A Study on the Relationship between Corporate Governance and Dynamic capital structure

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Abstract

Debt fund in capital structure is known as a control factor in corporate decisions. This is why the company's management is reluctant to change the capital structure toward increasing or decreasing the debt ratio. Any increase or decrease will lead to a change in controllers and it is usually the case that the management has no motivation to change the current optimal status into an unpredictable one. This research has dealt with variability of capital structure as effected by Corporate governance mechanisms (independence of the Board of Directors, controlling shareholders and internal audit) as a tool to control the management. It is expected that corporate governance mechanisms can affect the variability of capital structure and that the company's management makes faster decisions in order to get access to the targeted and optimal capital structure. Therefore, the single research hypothesis was tested using the sample of the companies selected using the systematic elimination method. Multivariate regression was used in hypothesis testing. Results revealed that the mechanisms of corporate governance have a significant direct relationship with dynamic and variable capital structure.

Keywords: Corporate Governance, Capital Structure

- Introduction

The impact of corporate governance on optimization of capital structure has been investigated by previous studies, but its effect on the variability rate of capital structure toward optimal capital structure (which is the organization's goal) has not yet been studied. Since the change of capital structure is the result of the management's decisions on how to supply the financial resources, it is therefore possible for the management to implement its own desired capital structure and not to welcome great changes in the capital structure. The general management's resistance against the changes of the capital structure is due to the effects that these changes will have on the company's regulatory framework and that management will intervene in the management's decisions and will change the status desirable for it. The manager's resistance against this change can also be due to unpredictability of the company's status in the future. Therefore, this research deals with the role of corporate governance in accelerating the process of transmission from the current capital structure into an optimal capital structure.

- Problem Statement

The separation of ownership and management leads to formation of the relation of representative and a conflict of interests between managers and shareholders, and this causes managers to do opportunistic behaviors and make decisions which are for their own interests and against shareholders'. In fact, the representation theory shows that in order to increase their own interests, managers try to conceal the bad news related to the company and to report the good one as fast as possible (Bagherabadi & Dadbeh, 2012). Lack of Corporate governance mechanisms makes it possible for managers to move toward their personal interests rather than the shareholders' (Berle & Means, 1932). One of the important tools of internal control in Corporate governance is the type of the financial supply of the company or indeed its capital structure, so that supply of capital by debt will automatically create a supervisor over the company's activities, because the capital supplier needs to control the company and its operation in order to maintain his capital in the company and make decisions on whether to keep his relation with the company or not. Previous studies (such as Chang et al., 2014) have shown that despite the fact that supply of capital via bonds and debt securities will end in some costs for the company, shareholders prefer that the internal sources of the company be distributed between the owners and that the external resources be used for supplying the needed capital, because managers use the resources of the company to their own interests and without any added value.

The dynamic capital structure represents the rate of changes of capital structure and indeed the changes of debt ratio. The more increase in the changes of debt ratio from a year to the next year, the more the dynamic and flexible the capital structure will b. the reason for capital change is access to the target capital structure. The general management should identify its optimal target capital and increase or decrease its debt ratio in order to achieve that structure. However, the changes in the capital structure may lead to reduction of the management's interests, and its increased resistance against the change in the debt ratio. The Corporate governance mechanisms, as a control factor, are expected to prevent the management from making selfish decisions. Therefore, considering these points, the research aims by this research at responding the following question: "Is there a significant relationship beta corporate governance and dynamic capital structure?"

