

Corporate Governance Mechanisms and Capital Structure Adjustment – A Conceptual Model

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Abstract

Purpose: This paper intends to provide a conceptual discussion on overlooked factors that might influence capital structure adjustment. Specifically, this paper aims to investigate the relationship between ownership structure and capital structure adjustment as well as to examine the interaction effect between ownership structure and board independence on capital structure adjustment.

Design/methodology/approach: From review of past literature, hypotheses are developed based on agency theory, theoretical arguments related to controlling shareholders and board independence as monitoring mechanism.

Practical implications: The combination of corporate governance mechanisms like ownership structure and board independence would provide a better insight for directors to analyse the factors that affect capital structure adjustment. Besides, existing shareholders and potential investors would gain additional inputs for monitoring the agency conflicts.

Originality/value: Existing studies that explore the nexus between ownership structure and board independence on capital structure adjustment are still limited. This study attempts to propose additional perspective to previous studies by considering corporate governance mechanisms as factors that might influence the adjustment speed of capital structure.

Keywords: Agency problem, Ownership structure, Capital structure adjustment, Board independence

Introduction

Despite of the continuous debates whether firm in practice have a target leverage or not, past literature have shown firm leverage do exhibit mean reversion (Frank and Goyal, 2007; Leary

and Roberts, 2005). In a survey analysis by Graham and Harvey (2001), more than 80% of Fortune 500 companies appear to have target debt ratio with different level of strictness. In the same vein, evidence from countries in emerging markets like Brazil and South Africa also display similar pattern where firms will adjust their leverage towards their target in the long-term (Kayo et al., 2018; Matemilola et al., 2013). Based on a survey evidence in Malaysia, 64% of the public listed companies appear to have certain level of target leverage (Ibrahim et al., 2012). Hence, these evidences imply firms do pursue specific target leverage within a certain range.

Capital structure adjustment refers to the process of rebalancing the mix of debt and equity to maintain firm's target leverage. The adjustment process is based on dynamic trade-off theory (Haron and Ibrahim, 2012; Hennessy and Whited, 2005; Strebulaev, 2007) and since high deviation would diminish firm value, firms are motivated to close the gap between actual and target debt ratio (Chang et al., 2014). As pointed out by Myers (1984) earlier, adjustment costs should be a focal point if firms expose to costs that may hinder the process to achieve the optimum leverage. Previous study have found even small transaction costs would distort firm to rebalance their capital structure (Fischer et al., 1989). Therefore, identifying the adjustment costs would not only help firm to have better estimation of the adjustment speed, but it also assists managers to select appropriate financing strategies to respond to these factors.

From corporate governance perspective, financing decision is vital because the financial contracts established between firm and capital provider would regulate who controls the company and how it impacts the shareholders or the bondholders if company fails to meet its financial obligations (Watson and Ezzamel, 2005). Besides, the ownership structure of a firm would determine the agency conflicts between shareholders and managers (principal-agent) or between the controlling and minority shareholders (principal-principal) (Claessens and Fan, 2003). In other words, the severity of agency conflicts should be considered by a firm since ownership structure would also influence the financial decision-making. Previous studies have acknowledged that dispersed ownership structure like in the UK and US would relate to the principal-agent conflicts (Claessens and Fan, 2003; Lean et al., 2015; Young et al., 2008). On the other hand, the agency problems related to concentrated ownership structure are stemmed from the conflicts between controlling and minority shareholders and this case is generally occurred in Asian firms as well as other emerging countries (La Porta et al., 2000; Young et al., 2008).

