INTRODUCTION

1.0 INTRODUCTION

This study is an attempt to explore the impact of corporate governance practices on capital structure decisions of listed firms in India. As a matter of fact, in India and elsewhere that unless and until any problem arises severely no serious attention is given to that and corporate governance is no exception. Even though corporate governance has gained noteworthy attention recently and much debates and discussions took place and are still taking place to justify its importance. In spite of that, the process of reform to strengthen corporate governance only appears and becomes inevitable when the present practices fail to stop a major corporate misconduct.

1.1 BACKGROUND OF THE STUDY

Corporations play a crucial role in ensuring fast-paced socio-economic growth and development of any country. The term ‘corporation’ evolved during 1600 from the Latin word ‘corpus’ meaning ‘body’ and the word ‘governaunce/governance’ which is now spelled as ‘governance’ was coined by Geoffrey Chaucer in the 14th century to refer to the process of governing the state or country. Therefore, governance pertinent to corporates referred as ‘Corporate Governance’. Separate legal entity is one of the characteristics of the corporation. The concept of separate legal entity evolved in the mid-19th century during the period between 1840 and 1880. Separate entity concept separates the ownership and management. Along with the introduction of separate legal entity concept, companies started focusing on finding efficient ways to raise capital that help them to earn more profits and draw the attention of investors to make investment in their companies. Corporations pooled the capital fund to achieve the objective.
of wealth maximization and financial sustainability. The evolution of the separate legal entity concept can be linked to the development of the corporations in particular and the economic and financial developments in general. But, this separation also led to the genesis of a problem described as agency problem in agency theory.

Agency theory predicts that the mis-alignment of interests between shareholders and managers could lead to agency problems or principal-agent problem, that is, managers engaged in activities for their own benefits rather than the benefits of the shareholders of the company (Jensen and Meckling 1976). The problem lies in motivating the agent to act in the interest of the principals rather than simply in their own interest (Shleifer & Vishny, 1997). Corporate governance is a way to deal with agency problem which arises due to separation of ownership and control. Corporate governance usually is woven around a fundamental question of assuring the suppliers of finance that they get the return on their financial investment. Decisions pertinent to a company are taken by the agents and as they are humans so there are chances that the decisions taken by them would be affected by their own self-interest. This self-interest gives rise to a cost called as agency cost and good corporate governance practices act as a mechanism to mitigate it.

Although agency problem existed since long and the origin of corporate governance can be traced back to conceptualization of agency problem but the term corporate governance was first time academically documented by Richard Eells in 1960. However, this word actually gained attention in 1980s as a response of collapse of many corporates around the world during that time. This change shifted the power of governance from the owner to the top management and from where the clashes between founder/owners and agent/managers came into notice. Corporate governance was given a formal structure in the early 1990’s. Its intricacies in the formal shape were presented in the Cadbury Committee Report of 1992. This committee was constituted in May 1991 jointly by London Stock Exchange, the Financial Reporting Council and the accountancy professionals in UK in the backdrop of series of financial scams and
corporate failures in the 1980s in Great Britain. These financial scams and failures created a fear in the minds of investors pertinent to the credibility of regulators and their competence in providing efficient capital market. The primary terms of reference of the committee were to consider various financial aspects of corporate governance. In U.K., this report was followed by a series of reports on this aspect including Greenbury Report (1995) which was a committee on director’s remuneration; Hampel Report (1998) which was a committee on corporate governance and Turnbull Report (1999) that discussed the director’s obligations.

‘Governance’ concept was extended towards quality governance in 1990s by World Bank and IMF and they coined the term ‘good governance’ which is associated with a general term conditionality i.e. conditions laid down for lending to other countries. Corporate governance too followed the same to form ‘good corporate governance’ by adopting good corporate governance practices.

In past few years, business ethics, corporate social responsibility and corporate governance have been touted towards stakeholders’ satisfaction and everyone speaks about these facets and so much so that most of the management schools inculcated them in their curriculum but only few are putting them to actual practices. There is a unanimous view that corporate governance helps in growth and development of the capital market which acts as one of the mediums of economic growth. No matter how sound macroeconomic policies are formed if the corporate governance system is poor it may always pose peril to the economy making difficult for it to attain macro-economic objectives.

The concept of corporate governance is growing day by day and not limited to just protecting the interest of the shareholders but to attain overall sustainability. The top management that is comprised of board of directors has the responsibility of the governance and is accountable overall.

