CORPORATE GOVERNANCE, OWNERSHIP STRUCTURE AND CAPITAL STRUCTURE: AN EMPIRICAL STUDY ON NON-FINANCIAL FIRMSListed IN PAKISTAN

By

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March 2016

Doctoral Dissertation Submitted to the Higher Degree Committee
Ritsumeikan Asia Pacific University
in Partial Fulfillment of the Requirements for the Degree of
Doctor of Philosophy
Acknowledgement

The completion of doctorate degree is quite a hard and trying task, and I would not have accomplished it without the support, guidance and encouragement from numbers of well-wishers. First of all, I am grateful to Almighty Allah, the most Beneficent, the Merciful and The Righteous Teacher for giving me health and opportunity to make me capable of completing this task.

The writing of this dissertation is a solo effort; however, it would have not be possible without the guidance of others. First of all my most sincere gratitude goes to my supervisor Professor, Suzuki Yasushi, for his continuous help, suggestions, support and guidance has made me able to complete this dissertation. I am highly indebted to my supervisor for his comments and contributions to this final draft. I would like to take this opportunity to acknowledge the help and encouragement of Professors A. Mani and J. Progler for their guidance during the course work. I also acknowledge the help and guidance provided by Dr. Nadeem Ahmad Sheikh. Moreover, I am grateful to the Ritsumeikan Trust and APU for supporting my academic life in APU. I further acknowledge the financial support of The Tokyo Foundation for nominating me for the Ryoichi Sasakawa Young Leader Fellowship for 2014-2015. I am thankful to the administrative staff, from the Student Office, Academic Office and Research Office for their assistance throughout my academic career at APU.

I acknowledge the great support and comments of my seniors, colleagues and seminar-fellows for their comments and suggestions on my presentations in seminar class, particularly, Dr. Sohrab and Dr. Bin, as well as brothers Sigit, Helal and Ali. Moreover, I express my sincere gratitude to all the friends who have encouraged and helped me in achieving this milestone. I am also thankful to Rebecca, Umar and Javed Bahi for their efforts to do the proof reading of this draft.

Lastly, and most importantly, I wish to express my deepest appreciation and gratitude to all of my family members. Especially to my parents who have devoted all their efforts and resources to me and have sent me their continuous prayers for my success. I am grateful to my elder brother Khan Zubair for taking care of family matters and allowing me to concentrate on my studies. To my wife Sehrish Shoaib and my little angel Zil Ayesh they deserve much more for their patience and support while I have been away from them during my studies than I can give. May Allah bless them with health, happiness and guidance.
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List of Acronyms

CCG : Code of Corporate Governance
CEO : Chief Executive Officer
CFO : Chief Financial Officer
CO : Companies Ordinance
CS : Company Secretary
ECGI : European Corporate Governance Institute
IAC : Internal Audit Committee
ICAP : Institute of Chartered Accountant Pakistan
IFC : International Finance Corporation
ISE : Islamabad Stock Exchange
KSE : Karachi Stock Exchange
LSE : Lahore Stock Exchange
OECD : Organization of Economic Co-operation and Development
PICG : Pakistan Institute of Corporate Governance
SECP : Securities and Exchange Commission of Pakistan
SBP : State Bank of Pakistan
SEO : Securities Exchange Ordinance
Abstract

The collapse of corporations, corporate scandals and financial crises certainly prove that corporate governance is a highly relevant topic in the field of corporate finance. These factors made market regulators, policy makers and governments around the globe establish and reform the principles of corporate governance. For the enhancement of the corporate governance mechanism, countries around the globe have introduced the Code of Corporate Governance (CCG). Similarly, as a part of financial liberalization and market reforms, the Securities and Exchange Commission of Pakistan (SECP) implemented the first CCG in 2002 and revised it in 2012. It is evident that SECP adopted the OECD Principles of Corporate Governance to the Pakistani CCG and its revision.

Nevertheless, SECP may have naively adopted the OECD Principles without adequate consideration of de facto realities of the unique practices of corporate finance in Pakistan. How should the SECP have done it? The OECD expects the policy makers in each country to improve and enhance the corporate governance mechanism through issuance and revision of CCG under a regulatory framework, where active cooperation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises are encouraged (OECD 2004). However, the separation of ownership and control of financing in modern corporations makes it very difficult for us to identify the balanced role of stakeholders in corporate governance. Therefore, this study aims to explore the unique features of corporate finance which should be reflected in the CCG. Such as, (i) the firm-specific factors that affect the capital structure choices of firms, which are influenced by the availability of financing sources; (ii) the impact of ownership patterns, under the separation of ownership and control mechanism.
on capital structure, specifically by analyzing the effects of managerial ownership, institutional shareholdings, and block-holders on capital structure decisions; and (iii) the impact of internal attributes of corporate governance on the selection of capital structure.

The empirical findings show that the firm-specific factors affect the debt ratios in the similar way to those in developed economies; however, with some anomalies. It further show that that the overall leverage level for Pakistani firms has declined. However, the proportion of short-term debt has slightly increased and suggest that many Pakistani firms rely on short-term debt, which is the drain of long-term capital for investment. In fact, their reliance on short-term borrowings has ironically become even more intense. This may predict that many Pakistani firms are exposed to higher liquidity risk even though they are reducing the overall leveraging. Moreover, the heavy reliance upon short-term debt is partly due to the under development of capital markets in the country.

The investigation result on the effects of ownership structure patterns on capitals structure indicates that managerial ownership and block-holders tend to encourage leveraging. This phenomenon predicts the exploitation of minority groups or other external stakeholders and signals the less prudent corporate governance mechanism. Furthermore, the results suggest prudent monitoring by institutional shareholders to reduce agency conflicts by diminishing managerial opportunism. However, contrary to this, the limited role of institutional shareholders in CCG reveals the limitations of CCG, and suggests an improvement and enhancement of the code with the active participation of other relevant stakeholders.

The study on effects of internal attributes of corporate governance on the selection of capital structure suggests that certain internal attributes have the explanatory power to affect a firms’ capital structure. For example, things such as board size, independent/outside directors,
CEO duality, managerial equity ownership and block-holders are positively related to leverage. Moreover, excess reliance on board size, board composition and CEO duality for the enhancement of governance mechanism would be futile without the participation of other stakeholders.

Based on the findings related to the firms’ financing sources and ownership patterns, the shortcomings which this dissertation found in the evolution of CCG in Pakistan include: (i) the failure by the CCG to take into account unique financing features, i.e. the heavy reliance of Pakistani firms on short-term debt, that is, the drain of capital for long-term investment; (ii) the ownership patterns suggest that the prudent monitors’ role of institutional shareholders, which is expected to minimize the agency conflict in firms’ choice of capital structure and corporate governance; (iii) the limited guidance in the current code, which does not adequately take into consideration the unique nexus in the Pakistani firms' selection of capital structure to mitigate the agency conflict. This dissertation provides empirical grounds for further discussions on the improvement of the current CCG by establishing an adequate ex post evaluation and governance mechanism.

**Key words:** Corporate governance, Capital structure; Ownership structure; Code of corporate governance; Non-financial firms; Karachi Stock Exchange; Pakistan.
Chapter 1

Introduction

1.1 Research background / Economic Realities

Corporate governance is an area that has attracted the attention of corporate managers, investors, academics, regulators and policy makers in the last two decades. The collapse of corporations, corporate scandals, and financial crises certainly prove that corporate governance is a highly relevant topic in the field of corporate finance. These factors made the market regulators, policy makers and governments around the globe to establish and reform the principles of corporate governance for fair and transparent corporate practices. For the enhancement of corporate governance mechanism, countries have introduced the Code of Corporate Governance (CCG) using rule based or principle based implementation protocols (see Tariq and Abbas, 2013). Rule-based regulation prescribes how to behave in detail, whereas in principle based regulation, norms are formulated as guidelines and the exact implementation is left to the subject of the norm (Burgemeestre et al., 2009). According to Reddy et al. (2010), every country follows one of these regulatory frame works. For instance, an example of rule-based code would be the “one size fit for all” in US, i.e. Sarbanes-Oxley Act (2002), while an example of principle-based regulation would be the “comply or explain” code in the UK, New Zealand and Australia. According to the information on European Corporate Governance Institute (ECGI)\(^1\), there are 97 countries and several international organizations e.g. OECD, World Bank, United Nations etc. that have issued one or more than one CCG.

In order to meet the international standards of market reforms of financial liberalization, Pakistan opened its secondary markets for foreign investors in 1991. Subsequently, in order to

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\(^1\) \url{http://www.ecgi.org/codes/all_codes.php} (As on November, 20\(^{th}\) 2015).
meet the demands of international investors, the Pakistani government has introduced various reforms in capital markets. As a part of these reforms the Securities and Exchange Commission of Pakistan (SECP) implemented the first CCG in 2002 and revised it in 2012 following the rule-based regulatory framework where compliance to the CCG is mandatory. It is evident that SECP adopted the OECD Principles of Corporate Governance to the Pakistani CCG and its revision. The OECD Principles include; (1) Ensuring the basis for an effective corporate governance framework; (2) Supporting the rights of shareholders and key ownership functions; (3) Maintaining the equitable treatment of shareholders; (4) Clarifying the role of stakeholders in corporate governance; (5) Promoting disclosure and transparency; and (6) Establishing the responsibilities of the board (OECD, 2004). At the same time, the OECD notes that a particular set of principles is by nature not applicable to all the countries, since each country has its unique background and conditions in the practice of corporate finance.

Corporate governance is concerned with the ways by which suppliers of capital to the firms assure themselves of getting returns on their investment (Shleifer and Vishny 1997). Thus, sound corporate governance practices are essential for raising funds from investors. The primary purpose of OECD’s Principles is to help policy makers in each country improve and evaluate frameworks for the promotion of fair corporate practices. This is to enhance the firms’ performance and sense of security to investors by improving the transparency and disclosure to unlock various sources of capital through the development of capital markets. However, the Pakistani CCG seems to fail to promote prudent practices of corporate governance which results in general inefficiency and high opportunity costs in Pakistani firms, and hinders the development of capital markets in Pakistan.

Theoretically, it is assumed that improved governance practices will lead to better
performance by increasing expected cash flows accrued to investors and reducing the cost of capital (Reddy et al., 2010, pp.90). Similarly, the OECD (2004) Principles of corporate governance state that a credible corporate governance framework, through effective enforcement and supervision mechanisms, can help to improve the confidence of investors, reduce the cost of capital, and underpin the functioning of financial markets, which in turn can result in the establishment of stable sources of financing. However, failure to formulate and enforce the prudent governance mechanism can result in various opportunity costs in the economy, such as a higher costs of capital for firms, reduced access to limited sources of capital, and the underdevelopment of capital markets. These factors play a significant role in an emerging economy like Pakistan. For instance, less developed capital markets means limited access to the capital for real investments. In such case, due to insufficient funding, firms have two options, those being to either give up their investment opportunities, even with positive net-present value (NPV), or to not borrow at a high cost of capital, which may result in higher transaction costs, moral hazards, and adverse selection problems. The transaction costs of investment, such as time, money, and efforts, determine the willingness of the investors. These higher costs hamper the investors’ confidence and the economic growth of the country as well.

By considering the multiple objectives to be accomplished, CCG development and implementation plays a strategic role at the policy making level in the economy of Pakistan. As a part of regulatory framework to bring the transparency and accountability in the corporate sector, it will help the firms to attract local and foreign investors. Also, this will further contribute to the economic performance of the firms, the development of capital markets, and the economy as a whole. However, the weaknesses and imperfections of regulatory practices can have an important impact on capital markets, ownership structure and control patterns, and firm
productivity, which can lead to poor development in economic institutions (Rais and Saeed, 2005, pp.1).

1.2 Research Questions

The OECD expects the policy makers in each country to improve and enhance the corporate governance mechanism through the issuance and revision of CCG under a regulatory framework. Active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises are encouraged (OECD 2004). The structures of corporate ownership and the financial system are the main factors that determine the country’s system of corporate governance (Davies and Schlitzer 2008). This study aims to explore the unique practices of Pakistani corporate finance which should be reflected in the CCG. We suggest how naively the SECP may have adopted the OECD Principles without adequate consideration on the unique practices of corporate finance in Pakistan. This study also addresses a number of important policy questions.

1. How did the SECP adopt the OECD Principles of Corporate Governance?

A capital market is expected to play a role in mobilizing financial resources to the corporate sector by attracting investors to invest in firms with better corporate governance and encouraging the firms to tap on various sources of capital through a prudent corporate governance framework. We should ask: under the limited capacity of capital markets in Pakistan, how feasible is the SECP as an organization to implement and enforce the CCG?

2. What are the unique practices of Pakistani corporate finance?

The revision of CCG in 2012 highlights the limitations and continuous improvement of the corporate governance mechanism in the country. Javed and Iqbal (2010) state that ultimately it is
the financial markets that reward good governance firms and punish bad ones. If that is the case, the firms with good governance have access to the long term borrowing through capital markets. We should ask: what are the unique practices of Pakistani corporate finance after the enforcement of CCG 2002? Besides, the separation of ownership and control in modern corporations makes it very difficult for us to identify the balanced role of stakeholders in corporate governance. We should ask: how do managerial ownership, institutional shareholding, and block shareholding work as prudent monitors of the corporate governance framework in Pakistan?

3. How should the SECP have adopted the CCG?

We draw several implications from this study to improve the Pakistani CCG.

1.3 Research Objectives and Methodology

To answer the first research question, this study overviews the history of introducing and revising the CCG in Pakistan upon the OECD Principles of Corporate Governance.

To answer the second question, this study draws on the long-lasting and widely recognized debate on the relationship between corporate ownership and capital structure to identify the features of corporate finance in Pakistan. First, we review the long-standing debate on the relationship between corporate ownership and capital structure (Modigliani and Miller, 1958; 1963; Groth and Anderson, 1997; Myers, 2001), followed by the debate on separation of control and ownership of corporations (Adam Smith, 1776; Berle and Means, 1932; Jensen and Meckling, 1976). Trade-off Theory, Pecking Order Theory, The Free-cash Flow Hypothesis, Agency Theory, and Market Timing Theory are contemplated to see which theory is most applicable for explaining the unique features of corporate governance that currently hinder the
optimal capital structure in Pakistani firms.

Additionally, this study aims to explore the following three major aspects; (i) the firm-specific factors that affect the capital structure choices of non-financial listed firms in Pakistan, which are influenced by the availability of financing sources; (ii) the impact of ownership patterns, under the separation of ownership and control mechanisms on capital structure, specifically by analyzing the effects of managerial ownership, institutional shareholdings, and block-holders on capital structure decisions; and (iii) the impact of internal attributes of corporate governance on the selection of capital structure (see the following "Data and Research Methods Specifications for the details).

