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CORPORATE GOVERNANCE AND CAPITAL STRUCTURE

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J E L Classification: M41, M20, G32.

Abstract: This research presents a thorough examination of how corporate governance impacts capital structure, utilizing agency theory to explain the alignment of managerial and shareholder interests in financing choices. The factors such as board size, board independence, and CEO duality have a positive effect on capital structure. Conversely, other factors, such as board gender, board meetings, board experience, and Audit Committee Size, have a negative correlation with capital structure. The Preferred Reporting Items for Systematic Reviews and Meta-Analyses (PRISMA) framework was utilized as the methodological approach. This process encompassed the identification, screening, eligibility assessment, and inclusion of relevant studies drawn from databases including Scopus, Web of Science, and Google Scholar. A total of 95 high-quality studies were scrutinized. The results offer insights into the influence of corporate governance on capital structure decisions in both developed and developing markets, providing significant implications for investors, analysts, and corporate stakeholders.

Introduction

Corporate governance is defined as the process of set of practices and rules by which a firm is controlled and held accountable to stakeholder. Managers

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become entrenched due to the separation of ownership among managers and shareholders. They are likely to choose those projects that are according to their interests, not shareholders (Ali, Zekiye & Sara, 2021). This causes poor management practices and a weak accounting and auditing system. Corporate governance mechanisms include board meetings, CEO duality, and board independence might have a direct impact on firm capital structure (Uddin, Khan & Hosen, 2019).

Boards of directors are accountable for the operations of the firm. The board of directors plays a significant role in financing decisions in, for example, capital structure. Due to the most important corporate governance failures, such as Adelphia, Enron, and WorldCom, the responsibility of the board of directors becomes dominant (Mwambuli, 2018). Capital structure is the mixture of debt and equity capital that firms maintain, especially using long-term capital. It is a framework for firms to use debt and equity for firm operations, and optimal capital structure increases the firm's value and reduces the cost of capital (Agyei & Owusu, 2014). Abdul-Qadir, Yaroson and Abdul (2015) argue that financing decisions are very vital for the performance of firms. Any decisions that are not in favor of the firm lead to bankruptcy.

Capital structure is an essential mechanism to reduce agency costs. These costs can be decreased by capital structure by two different processes. First, by enhancing managerial ownership in a firm by using debt financing (Ehikioya, Omankhanlen, Omodero & Isibor, 2021). The second process is to increase the chances of bankruptcy. Bankruptcy risk increases due to the use of debt financing by firms. These bankruptcy risks reduce the opportunistic behavior of managers (Gambo, Bello & Rimamshung, 2018).

In previous literature, limited evidence is available to determine the association between board structure and capital structure. The ideal capital structure within the agency cost framework aims to reduce firm expenses while enhancing the value of the firm, suggesting that capital structure is fundamentally dynamic (Oke, Saheed & Quadri, 2019).

Alabdullah (2018) research on Jordanian firms found a significant negative relation between capital structure and board size and a significant relation between capital structure and board independence.

Ahmed, Talreja and Kashif (2019) found that corporate governance is positive and it significantly influences capital structure decisions. This study investigates the impact of corporate governance on the capital structure of Pakistani firms. While the literature review includes both international and local studies, the hypotheses are tested exclusively on Pakistani firms to ensure contextual relevance. Grabińska, Kędzior, Kędzior and Grabiński (2021) describe how corporate governance rules were strengthened due to some corporate scandals (Enron, WorldCom) related to governing the firms. Boards of directors play an efficient part in monitoring the decisions of firms. Tarus and Ayabei (2016) argue that strong corporate governance influences the capital structure of firms, like the cost of financing and external financing, and this decision is linked with the board. The board of directors performs a key role in firm activities, and it is also responsible for the strategic decisions of firms regarding capital structure (Alabdullah, 2018).

