

COMPANY CHARACTERISTICS AND CORPORATE GOVERNANCE

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ABSTRACT

This paper seeks to examine the relationship between company characteristics and corporate governance. The sample confined to 119 companies of BSE Dollex 200 over the period 2008 to 2014. Corporate governance variables are promoter ownership, corporate ownership, financial institutional ownership, foreign institutional investors' ownership, board independence, women on board and board meetings and Company characteristics variables are leverage, age of company, net profit ratio, sales and net fixed assets. Panel data regression analysis is used to examine the relationship between company characteristics and corporate governance. The study found that corporate governance variables except women on board have significant association with company characteristics.

Keywords: Company characteristics, Corporate governance, Panel data, Regression analysis

Introduction

This paper seeks to examine the relationship between company characteristics and corporate governance. Corporate governance has become one of the most important subjects of discussion in the business world today. Corporate governance is “the system by which companies are directed and controlled” (Cadbury Committee, 1992). It is concerned with roles and responsibilities performed by board of directors to lead an organization and their relationship with the shareholders and other stakeholders (Pass, 2004).

After Liberalization, Privatization and Globalization (LPG) policy in India, investors' confidence was an important issue in materializing the policy. After the collapse of big firms in global markets, investors lost confidence in the firms. Similarly in India, due to corporate scandals investors lost confidence in firms. So economies started to reform their corporate policy regarding corporate governance. It is now widely held that corporate governance is an important element of organization structure. There are some characteristics of organization which impact the corporate governance. The present study includes company characteristics variables such as leverage, age of company, net profit ratio, sales and net fixed assets. The study is an attempt to examine the impact of such company characteristics on corporate governance in Indian context. The study used the panel data regression methods for the analysis.

The paper is organized as follows: in the next section, the study covers literature review and hypothesis development on corporate governance and firm performance. In Section 3, research methodology has been explained. Data analysis and

interpretation are given in Section 4. The last section presents the conclusions and managerial implications.

Literature Review and Hypothesis Development

This study used the panel data of 119 Indian firms to examine the relationship between company characteristics and corporate governance. Company characteristics have been considered as dependent variables and corporate governance as independent variables. Company characteristics variables are leverage, age of company, net profit ratio, sales and net fixed assets. Corporate governance variables are promoter ownership, corporate ownership, financial institutional ownership, foreign institutional investors' ownership, board independence, women on board and board meetings.

Company Characteristics and Corporate Governance

Leverage

Every firm needs to finance the funds from the market. Firms finance their operations with the alternate sources of financing. Previous studies tell that the use of debt yields tax savings, which accrue to shareholders (Modigliani and Miller, 1963; Baxter, 1967). If tax is the only factor, firms use hundred per cent capital as debt (Solomon, 1963). Leverage acts as an internal governance mechanism to reduce the cost of agency conflict (Jensen and Meckling, 1976), lower use of debt may be management's inefficiency as they may not be seek optimal use of debt. Use of debt ensures that the firm's resources are used effectively and efficiently, so that firm will be able to make the repayment (Gorton and Schmid, 2000). In presence of a costly agency problem, use of better corporate governance reduces the cost of debt (Cremers *et al.*, 2004; Klock *et al.*, 2005). This leads to a positive relationship between good governance and leverage (Florackis and Ozkan, 2009). Butt (2011) found that firms which maintain good governance structures have higher leverage ratios than those of firms with poor governance. Corporate governance is that part of organization that enables the manager to use more debt. Higher level of debt sometimes promotes the concentrated ownership (Shleifer and Vishny, 1997) or the firms have higher level of debt in the countries where concentrated ownership dominates (Berglof, 1991). Berger *et al.* (1997) shows that leverage is significantly lower when a firm has lower fraction of outside directors. Wen *et al.* (2002) reported significant and negative relationship between board composition and leverage, suggesting that managers seek lower leverage when they face strong corporate governance. There is a positive relationship found between leverage and corporate governance (Black *et al.*, 2003; Brown and Caylor, 2004; Silveira *et al.*, 2007). Keeping in view the above arguments, research hypothesis is developed as follows:

