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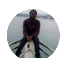
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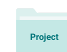

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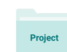

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CORPORATE GOVERNANCE MECHANISMS AND CAPITAL STRUCTURE

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ABSTRACT: The purpose of this article is to review studies on corporate governance and capital structure association and to proffer a precise understanding of its findings. There remains a good deal of uncertainty about this association. We shall argue that there is an incompatibility between the theories and reality. For example, agency and resource dependency theories predict this association to be positive, the general documented evidence is an inverse association between the cited variables. Yet, these theories are the most common in the literature. However, more multiple-theory oriented research is needed. In the view of the need for more review articles to guide future research, as it is less common in the literature, this article contributes to the literature not only in terms of evaluating the existing studies, assessing the inconsistent findings and identifying gaps but also sheds the light on the importance of some mechanisms of corporate governance that have been overlooked like board cognitive and demographic diversity (such as board tenure, gender, experience, etc.).

KEYWORDS: Capital Structure; Board Composition; Board Diversity; Corporate Governance; Malaysia

I. INTRODUCTION

Capital structure (CS) of a firm is influenced by several factors including the corporate governance (CG) quality (Jiraporn et al., 2012). In fact, the corporate governance concept is close to finance as defined by Shleifer & Vishny (1997) mechanisms in which lenders and shareholders are assuring themselves getting a return on their investments. In the past two decades, however, attention toward both issues (CG and CS) has triggered as a result of a series of financial crises. The Asian crisis in 1997 was mainly attributed to the excessive usage of debt as a result of weak monitoring process (Suto, 2003). The primary concern of corporate governance is, due to weak systems of corporate governance, a crisis might happen to a country as firms become too leveraged (Detthamrong, Chancharat, & Vithessonthi, 2017).

The challenge is that conventional reforms in most countries focus on accountabilities and investor protections that are mostly based on agency problems. In Malaysia for example, despite the many CG reforms (The Malaysian Codes of Corporate Governance was established in 2000 and came to revised in 2007, 2012, and 2017), several reports have been revealed concerning the over debt behavior of corporations. Total credit of the non-financial sector stood at 134% of the gross domestic product in 2018, while during the Asian financial crisis 1997 reached to 167.2% at its highest (Kana, 2019). Too much debt and potential crises might occur in the recent future because of too little financial discipline set by regulators. This suggests that the regulatory efforts initiated after the 1997 economic crisis did not result in better corporate performance (Ghazali, 2010). The trend raises the question (does a better governance structure lead to high borrowing activities?). To this end, we first provide an explanation of the theoretical frameworks in which studies on CS and CG can be understood. Then, we review the empirical studies on this association.

Given that there is no widely accepted theoretical model and a single theory fails to constantly explain this association. There is, therefore, a need for more review and conceptual work to provide a theoretical framework to guide future research (Baker et al., 2020). This review contributes to the literature not only in term of evaluating the existing studies examine CG attributes on CS, but also shed the light on the importance of some governance mechanisms that are overlooked on the literature.

Reviewing the empirical evidence we find that the agency theory and resource dependency theory are the most common in the literature and both theory predict a positive association between CG and CS. Yet, the general empirical evidence about this relationship is to be negative. Moreover, theoretical frameworks broadly differ in predicting the association between CG mechanisms and CS. Although the general evidence is that there is an inverse association between CS and CG, this result is inconsistent and even when it comes to individual governance attributes such as boardroom size or independence. In addition, some of the attributes of corporate

governance (such as boardroom tenure and diversity) have been overlooked in the literature.

Prior researches have a significant contribution to advance our knowledge on the CG-CS association. However, this topic is still full of interesting opportunities for more research. Based on our extensive review of previous studies, we provide directions for further studies in existing research streams, as well as major recommendations for new research agendas.

II. LITERATURE REVIEW

The literature of finance is replete with studies that attempt to investigate the determinants of firms' capital. One important factor affecting the capital structure documented in the literature is corporate governance. As it affects the financial choice and strategic decisions of firms (Adusei & Obeng, 2019; Detthamrong et al., 2017). The most classical way of explaining the governance impact on capital structure is in line with the agency conflicts in which managers can be constrained from pursuing inefficient investment and reduce the agency cost by using high level of financial leverage (Jensen, 1986; Ji, Mauer, & Zhang, 2019). The conflicts of interest between agent and principal and the firm's unique feature exert a significant impact on the debt level (Chang, Chou, & Huang, 2014). Also, a good governance structure facilitates access to external finance and lower the cost of capital (Doidge, Karolyi, & Stulz, 2007; Okiro & Aduda, 2015). Furthermore, debts serve as a channel of mitigating information asymmetry between outsiders and insiders (Myers, 1984), and signal manager's willingness to be monitored by outsiders/lenders (Jensen, 1986; Vijayakumaran & Vijayakumaran, 2019).