Malaysian corporate sector is a unique example of high concentrated ownership and control. Past evidence shows on average 40.4% of ownership in Malaysian firms are concentrated with a single large controlling shareholders (Claessens et al., 2000). Amran and Ahmad (2013) also find the ownership is concentrated with the state, families and large corporations. Recent evidence indicates ownership concentration in the top 100 Malaysian listed firms by the largest five shareholders for the period between 2011-2015 is 54.90% (Paramanatham et al., 2018). Since these controlling shareholders hold substantial percentage of voting rights, they would also have great influence in firm decision-making (Ishak and Napier, 2006). Besides, one of the most prevalent issues related to firms with high ownership concentration is the potential of minority shareholders expropriation. Expropriation can be in various forms for instance insiders gain more profits (La Porta et al., 2000), insiders buy more corporate assets for private benefits (Lean et al., 2015), hiring less qualified cronies in managerial positions (Faccio et al., 2001) or overpay

directors on board (La Porta et al., 2000). Liew et al. (2017) indicates the issue of minority shareholders expropriation arise in Malaysia due to the type of the codes on corporate governance which promotes the voluntary approach. Although MSWG (Minority Shareholder Watchdog Group) advocates shareholders activism, MSWG are not authorized to bring these expropriation cases to the court (Liew et al., 2017). Together, these loopholes act as incentives for controlling shareholders to expropriate minority shareholders' wealth. Hence, ownership concentration plays a significant role in estimating the adjustment speed since lack of separation of ownership and control would create opportunities for controlling shareholders to run the business for their own private benefits.

Taking account that firms in emerging economies are most likely guided by the informal institutions such as family ties, business relations, and personal connection (Young et al., 2008), relying on external corporate governance mechanism like ownership structure alone is insufficient.

Firms in emerging markets should also consider internal mechanism like board of directors to encourage high efficiency of shareholders' rights enforcement (Buvanendra et al., 2017). This is because directors on board should be viewed as 'trustees' of the company. Besides, in tackling the issue of agency conflicts, the presence of independent directors would provide a more effective oversight (Fama and Jensen, 1983) and limit any dysfunctional behavior in organization. Not only that, it is also essential to look at independent directors' background which qualify them as independent such as their tenures. Long tenures would clearly relate to the familiarity with the organization which somehow may erode board monitoring process (MCCG, 2012, 2017). Hence, hiring independent directors is essential to ensure boards are taking interests of all shareholders as well as to provide monitoring and strategic roles to prevent firm from taking excessive risks when rebalancing their capital structure.

The aim of this paper is to investigate the relationship between ownership structure and capital structure adjustment. This study also contributes to the existing knowledge on capital structure adjustment through the examination of the interaction effect between ownership structure and board independence on capital structure adjustment. Besides, for more fruitful valuation of investment, such examination is vital for potential investors to understand further the pattern of ownership concentration and how it affects the capital structure adjustment process. Not only that, this study would acknowledge shareholders regarding their important function as well as reassure them to detect the sign of abusing shareholders' rights in a firm. Present paper assumes firms in Malaysia have a flexible target leverage as supported in Ibrahim et al. (2012). Such flexible target leverage suggests that firms allow to deviate from the target and firms may set a new one as a result of leverage shocks. Present paper also differs from previous studies conducted in emerging economies in two different ways. First, this paper takes account the importance of combining external and internal corporate governance mechanisms in reducing agency conflicts. Secondly, whilst independent directors monitor corporate decisions (Mohd Ghazali, 2010), present study also uses board independence (fraction and tenure of independent directors) as a way of incorporating all necessary elements which associated with directors' capabilities to deliberate firm financing decision. The remainder of this paper follows as such section 2 is literature review which covers the capital structure adjustment, ownership structure, board independence and hypothesis development. Section 3 is the proposed conceptual

framework and finally, the last section would provide conclusions and directions for future research.

