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Impact of Corporate Governance Practices on Firm's Capital Structure Decisions

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Abstract:
The classical Agency theory relative to corporate governance believes that most of the time there is a conflict of interests between agents (managers or directors) and principals (shareholders). Agents (Managers) want to minimize agency costs in their decisions and this penchant compel them to increase the debt in the capital structure. The inclusion of debt may affect the overall performance and market value of the company. This paper analyzed theoretical and empirical studies that were done in the past and delineated the impact of major corporate governance practices on firm's capital structure decisions. Conclusions extracted from this study advocated that to mitigate the agency problems and for selecting an optimal capital structure, a good corporate governance is required that acts as a balancing tool. Every country should analyze corporate governance variables influence on firm's capital structure decisions for developing good corporate governance practices.

Keywords: *Corporate Governance, Capital Structure decisions, Leverage, Agency Theory*

1. Introduction

Corporate governance helps to govern a company by providing guidelines which are required for the survival of firm and welfare of its shareholders & stakeholders. On May 1991, Sir Adrian Cadbury Committee was set to look corporate governance issues in United Kingdom. This Committee defined Corporate Governance (CG) as "a system by which companies are directed and controlled. Its basic objective is to enhance and maximize shareholder value and protect other stakeholders' interest[9]". Shleifer, A. &Vishny, R.W., (1997) viewed that CG deals with the ways in which the supplier of finance to corporations assures themselves of getting a return on their investment (ROI). Investors always prefers to invest in a firm which is transparent in all its transactions and following good corporate governance practices. CG adopts practices that provide a trade-off between shareholders and stakeholders interests by choosing an optimal capital structure. Companies that adopt good corporate governance system generate trust and goodwill amongst the investors that helps them to raise funds at most reasonable costs.

Capital structure is most often referred to as a firm's debt/equity ratio, which provides insight about the risks related with a company for its potential investors. Optimal capital structure is one that reduce cost of capital and maximizes value of firm. Modigliani & Miller (1958) tried to prove the irrelevance of optimal capital structure under perfect market conditions in their work but later in 1963, they themselves found its relevance after the inclusion of taxes and bankruptcy cost. There are many researches done in the past that support its importance and decisions related to capital structure are the most fundamental issues that managers of firms have to face.

2. Objectives

To understand how corporate governance helps to mitigate agency problems and to find out the impact of corporate governance practices on firm's capital structuring decisions.

3. Methodology

This research paper used descriptive research design and is based on secondary data which were collected from various sources like websites, journals and articles. Conclusions were drawn from review of available literatures that provided an insight about the relevance of corporate governance in decisions related to firm's capital structure.

4. Theoretical Underpinnings

Decisions pertinent to capital structure are one the most imperative financial management decisions. Top management takes a lot of cautions while selecting the sources of funds like whether the funds should be raised through debt or equity or both? Decisions

related to capital structure are not restricted to a particular firm but are critical to all type of organizations and a single mismanaged financing decision could bring huge losses and bankruptcy, Nadeem and Zongjun (2011). A proper vigilance by corporate governance norms can compel the management to take decisions which mitigate the conflict of interests between shareholders and managers. This conflict of interests is known as agency problem (Fig.1). Continuous and intensive researches throughout the world are conducted to explore the issue of agency problem.

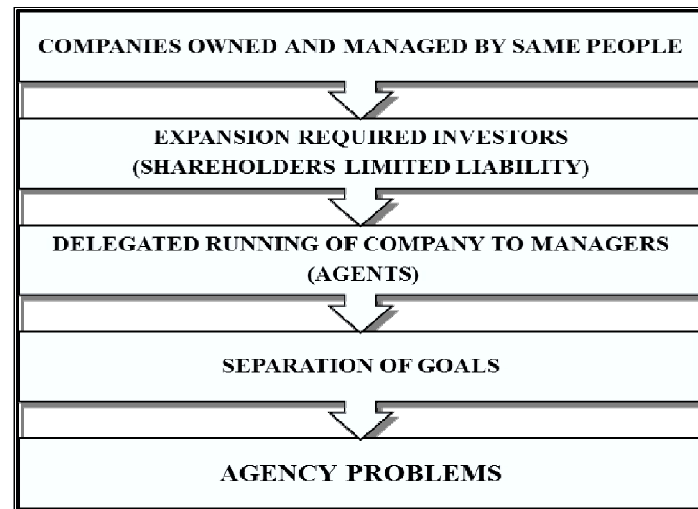

Figure 1
Source: kfknowledgebank.kaplan.co.uk

4.1. Agency Theory

Agency theory identifies the agency relationship where one party (the principal) delegates work to another party (the agent). Managers are supposed to be the 'agents' of a corporation's 'owners', but managers must be monitored and institutional arrangements must provide some checks and balances to make sure they do not misuse their power (Fig. 2). All costs resulting from managers misusing their position plus the costs of monitoring and disciplining them to try to prevent misuse are called 'agency costs', Blair (1996). Agency theory proposed that a cost due to a conflict of interest is the determinant of capital structure, and according to Fama& Miller (1972) and Jensen &Meckling (1976) referred that cost as an agency cost. Agency costs can be minimized by good governance systems.