Empirically, however, the general evidence is that better corporate governance and financial leverage are negatively associated. Firms with weak CG have a higher level of debt and have poor performance (Jiraporn et al., 2012). Managers confront with strong monitoring tend to seek a lower level of debts (Wen, Rwegasira, & Bilderbeek, 2002). Also, Haque, Arun, & Kirkpatrick (2011) find a significant negative relationship between the total as well as long term debt ratios and corporate governance quality. One possible explanation for these findings, firms with high corporate governance quality tend to borrow less regardless of the availability of funding source or better borrowing conditions (costs) to avoid potential shortcomings, losing control or reputation.

In contrast, Berger et al. (1997) contend that CEOs do not face pressure from either ownership or active monitoring tend to have lower leverage levels. Additionally, Detthamrong et al. (2017) find corporate governance does not exert any impact on the capital structure of firms. There are several factors have been put forward in order to explain this contradiction; one reason is that determinants of capital structure decisions are still unknown (Hussainey & Aljifri, 2012). Also, the complex pattern of corporate governance made it difficult to include all governance attributes on a single study or identify the relevant governance mechanisms that exert the most impact on capital structure. the majority of previous studies rely on a limited number of governance variables (Boateng, Cai, Borgia, Gang Bi, & Ngwu, 2017). Also, the usefulness of the findings of some prior studies is further limited because they rely on relatively small sample size and suggested further investigation with a larger sample size (Muazeib, Ghozali, Achmad, & Faisal, 2019; Pandey, Biswas, Ali, & Mansi, 2019; Tarus & Ayabei, 2016). Different theoretical ground has also contributed to the mixed findings. Finally, some studies failed to address the methodological issues such as endogeneity and reverse causality (Haque et al., 2011; Hussainey & Aljifri, 2012).

III. THEORETICAL CONFLICT

The conventional belief about CS is for firms to issue a high level of debt in order to reduce the conflict between managers and shareholders (Jensen, 1986, [free cash flow hypothesis]), or to benefit from the tax deduction of debt level (Myers, 1984, [trade-off theory]). However, the foundation of empirical researches on the relationship between CG and CS is constituted by several theories. These theories can be grouped into three categories (Table 1). Namely, agency-based theories, resources-based, and behavioral-based theories. It should be noted that agency-based theories and resources-based are the most commonly used in the literature that explicate the structure of capital and its association with corporate governance, and both groups predict this association to be positive.

According to agency theory, all governance mechanisms that are perceived as good governance practices helps to facilitate the access to finance and reduce the cost of debt as firms with such governance mechanisms are seen as essentially having an effective monitoring system. For instance, a firm with a large board size, the cost of capital is lower as creditors view these firms as essentially having an effective monitoring system (Anderson et al., 2004). Resource view theories also explain this association as the efficient governance mechanisms help to better link the firm with the external resource. Large board, more outsider directors, and more diversify board lead to more channels of communication with the external environment.

Yet, as mentioned earlier, the general evidence for the CG-CS relationship is negative. One possible explanation for this incompatibility. Financial leverage has a detrimental impact on corporate performance and

value as suggested by several recent studies (see, Ahmadi, Nakaa, & Bouri, 2018 [France]; Ciftci et al., 2019 [Turkey]; Le & Phan, 2017 [Vietnam]; Nguyen & Nguyen, 2020 [Vietnam]). Therefore, firms with high corporate governance quality tend to borrow less regardless of the availability of funding source or better borrowing conditions (costs) to avoid potential shortcomings, losing control or reputation which can be explained by the behavioral theories.

For instance, board gender diversity can introduce diverse ideas, perspectives, and knowledge into board decision-making and consequently increase the board independence and managerial monitoring (Carter, Simkins, & Simpson, 2003; Yang et al., 2019). According to agency theory, resource dependency theory, and signaling theory, board diversity should be associated with a high debt level. Nevertheless, women on the boards are risk aversion and more likely to prefer a firm to avoid risk and hold more cash in its investment policy as predicted by the behavioral theory. Yang et al. (2019) supports this argument and maintain a negative impact of mandated female representation on performance and firm risk.

