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Impact of Corporate Governance Mechanisms on Capital Structure of Firms

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ABSTRACT

The paper aims to explore the theoretical concepts and empirical studies related to the impact of corporate governance mechanisms on firm's capital structure. The study analyzes variables of corporate governance mechanisms such as board size, CEO duality, board composition, board skills, tenure of CEO and CEO compensation. The study is done through review of evidence in existing literature. The key finding of the research is that the empirical results on the relationship between corporate governance and capital structure of firms tend to be varied and inconclusive. Results vary from markets to markets due to differences in their ownership structure, legal and institutional systems.

Key Words: Capital Structure, Leverage, CEO Duality and Corporate Governance

INTRODUCTION & THEORETICAL FRAMEWORK

The determinant(s) of firm capital structure is an area of research that has occupied significant space in prior research. The pioneer work by Modigliani and Miller (1958) is considered to be the first contribution that showed the irrelevance of capital structure decisions on firm value in perfect capital markets. In Miller and

Modigliani (1963), corporate tax was incorporated in the model that relaxed the prefect market assumptions. They provided new evidence on how the firm value would increase if the level of debt increases. This would be due to benefit from debt tax shield when funding of activities is made through long-term debt. Numerous studies were conducted to further investigate and understand other drivers of corporate capital structure choices.

Bopkin & Arco (2009) identified volatility in earnings, asset tangibility, dividend payout ratio and profitability as significant firm level determinants of corporate capital structure. In other studies [Najjar & Hussainey (2011)] corporate characteristics such as firm size, firm risk and firm growth rate were identified as the main drivers of capital structure.

Jensen and Meckling (1976) showed how managers' may be interested in maximizing their own personal wealth at the cost of shareholder's money. There is a large information gap between shareholders, who are dispersed, and managers of a firm. This information asymmetry leads to managers using shareholders money for their own interests. Agency costs are the costs borne by shareholders to reduce information asymmetry between managers' and themselves. Jensen and Meckling (1976) pointed out that the use of debt can decrease the need for outside stock, and therefore help diminish the manager–stockholder agency problem. Jensen (1986) discussed the use of debt in reducing the agency problem (of overinvestment) by committing the firm to fixed interest payments. Therefore a pertinent question that arises is does corporate governance structure tend to influence leverage in a firm.

The Cadbury Committee (1992) defines corporate governance as the system by which companies are directed and controlled. Corporate governance structures provide mechanisms through which decisions are taken in a firm. There is a growing interest among researchers in management in the area of corporate governance, especially among large and listed firms. Another important argument in this debate is that do firms with good governance structures impact bondholders and lower the cost of debt financing (Klock et al 2005) and that could establish a link between strong corporate governance and high leverage.

In the previous studies corporate governance has been identified [Crutchley et al., 1999; Gul, 1999; Berger et al, (1997); Wen et al, (2002); Abor, (2007)] to influence the capital structure decisions of firm. Najjar & Hussainey (2011) in their study on UK firms found corporate governance characteristics such as board size and outside directorships as the main drivers of capital structure of firms.

Exploratory studies have been carried out to find links between firms' corporate governance and capital structure decisions. Recent studies have explored if adoption of corporate governance structures influence firm's financing decisions. Typical studies include the impact of internal and external corporate governance mechanisms such as board size, CEO duality, CEO tenure, board composition, board skills and audit type (external mechanism) on leverage.

OBJECTIVES

In this paper, we attempt to inquire capital structure with regard to corporate governance variables of firms. The key objectives of the paper are to study:

(i) What corporate governance variables have been treated in existing literature?
(ii) How corporate governance mechanisms influence firm capital structure and what is the direction of relationship?

The paper has been divided into seven sections as: {I} Abstract {II} Introduction & Theoretical Framework {IV} Evidence Review {V} Discussion {VI} Limitations {VII} Future Research Directions {VIII} References

RESEARCH METHODOLOGY

The paper utilizes both theoretical and empirical studies on relation between corporate governance variables and firm capital structure using evidence review methodology. The studies used in the review are mixed in nature and includes research work from both developed and emerging markets.

REVIEW OF EVIDENCE

Corporate governance mechanisms provide means and processes by which managerial actions in a firm may be monitored and controlled. What is the direction of relationship between corporate governance variables and leverage has been empirically tested by numerous authors for both large and small firms. Debt issuance is more likely to be used as a governance mechanism to reduce the conflict of interests between the agents and principals by reducing the agency costs of free cash flow available to managers (Jensen, 1986; Kochhar, 1996). Harford et al (2008) in their work stated how debt, and in particular, short-term debt has the potential to discipline managers and examined the role of the board in making financing decisions that provide this discipline and predicted that stronger boards will force the firm to hold more short-term debt. Wen et al, 2002 found preliminary empirical evidence that seemed to suggest that managers tend to pursue lower financial leverage when they face stronger corporate governance from the board. Hence, two perspectives on leverage are manifested; (i) the short term and long term perspective of holding debt (ii) high and low level of raising capital through debt.

We shall examine the evidence for the following corporate governance variables and their relation to leverage; (i) board size (ii) board composition (iii) CEO Duality (iv) CEO Compensation (v) tenure of CEO and, (vi) board expertise.