In order to answer the third question, this study aims to compare the practices of corporate finance in Pakistan with those in the other developed and developing countries. Also by comparing the results of this study with earlier studies, we shed analytical light on recent changes in the unique feature of corporate finance and the unique barrier to access of financial resources in Pakistan. Based upon the interpretations and implications from the results, we propose how the current version of CCG should be improved.

Data and Research Methods Specifications

This study uses a secondary data set for empirical analysis. The data sample was compiled from the financial statements of non-financial companies listed on Karachi Stock Exchange (KSE). The data sample is composed of data across firms over time, therefore this study employs the panel data procedure for empirical estimation. The use of panel data procedure is suitable to analyze the dynamics of change.

The investigation concerning the determinants of capital structure was done using data
gathered from 101 firms between the years of 2005-2012. In order to test for multi-collinearity among the variables, the study constructs a pair-wise correlation matrix. The investigation on the effect of explanatory variables on dependent variables (i.e. proxy of leverage) was done using the three panel econometric techniques, i.e. the pooled OLS, the fixed effects, and the random effects. The Hausman (1978) test was performed to choose the appropriate estimation model results for discussion, and the results of the test presented (see table 5.6) reject the null hypothesis and suggest the use of a fixed effects estimation result. Moreover, the adjusted $R^2$ for the fixed effects model is higher than the OLS and random effects model, which further supports it over other estimation models.

The investigation on the impact of ownership patterns and corporate governance on capital structure was done by employing the data of 101 firms listed on KSE during the period of 2004-2012. This study uses cross-sectional data, and employs panel data procedures for empirical analysis. It also uses the pooled OLS econometric technique to explore the effect of explanatory variables on dependent variables. Pooled OLS is more appropriate for cases where there is no firm, and no time specific effect. As such, the three dependent variables of total debt, long-term debt, and short-term debt were regressed against the explanatory variables as proxies of capital structure using the pooled OLS regression technique.

Finally, the CCG was scrutinized in light of empirical results of the study, particularly to examine the unique features of Pakistani corporate finance practices and their reflection in the development of CCG. Additionally, the significance of CCG 2002 is evaluated and critically analyzed using the revised clauses of CCG 2012 in order to articulate a proposal for future recommendations and continuous improvements.
1.4 Significance and Practical Implications of the Study

This study challenges the established but still controversial debate on the relationship between corporate ownership and capital structure in order to identify the features of corporate finance in Pakistan. The market imperfections highlighted in the analysis of corporate governance and capital structure suggest that the formulation and development of institutional settings can minimize the shortcomings of the governance mechanism. These institutional settings can play an effective role in the proper implementation and monitoring of governance mechanisms along-with education, training and protection of investors.

In accordance with the implementation of Pakistani CCG, it appears that the overall leverage level for Pakistani firms has declined. However, the proportion of short-term debt has slightly increased, and as such we suggest that many Pakistani firms rely on short-term debt. In fact, their reliance on short-term borrowings has actually increased. We should note that many Pakistani firms are exposed to higher liquidity risk even though they are reducing overall leveraging.

These empirical results suggest that managerial ownership and block holding might have ill-affected the governance in corporate finance, given the special context of Pakistan, which has encouraged higher leveraging. On the other hand, the results on the impact of internal attributes of corporate governance suggest the CCG 2012 guidelines, which encourage the expansion of directorial boards, the assignment of independent directors, and CEO duality, may have contributed less to prudent practices of corporate finance in Pakistani firms than expected.

The empirical results illuminate the role of institutional shareholders to mitigate principal-agent conflicts, although the correlation between institutional ownership and capital structure is not significant in our study. Findings on ownership concentration and block-holders
cast doubt on the protection of minority shareholders’ interests. Even in CCG 2012, only one sub-clause highlights the issue of minority shareholders. In general, findings endorse the predictions of theoretical framework, but point out the less prudent enforcement and implementation of the corporate governance framework. This suggests further improvement of CCG is inevitable.

In general, it is anticipated that the outcomes of this study will be of great use for corporate managers in order to understand the effects of firm specific factors, ownership structure, and corporate governance on features of corporate finance in Pakistan. In order to minimize agency conflicts related to the separation of ownership and control, block-holders, institutional shareholders, and other stakeholders should be involved in active monitoring, particularly in terms of financing choices. Moreover, creditors should also monitor the opportunistic behavior of managers by keeping an eye on their investment activities. Furthermore, this study will contribute to the existing literature by illuminating significant links between capital structure, ownership structure and corporate governance for firms in the developing country like Pakistan. Finally, the findings will lend a hand to policy makers and the SECP to formulate an effective regulatory mechanism in future revisions and modifications of the CCG by considering the unique characteristics of the local corporate environment. These characteristics include financing features and ownership patterns of the firms, the expanded role of other stakeholders, institutional shareholders as prudent monitors, and so forth.

1.5 Scope and uniqueness of the study

Empirically, only a few studies have explored the effects of ownership structure and corporate governance on capital structure and firm performance in Pakistan. For instance, Sheikh et al.

The primary focus of this study is to examine the limitation of CCG’s framework on the improvement of firms’ access to capital by reducing the cost of capital through the development of capital markets in the country. However, due to the constraints related to the data availability and other relevant issues, the study has not analyzed all of the relevant aspects of CCG. The variables used in the study are adopted from existing literature, and empirical investigation shows sufficient support for the argument raised in the study. Moreover, the following points highlight the uniqueness of the study.

1. Only a couple of studies such and Shiekh et al. (2013); Javed and Iqbal (2010) and Hasan and Butt (2009) have examine the impact of corporate governance on firms’ performance and ownership structure on limited data. However, to the author's best knowledge, no prior study has evaluated the CCG 2002 and 2012 in order to analyze it in terms of corporate finance, ownership and governance as this study has.

2. A few important studies have included the data of Pakistani firms to explore the factors affecting the capital structure. Notably, there have been the studies done by Getzman et al. (2014); Jong et al. (2008); Booth et al. (2001); and Demirguc-Kunt (1992), but their findings were based on the data of very few firms. However, this study analyzes a larger data sample consisting of various industrial sectors.
3. A small number of studies (Brailsford et al., 2002; Short et al., 2002) have explored the impact of ownership structure on capital structure and firms’ performance on Australian and UK firms respectively. Studies done by Berger et al. (1997); Firth (1995); Jensen et al. (1992); Friend and Lang (1998); Kim and Sorensen (1986) and Grossman and Hart (1982) examined the relationship of managerial equity ownership to firm’s leverage. In the case of emerging economies, only Wahba (2013); Ruan et al. (2011) and Hasan and Buut (2009) explored the impacts of managerial equity ownership on capital structure decisions, which affect firm performance. However, no prior study exists that has explored the influence of different ownership patterns on capital structure. This study unveils the significance of managerial ownership, institutional shareholdings and large shareholders’ (block-holders’) roles on financing decisions of Pakistani firms.

4. Above all, this dissertation provides an evaluation of CCG by presenting empirical evidence of non-financial firms listed in Pakistan. Moreover, it also makes comparisons between existing empirical studies, either on developed or developing economies, in terms of firm-specific characteristics in order to influence the choices of capital under separation of ownership and control through effective corporate governance mechanisms.

1.6 The Organization of the Dissertation

The dissertation is composed of 7 chapters. The organization of the remaining parts of the dissertation is as follows:

Chapter 2 presents the introduction, development, revision and implementation of the Code of Corporate Governance (CCG) in Pakistan. It also briefly introduces financial markets. It explains the historical development of CCG 2002, and the subsequently revised CCG 2012. The
purpose is to review the current position and historical development of capital markets, in the background of CCG. Moreover, it explains the capital raising mechanism of non-financial firms in security and non-security markets, as these markets play a significant role in providing a platform for the short-term and long-term financing needs of the firms.

Chapter 3 gives a review of existing literature. To begin, it provides a survey of theories and empirical explanations relevant to the factors that affect the capital structure. It then provides an explanation of different ownership patterns along with a summary of existing empirical findings. Finally, it presents a survey of corporate governance theories and its relevant empirical literature.

Chapter 4 presents the empirical part of the study, which explains the data, variables, hypotheses, and research methods in order to (i) explore the significant firm specific factors that affect the capital structure; (ii) examine the influence of ownership patterns on capital structure; (iii) examine the effects of internal attributes of corporate governance on capital structure.

Chapter 5 explains the empirical results of (i) factors affecting the capital structure (ii) the effects of ownership patterns on choices of financial structure (iii) the effects of internal attributes of corporate governance on capital structure.

Chapter 6 provides a discussion on regression results relevant to (i) factors affecting the capital structure (ii) the effects of ownership structure patterns on choices of financial structure (iii) the effects of internal attributes of corporate governance on capital structure.

Finally, chapter 7 describes the summary and conclusions of the study. It provides the policy proposals for the improvement of CCG based on the empirical findings. It also interprets the empirical results found in Chapter 5 in order to analyze future developments of firms financing sources and future access to the low-cost capital with the improvement of ownership
structure and governance mechanism. Lastly, it highlights the limitations of the study and provides recommendations for further research.
Chapter 2
Financial markets and Code of Corporate Governance

2.1 Introduction

In modern day economy, effective and fair corporate governance framework is considered as an important factor in the sustainable development of an economy. This can be achieved through the performance of companies and their access to various external capital sources. According to OECD (1999) corporate governance is a key element in microeconomic efficiency, enhancement of capital market functionality, and resource allocation among market players. In this respect, the corporate governance mechanism constitutes a broad range of principles, institutions, and regulatory framework including the accounting standards, financial disclosures and so forth. At policy making level the corporate governance framework has gained greater importance in both developed and emerging markets. In a broader perspective it has contributed to the economic, social, and legal environments that safeguard the corporate owner’s interests. Therefore, in Pakistan, an emerging market, it is vital for the sound development of capital markets, the protection of property rights, the reduction of transactions cost, and the cost of capital for firms operating within the economy.

With the passage of time, the persistent demand for corporate accountability and transparency has led to a legal compulsion for corporations to “comply or explain” the mechanism about fair corporate practices. To enforce standards of accountability and transparency, national governments and independent international organizations have enacted various guidelines on corporate governance. These include the Cadbury Report (1992) in the UK, the Organization of Economic Co-operation and Development (OECD) principles of corporate
governance (1999) and the Sarbanes-Oxley Act (2002) in the US.

2.2 Debate on Code of Corporate Governance

Businesses around the globe require investment from investors in order to expand their operations in local and global markets. Investors make sure that the business of a certain company is sound before providing the capital for such investments, and will continue like that in the future so that they may get a proper return on their investment. Effective and fair corporate governance practices address the investors’ expectations by establishing a transparent and accountable framework by protecting their interest. The growing importance and emphasis on corporate governance in last two decades has urged countries to take several formal and non-formal initiatives for the improvement of governance mechanism within the country. In this regard, several countries have issued the CCG as one of their regulatory frameworks to enhance the accountability, transparency, internal control, disclosure of information, responsibilities, evaluation, and compensation from the board of directors and so forth.

According to Mallin (2007), the development of corporate governance is taking place at a global level, and is a complex area having impact on ownership structure, investors’ protection through legal system, capital markets, and so forth. To achieve the mentioned objectives, countries across the globe have introduced various codes for the enhancement of their corporate governance mechanism. Aguilera and Cuervo-Cazurra (2004, pp. 417) defined the CCG by stating that “Codes of good governance are a set of ‘best practice’ recommendations regarding the behavior and structure of the board of directors of a firm. They have been designed to address deficiencies in the corporate governance system by recommending a comprehensive set of norms on the role and composition of the board of directors, relationships with shareholders and top
management, auditing and information disclosure, and the selection, remuneration, and dismissal of directors and top managers.” They further state that the CCG is important for the improvement of quality within the companies’ boards, requiring accountability between the companies and shareholders while maximizing the return to shareholders or stakeholders. The ultimate objective of this mechanism through development and improvement of CCG is to improve the institutional, legal and regulatory framework in the economy.

OECD published its initial set of principles of corporate governance, in 1999 and revised them is 2004 and 2015. OECD (2004) highlights that corporate governance is only part of the larger economic context in which firms operate and it is one of the important element for the enhancement of investor’s confidence, economic efficiency, and growth. It further emphasizes that an effective corporate governance system within a company and across the economy as a whole contributes to the investors’ confidence for the proper functioning of market economy. This lowers the cost of capital for firms and encourages the efficient use of resources which will result to the growth in the economy. The OECD identifies that its single set of principles is not fit for all, meaning that a single model of corporate governance is not applicable to all countries due to the unique characteristics of each country. However, Aguilera and Cuervo-Cazurra (2004) state that the principles issued by OECD as a transnational institute have wider applicability and address the important issues related to global corporate governance. The OECD principles do not promote any corporate governance model, but it aids developing economies in understanding how to improve the corporate governance mechanisms in their country. In this perspective it can be assumed that these principles provide standardized guidelines for developing economies to enhance their local governance mechanism. Table 2.1 highlights a few important points of the OECD principles of corporate governance revised in 2004, as quoted in Mallin (2007).
### Table 2.1: OECD principles of corporate governance

<table>
<thead>
<tr>
<th>Principle</th>
<th>Narrative</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Ensuring the basis for an effective corporate governance framework</td>
<td>The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law, and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.</td>
</tr>
<tr>
<td>2. The rights of shareholders and key ownership functions</td>
<td>The corporate governance framework should protect and facilitate the exercise of shareholders right</td>
</tr>
<tr>
<td>3. The equitable treatment of shareholders</td>
<td>The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.</td>
</tr>
<tr>
<td>4. The role of stakeholders in corporate governance</td>
<td>The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises.</td>
</tr>
<tr>
<td>5. Disclosure and transparency</td>
<td>The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the company.</td>
</tr>
<tr>
<td>6. The responsibilities of the board</td>
<td>The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board’s accountability to the company and shareholders.</td>
</tr>
</tbody>
</table>

*Source: OECD Principles of Corporate Governance (2004) quoted in Mallin (pp. 32, 2007)*
2.3 Importance and development of CCG in Pakistan

The role of corporate governance is necessary for the allocation of resources, specifically financing the needs of the firm, improving the investors’ confidence to attract more investment, and enhancing capital markets. Particularly in the case of capital markets, instilling confidence in the investors and protecting their interests are the primary roles of the corporate governance mechanism. As confirmed by La Porta et al. (1997), countries that have poor or weaker investor protection mechanisms have smaller capital markets. Efficient and well developed capital markets intermediate the availability of capital funds for a firm’s investment opportunities. This availability of the capital also results to the lower cost of capital. Moreover, Shleifer and Vishny (1997) also suggests that strong investors’ protection encourages firms to provide their funds for financing activities. In modern corporations, the corporate governance mechanism protects the investors’ interests and arises due to the separation of ownership and control. Based on these arguments the role of an effective and standardized Code of Corporate Governance (CCG) is important for the development of capital markets, for firms and easy access to capital that can ultimately contribute to the economic progress of the economy.

