Corporate Governance and Capital Structure: Empirical Evidence from Textile Weaving Companies of Pakistan

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Abstract

Purpose – Modern day organizations lay ample emphasis on developing a corporate structure which is in line with their strategic goals. However, the relationship between corporate governance and capital structure has not been defined clearly. This research paper aims at suggesting a theoretical and financial model that depicts the relationship between corporate governance and capital structure by taking into account some known measures of both.
Design / Methodology / Approach – Variables have been identified through the review of relevant literature and have been operationalized based on empirical evidence of previous studies. Linear regression analysis has been used to determine the impact of various measures of corporate governance on the capital structure of the firm. Data has been gathered from some of the textile weaving companies of Pakistan.
Findings – The results show that factors such as Firm Size, Independence of Board and Audit Committee, CEO Duality, Institutional Shareholding, Managerial Shareholding and Ownership Structure have a significant impact on capital structure (leverage) of the firms.
Practical Implications – The study is significant as it presents a comprehensive picture from the textile sector of Pakistan and highlights those factors which can have impact on the capital structure of a firm.
Originality Value – Many researchers have tried to explore the relationship between corporate governance and business value of the company, however little work has been done on exploring the relationship between corporate governance and capital structure. Furthermore, these studies are quite rare with reference to the Pakistani environment.

Keywords Capital Structure, Firm Value, Shareholding, Audit, CEO Duality

Research type Research Paper

1.0 INTRODUCTION

Corporate Governance has emerged as one of the most researched area of Management Sciences. The concept of "governance" is not new. It is as old as human civilization. In simple terms, ‘governance’ means the process of decision-making and the process by which decisions are implemented (or not implemented) (Christiansen, 2009).

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Governance can be used in several contexts such as corporate governance, international governance, national governance and local governance. Since governance is the process of decision-making and the process by which decisions are implemented, an analysis of governance focuses on the formal and informal actors involved in decision-making and implementing the decisions made and the formal and informal structures that have been set in place to arrive at and implement the decision (Sheng, 2010).

Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the boards, managers, shareholders and other stakeholders, and spells out the rules and procedures or making decisions on corporate affairs (Malik, 2012). By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance. According to Abor (2007), a modern organization that tends to follow the principles of corporate governance ensures that share-holder rights are protected, transparency is maintained in disclosures, a proper control environment is provided and the board of directors is empowered to take the right decisions. Such organizations try to align the interests of all the shareholders and the company.

The more recent research studies on this topic (Rehman, Daud & Qazi, 2015) have included factors like transparency, accountability, fairness, sustainable financial performance, fair treatment of stakeholders, enhancing company reputation, access to external finance and maximization of shareholder value, when defining corporate governance amongst the modern day enterprises. Similarly, as per Malik (2012), efficient corporate governance practices result in greater return on capital, attraction of ,long term investments, avoidance and mitigation of risk, greater productivity, and the confidence of the domestic and foreign investors. Citing a relevant example Sheng (2010) stated that well governed firms in Korea trade at a premium of 160% in comparison to the poorly governed firms and in its report World Bank (2009) cited that a study of S&P 500 firms showed that companies with improved CG practices performed better than companies with poor CG practices by about 19%.

At a global level, since 2002, many initiatives have taken to align the corporate governance mechanisms i.e. legislative reforms, definition of CG guidance and principles, governance rules for stock exchanged etc. The most important initiatives have been the preparation of the OECD principles of governance, based committee on banking supervision (BSBS), Sarbanes-Oxley act in US and the guidance on enhancing the corporate governance mechanisms for banks. Such initiatives have inspired developing countries like Pakistan to adopt CG codes, which are based on best practices around the developed world but have been customized to fit local conditions and regulations.

Several studies have also been conducted in Pakistan to study the impact of various measures of Corporate Governance such as size of the board (Javeed & Yaqub, 2015), composition of the board (Khan & Awan, 2012), skill-set of the board members, Dual role of the Chief Executive Officer (Yasser, Mamun & Suriya, 2014), Ownership Concentration (Hassan, Shaukat & Nawaz, 2014) on the overall firm value. However, conclusive evidence with respect to the relationship of corporate governance and firm value has not been given. At times, these studies tend to differ on the value of the same measure, thereby generating a need to revisit the subject area in more depth.

