LITERATURE REVIEW

2.0 INTRODUCTION

This chapter presents a theoretical grounding of the research and the review of literature. Both are detailed in various sections. The literature review has expounded on the theoretical perspectives that are believed to be important in a study pertinent to the relationship between corporate governance and capital structure. Several studies in or around the world have found that good corporate governance practices help in making efficient capital structure decisions. This implies that corporate governance practices may have an impact on capital structure decisions of the firms. However, it would be overstating the case to say that these studies are conclusive, because they have either failed to find a significant link or they find it otherwise.

2.1 THEORETICAL FRAMEWORK FOR CORPORATE GOVERNANCE

Corporate governance theory was first authored by Berle and Means in 1932. For the last few decades corporate governance has become a debatable issue among academic researchers, regulators and policy makers in context of firm’s capital structure. Capital structure decisions are one of the most significant decision areas in corporate finance that can affect the whole operations and functioning of the firms and therefore vital for the survival and overall sustainability of the firms. The capital structure of a firm is basically the financial framework which mainly consists of the debt capital and equity capital, raised from the capital market to finance the firm.
2.1.1 MAJOR THEORIES OF CORPORATE GOVERNANCE

The major theories related with corporate governance are:

1. Shareholder Theory
2. Stakeholder Theory
3. Stewardship Theory
4. Agency Theory

2.1.1.1 Shareholder Theory

Shareholder theory advocates shareholders’ wealth maximization approach. Shareholder theory states that shareholders invest their capital in the firm and expect to get higher return on it, in long term. Shareholders are recognized as real owners of the firm who invest their money in the business but, are the last claimants on company’s profit. After paying off all the liabilities they get the residual profits in the form of dividends while in case of loss they bear all the loss. As the profit increases their chances of getting return also increase. Most of the time they lack expertise to run and manage the business and are scattered widely all over the world, so management executives are hired and they work as the agents of the shareholders. Management takes decisions on behalf of shareholders and they are legally and morally responsible for making decisions that are expected to be in the shareholders’ interest. However, it is also expected from them that strategies to maximize profits should not be detrimental to the society and bounded within the business ethics.

Deakin (2005) stated that after the crash of the Wall Street in 1929, U.S. witnessed the Great Depression in the year 1930. Although this crash was not the only factor that led to it but was one of the factors that held to be responsible for the Great Depression. This paved the way for shareholder theory in U.S. This also led to debates over regulations of the companies. Shareholder theory came in the limelight after a fierce debate on this topic between Adolf Berle and Merrick Dodd. When Adolf Berle in 1931 wrote an article in Harvard Law Review in favor of shareholder theory, it was criticized and contradicted in the article written by Merrick Dodd in the same journal in 1932. Both views were
on the issue of the corporate objectives. Berle (1931) supported that the managers should act and take decisions that in the shareholders’ interest only while Dodd argued that managers have their obligations towards employees, customers and society also.

Milton Friedman originally proposed the shareholder theory in 1970. In one of his articles, published in New York Times, he emphasized on maximization of profits as a sole social responsibility of the business. This profit maximization objective is for the welfare of the shareholders, who provide finance for the business.

Mayer (1997) stated that considering the agency relation between shareholders and managers where shareholder(s) acts as principal(s) while manager(s) acts as agent(s). Managers run the business on behalf of shareholders after getting control of the company from the shareholders/owners as managers have expertise, skills and experience better than shareholders. They are expected to maximize shareholder’s wealth and being the contributors of the capital, their interests are ahead of any party who might affect or be affected by the business.

Macey (1991); Kraakman and Black (1996) found that Anglo-Saxon jurisdictions has long been dominant by the shareholder theory.

Hansmann and Kraakman (2001) stated that it was proclaimed that European stakeholder systems were converging to Anglo-Saxon systems of corporate governance. However, Keay (2011) argued that, soon after the proclamation, major corporates collapsed and scandals happened in both U.K. (i.e. HBOS Plc., Royal Bank of Scotland, Northern Rock) and U.S. (i.e. Enron Corporation, Freddie Mac, Lehmann Bros) which indicated that the system was not flawless.

With the evidence of major corporate misconducts that happened around the world including India like Enron, Worldcom, Satyam and Kingfisher etc. it can be concluded that the objective of earning more profits for shareholders compel the management to manipulate company’s financial statement, taking more debt or investment in risky projects. It can be said that maximizing profits for
shareholders only is a historic, narrow and traditional approach of the firm’s objective.

2.1.1.2 Stakeholder Theory

Stakeholder theory was proposed by Edward Freeman. This theory extended the social responsibility concept of the business from shareholders welfare to a broader concept of stakeholders’ welfare. Social responsibility is a responsibility towards anything that could be related to economy, law, ethics or even philanthropy. He used the word ‘value’ in place of ‘profits’ as business operates in society comprising of stakeholders, who are directly or indirectly affected by it. Gamble and Kelly (2001) stated that any person/group which can affect or be affected by the operations of a business are called stakeholder(s) of the business. It includes employees, customers, competitors, suppliers, creditors, government and the community. This theory seems to be heuristically stronger than shareholders theory. Scholars like Mills & Weinstein (2000); Greenwood (2001); Post et al. (2002); Ertuna (2005) supported stakeholder theory which advocates the interest of all stakeholders and is essential for the existence and sustainability of the firms.

Along with support it got, this theory was also criticized by many scholars on various grounds. Orts (1992) and Elaine (1996) argued that stakeholder theory is incompatible with good corporate governance in the same way it is incompatible with the business. Elaine (1996) argued that stakeholder theory overtly ignores that the accountability should be towards shareholders only. Stakeholder theory is based on the principle that corporations should be accountable to all the stakeholders including shareholders. He called it unworkable. If the corporations are accountable to everyone then its accountability will get diffused which in reality means, it is accountable to none. Key (1999) opined that stakeholder theory cannot be functionalized as it lacks specificity.
There are some companies around the world that have followed stakeholder theory as a part of their corporate social responsibility. Some companies have adopted this theory as they considered it ethical (accords to business ethics) while others to improve their goodwill. There are some companies that are criticized in U.K. as they are concealing their tax liability behind stakeholder theory and avoiding tax. This cannot be considered as illegal as they are just exploiting the loopholes of the tax system of U.K. in the name of CSR (Corporate Social Responsibility). Few names are Starbucks, Amazon, Google and Facebook.

2.1.1.3 Stewardship Theory

Stewardship theory was introduced by Donaldson and Davis in 1991. They opined that apart from motivation that is financial in nature there are other motivations that are non-financial or intangible in nature that could lessen the self-interest and opportunistic behavior of managers. This theory rejects the agency problem. Under the approach of stewardship on shareholder’s assets, the CEO inherently has the motivation for value maximization of the firm. Davis et al. (1997) stated that stewardship theory assumes that there are no inherent problems in the managerial motivation. It supposed that the CEOs believe that their own self-interest is not superior to firm’s interest and therefore they are always inclined towards decision making that are beneficial and effective for the firms.