The historical development of principles of corporate governance was started with the establishment of the Securities and Exchange Commission of Pakistan (SECP) in 1999\(^2\). SECP was established in light of the 1969 Securities and Exchange Ordinance (SEO), the Company Ordinance (CO) of 1984 and SECP act 1997. SECP enacted first CCG in March 2002 as a regulatory body of non-bank financial sectors including capital markets and corporate sectors. In response to the market concerns and the continuously evolving environment surrounding it, the CCG (2002) was revised and modified into the CCG (2012).

2.3.1 Code of Corporate Governance 2002

The SECP first introduced the CCG in March 2002 as a major reform for corporate governance practices in the country. The initial reforms included in the code were reforms enacted to address the issue of protecting minority shareholders. It further emphasized better information disclosure while recommending the improvement of internal and external audits and the establishment of internal audit committees for effective internal financial control. The SECP has made CCG (2002) as a part of listing stock exchange regulations.

The following section highlights the few clauses of CCG (2002) relevant to the scope of this study.

2.3.1.1 Independent directors

3 Clause (i) addresses the issue of independent board members. It states that all listed companies shall encourage effective representation of independent, non-executive directors, including those representing minority interests, on their boards of directors so that the Board as a group includes core competencies considered relevant in the context of each listed company.

1. The board of directors of each listed company includes at least one independent director representing the institutional equity interest of a banking company, the development of financial institutions, a non-banking financial institution (including a modaraba, leasing company, or investment bank), a mutual fund, or an insurance company.

Explanation

For the purpose of this clause, the expression independent director, means a director who is not connected with the listed company or its promoters or directors on the basis of a family

3 Content has been copied as quoted in the code: http://www.secp.gov.pk/CG/CodeofCorporateGovernance_2002.pdf
relationship and who does not have any other relationship, whether pecuniary or otherwise, with the listed company, its associated companies, directors, executives or related parties. The test of independence primarily stems from the whether such person can be reasonably perceived as being able to exercise independent business judgment without being subservient to any apparent form of interference.

Any person nominated as a director under sections 182 and 183 of the Companies Ordinance of 1984 shall not be taken to be an independent director for the above-said purposes. The independent director representing an institutional investor shall be selected by such investor through a resolution of its board of directors and the policy with regard to selection of such person for election on the board of directors of the investee company shall be disclosed in the Directors’ Report of the investor company.

2.3.1.2 Directors

The clauses (iii) through (vi) of the Code of Corporate Governance (2002) describe the qualification and eligibility criteria for a person to act as a director for a listed company.

(iii) No listed company shall have as a director a person who is serving as a director of ten other listed companies.

(iv) No person shall be elected or nominated as a director of a listed company if: his name is not borne on the register of National Tax Payers, except where such person is a non-resident and he has been convicted by a court of competent jurisdiction as a defaulter in payment of any loan to a banking company, a Development Financial Institution or a Non-Banking Financial Institution; or he, being a member of a stock exchange, has been declared as a defaulter by such the stock exchange.
(v) A listed company shall endeavor that no person is elected or nominated as a director if he or his spouse is engaged in the business of stock brokerage (unless specifically exempted by the Securities and Exchange Commission of Pakistan).

(vi) The tenure of office of Directors shall be three years. Any casual vacancy in the Board of Directors of a listed company shall be filled up by the directors within 30 days thereof.

2.3.1.3 Other important clauses of code

Clauses (vii) to (xiii) explain the responsibilities, power and functions of the board of directors, board meetings, and significant issues related to board of directors’ decision. The other remaining clauses of CCG describe the other important factors, like the role of the Chief Financial Officer (CFO), financial reporting, disclosures, audits, etc. The last three clauses deal with the compliance of the CCG:

(xlv) All listed companies shall publish and circulate a statement along with their annual reports to set out the status of their compliance with the best practices of corporate governance set out above.

(xlvi) All listed companies shall ensure that the statement of compliance with the best practices of corporate governance is reviewed and certified by statutory auditors, where such compliance can be objectively verified, before publication by listed companies.

(xlvii) Where the Securities and Exchange Commission of Pakistan is satisfied that it is not practicable to comply with any of the best practices of corporate governance in a particular case, the Commission may, for reasons to be recorded, relax the same subject to such conditions as it may deem fit.
2.3.2 Summary of the Code Corporate Governance 2002

This section summarizes the CCG 2002. The code highlights the following main points for the improvement of corporate governance practices in the country, such as:

1. The role, responsibilities, composition, eligibility, selection and removal criteria for the board of directors.
2. The appointment, qualification, selection, and responsibilities of the Chief Financial Officer (CFO) and the company secretary.
3. Corporate and financial reporting, director’s reports on financial and internal control, frequency and compliance of reporting, and independence of auditors.
4. Corporate ownership, issuance of new shares, and takeovers.
5. The selection, meeting, and duties of audit committees.
6. Internal auditing guidelines.
7. Criteria for external auditors.
8. Reports on compliance of corporate governance.

The Code emphasizes the representation of non-executive independent directors on the board. At least 25% of board members must be non-executive directors and independent directors must represent the interest of institutional equity ownership. However, it does not emphasize the role of independent directors to protect the interest of minority shareholders (see Clause (i) sub section (b)). One member can hold a maximum of ten board-ship positions while tenure of the board is stipulated for three years. It is the duty of board of directors to implement an effective internal control system, and the board should carry out their fiduciary duties in the best interest of their shareholders. This clause also requires the board to hold at least four board

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meetings to discuss the performance of the company. The board of directors is also responsible for issuing reports on ethics and fair business practices.

The CEO is able to appoint or remove the CFO with the approval of board of directors. Both the CFO and the company secretary must have the membership of recognized professional bodies. The code also sets a minimum educational and professional criterion for the selection of both positions. It also specifies that the CFO and secretary must attend all board meetings.

The code stipulates that unaudited quarterly financial reports must be issued with the approval of the CFO, the CEO, and the board of directors. The reports must comply with the guidelines issued by Institute of Charted Accountants of Pakistan (ICAP) and SECP. Moreover, the company must issue the final annual audited financial report within the last four months of each fiscal year.

Companies should issue their shares in compliance with stock exchange requirements with the approvals of SECP. In cases of corporate takeover, the code provides the following guidance. The board of directors must approve the operation of divestiture in the case that 75% of outstanding shares higher than the market value are taken, and minority shareholders must receive the same share price. If it is lower than the market price, it must be done by the approval of the SECP.

The code also provides guidelines to directorial boards for the formation of audit committees. Any one committee should contain at least three members, preferably members who are non-executive directors, including the chairman. It further recommends a framework for audit committee meetings. Audit committees have to work under the terms of references issued by the board of directors to ensure the compliance of internal reporting and governance standards. They must forward interim reports to the board of directors and the CFO through the company’s
secretary.

To address the issues of internal financial malpractices, the code recommends the establishment of an internal audit committee for effective internal control. The head of the internal committee should have access to the chair of the audit committee. The internal audit committee should also present its reports to the external audit committee in order to ensure that the financial information is sound.

The external auditors must be an independent organization having no other relation to the auditing firm except a professional one. The code also suggests the rotation of external auditors after every five years.

Finally every listed company must circulate a report of compliance with the code of corporate governance and submit it along with the annual report to the SECP. The compliance reports must be certified by statutory auditors.

2.3.3 Code of Corporate Governance 2012

Several studies have highlighted the importance of CCG’s development and improvement for the enhancement of corporate governance mechanisms in various countries (see Aguilera and Cuervo-Cazurra, 2004; Zattoni and Cuomo, 2008). The study by Aguilera and Cuervo-Cazurra (2004) concluded that the adoption of the CCG as practice improved the corporate governance system in the country. They further argued that improvements to the code were responses to exogenous and endogenous pressure that arose due to the deficiencies in the code. Several studies as well as the OECD highlight the CCG as an evolving mechanism to address the changing environment of businesses surroundings. In this vein, the OECD has revised the 1999 principles of corporate governance in both 2004 and 2014 respectively.
Similarly, in response to endogenous and exogenous factors, the SECP revised their own CCG in 2012. Following the implementation of the CCG (2002) the SECP has taken various steps to address the market imperfections, such as establishing new institutions like the Pakistan Institute of Corporate Governance (PICG). It plays a role in reviewing the code and is involved in the training and awareness of different players in the market. The PICG with International Finance Corporation (IFC) put forth a survey on corporate governance in 2007\(^5\). This survey found that the majority of the companies did indeed follow the CCG, as it was mandatory. However, the desired results still had yet to be achieved, and the primary reason was a lack of awareness for the implementation of code among relevant parties. The survey emphasized the role of company boards for the implementation of the CCG and the improvement of corporate governance. It further highlighted the importance of independent directors on corporate boards and audit committees. More importantly, the survey concluded that regulatory requirements related to the protection of minority shareholders need full implementation and strong monitoring.

As stated by the chairman of the SECP in his message on the implementation of a modified CCG (2012), corporate governance standards are dynamic and need to be reviewed in order to meet international standards of the governance. Therefore, in order to catch up with evolving corporate sector and financial markets, the CCG was revised again in 2012. The following section of the study highlights the important clauses relevant to the internal attributes of corporate governance that were revised in the CCG (2012).

The currently effective CCG (2012)\(^6\) in Pakistan has been in place since April, 2012. In contrast to the CCG (2002) which contained 47 clauses, the revised code comprises of 42 clauses that are

further divided to sub-clauses as well. Each clause addresses a single issue that is considered vital for fair corporate practices in Pakistan’s business environment. Several important clauses that address the composition of board members, the CEO, and outside board directors are as follows.

### 2.3.3.1 Independent directors

In CCG (2012), clause (i) provides the guidelines for directorial boards. The sub section (b) of this clause states that,

*The board of directors of each listed company shall have at least one and preferably one third of the total members of the board as independent directors. The board shall state in the annual report the names of the non-executive, executive and independent director(s).*

In CCG (2002) it was optional to have independent directors; however, now it has become mandatory to have at least one present on any company’s board of directors. The clauses (ii) to (v) highlight the roles, duties, and obligations of elected members of the board. They include that an individual may be a board member for a maximum of seven companies, compared to the ten companies stated in the previous version. It was also made mandatory for board members to evaluate their performance and provide guidelines for directorial training as well.

### 2.3.3.2 CEO Duality

Clause (vi) of the CCG (2012) defines the roles and selection criteria for the CEO. It states,

*The Chairman and the Chief Executive Officer (CEO), by whatever name called, shall not be the same person except where provided for under any other law. The Chairman shall be elected from among the non-executive directors of the listed company.*
It further explains that board members must clearly define the duties of the CEO and the board chairman.

This clause distinctly prohibits CEO duality, unlike CCG (2002) which made it voluntary to have separation between the CEO and the chairman. In summary, the CCG (2012) makes it mandatory for all the listed firms to submit a declaration of compliance to the code of corporate governance in their annual financial statements. Moreover, it also requires that this disclosure must be reviewed by the auditor of the financial statement. Good corporate governance ensures the accountability of the management and the board in use of such capital. According to its stipulations, the board of directors will also ensure legal compliance and their decisions will not be based on the consideration of political or public relations.

2.3.4 Comparison of Codes of Corporate Governance

This section highlights the clauses that have been modified or added to the CCG 20127.

1. The CCG (2012) made it compulsory to have at least one independent director on board, compared to the CCG (2002) where it was optional. It further provided expanded criteria for the assessment of independence of the director.

2. The new code made it mandatory that no more than 33% of board members should be executive directors, including the CEO, where in the CCG (2002) this proportion was 75%.

3. The CCG (2012) limits the board membership of a director to a maximum of seven companies. This means that one member can be on the board of directors of seven different companies, which were ten companies in the previous code.

4. The CCG (2012) implemented an annual performance evaluation criterion of board

7 Detailed presented in official version is provided in the appendix.
members. It states that after 2 years of the implementation of the CCG (2012) companies must establish the performance evaluation criteria of all board members.

5. In CCG (2002) it was optional to have the separation between the CEO and board chairman, but in CCG 2012 it is mandatory to separate the CEO and board chairperson.

6. In contrast to the CCG (2002), where the CEO was responsible for the appointment, remuneration, and removal of the Chief Financial Officer (CFO) and Company Secretary (CS), in the new code, boards are responsible for these actions, including the appointment of an Internal Audit Committee (IAC) head.

7. The CCG (2012) introduced the qualification, appointment, and removal criteria for IAC head.

8. Following the standardized international criteria of the CCG (2012) it enforced the disclosure of directorial remuneration in annual reports.

9. In the new code it is now mandatory that separate individuals should hold the position of the head of the IAC and the head of the board of directors. Moreover, it states that CFO and CS positions must not be held by the same person.

10. In the recommendations of the new code, company can outsource internal audit functions. In that case, companies must hire on a full time employee as head of internal audit as a coordinator between the service-providing firm and the board.

2. 4 Financial markets

*In developing economies, firms tend to have greater need of external capital to sustain growth, but these economies typically are unable to provide adequate protection for investors through a developed and well-functioning financial market. In underdeveloped financial and capital
markets, there is a greater probability of moral hazard and adverse selection, and investors are frequently exposed to risk (Jang, 2001, pp. 79).  

According to Isaksson and Celik (2013), “the quality of corporate governance plays a critical role at every stage of the investment process, including corporate access to equity, the allocation of equity among competing ends, and the continuous monitoring of corporate practices and performance.” They further argue that with the changes in the market, policy makers need to establish rules and regulations that contribute to the enhancement of the corporate governance mechanism and its impact on the functioning of the equity market. Therefore, this section will evaluate the role of the CCG in the case of Pakistan to achieve the above mentioned objective. It briefly summarizes the money market and capital markets, as facilitators of the flow of funds in the economy, as important components of financial markets in the country.

2.4.1 Money market in Pakistan  

Money markets as parts of larger financial markets deal with short-term conventional and Islamic securities with high liquidity. Short term securities are defined as the securities that have maturities of less than one year and are classified as highly marketable. Therefore, money markets target the participants who want to be involved in short term borrowing and lending. The individual investors have limited access to these securities, due to their large trade value. However, small investors have easy access to money market funds. Firms access money markets to finance their working capital needs. Moreover, the money market supplies funds for speculative buying of different commodities and securities. A well-developed money market is

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8 Jang, H.S (pp. 73-118, 2001); http://elibrary.worldbank.org/doi/abs/10.1596/0-8213-4862-0  
9 Information about financial markets has been taken from the websites of the Karachi Stock Exchange (Limited) and the Economic survey of Pakistan, 2013 by Ministry of Finance Pakistan. Websites are (http://www.kse.com.pk/ and http://www.finance.gov.pk/survey/chapters_13/06-Capital%20Markets.pdf)
required for channeling the funds to the most demanding sectors in the economy.