This study aims at exploring the impact of corporate governance on the capital structure of a firm, especially the textile weaving companies of Pakistan. Capital structure refers to combination of different sources of funds that firm uses to finance its overall operations and growth (Jensen & Meckling, 1976). Capital structure is a financial term and it is a mean to finance company's overall assets by selecting the appropriate mixture of debt (long term and short term) and equity (common equity and preferred equity) (Short, Keasey & Duxbury, 2002). Capital structure is often referred as the ratio between debt and equity which is called leverage and have influence on firm's performance. Equity holders demand for more return and hence cost of equity rises when debt is used. When debt is used, the shareholders have residual claim on company assets and bear additional risk (Masood, 2014).

A board has an important role in capital structure and in corporate governance. A board is generally composed of members who are not executives of a company, not shareholders, not blood relatives or in law of the family (Khan& Awan, 2012). An independent board is generally composed of members who have no ties to the firm in any way, therefore there is no or minimum chance of having a conflict of interest because independent directors have no material interests in a company (Bathala & Rao, 1995).

Present study also focuses on the CEO duality and the capital structure. In CEO duality, a person holds both positions of chief executive officer and chairman of the board. Literature provides two opposite views of CEO duality in this respect. According to agency theory (Jensen, 1986) CEO duality effects firm's performance negatively due to strong authority and decision making power especially in financial decision while stewardship theory support the duality due to the unity of the command, better and quick decision making rights.

Pakistani corporate sector is mainly characterized by high ownership concentration (Javaid & Iqbal, 2008). Most of the share holdings are owned by the families or other close group of investors (families, directors, foreign or institutional owners). In a traditional setup, the majority shareholders have more control on the firm resources and cash flows, which leads to concentration of control and ownership with the insiders (Cho & Kim, 2007).

Moreover, Capital markets are less developed in Pakistan and the size of primary and secondary debt market is significantly small. Therefore, companies are relying more on the banking sector for their debt financing needs. In case of Pakistan, external financing choices and as a result the firm's capital structure decisions are affected by ownership concentration (Masood, 2014). The ownership controlled firms tend to avoid borrowing in order to minimize the financial distress and to avoid bankruptcy risks (Fama & Jensen, 1983) whereas Grossman& Hart (1986) and Anderson (2003) in their empirical investigation, report the opposite results. Therefore, the existing empirical evidence is found to be mixed.

Based on the above discussion, the following research questions are being posed in this research study:

i. What is the relationship of capital structure with CEO duality?
ii. What is the relationship of capital structure with board independence?
iii. What is the relationship of capital structure with audit committee independence?
iv. What is the relationship of capital structure with ownership concentration?

2.0 LITERATURE REVIEW

Many research studies have highlighted that the capital structure of a firm simply means "…*the way a firm is financed"* (Friend & Lang, 1988). If an incorrect methodology of financing is selected, then the repercussions are faced by both the managers and the firm. Studies have shown that despite the tax benefit, increases in leverage, causes decrease in firm's performance. Short el al. (2012) found negative relationship between debt to equity and return on equity. Importance of optimal capital structure has also been emphasized by many researchers both historically and in the present context (Jensen & Meckling, 1986; Masood, 2014; Nazir, Aslam & Nawaz, 2012). They explained that optimal capital structure is a point where tax sheltering benefits provided by debt level is equal to the bankruptcy costs associated with debt. They suggested that managers of the firm should identify and maintain optimal capital structure. Javeed & Yaqub (2015) argued that manger is one who always wants to continue current operation even cash flows are poor and debt mitigate that problem and take firm toward the liquidation, but it incurs a cost. They further argued that there must be trade-off between the cost of liquidation and gain from liquidation. Therefore, ownership concentration plays a vital role in the capital structure of the firm.

The formal definition of a board of directors is the primary (highest) body of a company that is responsible for managing and controlling the operations of that company. Consequently, the board plays a major role in the strategic decision making process of the company. Researchers have tried to explore the link between the size and composition of the board and the subsequent CG measures taken by that company. Bathala and Rao (1995) found a significant relationship between the board size and the capital structure.

Carcello, Neal, Palmrose and Scholz (2011) found that firms with larger board of directors generally have low gearing ratios. He argues that larger boards exert pressure on managers to follow lower gearing levels and enhance firm performance.

