THE RELATION BETWEEN FINANCIAL MANAGEMENT AND CORPORATE GOVERNANCE: ANALYTICAL APPROACH AT THE LEVEL OF THE RISK MANAGEMENT STRATEGIES

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Abstract. *This paper presents the contribution of corporate governance to the risk management system of an enterprise from the perspective of the financial leverage. We assume that companies with a strong corporate governance framework are likely to enhance the optimality of their financial structure.*

We perform a literature overview on this topic, in parallel with an empirical approach that brings forth the effect of corporate governance framework on the company financial structure, with a special focus on leverage.

The empirical approach is developed using the Ordinary Least Squares methodology; the results of the research reflect a strong impact of corporate governance on the company financial structure.

We construct this finding from the perspective of the beneficial effects of an enhanced corporate governance framework which reduces agency costs, conferring to the company more credibility in the eyes of creditors.

Keywords: capital structure, financial management, governance, leverage, risk management

1. Introduction

Financial risk management has become more and more important during the last fifteen years. Globalization triggered capital market development and meanwhile the increase of the volatility which generated a high degree of incertitude at the level of the corporate segment.

Capital structure and financial performance of companies are impacted to a high extent by the volatility peculiar to global financial markets, generating the development of the financial management which focuses on the main variables representing the source of risk – interest rate, foreign exchange, equity and commodity.

Analysts have been preoccupied with identifying potential correlations between company' value and financial management, especially from the perspective of scale economies. Implementing financial management departments create incentive to economic growth since risk mitigation techniques support wealth accumulation.

This relationship represented the research object of studies concentrated especially on non-financial firms since financial institutions imply peculiarities in terms of capital structure.

There are various theories on the contribution of risk management to shareholders' value creation. Nevertheless, imperfections of capital market – agency costs, transaction costs, taxes, and increasing costs of external financing – represent the layer by which company value may increase to benefit of the shareholders.

Risk management tools represent the support to company' value maximization and it becomes essential in the context of capital market integration. Risk increase complemented by risk concentration may confer vulnerability to corporate segment. Therefore, risk management strategies contribute in an essential manner to value creation.

By definition, risk is related to uncertainties associated with returns from an investment. These uncertainties would translate into volatility or the fluctuation of the expected returns from an investment.

By analogy with corporate segment, risk derives from the fluctuations triggered by the modifications of various external and internal factors. These fluctuations are recorded especially at the level of the profitability indicators as well as at the level of capital structure ratios, reflecting the manner in which an aggregate assembly of factors can impose the volatility of company' financial performance.

This paper is concentrated on the relationship between financial management and corporate governance from the perspective of the capital structure. We consider financial leverage as a key component of capital structure and we analyze the impact of various financial indicators on the company's ability to attract external financial resources in conjunction with some peculiarities of the company corporate governance framework.

Thus, besides the firm related variables, we insert into the models some variables that reflect the key features of the corporate governance standards that the company have implemented.

The mixture between firm related and corporate governance related variables reflect the interference between corporate governance and financial management, in deeply connection with the risk management strategies.

This research continues as follows: in the next section we effect a literature review on the correlation between capital structure and corporate governance while in the third section we develop an empirical approach using the Ordinary Least Squares methodology. The results delivered by the econometric application are analyzed and construed in comparison with related studies.

The last section concludes.

2. Literature review

Company financial structure can be perceived as a receptor of various systems of factors deriving out of the firm and industry level, institutional, legal, political and social framework (Gietzmann and Ireland (2005)).

Apart of these factors, capital structure bears the mark of the board of directors' decision in respect of the company's financing policy, being deeply linked with the corporate governance area.

In line with this idea, previous studies highlighted the impact of corporate governance on capital structure (Hart, 1995, Fosberg, 2004, Anderson et al., 2007). This influence proved to be a strong one especially in the case of exchange traded firms as well as in the case of companies of large size. Most of the researches suggested that board size and structure, CEO duality and CEO compensation and tenure are the key variables of corporate governance.

In line with these findings, Berger et al. (1997) uncovered that companies with a large board have low leverage; this was due to the fact that large board is likely to impose managers to lower the company' indebtedness in order to increase its profitability.

Subsequent studies (Wen et al., 2002, Abor, 2007) revealed opposite findings, meaning that large boards encourage leverage and this results in a strict oversight exerted on the company' managers'; the latter revert to higher leverage as they pursue the policy of a positive correlation between debt and profitability.

Anderson et al. (2004) highlighted that is cheaper for companies with a large board to attract external financial resources since creditors perceive these companies as having a rigorous monitoring of the financing decision.

Wen et al. (2002) identified a negative relationship between number of outside directors on the board and leverage. The authors assumed that outside directors have the incentive to monitor managers very strictly, determining them to adopt a lower leverage in order to encourage a high market value of equity.

