

**THE MODERATING INFLUENCE OF CORPORATE GOVERNANCE ON THE
RELATIONSHIP BETWEEN CAPITAL STRUCTURE AND THE FIRM VALUE
OF COMPANIES QUOTED AT THE NAIROBI STOCK EXCHANGE**

BY

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DECLARATION

This Research Project is my original work and it has not been submitted for award of a degree in any other University.

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DEDICATION

I dedicate this work to my family especially my wife Rose, for her support and encouragement. My sons Ian and Mike, and above all to my daughter Liz. They all positively contributed to successful completion of this project. Lastly I wish to express special dedication of this Research Project to my late parents: Mama Phoebe and Mzee Thadayo Anyango for their strong positive attitude they instilled in me towards education.

ABSTRACT

The Research focused on the moderating influence of corporate governance on the relation between capital structure and firm value, of firms quoted at the Nairobi Stock Exchange (NSE). Local stream of studies of the influence of corporate governance on the relation between Capital Structure and firm value, have adopted duality approach in examining the relations among the three study constructs: the relation between firm value and capital structure, the relation between capital structure and corporate governance and the relation between corporate governance and firm value. They have ignored the mediation role of corporate governance. These studies therefore fail to give empirical analysis of simultaneous relationship of the three variables. The controversial empirical results on this topic can be attributable to lack of attention to the interaction between capital structure and other corporate Governance devices.

In this study, cross-sectional descriptive survey design was used. The population comprised 33 quoted companies on the NSE from year 2005 to 2009. Both primary and secondary data were used for this study. The former was collected from CEOs of listed companies while the latter was collected from annual financial statements of target firms using questionnaires. This study employed basic ordinary least square (OLS) regression which is fairly standard in exploring relationships between two sets of variables such as firm value and leverage, firm value and ownership, and leverage and ownership.

The study found that all the corporate governance devices have influence on the firm value and capital structure as shown by the Tobin Q. The study thus established regression equation to be: $Tobin\ Q = 4.833 + 1.771\ Board\ independence + 0.986\ CEO\ duality + 2.358\ Audit\ committee\ independence + 0.116\ Equity\ block\ holders$. Capital structure represents one of the many instruments that can preserve corporate governance efficiency and protect its ability to create value. The study recommends that firms should increase board compositions if the situation requires more transparency and accountability.

The study further recommends that for firms to have better market performance, it is necessary to adopt better corporate governance practices since such practices affect the firm value and that, leverage of the firms should be maintained at lower levels as it negatively affects the firm value.

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LIST OF ABBREVIATIONS

- CEO** : Chief Executive Officers
- CG** : Corporate Governance
- CHU** : Complaints Handling Unit
- CMA** : Capital Market Authority
- FV** : Firm Value
- GOK** : Government of Kenya
- ICF** : International Credit Fund
- MVE** : Market Value of Equity
- NSE** : Nairobi stock Exchange
- OECD**: Organization for Economic Cooperation and Development
- PRSCG**: Private Sector Corporate Governance Trust
- PS** : Preference Stock
- PWC** : PricewaterHouseCoopers
- ROA** : Return on Assets
- ROSC** : Report on the Observance of Standards and Codes
- SMEs** : Small Medium Enterprises
- TA** : Total Assets

CHAPTER ONE

1.0 INTRODUCTION

1.1 Background

Researches in Business Economics, and in particular, in Business economics and Finance have always analyzed the processes of economic value creation as their main field of studies (Hassan 2009). Capital structure became one of the main elements that following studies have shown as being essential in determining value. Capital structure decisions need to take into consideration the interaction with other important variables that determine value creation.(Rocca 2007). This study identifies these elements and examines the complex interaction between them: corporate governance, capital structure and firm value to determine the moderation role of corporate governance.