Board of directors is entrusted with the task of monitoring and controlling the actions of management. Board size is an important element of governance. Larger board size has more directors on board and is assumed to provide higher monitoring and control function. Anderson et al (2004) found that the cost of debt is lower for larger boards because creditors view these firms as having effective monitoring processes and hence such firms can raise debt at low cost. On similar lines, Wen et al (2002), Abor (2007), Bopkin & Arco (2009), Pfeffer & Salancick (1978) and Lipton & Lorsch (1992) have found a positive relationship between board size and leverage. The findings suggest that larger boards pursue higher leverage to raise company value. Wen et al (2002) found the relationship statistically insignificant while Bopkin & Arco (2009) found the relationship to be statistically significant. Berger et al (1997); Abor & Biekpe (2005); Mehran (1992) found a significant negative relationship between board size and leverage. Berger et al. (1997) argued that larger boards put pressure on managers to follow lower debt-to-equity ratio and enhance firm performance. Jensen (1986) argued that firms with high leverage or debt ratio rather have larger boards. This may be attributed to the difficulty of large boards in arriving at a consensus in decision making resulting into weak corporate governance and high leverage. Other researchers [Wiwattanakantang, (1999); Wen et al., (2002); Al-Najjar and Hussainey, (2009a)] found statistically insignificant relation between board size and debt-to-equity ratio

High proportion of independent directors is believed to be associated with high leverage. In their study on effects of corporate governance on firm's credit ratings, Ashbaugh et al (2006) found that credit ratings are positively related to board independence. Boards with higher number of independent directors indicate unbiased approach toward matters of the firm and hence improved adherence to the monitoring processes. Berger et al(1997), Abor (2007), Jensen (1986), Pfeffer & Salancick (1978), Abor & Biekpe (2005) established a significant positive relationship between external directors and leverage. Wen et al (2002) however found a negative relationship between the number of outside directors on board and leverage.

Firms can either have one-tier or two tier structure. In one-tier structure monitoring and control rights are vested in a single individual who holds both the positions of the CEO as well as the chairman whereas in two tier structure these positions are held by two different persons. Fama and Jensen (1983) define decision management as the right to initiate and implement new proposals for the expenditure of the firm's resources and decision control as the right to ratify and monitor those proposals. Hence, if both the decision management and decision control rights are vested in single individual, corporate governance may get weakened and may result into management entrenchment. Fosberg in his study on CEO duality and firm leverage found that two-tier structures (ie CEO non-duality) have higher debt-equity ratio, though the relationship is not statistically significant. Abor & Biekpe (2005), Abor (2007) established a positive relationship between CEO duality and capital structure.

Shareholder activists have paid lot of emphasis on pay for performance for top positions. CEOs with attractive fixed compensation might pursue lower leverage to reduce the financial risk and keep their jobs for attractive remuneration [Stulz (1988), Harris & Raviv (1988)]. Friend & Hasbrouck (1988), Friend & Lang (1988), Wen et al (2002) have found that fixed compensation results in low leverage. Jensen & Meckling (1976), Leland & Pyle (1977) and Berger et al (1997) however, found a positive relationship between CEO compensation and leverage.

The length of time a CEO spends in his office is also one of the variables treated in previous studies in relation to capital structure. Entrenched CEOs and directors prefer low leverage to reduce performance pressures associated with high debt. Higher CEO tenure implies need for timely debt repayments and maintaining good creditworthiness. Berger et al (1997), Wen et al (2002) found negative association between CEO tenure and leverage. Abhor (2007) found negative but statistically insignificant relationship between tenure of CEO and capital structure.

In their study on effects of corporate governance on firm's credit ratings, Ashbaugh et al (2006) found that credit ratings are positively related to board expertise. Abor & Biekpe (2005), found a positive relationship between board skills and capital structure. It is believed that board with higher expertise of members should imply, better monitoring and control of managers' decisions, resulting into higher credit ratings and higher confidence among bondholders regarding debt repayment.

DISCUSSION

The empirical results on the relationship between corporate governance and capital structure of firms tend to be varied and inconclusive. The fact may be that these variables, many of which have been found to be significant in some markets, and not significant in other markets, may be due to different legal, institutional, and cultural factors. But it is observed that, though insignificant and sometimes contradictory, some of the corporate governance variables such as board skills do influence leverage indirectly.

Most of these studies have been carried out in the context of diffused ownership systems and therefore the empirical results are influenced accordingly. The relation between corporate governance and capital structure has been the subject of extensive research in the developed countries, whereas only limited research has been carried out in the developing countries.

LIMITATIONS

This study is based upon research review; hence the limitations applicable to the authors' research work are applicable to the discussion in this study as well. The structure and results of various studies considered for review depend upon the intellectual and technical abilities of authors. Additionally, the discussion in the study is within the purview of previous studies referenced below; the existing literature might be much wider.

FUTURE RESEARCH DIRECTIONS

Studies need to specifically determine good corporate governance parameters to explain level of leverage in a firm for example previous studies compared large board size to leverage but whether large board size is a characteristic of good governance or not is not explained. Future research needs to integrate work with corporate governance studies on strong governance. More studies need to be carried out in the context of family-owned firms which is a common ownership form in majority of the countries.

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