The CEO duality influences the capital structure of the company (Fama and Jensen, 1983, Fosberg, 2004). Literature revealed the importance of the two-tier leadership (the impossibility for the same person to be simultaneously in the position of the board of directors' chair and CEO). Not permitting both decision management and decision control authority to be exerted in common, this contributes to the mitigation of the agency costs. Fosberg (2004) argued that firms which do not promote CEO duality are more likely to adopt an optimal capital structure, with a convenient weight of debt in the financial mixture. Moreover, Anderson et al. (2004) argued that a dual leadership violates the balance of power and authority, affecting the clear division of responsibilities at the head of the company. Shamsul (2004) set forth that the effectiveness of the board role diminishes in case of dual leadership since one person is entitled to manage both the operations (as a CEO) and the internal controlling (as a board chairman).

Another key variable of corporate governance that is likely to be correlated with capital structure consists of the CEO compensation scheme and tenure.

Literature revealed contradictory results in terms of the correlation between CEO compensation and financial leverage. Stulz (1988), Harris and Raviv (1988), Abor and Biekpe (2008) highlighted that companies which promote fixed compensation schemes for CEO adopt a lower leverage in order to diminish the financial risk while Wen et al. (2002) brought forth a negative relationship.

As for the CEO tenure, authors emphasized that CEO with a long tenure prefer low leverage due to their objective to reduce potential pressures of the shareholders in order to obtain a certain level of profitability. This aspect is determined by the fact that shareholders usually perceive a higher debt with a commensurate risk level, requiring an equivalent reward, which gives incentive to significant pressures exerted upon CEO.

3. Database and methodology

In an attempt to enlarge the existing literature on this topic, this study deals with the correlation between capital structure peculiarities and corporate governance. We follow the approach developed by Jaggi and Low (2000), Hail (2002) or Yu (2005), integrating in various equations variables enclosing the key features of capital structure and corporate governance system.

What it differentiates our study is precisely the focus on a more complex system of financial indicators, consisting of a wide range of variables that reflect both the manner in which external and internal financial resources mix in the capital structure of the company, as well as its tangibility; the latter indicator underlines the autonomy of the enterprise, deeply anchored in the corporate governance field.

In the credit analysis area, the tangible net worth serves as a proof for the company financial independency, determining its indebtedness degree and the tailoring of the risk management strategies.

Moreover, in case of a potential failure, the tangible net worth represents the basis upon which creditors manage to recover the lending they granted to the companies.

We consider the financial autonomy of the company to be related with the concept of corporate governance; in fact, tangible net worth reflects the overall policy adopted by the board of directors, with important implications on the overall activity of the company.

As for the corporate governance area, we use a part of the classic key variables that were valorized by similar studies (Hail (2002), Yu (2005)), such as board size, board meeting and dual leadership, but we also enlarge the set of variables relating to corporate governance by the CEO tenure and board management capabilities.

To analyze the correlation between capital structure and corporate governance, we elaborate the following equations using the OLS methodology:

$$FIN\_LEV_i = \alpha + \beta_1 * D\_L + \beta_2 * B\_DIM + \beta_3 * B\_MCAP + \varepsilon_i \quad (1)$$

$$TAN/TD_i = \alpha + \beta_1 * M\_TEN + \beta_2 * D\_L + \beta_3 * B\_DIM + \varepsilon_i \quad (2)$$

$$T\_D_i = \alpha + \beta_1 * MCAP + \beta_2 * M\_TEN + \beta_3 * B\_COMP + \varepsilon_i \quad (3)$$

where:

Fin_Lev_i = Total Debt/Equity;

D_L = Dummy variable which takes the value 1 if the positions of board of directors' chair and CEO are held by the same person and 0 otherwise;

B_DIM = The board size of the company;

B_MCAP = The number of board members with professional qualifications;

M_TEN = The time-period during which the CEO holds that position;

B_COMP = The number of outside directors divided by the total number of directors;

T_D = Total Debt/Total Assets.

We collect the corresponding financial information on 150 companies covered by the FTSE index. The main industries where the analyzed companies activate are:

i) manufacturing (75 companies); ii) trade (30 companies); iii) transport (20 companies) and; iv) food industry (25 companies). We eliminate firms activating in utility and banking field because of the peculiarities implied by their capital structure. The companies are characterized by a turnover of USD 100 mil. – 800 mil. per year, a number of approximative 70.000 – 130.000 employees and an age of about 10-25 years.

We collect financial information relative to these companies on a time-period of ten years (1998-2008). The companies included in our sample are located in USA, France, Italy, German, Spain, Belgium and Denmark.

This study tests the below hypothesis:

H_0: There is no relationship between capital structure and corporate governance key variables;

H_1: There is a relationship between capital structure and corporate governance key variables.