The capital structure of a company is the particular combination of debt, equity and other sources of finance that it uses for its long term financing. The key division in capital structure is between debt and equity. The choice between debt and equity capital is an important financial decision facing firms (Glen and Pinto, 1994). The capital structures (or financial structures) of firm is a specific mixture of operations. Capital structure decisions are crucial for any business organization. The decision is very important because of the need to maximize returns to various organizational constituencies and also because of the impact such a decision has on an organization's ability to deal with its competitive environment. In an attempt to set a capital structure that maximize overall market value, firms do differ in the way they deal with the issue of optimizing capital structure requirements (Abor and Biekpe, 2005).

Firm value (FV) is an economic measure reflecting the market value of the whole business; a sum of claims of all the security-holders: debt-holders, preferred shareholders, minority shareholders, common equity holders and others (Trout, R. 2000).

Corporate governance is the process and structure used to direct and manage the business affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long-term shareholder value, whilst taking into account the interest of other stakeholders. Keasey et al (1997) defines corporate governance to include the structures, processes, cultures and systems that engender the successful operation of an organization. The Cadbury Committee (1992) defines corporate governance as the system by which companies are directed and controlled. Corporate governance is about supervising and holding to account those who direct and control the management. Corporate governance has been identified as one of the important tools needed in managing any organization including corporation the compliance with codes of corporate governance which has become the norm for listed firms all over the world.

1.1.1 Corporate Governance and firm value

It is believed that good governance generates investor goodwill and confidence. Good corporate governance increases valuations and boosts the bottom line (Gompors et al, 2003). Better corporate frameworks benefit firms through greater access to financing, over cost of capital, better performance and more favorable treatment of all stakeholders (Claessens et al, 2002).

1.1.2 Corporate Governance and capital Structure.

Corporate governance has been identified in previous studies (see Berger et al., 1998; Friend and Lang, 1988; Wen et al., 2002) to influence the capital structure decisions of firms. These studies identified the main characteristic of corporate governance to include: board size, board composition, Chief Executive Officer (CEO) duality, tenure of the CEO, Equity blockholders and CEO compensation. However, empirical results on the relationship between corporate governance and capital structure appear to be varied and inconclusive. For instance the evidence on the ultimate effect of corporate governance compliance to high level of debt by company is mixed. Abor and Biekpe (2008) test on Small and Medium Enterprises (SMEs) indicate that there is positive relationships between capital structure and board composition, board skills and CEO duality and the result imply that SMEs pursue

lower debt policy with larger board size. Another key result that should be highlighted is SMEs with higher percentage of outside directors, highly qualified board members and one-tier board system rather employ more debt. Abor (2007) study on how corporate governance affects the capital structure found a significantly negative relationship between board size and capital structure and opposite finding on the association between CEO duality and leverage where it implies that larger boards adopt low debt policy and CEO as the board chairman tend to employ high proportion of debt. Similar findings done by Pfeffer and Salancick (1978), Lipton and Lorsch (1992), Berger et al (1997) and Wen et al (2002) on the relationship between corporate governance and capital structure came out with the conclusions that corporate governance influenced the capital structure decision of firms. These conclusions however, contradict with Jensen (1986) stating, high leverage or debt ratio was because of larger boards

1.1.3 Capital structure and firm value.

Starting from the seminal work of Modigliani and Miller (1958), capital structure became one of the main elements that following studies have shown as being essential in determining value. Half a century of research on capital structure attempted to verify the presence of an optimal capital structure that could amplify the company's ability to create value. Important, and still in vogue, is the debate between the two main theoretical perspectives, the trade-off approach (Kraus and Litzenberger, 1973), that balance the advantages and disadvantages of debt, and the pecking order approach (Myers, 1984, Myers and Majluf, 1984), that makes it evident that active and intentional role of management in how the firm's financial resources are decided on follows an order of preference (self-generated resources, debt and new equity).

