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Investigating the Relationship between Corporate Governance Characteristics and Financing Decisions

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Abstract

This paper investigates the relationship between the components of corporate governance structure including board characteristics, ownership structure, and financial leverage in the companies listed on Tehran Stock Exchange. The aim to this study is to examine the impact of board size, percent of non-executive directors, CEO-Chairman duality, percent of managerial ownership, institutional ownership, and governmental ownership on financial leverage of companies listed on Tehran Stock Exchange .In order to investigate research hypotheses, the data of 133 companies listed on Tehran Stock Exchange during the period of 2006 to 2014 has been investigated by implementing regression models based on panel data. In order to measure financial leverage, total debt ratio and the ratio of long-term debt to total assets were used. The results obtained from research indicate that there is a statistically significant and positive relationship between board size, the percentage of non-executive directors, and institutional ownership, CEO-Chairman duality and financial leverage; while, there is a significant and negative relationship between managerial ownership and financial leverage. Also, there is a significant and negative relation between long-term debt ratio and governmental ownership, while no significant relationship was found between total debt ratio and governmental ownership. Altogether, these findings prove the significant role of board characteristics and ownership structure on financing decisions made by firms.

Keywords: Corporate Governance, Board Characteristics, Ownership Structure, Financial Leverage.

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Introduction

Recent financial scandals happened in big corporations have increased the importance of corporate governance and powerful and righteous boards, more than ever. The separation of management from ownership has long been considered as the key to analysis of modern corporate governance. As pointed by Harford et al. (2007), previous studies have shown that financial leverage and the combination of debt maturity, especially short-term debts, are efficient ways for alleviating the agency problem (Grossman & Hart 1982; Jensen 1986; Stulz 1990; Hart & Moore 1995; Rajan & Winton, 1995). Debts play a monitoring and disciplinary role on management behavior; high debt levels increase the probability of bankruptcy, and therefore, keep managers from making decisions that might ruin firm value (Grossman & Hart, 1982).

Corporate governance and ownership structure facilitate value creation for shareholders through management, and therefore, can provide interests of individual and group shareholders. Good corporate governance can affect corporate governance decisions made by the board of directors, such as financing decisions and their type, amount and maturity (Hasan and Butt, 2009). On the other hand, the board of directors is considered as playing the most important role in protecting owners' interests, and in control and monitor executive management (Fama & Jensen, 1983). The board of directors is in charge of setting financing policies for firm (Harford et al. 2007). The impact of different aspects and characteristics of the board of directors on corporate governance environment is different, that is, some board characteristics are of more monitoring efficiency than other traits. Based on this view, the main purpose of this paper is to investigate the relationship between some corporate governance mechanisms, including board characteristics, on financial leverage of firms. The results of this paper can have implications for both investors and regulators. Our findings can help investors in their decisions about the board composition, so that they can exercise better control and monitoring in firms. Also, the results of this paper can assist regulators in assessing, and probably improving, controlling and monitoring mechanisms.

Previous studies in this area were mainly focused on experiences of developed countries. This study, therefore, examining the relation between boar characteristics, ownership structure, and Financing Decisions in an emerging market with different economic, social and cultural environment, can contribute to development of this area of literature.

The rest of this paper is organized as follows: in the next section the extant literature and previous studies will be review, and research hypotheses will be developed. The third section of this paper explains our methodology, followed by empirical results. In the final section, our results are interpreted and concluded.

