Ownership Structure, Corporate Governance and Capital Structure:

Evidence from Countries having FPI in Pakistan

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ABSTRACT

This study examines the relationship between ownership structure, corporate governance and firm leverage of listed companies in developing and developed equity market, having foreign portfolio investment in Pakistan since 2002. The sample period in this study is 2010 to 2016 for which firm level data for top 10 non-financial listed companies selected from stock exchange of each country has been observed by using pool regression analysis under common effect model approach. The measures of corporate governance variable are firm board size, Number of NED’s in board and CEO/Chairman duality. The measure of ownership structure is examined by managerial shareholders and institutional shareholders. Same impact of control variables is measure through size of firm and firm profitability. Results showed that firm board size and managerial shareholders is significantly negative relationship with leverage of firm. But corporate financing is found insignificantly influenced by CEO/Chairman duality and the existence of NED’s on the firm board. The control variables size of firm and firm profitability are found to have a significant impact on financing decision. Therefore results of the study suggest that corporate governance variables like ownership structure and firm board size play important role in the setting of financial decision of firm.
1. Introduction

The agency problem in the corporation is associated with the corporate governance mechanisms. The origin of corporate governance found back with the corporation ownership style and its control. Agency problems rise as an outcome of the relations between shareholders and managers and are grounded on conflicts of interest within the firm. The conflicts between the major shareholder (controlling shareholders) and minority shareholders (have no controlling power) is also part of corporate governance literature. According to recent corporate finance concepts agency cost is one of the factors of capital structure.

Only few studies discuss the relationship between corporate governance, ownership structure and capital structure like as Berger (1997), Friend (1988) and Abor (2007) investigate the dependence of corporate governance and debt level on the capital structure decisions of firms for developed and developing markets. But no study has been conducted to investigate the relationship between corporate governance, ownership structure and capital structure for Pakistani listed companies with comparison of countries having foreign portfolio investment in Pakistan. Pakistan is a developing market of South Asia and in past has shown outstanding performance, inviting considerable direct foreign investment and foreign portfolio investment (FPI).

This study began with the view that one resolution for the economic crises could be good corporate governance code. If companies are good governed and the interests of all stakeholders are taken care of a strong corporate culture could be built. Capital structure decisions are some of the primary decisions of businesses. The insertion of debt in the capital structure may disturb the overall performance and market value of the firm. This research will offer the policy makers with insight to the style of corporate governance and style of ownership which may confirm an optimal capital structure of firm. This research also beneficial for foreign investors to make foreign portfolio investment because this study identify that which country will be best for foreign portfolio investment (FPI) and in which country they can earn high returns on shares.

In this study we will studies the impact of three groups of variables on capital structure decision (Debt to equity ratio)\(^1\).

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\(^1\) Corporate Governance measures: Board Size, Composition of Board Members  
Ownership Structure measures: Institutional and Managerial shareholders  
Control measures: Firms Profitably and Firm Size
2. Literature Review

Many researchers have analyzed the impact of ownership structure, corporate governance and capital structure but they studied separately with developing and developed countries. Javid and Iqbal (2008) studied that Pakistani corporations has extra focus of ownership which is the response of weak legal system. The focus of ownership looks to have positive effect on firms’ value and performance measures. He also said that there was negative link between corporate governance practices and disclosures and clarity with focus of ownership. The identity of ownership matters more than the emphasis of ownership.

The family and director possession has positive effect on firm performance. The results of the study showed that the firm particular elements affect in concentration of possession, that is other investment views offers greater incentives for ownership emphasis however firm size has contradictory effect and leads to misapprehension of ownership. The general relationship develops from this study was that ownership concentration is an endogenous response of poor legitimate maintain of the investors and looks to have significant effect on firm performance. It assists application of corporate governance amendments at most at par with actual sector and financial sector changes (Brailsford, Oliver & Pua, 2002).

In Pakistan family owned business are more than institutional ownership and managerial shareholder also hold a major part of shares to get freedom to make firm major decisions. Afza and Mirza (2010) also found that the managerial shareholders and individual shareholders, cash flow sensitivity, size of firm and leverage were negatively correlated but operating cash flow and firm profitability were positively correlated with cash dividend. Managerial, individual ownership, cash flow and size of the firm were the major components of dividend behavior however leverage do not contribute meaningfully in causal the level of firm dividend payment.

