JOURNAL OF CURRENT RESEARCH IN SCIENCE (ISSN 2322-5009)
CODEN (USA): JCRSDJ
2014, Vol. 2, No. 2, pp:209-213
Available at www.jcrs010.com

ORIGINAL ARTICLE

INVESTIGATION THE EFFECT OF CORPORATE GOVERNANCE ON FIRM FINANCING DECISIONS

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ABSTRACT: A firm financing decision is one of most basic problems managers have to be compelled to face. In keeping with new theories of capital structure, such decisions will be plagued by varied factors, among that corporate governance is one. This study investigates the effect of corporate governance on firm financing decisions.
KEYWORDS: Corporate Governance, Capital Structure, financing decisions.

INTRODUCTION

Modigliani and Miller had developed a theory of capital structure. Although many Experts in the field have extended their capital structure theory, very few examined the relationship between corporate governance and capital structure. Since Modigliani and Miller capital structure irrelevance propositions, academic researchers have advanced a number of capital structure theories. These theories are extensive and can be classified into two groups: tax-based theories and non-tax based theories. Tax-based theories include both bankruptcy and trade-off theories; while non-tax based theories include agency, signaling, pecking order and transaction cost theories (Khaled Hussainey and Khaled Aljifri). The issues of corporate governance have usually been associated with large and listed firms. Good corporate governance is the rules and practices that govern the relationship within the managers and shareholders of corporations, as well as stakeholders such as employees and creditors, which contribute to growth and financial stability by underpinning market confidence, financial market integrity and economic efficiency (OECD). The present study focuses on the link between corporate governance and capital structure.

LITERATURE REVIEW

Capital structure decision is the vital one since the profitability of an enterprise is directly affected by such decision. The successful selection and use of capital is one of the key elements of the firms' financial strategy (Velnampy and Aloy Niresh, 2012). The existence of a well developed capital market, financial intermediary, corporate governance and the legal protection offered by a country assist the effectiveness of debt. Due to Sri Lankan economy experience on double-digit interest rate in the last few decades, therefore, most of Sri Lankan CEOs are reluctant to have debt with high interest rates. The financial condition of a business organization would depend on the resources it owns and the obligations it has to meets. Companies carry out various activities to make profits, and to generate wealth for further growth. Finance is considered as the most important for these activities (Velnampy, 2006). Management of the project failed to achieve the budgetary results. Even though, the Net Present Value (NPV), Internal Rate of Return (IRR) and benefit cost ratio shows the project as worthwhile. Profitability should be re invested into the business for its' survival (Velnampy, 2006). Modigliani and Miller maintained that based on some specific assumptions including the existence of perfect capital market, lack of income taxes, lack of bankruptcy costs, lack of agency costs and the existence of information symmetry among those who are active in capital market, managers cannot provide any change in firm's value, only because they have altered the structure of financing sources. In other words, the value of firm is independent from its capital structure. After the first studies done by Modigliani and Miller, many researchers decided to investigate the factors effective on firms' capital structure. Suhaila and Mahmood, (2008) examined the factors signifying capital structure and concluded that the variables effective on firms' financing decisions include the size of firm, profitability, the amount of tangible fixed assets and interest rates. Hunag and Song, (2006) investigated if kind of industry can have any effect on capital structure decisions and

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concluded that it can be effective on the use of debt and the performance of firm. Many definitions are provided by several committees and organizations and mostly every country has developed code of best practices on corporate governance based on the committees' reports and research conclusions. For example Cadbury Committee Report, (1992) defined corporate governance as "the system by which companies are directed and controlled". It is concerned with the duties and responsibilities of a company's board of directors to successfully lead the company, and their relationship with its shareholders and other stakeholder groups. It is also defined as a "process through which shareholders induce management to act in their interests, providing a degree of investor confidence that is necessary for the capital markets to function effectively". Good corporate governance practices are important in reducing risk for investors, attracting investment capital and improving the performance of companies (Velnampy and Pratheepkanth, 2012). There is no globally accepted set of corporate governance principles that can be applied to board structures as they depend on business practices and the legal, political and economic environment. However, the Cadbury Committee Report, (1992) considered board structure as an important corporate governance mechanism, which would result in improved performance. They addressed board structures, separation of the roles of Chief Executive Officer (CEO) and Chairman, non-executive directors' representation and board committees. Another mechanism for Corporate Governance which is investigated in different studies is 'board size'. Most researchers have found that board size can in two ways lead to the improvement of performance more need on the part of firm to make connections with the environment out of firm and more executive responsibility in firms (Krivogorsky, 2006). A limited list of international empirical studies on the relationship between corporate governance and capital structure is described below:

- According to Pfeffer and Salancick, (1978) and Lipton and Lorsch, (1992), there is a significant relationship between capital structure and board size.
- The results of Wen *et al.*, (2002) and Abor and Biekpe, (2007) also show a positive relationship between board size and financial leverage (capital structure).
- Berger *et al.*, (1997) found that firms with larger board membership have low leverage or debt ratio. They assume that larger board size translates into strong pressure from the corporate board to make managers pursue lower leverage or debt ratio rather than have larger boards.
- Ahmadpour *et al.*, (2012) collected data from 50 Iranian firms listed at Tehran Stock Exchange to examine the relationship between corporate governance and capital structure. They concluded a negative relationship between board size and debt to equity ratio. Authors also found that CEO duality does not significantly influence corporate financing behavior.
- Saad, (2010) carried out a sample of 126 Malaysian publically listed companies from four industries i) consumer products, ii) industrial products, iii) trading/services, and iv) plantations for the period from 1998 to 2006. Through multiple regression analysis, Saad found a negative relationship between CEO duality and capital structure, and positive relationships between board size and capital structure.
- Rehman *et al.*, (2010) investigated the relationship between corporate governance and capital structure of randomly selected 19 banks of Pakistan from 2005-2006. They found a positive relationship between board size and capital structure.
- Vakilifard took data from Tehran Stock Exchange (TSE), Iran over the over the period 2005–2010. They found a positive relationship between CEO duality and leverage, and a negative relationship between board size and leverage.
- Gill *et al.*, (2009) sampled small business owners from India and found that small business growth and family positively influence capital structure of small business firms.
- Coles found a positive relationship between board size and debt ratio in the US context.
- Jensen and Meckling, (1976), Berger *et al.*, (1997) and Abor, (2007) find a significant positive relationship between non-executive directors‟ percentage on the board and firm leverage ratio
- Shijun examined the relationship between board composition and firm's performance. The sample included 1252 firms during the years 1996 to 2006. In this research, he used the return of assets (ROA) and that of shares as criteria for measuring performance and also the variables board size and proportion of outside directors for measuring board composition. The results showed that there is a positive relationship between board size and proportion of outside directors with the performance of firm.
- Pfeffer and Salancick, (1978) who explain that when firms have more outside directors,

they increase protection against uncertainties and this increases the firm's ability to raise external debt.

CONCEPTUALIZATION

Based on the purpose of the study, the following conceptual model has been constructed. This model of corporate governance and capital structure introduces new constructs and uniquely combines them in specifying that the capital structure is a function of Leadership style, Board committee, Board size, Board meeting and Board composition.

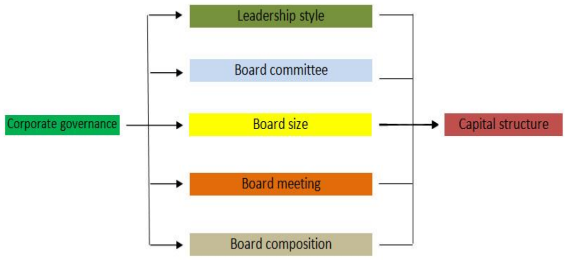

Figure 1: Conceptualization model

HYPOTHESIS OF THE STUDY

H1: There is a significant relationship between leadership style and firms ‘capital structure

H2: There is a significant relationship between board committee and firms ‘capital structure

H3: There is a significant relationship between board size and firms ‘capital structure

H4: There is a significant relationship between board meeting and firms ‘capital structure

H5: There is a relationship between board composition and firms ‘capital structure

H6: There is a significant relationship between corporate governance practices and firms ‘capital structure

RESEARCH METHODOLOGY

The objective of the study was to conduct an investigation of the corporate governance practices of listed manufacturing companies in North Khorasan of Iran and their effect on capital structure. The sample was selected from the 28 manufacturing companies listed in the Stock Exchange for the period 2009 and 2010 based on the availability of data.