Theoretical background

Non-executive directors and financial leverage

The existence of non-executive directors in the board of directors, is the footstone of modern corporate governance (Hasan & Butt, 2009), and signals the market that firm and

its executive managers are monitored and controlled efficiently (Fama 1980; Fama & French 1993), which mitigates agency problems. Pfeffer and Salancik (1978) found a significant and positive relationship between financial leverage and the ratio of non-executive directors. Pfeffer and Salancik (1978) stated that, due to their external viewpoint of firm, non-executive directors play a significant role in improving firm's capabilities and capacities. This, in turn, reduces the uncertainties about firm and its ability to raise funds. Moreover, the existence of non-executive directors leads to more efficient control and monitoring, and therefore, less agency problems. Jensen (1986) and Berger et al. (1997) also proved this relationship. On the other hand, the results of studies performed by Chang Kuo et al. (2012) and Wellalage and Locke (2012), revealed the reverse relationship. These circumstances show that managers have used less debt to avoid powerful corporate governance controls. According to this, our first research hypothesis is as follows:

H_1: *there is a significant relationship between the percentage of non-executive directors and financial Leverage.*

Board size and financial leverage

The board of directors plays an important role in making strategic decisions and managing the operations of the firm. The results from previous studies on the relationship between board size and financial leverage were contradictory. Some of studies showed that smaller boards will improve firm performance. When the board of directors is composed of several members, there will be more agency problems, because some of members may act as non-interested parties (Hermalin & Weisback, 2003); also, too many board members may cause problems in the ground of attaining unanimous decisions. When there are too many board members, the board cannot control and monitor the chief executive manager in an efficient manner (Lipton & Lorsch, 1992). Heng et al. (2012) studied the effect of board size on financial leverage of Malaysian firms. They found that there is a negative relationship between the number of board members and debt ratio for Malaysian firms.

On the other hand, the results from some other studies revealed that smaller boards cannot benefit from advantages of technical and diversified opinions stated in large boards; and, smaller boards can include less non-executive directors, and have limited time for meeting their monitoring and decision-making responsibilities. Sheikh and Wang (2012) found a positive relationship between board size and long-term debt. Ganiyu and Abiodun (2012) concluded that there is a positive relationship in this respect, and argued that the large number of board members might cause effective performance in connection with monitoring activities, and therefore, establishing different regulatory bodies in the firm along with high debt levels can help increasing firm's value. According to the results from previous studies, our second research hypothesis is defined as follows:

H_2: *there is a significant relationship between the number of board members and financial leverage.*

Duality of CEO-Chairman and financial leverage

When the CEO of the company is its chairman at the same time, this situation is usually referred to as the Duality of CEO-Chairman, in which the CEO has more potential discretion. In such situations, CEO may control the results of its business decisions, and underestimate the probability of failure (Wei et al., 2011). From a theoretical point of view, when CEO is the Chairman at the same time, conflict of interests will happen (Petra, 2005), and board's ability to monitor CEO will decrease. Combining the roles of CEO and chairman represents that there is not enough separation of controlling activities from monitoring activities of management (Fama & Jensen, 1983). Therefore, the separation of CEO from chairman can improve firm performance, and as a result, better financing and investing decisions will be made (Abor, 2007; Wellalage & Locke, 2012). This situation shows that, according to stewardship theory, CEO-Chairman duality can reduce communication conflicts in the firm and cause a sense of centralized decision-making. Accordingly, our third hypothesis is as follows:

H_3: *there is a significant relationship between CEO-Chairman duality and financial leverage*

Institutional ownership and the level of financial leverage

The existence of institutional owners, with high volumes of stockholdings and subsequent economy in gathering information, can be a good factor against agency costs derived from the separation of ownership from control. Large shareholders have incentives for monitoring the management of the firm, and therefore, they are expected to have more incentives to make decisions that maximize firm value (Jensen & Meckling, 1976). Al-Najjar and Taylor (2008) found that there is a negative relationship between institutional ownership and financial leverage of firms. Their results prove that the existence of institutional shareholders has an important impact on monitoring managers' performance, and therefore, alleviates agency costs. A study by Hussainey and Aljifri (2012) documented an inverse relationship between institutional ownership and the ratio debt to equity ratio. Accordingly, it can be stated that firms with higher institutional investors use less debt financing, which is according to Pecking order theory. On the other hand, Huson et al. (2006) found a positive relation between institutional ownership and debt ratio, and concluded that this relationship can be a result of easy access to different finance sources, such as loans or bonds. According to this notion, our fourth hypothesis is defined as follows:

H_4: *there is a significant relationship between institutional ownership and financial leverage*

Governmental ownership and financial leverage

Firms which government participates in their ownership have better access to various financing sources and higher chances to use loans with appropriate interest rates (Deesomsak et al. 2004; Ezeoha & Okafor 2009). Liu et al. (2011) in their study in China documented that State-Owned enterprises have higher financial leverage. Results from a study by Aljifri and Moustafa (2007) also proved the above findings by Liu et al. (2011).