The board of director is highest body of a company who is responsible for handling the firm. It shows dynamic role in planned decision about monetary mixture. Pfeffer and Salancick (1978) investigate the link between leverage of the firm and board size of the firm. The sign about course of correlation between board size of the firm and capital structure of firm is varied. Berger (1998) found that the firms which have large size board typically have low debt level. He argued that more board members put forth force to managers to follow lower leverage level and grow firm efficiently.
Sajid, Muhammad and Nasir (2012) examined that the larger director ownership and institutional ownership declines the level of agency cost of the firm. Smaller size boards also effect in reducing firm agency cost. The results also showed that the board independence has positive link with firm asset utilization. The separation of the post of CEO and chairman and their high remuneration also a cause of decline in agency cost.

Non-executive directors (NED’s) are basis of existing corporate governance code. The relationship between NED’s and capital structure decisions has been discovered but suggestion showed different results. Pfeffer (1977) emphasized that NED’s perform an important role in the success of the company to get appreciation from outside stakeholders. So this may indications to decrease in insecurity about firm and progress of the firm increase for financing. They also said that existence of NED’s on board favor to high debt level. Jensen (1986) also investigate that the firms with high debt level have comparatively more NED’s but firm with few number of NED’s favored low debt level.

An additional feature of corporate governance code of conduct is CEO/Chairman duality. It shows that the firms where the CEO also works as chairman of the board of firm has significant effects on the other decisions of the firm. Fama (1982) also studied that in a firm decision management and decision mechanism roles should be distinct. Titman (1989) found that firms with higher capital do not contemplate the agency and bankruptcy cost to decide the gearing level but these are the very low percentage of the firm value. So big firms may choose high level of debt in capital structure. Lang (1988) also said that the significant positive link between firm size and the firm debt level. Some of the research said that there is adverse association between firm size and firm debt level. According to Myers and Majluf (1984) the firms who earn big profits usually use low debt level because they favor funds which are internally arises like as retained earnings over debt and equity which also supported with packing order theory hypothesis.

3. Hypothesis

H1: ownership structure has significant relationship with leverage.

H2: Corporate governance has significant relationship with leverage.

H3: Firm performance has significant relationship with leverage.
4. Framework

Figure 1 illustrates the framework of the current research.

1. **Corporate Governance**
   - Board Size
   - Board composition
   - CEO/Chairman Duality

2. **Ownership Structure**
   - Institutional Shareholders
   - Managerial Shareholders

3. **Control Variables**
   - Firm Size
   - Profitability (ROA)

![Figure 1](image)

**Figure 1**
Framework of Study

**The General Form of Model**

\[
\text{LEV}_t = \beta_0 + \beta_1 (\log \text{BSZ})_t + \beta_2 (\% \text{NED’s})_t + \beta_3 (\% \text{INSTSHR})_t + \beta_4 (\text{MANGSHR})_t + \beta_5 (\text{ROA})_t + \beta_6 (\text{SZ})_t + \beta_7 (\text{CEO/Chairman})_t + \mu_t
\]

Where:

- LEVG = Leverage
- BSZ = Board size
- NED’s = Non-Executive Director
- INSTSHR = Institutional Shareholding
- MANGSHR = Managerial Shareholding
- ROA = Return on Assets
- SZ = Size of Firm
- CEO/Chairman = CEO/Chair Duality
\( \mu_t = \text{Error Term} \)

\( \beta_0 = \text{Intercept of this equation} \)

\( \beta_i = \text{marginal effect of on Leverage} \)

5. Data Description

According to State Bank of Pakistan (SBP) following are the countries having foreign portfolio investment (FPI) in Pakistan. We take stock exchange top non-financial 05 developed countries firms and 05 developing countries firm’s data to explore the impact of ownership structure and corporate governance on capital structure. The company's data took from Security and Exchange Commission of Pakistan (SECP), regulation authorizes websites of developed countries and company’s annual reports for the period of 07 years (2010 – 2016).