Literature Review and Hypothesis Development

Capital Structure Adjustment

Since the seminal work of Modigliani and Miller (1958), target (optimal) capital structure has been one of the most debatable issues discussed in previous literatures. Further et al. (1973) suggest target capital structure can be reached via the trade-off between tax advantage of debt and the costs of bankruptcy. Whilst firm leverage equals to its target at the optimum level, in practice, firm may not always adjust their leverage instantly due to costs of adjustment (Faulkender et al., 2012; De Haas and Peeters, 2006). There are various types of adjustment costs involved during the adjustment process. Previous studies attempt to identify factors like macroeconomic conditions (Baum et al., 2016), business cycle effects (Mai et al., 2017), legal and financial traditions (Öztekin and Flannery, 2012), bankruptcy cost (Elsas and Florysiak, 2011), corporate governance quality (Chang et al., 2014) and other corporate governance mechanism like CEO duality and ownership structure (Buvanendra et al., 2017; Morellec et al., 2012). Hence, any factors which can influence the adjustment speed should be identified to assist firm financing decision.

A growing body of literature reveals capital structure is estimated to reach at certain adjustment speed, however there is no consensus on the magnitude of adjustment rate. Based on international sample of G7 countries, the adjustment rate is expected to be 25% per year (Drobetz et al., 2015), whilst a study reveals the adjustment speed for Asian firms to reach their target leverage fall between 25% to 45% per year (Getzmann et al., 2014). In the case of Malaysia, the adjustment rate of non-financial firm is 57% (Ibrahim et al., 2012), whilst later study find the adjustment rate of Malaysian firm to be at 38.6% per year (Matemilola et al., 2015). Therefore, following subsection would provide theoretical arguments to support the hypotheses on factors that impact the adjustment speed.

Ownership Structure

Ownership structure is another possible factor which lead to variances in capital structure adjustment speed. This is because ownership structure heightens the conflicts of interest between shareholders and other stakeholders. The extant literature have covered the effect of ownership structure on target leverage (Morellec et al., 2012; Pindado et al., 2015; Short et al., 2010), however, there are still limited studies were conducted on the relationship between ownership structure and capital structure adjustment. Present study uses ownership concentration to measure the ownership structure. Ownership concentration refers to the amount of stock hold by controlling shareholders which can be either individuals, state, or large corporations (Ishak and Napier, 2006).

Previous studies indicates higher ownership concentration in Malaysian firms are associated with lower level of leverage (Lean et al., 2015; Paramanatham et al., 2018). This is similar to previous studies from overseas that find negative relationship between ownership concentration and leverage ratio (Driffield et al., 2007; King and Santor, 2008). Besides, it can be due to the fact that debt acts as a monitoring mechanism towards managerial activities (Jensen and

Meckling, 1976). Hence, this paper concludes Malaysian firms with high ownership concentration are underleverage. Besides, rebalancing the capital structure by issuing new equity involves relatively higher costs than debt which consequently, contributes to a slower speed of adjustment (Chang et al., 2014; Kayo et al., 2018; Morellec et al., 2012). In other words, since high ownership concentration is associated with high monitoring by controlling shareholders (Lean et al., 2015), if the trade-off theory holds, underleverage firm would rebalance their capital structure by issuing more debt. Hence, it can be hypothesized as follows:

H₁: Malaysian firm with high ownership concentration will have faster capital structure adjustment than firm with lower ownership concentration.

