CORPORATE GOVERNANCE AND CHOICE OF CAPITAL STRUCTURE

Aditya R Limaye, Arkansas Tech University, U.S.A.
Ahmed Elkassabgi, Arkansas Tech University, U.S.A.
Kuldeep Singh, Arkansas Tech University, U.S.A.
Debra Hunter, Arkansas Tech University, U.S.A.
Loretta Cochran, Arkansas Tech University, U.S.A.

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ABSTRACT

In this paper, we expand on the existing literature of corporate finance by analyzing the impact of corporate governance on the choice of capital structure for firms. Although other studies have analyzed this relationship, we extend the research by comparing the results across different industries such as healthcare, technology, consumer goods and industrial goods using a sample of 689 firms. The results show the relationship of corporate governance to the choice of capital is negative in the healthcare sector firms, positive in the consumer goods firms, and has no impact on technology or industrial goods firms.

***Keywords**: Corporate Finance, Corporate Governance, Capital Structure, Choice of Capital Structure*

1. INTRODUCTION:

The relationship between the variations of capital structure across industries has received considerable importance in the empirical and financial literature. Several studies have documented that capital structure would vary across industries [Graham and Leary (2011), Harris and Raviv (1991), Bowen, Daly, and Huber (1982), Bradley, Jarrell, and Kim (1984), Long and Malitz (1985), and Kester (1986)]. They have also shown that specific industries have a common leverage ratio which over time is relatively stable.

While the choice of the capital structure of a firm depends on several factors like the firm size, growth, profitability, liquidity, firm age, and other firm characteristics, it also varies according to the governance mechanism in the organization. The governance mechanism in the organization is known as corporate governance. Shleifer and Vishny (1997) define corporate governance as referring to how suppliers of finance assure themselves of a return on their investment. Corporate governance can be measured at different levels. Corporate governance at the firm level has been measured by the board characteristics, G index (Gompers et al., 2003) or the E index (Bebchuk et al., 2009). Other studies have used their own indices such as Black et al (2012) have used the BCGI Index. Some previous studies, like Li (2015), La Porta et al. (2000), Lombardo and Pagano (2006), La Porta et al. (1999) and Daines (2001), demonstrate that country-level characteristics like legal systems and investor protection are better measures of corporate governance or at the industry level.

We analyze the impact of corporate governance on the choice of capital structure across industries. Previous research shows that corporate governance can change across industries. Giroud and Mueller (2010, 2011) find that corporate governance does vary by industry structure, corporate governance structure matters more in noncompetitive industries, and that firms in non-competitive industries benefit more from good governance than firms in competitive industries while weak governance firms perform poorly only in non-competitive industries. Gillan et al. (2003) finds that the corporate governance mechanisms in a firm depend on the industry's investment opportunities, product uniqueness, competitive environment, and leverage. Also, leverage ratios which determine the capital structure of firms tend to