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Does Ownership Structure Impact on Capital Structure?

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Abstract

Taking the 2011-2015 public listed financial and non-financial firms in Pakistan as the sample of the study, this paper scrutinizes the sway of ownership structure on capital structure. The multivariate regression analysis technique is used because the dependent variable is influenced by the more than one independent variable. The final results reveal that capital structure decision is positively associated with the board of director size and non-executive director's percentage while it is negatively related with the percentage managerial shareholding.

Keywords: Ownership Structure, Capital structure, Board of director, Non-executive director

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Introduction

Capital structure theory is the financing structure and influencing factors of enterprises. Capital structure. A large amount of literature has focused on the trade-off theory and explains corporate debt financing conclusions. Some of these readings have

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been recognized as important factors or the company's capital structure arises from the costs arising from the agency. In the study of the capital structure and the other two theories, these study emphases on agency theory, and stabs find out the aspects that affect the capital structure.

Every firm is performing a number of different function. The important functions of the organization are the customer’s need and satisfaction, shareholder’s wealth maximization, employee’s satisfaction from the job and many others. All these functions are performed by the different departments, which includes the HRD, Management, Marketing, and Finance. Moreover, Finance department perform the different function which includes the shareholder’s wealth management, investment judgment and financing conclusion. Financing decision of a firm is based on the different factors of an organization. This may include the size of a firm, growth opportunities, types of business and also some time on the ownership structure of the company. A factor which will be considered in this paper is ownership structure and its effect on the capital structure result of the firm.

Ownership structure differs from firm to firm. Some firms are family owned business while the other is the public limited companies. Ownership structure may have a strong impact on the firm’s capital structure decision, as evident from the previous work done in this field. According to the Friend, Irwin and Lang (1988) negative relationship is exist between the managerial own shareholding and leverage ratio which means in the presence of managerial shareholding the leverage ratio will be low because leverage means high risk for business and manager when part of ownership less go for risky financing. An additional factor that may have an impact on the firm’s capital decision is the presence of non-executive member on the board, this factor is also considered by the number of researchers previously one of them is Jensen (1986) he found that companies with non-executive members mostly result in the higher gearing ratio. He is not a single person who provides evidence for this Abor and Bikpe (2007) also deliver similar evidence when they study the Small and Medium Enterprises of Ghana, where occurrence of the non-executive member or outside board member results in the high gearing ratio. Because non-executive member thinks that debt is cheapest source of financing. But the literature available shows that not only the non-executive member and managerial shareholding that affect the capital structure decision but also the board of director’s size may also have an impact on the capital structure decision. As in some organization, the board of director is comprised of large number it results in low gearing level, as evident from Berger (1997) bargains companies with a greater board of directors typically have low gearing levels. He struggles that greater boards exert force on managers to follow lower gearing levels and improve firm enactment.

Important of this paper is to find out the association between the factors that are evident from the literature available.

- Testing the association between the ownership structure and capital structure.
- Testing the association between managerial shareholding and capital structure.

- Testing the association between board size and capital structure.

- Testing the association between the presence of non-executive member in the board of directors and capital structure.

These are the important factors and relationship which is test through this research paper.

Capital structure verdict is amongst some of the important decision taken by the firm. The previous literature available on the topic shows that research done in this field has taken governance and ownership structure or ownership structure and stock market condition etc together. No one had taken ownership structure as a single factor to test its effects on the capital structure decision. That why in this research paper my main focus is on the association between the ownership structure and capital structure. Secondly, the work done on this topic before this study is mostly in foreign countries or we can say in foreign economies, only limited work is done in Pakistani market. So that why for this research paper I have taken this topic to find out the effect of the ownership structure of Pakistani firm on its capital structure decision.

Capital structure is technique companies raise capital to support their processes and future debt and equity portfolio development. Debt financing and equity financing is the two capital source of an enterprise. Companies issuing more debt bear high risk. The optimal capital structure should be the balance of debt and equity debt long term debt and short term debt, including long-term debt, long-term loans, and long term notes payable. Short-term debt includes short-term banks loans payable and accounts payable. Equity usually includes ordinary shares, preferred stock, and retained earnings. Most companies use debt and equity financing to minimize capital costs. The formation of the capital structure is commonly referred to as leverage.

This research will help in creating the knowledge about how in Pakistani market the ownership structure of the firm affects the capital structure decision of the firm. It creates the literature which will help in future research in the similar topic. No only in literature also in practical field it will provide the help for the companies in determining their capital structure because they have the result that shows that how the firm took capital decision when they are e.g. more family based or equity-based company or more debt provide the capital structure part.

Literature Review

Literature shows that corporate ownership structure has a significant impact business risk for subsequent financial leverage except from company characteristics (size, growth, risk, profitability, tangible and corporate ownership structure has a substantial impact on the capital structure (Hewa Wellalage and Rock, 2011; Pindado and Torre, 2011).