- Literature and Previous Studies

Corporate governance

In order to get to a comprehensive and complete definition of corporate governance, it is necessary to deal with the process whereby this concept has been set forth and developed. A review of different valid texts shows that the first and oldest concept of corporate governance has been derived from the Latin word of "Gubernare", meaning directing or guiding, which is used for steering a ship and this shows that the first definition of corporate governance focuses more on governance than on control (Hassas Yaganeh, 2006). A review of the literature shows that there is no agreed-upon definition for corporate governance. The present definitions of corporate governance lie in a wide scale. The limited views lie at one end of the scale and the open and extended views lie at its other end. The limited views restrict corporate governance to the relationship between the company and its shareholders. This view is expressed in representation theory. At the other end of the scale, corporate governance can be considered a network of relations that exist not only between the company and its owners (shareholders), but also between the company and a large number of beneficiaries such as employees, managers, salespeople, those who have bonds and debt securities and others. This view is expressed in Beneficiaries Theory. Corporate governance can be defined as the process of control and supervision to guarantee the company manager's performance in compliance with the shareholders' interests (Hassas Yaganeh, 2006). The Organization for Economic Cooperation and Development has defined corporate governance as the following: "a set of relations among the management, Board of Directors, shareholders, and other beneficiaries of a company". As a comprehensive and thorough definition, corporate governance can be defined as "rules, regulations, structures, processes, cultures and systems which lead to access to the goals of responsiveness, transparency, justice and observance of the beneficiaries' rights (Hassas Yaganeh, 2011).

Corporate governance deals with mechanisms whereby the beneficiaries of the company control the managers and members of the Board of Directors in such a way that the beneficiaries' (including those who bring the capital, the creditors and other beneficiaries such as employees, customers, suppliers and the government) interest will be preserved. Professional managers, entrepreneurs and the internal members of the company (mentioned under the general term of managers) control the key decisions of the company. The main subject in corporate governance is separation of ownership from control and the issues related to representative. Control mechanisms are needed due to separation of ownership from control. Therefore, corporate governance is a tool by which different shareholders control the company by applying certain rules included within the framework of the company's regulations and laws (Hassas Yaganeh, 2006).

Capital structure

The term "capital structure" refers to the type and ratio of different types of securities issued by the profit unit. Optimal capital structure is also a set of securities which maximize the overall value of the profit unit. But how can the maximum limit of value of the profit unit be determined? In the face of the above problem, financial managers have to develop their own special policies. If the company's stock price declines after the announcement of a new financial plan, it can be concluded that the implementation of the new financial plan will lead to the company value's getting out of the optimal limit. Meanwhile, financial institutions which provide credits and financial facilities can present the financial managers with their views about the financial plan of the profit unit. If the profit unit has to pay high (unconventional) interest, it can be considered a sign of its previous too much debt. Another source of information can be revising in classification of security clearance of the profit unit and lowering it by the financial analyst fluctuation (Shabahang, 2005). An optimal capital structure should have the following characteristics:

- Efficiency: a company capital structure should have the most profit. It should also maximize the shareholders' efficiency without imposing any surplus expenditure to the company.
- Risk: too much use of debt creates for the company the danger of not performing its commitments and increasing the possibility of bankruptcy. Debts should be used if they do not create a great risk for the company; otherwise, they should be avoided.
- Flexibility: capital structure should be flexible. In cases of changes of conditions, a company should be able to coordinate its capital structure with the new conditions in right time and with the least cost and also be able to provide the funds needed for investment in profitable activities.

- Borrowing capacity: the capital structure of a company should be proportionate with the borrowing capacity of that company and should not exceed it. A company's borrowing capacity depends on its ability to get future cash currencies. This cash fund should be so much that it can cover the fixed sums paid to creditors and main owners of the company.
- Control: capital structure should have the minimum risk of losing company control, especially because the main owners of companies are concerned about their loss of control over their companies (Vakilifard, 2009).

- Previous Studies

Yazdani (1994) investigated the factors determining and affecting the financial structure of the companies listed in Tehran Stock Exchange. The effect of the variables of company size, commercial risk and operational leverage on the capital structure leverage were not proved in this study. It is worth noting that these results have been obtained by studies in chemical, pharmaceutical and foodstuffs industries, wood and paper productions, machinery, and industries of cement and construction materials. Namazi & Shirzadeh (2005) investigated the impact of capital structure on profitability in the companies listed in Tehran Stock Exchange. The results of their study indicated that there is no strong and significant relationship between capital structure and profitability of companies. The use of debt and its effect on the interest and performance of companies is also different depending on the type of industry, that is, the type of industry affects the use of debts. Sheikholmolouki (2007) showed in his research that the use of debt has no considerable role in changing the value of the companies under study and it has sometimes had an opposite effect on the value of these companies and these companies have not been able to succeed in using the tax benefits. Mohammadi (2005) investigated the significant relationship between the rate of use of leverage in capital structure of companies and the variables of the structure of assets, liquidity, profitability, growth of profitability and growth of sales. The results of his research showed that during the period of investigation, the factors of the structure of assets, profitability and liquidity are among the factors that have a significant relation with capital structure and that the two variables of profitability growth and sales growth have a poor relation with capital structure. Bevan and Danbolt (2002) also conducted a research called "Capital structure and its Determinants in the U.K.'s Capital Maket. The findings of Rajan Zingales (1995) regarding the capital structure of the U.K. commercial units were re-investigated by this research. One of the results of this research was that short-term debts play a very important part in the capital structure of English companies. Guney et al. (2011) studied the relationship between capital structure and competition of production market, that is, the structure of the market of Chinese companies. Using unbalanced panel model and the control variables of profitability, company size, the value of assets, growth, uniqueness of assets, non-debt tax shield, capability of creating internal sources and current ratio, they analyzed the relationship between capital structure and market structure in static and dynamic ways. The research findings indicate a quota-like relationship between capital structure and market structure.