The stewardship theorists argue that some characteristics of the internal corporate governance structure could affect the ability of the steward or CEO to perform his/her duties. Therefore, the objective of maximizing shareholders’ wealth can be achieved when the governance structure gives complete authority to the CEO over all the decisions of the firm. In this way supporter of the steward theory i.e. Donaldson et al. (1991) and Davis et al. (1997) suggest that CEO duality i.e. when the same person holds the position of both CEO and Chairman, provides unity of command and control to CEO thereby enhances the value of firm as his/her decisions would be final and never
be countermanded by any other person higher in position and authority i.e. chairman. Albrecht et al. (2004) believed that CEO duality provides CEO, a collective rather than individualistic approach and the role of board of directors, is to assists him/her rather than acting as a monitoring mechanism. This theory suggested that executive directors are effective enough to take decision for the firms and there is a less need of outside or independent directors on the board. Hence, it minimizes the cost of monitoring by not having independent directors who may negatively impact the decisions taken by the CEO, by making the procedure time taking. Like shareholder and stakeholder theory, this theory was also criticized by some scholars. The bases of criticism were about not giving importance to board independence while encouraging CEO duality. Contrary to that both board independence and CEO non-duality are widely accepted as international standard and norms for good corporate governance and encouraged by international regulatory bodies.

2.1.1.4 Agency Theory

A survey of the literatures demonstrated that agency theory is the most popular theoretical perspective in the area of corporate governance and showed that it has received much attention from researchers exploring issues relating to corporate governance and executive compensation. As a result, governments and regulatory bodies have been influenced by this perspective in developing their regulations, codes and principles. That is, agency theory is legally assumed to provide the most comprehensive theoretical explanation for the relationship between management and shareholders, along with proposed solutions for the agency problem.

Agency theory was introduced by Jensen and Meckling in 1976. This theory was based on economic theory. According to agency theory shareholders (principals) delegate the control of the business (as they are dispersed) to managers (agents) as presented in Figure 2.1.
Agents run the business and are expected to act in the best interest of principals but the agents may make decisions that are beneficial for them due to their self-interest. They argued that due to separation of ownership and control, agents might not always act in the best interests of the principals. This non-alignment of interests of both the principal(s) and agent(s) creates conflicts and leads to a problem known as agency problem (Figure 2.2).

Continuous and intensive researches throughout the world are conducted to explore the issue of agency problem.
Fama and Miller (1972); Jensen and Meckling (1976) stated that agency problem results in agency costs. Agency costs are incurred and managers must be monitored to make sure they do not misuse their power. It includes sum of the monitoring expenditures incurred by the principal, the bonding expenditures incurred by the agent and the residual costs. Bonding expenditures include both punishment and reward expenditures i.e. punishment given to the agent in case agent acts against the interests of the principals while the reward in case of aligned interest between the two.

Eisenhardt, (1989) stated that as attitude towards risk of both the principals (shareholders) and agents (managers) are diverging, it creates problems. Principal is always inclined towards decision that has less risk while agent is interested in taking more risk. Shareholders delegate the responsibility of maximizing the shareholder’s value to managers, but, in case the event of conflict of interests arises between them, it results into rise in the agency costs.

Jensen (1986) argued that the use of debt helps in alleviating the agency problems of the firm as it involves fixed interest payments to the creditors. A proper vigilance by corporate governance norms can compel the management to take decisions which mitigate the conflict of interests between shareholders and managers.

There is a large information gap between shareholders and managers due to information asymmetry which may attract the interest of the managers in maximizing their own personal wealth at the cost of shareholders money. They pointed out that the use of debt can decrease the need of manager to look for outside stock capital and therefore help diminishing the shareholders-managers agency problem.

Hasan & Butt (2009) stated in their study that corporate finance theories and agency theory suggest that costs due to a conflict of interest are one of the determinants of capital structure and these costs can be minimized by adopting good governance practices. Hence corporate governance may help in mitigating
agency problems by forming ‘rules’ to deal with issues and protection of stakeholders and shareholders. Thus, the agency theory postulates the potential relationship between capital structure and corporate governance structure through the connection of agency costs.

Renton (1994) explained that ultimate internal authority within a company lie with the boards of directors.

Banks (2004) stated that boards of directors of the company are entrusted and given authority to make decisions that may affect the well-being of investors’ capital, employees’ safety, economic health of the communities, and executive power and incentives.

Saad (2010) examined 126 Malaysian publically listed companies from the year 1998 to 2006 using multiple regression analysis. His sample included industries from consumer products, industrial products, trading/services, and plantations. He concluded that board of directors is considered as one of the elements of the corporate governance which provides an efficient regulatory and controlling mechanism to mitigate the agency problems.

2.2 THEORETICAL FRAMEWORK FOR CAPITAL STRUCTURE

Capital structure decisions refer to decisions made about financing sources in which company leverage is represented. Firm’s debt/equity ratio or leverage gives insight related to the risks with a company for its potential investors. Shapiro and Balbirer (2000) explained capital structure of the company as the combination of debt and equity capital employed to fund the purchase of its asset. Saad (2010) described capital structure as the way a company finances its assets through a mix of equity and debt.

Optimal capital structure is one that maximizes value of the firm by reducing its cost of capital. Modigliani & Miller (1958) attempted to prove the irrelevance of optimal capital structure under perfect market conditions in their work but later
in 1963, they themselves found its relevance after the inclusion of taxes and bankruptcy cost. There are a number of researches done in the past that support its relevance. Decisions related to financing are the crucial and most fundamental issues that managers of firms have to consider.

Song (2005) stated that firms’ assets provide cash flow and that form their basic capital resources. Whenever firms need fund they issue equity share, preference share, and debt or hybrid securities, to finance its assets. These securities form capital structure. However, there are a number of theories that have been developed to find what combination forms the best capital structure.

Gill, Biger, and Mathur (2012) defined the optimal capital structure as the financing combination which consists of debt along with equity capital. However, this inclusion of debt is not 100% debt. It includes equity capital also and forms the ‘best debt to equity ratio’ for the firm that minimizes the cost of capital, maximizes the value of firm and decreases the chances of bankruptcy.

Cuong and Canh (2012) found that optimal debt ratio should not be more than 59.27% because a higher debt ratio negatively impacts firm value. Their study measured the optimum capital structure of seafood processing enterprises listed on two of Vietnam’s stock exchange markets during the period 2005-2010.