India opened up its economy in 1991 which brought up the growth initiators viz. liberalization, privatization and globalization. With the advent of these events,
Indian market became more reachable for domestic as well as foreign corporates which was vitally imperative for the growth and revival of the economy. On one hand, they facilitated firms to have access of funds from capital market but on the other hand, it also brought certain issues. Corporate scams were certainly one of those issues. Indian economy saw a number of scams since then, which brought about the issue of corporate governance into a realm for everyone to discuss. Some of the major scams included Harshad Mehta scam (1992), UTI scam (2001), Ketan Parekh scam (2001), Satyam Fraud case (2009), Speak Asia scam (2011) Reebok India scam (2012), National Spot Exchange Ltd. scam (2013), Saradha Group chit fund scam (2013), Sahara Group (2014), Kingfisher money laundering case (2015), & Ricoh India accounting fraud (2016). Such scams forced the regulatory body to pay more focus on the impending requirement and efficacy for an appropriate analysis of companies’ financial statements and to provide guidance to the investors in their financial decisions.

Penalties in India for non-compliance of corporate governance are suspension of trading and delisting from the stock exchange. There should also be a provision to encourage the companies if they effectively comply with the corporate governance norms. SEBI used to make changes in its regulations from time to time and issued stricter rules related to corporate governance. In case of corporate frauds/scams, there are no harsh penalties like longer imprisonment and heavy fines on top management in India as mentioned in Sarbanes Oxley Act of U.S. Poor corporate governance may be identified as one of the major factors in virtually all known instances of firm’s distress in the country. On 24th March, 2017 SEBI ordered and imposed a penalty of Rs. 1000 crore on Reliance Industries and the 12 entities for violating the provisions of Section 12A of the SEBI Act, 1992 and SEBI Regulations, 2003. They were found guilty on fraudulent and manipulative trades. This is the largest penalty imposed by SEBI in over 20-year of its history. On the other hand for Sahara group money laundering case, its owner Subrata Roy personal asset is assessed much more than the liability but he is not paying off the debt for one reason or the other and agreed to be in jail or parole and Kingfisher chairman & MD Vijay Mallaya is
still freely living a lavish life and trying to negotiate with banks for writing off company’s debt. Auctioning all his properties could not even recover one thirds of the loan amount.

An efficient corporate governance regime could provide guidelines to avoid unethical practices that are done in the name of enterprise. It supports in the efficient functioning of the enterprise which leads to wealth maximization, economic growth and development. In order to inculcate best corporate governance practices in India, various committees were setup to supervise corporate governance system. Three noteworthy committees are:

- SEBI constituted Kumar Mangalam Birla Committee (1999)
- Government constituted Naresh Chandra Committee (2002), and
- SEBI constituted Narayana Murthy Committee (2003)

The approaches and recommendations of these committees are similar to England’s Cadbury Committee and America’s Sarbanes-Oxley Act (2002). These committees recommended corporate governance measures for Indian listed companies that are equivalent with global corporate governance practices. On 7th May 1999, market watchdog, Securities and Exchange board of India (SEBI) constituted a committee chaired by Kumar Manglam Birla to suggest best corporate governance measures to be followed by listed companies of India which is based on CII (Confederation of Indian Industry) code. It aims to persuade companies to "adopt best practices on corporate governance". All listed companies have to follow norms under clause 49 set by it. Clause 49 of the equity listing agreement was introduced on suggestion of this committee. The committee brought out a report in 2000 but it was not implemented instantly on all the firms. It was implemented cautiously first on new and large listed firms. This cautiousness is due to the realization that these norms were just imported from other developed countries. Year 2001 witnessed the occurrence of some major scams around the world including India like Enron scam in the U.S. and Ketan Parekh scam in India, the Government of India passed an order on August 21,
2002 to constitute a high-level committee under the chairmanship of Naresh Chandra to scrutinize the auditor-company relationship and to standardize the role of auditors. It necessitates the need for customization of imported norms in Indian context. SEBI also initiated another committee under the chairmanship of Narayan Murthy in 2003 to bring up with better measures to implement corporate governance. Recommendations made by Kumarmanglam Birla and Narayana Murthy committees became the Clause 49 of the listing agreement which was finally implemented in 2006. There are some changes and modifications made in the clause which became effective from October 1, 2014 onwards.

India's reform efforts have confirmed that its corporate governance norms follow Anglo-American corporate governance model. However, its inability to implement and impose all-embracing new norms completely signifies that the full implementation of imported norms from one system to another is highly complex.

This is well accepted that companies with superior corporate governance system create trust and goodwill amongst the investors that enables them to procure funds at most reasonable costs. Investors always inclined to invest in a firm which is safe and transparent in all its transactions. Corporate governance practices relating to financing decisions provide a trade-off between shareholders and stakeholders by selecting an optimal capital structure. There is no one right answer of what exact amount of debt and equity should be employed to form an optimal capital structure. But it is always recommended not to include high debt as it decreases the tax advantage and increases the overall cost of capital. Therefore, selecting the wrong combination of capital structure could lead to financial distress and scams/frauds.