5.1 Data Collection

The data and information required for the study were collected from the Stock Exchange (SE) websites, annual reports, and the Stock Exchange publication.

5.2 Data analysis method

Various statistical methods have been employed to compare the data collected. These methods include cross-sectional analysis descriptive statistics and regression analysis.

RESULTS AND ANALYSIS

6.1 Regression analysis

The purpose of regression analysis is to find out the significant impact or influence of independent variable on dependent variable. In this study, Corporate Governance Practices is considered as independent variable or predictor variable, and the Capital Structure is considered as dependent variable. Table No 1 presents the results of the regression analysis. The results of the regression analysis summarized in table no 1. It shows that Corporate Governance Practices contributes significantly to Capital Structure ($F=3.737$; $P < 0.05$) and predicts 34 percent of the variation found.. Board Committee in the Corporate Governance Practices contributes significantly to Capital Structure. And also Capital Structure is not contributed significantly by Proportion of Non Executive Directors, Board Meeting and Leadership Structure in Corporate Governance Practices.

Table 1: Multiple regression analysis.

Coefficients[a]							
Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	-1.956	0.601		-3.257	0.004		
Board Committee	0.492	0.175	0.515	2.807	0.010	0.730	1.370
Board Meeting	0.012	0.028	0.083	0.445	0.660	0.716	1.397
Board Size	0.065	0.048	0.235	1.347	0.192	0.805	1.242
Leadership Structure	0.079	0.198	0.069	0.400	0.693	0.839	1.192
Proportion Of Non-Executive Directors	0.666	0.634	0.187	1.051	0.305	0.780	1.282

a. Dependent Variable: DEBT RATIO
NOTE: Significant at 0.05 levels.

Table 2: results of ANOVA test

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	4.196	5	0.839	3.737	0.013[a]
	Residual	4.940	22	0.225		
	Total	9.137	27			

A. Predictors: (Constant), Proportion Of Non-Executive Directors, Board Meeting, Leadership Structure, Board Size, Board Committee
B. Dependent Variable: Debt Ratio

Table 3: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	0.678[a]	0.459	0.336	0.47388	2.180

A. Predictors: (Constant), Proportion Of Non-Executive Directors, Board Meeting, Leadership Structure, Board Size, Board Committee
B. Dependent Variable: Debt Ratio

6.2. Multi-Collinearity

Two major methods were used in order to determine the presence of multi-collinearity among independent variables in this research. These methodologies involved calculation of a Tolerance test and variance inflation factor (VIF) (Velnampy, 2011). The results of this analysis is presented in table no 1 and 3.

According to the table no 1, None of the tolerance level is < or equal to 1; and also VIF values are perfectly below 10.Thus the measures selected for assessing independent variable in this study do not reach levels indicate of multi-collinearity and also the acceptable Durbin Watson range is between 1.5 and 2.5 .In this analysis Durbin Watson value of 1.883, which is between the acceptable ranges, Show that there were no auto correlation problems in the data used in this research.

Table 4: Hypothesis Testing

NO	Hypotheses	Results	Tools
H1	There is a significant relationship between leadership style and firms ‘capital structure	Rejected	Regression
H2	There is a significant relationship between board committee and firms ‘capital structure	Accepted	Regression
H3	There is a significant relationship between board size and firms ‘capital structure	Rejected	Regression
H4	There is a significant relationship between board meeting and firms ‘capital structure	Rejected	Regression
H5	There is a relationship between board composition and firms ‘capital structure	Accepted	Regression
H6	There is a significant relationship between corporate governance practices and firms ‘capital structure	Accepted	Regression

CONCLUSION

Corporate governance can greatly assist Companies by infusing better management practices, effective control and accounting systems, stringent monitoring, effective regulatory mechanism and efficient utilization of firms’ resources resulting in improved performance. Firms should embrace a well established corporate governance structures that will assist them to gain easier access to credit at lower cost since such firms are able to repay their debt on time.

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