Heng et al. (2012) examined the relationship between board characteristics and capital structure on 75 corporations listed on Koalalampour stock exchange in Malaysia during the period 2005-2009. According to them capital structure is one of the three financial decisions i.e. the investment decision, the financing decision and dividend decision, for improving upon the value of the firms. They underlined the importance of financing decision by explaining its direct relation to business continuity and its impact on the ability of the firm to deal with its competitors.

Theoretically, financing through debt is the cheapest source of finance (lowest cost of capital) due to the implicit tax advantages. Though, not often its inclusion in high percentage forms an optimal capital structure as the financial
risk and the risk of bankruptcy for the company generally increases with the increase in the debt. A company with optimal capital structure indicates that the leverage taken by it is at prudent level. Therefore, board of directors must do their best to select the capital structure that lead to both value maximization and stakeholders’ welfare. Within the many factors that affect the capital structure, researchers have suggested corporate governance as an effective issue to affect the debt proportion in a company. In compliance to corporate governance code of best practices, board of directors serves a good financing decision to the company.

Gompers et al. (2003) suggested that good corporate governance possibly impact company’s strategic decisions significantly. Board of directors takes these strategic decisions and a capital structure decision is one of those decisions. The board of directors is the top authority of a company who are responsible for practicing good corporate governance. Good corporate governance will help in proper and efficient practice to manage the business. This will further help in the reduced incidences of bankruptcy, corporate failures, weak internal control system, poor corporate structure etc. Thus, board of director’s features such as board size, presence of independent directors and CEO duality may have influence on the firm’s capital structure decisions.

2.2.1 MAJOR THEORIES OF CAPITAL STRUCTURE

Abor and Biekpe (2005) stated that capital structure decision is essential due to the necessity of maximizing returns to stakeholders and to enhance organization’s capability dealing with its competitors.

There are several theories of capital structure that can be found in the literature. However, this study examined four major theories:

1. The Modigliani and Miller Theory
2. Trade off Theory
3. Pecking Order Theory
4. Market Timing Theory
2.2.1.1 Modigliani and Miller Theory

Franco Modigliani and Merton Miller popularly known as Modigliani and Miller proposed the first capital structure theory in 1958. Their first proposition states that there is no optimal capital structure exists in a perfect market structure. Perfect market is market structure where there is no transaction costs; no taxes; homogenous expectations of the investors; information is freely available to all (information symmetry). In a perfect market, all combinations are equal and therefore, overall value of the firm is not affected by capital structure i.e. whether a firm raised its fund through debt or equity or a mix of debt and equity. Real assets determine the value of firm in perfect market structure. Baker and Wurgler (2002) stated that under Modigliani and Miller assumption there is no gain to a firm to switch between debt and equity. Brealey et al. (2008) opined that selection of long-term versus short-term debt should have no effect on the overall value of the firm. Hence, capital structure decisions do not affect the investment, borrowing, and operating policies of the firm. Modigliani and Miller proposition-II states return on equity increases in proportion to the debt-equity ratio and any rise in expected rate of return is exactly offset by an increase in financial risk. Huang & Song, (2006) stated that Modigliani and Miller propositions are based under the assumption of a perfect capital market and therefore debt policy has no effect on value of firm; however in reality there is no perfect market. All businesses operate in imperfect market. Also, Modigliani and Miller theory itself not able to explain the fact that debt ratios vary regularly from industry to industry. In spite of the limitations and contradictions of Modigliani and Miller theory, it is given due importance because it is the grounding theory that shifted the focus of researchers on capital structure of the firm.

Later, in 1963, Modigliani and Miller modified their own model and included company tax which was further extended by Miller in 1977 as he included personal tax in the model. The most important advantage of using debt as a source of financing is the ‘tax shield’.
2.2.1.2 Trade-Off Theory

The debate on the irrelevance theorem of Modigliani-Miller gave ground to the trade-off theory. This theory was suggested by Myers in 1984.

Jensen and Meckling (1976) stated that inclusion of debt in the capital structure can create conflicts of interest. These conflicts of interest may lead to agency costs either in the form of agency costs of debt or agency costs of equity. Agency costs of debt are the conflicts of interest between shareholders and bondholders while agency costs of equity are the conflicts of interest between shareholders and managers when the incentives of the shareholders (i.e. maximization of the value of the firm) and management (i.e. job securities, investment decisions to maximize their own personal wealth etc.) do not coincide.

Fama and French (2002) referred in their study that agency costs cause firms to identify their optimal leverage by weighing the costs and benefits of an additional dollar of debt.

Burgman (1996); Chen et al. (1997) Berk et al. (2010) stated in their respective studies that the trade-off theory suggested a trade-off between bankruptcy costs and tax advantages of debt. It described that the optimal capital structure for the firm is that financing mix at which the value of a firm maximizes. Trade off theory suggested that management set a target leverage ratio and then gradually try to achieve it to reach optimum capital structure.

De Wet (2006) has demonstrated that this target leverage ratio is influenced by three factors:

- Tax
- Financial distress costs and
- Agency costs
De Wet (2006) and Eriotis et al. (2007) stated in their respective studies that the interest payments on debt are tax-deductible for a firm which is referred as tax shield that allows a firm to pay lower taxes when using debt capital. This means that by including a large portion of debt in the capital structure helps in lowering the real after-tax cost of capital, which ultimately enhance the value of the firm. However, the tax advantage is up to certain level. Inclusion of debt in the capital structure after that level increases the legal interest liability. In case interest rate increases it will consume all its profits in paying off interest to the creditors. It also causes financial distress as the firm may not have sufficient funds to run its day to day functioning. There are possibilities that firms earnings are not enough to meet out all its obligations resulting in increased financial distress costs, which may further increases the chances of bankruptcy and decreases the overall firm value.

Bauer (2004) described the components of financial distress costs. It consists of two costs:

- Direct financial distress costs consist of bankruptcy costs which usually include legal and administrative fees.

- Indirect costs consist of the expenses or economic losses resulting from the event of bankruptcy.

Vasiliou et al. (2003) opined that to prevent conflicts of interest, firms need to employ independent directors to monitor and control the managers. This increases the agency costs.

Sibilkov (2009) argued that the firms choose the optimal capital structure (i.e. balance between the costs of debt and the benefits of debt) that minimizes their total agency costs.

Brealey, Myers, & Allen (2008) opined that high target leverage ratios should be preferred by the companies which have safe, tangible assets and plenty of taxable incomes to shield while equity financing should be opted by companies
with risky, intangible assets. Therefore static trade-off theory suggests that different firms should set their own target ratios that maximize value of the firm.