Wak Manmood (2009) studied the factors determining capital structure and came to the conclusion that the variables of company size, profitability, the rate of fixed tangible assets and interest rates are effective in companies' decisions of financial supply**.**

- The Research Purpose and Hypothesis

This research aims at investigating the relationship between corporate governance and variability of capital structure. Therefore, the hypothesis of this research is set forth in the following way:

"There is a significant relationship between corporate governance and variability of capital structure".

As encouragement toward investment and attraction of small and large capitals to the stock exchange and finally the companies listed in the stock exchange is done more than earlier, investors should be provided with high-quality and clear information so that it becomes possible to provide both investors and the public with appropriate opportunities for investment and eventually achievement of interests. Therefore, other goals of the research are as follow:

1- Investigating the relationship between the variables paves the way for investors to make smart decisions, and have useful and low-risk investments.
2- Identifying the factors affecting the increase or decrease of company risk for the company management and investors.
3- Identifying proper investments for the company management in order to increase efficiency and value of the company's shares.

- Research Methodology

The present research is an applied research in terms of purpose and a correlational one in terms of method. The method used in this research is quasi-experimental and post-event (using the events of the past), the research being within the field of positivistic researches of accounting and based on real information. For data collection in the theoretical fundamentals and literature of the research, librarian sources, articles, required books and Worldwide Network, organizational data and the reports made by the companies listed in stock exchange, the financial statements of the companies brought in the website of Tehran Stock Exchange and Novin Rahavard Software have been used. In this research, those companies which had been measured in terms of the Corporate governance index were divided into four categories and sorted from small to large. The first group was those with poor corporate governance, and the fourth category was those with strong Corporate governance. Then, the financial leverage was calculated for each existing company in categories with strong corporate governance and poor Corporate governance and the associated hypotheses were tested according to the model. Excel software, Eviews software and Regression Test and Spearman Correlation Test were used in testing the research hypotheses.

- The Population

The population of the present research includes the companies listed in Tehran stock exchange. In order to gather the research data, we selected the sample using the systematic elimination method for the five-year interval before 2012. The following conditions and limitations were considered in selecting the sample:

- Their financial period ends in Esfand and they cannot have changed their financial period during the mentioned years.
- The information related to their financial statements for that period should be available.
- Due to the special nature of activity, they should not be among the companies active in financial intermediation industry.

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Table 1: Sampling Using the Systematic Elimination Method

453	The number of companies in 2008
79	Companies with fiscal year end other than 29.12
55	Symbol halt in stock exchange for more than three months
85	Intermediation and investment companies
107	Lack of access to information
127	The number of companies left for investigation (sample size)

- **Explaining the research model and the method of measuring the variables**

Before offering the research model, we first present the variables of the research and how to measure them and then present the research model.

The independent variable: Corporate governance

The independent variable of the present research is Corporate governance which is measured based on mechanisms like controlling shareholders, independence of the members of the Board of Directors and internal audit so that the Corporate governance index is calculated by the sum of the score obtained from observing the mechanisms of Corporate governance in companies. The calculation of Corporate governance index is such that the companies with controlling shareholders are given the number 1 and the others are given the number zero, and the independence of the members of the Board of Directors is calculated by the ratio of the unemployed members to the total number of the members of the Board of Directors, so that if the ratio is more than 50 percent, the Board of Directors' independence degree will be high and the company will receive score 1, otherwise its degree of independence will be low and the company will receive the zero. Moreover, if a company has internal audit committee, it will receive the number one, otherwise it will receive zero. The total scores obtained by measuring for each company the three criteria of controlling shareholder, independence of the members of the Board of directors and internal audit of corporate governance index.