Zuoping (2009) stated, on the other hand, that firms with governmental participation have relatively lower debt ratio, as compared to other firms, and therefore, they use more equity financing. Also, firms during the period of transferring from governmental ownership to private ownership (privatization) may tend to keep lower leverage levels (Mohamed & Khairy, 2016). According to this view, our fifth hypothesis is as follows:

H_5: *there is a significant relationship between governmental ownership and financial leverage*

Managerial ownership and financial leverage

Using less debt than optimal leverage level, owner-managers will lose their wealth in the firm, just like other investors (Arbor, 2008). Therefore, managerial ownership can provide managers with enough incentive to keep appropriate level of financial leverage (Berger et al., 1997). Denis and Mihov (2003) also documented this positive relation. Likewise, results found by Kim and Sorensen (1986) and Arko and Bokpin (2009) showed that firms with higher managerial ownership have higher financial leverage levels. On the other hand, Friend and Lang (1988) documented a negative relationship between the percentage of managerial ownership and financial leverage. Therefore, our sixth hypothesis is defined as follows:

H_6: *there is a significant relationship between managerial ownership and financial leverage.*

Methodology

This paper uses a semi-experimental approach to test correlation between variables. We tested our hypothesis using multivariate regression analysis. Also, the needed data for our variable measurement purposes were obtained from financial statements and accompanying notes, and management discussion and analysis reports on TSE official website.

Sample

Our population includes all firms listed on Tehran Stock Exchange (TSE). Our initial sample includes all active firms listed on TSE for the period from 2006 to 2014. For homogeneity purposes, we include all observations except for (1) firms listed on TSE after the beginning of the year 2006, (2) firms operating in Financial industries, due to the special nature of their operations and elements of their financial statements, (3) firms with a fiscal year ended dates other than 22nd March each year (common fiscal year-end in Iran), for the interest of homogeneity of our sample, and (4) firms with missing data. The final sample includes 1197 firm-year observations that involve 133 unique firms during the years 2006 to 2014.

Research models and variables

As described earlier, this paper investigates the impacts of board characteristics and ownership structure on financial leverage of firms listed on TSE. We used two proxies for financial leverage, namely, the ratio of total debts (TDA) and the ratio of long-term

debts (LTDA). For our hypothesis purposes we used the model proposed by Wen et al. (2002) with some modifications, as follows:

$$TDA = \beta_0 + \beta_1 BSIZE_{i,t} + \beta_2 NED_{i,t} + \beta_3 DUALITY_{i,t} + \beta_4 OPER_{i,t} + \beta_5 GOVSH_{i,t} + \beta_6 MANAGSH_{i,t} + \beta_7 PROF_{i,t} + \beta_8 GROW_{i,t} + \beta_9 FSIZE_{i,t} + \beta_{10} TANG_{i,t} \quad (1)$$

$$LTDA = \beta_0 + \beta_1 BSIZE_{i,t} + \beta_2 NED_{i,t} + \beta_3 DUALITY_{i,t} + \beta_4 OPER_{i,t} + \beta_5 GOVSH_{i,t} + \beta_6 MANAGSH_{i,t} + \beta_7 PROF_{i,t} + \beta_8 GROW_{i,t} + \beta_9 FSIZE_{i,t} + \beta_{10} TANG_{i,t} \quad (2)$$

Where,

TDA = representing total debt ratio, calculated as total debts divided by the book value of total assets