In Pakistan, SECP (Securities and Exchange Commission of Pakistan) controls the system of corporate governance in firms. The board of directors is responsible for the implementation of efficient and effective control and policies of corporate governance, and it is the responsibility of shareholders to appoint directors and auditors to ensure that the firm is adequately following the principles of corporate governance. It is the board of directors' responsibility to properly execute the leadership responsibilities and management of capital structure (Ali et al., 2021).

The literature examined in this study encompasses both international and local research that investigates the correlation between corporate governance and capital structure. While numerous theoretical and empirical results are derived from international studies carried out in both developed and emerging economies (Ehikioya et al., 2021; Gambo et al., 2018; Grabinski et al., 2021; Oke et al., 2019), this study also integrates several significant studies that concentrate specifically on Pakistani firms (Ahmad & Nawaz, 2018; Bashir & Asad, 2018). The incorporation of international literature aims to offer a wider theoretical framework and to underscore global trends, while the inclusion of local studies aids in contextualizing the research within Pakistan's distinct regulatory, institutional, and corporate governance landscape. This amalgamation facilitates a more thorough comprehension of the research issue and guarantees that the hypotheses are anchored in literature pertinent to Pakistani firms. Consequently, the hypotheses formulated in this study are substantiated by both global theories and local empirical evidence.

The literature review highlights the conceptual and empirical significance of previous research rather than concentrating on their geographic emphasis. Given that the foundational theories, such as agency theory, are applicable across various contexts, incorporating studies that are not exclusively related to Pakistani firms does not undermine the validity of the hypotheses. The main objective is to integrate findings that contribute to the theoretical framework and research design, regardless of the national context. Consequently, it is not essential to explicitly indicate whether each reviewed study is related to Pakistan.

This research provides significant guidance related to how corporate governance practices influence the capital structure of firms. Its results, recommendations, and conclusions are beneficial for all stakeholders and financial managers for making decisions easily. Every country has its own rules and code of conduct, and when it comes to corporate governance, there is a requirement of ethical behavior with an aspect of corporate governance. In the remaining parts of the paper, in the second section, a review of previous studies will be discussed. In the last part, the conclusion and recommendations will be described.

Literature Review

Board Size and Capital Structure

Kajola, Olasibi and Fapetu (2019) state that boards of directors are accountable for the operations of firms, and the board of directors takes an active responsibility in financing decisions. Sheikh and Wang (2012) found that board size has a positive relationship with capital structure and board size. This result is reliable, with resource dependency theory suggesting that firms with large boards can increase funds from the exterior sources to increase the firm value. Ahmad and Nawaz (2018) found a positive association between board size and capital structure because larger boards effectively raise funds from external sources. Uddin et al. (2019) found an inverse relation between board size and capital structure. If the board members consist of institutional, professional, general, and independent directors, then board members are required to use low debt. Bokpin and Arko (2009) found that large board size take effective actions and effectively monitor the managers. Agyei and Owusu (2014) found a positive relationship between board size and capital structure because large boards exert pressure on managers to use the low debt level to increase the shareholder's wealth and firm performance as well. Abobakr and Elgiziry (2015) and Grabińska et al. (2021) found an inverse association between capital structure and board size, as large boards put pressure on the manager to use low debt levels. Alnori and Shaddady (2019) found an inverse relation between board size and capital structure. The larger the board size of a firm, the lower the level of debt financing used by the firm. Feng, Hassan and Elamer (2020) found that board size and capital structure have a positive relation because if a firm has a large board size, its management uses more debt. This outcome is consistent with agency theory, suggesting large boards have more supervisory resources.

H1: There is a positive relationship between board size and capital structure.