Hypothesis 1c (H_{1c}): *There is a significant positive relationship between leverage and corporate governance.*

Age of Company

Age of company is the difference between date of observing year and inception year. The weight of corporate governance

variables are likely to change across the stages of firm evolution. Individual governance provisions such as independence, accountability and transparency can have different impact at different stages of age of company (O'Connor and Byrne, 2006). Further, they found that quality increases when firms are mature. Older firms experience more governance problems; ownership concentration seems to decline over time (Helwege *et al.*, 2007; Holderness, 2009). Corporate governance indices worsen significantly with age, regardless how it is measured (Gompers *et al.*, 2003). Board size is positively related with age of company, which have poor governance (Yermack, 1996). Age of company found to have no relationship with board independence. However, the governance of older firms, as measured by different variables, seems to get poorer with age (Loderer and Waelchli, 2011). Based on the above statement, following research hypothesis is developed:

Hypothesis 2c (H_{2c}): *There is a significant negative relationship between age of company and corporate governance.*

Net profit ratio

Net profit ratio establishes the relationship between net income and net sales and indicates management's efficiency in manufacturing, administering and selling the products (Pandey, 2000). Gompers *et al.* (2003) found positive relationship between net profit ratio and corporate governance. It means better governed firms have better net profit ratio. The study has applied cross sectional regression technique to examine the impact of corporate governance on net profit ratio. Results found that independent directors did not have significant relationship with net profit ratio (Latief *et al.*, 2014). Bauer *et al.*, (2003) examined a negative relationship between corporate governance and net profit margin. So research hypothesis is developed to test the relationship:

Hypothesis 3c (H_{3c}): *There is a significant positive relationship between net profit ratio and corporate governance.*

Sales

Sale is an activity related with the selling or amount sold of goods or services. The study takes natural log of net sales. Net sales are the amount of sales after deducting returns, allowances and discount allowed. These sales numbers are reported in financial statements along with these deductions. A good sales number is the reflection of good relations of organization with the stakeholders and it shows the satisfaction of stakeholders. According to stakeholder theory, organization should keep the interests of all stakeholders for good corporate governance. This leads to a strong positive relationship between sales and corporate governance. Pandya (2013) found a positive correlation between firm sales and corporate governance score. Based on the above statement, following research hypothesis is developed:

Hypothesis 4c (H_{4c}): *There is a significant positive relationship between sales and corporate governance.*

Net Fixed Assets

Net fixed assets is the purchase price of all fixed assets such as machinery, land, buildings, vehicles etc minus accumulated depreciation such as plant and machinery after depreciation. Less value of net fixed assets shows that firm did not replace or upgrade the fixed assets. This may be due to lower demand of the products or willingly firms are not replacing or upgrading the fixed assets and employees are working with these fixed assets. This shows a negative approach of the firm and hence reflection of bad corporate governance. If the value of net fixed assets is more, then firm shows that firm is regularly replacing or upgrading the fixed assets. This may be good demand in the market or positive attitude of the management and hence better corporate governance adopted by the firm. This leads to a positive relationship of net fixed assets and corporate governance. Asset tangibility is measured as ratio of net fixed assets to total assets. Asset tangibility found to be positively related with corporate governance (Pandya, 2013), it can be assumed that net fixed assets is positively related with corporate governance. Hence it is hypothesized that:

Hypothesis 5c (H_{5c}): *There is a significant positive relationship between net fixed assets and corporate governance.*

Research Methodology

Objectives of the Study

The broad objective is to study the relationship between company characteristics and corporate governance in Indian

companies. For this purpose, the following sub-objectives have been framed:

1. to determine the relationship between Leverage and Corporate governance;
2. to determine the relationship between Age of Company and Corporate governance;
3. to determine the relationship between Net Profit Ratio and Corporate governance;
4. to determine the relationship between Sales and Corporate governance; and
5. to determine the relationship between Net Fixed Assets and Corporate governance.

Sample Selection and Data Collection

Out of the total sample of 200 companies of BSE-Dollex listed on the Bombay Stock Exchange, 119 companies are selected for the analysis. The study has been taken over the period 2008 to 2014 and secondary data has been used and it has been collected using company annual reports, corporate governance reports and financial database from Prowess database maintained by Centre for Monitoring Indian Economy. Banks, finance and insurance companies have been excluded from the sample because of their special capital structure.