In Pakistan, the money market provides a system through which the banking system makes maximum profit out of its available resources before approaching the last resort of lending, i.e. the State Bank of Pakistan (SBP). The money market is mostly an inter-bank mechanism where banks act as lenders and other participants as borrowers. Other financial institutions can also lend their surplus funds on call in the money market. These transactions are held in the city of Karachi, the financial hub of Pakistan where the head offices of most major banks are located. Bank branches from various parts of the country send their surplus funds to head offices in Karachi for investment and borrow from the head office in the times of need. Apart from domestic banks, foreign banks also participate in the money market. Banks use discounting bills as lending instruments to reputable parties.

In order to develop the discounting bill, the SBP operated a Bill Discounting Scheme in 1960s, where it used exchange bills that arose out of commercial or trade transactions to provide credit facilities. In a practical situation, scheduled banks lend money to borrowers against the issuance of promissory notes within 90 days. Then banks then uses these promissory notes to borrow from the SBP. Historically, the SBP\textsuperscript{10} issued three month treasury bills (TBs) in 1948-49 with the idea of providing banks with short-term investment opportunities in order to resolve the seasonal fluctuation in interest rates rather than simply raising finance for the government. This service was suspended during 1959-60 due to a decline in the money market. After that, in 1980 the SBP again started to issue treasury bills to raise the funds for the government. It flourished after 1991 through switching to a market based monetary policy. From 1992, public debt was auctioned and the rates of returns were decided in the market. Moreover, the money supply

\textsuperscript{10} More information about money market and capital market in Pakistan it obtained from “Money and Banking in Pakistan” by S.A Meenai, revised and expanded by Javed A. Ansari. Oxford University Press, 2001.
management system was introduced in 1995 through auctioning off public debt instruments of different maturities in the open market.

2.4.2 Capital markets in Pakistan

Capital market plays an important role in the economy by mobilizing idle savings from house-holds in order to allocate funds for capital formation in the economy, which in turn contributes to the existing capital stock. It is considered the backbone of the economy for its role in channeling funds for investment. More precisely, capital markets bring in household savings for productive use through investors. They create investment opportunities in the form of equities, medium and long term bonds, mutual funds, insurance policies, and so forth. This is contrary to money markets, which constitute short-term investment opportunities. Capital markets provide various platforms to the investors to diversify their investments to reduce the financial risk. Capital markets provide the platform for businesses to finance their medium and long term investments.

In modern economics the role of capital markets in economic growth and development of economies is inevitable. It is assumed that countries with well-developed capital markets are more prone to robust long term economic growth. Efficiently operative capital markets are not only for the source of financing private sector, but they also meet the demand of government borrowings. However, it can be assumed that Pakistani capital markets are underperforming. For instance, the market capitalization to GDP ratio given in table 2.2 shows that Pakistani stock markets are undervalued and are lowest among all the countries mentioned in the table.

2.4.3 Securities market

In Pakistan securities are traded in two sub markets of security markets known as the primary
market and the secondary market. The primary market provides the platform for the newly issued securities for long-term capital procurement. To issue these securities to investors, investment banks act as underwriters on behalf of a security issuing company. The issuing company then uses the investment banks services because it is less costly to sell new securities than to sell securities to each investor individually.

Table 2.2: Market capitalization comparison

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP (2010) (USD Billions, PPP)</th>
<th>Market Capitalization (USD millions)</th>
<th>Market CAP/GDP (nominal)</th>
<th>Number of all listed companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangladesh</td>
<td>244.33</td>
<td>46999</td>
<td>47%</td>
<td>302</td>
</tr>
<tr>
<td>China</td>
<td>10085.71</td>
<td>4762836</td>
<td>81%</td>
<td>2063</td>
</tr>
<tr>
<td>India</td>
<td>4198.60</td>
<td>3228455</td>
<td>210%</td>
<td>6586</td>
</tr>
<tr>
<td>Indonesia</td>
<td>1029.79</td>
<td>360388</td>
<td>51%</td>
<td>520</td>
</tr>
<tr>
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<td>410534</td>
<td>172%</td>
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<td>Pakistan</td>
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<td>38168</td>
<td>21.8%</td>
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<td>157320</td>
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<td>Singapore</td>
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<td>Thailand</td>
<td>586.82</td>
<td>277731</td>
<td>87%</td>
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Source: Quoted from Reform priorities in Asia taking corporate governance to a higher level OECD (p. 8, 2011) (World Bank Data Base http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP_PPP.pdf and World Federation of Stock Exchanges.)

The investments banks generally issue securities to all investors at a set price; in this way company can procure a fixed amount of capital from all new securities. Contrary to the primary
market, the secondary market provides a platform for the trading of previously issued securities. Unless issuing company purchase back their issued securities, they will not affect the outstanding amount of the securities. In general, they only transfer the ownership to new investor from previous owner.

As a part of financial liberalization, Pakistan opened its secondary markets to foreign investors in 1991. Meanwhile, the government initiative of privatization resulted in the rapid growth of capital markets. Under the privatization policy, the Pakistani government opened the doors of public companies to domestic and foreign investors. Under this policy, the government opened the door for the private sector to invest in commercial banks, general insurance companies, mutual funds, and so forth. The financial liberalization prophecy encourages the government to deregulate the national economy. Under this majority, the sectors were liberalized by the government, barring a few strategic sectors, and this resulted in increased foreign investments in Pakistan\textsuperscript{11}.

There are three stock exchanges in the country, these being the Karachi Stock Exchange (KSE), the Lahore Stock Exchange (LSE), and the Islamabad Stock Exchange (ISE). These stock exchanges provide a platform for the trading of previously-issued securities such as debt, equity, and hybrid securities through brokers.

\textsuperscript{12}KSE is the most liquid and largest stock exchange in the country. The KSE was established soon after the independence of Pakistan on the 18\textsuperscript{th} September 1947. It was incorporated as a guarantee limited company on 10\textsuperscript{th} March, 1949. On August 27\textsuperscript{th}, 2012 it was demutualized as the Karachi Stock Exchange Limited (KSEL). In the demutualization process, 40\% of stakes with management control were sold to strategic investors, 40\% were retained by

\textsuperscript{11}Information about financial liberalization of secondary market liberalization is taken from annual dairy, published by Karachi Stock Exchange Limited Pakistan.
\textsuperscript{12}General information about Karachi Stock Exchange is available at (www.kse.com.pk)
ex-members/now-shareholders, and 20% were offered to the general public. In the beginning, the KSE started its operation with five companies and paid up capital of 37 million rupees (Rs) with 50-shares index. The growth of market size with the passage of time resulted in the introduction of the KSE-100 index on November 1, 1991. To date, this index is considered as a generally accepted benchmark of the exchange. KSE-100 represents the 80% market capitalization and consists of 100 companies listed on the exchange. Furthermore, in order to have a benchmark with which the stock price performance can be compared over a period of time, exchange is done using the KSE-30 index. Using global free-float methodology, the KSE-30 index shows the free-float market value of 30 companies in relation to the base period. Following the same method, the KSE introduced the KMI-30 (KSE Meezan Index) with the cooperation of the Al-Meezan Investment Bank. The objective of this index was to scrutinize the performance of Shariah compliant equity investments. It is also calculated by the free float methodology. Since 2002 KSE has introduced computerized trading system named Karachi Automated Trading System (KATS).

Historically, the KSE has achieved remarkable achievements, it being the most liquid stock exchange of the country. For instance, in 2002, the KSE was declared the best performing stock market in the world. As of September 4th 2015, 560 companies are listed on KSE with a total listed capital of Rs. 1,256,920.65 million, and a total market capitalization of Rs. 7,342,914.88 million. The KSE-100 index closed on the same day with a total of 33891.08 points.

Apart from the KSE two other stock exchanges are functioning as a part of security markets in Pakistan. The LSE stands second to the KSE in term of trading and exchange. It was established in October 1970. It currently serves companies functioning in various cities of the Punjab province. ISE is the newest among three exchanges in the country. It was established in

2.4.4 Non-securities markets

The non-securities market comprises of development financial institutes (DFIs), commercial banks, and specialized banks/institutions for industry, small enterprises, housing, and agriculture. In contrast to securities market, the non-security market is dominant in Pakistan. It provides medium and long term financing/debt funds through bank and non-bank financial institutions to industries, businesses, and other users. The major products of the market include leases, mortgages, loans, and so forth. There are also non-banking financial institutes that are part of this market and provide financing to the households, such as house building finance corporation of Pakistan.

![Figure 2.1: Financial markets structure in Pakistan](image)

2.5 Summary

This chapter provides a review of the debate on the CCG. Initially it highlights the significance of the CCG by summarizing the OECD principles of corporate governance, followed by the importance of the CCG for a developing economy, such as in Pakistan. In line with the objectives of the study, this section specifies the historical development of the CCG (2002) along with a summary of most relevant clauses. Following this, it summarizes the CCG (2012),
especially, highlighting the revisions and modifications made to the initial CCG by providing a summary of the comparisons between CCG (2002) and (2012).

One of the objectives of the study is to examine the role of the CCG in the development of capital markets in the country. Therefore, second part of the chapter reviews the financial markets of Pakistan. It primarily covers the historical development of the financial markets in the country. The final section provides the summary of money, capital, securities, and non-security markets in the country.
Chapter 3
Theoretical background and literature review

3.1 Debate of theories

The significance of corporate ownership structure on capital structure choices has been argued in literature. The debate on separation of control and ownership of corporations, goes back at least to times of Adam Smith (1776) in reference to joint-stock companies. However, concept of current modern publicly held large corporation was put forwarded by Berle and Means (1932). The separation of ownership and control, especially in large corporations refers to, where shareholders as owners (residual claimants) provide the finances required to run the business. Managers control the firm and its resources on behalf of its owners, i.e. shareholders. Jensen and Meckling (1976) in their seminal work on the principal-agent problem, defined the agency costs that occurred in relation to separation of ownership and control.

The separation of ownership and control has become one of the most discussed topics in the study of corporate governance and corporate finance, particularly after the corporate scandals of Enron and WorldCom since the start of this century. These failures certainly prove the importance of efficient governance mechanism even in the developed economies where they have well developed capital markets, organized institutional frameworks, effective regulatory framework etc. In literature corporate governance is described as a mechanism to minimize the agency conflicts of principal-agent in relation to separation of ownership and control in modern corporations. On the other hand, corporate finance theories deal with the strategic decisions of firms financing choices, in terms of cost of capital. Several scholars, point out the existence of agency cost related to suppliers of capital, i.e. shareholders (residual claimants), debt holders
(creditors) and managers that control the usage of supplied capital. On the basis of this argument, corporate scholars point out the agency cost as one of the determinants of capital structure, and propose the corporate governance mechanism to alleviate the agency cost.

The debate on capital structure starts with pioneering work of Modigliani and Miller (1958; here after MM theorem) famous irrelevance theorem. MM theorem (1958) proposes the irrelevance of choices between debt or equity n capital structure decisions in frictionless markets. Later on in response to criticisms by scholars, Modigliani and Miller (1963) argue the use of debt to avail debt-related tax benefits. Since then literature has evaluated the firm’s capital structure in terms of taxes, asymmetry of information, imperfect markets, etc. and developed new theories such as Trade-off theory, Pecking Order Theory, Free cash flow hypothesis, Signaling model, and Market timing theory. Jensen and Meckling (1976) in their seminal work, first time evaluated the ownership and capital structure under agency theory framework. Hart (1995, pp. 147) explains that “why agency theory perspective is important, and in particular, why the conflict of interest between a company’s managers and its investors is crucial for an understanding of capital structure.” He further states that in contrast to other theories, agency theory has an advantage, i.e. it explains why firm issue debt and why failure to make debt payments has a penalty in the form of bankruptcy. It concludes that though, agency approach is not the whole story, along with other mentioned factors, it can help to develop a complete capital structure theory (see Hart, 1993).

In contrary to this, several scholars see the profound involvement of corporate finance and governance with the capital structure. Williamson (1987) study states this relationship in following words, i.e. “debt and equity are not mainly as financial instrument, but also as alternative governance mechanisms”. In existing literature several eminent scholars laminate the
relationship among corporate governance, capital structure, and separation of ownership and control, etc. under the lens of agency theory and transaction cost economics (see Hart, 1993; Williamson, 1987; Jensen and Meckling, 1976; Coase, 1937).

In summary, in order to evaluate the CCG, 2012 by exploring the unique financing feature of the non-financial firms section 3.2 reviews the mainstream capital structure theories followed by the section 3.3 that provides the review of empirical literature on determinants of capital structure. Afterwards, section 3.4 reviews the empirical debate on impact of ownership patterns such as managerial ownership, institutional shareholdings and presence of bloc-holders on capital structures. Finally, section 3.5 and 3.6 review the corporate governance theories and empirical literature on impact of corporate governance attributes on capital structure respectively.

3.2 The capital structure theories

Capital structure refers to mix of debt and equity securities to finance the real time investments. There is no single universal capital structure; however, literature does highlight the different conditional optimal capital structure theories. These theories of capital structure are based on assumptions of, tax benefits, information asymmetry, agency costs, and market imperfection and so on. Agency costs in context of real markets contrary to MM theorem (1958) discussed in literature are transaction cost; monitoring cost; bankruptcy cost; moral hazard; adverse selection and other information related agency costs. In the line with objectives of this dissertation, firstly, we will review the mainstream capital structure, governance and ownership structure theories respectively followed by the review of empirical studies based on these mainstream theories’ assumptions.
3.2.1 Trade-off theory

The origin of the trade-off theory (static) goes back to the study of Modigliani and Miller (1963) which in response to the criticism on MM theorem (1958) they suggested the use of debt as a financing tool based on debt-related tax benefits. To address the issue Kraus and Litzenberger (1973) state that “firm should trade-off bankruptcy cost with the tax benefits (tax shield) of debt to arrive at an optimal capital structure.” Their model concludes the taxation on corporate profits, and the existences of bankruptcy are market frictions contrary to MM theorem (1958) assumptions. The present value of gains resulting from debt financing (tax shields), contributes to the value maximization of the firm. To get the tax benefits, this theory supports the maximum use of debt. However, there exists an offsetting cost of debt, i.e. bankruptcy, increase in debt increases the financial distress. Haugen and Senbet (1978) divide the financial distress cost into direct and indirect cost. Direct cost includes the legal and administrative cost of bankruptcy, cost of reorganization, higher agency costs such as monitoring cost, moral hazard, etc. and higher cost of debt or equity due to the loss of creditworthiness even in case if default is avoided. Indirect costs include loss of trust by other stakeholders such as employees, suppliers, customers, etc.