Abor (2007) have also examined the relationship between corporate governance and capital structure decisions of Ghanaian Small and Medium Enterprises and found a negative relationship between board size and leverage ratios. On the other hand, Anderson, Mansi and Reeb (2004) found a positive relationship between board size and capital structure. He argues that large boards follow a policy of higher levels of gearing to enhance firm value especially when these are entrenched due to greater monitoring by regulatory authorities. On the other hand, latest research studies (Khan& Awan, 2012) have also argued that larger board may find it difficult to arrive on a consensual decision, which ultimately affects the quality of corporate governance within the organization and would translate into higher financial leverage levels.

Another concept that has emerged is the presence of non-executive directors in the board. Researchers have tried to explore a practical relationship between the presence of non-executive directors and capital structure, but the results have been mixed. Carcello et al. (2011) have tried to prove that non-executive directors play a major role in enhancing the value of the company and gain shareholder confidence. This somehow leads to the reduction of uncertainty about company's ability to generate funds for investment. This study also states that presence of non-executive directors leads to lower gearing ratios in the companies.

Apart from the composition of the board, another important factor is the "independence" of the board and audit committees. Corporate governance has highlighted many standards in its aim to mitigate the agency problem between the management and shareholder (Jensen, 1986). The objective is to safeguard the interests of the shareholders. The audit committee independence and board independence are among other measures which determine the effectiveness of the governance system (Chan & Li, 2008). Both the audit committee independence and board independence improves the protection of shareholder's interests by creating effective governance environment (Krishnamoorthy & Maletta, 2012). Independence of directors is evaluated by the degree to which directors are free from conflicts of interest that might limit their ability to act solely in the interest of the organization (Arslan, Zaman, Malik, Mehmood, 2014).

A major feature of the present corporate governance measures is the dual role of the CEO i.e. a company in which the CEO also serves as the head/chair of the board of directors. This organizational arrangement has a direct impact on the financial decision making of the company. This aspect has been given ample importance in the literature for the past decade or so, as Jensen and Fama (1983) stated that in a firm, decision management should be segregated from decision control. Decision management function encompasses the right to initiate and execute new proposals for the disbursement of the firm's resources while decision control function comprises of the right to approve and monitor those proposals. This division would ensure that internal controls and checks are well in place. The recent research studies (Yasser, Mamun and Suriya, 2015) have also reemphasized on this particular concept and have argued that the chief decision management authority (CEO) should be separate from the chief decision control authority (Chairman). According to Nazir, Aslam and Nawaz (2012), the chair/head of the board of directors is the primary authority for decision control management; therefore such a position should not be controlled or managed by the CEO. Presence of CEO/Chair duality indicates a conflict, which leads to agency problems within a company.

Ownership structure includes the concept of ownership concentration and managerial ownership (Hassan, Shaukat and Nawaz, 2014). Many research studies (Arslan and Zaman, 2014; Masood, 2014) have discussed this parameter of corporate governance, as having a significant impact on the capital structure of a firm. Similarly, according to the research conducted by Hassan and Butt (2009), lower ownership concentration and lower managerial ownership increases the quality of corporate governance within a firm. Greater ownership in few hands increases the likelihood of using the organizational resources for self-interest, as the primary control of the entire firm lies with them (Friend and Lang, 1988).

Previous studies in Pakistan have focused on various measures of corporate governance and their impact on overall profitability and firm value (Javeed and Yaqub, 2015; Javeed, Hassan and Azeem, 2014). Likewise, other studies have either focused on only one aspect of corporate governance (Masood, 2014; Nazir, Aslam and Nawaz, 2012; Yasser, Mamun and Suriya, 2014; Arslan et al., 2014) or have focused on an industry other than textile. Therefore, there is a need for a comprehensive study that takes evidence from the above mentioned research studies and compares the impact of corporate governance on capital structure of a firm, especially in the textile weaving companies of Pakistan. The purpose of choosing textile weaving companies is that the textile sector is one of the largest sector in Pakistan, and any evidence generated from this sector, can be generalized to other sector/industries of Pakistan as well.

3.0 METHODOLOGY

The purpose of this research is the investigate the impact of corporate governance measures on the capital structure of the textile weaving companies listed with Pakistan Stock Exchange (PSE). As of 2014, a total of 14 textile weaving companies are listed with PSE, out of which the annual reports (financial data) of 11 companies is easily available. Financial data for three years i.e. 2012, 2013 and 2014 has been used for this study.

The design of the research mainly focuses on secondary data, as the annual reports of the companies have been used to generate the required statistics. Moreover, as highlighted in the preceding section review of relevant literature has been used to extract important variables. The sample consists of 62 observations of 11 companies over a period of three years.