Existence and composition of the board (i.e. number of executive, non-executive directors, independent directors and affiliated/ nominee directors), remuneration to the board members, relations with shareholders (including participation in the AGM), accountability and audit, committees established to monitor strategic decisions are few parameters/characteristics on which governance can be analyzed and measured.
Although corporate governance reduces agency costs, it may also have an impact on a company’s capital structure decisions and the quantum of debt a company issues. A company’s capital structure constitutes its relative proportion of debt and equity and influences managers’ incentives and investment decisions. The knowledge of how to raise finance has always been thrived in attracting research interest as it is a tool for social and economic development. It helps the corporates’ management in adopting the efficient practice which led to minimize the incidence of corporate failures and poor corporate structure. Poor corporate governance may not only pose a risk to the business entity but also indeed adversely impact the capital market and the whole economy.

Capital structure management helps to reduce the cost of capital and maximize the shareholders’ wealth. In last two decade’s studies relevant to capital structure decisions and factors that influence it gained attention. Based on the novel theories of capital structure, to some researchers, corporate governance is one of the factors that influence capital structure of a company. They have recommended that corporate governance is a useful factor that could influence the debt proportion in a company.

Corporate boards are one of the most important governance mechanisms that protect shareholders’ interests by monitoring managerial activities. Board of directors are occupied in taking company’s strategic decisions, therefore they obey with corporate governance code of best practices and provide good decisions to the company. Indian corporate governance norms are imported from the developed countries jurisdictions that follow ‘Outsider Model’ of corporate governance in which shareholders have less involvement in the decision making and management of the company. Contrary to that, Indian corporates follow ‘Insider Model’ of corporate governance in which the board decisions are influenced by the majority shareholders, promoters and the promoter group. Also, in shareholder meetings they are in a position to take decisions that are favorable to them. There is no doubt that adopting the world’s best norms Indian companies would become effective in its functioning but transplanting the norms without considering the home country issues would not be wise. Good corporate
governance practices possibly had significant impact on company’s planned
decisions such as outside financing, which are taken at board level and therefore,
board of directors is the important element of the corporate governance. Board of
directors is the topmost body of a company that is accountable for running the
firm and its operations. It plays fundamental role in planned decisions concerning
capital structure decisions. When there is good corporate governance and capital
structure, there will be appropriate and efficient practice in the management of
business entities. This will ultimately lead to decrease in the incidences of
corporate failures, poor internal control system, poor corporate structure,
disorderliness both on the part of management and workers. Therefore, board of
director’s features such as CEO/Chair duality, presence of non-executive
directors or independent directors and board size may have direct control on the
firm’s capital structure decisions. It is evident from the studies that firms that
obtain large portion of funds through debt in their capital structure generally have
inefficient corporate governance system.

As explained earlier, agency theory relative to corporate governance assumes that
there is a non-alignment of interests between agent (managers or directors) and
principal (shareholders). Agents (Managers) want to reduce agency costs by
taking decisions that is beneficial for them (like job security, incentives etc.) and
that compel them to raise the debt in the capital structure of the firm. The
inclusion of debt may influence the overall performance and market value of the
company. In other words, the managers of a firm may be tempted by the
advantages offered by leverage (debt). They may exploit this opportunity by
increasing debt capital proportion in capital structure at the expense of
shareholders as it is the shareholders who actually bear the risk. Due to
asymmetric information, managers have more information about the company
than shareholders which makes it possible for managers to take advantage of
shareholders’ lack of knowledge. This ultimately leads to the genesis of agency
problem and corporate governance is the only mechanism to mitigate it.

From the past evidences and researches, the author has come to an opinion that
corporate governance may affect capital structure decisions. In developed
countries, researches related to corporate governance and capital structure have been carried upon in ample quantity, but few attempts have been made to examine this relationship in the emerging economies like India. There is scant literature available that elucidates how corporate governance influences the capital structure decisions in India.

1.2 RATIONALE OF THE STUDY

The above discussion leads to a promising conclusion that corporate governance is closely related to the agency problem and can serve as a tool to reduce agency costs. Corporate governance takes into account the relationship between shareholders, managers and other stakeholders and is significant in controlling and managing a firm. The issue of corporate governance is even more important in transitional economies like India. Even the best standards cannot prevent instances of major corporate misconducts. In India, the major characteristics of corporate governance norms and standards are imported from the jurisdiction of other developed countries. It is obvious that every country is different in terms of social, economic, cultural and legal environment and therefore there is a need to understand what norms work in Indian scenario. Effective implementation can only be made possible when these international best standards and norms are developed and customized according to the unique issues of Indian system. There is a need to comprehend what makes the Indian scenario separate so as to build some practical suggestions on how to strengthen the Indian corporate governance within its own legal framework.