Trade-off model predicts the adjustment of the debt ratio by a firm to an optimal debt level. So what is the optimal debt ratio; firm’s optimal debt ratio is usually viewed as determined by a trade-off of the costs and benefits of borrowing, holding the firm’s assets and investment plans constant (Myers, 1984). More precisely, where the benefits from extra dollar of a debt equal to the cost incur with the probability of financial distress (see Myers, 2001). Trade-off model is categorized into two models, i.e. static and dynamic trade-off model. The static trade-off theory is a single period trade-off between the tax benefits of the debt and the deadweight cost of bankruptcy as well as the agency cost of debt and equity (Baker and Martin, 2011, pp.19).
In dynamic Trade-off model debt ratios deviate from an optimal ratio for most of the firms. Fischer et al. (1989) conclude the firms even in trade-off setting with a fixed cost of issuing equity, firms may adjust the leverage only when it drives further than the extreme level, in their capital structure. Despite the advantages and disadvantages of the debt financing empirical literature lack consensus on an optimal debt level, and either firm should move toward adjusted debt target or adjust it periodically.

Several researchers tested the trade-off model hypothesis but couldn’t find conclusive support for the theory. For instance, Myers (1977) finds out that debt financing maximizes the market value of the firms, due to tax deductible interest expenses while ignoring the bankruptcy cost. In contrast Fama and French, (1998) found no support for the tax shield contribution to the firm’s market value. Kim (1982) explores in the presence of significant leverage related bankruptcy and agency costs and untaxed income from equity, then the marginal bondholder’s rate will be lower than the corporate rate, finally debt financing will have a positive tax advantage. Similarly, MacKie-Mason (1990) provides evidence of tax effects on the choices between debt and equity. It states that companies with the low marginal tax rates are more likely to choose equity over debt as compared to the profitable firms facing the full legal tax rate. These findings endorse the trade-off theory predictions by suggesting that taxpaying firms favor debt over equity. However, it is difficult to infer from the MacKie-Mason (1990) study that different tax rate or debt contributes to the market value of the firm or not (see Myers, 2001; Fama and French, 1998; Graham, 1996).

In sum, even though there are some discrepancies in trade-off theory, however, its predictions on optimal capital structure choices have strong practical appeal. It rationalizes the use of debt in capital structure decisions, particularly for firms with high tangible assets and
positive future cash in-flow. This will help the firm to take more advantage on the tax shield compared to the firms with fewer tangible assets.

3.2.2 Pecking Order Theory

Pecking Order Theory unlike the trade-off model considers debt as a secondary source of financing. Myers (1984) predicts an order to follow for financing sources, it states firms better utilize internally generated sources (retained earnings) first, then go for debt and equity respectively. This financing order was based on the adverse selection model of Myers and Majluf (1984) which states that outside investors are less informed than managers, which may affect negatively the market price of equity (further see Akerlof, 1970, markets for lemons). Because of this mispricing of equity in the market due to information asymmetry, new shareholders will purchase the equity at low price, and eventually this loss will be higher than the net present value (NPV) of the project. This will result in net loss for the existing shareholders. In this case, managers will not invest in the project even with positive NPV. In order to finance, investment theory predicts when investment exceeds from earnings debt financing will increase or vice-versa. To avoid this kind of underinvestment, Myers (1984) suggests managers to follow pecking order, i.e. to use the internal sources (retained earnings), debt and equity as a last source of capital in order to cope with information asymmetry, transaction cost and adverse selection problems. Krasker (1986) endorses the adverse selection problem highlighted by Myer and Majluf (1984) in relation to the issuance of risky security either in the form of debt or equity.

A strict interpretation of Pecking Order model suggests that firms do not aim at any target debt ratio; instead, the debt ratio is just the cumulative result of hierarchical financing over time. Firms that face a financial deficit will first resort to debt, and will be observed later at higher
debt ratios (Shyam-Sunder and Myers, p. 223, 1998). Therefore, it can be assumed that the optimal choices of capital structure under pecking order hypothesis are continuously evolving.

Similar to other capital structure theories’ empirical literature on Pecking Order Theory provides mix findings. Shyam-Sunder and Myers (1999, pp. 242) state that “pecking order is the perfect first-order descriptor of corporate financing choices.” Frank and Goyal’s (2003) study on data of US firms, supports the pecking order in larger firms. Critics of theory suggest that pecking order suggests, it may work well in case of issuing securities (debt or equity) for initial financing, however, may not work well in case of deficit financing. Lemmon and Zender (2004) conclude that debt rated firms use debt over equity in contrast small firms with high growth and no debt rating issues equity. They further argue that these small firms rely on equity due to their limited debt capacity. Their results are consistent with the findings of Frank and Goyal (2003); and Fama and French (2002). However, Frank and Goyal’s explanation argues that these small firms are more prone to information asymmetry, and issue equity under the Pecking Order Hypothesis. Moreover, Agca and Mozumdar (2005) explore no support of Pecking Order Theory in their financial structure decisions of small firms. Finally studies of Leary and Roberts (2010) and Chirinko and Singha (2000) report no support for Pecking Order Theory.

The general assumption of Pecking Order Theory is that high-profit generating firms are less dependent on debt compared to firm with lower profitability. Empirical studies on exploring the determinants of capital structure under Pecking Order Theory hypothesize negative relationship between profitability and leverage, studies such as (Khan, 2014; Sheikh and Wang, 2011; Jong et al., 2008; Viviani, 2008; Zou and Xiao, 2006; Bauer, 2004; Chen, 2004; Booth et al., 2001; Wald, 1999; Rajan and Zingales, 1995 and Titman and Wessels, 1988) endorse the Pecking Order Hypothesis. Based on these findings, one cannot conclude that absoluteness of
Pecking Order Theory; however, it can be endorsed as it helps us to understand the financing choices of firms.

Additionally, critics of this theory point out when and how much debt a firm should go for followed by equity or firm should only rely on debt as an external source of financing? “Debt capacity” limits the use of debt within Pecking order, and existing literature lacks evidence to define the proper debt capacity (see Frank and Goyal, 2007). In response to adverse selection point of view in Pecking Order Theory, Korajczyk et al. (1991) states with the varying adverse selection for new equity, firms issue the equity when markets are more informed about the firm’s quality. This argument is further elaborated and endorsed in Baker and Wurgler (2002) market timing theory. In sum, pecking order does explain why the major portion of the external financing comes from debt. It also explains why profitable firms with sufficient internal funds should not rely on debt but unlike trade-off theory, it does not predict any target debt ratio for a firm.

According to Korajczyk et al. (1991, pp. 686) due to asymmetries of information, insiders with superior information about the firm have an incentive to issue shares when the firm is overvalued. Consequently, outsiders lower their evaluation of the issuing firm’s quality. This creates a “lemons market” [Akerlof (1970) and Myers and Majluf (1984)] in new equity issues. They further argue that it is assumed that a firm can issue risky securities when the market is most informed, because there will be lower impact on equity prices due to lower information asymmetries. Therefore, as of the firm’s discretion in the timing of issues of risky securities, we should expect to see these issues clustered after information disclosures such as annual reports or quarterly earnings releases (Korajczyk et al. 1991).

Moreover, in order to avoid the adverse selection and information asymmetry pecking
order theory predicts the hierarchal financing order. However, market timing theory predicts that low-leverage firms tend to be those that raised funds when their valuations were high, and conversely high-leverage firms tend to be those that raised funds when their valuations were low (Baker, 2002, pp.29).

3.2.3 Agency theory

Berle and Means (1932) proposed the separation of ownership and control in modern corporations. As quoted in Berle and Means revised version (1967, p. 66) that “Ownership of wealth without appreciable control and control of wealth without appreciable ownership appears to be a logical outcome of corporate development.” Since then extensive literature analyzed the phenomenon of ownership and control under the corporate governance mechanism. Jensen and Meckling’s (1976) work expanded the scope of the agency theory framework to corporate finance literature. Agency theory is built in the context of principal-agent relationship to address the agency conflicts in the agency (firm). Agency relationship is defined “as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent” (Jensen and Meckling 1976). They define agency cost as sum of,

1. *The monitoring expenditures by the principal*

2. *The bonding expenditure by the agent*

3. *The residual loss*

Unlike, MM theorem (1958) irrelevance proposition which assumes no agency cost and suggests that choice between debt, and equity has no material effect on firm performance in perfect capital markets. Agency theory suggests that there is a material effect of choice between
debt and equity even in frictionless markets and no taxes. Its assumptions are based on the agency costs of debt and equity. According to Jensen and Meckling (1976) agency cost arises as a conflict of interest between the principal and agent, and recognizes potential agency conflicts between shareholders and debt holders (principals), and managers (agent). They strongly support that agency cost is not independent of capital or ownership structure and proposes that an optimal capital structure can be achieved by offsetting the agency cost of debt to the benefits of debt.

The conflicts of interest between managers and shareholders result in various agency problems such as *shirking*, *entrenchment*, which refers to the misuse of firm’s resources under the discretion of managers. Most of the literature uses agency theory to address the mentioned conflicts. However, limited literature uses the agency theory to analyze the corporate capital structure. In fact, since MM theorem (1958) the literature has tended to focus on the role of taxes, information asymmetry, or imperfect markets as the explanation of capital structure decisions but has not included the agency problems (Hart, 1995, p.147). A part from these factors he highlights the importance agency theory to understand the conflict of interest between providers of finances and controllers of finances in its relation to capital structure decisions. Hart (1993) argues that agency approach has more advantages over other theories of capital structure, as it clearly explains why the firm issues senior debt (long term) and why firm’s failure to meet debt obligations leads to bankruptcy as a penalty. This study further expands the argument of agency theory by highlighting the conflict of interest between shareholders and debt holders, which has been missing in the agency theory.

In modern large corporations, shareholders (residual claimants) delegate the control of their finances to managers (non-residual claimants), as managers hold less than 100% residual
loss that results in conflict of interest between the two parties. On the other hand, conflict between debt holders and shareholders arises because debt encourages the shareholders to invest sub optimally. Through which shareholders gain the benefits on the creditor’s money, but if investment fails, the creditors have to bear the consequences. This phenomenon is known as “asset substitution effect” an agency cost of debt (see Muradoglu and Sivaprasad, 2011).

Jensen and Meckling (1976) introduced “alignment of interest” hypothesis, i.e. equity ownership for managers to solve the principal-agent interest conflict. After that several scholars shed the light on the agency conflicts related to managerial behavior, such as, shirking, managerial opportunism, managerial entrenchment and proposed different hypothesis to overcome these conflicts, e.g. active monitoring hypothesis, creditors’ monitoring hypothesis, managerial incentives and so forth (see Shleifer and Vishny, 1986; Grossman and Hart 1982; Alchian and Demsetz, 1972). As mentioned by Hart (1993) that very limited empirical research has been done to explore the capital structure of a firm in agency theory framework, particularly in terms of its role in significance of ownership structure on financing choices. Few studies like (Brailsford et al., 2002; Short et al., 2002; Ruan et al., 2011; Wahba, 2014) have explored the relation of insider and outsider ownership patterns on financing choices and its ultimate impact on firm’s performance. They explored the variance in debt financing with the changing managerial equity ownership. Empirical evidence fails to establish a consensus on the relationship between ownership structure patterns and capital structure. Due to lack of consistent findings, agency theory approach may not cover the complete understandings of optimal capital structure, but it does provide useful insight to explain the tendency of managers and shareholders towards the debt.
3.2.4 Free cash flow theory

Similar to other capital structure theories, free cash flow theory conditionally advocates the optimal capital structure. In financing decisions, free cash flow hypothesis supports the use of debt even in the presence of its agency cost. It claims, in spite of financial distress, debt can contribute to firm value (Myers, 2001). Free cash flow is cash flow in excess of that required to fund all projects that have positive net present value when discounted at the relevant cost of capital (Jensen, 1986). The free cash flow inflates the conflict between managers and shareholders on the issue of pay out when a firm generates excessive cash flow. Free cash flow hypothesis claims to resolve the problem of motivating the managers to disgorge the cash instead of using it in organization inefficiencies or investing it at below the cost of capital.

Jensen (1986) states that agency cost of debt has been discussed extensively in literature. However, using of debt as a motivation tool for managers has been ignored. He named it “control hypothesis,” which states that managers by issuing debt show their commitment for future cash outflow, instead of dividend payout. Debt-related commitments reduce the availability of free cash flow under managers’ discretion, which ultimately minimizes the agency cost of free cash flow. Jensen (1986) called this control effect of debt as a potential determinant of capital structure. Similar to this in an earlier study Grossman and Hart (1982) postulate the debt issuers monitoring as a mechanism to bind the managers to reduce their perquisites and minimize the possibility of bankruptcy.

In contrast to Jensen (1986) and DeAngelo and DeAngelo (2006) points out that firm can control agency cost by using low leverage, substantial dividend payouts and holding moderate cash, while preserving the financial flexibility. Critics of free cash flow do endorse the use of leverage to mitigate the agency conflicts, however, point out that high leverage reduces the
firm’s financial flexibility. In sum, Jensen (1986) himself points out that control hypothesis does not mean that debt can always have positive control effects. However, despite debt’s agency costs and related risks it has potential to maximize the firm value by putting the firm on a diet deal.

3.2.5 Signaling model

This model also highlights the importance of information quality for financial structure decisions. Primary assumption of this model is that inside managers pose more reliable information about the firm. Signaling model predicts how managers can use this information to send the signal to the market through their financing choices. More precisely, capital structure serves as a signal of private information (Ross 1977). This model postulates that when manager feel that markets under value the equity of their firms, they issue debt. Issuance of debt is perceived as a signal in the market, investors assume it as a sign of positive cash inflows to the firm to meet the debt related future obligations. Miglo (2010) states that signaling model lacks empirical evidence for its core assumption, i.e. prediction of positive reaction by market on issuance of debt. However, there exists some empirical support for negative reaction of market the leverage decreasing transactions or a positive market reaction for leverage increasing transactions except debt (see Masulis, 1980).

On the positive, side signaling model explores the other discussions, such as how a firm after issuing an equity shortly after the issuance of debt can improve its performance or contrary to the main prediction, why high-profit firms may not issue the equity as a signal to market (see Brick et al., 1998; Noe, 1988). Additionally, the adversaries questioned the model on the odds of debt such as financial distress and associated agency costs. Despite these flaws, Ross (1977) was
the first who introduced the signaling mechanism to address the information asymmetry between insiders and outsiders.

3.2.6 Market timing theory

The idea of market timing is not new, Korajczyk et al. (1991) in response to adverse selection point of view in Pecking Order Theory, states, with the varying adverse selection for new equity; firms issue the equity when markets are more informed about the firm’s quality (also see Lucas and McDonald, 1992 and Lucas and McDonald, 1991). However, this idea appears as a main-stream capital structure theory named “market timing” in the work of Baker and Wurgler (2002). This theory presents two versions of market timings one addresses to the information asymmetry issue highlighted in Pecking Order Theory, Myers and Majluf (1984) and other is adverse selection in equity financing proposed by Korajczyk et al. (1991).