The capital structure decision is of prime importance for the organization. There are number of factors that affect the capital structure decision of the firm. Which includes the firm size, firm area of operation, leverage level, gearing ratio etc. but the final decision is taken by the top management of the company and some time by the owner of the business.

So ownership structure could also be the main factor involved in capital structure determination. Researchers ignored this area of research. In this initial part of previous work done in this area is presented.

Wen (2002) finds direct and positive association between capital structure and board of director's size. Wen (2002) argues that when the board is large it is difficult to reach consensus and also board exert pressure on the managers to go for the high gearing as it enhance the performance of the company. Jensen (1986) also provides historic support for the direct association between gearing ratio and the board size. Anderson (2004) explain that in the presence of larger board the debt financing become easy as the outsider is in confidence that large number of monitors are present. And debt financing is possible with less cost as compare with other sources of financing.

Now a day the Non-executive directors are important part of modern corporate governance system. The presence of the nonexecutive directors also play important role in capital structure decision. Researchers view about the non-executive members is following.

Jensen (1986) found that companies with non-executive members result in the higher gearing ratio. Berger (1997) also found the similar result later in 1997. Abor and Biekpe (2007) provide evidence from the SMEs of Ghana where presence of the outside board member result in the high gearing ratio. Because they emphases on the cheapest source of financing. Pfeffer and Salancick (1978) explain that the presence of non-executive member enhance the firms creditworthiness which result in easy availability of financing from outer sources. This results in the higher level debt ratio. But Wen (2002) provides different result, according to Wen there is negative relationship between the non-executive member on the board of firm and the level of debt financing. Because in the presence of outsider the manager perform well and keep the gearing ratio low because high gearing result in the more risk to business. Companies with the non-executive directors more emphasize on the increase in shareholder value.

On the bases of literature available we can conclude that managerial shareholding, size of board and the presence of the non-executive member are the factor that affects capital structure decision of firm. According to previous research the association between the capital structure and above factor is some time negative and other time positive the basic aim of this research is to find out the association in Pakistani market.

Data collection and Methodology

This research paper reveals the relationship between ownership structure and capital structure. 5years period 2011-2015 secondary data of Financial and non-financial firms compiled from Karachi stock exchange listed firms. For the calculation of non- executive directors and managerial shareholding carefully read out the annual reports of Karachi stock exchange firms.

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For the total sample, we exclude firms without complete data company negative assets are also excluded. All variables at 0.5% level tail each tail to eliminate the effects of outliers (Li, et al., 2009).

Variables

Dependent Variable - Capital structure

Dependent variable of this paper is capital structure. Capital structure refers to the company's long-term debt, short-term debt, equity, and preferred stock. Capital structure is how to use diverse sources of Investment for the inclusive process and growth of enterprises to provide funds.

Independent Variable- Ownership structure

Ownership structure is the independent variable of this study. Variables included Ownership concentration, managerial ownership, state, and Corporation Ownership. Following Jong (2002) and Liu, et al. (2011) equity concentration Described by the proportion of major shareholders in the total share capital. Largest party Ownership term includes the nonlinear relationship between ownership capture concentration and leverage. Management shareholding ratio is defined as shares held by senior executives. State ownership and corporate ownership is defined as part of state and corporate ownership.

Managerial shareholding (Managerial ownership)

Managerial shareholding refers to the how much of the total shareholding is in passion of the managerial staff of the organization. Corporate stock generally held by officers or directors of a company that receives no dividend until a specified amount has been paid on the common stock but that receives a large share of the residual profits. It is calculated through the ratio or percentage of total shares held by the managers.

The increase in managerial ownership forces managers to assume responsibility the consequences of wealth, thereby coordinating management and shareholder。 This reduces management incentives for consumer allowances and wealth to shareholders (Jensen & Meckling, 1976). As mentioned earlier, the debt can be used to monitor management activities. Therefore, debt and managerial ownership can be considered as an alternative mechanism to mitigate agency costs (Mohammad al). ET, 1998). Then, with the increase in managerial ownership, the discipline of debt use can be reduced.

Size of board of director

The final size is expected to be different for each board. One size does not fit all. Each board would like to describe its best capacity at any given time. The size of the board of directors may deviate from the board life cycle in time, its work, its financing requirements, and whether it is a national or local board of directors. In most states, the law prohibits the minimum amount of nonprofit committee. Is generally three, but in some states only one board member is necessary. Some boards operate under a representative order; their arrangements need to reflect voters, which puts upward pressure on the scale. Production communication is done through a set of size effects, the group's undercurrent may become the finishing board standard. The size of the board is designed to track the size of the board. Non-executive member in board of directors

Non-executive directors (NED)

That is our outside directors of the board of directors of the company who do not perform a part of the management team. They are not employees or with any of its Affiliated Companies in any other way is from internal differentiation and board members, who are those who can also be executed before or served (the most frequent company executives of the company). The board of directors of non-executive directors is independent directors, and they are independent directors from other sources of distinguish independent non-executive directors' motto is allowed in the company's stock, while allowing independent directors are not. The presence of non-executive directors is calculated by sampling the non-executive members of the board of directors.