LTDA = representing long-term debt ratio, calculated as long-term debts divided by the book value of total assets

BSIZE = the number of board members

NED = the percentage of non-executive directors in board

DUALITY = a dummy variable which equals 1 if one person is in charge of CEO and Chairman at the same time, and 0 otherwise

MANGSH = the percentage of total shares owned by the board of directors

OPER = the percentage of total shares owned by institutional owners

GOVSH = the percentage of shares owned by government

SIZE = natural logarithm of the book value of total assets

PROF = the ratio of earnings before interest and taxes (EBIT) to the book value of total assets

GROW = the percentage of change in total sales/revenues from past year

TANG = the ratio of total fixed assets to the book value of total assets

Empirical results

Tests for determining the type of data

Before proceeding with regression analysis, we need to determine the type of data, and choose the appropriate method for regression estimation. In order to determine whether our data are either pooled or panel data, we used Limer's test (Chaw's test). Then we performed Hausman's test to determine whether our data represent fixed effects or random effects. Summary of results for these two tests are reflected in Table 1. As presented in Table 1, since Limer's F-statistic is significant for both regression models, and also considering statistical significance of Chi-square for Hausman test in both models, we estimated our regression models using panel data with fixed-effects method.

Table 1: Results from tests for determining the type of data

Model	**Chaw's test results**		**Hausman's test results**	
	F-statistic	Type of data	Chi-square	constants
Model(1)	5.109***	Panel	37.029***	Fixed-effects
Model(2)	7.147***	Panel	45.429***	Fixed-effects
***significance at 1% level				

Results from regression analysis

After determining the type of data used in our regression models, now we can choose the appropriate regression approach to run our models. Results from regression estimations are presented in Tables (2) and (3).

Table2: results from model

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.139	0.127	-1.101	0.272
NED	0.246	0.049	5.021***	0.000
BSIZE	0.028	0.012	2.262**	0.024
DUALITY	0.127	0.024	5.211***	0.000
OPER	0.614	0.097	6.343***	0.000
GOVSH	0.004	0.043	0.101	0.92
MANAGSH	-0.168	0.047	-3.538***	0.000
GROWT	0.024	0.024	1.016	0.31
TANG	-0.257	0.056	-4.555***	0.000
PROF	-0.721	0.068	-10.581***	0.000
FSIZE	0.018	0.007	2.786***	0.006
R^2	70%	F-statistic	15.17	
Adjusted R^2	65%	Prob(F-statistic)	0.000	
***, ** Represent 1 percent and 5 percent significance, respectively.				
This table shows the results of our basic regression model on the relationship between total debt ratio and board characteristics and ownership structure. The dependent				

variable is the ratio of total debts (TDA). The independent variables are the number of board members (BSIZE), the percentage of non-executive directors in board(NED), Duality (a dummy variable which equals 1 if one person is in charge of CEO and Chairman at the same time, and 0 otherwise),the percentage of total shares owned by the board of directors(MANGSH), the percentage of total shares owned by institutional owners (OPER),the percentage of shares owned by government(GOVSH), firm size (SIZE, the natural log of total assets), profitability (PROF, the ratio of earnings before interest and taxes (EBIT) to the book value of total assets(PROF),firm growth (GROW ,the percentage of change in total sales/revenues from past year, the ratio of total fixed assets to the book value of total assets(TANG)

Table 3: results from model 2

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.084	0.116	0.726	0.468
NED	0.211	0.045	4.706***	0.000
BSIZE	0.002	0.011	0.138	0.89
DUALITY	0.041	0.022	1.814	0.07
OPER	0.466	0.089	5.246***	0.000
GOVSH	-0.077	0.039	-1.987**	0.048
MANAGSH	-0.169	0.044	-3.881***	0.000
GROWT	0.008	0.022	0.387	0.699
TANG	-0.497	0.052	-9.619***	0.000
PROF	-0.575	0.062	-9.198***	0.000
FSIZE	0.023	0.006	3.791***	0.000
R^2	70%	F-statistic		15.04
Adjusted R^2	65%	Prob(F-statistic)		0.000
***, ** Represent 1 percent and 5 percent significance, respectively.				