The Interaction Effect of Board Independence

Besides, factors like high agency costs would prevent firm to adjust their capital structure rapidly (Chang et al., 2014). As highlighted earlier, the agency problems related to concentrated ownership structure involves the conflicts between controlling and minority shareholders (Young et al., 2008). Hence, to reduce such agency problems, present study proposes an internal corporate governance mechanism which is board independence. It has been argued that board independence is a powerful board with high proportion of outside directors and involve in separation between CEO and chairman (Liao et al., 2015). In the past several years, many researchers use either number, fraction or percentage of outside or non-executive director as one of the measures for board independence (Alves et al., 2015; Frijns et al., 2016; Gygax et al., 2017). Although numerous studies have attempted to explain the impact of board independence on capital structure, yet the results are found to be mixed. Based on a large sample of non-financial firms, Ferreira et al. (2012) find number of independent directors increase with debt ratio and firm complexity. This is similar to the earlier study that discover a board with more independent directors tend to hold more short-term debt (Harford et al., 2008). In contrast, Morellec et al. (2012) find board independence is negatively related to agency cost which lead to a lower risk of capital structure. Whilst, a recent multivariate analysis which include four countries (Malaysia, Pakistan, Singapore and Indonesia) find board independence is not related with any specific form of raising capital (Khawaja et al., 2018). Tenure of independent directors is also one of the main concerns highlighted by the policymakers (Choor Soi, 2016). Long tenure of independent directors which is exceed more than 9 years would relate to the issue of “familiarity” with the organization (MCCG, 2017). Yet, since tenure can also be a proxy for firm-specific experience (De Maere et al., 2014), directors’ tenure is expected to enhance boards’ capability in monitoring and providing resources to the firm (Hillman et al., 2009). Hence, consistent with earlier spirit of independent directors mentioned in MCCG (2012, 2017) and findings in Morellec et al. (2012), board that consists of more independent directors with longer tenure not more than 9 years would expect to provide more effective oversight, reduce the agency conflicts and indirectly influence the relationship between ownership structure and capital structure adjustment.

H₂: Board independence would influence the relationship between ownership concentration and capital structure adjustment.

Proposed Research Framework

Based on literature review above, a research framework is proposed as shown in Figure 1. Ownership concentration as a dimension of ownership structure is perceived as predictor of capital structure adjustment speed. In the meantime, board independence is expected to interact with the ownership structure and capital structure adjustment speed. This study also will employ three control variables including firm age, firm size and industry type which is similar to previous studies (Chang et al., 2014; Kayo et al., 2018; Morellec et al., 2012). Additionally, this study adopts other control variables mentioned in previous studies (Flannery and Hankins, 2013; Öztekin and Flannery, 2012) which are related to firm characteristics and country-specific variables including firm growth, firm profitability, firm tangibility and also GDP growth.

