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Corporate Governance and Financing Dicisions of Listed Firms in Pakistan

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Abstract

The purpose of the study is to explore the link between corporate governance mechanisms and firms financing decisions. We have selected 24 banks which were listed on the “Karachi Stock Exchange”, during the period of 2008-2012. The Ownership Concentration, composition and size of the board, and role duality were considered as independent corporate governance variables while firm specific control variables were size, liquidity, profitability and tangibility of assets. Debt ratio is taken as a dependent variable representing firm’s financing decision (capital structure). The results indicate that Ownership Concentration, Size of the board, and leverage are positively correlated. However no significant relationship was found between Board composition, CEO duality and capital structure. We use panal least square regression to determine the affect of corporate governance and firm level characteristics on capital structure.

Keywords: Banking Sector, Capital Structure, Corporate Governance

GEL Classifications: G30, G32

1. Introduction

Corporate governance (CG) has gained a lot of attention in the last decade from different interested parties such as regulators, professional bodies and academics. However, despite this fact, no specific definition has won general agreement among these parties Solomon (2007). Therefore, the traditional literature on corporate governance approaches the subject from various angles and reveals a number of definitions based on different business environments and corporate systems. In its narrowest sense, (Shahid, 2001, p. 3) defined CG as "the set of rules and incentives by which the management of a company is directed and controlled in order to maximize the profitability and long term value of the firm for shareholders". This definition tends to accord with the agency theory, in which companies should act in favour of shareholders by maximizing their profits Shahid (2001). In a broader sense OECD (2004, p. 1) describes CG as a set of relationship between a firms management its board its directors and other stakeholders.

Capital structure is basically a mix of company’s leverage and equity that a firm uses to finance its assets Gul et al, (2012). By issuing bonds or long-term notes payable firms can generate debt, while equity consists of common stock and preferred stock. The proportion of debt in capital structure is measured by leverages. The capital structure decision has played a very pivotal role in the establishment and growth of firms for many years. Capital structure decisions provide opportunities that help in increasing the wealth of the shareholders. The article tries to explore the link between corporate governance mechanisms and capital structure for a sample of 24 listed banks in the “Karachi Stock Exchange (KSE)” during the period 2008-2012. The reminder of the paper is as follow. Section 2 highlights the prior literature on corporate governance and capital structure. Section 3 addresses the methodology and measurement of variables and sections 4 discuss analysis of results and conclusion.

2. Literature Review

It has been found in prior literature that capital structure decisions are affected by corporate governance mechanisms for example Berger *et al*, (1997); Wen *et al*, (2003) and Abor (2007). Main corporate governance

mechanisms identified in the literature are size and composition of the board, CEO/Chair duality, tenure of the CEO and CEO compensation etc. Size of the board and capital structure was found to be positively correlated in previous studies such as Wen et al (2002) and Abor (2007). They argue that in order to increase firm performance firms with larger board's uses higher leverage in their capital structure because larger boards are more entrenched and are more closely monitored by regulatory authorities. However an inverse association was found in a study by Berger et al (1997) between size of the board and firms leverage. Furthermore significant association was found between board size and leverage in studies by Pfeffer and Salancick (1978) and Lipton and Llorsch (1992). Large size boards are associated with higher agency problems which weakens corporate governance due to which leverage increases, however low leverage firms have fewer numbers of outside directors Jensen (1986). Duality is another variable which is extensively investigated in prior literature to have an effect on leverage; duality means that same person acts as CEO and chairman of the firm. Fama and Jensen (1983) argue that in order to reduce agency problem the roles must be performed by different persons. If dual roles are performed by same individual it will be difficult for management to perform its key objective which is to evaluate manager's performance. Thus Fama and Jensen suggest splitting the monitoring of decisions from implementation of decisions to reduce agency problems. It was found in a study by Fosberg (2004) that firms with split roles uses higher amount of leverage, but this relation was statistically insignificant. On the other hand Positive association was found by Abor and Biekpe (2007) between duality and firms leverage. Non executive directors is an important corporate governance mechanism which increases a firms capability because outside investors have more confidence on firms with more non executives in board decision making Pfeffer and Salancick (1978). Jensen (1986) argues that companies with increased leverage have fewer non executive directors. In a study by Abor and Biekpe (2007) in the context of Ghana found that non executive directors and CEO duality have positive correlation with firm's capital structure.