Hypothesis-testing

The results from estimation of our two regression models are reflected in tables (2) and (3). In these two tables, positive (negative) coefficients show positive (negative) relationship between each of variables and financial leverage. Also, considering the fact that we used two proxies for financial leverage, each of hypotheses was tested two times (once measuring financial leverage as total debt ratio, and another time measuring financial leverage using long-term debt ratio). Results related to financial leverage as total debt ratio is presented in table (2), and results for model specification measuring financial leverage using long-term debt ratio is summarized in table (3).

First hypothesis

Our first hypothesis focuses on the relationship between non-executive directors and financial leverage. As shown in table (2), considering statistical significance of coefficient estimated for NED (t-statistic 5.020), with a positive amount of 0.245, it can be concluded that there is a significant and positive relationship between NED and

financial leverage (measured as total debt ratio). Alternatively, measuring financial leverage as long-term debt ratio, as shown in table (3), coefficient estimated for NED was statistically significant (t-statistic 4.706), with a positive amount of 0.211, NED has a positive and significant relationship with financial leverage. According to the mentioned findings, our first hypothesis is accepted at confidence level of 99 percent. This finding is consistent with evidence provided by Berger et al. (1997), Al-Najjar and Taylor (2008), Sheikh and Wang (2012).

Second hypothesis

Our second hypothesis states the relation between board size and financial leverage. According to figures presented in table (2), considering statistical significance of coefficient estimated for BSIZE (t-statistic 2,262), with a positive amount of 0.028, there is a significant and positive relationship between BSIZE and financial leverage (measured as total debt ratio). Therefore, our second hypothesis is accepted at confidence level of 95 percent. This finding is consistent with results found by Ganiyu and Abiodun (2012), Hussainey and Aljifri (2012), and Sheikh and Wang (2012).

Also, measuring financial leverage as long-term debt ratio, as shown in table (3), coefficient estimated for BSIZE was not significant at conventional levels of confidence (t-statistic 0.138). That is, no significant relationship was found between long-term debt ratio and board size.

Third hypothesis

Our third hypothesis focuses on the relationship between CEO-Chairman duality and financial leverage. According to table (2), considering statistical significance of coefficient estimated for DUALITY (t-statistic 5.211), with a positive amount of 0.127, it can be concluded that there is a significant and positive relationship between DUALITY and financial leverage (measured as total debt ratio). Alternatively, measuring financial leverage as long-term debt ratio, as shown in table (3), coefficient estimated for DUALITY was statistically significant (t-statistic 1.811), with a positive amount of 0.041, DUALITY has a positive and significant relationship with financial leverage. According to the theses findings, our third hypothesis is accepted at confidence level of 99 percent (90 percent for long-term debt ratio). This finding is consistent with evidence provided by Abor (2007), Wellalage and Locke (2012), Ganiyu and Abiodun (2012).

Fourth hypothesis

Our fourth hypothesis focuses on the relation between institutional ownership and financial leverage. According to figures presented in table (2), considering statistical significance of coefficient estimated for OPER (t-statistic 6.343), with a positive amount of 0.614, there is a significant and positive relationship between OPER and financial leverage (measured as total debt ratio). Furthermore, looking at figures in table (3), the coefficient estimated for OPER was significant (t-statistic= 5.246), with a positive amount of .465, stating a positive relationship between institutional ownership and long-term debt ratio (our second proxy for financial leverage). Therefore, our second

hypothesis is accepted at confidence level of 99 percent. This finding is consistent with results documented by Hussainey and Aljifri (2012), Huson et al (2006).