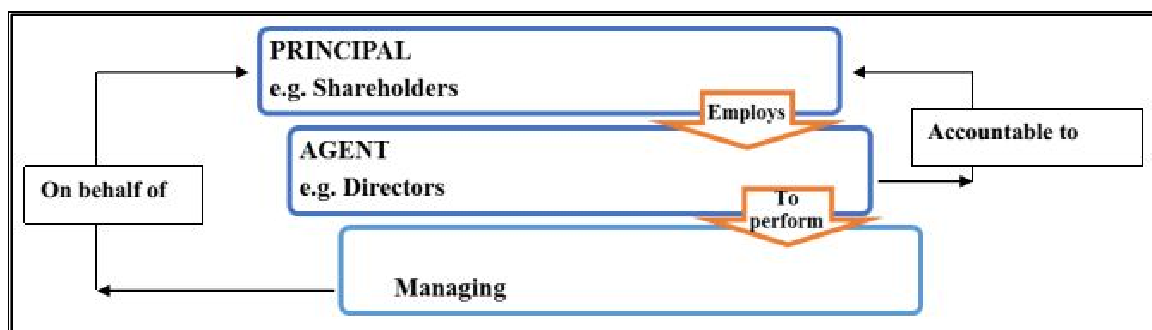

Figure 2
Source: kfknowledgebank.kaplan.co.uk

5. Empirical Background

Before investing in a business, investors make sure themselves that their funds will be invested safely and that business is financially sound enough to provide them their desired returns in future. Corporate governance provides guidelines related to board size, board compositions, CEO duality, audit, board meetings etc. In this study, relationships are analyzed between:

- Capital Structure and Board size
- Capital Structure and Board Composition / Board Independence
- Capital Structure and CEO/Chair Duality

Along with this, how profitability and size of the firm affect Capital Structure decisions are also analyzed. Researchers test these relationship empirically to analyze whether corporate governance variables influence a firm's capital structure decision and abating agency problems that persists in almost all the firms.

5.1. Capital Structure and Board Size

Evidences related to capital structure and board size are mixed. On one side, there are studies that support positive relationship between board size and high leverage (debt). It means as the number of board of directors increases in the firm, inclusion of debt in capital structure also increases. Hence large board size is associated with higher proportion of debt. Marsh (1982), Jensen (1986), Berger et al. (1997), Friend and Lang (1988) and Wen et al. (2002) found positive relationship between capital structure and board size and large boards include high level of debt in their capital structure.The existence of significant relationship between capital structure and board size were argued by Pfeffer and Salancick (1978), Lipton &Lorsch (1992) and Rose, C. (2006). Jackling and Johl (2009) found positive impact of large board size on the performance of the firms. On the other side, there are another group of researchers who finds evidences about the negative relationship between board size and capital structure. They found that firms with large board size (board of directors) have low leverage (D/E) levels and argued that large board exerts pressure on managers to include low level of debt in capital structure which ultimately enhance performance of the firm. Anderson (2004) examined firms with larger board generally has low cost of debt which makes it cost effective. Financing through debt let the creditors of funds believe that these companies will be monitored more effectively by a diversified portfolio of experts. Abor (2007) found a negative relationship between board size and capital structure decisions of Ghanaian SME and examined large board size SMEs have low level of debt. Jiraporn and Liu (2008) showed that the companies with staggered board have comparatively low leveraged level than other boards.

5.2. Capital Structure and Board Composition / Board Independence

The relationship between presence of Non-Executive Directors (NED) and capital structure has been discovered by few researchers but evidence in this regard is mixed. Shlifer and Vishney (1997) analyzed ownership concentration is one of the important determinants of corporate governance. A board is more independent if it has more non-executive directors (NEDs). Non Executive Directors (NED) or independent directors are essential part of modern corporate governance mechanisms. Pfeffer and Salancick (1978) stated that presence of Non-Executive Directors (NED) decreases the uncertainty related to company and enhance ability of the company to raise funds. Large number of Non-Executive Directors (NED) on board led to high level of debt (leverage). Fama, (1980) recognized that Non-Executive Directors may act as “professional referees” to ensure that competition among insiders stimulates actions consistent with shareholder value maximization and companies having high leverage levels have relatively more external directors. Jensen (1986); Berger et al. (1997); Abor (2007); Grossman and hart (1986); Anderson et al., (2003) also concluded that there exists a positive correlation between board composition and capital structure. On the other hand, Wen et al. (2002) concluded the existence of significantly negative relationship between leverage level and representation of Non-Executive Directors (NED) (external directors) on the board because Non-Executive Directors (NED) monitor the managers more efficiently and effectively that managers are forced to seek lower leverage levels for achieving superior outcome. Therefore, higher proportion of non-executive directors in the board helps to reduce the agency cost.