Dependent variable: variability of capital structure

The dependent variable of the research is variability of capital structure which is calculated by measuring the rate of conversion of financial leverage or the ratio of the company's debt in the current year to its debt in the next year, and the following formula is used for measuring the rate of changing financial leverage:

Model (1):

$$DR_{i,t+1} - DR_{i.t} = \delta\left(DR^{*}_{i,t+1} - DR_{i,t}\right) + \varepsilon_{2i,t+1}$$

δ= This coefficient is equal to the rate of changes of capital structure to the target structure. The above model calculates the extent to which company i has covered difference with target capital from the current year to the next year of its capital structure change (which is the company' financial leverage). .$\delta = 1$ shows the high rate of the change of the company's capital structure to the target capital structure. The company has actually changed its structure to the target capital structure. $\delta < 1$ *shows the rate of the changes of current capital structure to the target capital structure.*

$DR_{i,t+1}$= *is equal to the financial leverage of the next year (which is measured by the ratio of debt to the company's assets in the next year).*

$DR^{*}_{i,t+1}$ = this is the variable of target capital structure which is measured via the following formula for company i during the time t. After calculation of the model for a set of companies, the coefficients $\beta\ and\ \gamma$ are determined based on Model 2. Then we predict the company's target capital structure using Model 2 based on the model obtained (Chang et al., 2014).

Model (2): Estimation of coefficients of $\beta\ and\ \gamma$:

$$DR_{i,t+1} = \gamma GOV_{i,t} + \beta X_{i.t} + \varepsilon_{1i,t+1}$$

Model (3) is the estimation (prediction) of the target capital structure for each company using the coefficients β and γ based on Model (2):

Model (3):

$$DR^{*}_{i,t+1} = \gamma GOV_{i,t} + \beta X_{i.t} + \varepsilon_{1i,t+1}$$

$GOV_{i,t}$= is the index of Corporate governance which is measured based on controlling shareholders, the Board of Director's members' independence and internal audit. Corporate governance index is calculated via the sum of the companies' scores in observing the mechanisms of corporate governance.

$X_{i.t}$ = this vector represents the control features of companies with the following elements:

1- The ratio of market value to the book value of the company (MB)
2- The ratio of fixed assets to the total assets (FA)
3- The ratio of earnings before interest and taxes to the total assets (EBIT)
4- The ratio of depreciation costs to the total assets
5- The company size equal to the natural logarithm of the total assets (SIZE)

After calculation of the research variables, it is time to present the general model of the research which investigates the corporate governance index and the variability rate of capital structure:

Model (4):

$$\delta_{it} = a_0 + a_1 CGI_{it} + \varepsilon_0$$

δ = the variable of variability rate of capital structure (dynamic capital structure) of company i during the year t.

CGI_{it} = the variable of Corporate governance index of company i during the year t.

Control Variables:

This set of variables includes variables which affect the dependent (or independent) variable separately (Smith, 2003). As the independent variable cannot predict the dependent variable completely, incorporating control variables into the model will result in a decrease of prediction error. It is noticeable that some control variables whose effect on the dependent variable has been previously studied have been used in this research.

The control variables of the research are a vector of six variables defined and measured in the following way:

The ratio of the market value to the book value of the company: as its name indicates, this variable is obtained by dividing the market value of the owners of the company value into the book value of the stock.

The ratio of fixed assets to the total assets: this ratio shows the percentage of the company's fixed assets obtained by dividing the book value of the fixed assets into the total book value of the company's assets.

The ratio of earnings before interest and taxes to the total assets (EBIT): this ratio represents earnings obtained by dividing earnings before interest and taxes into the total book value of the company's assets.

The ratio of depreciation costs to the total assets: this ratio is also obtained by dividing the depreciation costs into the total book value of the company's assets.

The company size: this variable indicates how big a company is, and the natural logarithm of the company's total assets is used to control it.