Previous research that attempted to determine the relationship between capital structure and firm value revealed mixed results. By using equity capital ratio to proxy for the capital structure, Berger and Udell (2006) found that lower equity capital ratio is associated with higher firm performance. Firm value is documented to have a positive (negative) relationship with leverage for firms in stable environments (dynamics

environments) (Simerly and Li 2000), and low-growth firms (high-growth firms) (McConnell and Servaes (1995).

The controversy that has emerged in trying to verify the validity of these theories (Harris and Raviv, 1991) has stimulated an attempt to find solutions that can “strengthen” theoretical hypotheses and improve econometric models, also because of the difficulties found when trying to apply the theories to reality (Bhagat and Jefferis, 2002). Some recent contributions (Fluck, 1998, Zhang, 1998, Zingales, 2000, Myers, 2000, Heinrich, 2000, Bhagat and Jefferis, 2002, Berger and Patti, 2003, Brailsford et al., 2004, Mahrt-Smith, 2005) show that there is again quite a bit of interest in the topic of firm capital structure, on whether or not it is necessary to consider the important contribution offered by corporate governance as a variable that can explain the connection between capital structure and value, controlling opportunistic behavior in the economic relations between shareholders, debt holders and managers.

1.1.4 Moderating role of corporate governance on the relation between Capital Structure and firm value.

Capital structure can influence firm value by: limiting conflicts of interest that can emerge between shareholders and debt holders and the probability that there will be costs related to distress and bankruptcy (Jensen and Meckling, 1976, Williamson, 1988); modifying the types of incentives offered to management (Jensen and Meckling, 1976); limiting management activity (Jensen, 1986); managing problems having to do with information asymmetries (Ross, 1977); encouraging shareholders and other financiers to check up on management’s actions (Shleifer and Vishny, 1986); and encouraging, above all, firm-specific investments of human capital and promoting efficiency in how decision making power is distributed in the firm (Zingales, 2000)..

Capital structure is influenced by corporate governance and vice versa, a change in how debt and equity are dealt with influences firm governance activities by modifying the structure of incentives and managerial control. Managers will tend to have preferences when determining the composition of the firm's capital structure. Through a specific

design of debt contracts and equity, it is possible to considerably increase firm governance efficiency (Rocca 2007).

On the other hand corporate governance influences choices regarding capital structure. Myers (1984) and Myers and Majluf (1984) show how firm financing choices are made by management following an order of preference. If the manager chooses the financing resources it can be presumed that she is avoiding a reduction of her decision making power by accepting the discipline represented by debt. Internal resource financing allows management to prevent other subjects from intervening in their decision making processes. De Jong (2002) reveals how managers try to avoid using debt so that their decision making power remains unchecked. Zwiebel (1996) has observed that managers don't voluntarily accept the "discipline" of debt; other governance mechanisms impose that debt is issued. Jensen (1986) noted that decisions to increase firm debt are voluntarily made by management when it intends to "reassure" stakeholders that its governance decisions are "proper".

Controversial evidence on the relation between capital structure and value (Harris and Raviv, 1991) and the ambiguous results that have emerged regarding the existence of a relation of optimal debt are thus connected to the necessity to take the specific structure of corporate governance into consideration (Heinrich, 2000, Mahrt-Smith, 2005).

The relation between capital structure and value is actually explained by corporate governance that "intervenes" ("intervening variable") in the relation between capital structure and value. This would create a "bridge" by mediating between leverage and value, thus showing a connection that otherwise would not be visible. It can not be said that there is no relation between capital structure and value (Modigliani and Miller, 1958), but the connection is mediated and, in an economic sense, it is formalized through a causal chain between variables. In other words, it is not possible to see a direct relation between capital structure and value, but in reality capital structure influences firm governance that is connected to firm value. By keeping the dimensions of corporate governance under control, using an econometric model, the actual relation between capital structure and value could be seen, whereas it was previously absent, distorted or

not statistically supported (Corbetta 1992). Capital structure would contribute to how governance is organized and thus, as a consequence, to the creation of value together with the other governance instruments.