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<th>Theoretical optimum capital structure is achieved when,</th>
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<td>Present value of tax savings = Increase in the present value of costs of distress (due to further borrowing)</td>
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2.2.1.3 Pecking Order Theory

The pecking order theory was first developed by Donaldson in 1961. He investigated and found that, when a firm requires funds its management strongly prefers retained earnings. Donaldson was trying to observe the financing behavior of the managers. In an attempt to find a theoretical base for Donaldson results Myer’s in 1984 argued that traditional capital structure theories failed to explain the actual financing behavior. He extended the pecking order theory of Donaldson and presented a different perspective to determine the optimal capital structure. According to this theory firms should only consider equity if debt capacity is reached and retained earnings are exhausted. This theory has a different perspective as compared to other theory of financing. This theory assumes that managers have more information regarding the company than outside investors. Managers’ knowledge pertinent to risk, investment avenues and values lead to asymmetric information.

Fama and French (2002) supported the pecking order model that more profitable firms are less levered.

Singh et al. (2003) stated that in a situation of asymmetric information debt is better choice than equity. Pecking order theory does not consider optimal capital structure therefore it assumes the advantage of interest tax shields and financial distress as second order.

Smart et al. (2004) argued that as there is no concept of optimal capital structure in pecking order theory, firms try to minimize associated costs instead of selecting optimal debt to equity ratio.
La Rocca et al. (2007) concluded from their results that firms prefer retained earnings or internal financing over external financing. This indicated that the order of raising funds is first the use of retained earnings, then new debt, then risky or convertible debt and preference shares and finally the issue of new equity.

Brealey, Myers, and Allen (2008) argued that companies try to issue new shares when their share price is either fairly priced or overpriced. As investors are well informed, when the companies announce issue of their shares investors don’t turned up and this lead to the fall in share price. Therefore, whenever companies need funds they prefer debt over underpriced shares. Companies try to time issues when shares are fairly priced or overpriced. This indicates a pecking order, in which investment is first funded with retained earnings then by issue of new debt and lastly with new equity shares.

Morri et al. (2009) opined that pecking theory has no well-defined optimal target debt ratio because the current leverage of a firm reflects its cumulative requirements of external financing.

Adesola (2009) opined that due to information asymmetry firms may prefer debt over equity financing.

Shyam-Sunder and Myers (1999) concluded in their study that the pecking-order theory is an important theory that helps to explain corporate leverage as it captures larger variations in actual debt ratios than the trade-off theory. However, Frank and Goyal (2003) contradicted that pecking-order theory cannot explain financing behavior of small high-growth firms since they have high level of information asymmetry.

2.2.1.4 Market Timing Theory

Market Timing Theory is a part of behavioral finance. In 2002, Baker and Wurgler argued that in an inefficient market, financial managers are more informed than investors. Managers exploit this condition and take an advantage
by issuing shares at high price while they repurchase when share price falls. This theory is contrast to the trade-off and pecking order theories. Baker and Wurgler documented that market timing has a significant effects on capital structure as leverage of firms is negatively associated with their historical performance.

Huang and Ritter (2004) observed publicly traded U.S. firms in their study and identified that a large proportion of their funding requirements, is financed through the external shares when the expected equity risk premium is low.

2.3 EMPIRICAL BACKGROUND

The extant literature identified and included the main characteristics of corporate governance in the study. These characteristics of corporate governance are related to board characteristics i.e. board size, board independence, and CEO duality. The researcher chooses to believe that when the corporate governance gets better, the choice of financing mix in the capital structure improves, which ultimately lead to the shareholders’ wealth maximization. This is because of corporate governance which is designed in such a way that intends to prevent the managers to work unethically. Abbott & Parker (2000) gave the reason that when corporate governance gets better, the capital structure contains less bankruptcy costs and that is safer for the shareholders capital. Bankruptcy costs are detrimental for the objective of shareholders’ wealth maximization; this signifies the importance of the capital structure choice. Bankruptcy costs can be minimized by having less debt in the capital structure as debt or leverage is a representation of bankruptcy risk.

Awoyemi (2009) opined that the investors are losing their trust in the capital market due to financial scandals around the world. There is a need to enhance the efficacy of existing corporate governance practices in promoting transparency and accountability.

Pae and Choi (2011) stated that the effects of agency problem could lead to corporate misconducts and become detrimental to the whole economy. It is
evident from some major corporate failures and global economic crisis of 2008 that estimating the impact of implementation of corporate governance norms on company leverage ratios is necessary.

Empirical evidences show that businesses with superior governance practices generate more profits, higher returns on equity and provide larger dividends. Broad corporate financial decisions i.e. decisions pertaining to financing or capital structure, investment and dividend policies are made by the corporates’ management committee or at the level of board. All three financial decisions are interlinked. Board of directors is the highest body of a company that is responsible for managing the firm and its operation. In compliance with corporate governance code of best practices, board of directors serves an efficient financing decision to the company. It plays a vital role in strategic decisions related to capital structure. Different corporate governance variables have been employed in this thesis. These variables were presented by prior studies as effective factors in mitigating agency problems.

Before investing in a business, investors make sure themselves that their funds will be invested safely and that business is financially sound enough to provide them their desired higher returns in future. Researchers around the world tested the relationships empirically to analyze whether corporate governance variables influence a firm’s capital structure decision and abating agency problems that persists in almost all the firms. Corporate governance provides guidelines related to board size, board compositions, CEO duality, audit, board meetings etc. On the basis of previous empirical work, board size; board independence; and the duality of leadership seem to be the key variables, mobilized by researchers to characterize the board of a company. Along with this, studies that are related with profitability and size of the firm affecting capital structure decisions are also analyzed.

- Board size and Capital Structure
- Board Independence and Capital Structure
- CEO Duality and Capital Structure
Evidence from prior literatures like Friend and Lang (1988); Berger et al. (1997); Crutchley et al. (1999); Wen et al. (2002); and Abor (2007) concluded that corporate governance influences capital structure decisions of firm. Therefore, corporate governance has been identified as one of the contributing factors for firm’s financing decisions which in the long run may have an impact on the financial condition and performance of a firm.

Najjar & Hussainey (2011) found preliminary evidence in their study on UK listed firms that corporate governance characteristics such as board size and board independence are the main drivers of the firms’ capital structure.

Empirically evidence on the relationship between corporate governance and capital structure appear to be mixed or varied or heterogeneous and inconclusive.

2.3.1 Board Size and Capital Structure

Liptons and Losch (1992) and Jensen (1993) in their theoretical articles opined that board size is one of the important determinants of corporate governance effectiveness.

Empirical evidences related to capital structure and board size are mixed. On one side, there are studies that support positive relationship between board size and leverage (debt) while on other side there are studies that support negative relationship. Studies in which researchers have supported positive relationship are:

Pfeffer and Salancick (1978) identified the existence of significant positive relationship between board size and capital structure. Large boards pursue higher leverage to raise company value.

Marsh (1982) found a significant positive relationship between board size and capital structure.
Friend and Lang (1988) found large boards include high level of debt in their capital structure. It indicated that as the number of board of directors increases in the firm, chanced for inclusion of debt in capital structure also increases. Hence, large board size is associated with higher proportion of debt.