Board Independence and Capital Structure

Abobakr and Elgiziry (2015) describe that non-executive directors' play a key role in reducing agency problems and improving the process of decision-making. Sheikh and Wang (2012) found a significant and positive association between outside directors and capital structure. This result suggests that independent directors closely and effectively supervise the organization and compel management to select those actions that are in favor of shareholders. Jaradat (2015) found a positive association between capital structure and board independence. This result suggests that independent directors control the actions of managers and force managers to use those policies that increase shareholders' wealth. Uddin et al. (2019) found a positive relation between capital structure and board independence due to the fact that families and close relatives appointed non-executive directors to the board. Abdul-Qadir et al. (2015) found that independent directors are positively associated with capital structure because independent directors are considered monitoring tools to monitor the managers. Ahmad and Nawaz (2018) found a positive relationship between capital structure and board independence, as due to a greater proportion of independent directors on the board, creditors' trust increases in the firm. Abdoli, Lashkary and Dehghani (2012) found a negative relationship between capital structure and outside directors, as they strictly control the management of the firm regarding the usage of debt financing.

H2: There is a positive relationship between board independence and capital structure.

CEO Duality and Capital Structure

Sheikh and Wang (2012) stated that the responsibility of the CEO is to manage the activities of a firm and the chairman is responsible for handling business affairs, while CEO duality occurs when the CEO also serves as the chairman of the firm. El-Habashy (2018) found that CEO duality is positively associated with capital structure, and this result is reliable with agency theory. Sheikh and Wang (2012) found an inverse association between capital structure and CEO duality. Inverse association shows that the CEO also working as chairman on the board is likely to prefer a low debt ratio to reduce the risk of high debt. Ahmad and Nawaz (2018) found an inverse association between capital structure and CEO duality. Most Pakistani firms are family-owned by close relatives; that is why they prefer debt financing. Uddin et al. (2019) found a positive association between capital structure and CEO duality. The CEO and chairman are the same person; the CEO fulfills his responsibility very effectively. Alabdullah and Mohamed (2023) found a positive and significant association between CEO duality and capital structure, which clearly describes the importance of CEO duality in making capital structure decisions.

H3: There is a positive relation between CEO duality and capital structure.

Board Gender and Capital Structure

Jaradat (2015) describes that, according to resource dependence theory, board directors with diverse experience can attain resources. On the other side, agency theory describes that firms have more advantages when they have diversity on the board. He also found a positive association between capital structure and board gender. This outcome is according to resource dependency theory, which describes that diversity on the board provides an advantage to raise funds. Abobakr and Elgiziry (2015) found an inverse relation between the proportion of females on the board and capital structure because board gender decreases the information asymmetry between management and shareholders. Thakolwiroj and Sithipolvanichgul (2021) found no relation between capital structure and board gender. Adams and Ferreira (2009) argue that female members on the board are more punctual in attending board meetings. Alves, Couto and Francisco (2015) also found that firm financing decisions are also affected due to the board's diversity, which suggests that a diversified board would perform better.

H4: There might be an inverse relation between board gender and capital structure.

Board Meeting and Capital Structure

Conger, Finegolda and Lawler (1998) describe that conducting regular board meetings indicates that the board is active in monitoring the activities of a firm. Supervision of executive management can be easily done by frequent meetings. It decreases the agency costs and increases the firm's performance. Doan and Nguyen (2018) describe that eight board meetings per year are economical. Bashir and Asad (2018) found that board meetings are positively related to the firm's performance. Agency theory describes how board meetings align the interests of shareholders and managers. Frequent board meetings are helpful for monitoring the efficiency of board members (Brick & Chidambaran, 2010). Board meetings reduce borrowing costs by impacting lenders' evaluation of risk (Lorca, Sánchez-Ballesta & García-Meca, 2011).

H5: There might be an inverse relation between board meetings and capital structure.

Board Experience and Capital Structure

Board experience is an important mechanism that influences firm performance because the performance of a board improves due to board expertise and experience (Wen, Rwegasira, & Bilderbeek, 2002). Gîrbină, Albu and Albu (2012) found that the performance of a firm is significantly influenced by board members who have superior financial qualifications. Peni (2014) found that executive experience is positively associated with the firm's performance. Board education and board experience are positively related to the firm's performance (Darmadi, 2013). Wen et al. (2002) found that experienced CEOs have less debt. Custódio and Metzger (2014) described how the work experience of the CEO influences the financial policies of the firm.