The relation between capital structure and corporate governance becomes extremely important when considering its fundamental role in value generation and distribution (Bhagat and Jefferis, 2002). Through its interaction with other instruments of corporate governance, firm capital structure becomes capable of protecting an efficient value creation process, by establishing the ways in which the generated value is later distributed (Zingales, 1998); in other words the surplus created is influenced (Zingales, 2000).

Capital structure could also intervene or interact in the relation between corporate governance and value. In this manner a complementary relationship, or one where substitution is possible, could emerge between capital structure and other corporate governance variables. Debt could have a marginal role of disciplining management when there is a shareholder participating in ownership or when there is state participation. To the contrary, when other forms of discipline are lacking in the governance structure, capital structure could be exactly the mechanism capable of protecting efficient corporate governance, while preserving firm value (Rocca 2007)

1.2 Statement of Problem

The Research focuses on the intervening role of corporate governance on the relation between capital structure and firm value of companies quoted in the Nairobi Stock Exchange. Local stream of studies of the influence of corporate governance on the relation between Capital Structure and firm have adopted duality approach in examining the relations among the three study constructs: the relation between firm value and capital structure, the relation between capital structure and corporate governance and the relation between corporate governance and firm value (Lang'at, 2006; Musyoki, 2009; Ngaruiya, 2007). They have ignored the mediating(moderating) role of corporate governance. Many of these local studies therefore fail to give empirical analysis of simultaneous relationship of these three variables.

In addition, the problems of endogeneity and causal relationships have always been raised in the discussion of the relationships between two of these variables; between corporate governance and capital structure; between corporate governance and firm value; or between capital structure and firm value. Hence, it is important to empirically investigate the interrelationships between them, as these three variables are highly significant to corporations, and play a pivotal role in corporate decision making and value creation.

The studies on the topic elsewhere show a large stream of controversial empirical results. For instance among others, Gedajlovic and Shapiro (1998) found a positive and significant relationship between ownership concentration and performance after taking into consideration the interaction between ownership concentration and diversification, whereas Mehran (1995) found a positive relationship between insider ownership and performance after outside and board monitoring variables have been controlled. Contrary to this, Demsetz and Villalonga (2001) found there is no significant relation between ownership structure and firm performance.

The studies that have attempted to analyze the three variables (such as Byers et al. 2008) were conducted in developed economies and the conclusions in these studies may vary if empirical analysis were replicated in the local environment. Therefore there is need to carry out empirical studies in Kenya to analyze the interrelationships between the three variables.

Capital structure represents a corporate governance device that can preserve corporate governance efficiency and protect its ability to create value but is always ignored in the capital structure-firm value studies. Therefore the relation between capital structure and a firm's value needs to take directly into account the mediation role of corporate governance.

In summary, the research gaps of this topic are: lack of local research that encompass simultaneous analysis of the three variables; ignoring the mediation role of corporate governance in analyzing the relation between capital structure and firm value and the fact that in dual studies of examining the relations among the three study constructs of: the

relation between firm value and capital structure or corporate governance, conclusions are contradictory and inconclusive.

This research project addresses these gaps by attempting to answer the question: Is there a moderation role of corporate governance (ownership concentration, managerial ownership; the role of board of directors; etc) on the relation between Capital Structure and firm value?

1.3 Objective of the Study

To determine the mediating role of corporate governance on the relation between capital structure and firm value of firms quoted at Nairobi Stock Exchange.

1.4 Importance of the study

The importance of the study are:

Academics and Researchers

The study of the relation would enrich our understanding about whether or not firms that are vulnerable to expropriation issue more debts to have more resources to use for private interests and how this translates into firm value. Scholars may also wish to use the findings of this study as a basis for further research on these unresolved issues of optimal capital structure.

Regulatory Authorities.