The individual theory of the governance-capital structure association is well understood. Nevertheless, the puzzle of capital structure is unsolved due to the lack of comprehensive and clear theoretical framework, as the number of empirical research increase, there will be, equally, a growing number of mixed results. Therefore, there is a need for more multiple-theoretical work and conceptual research that help to explain seemingly conflicting findings in the empirical literature.

Table 1. The impact of different governance attributes on CS according to alternating theories

	Agency					Resource		behavioral	
	Agenc theory	Managemen friendly hypothesis	Cost of capital hypothesi	Signaling theory	Trade-o theory	Stewardsh p theory	Recourse dependen y theory	Behaviou al theory	Pecking order theor
Board size	+		+	+	+	na	+	-	-
Board diversity	+		+	+	+		+	-	-
Board independence	+	+	+	+	+	na	+	-	-
CEO duality	-		-	-	-	+	-	+	+
Board tenure	-	-	+	-	+		+	+	-
Ownership concentration	+		-	+	+		na	na	-

''+'' positive, ''-'' negative, and ''na'' no clear prediction.

IV. REVIEW OF EMPIRICAL RESULTS

As discussed earlier, the empirical findings of the CG and CS association are inconclusive for several reasons. The theoretical background is one important factor, as theories utilized by the finance literature have also embraced the agency problems. However, reviewing the empirical evidence we find that the cited relationship has received remarkable attention from researchers focusing on developed markets. Table 2 summarizes the results of recent studies attempt to examine the relationship between CG and CS. We discuss related literature to the association of several CG attributes and CS. Apart from incompatible results of prior work, different studies rely on different and limited number of governance attributes. There is a lack of researches that empirically investigate the impact of board cognitive and demographic diversity on capital structure (such as board tenure, gender, experience, etc.).

4.1 Board Size

The boardroom is one of the most important factors affects the financial choices and approving strategic decisions of a company (Adusei & Obeng, 2019; Detthamrong et al., 2017); ensure that the firm operates efficiently, competitively and secure critical resources that are needed to enhance a firm's operations (Hillman, Cannella, & Paetzold, 2000). An effective boardroom is, therefore, essential to the success of a firm. However, the clear guidance of the appropriate boardroom size does not exist (Detthamrong et al., 2017). In view of the resource dependency theory, the boardroom act to link the corporate with external resources that are needed for the firm to survive (Pfeffer, 1972). A large boardroom provides more channels of communication with the external environment (Hillman & Thomas, 2003). Agency theory suggests that a firm with a large board size perceived as a good governed firm facilitating access to external finance. Large board seeks higher debt to raise company value (Abor, 2007), in which the cost of debt would be low as lenders view such companies having an effective monitoring system (Anderson et al., 2004). Large board seeks higher debt to raise company value (Abor, 2007). Nevertheless, the findings prior studies are still inconclusive and mixed (i.e., Detthamrong et al.,

2017; Germain, Galy, & Lee, 2014; Hussainey & Aljifri, 2012; Jensen, 1986; Sewpersadh, 2019; Tarus & Ayabei, 2016).