H6: There might be an inverse relation between board experience and capital structure.

Audit Committee Size and Capital Structure

The audit committee is considered an important mechanism of corporate governance in enhancing supervisory board efficiency (Detthamrong, Chancharat & Vithessonthi, 2017).

A numerous audit committee is in a better position to supervise, which can be useful for identifying and solving the issues in annual reports of firms (Li, Mangena & Pike, 2012).

Financial statements are used to provide information to capital providers about the credit risk of a firm. This information is helpful for obtaining a loan (Chen, He, Ma & Stice, 2016).

Pecking order theory describes how firms with greater audit committees enjoyed free cash flows due to efficient monitoring tools (Benjamin & Karrahemi, 2013). Li et al. (2012) found a positive relation between audit committee size and firm performance. Ahmed et al. (2019) and Detthamrong et al. (2017) found that a negative relation exists between audit committee size and capital structure.

H7: There might be an inverse relation between audit committee size and capital structure.

Methodology

This section describes the methodology utilized to perform a thorough literature review concerning the connection between corporate governance and capital structure. The literature search was carried out across various academic databases, including Scopus, Web of Science, and Google Scholar. Keywords such as “corporate governance”, “capital structure”, and “ownership structure” were employed. The search was restricted to peer-reviewed articles published and written in English. Studies that examined the relationship between governance mechanisms and firms’ capital structure were given priority. Initially, around 95 articles were identified through keyword searches. Following a screening of titles and abstracts for relevance to the research focus, 55 articles were chosen for a full-text review. Ultimately, 42 studies were incorporated into the final review based on their direct relevance to the nexus of corporate governance and capital structure.

Table 1. Inclusion and Exclusion Criteria of an Article

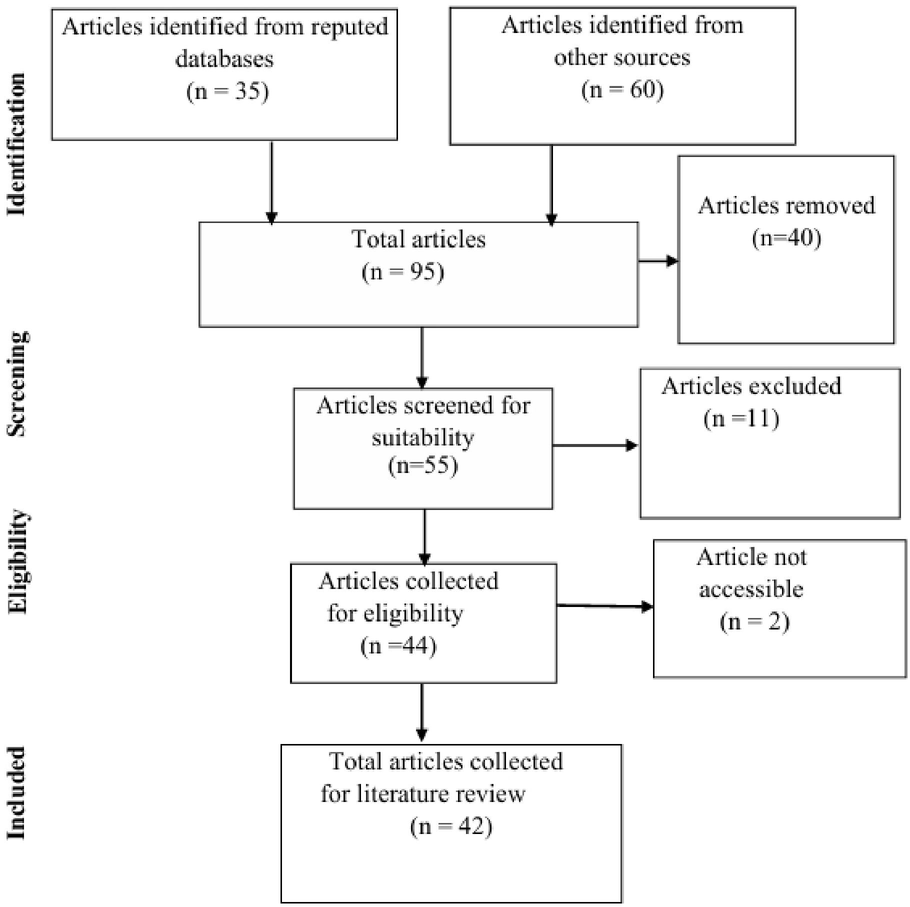
Criteria for Acceptance	Criteria for Rejection
– Only full-length research articles on corporate governance and capital structure were included. – Articles from reputable database like Scopus, Web of Science, and Google Scholar were selected for quality and credibility. – Only English-language publications were included. – Only high-quality peer-reviewed journal articles were included.	– Non-English articles were excluded. – Book reviews, surveys, and conference papers were excluded. – Unpublished works were excluded. – Articles with incomplete or missing data were excluded. – Articles with insufficient data were excluded. – Duplicate articles were excluded