Fifth hypothesis

Our fifth hypothesis focuses on the relationship between governmental ownership and financial leverage. As shown in table (2), considering the fact that the coefficient estimated for GOVSH was not significant at any of conventional confidence levels (t-statistic 0.101), there is no significant relationship between governmental ownership and total debt ratio. However, measuring financial leverage as long-term debt ratio, as shown in table (3), coefficient estimated for GOVSH was statistically significant (t-statistic -1.987), with a negative amount of -0.077, GOVSH has a negative and significant relationship with financial leverage. As a result, our fifth hypothesis is accepted at confidence level of 95 percent. This finding is consistent with results from a study by Zuoping (2009).

Sixth hypothesis

Our last hypothesis predicts the relation between managerial ownership and financial leverage. According to figures presented in table (2), considering the significant and negative coefficient estimated for MANAGSH (t-statistic -3.537), amounting -0.168, there is a significant and negative relationship between MANAGSH and financial leverage (measured as total debt ratio). Alternatively, measuring financial leverage as long-term debt ratio, as shown in table (3), coefficient estimated for MANAGSH was negative and significant, as well, (t-statistic -3.881; Beta= -0.169). That is, there is a significant and negative relationship between long-term debt ratio and managerial ownership. Therefore, our sixth hypothesis is accepted at confidence level of 99 percent. This finding is consistent with results found by Sheikh and Wang (2012) and Friend and Lang (1988).

Conclusion

The purpose of this study is to empirically examine the relationship between some of corporate governance mechanisms (board characteristics and ownership structure) and financial leverage among firms listed on Tehran Stock Exchange (TSE). Our results, based on data from 80 firms listed on TSE during the period 2008 to 2014, led to acceptance of our all six hypotheses; in other words, our findings show that board characteristics and ownership structure play an important role in determining the level of financial leverage.

In more details, this study shows that there is a significant and positive relation between non-executive directors and financial leverage. This shows that, existence of non-executive directors in the board of directors alleviates agency costs (Fama & Jensen, 1983), and their role leads to better controlling and monitoring, as a result of which managers can raise funds at lower costs.

Our other findings revealed that there is a significant and positive relationship between board size and financial leverage (measured as total debt ratio).The high number of board

members is likely to improve the performance of the board in monitoring activities, and therefore, establishing different regulatory bodies in the firm along with high debt levels can help increasing firm's value (Ganiyu & Abiodun, 2012). Moreover, our findings showed that CEO-Chairman duality can lead to higher financial leverage levels. These show that, consistent with stewardship theory, CEO-Chairman duality can mitigate agency conflicts in the firm, and in turn, establish a sense of centralized decision making. This duality can improve firm performance and increase the quality of financing and capital structure decisions (Mohamed & Khairy, 2016).

With respect to ownership structure, our findings revealed a significant and positive relationship between institutional ownership and financial leverage; probably due to easier access to various financing sources. Also, we did not find any significant relation between governmental ownership and total debt ratio, while there is a significant negative relation between long-term debt ratio and governmental ownership. One possible explanation in this respect could be the fact that during the transition period from governmental ownership to private ownership (privatization) in Iran, firms showed lower tendency to use long-term debt-financing. We also found a negative relation between managerial ownership and financial leverage. Since debts have particular non-diversified risks (non-diversifiable) for individuals in the firm, as compared to outsiders, managers tend to choose lower debt levels (Friend & Lang, 1988). Alternatively, this negative relationship can be due to high interest rates of loans in Iran, as a result of which managers may prefer equity financing over debt financing.

Finally, we found negative relationships between intangible assets and profitability, and financial leverage; that is, profitable firms expose themselves to lower risks, and use less debt-financing. Also, there is a positive relation between firm size and financial leverage, stating bigger firms have more tendency and capacity to attract debts.

Altogether, our findings reveal the important impacts of corporate governance characteristics on capital structure of firms listed on TSE. These findings can be useful for both investors and regulators. Our findings can assist investors with respect to the board composition, which in turn, increases the quality of their monitoring; regulators also can use our results to identify and better understand effective monitoring tools.

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