Till date review of literature suggests that the studies on the relationship between corporate governance and capital structure have not been adequately explored. This study examines the relationship between corporate governance practices and firm’s capital structure in background of Indian firms. A complete review of related literature reveals that although there are number of related prior empirical studies conducted in developed economies. However, the same cannot be said of developing economies since most of the works are theoretical in nature and practical works in this area of research have mostly focused on the impact of
corporate governance on firm’s performance or inspected the influence of ownership structure on firm value while limited studies focused on capital structure. There is a growing interest among researchers in management in the area of corporate governance especially among large and listed firms. Therefore, this study inspects the influence of corporate governance on the capital structure of listed firms in India. This study emphasizes on board of directors because it is one of the most important mechanisms of corporate governance. Theoretically, based on the board of director’s decision, a company decides its capital structure. In compliance to corporate governance norm of best practices, board of director is expected to serve a good financing decision or an optimal capital structure to the company. The existing literature suggested board size, boarding independence, and CEO duality as the main characteristics of corporate governance. However, empirical results on the association between corporate governance and capitals structure appear to be different and inconclusive. Hence, relationship between corporate governance and capital structure has not been fully explored. Conducting a research based on this problem proposes to enable the managers and the shareholders of the firm in tackling some of the issues related to capital structure. This research adds to the literature by highlighting the significant link between some corporate governance measures and capital structure choices of listed firms in India. Therefore, this study theoretically and practically attempts to provide evidences for the existence of relationship between corporate governance and capital structure in India.

1.3 RELEVANCE OF THE STUDY

The study is relevant from the academic, managers, regulators and policymakers’ perspective. This study contributes to the existing body of literature on the relationship between corporate governance and capital structure in Indian context. To the best knowledge and information of the researcher, a very limited research has been conducted recently. The result may provide a good guideline for managers and stakeholders to understand whether their companies are practicing good corporate governance practices or not. Without empirically testing the effect
of corporate governance norms it would be difficult to say that board characteristics or functions have brought any significant change in the decision making. Just as any change takes time, so too good corporate governance implementation will bring change in the system with time. India has adopted the best and most robust corporate governance norms from the other countries jurisdiction. But merely having best norms or regulations of the world could not bring the change in the corporate functioning and corporate misconduct.

Listed companies are trying to comply with corporate governance norm which is evident from the outcomes of the checklist provided by SEBI. Compliance is the necessity in Indian environment but the purpose should not be just to complete the paper work. There are few old conglomerates that follow the corporate governance long before it became mandatory like Tata, Birla and Infosys. However, recent cases of Tata and Infosys are examples that irrespective of having best norms of the world, there is something in which India is lagging which made us fail on effective decision making. Therefore empirical studies are required to understand what works in Indian system so that proper and effective norms are implemented otherwise it would remain a box ticking exercise.

1.4 SCOPE OF THE STUDY

Although this study is limited to non-financial listed firms in India but its scope is vast. This study tries to link the research gap through investigating the relationship between the board characteristics and capital structure decisions. As board plays an important role in determination of financing mix of the companies. This study addressed the issues relating to some pertinent questions emerging within the domain of study problems. The study seeks to answer the following questions:

Whether board size has positive or negative relationship with capital structure?
Whether Board Independence and CEO duality play any role in determining capital structure? Does capital structure have any relationship with the
profitability and size of the firm? Do the norms related to corporate governance in India helping the firms to cope up with their losses and bankruptcy?

1.5 LIMITATIONS OF THE STUDY

In spite of all precautions taken, this study is not completely free of limitations. All companies whose business are financial in nature were excluded as they exhibit different characteristics from non-financial listed companies since their debt-like liabilities are not strictly comparable to the debt issued by non-financial firms. This study is also limited in temporal scope to four years i.e. the period from 2012 to 2015. This study basically examines the impact of corporate governance on the capital structure of listed firms in India and is limited to three corporate governance attributes board size, board independence, and CEO-duality. Sample selection criteria have limited the study to large and listed firms only.

1.6 SUMMARY OF CHAPTER

This chapter outlines the entire philosophy and through-process behind conducting this research. It introduces the background of the study; speaks of few previous studies in the related area; states the rationale; relevance and scope of the present study. It also delineates the scope of the research while also stating its limitations.