Description of Variables

The variables of the study are presented in the following table

Table 1.1: Description of Variables

Variable	Description/Measurement
Corporate Governance Variable	
Promoter/Insider Ownership (PO)	Percentage of shares held by promoters.
Corporate Ownership (FO)	Percentage of shares held by corporate bodies.
Financial Institutional Ownership(FIO)	Percentage of shares held by Financial institutions.
Foreign Institutional Investors Ownership (FIIO)	Percentage of shares held by Foreign institutional investors.
Board Independence (BIND)	Percentage of independent directors on the board.
Women on Board (WB)	Percentage of women on the board.
Board Meetings (BM)	Total number of annual meetings in a year.
Company Characteristics Variable	
Leverage (Lev)	Ratio of debt to equity.
Age of Company (LogAge)	Natural log of age of company. Age of company is the difference between the date of inception and the observing year of the company.
Net Profit Ratio (NPR)	Ratio of net income to net sales.
Sales (LogNsales)	Natural log of net sales.
Net Fixed Assets (LogNFA)	Natural log of net fixed assets.

Model Formulation

To achieve the objectives, following models have been developed to test the hypotheses:

$Lev = \beta_1 + \beta_2 BIND + \beta_3 WB + \beta_4 BM + \beta_5 PO + \beta_6 CO + \beta_7 FIO + \beta_8$

$FIIO + \epsilon_{it}$

$LogAge = \beta_1 + \beta_2 BIND + \beta_3 WB + \beta_4 BM + \beta_5 PO + \beta_6 CO + \beta_7 FIO + \beta_8 FIIO + \epsilon_{it}$

$NPR = \beta_1 + \beta_2 BIND + \beta_3 WB + \beta_4 BM + \beta_5 PO + \beta_6 CO + \beta_7 FIO + \beta_8 FIIO + \epsilon_{it}$

$$\text{LogNsales} = \beta_1 + \beta_2 \text{BIND} + \beta_3 \text{WB} + \beta_4 \text{BM} + \beta_5 \text{PO} + \beta_6 \text{CO} + \beta_7 \text{FIO} + \beta_8 \text{FIIO} + \text{eit}$$

$$\text{LogNFA} = \beta_1 + \beta_2 \text{BIND} + \beta_3 \text{WB} + \beta_4 \text{BM} + \beta_5 \text{PO} + \beta_6 \text{CO} + \beta_7 \text{FIO} + \beta_8 \text{FIIO} + \text{eit}$$

Where BIND, WB, BM, PO, CO, FIO and FIIO are corporate governance variables and Lev, LogAge, NPR, LogNsales, LogNFA are company characteristics variables. $\beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6, \beta_7, \beta_8$ are the coefficients and eit is the error term.

Data Analysis Tools

The study used panel data that have both cross sectional and time variation to control unobserved firm heterogeneity. Panel data eliminate the autocorrelation of variables in time series data and heteroskedasticity of individuals in cross-section (Wu *et al.*, 2009). To analyze the data different statistical tools have been used. These include descriptive analysis, correlation analysis, unit root test and panel data regression methods. E-View Version 6 has been used for analysis. Panel data regression techniques are suitable for this analysis. These are Fixed Effects Model and Random Effects Model (Gujarati, 2003) and Hausman test has been used to find the better model.

Analysis and Interpretation

Descriptive Analysis

Table 1.2 provides the mean, median, minimum, maximum and standard deviation of the variables from year 2008 to 2014.

The descriptive statistics for Leverage shows that mean value is 0.458 which indicate that Indian firms use more than fifty per cent sources other than debt to run the business. Net profit ratio is measured as ratio of net income to net sales. Its minimum value (-0.150) shows that negative profits and maximum value (9.830) has positive profits. Sale is measured as natural log of net sales. Its standard deviation is 1.404. Net fixed assets are taken as natural log of net fixed assets. Its mean value is 9.274. The standard deviation value (1.710), minimum value (4.621) and maximum value (14.242) show the variation in net fixed assets of Indian firms.