Table 1 Data Set

Symbol	Name	Annual Reports Availability?
ASHT	Ashfaq Textile	Yes
AYZT	Ayaz Textile	No
FML	Feroze 1888	Yes
HKKT	Hakkim Textile	Yes
ICCT	I.C.C.Textile	Yes
MOHE	Mohib Exports	No
PRWM	Prosperity Weaving (Nagina Group)	Yes
SDIL	Saleem Denim	No
SDOT	Sadoon Textile	Yes
SERF	Service Fabrics	Yes
SMTM	Samin Textile	Yes
STJT	Shahtaj Textile	Yes
YOUW	Yousuf Weaving	Yes
ZTL	Zephyr Textile	Yes

Variables

The Independent Variables used in this study are the size of the firm, The Composition and Independence of the Board, CEO/ Chair Duality and Ownership Concentration. Dependent variable used to calculate capital structure is the "Debt Ratio".

- **Dependent variable: Capital Structure (Leverage):** Capital Structure is the dependent variable and it is quantified by using debt to equity ratio. Debt to equity ratio can be calculated either by using market value or by using book value. The use of book value measure of leverage has been preferred in this study. The reason is that optimal level of leverage is determined by the trade-off between the benefits and costs of debt financing.
    - Currently, less than two dozen term finance certificates are being traded at Pakistan Stock Exchange (PSE) while the number of listed companies is well over 600. Most companies find it quite difficult to access the capital market for debt financing. Under these circumstances, we considered it wise to take the total debt figure for measuring the companies' gearing level.
- **Board and Audit Committee Independence:** Corporate governance has highlighted many standards in its aim to mitigate the agency problem between the

management and shareholder. The objective is to safeguard the interests of the shareholder. The audit committee independence and board independence are among other measures of effective governance system. Both the audit committee independence and board independence improves the protection of shareholder's interests by creating effective governance environment.

- **CEO/Chair Duality:** If a person holds both slots of chief executive officer and chairman than it may create agency problems. Higher level of control by CEO may lead to managerial opportunistic behavior and can lead to lower gearing levels under entrenchment hypothesis. It is hypothesized that CEO/Chair duality is negatively related to leverage levels.
- **Ownership Concentration:** From a firms' perspective, ownership structure determines the firms' profitability, enjoyed by different stake-holders. In particular, ownership structure is an incentive device for reducing the agency costs associated with the separation of ownership and management.
- **Size of Firm:** Large firms generally have close links with their lenders and find it easy to arrange debt on favorable terms. Therefore, it was hypothesized that there exists a positive relationship between the size of firms and leverage level. Size of Firm is measured as logarithm of total assets.

Conceptual Framework of Research

Conceptual framework provides the blue print of how a research is conducted. It explains the variables and their logical relationships along with hypotheses that are still to be tested. It also explains the instruments used to collect and record data, technique to select sample and its size, and the data analyses techniques to interpret the data. The conceptual model being proposed for this research study:

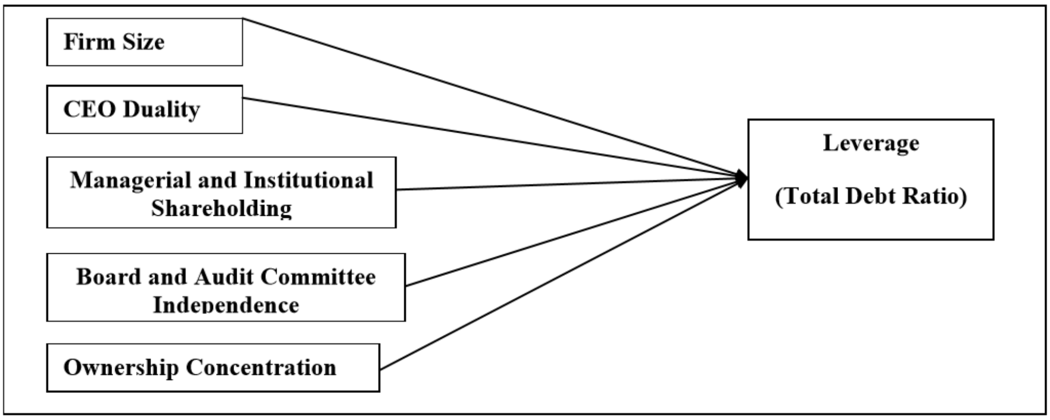

Figure 1 Conceptual Framework of the Study

Operationalization of the Variables

These variables are defined in detail (along with references from literature) in the table given below:

Table 2 Operationalization of Variables

Variable	Details	Hypothesis Statement
Independence of Board and Audit committee	According to Krishnamoorthy and Maletta (2012) the governance strength of the audit committee is increased with independent directors. Similarly, Arslan et al. (2014) put forwarded that firm with independent audit committee have lower cost of debt financing. Chan and Li (2008) found the evidence that the presence of independent and expert members on board and committees improve firm value. This argument was also proposed by Carcello et al. (2011) who found the inclusion of outsiders on the board is associated with an abnormal stock return. However, the effectiveness of the audit committee system may be questioned when management influences the selection of audit committee members for its interest, not for shielding stockholders' wealth (Carcello et al., 2011).	***H1: Independence in Board and audit committee is positively associated with capital structure of a firm.***
Ownership Concentration	A wide ranges of studies found that managerial/executive ownership relates to the organizational performance (Fama & Jensen, 1986; Cho & Kim, 2007; Hassan & Butt, 2009; Arslan & Zaman, 2014). Morck Shleifer and Vishny in 1988, found a see-saw shaped relationship between managerial ownership and firm value. At low level of managerial ownership(less than 5%) there is a positive relationship, however, when the level increases (5 to 25%) the relationship becomes negative. But, as we increase the ownership to more than 25%, the relationship again becomes positive. On the other hand a study by Larcker and Tayan (2011), of the US firms found that managerial ownership had no generalizable relationship with firm performance. Moreover, recent study of Hassan and Butt (2009), in Pakistan found that low level of managerial ownership of stock (less than 20%) increases the quality of corporate governance. Higher ownership concentration leads to lower the corporate governance quality. The financial performance is decreased with increased ownership concentration, because this raises the firm's cost of capital as a result of decreased diversification opportunities or decreased market liquidity (Fama and Jensen, 1983).	***H2: Ownership concentration is positively associated with capital structure of a firm***

CEO Duality and Capital Structure	Researchers (Chen, Hou & Lee, 2012) have shown that companies which have separate CEO and Head of Board of Directors generally employ optimal amount of debt in their capital structures. Such firms tend to have greater financial leverage. But, this research study has shown that relationship between CEO duality and firm's corporate governance is statistically insignificant. On the other hand, Abor (2007) found a positive relationship between gearing levels and duality of CEO.	***H3: CEO duality is positively associated with capital structure of a firm.***
Firm Size and Capital Structure	The relationship between leverage (debt ratio) and size of the firm has widely been discussed in the literature. Some authors (Titman & Wessel, 1988) have shown a positive relationship between the firm size and leverage (debt ratio). Large firms may prefer to utilize higher gearing levels. Similarly, Friend & Lang (1988) have also shown a positive relationship between the two. On the other hand Chan & Li (2008) showed a negative relationship between debt ratio and size of the firm. They have shown that large firms are well established and generally show good performance record, which allows them to issue equity at fair prices. This reduces the dependence of such firms on debts.	***H4: Firm Size is positively associated with capital structure of a firm.***

Regression Model

The research is based on pooled data as it contains the data extracted from 11 companies at different period of time. Ordinary Least Square (OLS) method has been used to develop a regression model. The model is defined as follows:

The equation made to test the panel data in our study using the independent variable would be as follow:

$$Lev = a + b_1(FS) + b_2(CD) + b_3(BACI) + b_4(OC) + \epsilon$$

Where,

a = constant term

b = coefficient of the variable

Lev = Leverage (Debt Ratio)

FS = Firm Size

CD = CEO / Chair Duality

BACI = Board and Audit Committee Independence

OC = Ownership Concentration

ϵ = error term

4.0 RESULTS AND DISCUSSION

The results for this study have been drawn by analyzing the data obtained from 11 textile weaving companies listed in PSE. The data has been collected from the annual reports of these companies. The relationships have been determined by applying regression model and descriptive statistics of all the variables. The obtained results are discussed below.