Table 1
List of Countries Having Portfolio Investment in Pakistan

<table>
<thead>
<tr>
<th>Developed Countries</th>
<th>Developing Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.K.</td>
<td>China</td>
</tr>
<tr>
<td>Norway</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>Canada</td>
<td>Qatar</td>
</tr>
<tr>
<td>USA</td>
<td>Korea (South)</td>
</tr>
<tr>
<td>Australia</td>
<td>Kuwait</td>
</tr>
<tr>
<td>Japan</td>
<td>UAE</td>
</tr>
<tr>
<td>France</td>
<td>Saudi Arabia</td>
</tr>
<tr>
<td>Germany</td>
<td>India</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Pakistan</td>
</tr>
</tbody>
</table>

(Source: State Bank of Pakistan (2016))

6. Data Analysis

Table 2 shows the descriptive statistics of variables. Results expose that average board size in developing countries firms is 10.5 with biggest board size of 14 board members and minimum board members are 5 and the average board size in developed countries firms have large board as compare to developing countries board size. Non-executive director (NED’s) found 56% of board but in developing countries’ firms have few NED’s as compare to developed countries firms. Which is a legitimately good sign but we cannot say all the NED’s are works independently. Managerial shareholders in developing countries firms is about 18% and in developed countries firms 29% which also shows that in developing countries
firms may use high debt level as compare to developed countries firms. Institutional shareholding is 9% in developing countries and 22% in developed countries firms which is reasonable in both economies. Average debt ratio of non-financial firms is 0.166 and in developed countries firm debt ratio is 1.79 which is higher than firms doing business in developing countries which representing a fairly reasonable overall financial mixture.

Table 2
Descriptive Statistics

<table>
<thead>
<tr>
<th>Variables</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leverage</td>
<td>0.799</td>
<td>2.65</td>
<td>0.166</td>
</tr>
<tr>
<td>Board Size</td>
<td>5</td>
<td>14</td>
<td>10.5</td>
</tr>
<tr>
<td>NED’s</td>
<td>3</td>
<td>8</td>
<td>5</td>
</tr>
<tr>
<td>CEO/Chair</td>
<td>0</td>
<td>1</td>
<td>0.609</td>
</tr>
<tr>
<td>MNGSHR</td>
<td>10</td>
<td>28</td>
<td>14</td>
</tr>
<tr>
<td>INSHR</td>
<td>5</td>
<td>34</td>
<td>27</td>
</tr>
<tr>
<td>Firm Size</td>
<td>0.61</td>
<td>1.20</td>
<td>4.42</td>
</tr>
<tr>
<td>Profitability</td>
<td>-2.45</td>
<td>4.31</td>
<td>4.98</td>
</tr>
</tbody>
</table>

Table 3 shows the results of correlation. The profitability of non-financial firms is negatively correlated with debt level of firms which is consistent with pecking order theory that firms firstly use internal sources for finance and then use debt and equity for financing. Results of both developing and developed countries non-financial firms are consistent with this theory.

Table 3
Correlation Analysis

<table>
<thead>
<tr>
<th>Variables</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.Leverage</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2.Board Size</td>
<td>-0.810*</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.NED’s</td>
<td>0.519</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.CEO/Chair</td>
<td>0.390</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.MNGSHR</td>
<td>-0.498*</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6.INSHR</td>
<td>0.701*</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7.Firm Size</td>
<td>0.594**</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8.Profitability</td>
<td>-0.691*</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**. Correlation is significant at the 0.01 level (2-tailed).
There is a positive significant relationship between debt and the firm size but in developed countries firms having more collaterals get more loans and in developing countries due to small collaterals firms may cannot use high level of debt.

Correlation analysis also shows that managerial shareholding in developing and developed countries is negatively correlated with leverage but Institutional shareholding is positively correlated in both developing and developed countries firms with leverage. This relationship exists due to efficient monitoring and decline of agency cost which is determinant of capital structure.

The board size is negatively significantly correlated with leverage in developing and developed countries and support that the larger board size my put pressure on management to use low level of debt and enhance the firm performance.

Relationship between Non Executives Directors and leverage is not significant in developing countries but significant relationship exists in developed countries firms because in developing countries firms are family owned and NED’s are not works independently.