Board independence shows that mean value is 51.110 which suggests that firms in India have more than fifty per cent independent directors which implies firms take independent and effective decision making. The analysis shows that average of women on board is 5.137 which indicate that Indian firms have five per cent women on their board. Board

meetings have mean value 6.403 which shows that Indian firms have six board meetings in a year. The analysis shows that mean value of corporate ownership is 4.925 which conclude that very less percentage of corporate ownership found in Indian firms and also wide dispersion in pattern of corporate ownership. Financial institutional ownership has mean value 11.748 and Foreign institutional investors' ownership has mean value 14.831 which indicate that foreign institutional investors have more shareholding in Indian firms.

Correlation Analysis

Correlation analysis provides the correlation between dependent and independent variables and also among the independent variables to check the multicollinearity. Table 1.3 shows the correlation among the explanatory variables. The maximum correlation between Promoter ownership and foreign institutional investors' ownership is -0.535. According to Kennedy (1985), correlation coefficient value between explanatory variables should not exceed to 0.8 for the absence of multi-co linearity. It shows the absence of multicollinearity between the explanatory variables.

Board independence and women on board has significant positive correlation 0.113. Women on board have significant negative correlation with corporate ownership and financial institutional ownership. Board independence has significant negative correlation with board meeting, promoter ownership and financial institutional ownership and significant positive correlation with foreign institutional investors' ownership.

Table 1.4 shows the correlation between the dependent and independent variables. Leverage (Lev) shows significant positive correlation with corporate ownership and significant negative correlation with financial institutional ownership. Age of company (LogAge) shows significant negative correlation with board meeting, promoter ownership, corporate ownership and foreign institutional investors' ownership. Net profit ratio (NPR) has significant positive correlation with board meeting and foreign institutional investors' ownership and significant negative correlation with financial institutional ownership. Sales (LogNSales) show significant positive correlation with board meeting and financial institutional ownership and significant negative correlation with corporate ownership and foreign institutional investor's ownership. Net fixed Assets (LogNFA) show significant positive correlation with board meeting and financial institutional ownership.

Table 1.2: Descriptive analysis of Company Characteristics and Corporate Governance Variables

	BIND	WB	BM	PO	CO	FIO	FIIO	Lev	LogAge	NPR	LogNSales	LogNFA
Mean	51.110	5.137	6.403	53.437	4.925	11.748	14.831	0.458	3.509	0.171	10.652	9.274
Median	50.000	0.000	6.000	52.970	3.510	10.280	13.770	0.270	3.526	0.131	10.483	9.176
Maximum	88.000	33.330	33.000	98.380	56.830	38.980	64.700	10.370	4.710	9.830	15.322	14.242
Minimum	0.000	0.000	3.000	0.000	0.000	0.000	0.000	0.000	0.000	-0.150	4.883	4.621
Std. Dev.	11.900	6.751	2.659	19.173	5.410	8.348	10.598	0.638	0.665	0.357	1.404	1.710
Observations	831	831	826	833	833	833	833	833	833	833	833	833

Table 1.3 : Correlation Matrix of Explanatory Variables

Correlation	BIND	WB	BM	PO	CO	FIO	FIIO
BIND	1.000						
WB	0.113*	1.000					
BM	-0.176*	-0.094*	1.000				
PO	-0.205*	0.060***	0.029	1.000			
CO	0.141*	-0.158*	0.000	-0.380*	1.000		
FIO	-0.015	-0.161*	-0.029	-0.492*	0.012	1.000	
FIIO	0.190*	0.060***	0.014	-0.535*	-0.002	-0.039	1.000

Note: *, ** and *** represents level of significance at 1 per cent, 5 per cent and 10 per cent respectively.

Table 1.4: Correlation between Dependent and Independent Variables

	BIND	WB	BM	PO	CO	FIO	FIIO
Lev	-0.024	-0.016	0.026	-0.008	0.071**	-0.075**	0.006
LogAge	0.056	-0.035	-0.077**	-0.159*	-0.121*	0.415*	-0.188*
NPR	-0.009	-0.003	0.258*	0.008	-0.023	-0.119*	0.096*
LogNSales	-0.020	0.038	0.165*	0.024	-0.095*	0.151*	-0.057
LogNFA	0.004	0.054	0.143*	-0.043	-0.021	0.125*	-0.011

Note: *, ** and *** represents level of significance at 1 per cent, 5 per cent and 10 per cent respectively.