The study would also benefit the Capital Markets Authority (CMA). Given the reforms on corporate governance due to the previous corporate scandals (eg Uchumi Supermarkets), the significance of the results of this study cannot be overemphasized. As a regulatory body, CMA needs to fully appreciate whether or not corporate governance have influence on capital structure and firm value.

Shareholders and Potential Investors

Firms' shareholders also need to appreciate the possible agency issues in determining the firm's financing decisions. The agency problems may also arise between the firm's

controlling shareholders and the debt providers and between the debt suppliers and their minority shareholders. For example, the controlling shareholder of a firm and the firm's debt providers might belong to the same business groups. In such a case, instead of performing the active monitoring and governance function, the debt suppliers could become the centre of corrupted crony systems.

Management

Management of publicly quoted companies would benefit from the study as they need to make more informed financial decisions. Investors would also make use of the findings of this research to be able to make more informed decisions, as they will be aware of the corporate governance structures to expect before they invest in a firm

Financial analysts and Consultants

Others to benefit would be financial consultants and scholars who intend to analyze the content of information contained in financial reports to be able to offer proper advice to clients on the possible effects of reported corporate governance compliance levels.

CHAPTER TWO

2.0 LITERATURE REVIEW

2.1 Introduction

This section reviews on previous studies that have been conducted related to the present study. It is divided into twelve subsections. These subsections review the theory and empirical evidence on the relationship between corporate governance and firm value, between corporate governance and capital structure, between capital structure and firm value, and between these three variables themselves by first reviewing the role of corporate Governance. The objective of this section is trying to identify the potential gaps on the studies that have been conducted on the three variables (Corporate governance, capital structure and firm value).

Three theories form the theoretical foundation of the study. These theories are appearing on subsection 2.2.1 to 2.2.3. This is followed by a brief statement on the role of corporate governance in value creation on subsection 2.3. The next three subsections review the relationship between corporate governance and firm value on subsection 2.4, capital structure and firm value on subsection 2.5, corporate governance and capital structure on subsection 2.6 and relationships between the three variables on subsection 2.7.

The empirical studies on the topic appear on subsection 2.8 to form conceptual framework on subsection 2.9. The study then reviews the state of corporate governance in Kenya on subsection 2.10. The motivation of the study is discussed on subsection 2.11 and finally the chapter ends with a summary of literature review on subsection 2.12.

2.2 Theoretical Foundation of the Study

The core theories of this study are theories that dominate the fields to be investigated which are agency theory, free cash flow theory and trade-off theory.

2.2.1 Agency Theory

This theory has its origins in the early 1930s when Berle and Means (1932) explored the corporate revolution. They revealed that at the early stage, corporations were managed by the founders themselves. As corporations grew, the owners sought external sources of financing. Hence, corporations issued equity. As a result, corporations became owned by external shareholders, where the evolution of separation between owners (ownership) and managers (control) commenced Berle and Means (1932).

There are three types of separation of ownership and control. The first is majority control. This is where some of the shareholders own majority of shares, and the remainder are widely diffused and only hold a portion of the shares. Hence, only the remainder shareholders are separated from control. The second is minority control, where ownership is widely spread. As such, the greater part of ownership is practically without control. The third is management control. There is no existence of large minority shareholders which results directors or managers responsible in controlling the corporation. The third type of separation of ownership and control is known as Quasi-public Corporation, which it has been resulted as the increment of owners. This happened because quasi-public corporation get its supply of capital from a group of investors, known as “investing public” (Berle and Means 1967). There are two types of investors, which are either as an individual, they invest directly in purchasing the corporation’s stocks or bonds, or invest indirectly by investing in insurance companies, banks and investment trusts, which will invest in corporate securities on behalf of the investors.