- Findings

Descriptive Statistics

In order to get better knowledge of the population under study and more familiarity with the research variables, it is necessary, prior to the analysis of the statistical data, to describe these data. The descriptive analysis of the data is also a step toward identifying their pattern and a base for describing the relations between the variables used in the research.

Table 2: Descriptive Statistics

	Corporate governance index (CGI)	Variability (dynamicity) rate of capital structure (δ)	Vector of control variables (X)
Mean	1.42	2.99	41.15
Median	1.00	0.00	39.69
Maximum	3.00	0	2838.55
Minimum	0.00	513.63	-531.52
Standard deviation	1.09	35.34	123.67
Skew	0.24	-11.10	18.05
Kurtosis	1.75	142.21	414.85
Number of observations	635.00	635.00	635.00

Table 2 shows the characteristics of the variables by numbers so that it displays the data's mean, and distribution, skew and kurtosis of the collected data for testing the data. The descriptive features of the data of each variable have been shown in each column of the variables. These features or descriptive statistics show a single aspect of each variable's data. For example, for the variable of Corporate governance, the data mean shows is equal to 1.42, which shows in comparison with the highest number and the lowest one which are 3 and zero respectively that the indices of Corporate governance (audit committee, independence of the board of directors, controlling shareholder) are rarely observed in the companies listed in Tehran Stock Exchange. Furthermore, the mean of the variable of the variability rate of capital structure is -2.99, showing that the variability rate of capital structure in the companies listed in Tehran Stock Exchange is not moving toward an optimal structure and is changing irregularly in comparison with the highest and lowest numbers (75.30, -513.63). if the variability rate is equal to 1, it shows that the company's changes are exactly in line with the target structure, but if it is zero, it shows a lack of change in the capital structure. However, if it is higher than 1 (the negative numbers have been changed into positive ones), it shows severe changes in the capital structure, which is not god for achievement of the target capital structure. The maximum, minimum and mean of dynamic capital structure shows that the variability of capital structure is very high in Iran and there is no stability in capital structure in this country.

Analytical statistics

At this stage, after determining and calculating the independent and dependent variables and describing them through descriptive statistics such as mean, mode, median, standard deviation …, the researcher tests and analyses the research hypothesis.

- Hypothesis analysis and Testing

The Panel Date Regression Test (Panel Data) will be used for testing the research hypothesis. As the data used in the research are panel data, they demand their own special stages for doing the needed test. In general, the model's estimation using panel data includes the following stages:

1- The test of identifying reliability on the data
2- Model estimability test in the form of panel data.
3- Test of determining fixed effects or random effects
4- Estimation of parameters

Testing the Reliability of the variables

Tests such as LLC, ISP, PP and ADF have been used for testing the reliability of the variables. Some of these tests have sometimes shown different results. Table 3 shows the results of Levin Lin Chu test for identifying reliability of the research variables. The table below shows that as the Levin Lin Chu statistic probability is less than 5 percent for all of the variables, they are all reliable. Lamer F-test and Hausman will be administered then.

Table 3: Reliability of the Research Variables

variable	statistic	Statistic probability
Corporate governance index	-2.70654	0.0034
Variability rate of capital structure	-9.28525	0.0000
Vector of control variables	-22.5966	0.0000

(Chow) F-test to select changing or fixed intercept

Chow test (Lamer F-test) is used for determining the homogeneity (common fixed value) of different stages. Hypotheses are introduced in this test as follow:

HO: the intercepts of the model are equal = integrated data method

H1: at least one of the intercepts of the model is different from the others = panel data method

Table 4: Lamer F-Test for Selecting Changing or Fixed Intercept Model

Research hypotheses	Type of test	Statistic value	Statistic probability	result
The main hypothesis of the research	F-test (Lamer)	0.976235	0.5565	H0 is confirmed and Fixed Effects Model is rejected.
	Chi-square Test	137.933247	0.2204	

According to table 4, which shows the outputs of Lamer F-test, F-statistic probability shows that the level of significance for the single hypothesis of the research is lower than 5 percent. Therefore, H0 is confirmed, but H1 is rejected, meaning that the integrated data approach is confirmed. Hausman Test is used to examine the fixed effects model against random effects model, and as the result of Lamer F-test shows, this test does not need to be re-administered.