Methodology

The final model for the econometrics test will become like that.

$$LEV\ it = \beta 0 + \beta 1\ (\%\ NED)\ it + \beta 2\ (Log\ BZ)\ it + \beta 3\ (MSH)\ it + \varepsilon t$$

LEV= Leverage ratio of firm/ capital structure

NED= Non- executive directors on the board

BZ= Board of director size

MSH= Managerial shareholding out of total shareholding

$\beta 0$ = Intercept of both variables

ε= Error term

Empirical results

Table 1 Descriptive statistics.

	CS(Leverage)	%MS	BZ	%NED
Mean	3.598408317	14.67753253	8.35049505	59.63968596
Median	1.78	2.12	8	62.5
Mode	0.38	0	7	85.71428571
Standard Deviation	14.99227396	21.47589623	1.804405091	26.9457274
Kurtosis	169.309169	2.028692406	6.588484765	-0.535703065
Skewness	5.268722111	1.630912874	2.083865829	-0.581074982

Minimum	-238.5	0	6	0
Maximum	175.8	93.1105641	17	100

The descriptive statistics reveal that the average board size for the Pakistani listed financial and non-financial firms are 8.35. Most of the firms include the 8 to 11 members in their board of directors. The analysis also shows that the maximum number is 17 while minimum numbers are the 6.

The descriptive analysis also indications that the fraction of non-executive directors is 59.64 percent which is fairly a good sign as the existence of non-executive directors made the fair business practices possible. Also the current value is higher than the previous research done by the butt S.A and which shows that the 48 percent of the board memberships are the non-executive directors.

According to the analysis the managerial shareholding is 14.68 percent which is less than the previous research done in the in which the value was 21.48 percent. The less percentage of shareholding means the less alignment of interest so the managerial decision may not the best one and fully committed.

Table 2 exhibits the correlation matrix

	capital structure	%MS	LogBZ	%NED
Capital structure	1			
%MS	-0.01526339	1		
LogBZ	0.02801885	-0.16171	1	
%NED	0.04699067	-0.09874	0.243249	1

The correlation matrix shows that the negative relationship is exist between the leverage and managerial shareholdings which means that as the managerial shareholdings decrease the leverage ratio become high, as the less managerial shareholding means the less alignment of the interest of manager with the business. So the manager more easily go for the debt financing as they are less concerned with the risk of the business,

The correlation results also reveal that board of director's size and leverage are positively related with each other. This result shows the larger board and board which is comprise of the independent and non-executive directors are more dependent able for the institutions to lending. So that results show that the firms more often go for the debt finance as it is easy and comparatively cheaper source.

The association among the fraction of non-executive directors as well as leverage is optimistic which shows that the presence of the non-executive director increase the confidence of the institutions on the firm. Which results in the decision that they are more easily agree to lend the loan for the firm. Because the presence of the non-executive directors insures that the firm is performing according to the

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code of corporate compliance and non-executive director's monitors the fire conduct of the business. So that is reason behind the positive relationship between the both variables.

Table 3 Multi-variant regression analysis.

	Coefficients	t Stat	P-value
Intercept	-0.437818426	-0.057363815	0.954278258
%MS	-0.005897791	-0.186491367	0.852134937
LogBZ	1.295120692	0.352765783	0.107244124
%NED	0.023461956	0.914917306	0.360675173

Multivariate regression analysis shows that the 1 unit changes in the managerial shareholding bring the 0.0058 decrease in leverage when all other variables remain constant. This result shows that negative relationship exist between leverage and managerial shareholding because when the manager are also shareholder of the business they want to reduce the business risk and keep the leverage level on save point.

According to the multivariate regression analysis the 1 unit change in board of director size bring the 1.29 unit increase in the leverage ratio when all other variables remain constant. The reason behind this increase is that the larger board includes the representative of shareholders and they may vote against issue of new share as it will divided the shareholders wealth, and board more easily agree on the debt financing.

The third result shows that the 1 unit change in the non-executive director bring the 0.023 unit positive change in the leverage when all other variable remain constant. The reason for this positive effect presence of the non-executive and independents directors increases the creditability of the board that it runs the business according to the rules and regulations. The financial institutions more easily lend the loan for such firms.

Conclusion

This study empirically examines the association between capital structure and ownership structure from 2011-2015 financial and non-financial companies in Pakistan. Multiple regression analysis is used to find the association between capital structure and ownership structure. The consequences show that there is a positive correlation between the existence of non-executive directors and capital structure, and there is a similar association between board size and capital structure. Therefore, we can conclude that capital structure or financial conclusions are influenced by the size of non-executive directors and board of directors.

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