Market timing theory primarily postulates that capital structure evolves as the cumulative outcome of past attempts to time the equity market (Baker and Wurgler, 2002). They further claim that capital structure theory is not the quest to maintain a target capital structure, it is the result of equity market timing. Such as, firm issue the equity when its share prices are high, and issue debt when share prices are low. In their study, they concluded that high leveraged firms are those who at the time of need of capital for real investment went for debt finances when their share prices were low in the market. On the contrary, low leveraged firms are those firms, which choose equity financing due to higher share price value in the market.

Unlike other theories of capital structure, this theory lacks of empirical evidence. However, Baker and Wurgler (2002) support their argument with the findings of Graham and Harvey (2001) survey of chief financial officers (CFO). Their survey concludes that two-thirds
of responding CFOs claim that market share prices influenced their financing decisions. Frank and Goyal (2007) state that market timing theory as a competitor to conventional theories is not yet established.

3.2.7 Corporate control and Product cost theories

A part from the mainstream capital structure some scholars have evaluated the capital structure under corporate control theories and product cost theories. The work of Harris and Raviv (1988) and Stulz (1988) on capital and ownership structure and future corporate control proposed the theory of corporate control and capital structure. This theory states that the capital structure choices through voting control between managers, and outside investors affect the outcome of takeovers. The basic idea here is that managers choose a capital structure and ownership structure that favors them in future takeover battles. A higher fraction of equity held by management decreases the probability of takeover (Stulz, 1988). Israel (1992) uses debt as a mechanism that enables the incumbent management to obtain the maximum value from the rival, and his prediction was based on the assumption that management knows the characteristics of the rival with certainty. However, there is no evidence of value maximization from rivals with uncertain characteristics.

Brander and Lewis (1986) argue that product markets, and financial decisions will normally be related and have proved that for a particular industry structure, financial structure decisions and product market decisions follow in sequence. In another study Singh et al. (2003) explore that leverage has a positive relation across product lines but has a negative relationship with geographic diversification. Norton (1995) argues that role of debt sustained by franchisee is a potential screening device in franchising, and concludes franchising as a capital structure issue.
Several studies explore the association between characteristics of products or marketing strategy and capital structure and find the evidence to support this relationship (see Kale and Shahur, 2007; Stomper and Zulehner, 2004; Campello, 2003& 2006). Like most of the other theories, this theory also needs support from empirical evidence to validate the existing research.

3.2.8 Testing the Trade-off vs Pecking Order Theory

After reviewing all the theories of capital structure it is important to test that, among all, which theory has the most explanatory power. Majority of the studies empirically examine the trade-off and Pecking Order Theory; therefore, it is useful to explore the prominent time series variables of these theories. Proponents of trade-off theory predict an optimal level of the debt ratio and firm gradually adjusts towards it. The target cannot be observed directly, but proxies can be calculated (Myers, 2001). On the other hand, Pecking Order Theory arose from corporate practices and addresses the information asymmetry which was ignored by trade-off model.

According to Baskin (1989) during the last fifty years, statistical studies conducted in five countries provide strong support for the Pecking Order Hypothesis. Shyam-Sundar and Myers (1999) study on the data of 157 firms from 1971 to 1989, which tested time series variance predictions, concludes that Pecking Order Theory has more time-series explanatory power than trade-off model. In contrast, Chirinko and Singha (2000) concluded that they could not find any support for either of the two theories. Frank and Goyal (2003) find a mean reversion in leverage but do not offer support for the pecking order. Fama and French (2002) find that debt ratios contain a mean reversion at slow speed, but conclude their study with the support for both theories. Booth et al. (2001) concludes that both theories have strong explanatory powers and argue that variables used for examination of a hypothesis of one theory can be classified as
variables of the other theory. Most of the factors that are frequently used in empirical literature are tangibility, firm size, growth opportunities, profitability and volatility. Frank and Goyal (2009) denote most of these factors as “core model of leverage” In sum, empirical evidence on both theories explores various factors and variables, and had potentially contributed to the understanding of capital structure, thus, neither of the two main theories can be rejected.

Table 3.1: Predictions of trade-off theory and Pecking Order Theory

<table>
<thead>
<tr>
<th>Factor</th>
<th>Trade-off theory</th>
<th>Pecking Order Theory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tangibility</td>
<td>Positive</td>
<td>Negative</td>
</tr>
<tr>
<td>Firm size</td>
<td>Positive</td>
<td>Negative</td>
</tr>
<tr>
<td>Growth opportunities</td>
<td>Negative</td>
<td>Positive/Negative</td>
</tr>
<tr>
<td>Profitability</td>
<td>Positive</td>
<td>Negative</td>
</tr>
<tr>
<td>Volatility</td>
<td>Negative</td>
<td>Negative</td>
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</tbody>
</table>

*Source: Bessler et al. (2011, pp.23)*

In summary, since the MM theorem (1958) several scholars conducted research to explore the optimal capital structure theory to understand the financing behavior of the firm. However, it still lacks of consensus, and is in need of further research. There is no single universal theory of debt-equity choice and no reason to expect one. However, there are several conditional theories of capital structure with their different relative emphasis. Such as, trade-off stresses on tax, pecking order emphasizes on information asymmetry, agency theory on
principal-agent conflict, free cash flow theory on agency cost and market timing theory on market conditions at the time of financing. Table 3.1 presents the central predictions of pecking order and trade-off theories regarding the relationship between selected factors of capital structure and leverage.

**Table 3.2: Summary of capital structure theories**

<table>
<thead>
<tr>
<th>Theory</th>
<th>Summary</th>
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<tbody>
<tr>
<td>Trade-off theory</td>
<td>This theory postulates that firms offset the tax benefits from debt against the probable cost of debt, such as, financial distress, in their financing decisions. Firms choose the target capital structure to improve their performance. Firms with tangible assets and higher taxable income prefer to follow this model to gain the tax shield benefits. On the contrary, low profitable firms with less tangible assets primarily rely on equity financing.</td>
</tr>
<tr>
<td>Pecking Order Theory</td>
<td>In order to solve the asymmetry of information this theory proposes a hierarchy among three financing sources i.e. internal funds (retained earnings), debt and equity. It suggests that when available, firms should utilize internally available funds, and if required choose debt over equity in case of external financing Unlike trade-off model this theory does not predict the targeted capital structure. According to this theory less profitable firms rely on debt after exhausting the internal funds, not because of high target debt ratio.</td>
</tr>
<tr>
<td>Agency theory</td>
<td>This theory is centered on principal-agent conflicts. It states that the agency costs are related to monitoring of management to assure that they work within the firm’s contractual arrangements with shareholders and creditors. An optimal capital structure can be determined by off-setting the agency cost of debt against the benefits of debt (Jensen and Meckling, 1976). Unlike the MM theorem’s (1958) irrelevance of choice between debt and equity in perfect markets, agency theory states that even in frictionless markets without taxes choice between equity and debt does affect the financing structure.</td>
</tr>
<tr>
<td>Free cash flow theory</td>
<td>Free cash flow hypothesis states that despite possibility of financial distress high risk debt can enhance the firm performance. However, it also argues that it does not mean that debt can always have a positive effect. This hypothesis fits for mature firms that are disposed to overinvestment.</td>
</tr>
</tbody>
</table>
Signaling model

This model suggests that managers have more quality information about the firm compared to outside investors. Managers use capital structure choices to serves as a signal of private information (Ross 1977). This model postulates that when manager feel that markets under value the equity of their firms, they issue debt.

Market timing theory

According to market timing hypothesis firms adjust their capital structure in responses to the changes in the market. For instance firms prefer to issue equity when market prices of their shares are high, and prefer debt when share prices are low.

Corporate control and Product cost theory

Corporate control theory states that the capital structure choices through voting control between managers and outside investors affect the outcome of takeovers. The basic idea is that managers choose a capital structure and ownership structure that favors them in future takeover battles. According to product cost theories, industry structure, financial structure decisions and product market decisions are related to each other.

Source: Author’s compilation based on existing literature

3.3 Determinants of capital structure

Existing literature has produced numerous firm specific factors as determinants of capital structures that are influential on corporate leverage and ultimately on financing choices of the firm. The lack of consensus on one full fledge theory of capital structure makes it more difficult to fully rely on these factors. As Myers (2001) expresses that “there is no universal theory of debt-equity choice, and no reason to expect one”. However, there are conditional theories of capital structure that so explain the roles of these firms factors as determinants of capital structure. According to Harris and Raviv (1991) the consensus is that firm’s leverage decreases with profitability, earnings volatility, probability of bankruptcy and uniqueness of product. While leverage increases with firm size, liquidity, non-debt tax shields, growth opportunities. Therefore, study reviews the following factors that affect the capital structure choices. Such as, profitability,
firm size, liquidity, tangibility, earnings volatility, growth opportunities and firm’s age.

3.3.1 Profitability

Trade-off theory predicts a positive relationship between leverage and profitability. This assumption is based on the argument that more profitable firms expect to face low cost of financial distress and more tax shield benefits. However, more profit means more cash, this free cash under management discretion contributes to cash payout conflict between managers and shareholders. The free cash flow theory suggests the use of debt to discipline the managers and disgorge the free cash. Hence predicts a high leverage for more profitable firms. Alternatively, pecking order suggests that more profitable should initially use internal funds over external for financing and predicts high profitable firms as low leveraged. Most of the empirical findings reported negative relationship of profitability with leverage. This negative relationship is consistent with Pecking Order Hypothesis and in contradiction to trade-off model. Following studies explored the negative relationship, Alipour et al. (2015); Hossain and Hossain (2015); Getzmann et al. (2014); Koksal and Orman (2014); Khan 2014; Sheikh and Wang (2011); Cespedes et al. (2010); Karadeniz et al. (2009); Qureshi (2009); Serrasqueiro and Rogao (2009); Jong et al. (2008); Huang and Song (2006); Zou and Xiao (2006); Tong and Green (2005); Bauer (2004); Chen (2004); Pandey (2004); Fama and French (2002); Booth et al. (2001); Wald (1999); Rajan and Zingales (1995); Baskin (1989); Titman and Wessels (1988) and Myers (1984).

3.3.2 Firm size

Firm size is highlighted as an essential determinant of capital structure in existing empirical
literature. The survey study by Harris and Raviv (1991) states that there is consensus on increase in leverage with the size of firm. In agreement with this Rajan and Zingales (1995, pp.1451) states that larger firms tend to be diversified and fails less often, so size may be an inverse proxy for the probability of bankruptcy. If so, size should have a positive impact on supply of debt. However, size may also be the proxy for the information outside investors have, which should increase their preference for equity relative to debt. And in their study on G7 countries they found size is positively correlated with debt except Germany where it is negatively related. The findings of positive relation of size to leverage are consistent with the trade-off theory. While, negative relationship endorses the Pecking Order Theory, under the assumptions that the problems of information asymmetry and adverse selection are relatively less in large corporations. As a result large firms should be more competent to issue information sensitive securities like equity compared to debt in contrast to smaller firms. Agency theory in extension to trade-off model suggests the lower agency cost of debt for large firms and predicts a positive relation of size to leverage. These firms have comparatively low monitoring cost because of low volatile cash flow and easy access to capital markets.

Empirical studies report mixed results. Poyry and Maury (2010) explored the negative relationship between size and leverage in Russian state owned companies. Wald (1999) explored the positive relationship between size and leverage for firms in Japan, UK and US, while reported negative and positive but insignificant for firms in Germany and France respectively. Alipour et al. (2015) and Chen (2004) finds negative relationship between firm size and leverage in Iranian and Chinese firms respectively. In contrast, following empirical studies reported positive relation between firm size and firm leverage, Getzmann et al. (2014); Khan 2014; Sheikh and Wang (2011); Sbeiti, (2010); Poyry and Maury (2010); Frank and Goyal (2009);
Qureshi (2009); Serrasqueiro and Rogao (2009); Jong et al. (2008); Erriotis et al. (2007); Huang and Song (2006); Zou and Xiao (2006); Bauer (2004); Deesomsak et al. (2004); Fama and French (2002); Bennett and Donnelly (1993) and Marsh (1982).

3.3.3 Liquidity
In general liquidity refers to the possession of cash or assets easily convertible into cash. Trade-off theory argues that firms with more liquid assets should use leverage in their capital structure, due to its ability to meet their contractual obligations on time. In contrast to trade-off theory which predicts positive relationship between liquidity and leverage, Pecking Order Theory projects a negative relation. It assumes that firms with higher liquidities prefer to use the internally available funds as a primary source of financing and borrow less. Jong et al. (pp.1964, 2008) states that the most of the negative significant coefficients between liquidity and leverage belong to advanced economies. And the corporate sector’s condition in developed economies is likely to meet the predictions of traditional theories of capital structure. Some other studies also endorse the Pecking Order Hypothesis such as, Alipour et al. (2015); Sheikh and Wang (2011); Sbeiti (2010); Viviani (2008); Mazur (2007) and Deesomsak et al. (2004).

3.3.4 Tangibility
Tangibility refers to the availability of tangible assets, such as plant, machinery, equipment and so forth. Existing literature also treats tangibility ad a proxy for agency costs. For outside investors it is easy to evaluate the tangible assets compared to intangible assets such as, good will, brand value etc. According to Myers and Majluf (1984) there are some costs related to the issuance of securities, and managers have better information about it compared to external
shareholders. Hence, issuing the debt backed by assets minimizes these costs and protects the debt holders from managerial opportunistic behavior. Jensen and Meckling (1976) and Myers (1977) state that shareholders of high leveraged firms have an incentive to invest sub optimally to increase return on their investments from creditor’s wealth. Therefore, in order to protect themselves from shareholders exploitation, bondholders issue asset backed loan because the collateralized debt can be used for specific project only. Moreover, the presence of more tangible assets means that firm has a greater ability to issue secured debt, and is not bound to release more information to the market about their profits. Like other determinants of capital structure, findings on relationship between tangibility and leverage report mixed results. Some empirical studies explored the positive relationship between leverage and tangibility. These include, Getzmann et al. (2014); Ramjee and Gwatidzo (2012); Cespedes et al. (2010); Frank and Goyal (2009); Serrasqueiro and Rogao (2009); Jong et al. (2008); Huang and Song (2006); Zou and Xiao (2006) and Chen (2004).