Unit Root Test

To check the stationary of data, Levin, Lin and Chu Unit root test can be used. It is applicable on panel and pooled data (Levin *et al.*, 2002). Table 1.5 presents the results of unit root test. The hypothesis for the unit root test is:

Null Hypothesis H_0 : Variable is not Stationary or got Unit root

Alternate Hypothesis H_1 : Variable is stationary

The values of unit root test are significant at 1 per cent for all variables; it rejects the null hypothesis and accepts the alternate hypothesis i.e. variable is stationary.

Table 1.5: Levin, Lin and Chu Unit Root Test Results

Variable	Statistic	P- value
Leverage (Lev)	-80.961*	0.000
Age of Company (LogAge)	-53.452*	0.000
Net profit ratio (NPR)	-32.585*	0.000
Natural Log of Net Sales (LogNSales)	-5.747*	0.000
Natural Log of Net Fixed Assets (LogNFA)	-17.463*	0.000
Promoter Ownership (PO)	-678.07*	0.000
Corporate Ownership (CO)	-28.87*	0.000
Financial Institutional Ownership (FIO)	-14.106*	0.000
Foreign Institutional Investors' Ownership (FIIO)	-24.459*	0.000
Board Independence (BIND)	-23.005*	0.000
Women on Board (WB)	-22.102*	0.000
Board Meetings (BM)	-29.170*	0.000

Note: * represents level of significance at 1 per cent.

Panel Data Regression Analysis

Table 1.6 presents the results of both Fixed Effects Model and Random Effects Model. Hausman test results are found to be significant when Leverage (Lev), Age of Company (LogAge), Sales (LogNsales) and Net Fixed Assets (LogNFA) are taken

as dependent variable, so Fixed Effects Model results are taken in consideration and with Net Profit Ratio (NPR) as dependent variable, Hausman test results are found to be insignificant, so Random Effects Model results are taken in consideration in that case. Results of the table shows adjusted

R² value is 56.8 per cent in case of Lev, 97.6 percent in case of LogAge, 92.6 percent in case of LogNsales and 94.3 percent in case of LogNFA, which indicates the good explanatory power of the model in case of Fixed Effects Model. Adjusted R² value is 5.13 per cent in case of NPR as dependable variable. Random Effects Model has a poor explanatory power, indicates by low adjusted R² value.

Results revealed that Leverage (Lev) is positively significantly associated with board meetings, promoter ownership, corporate ownership and negatively significantly with foreign institutional investors' ownership (Black *et al.*, 2003; Brown and Caylor, 2004; Silveira *et al.*, 2007).

Age of Company (LogAge) found to be positively significantly associated with board independence, promoter ownership, corporate ownership, financial institutional ownership, foreign institutional investors, hence it rejects the

hypothesis H_{2c} (Gompers *et al.*, 2004; Holderness, 2009; Helwege *et al.*, 2007). Net Profit Ratio (NPR) found to be positively significantly associated with board meetings, which favours the hypothesis H_{3c} (Gompers *et al.*, 2003) and negatively significantly associated with financial institutional ownership, which rejects the hypothesis H_{3c} (Bauer *et al.*, 2004).

Sales (LogNsales) found to be positively significantly associated with board independence, promoter ownership, corporate ownership, foreign institutional investors and negatively significantly associated with board meetings, hence hypothesis H_{4c} is rejected (Pandya, 2013). Net Fixed Assets (LogNFA) found to be positively significantly associated with board independence, promoter ownership, corporate ownership, foreign institutional investors and negatively significantly associated with board meeting.