Jasir ilyas (2008) during the period 2000-2005 in Pakistani listed non financial firms show that most of the firm tends toward the internal financing instead of the debt. In Pakistan debt or long term financing is not considered as prior to internal equity financing because the bond market in Pakistan is not yet so developed. Titman & Wessels (1988), using data from US industrial companies found that variable tangibility has insignificant affect on leverage. However leverage and profitability were found to have negative correlation. In a comparative study Rajan & Zingales (1995) use profitability, size, tangibility and growth and found that profitability, tangibility and growth are negatively related to debt ratio. Whereas size and debt ratio were insignificantly correlated. Fitim-Deari and Media-Deari (2009) in his investigation into Macedonian companies during the period 2005-2007 argue that in Macedonia financial market is poor and bondholders are absent thus, they don't prefer to issue bonds to borrow money. They found that their sample firms use internally generated funds to finance assets. Tariq, Majed and Zia-ur-rehman (2011) done his work on data taken from Pakistani listed sugar and allied industry firms and provide mix results. They found that profitability is negatively correlated with leverage, whereas tangibility and leverage have strong positive correlation, while the remaining variables were statistically insignificant.

3. Research Methodology

The sample for the study consisted of companies in the banking sectors that were listed in the "Karachi Stock Exchange" during the period 2008 to 2012. Companies that were not listed in the "Karachi Stock Exchange", for the duration of the five year period were left out. Companies that did not have a full set of data on variables mention in the study were also left out. Statistical analysis techniques were used to provide descriptive statistics to determine the mean, median, standard deviation of each construct variable. Panal regression analysis was used in the study.

The general form of our model is:

$$DR_{it} = \alpha + \sum_{i}^{n} \beta_i X \varepsilon_{it} \quad \ldots\ldots (1)$$

DR *it* = firms i debt ratio at time t,

α = the intercept

β*i*= the change co-efficient for *Xit* variables

X it = firm's i independent variable at time *t*

3.1 Variables of the Study

3.1.1 Dependent Variable

3.1.1.1 Debt Ratio

Following Rajan & Zingales (1995), Booth et al, (2001) and Beven & Danbolt (2002) we define debt ratio (financial leverage) as:

Debt ratio (DR it) =total debt/total assets

3.1.1.2 Board size

In this study size of the board is taken as an independent variable, because of its importance in the strategic decisions of a company like capital structure. We have taken the proxy of natural log of total board members to measure size of the board.

3.1.1.3 Board composition

This variable is measured by the number of non executive directors divided by total directors on the board. Outside investors prefer a firm with more non-executive directors because it is a signal that the firm is monitored efficiently. Therefore such firms can obtain funds from the capital market on better terms.

3.1.1.4 CEO/Chair Duality

A dummy variable duality is used in the study which takes the value of 1 if CEO is chairman; otherwise 0. Fama and Jensen (1983) argue that a corporation needs to have different persons as CEO and chairman in order to reduce agency conflicts. In light of entrenchment hypothesis if both the roles are performed by same individual then it will lead to managerial opportunistic behavior and can lead to lower leverage.

3.1.1.5 Ownership Concentration (OC)

Ownership concentration is measured by the amount of stock owned by individual investors and large-block shareholders divided by total share

3.1.1.6 Firm Size

There are mix results about the relationship of size and debt ratio. Researchers such as Titman and Wessels (1988), justify the positive relationship between size and debt ratio. Large firms are more diversified and have less chances of bankruptcy thus lenders prefer larger firms. According to Um (2001) firm size may proxy for the debt agency costs (monitoring cost) which arise from the conflict between managers and investors. Size is proxied by total assets.

3.1.1.7 Liquidity

Current ratio is used to represent liquidity which is equal to current assets divided by current liabilities. We expect that debt ratio is negatively correlated with liquidity of the firm simply because the firm that use more debt will use more current liabilities and by paying their short term obligations they will have less amount of current assets.

3.1.1.8 Tangibility of Assets

Tangible assets are collateralizable because they are acceptable to creditors as a security for issuing the debt, therefore if the company then default on the debt, the assets must be seized, but the company may be in a position to avoid bankruptcy. In an uncertain world, with asymmetric information, tangible assets are most widely accepted source for bank borrowing and raising secured debt. The interest rate for those firms who have more fixed assets will be lower because they can use this large amount of fixed assets as a security to creditors. On the other hand, a firm with little collateralizable assets faces the difficulty to raise funds via debt financing because of high cost of debt. Tangibility is measured by fixed assets divided by total assets.

3.1.1.9 Profitability

According to Myer and Majluf (1984) firms will go for internal finance over external finance, and firms who have a large amount of retained earnings (profitability) will first finance their investments with retained earnings. Moreover, according to Jensen and Meckling (1976, 1986) managers of profitable firms will use internal funds for their self interest rather than shareholders interests. Profitability is proxied by net income before taxes divided by total assets.

3.2 Hypothesis

H1: Concentrated ownership and firms leverage has significant correlation

H2: Composition of the board and firms leverage has significant correlation

H3: Size of the board and firms leverage has significant correlation

H4: CEO/Chair duality and firms leverage has significant correlation

H5: Tangibility and firms leverage has significant correlation

H6: Profitability and firms leverage has significant correlation

H7: Liquidity and firms leverage has significant correlation

H8: Firm size and firms leverage has significant correlation

4. Discussion of Results

Table 1 presents the descriptive statistics for dependent and independent variables discussed above. Descriptive statistics include the mean, median, standard deviation, minimum and maximum, values for the period 2008-2012. The data contains 24 banks listed in the, "Karachi Stock Exchange".