Table 2. Summary of the recent studies on the CG and CS association

Author	Sample	Governance Attribute	Theory	Key Findings
Farooq & Pashayev (2019)	6 European Countries 369 firms 2010-16	CEO director CEO duality Board independence	Agency theory	At 10th and 90th quantile, chairman of Ex-CEO, audit committee independence, and CEO director significantly affect capital structure.
Berķe-Berga & Dovladbekova (2019)	9 European countries 1,676 firms 2016	CEO duality Board independence Board size	Trade-off theory Agency theory Pecking order theory	The increase of corporate governance quality lead to lower level of debt.
Vijayakumaran & Vijayakumaran (2019)	China 1844 firms 2003-10	Managerial ownership Legal-person ownership Board size Board composition	Trade-off theory Agency theory	Managerial and legal-person ownership have a positive impact of leverage lever. While, state-ownership, foreign ownership exert a negative influence. Board size and composition do not influence the capital structure of firms.
Bajagai et al. (2019)	Nepal 2011-16 20 firms	CEO duality Board composition Board size Board meeting institutional ownership	Agency theory	Corporate governance variables like boardroom composition, managerial ownership, CEO duality, meetings exert a positive influence on capital structure.
Ji et al. (2019)	USA 1,191 firms 1998-14	institutional ownership managerial ownership CEO power antitakeover	Creditor alignment managerial entrenchment	In diversified firms, leverage has a positive association with managerial entrenchment. While this association is negative in focused firms.
Muazeib et al. (2019)	Malaysia 92 firms 2014-15	Board composition Board meeting Audit committee meeting Audit committee composition Audit committee size Board size	Agency theory	The meetings of boards and board size are positively associated with debt level. audit committee size negatively affect capital structure. Other variables have no relationship with capital structure.
Sewpersadh (2019)	South Africa 713 firms 2011-16	Board size Board independence CEO duality Audit committee Ownership concentration Director ownership	Agency theory Free cash flow Trade-off theory Stakeholder theory Pecking order theory	Positive impact of director ownership and CEO duality on leverage. While negative relationship was found between boardroom size, audit committee independence, and leverage.
Kieschnick & Moussawi (2018)	USA 1996-16	CEO duality Board independence Board size	No theory	Negative association between governance attributes and financial leverage.
Detthamrong et al. (2017)	Thailand 493 firms 2001-14	CEO duality Board independence Board diversity Audit reputation Ownership concentration Audit committee Board size	Agency theory Trade-off theory Social theory	No association between level of debt and corporate governance.

4.2 CEO Duality

In a firm with CEO duality, the two essential decision making will have the same personality and perspective. This can trigger the agency problems and information asymmetric as it enables executive to control the disclosure of information to directors and shareholders (Detthamrong et al., 2017); influences the financing decision of the firms (Abor, 2007). The responsibility of the CEOs is mainly to initiate and implement strategic decisions (decision management). The responsibility of the boardrooms, on the other hand, is to endorse and monitor the decisions of the CEOs (decision control). If both positions are held by the same individual, it may create agency problems "who will monitor the monitor?". The stewardship theory, however, suggests that managers implement their strategic decisions better with greater discretion. This strengthens the firm's capability to defend itself from the uncertainty of the external environment, thus increasing the ability of the firm to raise funds (Pfeffer, 1972). Empirically, however, several studies have been supported each point of view and as the number of empirical research increase, there will be equally, a growing number of mixed result (i.e., Abor, 2007; Alves, Couto, & Francisco, 2015; Tarus & Ayabei, 2016).

4.3 Ownership Concentration

It is commonly held that the ownership concentration minimizes the agency problems and empowers the boardroom. According to agency theory, the concentration of ownership leads to more effective monitoring as small shareholder's blocks might be too small to have an incentive in monitoring the management. Also, when legal protection is relatively weak, concentrated ownership offers the best protection to the interests of shareholders (Agrawal & Knoeber, 1996; Denis & Mcconnell, 2003). Firm with high ownership concentration prefers to use more financial leverage rather than equity as the shareholders want to avoid losing control over the firm (Céspedes, González, & Molina, 2010). However, empirical evidences have been also mixed (i.e., Deesomsak, Paudyal, & Pescetto, 2004; Paligorova & Xu, 2012; Sheikh & Wang, 2012). Block-holders may show greater ability to force managers to take on more leverage to decrease managerial opportunism (Sheikh & Wang, 2012). Nevertheless, ownership concentration might shift the conflict between manager and shareholder to large shareholder and small shareholder interest conflict (minority and majority shareholder conflict). Large block-holders are argued to be detrimental to corporate valuation because they might misuse their increased power for private benefits at the expenses of other stockholders (Porta et al., 2002; Shleifer & Vishny, 1997). Thus, capital structure is affected by the expropriation activities of ultimate owners that have excess control rights (Deesomsak et al., 2004; Paligorova & Xu, 2012).

4.4 Board Independence

According to agency theory, the top managers generally face more rigorous monitoring when the boardroom is monitored by independent outside directors (Wen et al., 2002). Thus, more independent boardroom signals to the market that the company is being adequately controlled so fund suppliers consider the company more creditworthy. As a result, raising long term funds through debt financing would be easier. Moreover, firms with more independent directors may have more debts as the independent directors may different perspectives and knowledge that provide more channels between the company and finance supplier (resource dependency hypothesis) (Pfeffer, 1972). Thus, facilitating the way for a company to a higher degree of debts with better conditions (Berger et al., 1997). Despite the fact that both theories predict a positive association, the findings of prior studies are mixed (see, Wen et al., 2002; Kyereboah-coleman & Biekpe, 2006; Sheikh & Wang, 2012; Alves et al., 2015).