Jensen (1986) argued that firms with large boards have high leverage or debt ratio as compared to small boards. This may be attributed to the difficulty of larger board in arriving at a consensus in decision which can ultimately affect the quality of corporate governance and translated into higher financial leverage levels.

Lipton and Lorsch (1992) proclaimed that large boards have more debt as compared to small boards, as conflicts and disagreements can arise among the board members and therefore they raise funds by taking more debt.

Wen et al. (2002) found preliminary evidence in their study on Chinese listed firms and concluded a positive but insignificant relationship between corporate governance and capital structure decisions. Large boards follow a policy of taking higher level of leverage to enhance firm value while managers tend to take lower debt when they face stronger corporate governance from the board.

Coles et al. (2008) found a positive relationship between board size and debt ratio in context of US. Firms with high leverage (debt ratio) may have greater advising requirements which are fulfilled by large board size.

Bopkin and Arco (2009) found significant positive relationship between board size and capital structure of a firm.

Hussainey and Al-Nodel (2009) found a positive relationship between board size and capital structure. They argued that large boards follow a policy of higher levels of leverage to attain the objective of value maximization especially when these are entrenched due to greater monitoring by regulatory authorities.

Ganiyu and Abiodun (2012) observed a positive relationship between board size and leverage for the companies under survey in the food and beverage industry
in Nigeria. They suggested that large boards are likely to practice effective monitoring due to the sufficient numbers of directors and opt for high debt policy to improve the value of the company. Also, due to large number of members on the board, conflicts in decision making arise which may make the corporate governance system weak and thereby resulting in higher leverage.

On the other side, there are another group of researchers who explored evidences about the negative relationship between board size and capital structure. They found that firms with large board size (board of directors) have low leverage (D/E) levels and vice versa.

Mehran (1992) observed significant negative relationship between board size and debt equity ratio as a measure of capital structure.

Hart (1995) investigated and found a significant negative relationship between board size and capital structure.

Berger et al. (1997) argued in their study on U.S. firms that a larger board size leads to strong pressure in the board room to pursue lower leverage as a way of enhancing firm performance hence board size has significant negative impact on capital structure. However, the correlation between the two shows significant positive association.

Anderson (2004) examined that creditors of firms generally believe that larger board has effective monitoring processes and they raise fund using debt which makes it cost effective.

Abor and Bikpie (2007) in their study which was based on 22 firms listed on the Ghana Stock Exchange (GSE) during 1998-2003 to explore the effect of corporate governance on the capital structure in Ghana (West Africa). They found a significant negative relationship between board size and capital structure. The size of board is found negatively related with debt to equity ratio indicating larger boards may exert pressure on managers to follow low debt levels and thereby, enhances the firm performance.
Jiraporn and Liu (2008) showed that the companies with staggered board have comparatively low leveraged level than other boards.

Hassan and Butt (2009) examined the relationship between corporate governance and capital structure on 58 randomly selected non-financial listed companies of Pakistan during the period 2002 to 2005. They used multivariate regression analysis under fixed effect model to reveal that board size and managerial shareholding is significantly negatively correlated with debt to equity ratio.

Bodaghi and Ahmadpour (2010) examined the data from 50 Iranian firms listed at Tehran Stock Exchange (TSE). They found a negative relationship between board size and debt to equity ratio.

Mahdi et al. (2011) found a negative relationship between board size and leverage.

Vakilifard et al. (2011) investigated the data of Iranian firms listed at Tehran Stock Exchange (TSE) over the period 2005-2010. They found a negative relationship between board size and leverage.

Heng et al. (2012) studied the relationship between board characteristics and capital structure on 75 corporations listed on koalalampour stock exchange in Malaysia during the period 2005-2009. The results of the study revealed a negative relation between the board size and leverage (represented by debt to asset ratio).

Ranti (2013) provided evidence of a significant negative relationship between board size and the capital structure of select listed firms in Nigeria (West Africa).

Precious Angelo Brenni. (2014) examined 26 real estate companies listed on London Stock Exchange during 2000 to 2009 using panel data regression. He documented a significant negative relation between board size and leverage. This indicated that firms with larger board sizes employ less leverage.
Aziz et al. (2013) observed no remarkable results from the firms in Pakistan as expected. This indicated that lack of implication of corporate governance is worst affecting the capital structure.

Uwigbe (2013) examined the impact of board size on capital structure amongst 40 randomly selected firms listed on the Nigeria stock exchange. He observed a significant negative relationship between board size and the capital structure.

Wiwattanakantang (1999); Al-Najjar and Hussainey (2009a); Priya and Nimalathasan (2013); Kajanthiran (2012); Peiris and Fernando (2013); Ajanthan (2013); Achchuthan et al. (2013); and Velnamphy and Nimalathasan (2013), found in their respected studies that board size has insignificant impact on capital structure decision of non-financial companies.

2.3.2 Board Independence and Capital Structure

Board Independence is one of the keystones of modern corporate governance. A board is more independent if it has more outside directors i.e. Independent/Non-Executive Director (NED). They are essential part of modern corporate governance mechanisms. According to the report on company law of India, independent director should mean a Non-Executive Director (NED) of the company. Literatures suggest all independent directors are NEDs but all NEDs are not independent directors. Presence of independent directors on a company’s board provides confidence to the creditors that company is being monitored effectively. In future, if the company requires funds it helps it to raise long term funds easily through debt. Independent directors have better knowledge, expertise, vision and freedom to take effective decisions than inside managers. Their presence is expected to provide close monitoring and take proper actions regarding the implementation of corporate governance regulations. El Gaied and Rachdi (2009) stated that the independent directors have no connection or contractual relationship with company as they are neither shareholders nor having family relationships with founder/Chairman/CEO.
The relationship between presence of Independent Directors (IDs) and capital structure has been studied by few researchers but empirical evidences in this regard are mixed. Studies in which researchers have found support for the existence of positive relationship between board independence and capital structure are:

Pfeffer and Salancick (1978) emphasized in their study that independent directors play a significant role in enhancing the image of the company for external stakeholders which makes it easier to raise funds from them and thereby help in the reduction of risk and uncertainty. They concluded a positive relationship between board independence and leverage in their study. This implies that large number of Non-Executive Directors (NED) on board led to increase in the debt level (leverage).

Fama (1980) documented in his study that Non-Executive Directors may act as “professional referees” to ensure that, competition among insiders encourages actions that are consistent with shareholder wealth maximization and concluded that companies that have relatively more external directors are involved in taking high leverage.

Jensen (1986) found a positive relationship between board independence and leverage.

Grossman and Hart (1986) found a positive relationship between board independence and leverage.