Estimation of the research model coefficients

After the tests of reliability and Lamer F-test, the coefficients of the hypothesis model should be estimated in accordance with the results obtained from the above tests and multivariate regression model has been used for this purpose:

Testing the research hypothesis:

The following model has been used for testing the research hypothesis:

$$\delta_{it} = a_0 + a_1 CGI_{it} + \varepsilon_0$$

δ = the variable of variability rate of capital structure (dynamic capital structure) of company i during the year t.

CGI_{it} = the variable of Corporate governance of company i during the year t.

Table 5: Results Of Testing H1

variable	coefficients	t-statistic	Level of significance
Fixed number	-0.867923	-3.945698	0.0001
Corporate governance index	0.265788	3.040301	0.0025
Coefficient of determination	0.014392	F-statistic	9.243431
Adjusted coefficient of determination	0.012835	F probability	0.002461
Durbin-Watson statistic			1.542621

Durbin-Watson statistic shows a lack of correlation among the components as the value of this statistic is equal to 1.54, which is between 1.5 and 2.5. The F-statistic probability in table 5, related to the results of testing the research hypotheses shows that there is a significant linear relationship between the variables of the research, because its F-probability statistic is less than 5 percent. T-test is used to examine the significance of the calculated coefficients.

Table 5 which summarizes testing the research hypothesis shows that the variable of Corporate governance index which is the independent variable of the research has had a significant relation with the dependent variable of the research (variability rate of capital structure), because the t-statistic probability of this variable is equal to 0.0025, which is less than 0.05, and its coefficient is 0.26, showing the changeable ability of Corporate governance index in explaining the changes of the variability rate of capital structure, so that 26 percent positive change will occur in the variability rate of capital structure only with one unit of positive change in the Corporate governance index.

- **Conclusion and Discussion**

According to the research hypothesis, there is a significant relationship between corporate governance and variability of capital structure. Based on the theory that supports this hypothesis and has been put forward in the research conducted by Chang et al. (2014), it is predicted that in order to maintain their benefits and positions in the company and to reduce the risks occurring as a result of the changes in the company's structure, the managers of companies are reluctant to change the present status into an unknown and vague one. Since companies should seek to gain access to the best ration of debt for increasing the company's profitability and financial performance, therefore, their goal should be to achieve an optimal capital structure. However, conflict of interests between the management and shareholders slows down the management in changes of the capital structure because an increase or decrease in debt ratio can endanger the management's interests. An increase in the debt ratio is along with an increase in the controls and supervisions by the new suppliers of capital. Therefore, the management will not agree on the change of the capital structure by increasing the debt ratio. A decrease in the debt ratio can also change the conditions against the management's interests so that it can be along with a reduction in the debt ratio and replacement of the old suppliers with new ones with whom the management may not be able to communicate and create aligning interests as easily as it did with the old suppliers as it has no familiarity with them. In other words, management can create close relationship with the suppliers of capital and debt after a while, but the new suppliers' arrival in the company can turn the optimal conditions into suboptimal ones for the management.

The results revealed that there is a significant linear relationship between the variables of the model, and that the independent variable can account for the changes of the dependent variable up to 26 percent. In other words, the independent variable (Corporate governance index) can be effective in explaining the reason of the changes of the dependent variable up to 26 percent. The results of the research hypothesis showed that in the companies listed in Tehran Stock Exchange, an increase in the corporate governance index will result in an increase in the rate of the changes of capital structure toward gaining access to the target capital structure. This result shows that lack of corporate governance mechanisms in Iranian companies persuades and encourages managers to maintain their own interests. Therefore, it is recommended that investors, owners and shareholders of companies be careful in choosing their shares for investment rate of the changes of capital structure about the existence of corporate governance mechanisms and to take them into consideration in their decisions. Moreover, in order to elaborate the relationship between corporate governance index and the rate of changes of capital structure, it is recommended that a similar research be conducted in other time periods especially in longer periods of time, and that this research is re-conducted in other industries due to the effect of industry in capital structure and its variability. It is also suggested that other criteria and indices of measurement of corporate governance such as the presence of institutional shareholders be investigated in similar studies.

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