Source: authors' own compilation.

PRISMA Flowchart

Steps included in literature review through PRISMA have been shown below.

Figure 1. Flow Chart Representing Data Extraction



Source: authors' own compilation.

Agency Theory

Agency theory offers a valuable framework to determine the connection between corporate governance and capital structure. It posits that managers, serving as agents for shareholders, might prioritize their own interests, such as job security or personal risk aversion, over those of the shareholders, especially in situations of inadequate oversight (Tarus & Ayabei, 2016). These conflicts of interest can result in suboptimal financing choices and enhance agency costs. In this regard, corporate governance mechanisms are essential in aligning managerial actions with shareholder goals. Strong corporate governance can limit managerial opportunism and promote financing decisions that align more closely with value maximization. Therefore, the decision between debt and equity financing may be persuaded not only by market conditions or firm characteristics but also by the effectiveness of a firm's governance framework. This research utilizes agency theory to explore how different corporate governance mechanisms influence firms' capital structure decisions. By analyzing this relationship, the study enhances the understanding of how corporate governance can mitigate agency costs and influence financing decisions (Naseem, Zhang, Malik & Rehman, 2017).

Conclusion

A significant literature has been available on corporate governance and capital structure. This research presented a literature review about how corporate governance impacts capital structure. After conducting a literature review, corporate governance has a significant influence on the capital structure of firms. All attributes of corporate governance (board size, board independence, and CEO duality) have a positive relation with capital structure, while other corporate governance attributes (board gender, board meeting, board experience, and audit committee size) have a negative relation with capital structure.

Gap

While previous research has investigated the effects of various individual board characteristics, such as size, independence, gender diversity, meeting frequency, experience, and audit committee size on corporate debt, the comprehensive influence of these multiple governance aspects on capital structure has not been thoroughly examined. In particular, there is a scarcity of studies that have looked at how these elements of corporate governance interact in determining financial decisions, especially within the same institutional or industry context. Furthermore, much of the existing literature has concentrated on either developed markets or specific sectors, with insufficient focus on emerging markets or cross-country comparisons, where governance practices and financial conditions vary significantly. Additionally, the potential moderating effects of board characteristics (for instance, whether gender diversity influences the relationship between board size or independence and debt) have not been adequately explored in emerging economies. This creates a gap in understanding the complex, combined role of comprehensive board governance in affecting a firm's capital structure. This research aims to fill this gap by analyzing multiple corporate governance factors simultaneously and offering practical recommendations for optimizing corporate governance while making financial decisions for firms.