4.5 Board Diversity

Board diversity can be defined as the heterogeneity among directors in terms of ethnicity, experience, age, education, nationality, gender, age, and many other aspects. In today's business environment, encouraging the diversity of boardroom is an essential aspect of corporate governance practices as it provides new perspectives and insights to the boardroom (Carter et al., 2003; Yang et al., 2019); enhances the organization's connections with the external environments. Kagzi and Guha (2018) improve the image of the firm (Ujunwa et al., 2012; Fernández-Temprano and Tejerina-Gaite, 2020); increases network connections, resources, creativity, innovation and more effective problem-solving, by involving a broader range of perspectives (Amin & Nor, 2019; Cheong & Sinnakkannu, 2014; Fernández-Temprano & Tejerina-Gaite, 2020).

According to Erhardt, Werbel, & Shrader (2003), diversity of the board can be categorized into two groups; demographic diversity such as gender, race, ethnicity, and age; cognitive diversity including education, experience, and personal values. There are very few efforts at examining the impact of board diversity (both cognitive and demographic) on capital structure and researchers mainly examined the influence of boardroom diversity on firm performance (Detthamrong et al., 2017); risk management (Sila, Gonzalez, & Hagendorff, 2016); leadership contribution (Huse & Grethe, 2006). The existing studies focused on gender diversity-capital

structure nexus. Farooq & Pashayev (2019) contend that gender diversity of the board exerts a significant impact on capital structure. Similarly, Alves et al. (2015) and Bajagai et al. (2019) find a positive association between gender diversity and leverage. Other scholars, however, failed to find a link between both variables (Detthamrong et al., 2017). In addition, board tenure is also a critical issue affecting board independence. The increase of the director's tenure is accompanied by an increase in the governance quality (Iturralde et al., 2016; Vafeas, 2003); increase knowledge about the firm and its business environment (Vafeas, 2003). It is, therefore, expected to facilitate access to finance and reduce the cost of capital. Long-tenured directors may be related to a better service role as they gain knowledge over time (Iturralde et al., 2016). This argument was supported by (Huang & Hilary, 2018) suggesting that accumulative experience facilitates the excess of external financial resources. There are a few research examine the association between board tenure and; task involvement (Veltrop, Molleman, Hooghiemstra, & Ees, 2018); Governance quality (Iturralde et al., 2016; Vafeas, 2003); entrepreneurship (Breton-Miller, Miller, & Bares, 2014); CEO compensation (Byrd, Cooperman, & Wolfe, 2010); and only one study conducted by Ishak, Aziah, & Kassim (2011) investigate the impact of the long-tenure directors on capital structure and found it to be negative. One possible explanation for these findings is that the long-tenured of directorship and familiarity may erode the boardroom's objectivity of monitoring function. As suggested by the management friendliness hypothesis (Vafeas, 2003). Thus, a firm with long-tenured directors perceived as a poor governance firm (based on agency theory). Consequently, it reduces the financial leverage activities as the costs of external finance increase.

V. CONCLUSION

The prior researches have a significant contribution to advance our knowledge on the CG-CS association. However, this topic is still full of interesting opportunities for more research. We reviewed the recent studies in an attempt to answer the question of 'does a better governance quality lead to high borrowing activities?' Reviewing the empirical evidence we find that the general empirical evidence about this relationship is to be negative. Whereas, the most used theories in the literature predict this nexus to be positive. This result is inconsistent and even when it comes to individual governance attributes such as board size or board independence the prior findings are inconclusive and the theoretical frameworks broadly differ.

Several limitations are identified that might be the reason for the inconsistency (such as theoretical framework, methodological issues, sample size, corporate governance variables employed, etc.). Also, the cited relationship has received remarkable attention from researchers focusing on developed markets. We, therefore, encourage studies to further explore the influence of other attributes of corporate governance variables that are less explored such as board demographic and cognitive diversity, board committees, and audit aspects in developing context. We also encourage scholars to examine the interaction between theories as well as corporate governance variables. Most of the prior studies focused on how capital structure is affected by firm-level characteristics of corporate governance and ignoring the country-level characteristics. This study provides a guidance future work to understand the nature and characteristics of the CG-CS association and have some implications for practitioners and regulators.

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