5.3. Capital Structure and CEO/Chair Duality

CEO/Chair duality is one of the important features of corporate governance (CG). CEO/Chair duality presence signals the absence of separation of decision management and decision control but it ultimately leads to agency problems which directly affect the capital structure decisions of the company. Fama and Jensen (1983) argued that role of CEO and chairman should be separate because CEO is the chief decision management authority while chairman is the chief decision control authority. Fosberg (2004) concluded that separate CEO and chairman have higher leverage levels and results in optimal amount of leverage. Abor and Biekpe (2007) also found evidence about the presence of positive relationship between CEO duality and capital structure. While Fosberg (2004), Kyereboah-Coleman and Biekpe (2006) evidenced negative relationship between them.

5.4. Capital Structure and Profitability

Pecking order theory in the presence of asymmetric information, a firm would prefer retained earnings over debt or equity. The firm would issue debt when retained earnings are exhausted. Issuing of new equity would be the least attractive alternative for the firm. Profitable firms are likely to have more retained earnings and because of that a negative relationship is expected between leverage and past profitability, Donaldson (1961); Myers and Majluf, (1984). Titman and Wessel (1988) found profitability having negative relationship with capital structure. They also found that small firms rely on short term financings. Barton, Ned, and Sundaram (1989), Cassar and Holmes (2003); Esperanca, Ana, and Mohamed (2003); Sogorb-Mira and How (2005); hall, Hutchinson, and Michaelas (2004) also suggested a negative relation between the leverage and firm size. It is clear from above studies that profitability of firms and leverage both are negatively correlated with each other.

5.5. Capital Structure and Size of the Firm

Marsh (1982), Friend and Lang (1988) and Bhaduri (2002) support the positive relationship between size of firm and leverage. Large firms generally have more inclination towards diversification. As they are less prone to bankruptcy they do not consider the bankruptcy costs in deciding the level of leverage as which forms a small proportion of the total value of the firm. Therefore, large firms may prefer to use higher level of debt or leverage and a positive relationship is expected between a firm’s size and its leverage, Titman and Wessels (1988). Titman and Wessel (1988) found that small firms rely on short term financings. Hefty firms normally have deep associations with the financers as they get long term debt easily. So it is expected that there is optimistic link between size of firms and their leverage, Uglurlu (2000). Other group of researchers found evidence about the existence of negative relationship between size of firm and leverage. Rajan and Zingales (1995) stated that there exists a negative relationship between firm size and its leverage. They suggested that large firms are generally well-established and have good performance

track record. Their good financial health enables them to raise funds through equity shares at fair prices which in return reduces their dependence on debt. Barton, Ned, and Sundaram (1989), Cassar and Holmes (2003); Esperanca, Ana, and Mohamed (2003); Sogorb-Mira and How (2005); hall, Hutchinson, and Michaelas (2004) also suggested a negative relation between the leverage and firm size.

6. Conclusion

Theoretically, financing through debt is the cheapest source of finance (lowest cost of capital) due to tax advantage. Although rarely, its inclusion in high proportion forms an optimal capital structure because financial risk and the threat of bankruptcy for the company generally increase with the increase in the debt. A company with optimal capital structure indicates that the leverage taken by it is at prudent level.

In last two decade's studies, capital structure decisions, its issues and factors that influence it gained attention. Based on the new theories of capital structure, to some researchers, corporate governance could be one of the factors that affect capital structure of a company. It is evident from the studies that are conducted around the world, firms that derive large proportion of funds through debt in their capital structure generally have poor corporate governance system. Empirical studies have shown that CG influences capital structure decisions in one way or the other and there is no neutral kind of relationship. Mixed relationships i.e. in some countries it has positive relationship while in other countries it has negative relationship, may be due the type of economy (developed, developing or emerging) however, this need to be tested. In this way, each country should analyze empirically the impact of corporate governance variables on financing or capital structuring decisions to form the best corporate governance practices that helps in selecting optimal capital structure that minimizes the cost of capital of the firm which ultimately resulted in value maximization and eventually confiscate any chances of bankruptcy (Fig. 3).

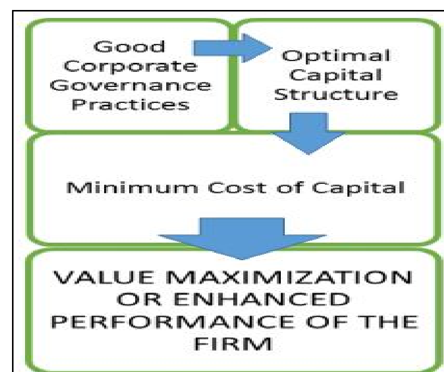

Figure 3

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