Berger et al. (1997) indicated that companies with higher debt level have relatively more non-executive directors as compared to companies having less proportion of non-executive directors. According to Berger et al. leverage is significantly lower when a firm has a low fraction of outside directors (non-executive directors). Boards with more outside directors monitor CEOs more actively, causing those managers to adopt capital structure with more leverage.
Abor (2007) found a positive correlation between board independence and leverage.

Abor and Biækpe (2007) examined a positive relationship between board independence and debt ratio.

Heng et al. (2012) studied the relationship between board characteristics and capital structure on 75 corporations listed on koalalampour stock exchange in Malaysia during the period 2005-2009. Their study showed that the presence of independent non-executive directors on the board has significant positive correlation respectively with debt to asset ratio.

Studies in which researchers have found support for the existence of negative relationship between board independence and capital structure are:

Wen et al. (2002) found preliminary evidence in their study on Chinese listed firms and concluded the existence of a significant and negative relationship between board independence and leverage level. They believed that Non-Executive Directors (NEDs) monitor the managers more efficiently and effectively that compel managers to minimize the inclusion of debt for enhancing the firm performance. Therefore, presence of non-executive directors in high proportion on the board helps to reduce the agency cost.

Anderson et al. (2004) concluded a negative correlation between board independence and leverage.

Brennan and McDermott (2004) found a negative relationship between board independence and leverage (debt ratio).

Matolcsy et al. (2004) observed sample of 306 firms listed on the Australian Securities Exchange and found a negative relationship between board independence and leverage (debt ratio).

Peasnell et al. (2006) found a negative relationship between board independence and leverage (debt ratio).
Studies in which researchers have found no significant relationship between board independence and capital structure are:

Bopkin and Arco (2009) found a positive but no significant relationship between board independence and debt ratio.

Kuo et al. (2012) observed in their study that independent directors of firms are inclined towards low debt level. This indicated a negative relationship between board independence and leverage.

Precious Angelo Brenni. (2014) examined 26 real estate companies listed on London Stock Exchange during 2000 to 2009 using panel data regression. He found no significant relationship between board independence and leverage.

Priya and Nimalathasan (2013); Kajanthiran (2012); Peiris and Fernando (2013); Ajanthan (2013); Achchuthan et al. (2013); and Velnamphy and Nimalathasan (2013) found in their respective studies that board independence has no significant impact on capital structure decision of non-financial companies.

2.3.3 CEO Duality and Capital Structure

CEO duality is a situation where the CEO is also the chairman of the board hence it can be assumed that it influences the financing decision of the firm. Usually CEO has the responsibilities to manage the activities of the companies and chairman has the responsibility to deal with the activities of the board. CEO duality is one of the important characteristics of corporate governance (CG). Many literatures suggest that if a person holds both the position i.e. chief executive officer and chairman, then it may create agency problems. Higher level of control by CEOs may involve them in opportunistic behavior and can lead to low leverage under entrenchment hypothesis. Firms can either have one-tier or two-tier structure. CEO duality is a part of one tier structure where monitoring and control rights are vested in a single individual whereas CEO non-duality is a part of two-tier structure where both the positions are held by
two different persons. Agency theory argued that that CEO and chairman of the board should be separate entities in order to maximize shareholders’ interest. Williamson (1985) suggested that CEO duality advocates stewardship theory which indicates that when CEO and chairman, are the same person, it maximizes the shareholders’ wealth and facilitates the company’s decisions.

Empirical evidences related to CEO duality and capital structure are mixed. Studies in which researchers have found support for the existence of positive relationship between CEO duality and capital structure are:

Vakilifard et al. (2011) investigated the data of Iranian firms listed at Tehran Stock Exchange (TSE), over the period 2005-2010. They found a positive relationship between CEO duality and leverage.

Locke and Wellalage (2012) found a significant positive relationship between CEO duality and capital structure in their study. They conducted their study on 113 Sri Lankan companies during the year 2006 to 2010.

Wellalage and Locke (2012) examined capital structure choices of corporate firms in New Zealand and observed a positive relationship between CEO duality and debt.

Mokarami et al. (2012) analyzed firms in Iran and found a positive significant correlation between CEO duality and debt ratio indicating that firms with CEO duality include more debt in their capital. They suggested that CEO duality supports stewardship theory due to which there is decrease in communication conflicts and presence of clear sense of centralized decision making.

Fama and Jensen (1983) discussed in their research that there should be separate decision management and decision control functions in a firm. Presence of CEO duality leads to agency problems which directly affect the capital structure decisions of the company and increases the debt level of the company.
Hart (1995) observed in his study that CEO duality tends to employ high proportion of debt and found a positive relationship between the CEO duality and leverage.

Abor and Biekpe (2007) revealed that listed companies employ high debt with CEO duality. Their study found an evidence of significant positive relationship between gearing levels and CEO duality.

Nazir et al. (2012) and Gill et al. (2012) found positive relation between CEO duality and leverage.

Faleye (2004) revealed that uncertain environment, high managerial ownership and small board size of Sri Lanka made the firms more likely to have CEO duality.

Olobukuold Ranti (2013) observed select firms listed on Nigeria Stock Exchange in Nigeria (West Africa) during 2006-2011 and found a significant positive relationship between CEO duality and the capital structure.

Heng et al. (2012) examined the relationship between board characteristics and capital structure on 75 corporations listed on koalalampour stock exchange in Malaysia during the period 2005-2009. They found a significant positive relationship between CEO duality and capital structure.

Emamgholipour et al. (2013) investigated a sample of 665 listed companies in Tehran Stock Exchange for the period 2006-2010 to test the effect of CEO duality on the capital structure. Their results suggested a significant and positive relationship between the CEO duality and capital structure of companies.

Studies in which researchers have found support for the existence of negative relationship between CEO duality and capital structure are:

Berger et al (1997) examined panel of 434 firms between 1984 and 1991. They observed the associations between managerial entrenchment and firm’s capital structure. Entrenchment is defined as the extent to which managers fail to
experience discipline from the full range of corporate governance and control mechanisms, including monitoring by the board, the threat of dismissal or takeover, and stock or compensation based performance incentives and entrenched managers are those who have discretion over their firms' leverage choices. They observed that firms with entrenched CEOs avoid debt. In a cross-sectional analysis, they found that leverage levels are lower when CEOs do not face pressure from either ownership and compensation incentives or active monitoring.


Ganiyu and Abiodun (2012) observed a negative correlation between CEO duality and debt equity ratio for the companies under survey in the food and beverage industry in Nigeria.

Studies in which researchers have found no significant relationship between CEO duality and capital structure are:

Fosberg (2004) opined that firms with CEO non-duality generally have higher debt level leverage. He found negative but is not statistically significant relationship between CEO duality and leverage. According to Forberg, firms with CEO duality showed less dependency on debt as they face less information asymmetry problems.