Recommendations

The analysis indicates that there is a positive correlation between board size and board independence with capital structure, suggesting that firms with larger boards and a greater proportion of independent directors are more inclined to incur debt. This may demonstrate the ability of larger and more independent boards to secure external financing or support strategies that involve increased debt for growth or expansion. Conversely, board gender diversity, the frequency of board meetings, board experience, and the size of the audit committee seem to exhibit a negative correlation with capital structure. This implies that boards characterized by higher gender diversity, more regular meetings, experienced members, and larger audit committees are more likely to adopt more conservative financial strategies, preferring lower levels of debt. These negative correlations may stem from improved monitoring, risk aversion, and a heightened focus on financial prudence among these boards. In light of these findings, it is advisable for firms to strive for an optimal balance in board composition, leveraging the benefits of larger and independent boards to enhance capital acquisition while also fostering diversity, experience, and proactive oversight to reduce excessive risk-taking. Improving board gender diversity and experience can also lead to enhanced governance practices that align with sustainable debt policies. Furthermore, augmenting the size and effectiveness of audit committees can further bolster financial oversight, thereby mitigating potential risks linked to high capital structure. For policymakers and corporate governance organizations, these insights highlight the necessity of formulating guidelines that promote diverse and experienced boards in conjunction with effective audit committees, thereby encouraging a balanced approach to financial decision-making. Future research should explore these relationships in greater depth, taking into account industry-specific factors and possible moderating effects, to offer more nuanced recommendations that can better assist firms in managing their capital structures effectively.

Suggestions

Based on the findings of this study, several important suggestions can be made for firms, regulators, and corporate governance practitioners around the world. Firstly, the positive correlation between board size and capital structure suggests that larger boards may be more inclined to higher levels of debt financing, potentially due to improved access to resources and a wider range of expertise; however, this also raises issues regarding coordination inefficiencies and the likelihood of adopting riskier financial strategies. Consequently, firms should aim globally to maintain an optimal board size that encourages constructive dialogue and strategic financing while ensuring effective oversight. Similarly, the positive link between board independence and capital structure indicates that independent directors can significantly influence capital structure decisions. However, global companies must ensure that these directors are not merely symbolic figures, but are well-qualified, financially literate, and empowered to challenge aggressive financing practices. The inverse relationship noted between board gender diversity and capital structure supports existing research that connects diverse boards with more conservative and risk-aware decision-making. Therefore, organizations in all regions should prioritize gender diversity as a strategic governance necessity not only for the sake of equity and inclusiveness but also for its potential to enhance financial prudence. Furthermore, the observation that a higher frequency of board meetings is associated with lower debt underscores the importance of active board participation. Globally, boards should transcend formalities and cultivate a culture of ongoing oversight, particularly concerning financial policies. The negative correlation between board experience and capital structure further emphasizes the necessity for experienced directors who can provide historical insight and risk awareness in the boardroom. Companies should focus more on attracting directors with extensive industry knowledge and a proven history in financial governance.

Future Research Directions

Utilize dynamic panel models or non-linear methodologies to evaluate the impact of alterations in governance mechanisms (such as board independence and CEO duality) on capital structure decisions over time. Investigate how firms with robust ESG or stakeholder-focused governance practices approach debt versus equity financing in distinct ways. Conduct comparative analyses between emerging and developed markets to comprehend the influence of governance on debt within varying regulatory frameworks. Do risk-averse boards exhibit a preference for lower debt ratios? In what ways does overconfidence or entrenchment affect capital structure decisions? Examine whether the implementation of technology-driven governance tools is associated with modifications in capital structure strategies. Assess whether strong governance serves as a buffer against excessive debt or facilitates more effective debt restructuring. Explore how such governance structures impact capital structure decisions, particularly concerning control rights and risk preferences. Create and evaluate new governance indices specifically designed for capital structure research. Investigate how governance mechanisms either promote or limit the utilization of green bonds, sustainability-linked loans, and other ESG-aligned capital instruments.

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