After applying the correlation matrix, we identified the lack of multicollinearity of the variables.

4. Results and discussions

The statistic output enclosed in table no.1 permits us to reject the null hypothesis which denies the existence of a relationship between financial indicators reflecting company' capital structure and corporate governance.

The first equation highlights a strong effect of dual leadership and management capabilities on financial leverage while the board dimension does not exert any influence.

The positive influence of dual leadership on financial gearing is in line with the findings of Fosberg (2004) and Anderson et al. (2007) who revealed that CEO duality encourages the adoption of an aggressive financial leverage. This can be interpreted by the fact that a double position held by the same person (chair of board of directors and CEO) creates the incentive for a precise perspective on the financial standing of the company, encouraging the contraction of external debt. Moreover, double leadership implies more responsibilities and consequently the greed for additional compensation that may be obtained if the company becomes more profitable. The increase of the profitability may occur in the context of a positive effect of financial leverage.

The positive effect of management capabilities on financial leverage is explained by the managers' expertise that gives them the incentive to increase the company's indebtedness on the condition of a proper risk management strategy of the company; a manager with a certain qualification is in the position to benefit from the positive effect of financial leverage.

The second equation integrates the board dimension and management tenure as factors that impact the tangible net worth. While board dimension is irrelevant in case of financial leverage, its effect on the tangible net worth is positive.

The management tenure may contribute to the tangible net worth from the perspective of its expertise accumulated over time that may lead to a sustained investment policy and consequently to the build up of a significant tangible net worth. The longer the period that a manager holds a position in a company, the more he is preoccupied with the developing of investment plans.

The management tenure acts as a positive factor for the indebtedness degree in the third equation as well. We can appreciate that a longer experience of a manager in a company supports him to have a solid perspective on the enterprise financial standing, enabling him to take on important debt level.

As in the case of the second equation where management capabilities encourage financial leverage, in the third one, the same explanatory variable acts in a similar manner in relation with the weight of total debt in total assets.

The board composition is not relevant for the company debt policy, in line with the findings of Berger et al. (1997). Previous researches underlined that corporate governance is more effective when the board is restrained since it is in the position to perform duly the oversight of the company and consequently the control of financial leverage (Jensen (1986), Lipton and Lorsch (1992)). Abor (2007) highlighted that larger boards adopt low debt policy.

Berger et al. (1997) argued that managers have incentives to adopt a lower leverage in order to increase their equity base, especially in the case of large companies. More over, smaller boards increase the accountability of directors, rendering them responsible for the financing decisions.

In conclusion, this section approached the relationship between corporate governance and capital structure from the perspective of the influences that key variables of corporate governance may exert on financial indicators that reflect the key features of capital structure. The statistic output permitted us to reject the null hypothesis that denied a potential relationship between capital structure and corporate governance, revealing that management capabilities or management tenure may have an impact on the company indebtedness degree or on the company tangible net worth.

Thus, corporate governance system may act as an additional factor in respect of capital structure, adding to the series of classic factors such as firm, industry or country level characteristics, institutional, legal, political and social framework.

Table 1

Statistic output corresponding to the relationship between corporate governance and financial management

Equation / Indicator	Equation I	Equation II	Equation III
Financial leverage	Dependent variable		
Tangible Net Worth/Total Debt		Dependent variable	
Total Debt/Total Assets			Dependent variable
Dual Leadership	1.226** (1.22) 0.0011	1.116 (0.031) 0.001	
Board Dimension	1.336 (1.220) 0.955	1.126*** (1.227) 0.010	
Management Capabilities	1.552** (1.117) 0.139		3.315*** (2.551) 0.001
Management Tenure		1.215* (1.700) 0.003	1.552** (4.112) 0.011
Board Composition			2.104 (0.551) 0.020
Adjusted R-squared	0.445	0.521	0.551

Source: own computations.

5. Conclusions

This paper presents the contribution of corporate governance to the risk management system of an enterprise from the perspective of the financial leverage. We assume that companies with a strong corporate governance framework are likely to enhance the optimality of their financial structure.

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The management tenure may contribute to the tangible net worth from the perspective of its expertise accumulated over time that may lead to a sustained investment policy and consequently to the build up of a significant tangible net worth.

The management tenure acts as a positive factor for the indebtedness degree in the third equation as well. We can appreciate that a longer experience of a manager in a company supports him to have a solid perspective on the enterprise financial standing, enabling him to take on important debt level.

As in the case of the second equation where management capabilities encourage financial leverage, in the third one, the same explanatory variable acts in a similar manner in relation with the weight of total debt in total assets.

Based on the statistic output, we reveal that corporate governance system may act as an additional factor in respect of capital structure, adding to the series of classic factors such as firm, industry or country level characteristics, institutional, legal, political and social framework.

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