Bokpin and Arko (2009) observed listed companies in the Ghana Stock Exchange to explore the effect of ownership structure and corporate governance on the capital structure decisions. Study consisted of 138 companies as sample for the time period of 2002-2007. The obtained result showed that there is no significant relationship between CEO duality and capital structure.
Bodaghi and Ahmadpour (2010) examined the data of 50 Iranian firms listed at Tehran Stock Exchange. They found that CEO duality has no significant impact on corporate financing decisions.

Saad (2010) examined 126 Malaysian publically listed companies from 1998 to 2006 using multiple regression analysis. His sample included industries from consumer products, industrial products, trading/services, and plantations. He found no significant relationship between CEO duality and capital structure in his study.

Precious Angelo Brenni (2014) examined 26 real estate companies listed on London Stock Exchange during the year 2000 to 2009 using panel data regression. He found no significant relationship between CEO duality and leverage.

Priya and Nimalathasan (2013); Kajanthiran (2012); Peiris and Fernando (2013); Ajanthan (2013); Achchuthan et al. (2013); and Velnamphy and Nimalathasan (2013), found in their respective studies that CEO duality has insignificant impact on capital structure decision of non-financial companies.

### 2.3.4 Profitability and Capital Structure

Black et al. (2006) states that Return on Assets (ROA) is one of the indicators of the profitability. ROA ratio is calculated by using net income and total assets. It reflects the ability of a company and efficiency of management, to effectively utilize its total assets to generate profits. It shows a unit change of earning derived from each unit of assets used.

Empirical evidences related to profitability and capital structure are mixed.

Wippern (1966) studied the relationship between financial leverage and value of firm of some industries and found a positive relationship between profitability and debt.
Abor (2005) studied some of the Ghana stock exchange listed firms and found that there is a positive relationship between Return on Equity and short-term debt to total assets.

Gill, et al. (2011) tried to extend Abor (2005) study by examining a sample of 272 services and manufacturing firms listed on New York. They found that there is a positive relation profitability and between debt.

Hovey (2010) investigated Chinese companies for the time period 1999-2005 and concluded a significant and negative relationship between profitability (Return on Assets) and leverage.

Holz (2002); Sarkar and Zapatero (2003); Dessi and Robertson (2003); Baum et al. (2006); Margrates and Psillaki (2010) evidenced a positive relationship between profitability and debt in their respective studies.

Baysinger and Butler (1985); Bopkin and Arco (2009) identified profitability as a significant determinant of capital structure of firm and return on assets (ROA) is the most commonly used accounting-based measures.

Titman and Wessel (1988) evidenced that profitability has negatively correlated with capital structure and their study also witnessed that small firms are mostly dependent on short term financing.

Barton et al. (1989) stated that under the condition of ceteris paribus firms with high profit rates have relatively lower debt ratio as these firms’ internal funds or retained earnings are sufficient enough to fulfill the funding needs.

Rajan & Zingalas (1995) confirmed a significant and negative correlation between profitability and leverage in their study.

Myers and Majluf (1984) indicated that firms that generate profits generally have low debt as these firms prefer internally generated funds over external financing.
Mendell (2006) examined 20 firms of the forest industry and results of his study indicated the existence of a negative relationship between profitability and debt.

Mohammad and Jaafer (2012) investigated 39 companies listed on Amman Stock Exchange to analyze the relationship between debt and profitability. Results of his study indicated significant and negative relationship between debt (short term, long term, and total) and return on equity.

Kebewar (2013) examined 2325 trade sector companies of France for the period 1999 to 2006. Results of his study indicated that debt has negative affect on profitability.

Anandasayanan Subramaniam (2013) investigated manufacturing firms listed on Colombo stock Exchange and found a significant and negative relation between debt and profitability.

Wali, Fatima, and Mehboob (2012) investigated 17 textile companies listed on KSE from 2003 to 2007 and found that the short term debts have negative relation with profitability.

Krishnan and Moyer (1997); Gleason et al. (2000); Goddard et al. (2005); Nguyen & Ramachandran (2006); Zeitun and Tian (2007); King and Santor (2008); Kajola (2010); Lim (2012) also found negative relationship between debt and profitability in their respective studies.

The argument given to justify the negative relationship between capital structure and profitability is based on pecking order theory. Companies that earn more profits have more internal resource or retained earnings to use for the purpose of investment and growth and therefore they are less dependent on debt.

2.3.5 Size of the Firm and Capital Structure

Firms which are larger in size generally have close relations with their lenders and therefore, these firms find it easier to arrange debt on their favorable terms.
Trade-off theory supports a positive relationship between the size of a company and its financial leverage while the pecking order theory supports negative relationship between the size of a firm and its financial leverage. Bhaduri (2002) suggested that the optimal capital structure choice can be affected by firm size.

Empirical evidences related to size of the firm and capital structure, are mixed.

The argument given for the positive relationship between firm size and leverage is that as the business grows and expands, the company’s stream of cash flows stability becomes stronger. As the stability of the company improves, it can afford to incur more debt. Larger companies have less risk, less prone to bankruptcy, have more transparency and more diversified as compared to smaller ones. All these factors help the larger firm in getting easier access to debt financing.


Castanias (1983) suggested that smaller firms may have lower debt ratio as these firms find it relatively more costly to resolve information asymmetries with the providers of the funds.

Titman and Wessels (1988) posit that raising funds through equity is costlier for small firms which compel them to rely less on equity. In contrast, large firms may prefer to use high leverage and therefore a positive relationship is expected between a firm’s size and its leverage.

Rajan and Zingales (1995) indicated that the leverage of U.S. firms is positively correlated with firm size. They suggested large firms are expected to employ higher amount of debt than small firms as they are generally well-established, more diversified, have good performance track record, less risky.
Uglurlu (2000) stated that large firms normally have deep relationship with the provider of the funds as they get long term debt easily. Consequently it is expected to have a positive relation between size of firms and leverage.

Dalbor and Upneja (2002) investigated publicly traded US restaurant firms and found that long-term debt has positive relationship with firm size.

Al-Sakran, (2001) and Hovakimian et al. (2004) observed in their respective studies an empirical evidence of a positive relationship between size of firm and capital structure.

Kurshev and Strebulaev (2005) found in their study, a strong positive relation between size of firm and capital structure.

Hassan (2011) argued that firm size is major determinant of capital structure for listed insurance firms in Nigeria.

Ogbulu and Emeni (2012) found in their study that size of firm has a positive relationship with capital structure of listed firms.

Studies in which researchers have found the existence of negative relationship between size of firm and leverage are:

Marsh (1982) argued that due to their limited access to equity capital small companies tend to rely heavily on debt for their funding requirements.