Table 1: Descriptive statistics

	Mean	Median	Min	Max	Std. Deviation
DR	0.8378	0.8124	0.4924	1.1547	0.1142
OC	0.63524	0.69245	0.0000	1.0000	0.19523
BC	0.55247	0.61247	0.0000	1.0000	0.21457
BS	4.2541	5.3245	3.0000	7.0000	0.39524
CEO	0.06825	0.0000	0.0000	1.0000	0.21547
PROF	0.0549	0.0199	-0.1120	0.2841	0.0499
TANG	0.0587	0.0251	0.0039	0.5449	0.1014
LIQ	1.3321	1.0452	0.5120	2.5421	0.2429
SIZE	10.2457	11.1900	6.41002	13.7612	1.1452

Table 2: Result of Regression Output

Variables	Coefficient	Std. Error	t-Statistic	Prob.
OC	0.11254	0.019524	3.25414*	0.0000
BC	0.000241	0.004524	0.04524	0.6524
BS	0.049575	0.02451	2.1368**	0.0328
Duality	0.005624	0.004578	0.67854	0.49524
Profitability	-0.327480	0.075326	-4.347495*	0.0000
Tangibility	0.077511	0.045258	1.712626***	0.0878
Liquidity	-0.055972	0.024483	-2.28613**	0.0229
Size	0.067685	0.002625	25.78178*	0.0000
Intercept	0.255100	0.048527	5.256818*	0.0000

R-squared	0.574214	Mean dependent var	0.653214
Adjusted R-squared	0.564572	S.D. dependent var	0.235475
S.E. of regression	0.124810	Akaike info criterion	-1.785324
Sum squared resid	4.635471	Schwarz criterion	-1.452142
Log likelihood	231.4523	F-statistic	49.23142
Durbin-Watson stat	1.624457	Prob (F-statistic)	0.000000

*significant at 1% level, **significant at 5% level, ***significant at 10% level.

In this study R-square value is 57%. Profitability is found to be negatively correlated with firm's debt ratio. It means that profitable firms in Pakistani banking sector maintain low debt ratios. The results show that ownership concentration and dependent variable capital structure are significantly positively correlated. The association between firms leverage and explanatory variable board composition is positive but this relation is insignificant thus our hypothesis which predicts significant link between board composition and leverage is not supported. Further it was found that leverage increases as size of the board increases and this relationship is statistically significant thus our hypotheses cannot be rejected. As shown in Table, the coefficient of CEO is not statistically significant; this indicates that CEO duality has no significant effect on capital structure; thus our hypothesis is not supported. Tangibility, with positive coefficient is significantly related to debt. The finding is in conformity with the prediction of Jenson and Meckling (1976) and Myer's (1977). The advantage of debt investment is that creditors receive uninterruptible stream of income due to debt investment except in case of bankruptcy. Creditors have no tension about the interest payment by firm on their debt, if the firm is performing well. But it well be difficult for them to continuously monitor the operations and performance of the firm, therefore they can overcome this trouble by asking the security of fixed assets like land, building, machinery etc. Thus creditors will be willing to give loans to those firms who provide there fixed assets as a security against debt. Therefore firms with less fixed assets cannot borrow large amount of debt because of high cost of debt, but on the other hand firms with higher amount of fixed assets in total assets can borrow more due to lower interest rate. Similarly, the results between liquidity of the firms and its debt ratio show significant negative relationship in banking sector. Companies with high liquidity tend to use less amount of debt, simply because it provides an indication that firms generally finance their activities by internal funds. The relationship between size and

dependent variable debt ratio is positive and statistically significant. This means that larger firms have high debt ratio. Considering the fact that large firms are more diversified, bear less risk and have more consistent cash flows, therefore they can afford higher levels of debt.

5. Conclusion

The purpose of the present study is to investigate whether there is any relationship between some specific features of corporate governance and capital structure of listed banks in the "Karachi Stock Exchange (KSE)". We have selected 24 banks which were listed on the KSE during the period of 2008-2012. The Ownership Concentration, Board composition, Board Size, and CEO duality were considered as independent corporate governance variables while firm specific control variables were size, liquidity, profitability and tangibility of assets. Debt ratio is taken as a dependent variable representing firm's financing decision (capital structure). The results indicate a positive relationship between Ownership Concentration, Board Size, and capital structure. However no significant relationship was found between Board composition, CEO duality and capital structure. We use panal least square regression to determine the affect of corporate governance and firm level characteristics on capital structure.

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