Descriptive Statistics

Table 3 Descriptive Statistics (Computed)

	FS	CD	BACI	OC	Lev (DR)
Mean	0.913341	0.213231	0.569123	0.891791	0.581145
Median	0.000000	0.000000	0.621000	0.876391	0.521255
Maximum	0.974451	1.000000	0.895000	1.138241	0.972213
Minimum	0.653342	0.000000	0.089890	0.194545	0.178831
Std. Deviation	0.204114	0.323391	0.191545	0.167743	0.214663
Observations	62	62	62	62	62

According to the descriptive statistics presented in the above table, the mean value of the firm size is around 91% i.e. the textile weaving companies operating in Pakistan are mostly owned by large investment groups. Textile Weaving is just one of the many companies owned by these groups. The Independence of Board and Audit Committee has been measured in terms of the Board Composition i.e. the presence of outside directors within the board. As per the statistics, the board independence in textile weaving companies is around 57%, which is reasonable as compared to other countries. According to (REF), the percentage of outside directions in majority of the US companies is around 63%. Similarly, as far as CEO/Chair duality is concerned, the table shows that around 22% of the companies have CEO's serving as the Chair of the Board. This shows that approximately 78% of the textiles weaving companies in Pakistan do not have CEO's as the head of the Board, which is in turn a positive sign for corporate governance.

Debt Ratio of the textile companies is approximately 58%, which shows that these companies tend to take more than debt and rely less on equity. This percentage is slightly higher than those found in other developing countries. As per a survey conducted in 2012 by Joseph et al. the highest debt ratios across the globe are observed in Portugal, South Korea, Indonesia and Pakistan.

Ownership Concentration for textile weaving companies of Pakistan is around 89% i.e. the tendency of the owners holding 10% or more shares in the company is 89% in this sector. This consequently will have significant impact on the corporate governance measures of the firm.

Regression Analysis

In order to calculate the impact of corporate governance on capital structure of the textile weaving companies of Pakistan, the panel data ordinary least square method of regression is used. The table highlights the results:

Table 4 Regression Analysis

Variable	Coefficient	Std. Error	t-statistic
Lev (DR)	0.429661	0.090231	4.138040
FS	1.014536	0.216661	3.211141
CD	-0.159014	0.049221	-3.678811
BACI	1.214550	0.213551	4.124411
OC	-0.332521	0.127180	-2.598691
R^2	0.638908		
Adjusted R^2	0.589980		
Std. Error	0.167865		

The above table shows the results obtained from the regression analysis. It clearly indicates that the firm size is positively related with Leverage (Debt Ratio) and is also statistically significant. The Independence of the Board and the Audit Committee (measured in terms of Board Composition) shows a positive relationship with debt ratio, and is also statistically significant. CEO/ Chair duality and Ownership concentration are negatively related to the debt ratio (leverage), however they are statistically significant.

According to the table above, R2 of 0.63 indicates that the regression model for this study explain 63% of the variance.

5.0 CONCLUSION

This research study has been conducted with one core objective in mind i.e. to propose a conceptual model between factors related to corporate governance and capital structure and to find a conclusive relationship between various measures of corporate governance and capital structure of the firm. This relationship was studied from the context of Pakistani organizations (listed textile weaving companies) to create a local relevance. Study is based upon the combination of primary and secondary data. The empirical evidences cited in the preceding sections show the highly levered firms perform better than their contemporaries. As far as the factors of corporate governance are concerned, there exists a significant relationship between the “independence” of boards and audit committees and subsequent capital structure. The empirical studies conducted in the past on this issue have not been able to generate sufficient statistical evidences which show that leverage has any linkage with corporate governance measures.

In the past few years, various public institutions in Pakistan (government-controlled) have tried to align the corporate governance measures for organizations operating in the county, however, when compared to developed countries the local firms still lag behind. The recent corporate scandals related to privatization of PTCL, PIA, Steel Mills raise question about the corporate governance standards and strength of boards in Pakistani organizations. According to Javeed and Yaqub (2015), "…*Shareholders interest is in their wealth maximization, management in their salaries and other benefits, creditor have interest in the sound position of company to be able to pay back their money along with returns, state have interest due to proper tax assessment and collection*". Thus all of these stakeholders contribute as capital to a firm, in one form or the other.

Based on the above discussion, it can be said that Corporate Governance is at an evolutionary stage in developing countries like Pakistan. However, there are several examples of poor governance in western (developed) organizations as well. Therefore, this subject area still offers a lot of scope for researchers to further explore the aspects associated with corporate governance and come up with some conclusive evidence about the measures which significantly impact the firm performance, irrespective of the operating environment.

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