On the other hand, Titman and Wessels (1988, pp.3) state that “the tendency of managers to consume more than the optimal level of perquisites may produce the opposite relation between collateralizable capital and deb levels”. Grossman and Hart (1982) suggest that higher level debt diminish this tendency because of the threat of bankruptcy. Therefore, firms with less tangible assets may prefer high debt level to limit the perquisites of their managers. This agency explanation suggests a negative relationship between tangibility and leverage. Booth et al. (2001) investigates the capital structure of ten developing countries. They explores that with total debt ratio tangibility is associated with decreases in the debt ratio, but with long term debt ratio it is associated with increases in debt ratio. These findings imply that firms with tangible assets will use long term debt, but that the overall debt ratio will go down. Amongst ten developing
countries there exists a negative relationship between tangibility and leverage for firms in Brazil, India, Pakistan and Turkey (see Booth et al., 2001). Several other studies also endorse this relationship such as, Alipour et al. (2015); Khan (2014); Sheikh and Wang (2011); Poyry and Maury (2010); Sbeiti (2010); Bokpin and Arko (2009); Karadeniz et al. (2009); Mazur (2007) and Bauer (2004).

3.3.5 Earnings volatility

Earning volatility is a measure of earnings risk (business risk), in capital structure it used as a proxy for probability of financial distress and is supposed to have a negative relationship with leverage. Bradley et al. (1984, pp. 877) states that earnings volatility helps to explain both inter and intra industry variations in firm’s leverage. They explored earning volatility as an important, inverse function of firms leverage. Empirical findings report mixed results on this relationship. For instance, Hsia (1981) states that earning volatility (business risk) is positively related to firm leverage. Similarly Kim and Sorensen (1986) argue that high operating risk firms use more debt instead of relying less on debt. Booth et al. (2001) through his study on ten developing economies explored that business risk is negatively related to leverage in six economies and positively in four economies. Most of the existing empirical literature reports the negative relationship between the mentioned variables, such as, Alipour et al. (2015); Sheikh and Wang (2011); Jong et al. (2008); Huang (2006); Fama and French (2002); Booth et al. (2001); Wald (1999); Chaplinsky and Niehaus (1993) and Titman and Wessels (1988).

3.3.6 Growth

As quoted in Rajan and Zingales (1995, pp.1451) high levered firms are more likely to pass up
profitable investment opportunities (Myers, 1977). Therefore, they suggest the use of equity financing for firms with high future growth opportunities. Growth opportunities are highlighted as intangible assets for a firm. Trade-off theory suggests that, as these intangible assets cannot be used as collateral and do not generate taxable income, such kind of firms should borrow less. However, firms having growth opportunities hold more options for future investments than firms with lesser opportunities. They have more to lose and the debt-overhang is no problem for a firm lacking valuable investment opportunities (Myers, 2001). Thus, it predicts a negative relationship between growth and leverage. Empirical studies produced mixed results, for instance Titman and Wessels (1998) found no support for increase in debt-ration with future growth opportunities. According to Harris and Raviv (1991, pp. 334) the available studies generally agree that leverage increases with growth opportunities. Similarly, Ramjee and Gwatidzo (2012); and Cespedes et al. (2010) reports a positive and significant relationship between leverage and growth in their studies on firms of South African and Latin America respectively. However, several empirical studies also reported negative relationship between leverage and growth opportunities, such as, Alipour et al. (2015); Hossain and Hossain (2015); Chakraborty (2010); Frank and Goyal (2009); Eriotis et al. (2007); Zou and Xiao (2006); Deesomsak et al. (2004); Wald (1999) and Kim and Sorensen (1986).

3.3.7 Firm Age

Since the MM theorem (1958) was based on the perfect market’s assumption. However, in capital markets, firms’ debt policies may reflect imperfect or incomplete capital markets (Myers, 1977, pp. 148). In such context, firm age is highlighted as a market imperfections in terms of firms’ financing choices. Trade-off model assumes that older firm on the basis of their historical
reputation may choose or have an access to higher leverage in order to gain benefits from tax shield. Trade-off model predicts a positive relationship of firm age to leverage. Contrary to this, Pecking order predicts a negative relationship between firms’ age and leverage. It hypothesize that older firms with sufficient sources will rely on internal funds in financing to avoid the problem of information asymmetry. According to Audretsch and Elston (1997) firm age is also an important factor in accessing debt finance, because it may be costly for smaller or relatively new firm to tackle the asymmetric information problems with their creditors. Hence these firms may have access to lesser debt or a debt with higher cost (see Baas and Schrooten 2006; Cassar 2004). The debt capacity (see Myers, 1977) is for relatively new firms may also be low compared to older firms due to the risk factor of these firms. As suggested by Bolton and Freixas (2000) that firm risk or firm age can be alternative for proxies of debt capacity. Most of the empirical findings supports the prophecy of Pecking Order Theory. For instance, Kramer (2015); Khan (2014); Mac an Bhaird and Luce (2010) and Peterson and Rajan (1994) reported a negative relationship between firm age and leverage.

3.4 Ownership structure and capital structure

Since MM theorem (1958) the literature has opted to emphasize on the various factors to investigate the capital structure, but very limited studies comprises the agency problems in the study of optimal capital structure. The agency theory has power to illuminate the conflict of interest between providers of finances (owners) and controllers of finances (managers) in its relation to capital structure decisions (Hart, 1995, p.151). According to Hart (1993) despite limited empirical evidence, agency approach have more advantage on other theories of capital structure, as it clearly explains why the firm issue senior debt (long term) and why firm failure to
meet debt obligations leads to bankruptcy as a penalty.

How the principal-agent relation in perspective of ownership structure does affects the capital structure in corporate finance? Hart (1995, p.151) states that “although the agency approach may not be the whole story, it would seem to be an essential part of any fully developed theory of capital structure.” He further argues that great deal of empirical work on capital structure theories have produced, what he called “stylized fact”. For stylized facts he refers to, high profitable firms have low debt, more tangible assets firms have high debt, debt for equity-swaps rise the share prices and so forth (see Hart, 1995, p. 141,). However, how much these stylized facts remains valid under different ownership patterns are yet to be explore. Despite the insufficient empirical evidence on ownership structure and capital structure under the agency approach, Hart (1995) argues that the strong potential of agency theory to recognize the agency cost of debt and equity in capital structure choices.

In an agency framework a part from agency theory different other studies proposes different assumptions to tackle the agency conflicts rise due to the separation of ownership and control. The classical work by Jensen and Meckling (1976) proposes “interest alignment hypothesis” through manager’s equity ownership; debt-holders monitoring by Grossman and Hart (1982); free cash flow hypothesis Jensen (1986); and Shliefer and Vishny (1986) propose the “active monitoring hypothesis” stating that external block-holders can reduce the managerial opportunism caused by the principal-agent relation. Opportunistic behaviors of managers include consuming excessive amount of perks, shirking of their responsibilities, and investing in negative net present value (NPV) projects that prioritize managers' personal benefits instead of shareholders or firms (also see Fosberg, 2004). Moreover, Berger et al. (1997) study the relationship between managerial entrenchment and firms’ capital structure, and conclude that
entrench managers may not choose optimal capital structure. They define entrenchment as “the extent to which managers fail to experience discipline from the full range of corporate governance and control mechanisms”.

According to La Porta et al. (2000) that change in the capital structure of the firms changes the allocation of power between the “insiders” and “outside” investors, which ultimately change the firm’s investment policy. Hence, the internal and external ownership has a significant influence on financing choices of firm. In existing literature very few studies have explored the ownership structure pattern that can influence the choices of capital structure. Because, the ownership structure pattern resulted from the equity distribution between managers and shareholders may have significant relationship with the leverage. Existing empirical have used either managerial equity ownership or large shareholders (block-holders) or both as attributes of ownership structure that influence the choices of leverage (Wahba, 2014; Ruan et al., 2011; Brailsford et al., 2002; and Short et al., 2002). These attributes of ownership and their association to capital structure choices are discussed below.

3.4.1 Managerial equity ownership

Jensen and Meckling (1976) suggest the equity ownership for managers in order to minimize the agency conflict that arises due to the separation of ownership and control. They name it “interest alignment hypothesis” and some studies highlighted it as convergence of interest hypothesis. The bonding of agents as residual claimants can enhance the firm performance by reducing their discretion to consume perquisites and expropriate the shareholders’ wealth. However, this raises the question of optimal level of managerial equity ownership. Because, the increase in equity ownership will transfer the control power of external shareholders to the managers. Hence, at
high levels of managerial share ownership there are incentives to decrease debt levels than would otherwise be the case (Brailsford *et al.*, 2002, pp.3). It seems logical that managers with higher equity stake may become risk averse and less likely to rely on debt financing in order to avoid the agency cost of debt. On the other hand, it is more likely for managers to involve in shirking or opportunism, due to weaker control limitations from other shareholders. In order to cop up with such kind of situation, Grossman and Hart (1982) supports the usage of debt as a monitoring tool.

However, if managers with high equity stake assume to decrease the debt financing. In extreme case in the absence of debt, no pressure of creditors’ monitoring and no threat of bankruptcy. This will result to another problem i.e. it may spoil managers to free-ride on their internally-vested individual interest, losing incentives to maximize the returns for all the shareholders. Moreover, Jensen (1986) free cash flow hypothesis also support the use of debt to minimize the agency cost of free cash, by decreasing the free cash under manager’s discretion and perquisites. In sum, lack of theoretical consensus is supported by mixed empirical findings as well. For instance, Wahba (2014) study on Egyptian firms reported negative relationship between managerial ownership and capital structure while examining the firm performance. Ruan *et al.* (2011) concluded a non-linear relationship between managerial ownership (MO) and leverage in Chinese private firms. They reports a positive relation if MO is more that 18% or less than 46%, and a negative relationship if MO is less than 18% or more than 46%. Findings of Ruan *et al.* (2011) are consistent with the findings of Brailsford *et al.* (2002) study on Australian firm which also concluded a non-linear relationship. Firth (1995); Bathala *et al.* (1994); and Friend and Lang (1988) studies on US firms data reported a negative relationship between insider ownership and debt. Contrary to this, Sun *et al.* (2015); Khan and Suzuki (2015); Short *et
al. (2002); Berger et al. (1997) and Kim and Sorensen (1986) reported a positive relationship.

3.4.2 Institutional shareholders

Agency literature proposes various options to minimize the agency conflicts related to the separation of ownership and control. This includes both the internal and external mechanism. Internal includes of managerial ownership through the convergence of interest (see Jensen and Meckling, 1976). External mechanism includes of creditors monitoring, active large shareholders (block-holders) monitoring and institutional shareholders monitoring (see Grossman and Hart, 1982; Brailsford et al., 2002; Pound, 1988). According to Pound (1988), efficient monitoring hypothesis, institutional investors have greater expertise and which can help them to monitor managers’ activities at lower cost compared to individual shareholders. Moreover, they can also exert pressure on management through their voting power, to restrain the managers’ opportunistic behavior, while protecting their interests. McConnell and Servaes (1990) also endorse the Pound (1988) efficient monitoring hypothesis, i.e. positive role of institutional shareholders as effective monitors to improve the firm performance.

In perspective of capital structure Chaganti and Damanpour (1991) explores that the size of institutional shareholdings is significantly related to capital structure. They further conclude that institutional shareholders have the effect of lowering the long-term debt to capital ratio (Chaganti and Damanpour, 1991, pp. 489). This relation can be seen as that institutional shareholder less rely on debt due to agency cost of debt i.e. financial distress. They may behave conservatively, because in case of bankruptcy, their institution’s performance is also at stake. However, proponents of institutional shareholders relate them and effective external monitoring. For instance, institutional investors have the opportunity, resources and ability to monitor,
discipline and influence managers of firms (Monks and Minow, 1995). Which can ultimately contributes to resolve the agency problems. Moreover, the institutional ownership and outside blockholder ownership are negatively related to agency cost, suggesting the independent outside monitoring of management is effective (Morellec et al., 2012, pp. 831). They further argue that as institutional ownership have an impact on agency conflicts so it can also impact on firm financing decisions as well.

A handful of studies have explore the role of institutional shareholding on ownership, but is still lack of consensus. Chaganti and Damanpour (1991) explores an inverse relation between institutional ownership and debt. Additionally Morellec et al. (2012) only highlights the significance of institutional shareholdings on financial structure. Moreover, Hussainey and Aljifri (2012); Huang et al. (2011) reported a negative relationship between institutional ownership and firm’s leverage.

### 3.4.3 Large shareholders

According to Stiglitz (1985) the concentrated ownership (block-holders / large shareholders) have enough incentives to control and monitor the managers due to their ample stake in the firm. It predicts that they should bear higher monitoring costs due to their “limited diversification”. This higher monitoring cost results from collecting adequate and effective information. Blockholders have incentives to bear such cost, that can prevent the managerial opportunism and excessive perquisites, which can contribute to shareholders wealth. However, in such case minority shareholders may “free-ride” on block-holders expenses. Similarly, where corporation have large non-managerial investors, management may not be able to adjust debt ratio by its own interests, and the debt ratio would be expected to be higher than where such investor do not exist.
and may be closer to the optimal level from the viewpoint of diversified investors (Friend and Lang, 1988, pp.272). Moreover, block-holders also prefer to employ debt as a disciplining mechanism to use the creditors monitoring on managers. In this way block-holders can decrease their monitoring cost as highlighted by Stiglitz (1985). On the other hand, Shliefer and Vishny (1986) state that the absence of block-holders may results to weaker shareholders monitoring and control, which may encourage managers to exploit the corporate sources for their individual perks and privileges.

Stiglitz (1985) assumption predicts a positive relationship between block-holders and leverage. Similarly, Grossman and Hart (1982) predicts that debt related obligations reduce the potential perquisites under managers’ discretion. Contrary to this Jensen and Meckling (1976) optimal ownership hypothesis predicts a negative relationship between external block-holders and leverage in optimal ownership structure. In line with the theoretical assumptions empirical findings also provides mix findings. For instance, Sun et al. (2015); Brailsford et al. (2002); Berger et al. (1997); Firth (1995); and Friend and Lang (1988) reported a positive relationship between block-holders and firm’s leverage. However, studies such as, Short et al. (2002); Bathala et al. (1994); Grier and Zychowicz (1994); Chaganti and Damanpour (1991) and Zeckhauser and Pound (1990) reported a negative relationship between block-holders and leverage.

3.5 Theories of corporate governance

Corporate governance is an area that has grown rapidly in the last few years. The failures of Enron and WorldCom certainly prove that corporate governance is still a highly relevant and timely topic, even for a capital market in a developed or developing country. Businesses around
the world need to be able to attract funding from investors in order to expand and grow. Before deciding to invest their money in particular business investors want to be as sure as they can be that the business is financially sound and will continue to be so in near future. Investors, therefore, need to have confidence that the business is being well managed and will continue to be profitable. In order to have this assurance, investors look at the published annual reports and accounts of the business and other information released by the company. Although, the annual report may give a reasonably accurate picture of the business activities and financial position at that point in time, there are many facets of the business that are not effectively reflected in the annual report and accounts.

There have been a number of high profile corporate collapses that have arisen despite the fact that the annual reports and accounts depicted otherwise. These corporate collapses have had an adverse effect on stakeholders like shareholders, employees, and suppliers etc. In essence, corporate collapses affect us all. Why have such collapses occurred? What might be done to prevent such collapses happening again? How an investor’s confidence can be restored? The answers to all these questions are linked to corporate governance because a lack of effective corporate governance mean that such collapses would occur.

