firm_Size	-0.013	-1.60	0.111	-0.021	-2.14	0.033
M/B	-0.030*	-3.62	0.000	-0.033	-4.28	0.000
ROA	-0.696*	-7.06	0.000	-0.757	-7.67	0.000
ROE	-0.098*	-5.50	0.000	-0.088	-5.46	0.000
Firm_Age	0.027**	2.45	0.014	0.023	1.95	0.052
Sales	0.038*	5.20	0.000	0.043	4.81	0.000
Current	-0.009**	-2.35	0.019	-0.010	-2.16	0.031
Intercept	0.095	1.01	0.311	0.188	2.10	0.036
Industry effects	YES			YES		
Year effects	YES			YES		
Observations	1.638			1.484		
F statistic	42.28			44.81		
Adjusted R <sup>2</sup>	0.4646			0.4866		

\*, \*\*, \*\*\* = Significant at the 1%, 5%, and 10% confidence levels, respectively. To minimize data loss and extreme values in the regression analysis, continuous values were winsorized at the 1st and 99th percentile

experienced and financially savvy audit committees are less likely to be highly leveraged. This relationship is likely because audit committees are important in overseeing a company’s financial reporting and compliance with debt covenants. Therefore, companies with strong audit committees are less likely to take on excessive debt and become overextended.

Table 4 shows the regression analysis results using interaction and control variables expected to affect capital structure. The results for model three are reported in column three and for model four are reported in column four. The results indicate that both non-financial experts and untenured audit committee members are positively and significantly associated with leverage. This result is consistent with the main findings in model 1. In addition, this finding shows that companies with these types of committee members are more likely to have higher levels of debt. This is likely because these individuals are less likely to be aware of the potential risks associated with taking on debt. As a result, companies with these committee members may be more likely to make imprudent decisions regarding leverage.

**Table 4** Regression analysis

Variables	Model 3			Model 4		
	Coefficient	<i>t</i> -statistic	<i>p</i> value	Coefficient	<i>t</i> -statistic	<i>p</i> value
Non (financial × tenure)	0.025**	2.50	0.013			
Financial × tenure				−0.015	−1.25	0.210
AC_Size	−0.010	−0.76	0.447	−0.008	−0.63	0.527
AC_Ind	0.013	0.78	0.433	0.012	0.77	0.442
B_Size	−0.009*	−3.31	0,001	−0.009	−3.25	0.001
B_Ind	−0.053	−0.74	0.460	−0.049	−0.69	0.489
B_Gender	−0.019***	−2.03	0.043	−0.017	−1.84	0.067
B_Race	0.006	0.67	0.506	0.006	0.62	0.537
Duality	0.021***	1.80	0.072	0.022	1.94	0.053
BIG4	0.041*	3.63	0.000	0.041	3.65	0.000
Auop	−0.057**	−2.22	0.027	−0.057	−2.26	0.024
Firm_Size	−0.015	−1.80	0.072	−0.014	−1.70	0.090
M/B	−0.031*	−3.92	0.000	−0.031	−3.93	0.000
ROA	−0.699*	−7.07	0.000	−0.694	−7.06	0.000
ROE	−0.097*	−5.48	0.000	−0.097	−5.54	0.000
Firm_Age	0.027**	2.48	0.013	0.029	2.56	0.011
Sales	0.039*	5.34	0.000	0.039	5.22	0.000
Current	−0.008**	−2.34	0.019	−0.009	−2.37	0.018
Intercept	0.091	0.99	0.324	0.068	0.73	0.464
Industry effects	YES			YES		
Year effects	YES			YES		
Observations	1.638			1.638		
F statistic	44.15			43.25		
Adjusted <i>R</i> <sup>2</sup>	0.4679			0.4665		

\*, \*\*, \*\*\* = Significant at the 1%, 5%, and 10% confidence levels, respectively. To minimize data loss and extreme values in the regression analysis, continuous values were winsorized at the 1st and 99th percentile

## Conclusion

A company's capital structure refers to the mix of debt and equity that the company uses to finance its operations. The capital structure is an important factor in a company's financial stability and its ability to generate profits. On the other hand, the audit committee is an important corporate governance mechanism responsible for ensuring that the company has the necessary financial resources to support its operations and growth. With this study, we aim to contribute to the understanding of how these two important corporate governance mechanisms interact and to give an idea about the potential benefits and costs of different capital structures for companies.

This study explores the relationship between audit committee financial expertise and tenure and capital structure decisions. In this context, a regression analysis was carried out using 1638 observations collected from non-financial companies traded

in Borsa Istanbul between 2009–2019. The results show that audit committee financial expertise and tenure influence capital structure decisions.

Our findings make several significant contributions. First, we have contributed to limited literature by investigating whether audit committee financial expertise and tenure are associated with capital structure decisions. Second, our study is important for understanding the relationship between the audit committee and capital structure decisions of companies in developing countries. In developing countries, the capital structure decision is even more important because the cost of capital is often higher than in developed countries. Thus, the capital structure decision is important for companies in developing countries because it can affect the company's cost of capital, profitability, and ability to raise capital in the future. In developing countries, where there is often a lack of transparency and weak corporate governance, the audit committee can play a vital role in ensuring that the capital structure decisions are in the company's and its shareholders' best interests. Finally, the implications of the study have the potential to provide valuable insights for policymakers. Because audit committees with more financial expertise tend to have lower levels of leverage, policymakers may require companies to have more financial expert members on their audit committees.

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