Wald (1999) observed a negative relationship between firm size and debt in Germany. He documented that larger firms tend to have less debt as a small number of professional managers control a sizable percentage of big industrial firms’ stocks (such as Siemens and Daimler-Benz) and have the power to push the management to act in the shareholder’s interests.

Hovey (2010) investigated Chinese companies for the time period 1999-2005 and concluded a significant and negative relationship between firm size and leverage.
Emamgholipour et al. (2013) found a significant and negative relationship between firm size and capital structure.

Researchers like Barton, Ned, and Sundaram (1989); Cassar and Holmes (2003); Esperanca, Ana, and Mohamed (2003); Hall et al. (2004); Sogorb-Mira et al. (2005), suggested a negative relation between the firm size and leverage.

However, researchers like Remmers et al. (1974); Kim and Sorensen (1986); Kester (1986); Karadeniz et al. (2012, found no significant effect of size of firm on capital structure in their respective studies.

2.4 EMPIRICAL STUDIES ON RELEVANT AREA IN INDIA

There are few researches available in Indian context which are related to the relationship between corporate governance and firm performance. Indian studies showed varied outcome which are similar to the worldwide findings, where no conclusive evidence or consensus for any one school of thoughts are available. Therefore the results have been mixed in nature. There are very scant studies available in relation to the corporate governance and capital structure in India. Therefore, the following studies are mainly related to corporate governance and firm performance while few researches pertinent to corporate governance and capital structure are delineated here, which are available till date to the researcher’s best knowledge.

Pathak (1997) investigated 135 Indian firms listed on Bombay Stock Exchange (BSE) during the period of 1990-2009. His study examined the relative importance of six factors i.e. tangibility of assets, growth, firm size, business risk, liquidity, and profitability on the capital structure decisions of publicly traded Indian firms. The results of the study found that all the six factors have significant impact on the capital structure decisions.

Kumar (2005) examined the relationship between corporate governance and capital structure during the period 1994 to 2000 in India. He used ownership structure as a proxy variable for corporate governance and debt ratio as a proxy
variable for capital structure. He observed that capital structure has an insignificant and non-linear relationship with corporate governance. He further suggested that firms with higher outside ownership or lower institutional ownership tend to have low debt.

Dwivedi and Jain (2005) investigated the relationship between corporate governance and firm performance. They observed 340 large listed Indian firms which spread across 24 industry groups for the period 1997-2001 and found a weak but positive relationship between board size and firm value in their study.

Ghosh (2006) investigated the data of 127 listed manufacturing firms in India for the year 2003 to explore the association between financial performance and board’s characteristics. Findings of the study indicated that keeping various firm-specific factors constant, larger boards tend to decrease the performance of firm.

Ajay Kumar Garg (2007) examined the relationship between corporate governance variables and firm performance. Garg used board independence and board size to represent the corporate governance. The study evidenced that board size is inversely related to performance which indicated that smaller board size add value and improve the performance of the firm. However, results indicated that board independence has no significant impact on firm performance which signifies that independent directors were unable to perform effectively.

Pattanayak (2008) investigated the effect of insider ownership on firm value (measured by Tobin's Q) on 1833 firms listed on Bombay stock Exchange in India for the periods of 2000-01 and 2003-04. He found that firm value increases with the rise in insider ownership.

Jackling et al. (2009) examined the relationship between corporate governance and financial performance of Indian companies. The results suggested that large board has a positive impact on performance of the companies.
Akshita Arora (2010) tested the relationship between corporate governance and performance indicators for Indian firms. The results indicated that the boards are dominated by executive directors and frequency of board meetings is high that help in enhancing the firm performance.

Aman Srivastava (2011) argued that ownership structure of any company is a serious agenda for corporate governance and that of firm performance. He investigated 98 most actively listed companies of Bombay Stock Exchange of India for the year 2009-10 and tried to explore the relationship between corporate governance and performance indicators for Indian firms. The results of regression indicated the presence of highly concentrated ownership structure and dispersed ownership percentage, impact certain measures of accounting performance indicators like ROA and ROE but not stock market performance indicators.

Chugh et al. (2011) investigated that the relationship between corporate governance and financial performance. The results of this study reflected that board size creates better opportunities for firm performance while high board independence lowers the firm’s financial performance.

Chatterjee (2011) investigated the relationship between corporate governance and firm performance by using multiple regression models. His study revealed that larger boards are negatively related to firm performance. However, in case of Public Sector Units, board size is insignificant in determining the performance of firm. Along with that, board independence is insignificant across all categories of firms in India indicating that independent directors are unable to play effective role.

Varshney et al. (2012) examined the relationship between corporate governance and firm performance using NSE listed firms in India. They examined corporate governance variables like board size, board composition, board activity, CEO duality, ownership structure and board business on firm performance i.e.
Economic Value Added (EVA). Results of their study showed that only board size was significantly and positively associated with firm performance.

Arora (2012) examined the Indian firms for the period 2001-2010 to explore the relationship between corporate governance and firm performance. The variables used for corporate governance were board size, outside directors, number of meetings held while variables used for firm performance were both market-based and financial based indicators. Arora used panel data fixed effects regression model and simultaneous equation method to explore the relationship and found significant impact of corporate governance on firm performance. The results indicated that corporate governance helps in the improvement of firm performance in Indian context. Although the relationship shown by the results were weak and researcher indicated that policymakers should pay more attentions and seriousness towards corporate governance reforms.

Gill et al. (2012) tested the perceived relationship between corporate governance and capital structure on 600 small service companies in India. Survey pertinent to corporate governance and capital structure of small business service firms were conducted. The results of the study showed that board size and CEO duality positively impact the capital structure.

Kaur (2015) analyzed 100 Indian firms listed on the Bombay Stock Exchange using multiple regression analysis and observed a significant positive association between promoter ownership and board size with firm performance.

A comprehensive review of related literature reveals that although there are series of related prior empirical studies in this area of research from developed economies. However, the same cannot be said of developing economies since most of the work are theoretical in nature and empirical works in this area of research have mostly focused on the impact of corporate governance on firm’s performance or examined the influence of ownership structure on firm value while limited study focus on capital structure.
2.5 SUMMARY OF CHAPTER

This chapter is divided into two major sections, section one contains the theoretical approaches of corporate governance and capital structure. Second section contains the empirical studies pertinent to corporate governance and capital structure relationship. There is a growing interest among researchers in management in the area of corporate governance especially among large and listed firms. Hence, this study investigates the impact of corporate governance on the capital structure of listed firms in India. The extant literature identified the main characteristics of corporate governance to include in the study as board size, board independence, and CEO duality. However, empirical results on the relationship between corporate governance and capital structure appear to be varied and inconclusive indicating that the relationship has not been fully explored. Therefore, this study investigates the relationship between corporate governance practices and firm’s capital structure in context of Indian firms.