Table 1.6: Company Characteristics and Corporate Governance

	Lev		LogAge		NPR		LogNsales		LogNFA	
	Fixed Effects	Random Effects	Fixed Effects	Random Effects	Fixed Effects	Random Effects	Fixed Effects	Random Effects	Fixed Effects	Random Effects
CONSTANT	-0.584** (-1.717)	0.237 (0.870)	3.233* (38.929)	3.278* (34.234)	0.112 (0.418)	0.025 (0.181)	8.790* (28.408)	8.808* (27.763)	7.869* (23.655)	7.911* (22.359)
BIND	0.000 (0.034)	(0.000) (0.114)	0.002* (4.761)	0.002* (4.727)	-0.001 (-0.841)	0.000 (0.237)	0.013* (6.786)	0.012* (6.464)	0.009* (4.617)	0.009* (4.472)
WB	-0.002 (-0.475)	-0.002 (-0.513)	-0.001 (-1.512)	-0.001 (-1.470)	0.000 (0.105)	-0.000 (-0.182)	-0.001 (-0.251)	-0.000 (-0.010)	0.004 (0.994)	0.005 (1.138)
BM	0.018*** (1.893)	0.015*** (1.774)	-0.022* (-9.461)	-0.022* (-9.529)	0.027* (3.473)	0.033* (6.501)	-0.050* (-5.696)	-0.045* (-5.153)	-0.035* (-3.644)	-0.031* (-3.312)
PO	0.018* (4.258)	0.003 (1.379)	0.002** (2.148)	0.001 (1.607)	-0.001 (-0.321)	-0.000 (-0.546)	0.015* (4.021)	0.015* (4.318)	0.010** (2.529)	0.009** (2.510)
CO	0.010*** (1.679)	0.008 (1.464)	0.005* (3.620)	0.004* (3.100)	-0.002 (-0.524)	-0.002 (-0.825)	0.035* (6.356)	0.033* (6.031)	0.015** (2.550)	0.014** (2.426)
FIO	0.000 (0.137)	-0.002 (-0.602)	0.003* (2.915)	0.004* (3.418)	0.001 (0.354)	-0.004** (-2.170)	0.007 (1.629)	0.010** (2.236)	0.003 (0.704)	0.005 (1.048)
FIIO	-0.008** (-2.015)	-0.007** (-2.065)	0.006* (7.190)	0.006* (6.571)	(0.000) 0.271	0.001 (1.079)	0.025* (7.032)	0.024* (6.884)	0.027* (6.996)	0.026* (6.865)
Adjusted R ²	0.568	0.020	0.976	0.173	0.155	0.055	0.926	0.138	0.943	0.102
F-statistic	9.703*	3.462*	278.317*	25.698*	2.217*	7.933*	84.749*	19.949*	110.400*	14.506*
Hausman test	$\chi^2(7)$ 30.984*		$\chi^2(7)$ 60.513*		$\chi^2(7)$ 7.485		$\chi^2(7)$ 31.860*		$\chi^2(7)$ 17.102**	

Note: 1. *, ** and *** represents level of significance at 1 per cent, 5 per cent and 10 per cent respectively. 2. Values of t-statistics are provided in parenthesis below the co-efficient estimates.

Conclusions and Managerial Implications

The study used the panel data of 119 Indian firms to examine the relationship between company characteristics and corporate governance. After analysis, it is found that board independence is positively significantly associated with age of company, sales and net fixed assets. Women on board (WB) did not show any significant association. Board meetings show significant positive relation with Leverage (Lev) and Net Profit Ratio (NPR) and significant negative relation with Age of Company (LogAge), Sales (LogNsales) and Net Fixed Assets (LogNFA). Promoter ownership and corporate

ownership found to be significant positive associated with Leverage (Lev), Age of Company (LogAge), Sales (LogNsales) and Net Fixed Assets (LogNFA). Financial institutional ownership found to be significant positive association with Age of Company (LogAge) and significant negative association with Net Profit Ratio (NPR). Foreign institutional investors ownership found to be significantly positively associated with Age of Company (LogAge), Sales (LogNsales) and Net Fixed Assets (LogNFA) and significantly negatively with Leverage (Lev). It can be concluded that all the corporate governance variables except

women on board show significant association with company characteristics.

The empirical study provides suggestions to Indian firms to improve corporate governance. As study implies that almost all the variables of company characteristics are significant with corporate governance, so managers of firms should enhance such variables to improve corporate governance.

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