Table 4
Pooled Regression

<table>
<thead>
<tr>
<th>Variables</th>
<th>Co-efficient</th>
<th>t-statistics</th>
<th>Probability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>5.7817</td>
<td>0.631820</td>
<td>0.5277</td>
</tr>
<tr>
<td>Board Size</td>
<td>-0.5015</td>
<td>-15.01225</td>
<td>0.0000</td>
</tr>
<tr>
<td>NED’s</td>
<td>0.5825</td>
<td>20.79942</td>
<td>0.0700</td>
</tr>
<tr>
<td>CEO/Chair</td>
<td>0.2735</td>
<td>0.136508</td>
<td>0.8915</td>
</tr>
<tr>
<td>MNGSHR</td>
<td>-0.7694</td>
<td>-1.168489</td>
<td>0.0029</td>
</tr>
<tr>
<td>INSHR</td>
<td>0.5291</td>
<td>17.62009</td>
<td>0.0000</td>
</tr>
<tr>
<td>Firm Size</td>
<td>0.5148</td>
<td>11.47233</td>
<td>0.0000</td>
</tr>
<tr>
<td>Profitability</td>
<td>-0.0964</td>
<td>-2.102811</td>
<td>0.0358</td>
</tr>
</tbody>
</table>

Table 4 shows the results of pooled regression analysis. The analysis shows that an increase of 1 percent in Profitability cause to decrease debt by 9.6 percent and shows the significant relationship at 0.05. Results of this regression supported with economic relationship and with pecking order theory which said that firm with high profit use retained earnings firstly then move to external debt and equity financing.

Leverage is significantly affected by firm Size because an increase in firm size also increase the propensity of the firm to get more debt financing. It may be due to the reason may be that large firms are well-known in the markets and they have more tangible assets to use as
collateral so they have edge to get more debt from banks and other financial institutions. Results also shows confirmation about the presence of significant negative relationship between board size and leverage. This link is reliable with result of correlation analysis and also supported with Berger (1996) which found that larger boards normally favor low gearing level and more focus on the firm performance.

Existence of NED’s in the firm board has no impact on debt level. In developing countries like Pakistan it may be cause of family owned business and in these firms NED’s are mostly agents of financial institutions who are controlling shareholders of the firm. In developed countries firms have more institutional shareholders and NED’s are independent to make strategic decisions of the firm because if NED’s are not independent then they are ineffective in board such as in Pakistani firms. In the same way institutional shareholders and CEO/Chairman duality has no significant impact on leverage.

Managerial shareholders are negatively affects leverage of the firm. Results shows that an increase in managerial shareholding by 1 percent may lead to decline in debt level by leverage by 0.76 percent. It may be reasoned that high gearing level increase the probability of default and managerial shareholder has long term interest so they favor the low gearing level. These results are supported with Irwin and Lang (1988) they said that lack of external shareholders the tendency to have low debt level will continue and will effect in high non diversifiable risk of leverage to management of the particular firm.

7. Conclusion

This study empirically studies the relationship between ownership structure and corporate governance dependence on capital structure (debt level) for developing and developed non-financial listed companies for the period 2010-2016 by using pool regression analysis. Results of the study showed that size of the board is significantly linked to leverage of the firm. But representation of NED’s in firm board and CEO/Chairman Duality has insignificant connection with gearing level.

On the other hand, in developed countries NED’s has significant impact on gearing level due to independent of NED’s. The managerial shareholders have negative association with leverage and institutional shareholders has positive association with leverage which is reliable with corporate governance code of philosophy but this relationship is statistically not significant. In developing countries, the reason of family owned business and close held firms which may take more time to accept change in code of conduct.
The major elements of capital structure like firm size and firm profitability have significantly effect on gearing level. Firm profitability is significantly negative relationship with gearing and also supported with the packing order theory. Firm size has significant positive link with leverage because as the size of the firm increase their tangible assets and also get successful name in market so that’s why getting loan easily from financial institutions. So we can conclude that ownership structure and corporate governance has significant associations with the financing decisions and foreign investors of portfolio investment can get help through this study and know that how he can earn more return and which country suits him for portfolio investment. After 2002 the corporate governance codes are implemented in mostly developing countries and it also identify that one of the reason of financial crises is lack of corporate governance codes in firms. Mostly firms not follow the codes and no systematic regulations are set by government and other regulatory authorities to implement these corporate governance codes. Nowadays, in Pakistan SECP and Chamber of Commerce make strategies to ensure that all the listed firms follow the corporate governance codes. These steps can may help to reduce the economic crises and other misrepresentation in firm’s books of accounts and protect the interest of all the stakeholders which is basic object of corporate governance code.

8. Future Research Direction

In future researchers can take all the countries having foreign portfolio investment in Pakistan and also take top 100 listed companies of developed and developing countries. Sample period can also expand up to 15 years. So then researcher may know the impact of ownership structure, corporate governance and firm leverage.

References