3.5.1 Definition of corporate governance

The basic agency problem suggests a possible definition of corporate governance as addressing the conflict of interest, information asymmetry, adverse selection and a moral hazard problem. A good governance structure is then one that selects the most responsible managers and makes them accountable to investors. This phenomenon can be described as “the ways in which the suppliers of finance to the corporations assure themselves of getting a return on their investment
The Organization for Economic Cooperation and Development (OECD)\textsuperscript{13} provides another perspective on its Principles of Corporate Governance by addressing five areas: (i) the rights and responsibilities of shareholders (ii) the role of the stakeholders (iii) the equitable treatment of shareholders (iv) disclosure and transparency (v) the duties and responsibilities of the board. It defines corporate governance as, the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the Board, managers, shareholders and other stakeholders, and spells out the rules and procedure for making decisions on corporate affairs. By doing this, it also provides the structures through which the company objectives are set, and the means of attaining those objectives and monitoring performance.

Corporate governance is rather a newer field in number of disciplines such as, finance, economics, accounting, management, organization behavior and so forth. Therefore, it is affected by the theories of this discipline. The main theory that has influenced most for the development of governance mechanism and provides theoretical framework to address the governance related issues is the agency theory. The other theories mostly highlighted in literature are, transaction cost economics (TCE), stakeholder theory, stewardship theory, resource dependency theory.

\subsection*{3.5.2 Agency theory}

The debate on separation of control and ownership of corporations at least goes back to Adam Smith (1776) in reference to joint stock companies. As quoted by Jensen and Meckling (p. 305;\footnote{http://dx.doi.org/10.1787/9789264173705-en ; (OECD 1999, corporate governance principles, online library)}
1976) in their work by referring to Adam Smith (1776) citing from, Adam Smith, The Wealth of Nations (1776) Cannan edition (Modern Library, New York, 1937, p.700);

“The directors of such (joint-stock) companies, however being the managers rather of other people’s money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention of small matter as not for their master’s honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company”.

The concept of agency problem as highlighted by Smith has been resulted to extensive research, because it is the inherent relationship between the providers and controllers of the capital. In contrast the concept of current modern publicly held large corporations and prescribed role of ownership and control in these corporations was put forwarded by Berle and Means (1932). The separation of ownership and control especially in large corporations’ i.e. corporate governance refers to how the shareholders as owners (residual claimants) can monitor the hired managers who run the firm and manage its resources on behalf of the owners. Since Berle and Means (1932) studies on corporate governance have explored the adverse consequences of separation of control and ownership. The conflict of interest which occurs due to the split-up between shareholders and management, inflates when ownership becomes dispersed. This fragmentation of ownership neutralizes the power of shareholders. On the other hand, the fact that most holdings are relatively small enables the shareholders to sell their holdings when unsatisfied. But, the inability of large shareholders to hold the board of directors accountable
puts the agency problem firmly on the corporate governance program.

Jensen and Meckling (1976) in their seminal work on the principal-agent problem, defined the agency costs that occurred in relation to the separation of ownership and control. They elaborated the mechanism of causing agency costs in light of the ownership claims held by *insiders* (managers) and *outsiders* (investors with no direct role in management of firm), respectively. They highlighted two types of conflicts i.e. conflict between shareholders and managers, and conflict between shareholders and creditors. They argue that the agency cost may vary in accordance with the shirking activities by the agent, pointing out the importance of close monitoring by the principal to prevent the agent's shirking. In order to minimize the interest conflicts, they propose equity ownerships by managers (managerial ownership) to reduce the agency costs and potential shirking actions by aligning the agent’s interest with principal to share the residual. In summary, existing literature has highlighted following agency conflicts between principal-agent, such as, shirking, managerial entrenchment, managerial opportunism and so forth Berger *et al.* (1997); Shleifer and Vishny (1986); Gorssman and Hart (1982); Jensen and Meckling (1976); Alchian and Demsetz (1972). Additionally, information economics has contributed to analyze the other agency costs due to information asymmetry such as moral hazard and adverse selection effects (see Greenwald and Stiglitz, 1990; Jensen and Meckling, 1976; Alchian and Demsetz, 1972; and Akerlof, 1970).

The principal-agent conflict has several other dimensions as well e.g. the agent misusing his power for pecuniary or other advantage, and the agent may not take appropriate risk in pursuance of principal’s interests because the agent may not get benefit from this risk compared to the principal’s benefit. This may also be due principals or agents different attitude to risk. The information asymmetry is also one the problem between principal and agent; this is due to access
to different level of information by principal and agent i.e. the agent has more precise and most recent information compared to the principal.

Apart from conflict of interest between managers and shareholders, the conflicts between shareholders and debt holders only arise with the risk of default. There is a default risk related with debt therefore debt-holders are interested in firm’s value or risk. But, if there is a chance of default, then shareholders can gain at the expense of creditors. As equity is a residual claim, so shareholders gain when the value of existing debt falls, even when the value of the firm is constant (Myers, 2001). Risk shifting as an agency problem was firstly highlighted by Jensen and Meckling (1976) in which firstly managers invest in riskier assets. Where high risk increases the upside for shareholders, but the creditors absorb the downside. Secondly, managers working for the interest of shareholders can increase the payout to shareholders by borrowing from creditors. In this case even the overall value of the firm remains same, but the market value of the existing debt decline. The payout cash to shareholders offset the decrease in their shares value. Finally managers by taking the advantage of insider information can cut back the equity investment or can postpone immediate bankruptcy or restructuring by hiding the information related to financial problems from the creditors.

In the discussion of agency theory above, the importance of separation of ownership and control of firm was emphasized. As firms have grown in size, whether caused by the desire to achieve economies of scale, by technological advances, or by the fact that natural monopolies have evolved, they have increasingly required more capital, which has needed to be raised from capital markets and a wider shareholder base has been established. The problems of the separation of ownership and control and the resultant corporate governance issues have thus arisen.
3.5.3 Transaction cost economics

Transaction cost economics (TCE) as expounded by the work of Williamson (1975; 1984) is often viewed as a closely related to agency theory. TCE views the firms as a governance structure whereas agency theory views the firms as a nexus of contracts. Basically, the latter means that there is a connected group or series of contracts amongst the various players, arising because it is seemingly impossible to have a contract that perfectly aligns the interests of principal and agent in a corporate control situation. The incomplete contracts in real world expose the related parties to different hazards which incurs various agency cost to them (see Williamson, 1995, 1985, 1975; Grossman and Hart, 1988; Klein et al., 1978; and Alchian and Demsetz, 1972). The basic insight of TCE is that transactions must be governed as well as designed, carried out, and that certain institutional arrangements affect this governance better than others (Shelanski and Klein, 1995, pp.336).

The classical article by Coase (1937) opens a puzzle of transaction cost, examines the rationale for firms’ existence in the context of a framework of the efficiencies of internal, as opposed to external, contracting. He drew attention to transaction cost economizing as the hitherto missing factor for explaining why markets were used in some cases as hierarchy in other cases averted. It concludes that there are certain economic benefits to the firm itself to undertake transactions internally rather than externally (see Coase, 1937). Williamson (1984) builds on the earlier work of Coase, and provides a justification for the growth of large firms and conglomerates, which essentially provide their own internal capital market. He states that the cost of any misaligned action may be reduced by judicious choice of governance structure rather than merely realigning incentives and pricing them out.

Hart (1995) states that there are a number of costs to writing a contract between principal
and agent, which include the cost of thinking about and providing for all the different eventualities that may occur during the course of the contract, the cost of negotiating with others, and the costs of writing the contract in an appropriate way so that it is, for example, legally enforceable. He further indicates that, in a world of incomplete contracts (where agency problems are also present), governance structure does have a role.

Governance structure can be seen as a mechanism for making decisions that have not been specified in the initial contract. This can result in various costs highlighted by TCE e.g. for each contract there is \textit{ex ante} cost i.e. screening cost and \textit{post ante} cost such as monitoring cost to address the issues like, moral hazard, adverse selection and so forth. Such kind of cost inflates the conflicts among stakeholders in the agency framework, and corporate governance mechanism endeavors to minimize these conflicts. Stiles and Taylor (2001) point out that both theories (TCE and agency theory) are concerned with managerial discretion, and both assume that managers are given to opportunism (self-interest seeking) and moral hazard and that, managers operate under bounded rationality. Both agency theory and TCE regard the board of directors as an instrument of control. Therefore managers try to satisfy board by maximizing the firm’s profit.

3.5.4 Stakeholder theory

Stakeholder theory takes account of a wider group of constituents rather than focusing on shareholders. A consequence of focusing on shareholders is that the maintenance or enhancement of shareholder value is significant, whereas when a wider stakeholder group, such as employees, providers of credit, customers, suppliers, government, and the local community, is taken into account, the overriding focus on shareholder value becomes less self-evident. Nevertheless, many companies do strive to maximize shareholder value whilst at the same time
trying to take into account the interests of the wider stakeholder group. One rationale of giving privilege to shareholders over other stakeholders is that they are the recipients of the residual free cash flow. This can be perceived as that shareholders will not be the only beneficiaries but it will also contribute to the society as well. In sum stakeholder theory intends to broaden the role of each stakeholder, such as broadening the role of management from only profit maximization to consider the claims and interests of other stakeholders (see Mitchell et al., 1997).

Shareholders and stakeholders may favor different corporate governance structures and monitoring mechanisms. Such as, one can observe the differences in the corporate governance structures and monitoring mechanisms of Anglo-American model, with its emphasis on shareholder value and a board comprised totally of executive and non-executive directors elected by shareholders, compared to the German model, where by certain stakeholder groups such as employees, have a right that their representatives should sit on the supervisory board alongside the directors.

An interesting development that is put forward by Jensen (2001) who states that traditional stakeholder theory argues that managers of a firm should take account of the interests of all stakeholders in firm but, because the theorists refuse to say how the trade-off against the interests of each of these stakeholder groups might be made. There are no defined measureable objectives and this leaves managers unaccountable for their actions. Jensen therefore advocates enlightened value maximization, which he says is identical to enlightened stakeholder theory. Enlightened value maximization, utilizes much of the structure of stakeholder theory but accepts maximization of the long-run value of the firm as the criterion for making the requisite trade-offs among its stakeholders, and therefore solves the problem that arises from multiple objectives that accompany traditional stakeholder theory.
3.5.5 Stewardship theory

Stewardship theory draws on the assumptions underlying agency theory and TCE. The work of Donaldson and Davis (1991) as an alternative to agency theory introduced a new approach to corporate governance i.e. stewardship theory. In agency theory principal-agent model framework, the shareholders are the principal and managers are agents, and managers are assumed as self-centered opportunistic agents. In contrast stewardship model argues a view of managerial motivation by considering the managers as a steward of the firm. The executive manager, under theory, far from being opportunistic shirker, essentially wants to do a good job, to be a good steward of the corporate assets (Donaldson and Davis, 1991, pp.51). Moreover, it supports the re-allocation of control from owners to professional managers and predicts its positive impact on managing the complexity of modern corporations. Empowered managers with control steward the corporate assets and use them for the profit maximization of the firm. It also supports the insider board of directors with more knowledge, expertise, information about the businesses and commitment to the firm. On the basis of this assumption it predicts that shareholders will have maximum return on their investment as well.

According to Donaldson and Davis (1991) in contrary to agency theory that supports the separation of CEO and board’s chairmanship to minimize the managerial opportunism, stewardship theory stresses the beneficial consequences on shareholder returns of facilitative authority structures which unify command by having roles of CEO and chair held by the same person. The safeguarding of returns to shareholders may be along the track, not of placing management under greater control by owners, but of empowering managers to take autonomous executive action. However, opponents of stewardship model questions its validity in relation to the possibility of manager’s opportunistic self-serving behavior.
3.5.6 Resource dependence theory

Resource dependence theory is based on the idea that organizations attempt to exert control by co-opting the resources needed to survive. The concept of co-optation has important implications for the role of the board and its structure. It emphasizes on the role of directors as supporters of resources for the enhancement of firm performance. Proponents of this theory emphasize the broader role for board members in addition to their monitoring duties (see Johnson *et al.*, 1996; Zahra and Pearce, 1989). According to Pfeffer and Salancik (1978) in resource dependence model, the purpose of an organization to hire a director, apart from the traditional role is who from his own expertise and network will come to support the organization. This support will increase the firm performance and ultimately will increase the returns to shareholders. Moreover, they view corporate financial interlocks as mechanisms by which corporate managers coopt sources of environmental uncertainty (Burt, 1983). In literature financial interlocks have been explored as a governance mechanism. For instance, the presence of a representative of a financial institution on a firm’s board increases the financial institution ability to monitor the firm’s behavior, and willing to lend more to firms where their representatives are member at board of directors (Stearns and Mizruchi, 1993, pp.615). Hence, board members with high level links to external environment could contribute to company’s access to various resources, thus contributing to the corporate governance and firm’s performance.

3.5.7 Other relevant theories

*Managerial hegemony*: It refers to the circumstances when professional managers of the firm are more powerful and influential on strategic decisions than of corporate governing boards.

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Table 3.3: Summary of corporate governance theories

<table>
<thead>
<tr>
<th>Theory</th>
<th>Summary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agency theory</td>
<td>Agency theory highlights the conflicts of interest between principal and agent that arise due to the separation of ownership and control. Jensen and Meckling (1976) propose alignment of interest hypothesis i.e. managerial equity ownership. Through which managers also become the residual claimants and are assumed to work for the value maximization of the firm.</td>
</tr>
<tr>
<td>Transaction cost economics</td>
<td>The work of new institutional economists, states that incomplete contracts in real world expose the related parties to different hazards, which results to various agency costs. TCE views the firm itself as a governance structure, and try to minimize the agency cost through the selection of an appropriate governance structure.</td>
</tr>
<tr>
<td>Stakeholders theory</td>
<td>This theory insists on the interests of a large group of constituents rather than solely focusing on shareholders. And suggests the direct representation of each stakeholder in the governance structure.</td>
</tr>
<tr>
<td>Stewardship theory</td>
<td>This theory considers the directors as the stewards of the firm and assumes that they work in the best interest of firm by utilizing the assets for value maximization of the firm instead of using for their personal benefits.</td>
</tr>
<tr>
<td>Resource dependence theory</td>
<td>It suggests that qualified boards with experience, expertise and high level of link with external environment would help the firm to acquire sufficient resources required for value maximization.</td>
</tr>
</tbody>
</table>

Source: Author’s compilation from literature with reference from Mallin (2007)

Proponents of managerial hegemony support the role of managers based on their knowledge of day to day operations of the firm. Mace (1971) that managers may take the control from managers through various means such as, information asymmetry and elite networks.