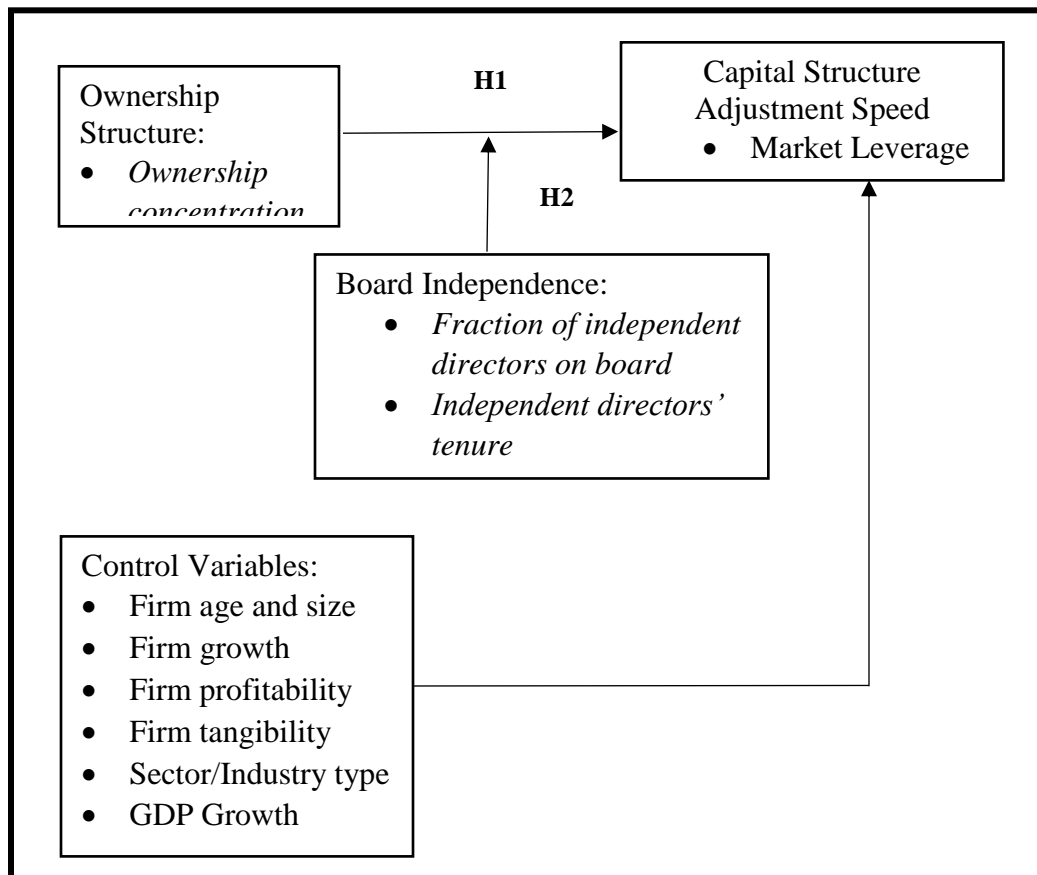


Figure 1: Proposed Research Framework

Data and Methodology

The data for this study will be based on secondary data which can be obtained from annual reports and online database. This study will comprise all non-financial public listed companies with market capitalization of RM2 billion and above at the beginning of company financial year. This is consistent with definition of large companies provided in latest Malaysian Codes on Corporate Governance (MCCG) 2017. Besides, controlling shareholders are determined based on the cut-off 20% of voting rights (Mishra et al., 2001).

Panel System Generalized Method of Moment (GMM) will be utilized in this study to estimate the target capital structure (Flannery and Hankins, 2013; Matemilola et al., 2015). Previous studies have found system GMM would rectify the endogeneity issues between variables by using more relevant instrumental variable (Blundell and Bond, 1998). Besides, there are mixed views on the best measure of leverage. As highlighted by Frank and Goyal (2007), book value of leverage is merely a “plug number” from the balance sheets, derived by past figures, yet it captures well reflection of the target leverage set by the management (Haron, 2014). On the other hand, market value of leverage is able to relate the ownership of a firm by shareholders and creditors whilst at the same time, it is considered as forward-looking. (Chang et al., 2014; Welch, 2004). Therefore, this paper follows some recent studies (Chang et al., 2014; Flannery and Rangan, 2006) and employs market leverage, which can be measured by the ratio of total debt to the sum of total debt and firm’s market value.

Further, this paper also will apply the standard partial-adjustment model as described in Flannery and Rangan (2006) to capture the leverage adjustment towards its target as mentioned below:

$$\text{Debt}_{it} - \text{Debt}_{it-1} = \lambda (\text{Debt}_{it} - \text{Debt}_{it-1}) + \mu_i \quad (1)$$

Based on the model above, λ is the average speed of capital structure adjustment, Debt_{it} is the target leverage whilst, $\text{Debt}_{it} - \text{Debt}_{it-1}$ are the recent leverage and lagged of 1 period leverage. Full adjustment will take place when λ equals to 1 and no adjustment takes place when λ is 0. Since the target capital structure is unobservable, the target leverage needs to be estimated first (Frank and Goyal, 2007). The target leverage is a regression of observed leverage on firms’ specific determinants of target capital structure (Lemmon et al., 2008), and the fitted value will be inserted in the partial adjustment model above.

Conclusion

The proposed framework provides a reasonable approach to tackle the unresolved question relating to the relationship between ownership structure and firm financing decision. Specifically, the findings of this study offers some important insights about the effect of external corporate governance mechanism like ownership structure (Watson and Ezzamel, 2005) and internal mechanism like board independence on the capital structure adjustment. Since large controlling shareholders are more likely influence firm financing decision, the proposed framework uses board independence as a monitoring mechanism. The proposed framework would also help to determine the speed of adjustment towards firms’ target debts. At the same time, the expected results of adjustment speed would indirectly provide the level of adjustment cost that hinder the adjustment process. Therefore, future research should be done to test the proposed framework for validation.

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