The separation of ownership and control has also resulted in divergence of interests between shareholders and the managers. How big or small the divergence might depend on the size of the corporation itself. As a result, managers are now responsible with regard to the shareholders, employees, customers and state. This also has ruined the unity which is known as property. Before the corporate revolution, men (owners) owned and used property by themselves, or in other words, the owners of corporation do not only own the property, but are also responsible in managing it. As such, they were entitled for the profits generated by the property. Hence, they will fully-utilized the property that they

have in the corporation in generating profit. In contrast, after the corporate revolution, i.e. in the quasi-public corporation, the owners of the property will not directly use it, but they will still get the profits generated as a result of using the property. Men (managers) who control the property were only entitled to a small portion of the profits. As a result, profits were not the main objective for the owners in encouraging them to efficiently use the property, and corporation now is not operated based on the main objective which is profit maximization, which this situation has been found to contradict with the economic principle. It can be concluded that, this was the time where the owners or shareholders of corporation have started in aiming maximization of their wealth as the main objective to be achieved in the willingness of them in investing in any corporation Berle and Means (1967).

Agency costs might destroy firm value, which means it might destroy the shareholders wealth as well, as maximization of shareholders wealth will be achieved when the firm value is maximized. Hence, the agency costs are not good to the owners of the firm. One of the consequences that have risen from this situation was the importance of monitoring mechanisms, so that managers will perform in order to meet the shareholders' objective. Hence, it will reduce the agency problem and as a result firm value will increase. Even though Ross (1973) argued that it might be difficult to monitor the managers, various monitoring mechanisms have been suggested in the literature in reducing the agency problem. It is suggested that there are three ways in monitoring firm managers which are in within the firm, outside the firm and the role play by government regulation in a country. Within the firm relates to mechanisms that the firm has greater discretion over, such as board size and composition as well as compensation. Outside of the firm or the external mechanism, debt or leverage, ownership concentration or large shareholders and corporate takeovers, have been suggested in the literature as the monitoring mechanisms to reduce the agency problem. For the purpose of this study, ownership concentration will be used in representing the monitoring mechanism. Ownership concentration can be categorized as non-managerial owners, institutional shareholders, family-owners and state-owners Ross (1973). This study will focus on monitoring firm managers within the firm which comprise the corporate governance devices.

2.2.2 Free Cash Flow Theory

According to free cash flow theory of capital structure innovated by Jensen (1986), leverage itself can also act as a Corporate governance device and thereby reduces the agency problem (hence increasing firm value), by reducing the agency costs of free cash flow. There are some consequences derived if firm is employing higher leverage level. Managers of such firm will not be able to invest in non profitable new projects, as doing so the new projects might not be able to generate cash flows to the firm, hence managers might fail in paying the fixed amount of interest on the debt or the principal when it's due. It also might cause in the inability to generate profit in a certain financial year that may result in failing to pay dividends to firm shareholders Jensen (1986).

Employing more leverage, managers are forced to distribute the cash flows, including future cash flows to the debt holders as they are bonded in doing so at a fixed amount and in a specified period of time. If managers fail in fulfilling this obligation, debt holders might take the firm into bankruptcy case. This risk may further motivate managers to decrease their consumption of perks and increase their efficiency (Grossman and Hart 1982). This statement has been supported by Jensen (1986) which states that from the agency view, the higher the degree of moral hazard, the higher the leverage of the firm should be as managers will have to pay for the fixed obligation resulting from the debt. Hence, it will reduce managers' perquisites. Extensive research suggests that debt can act as a self-enforcing governance mechanism; that is, issuing debt holds managers' "feet to the fire" by forcing them to generate cash to meet interest and principle obligations (Gillan 2006).

Leverage might not only be able to reduce the agency costs of free cash flow, but also can increase the efficiency of the managers. This is due to the debt market that might function as a more effective capital market monitoring. In addition, in order to obtain the debt financing, managers must show their abilities and efficiencies in managing the firm. Empirically, it has been proven, among others by Byers, Fields and Fraser (2008) that leverage proxied by bank lenders, can be a substitute monitoring mechanism especially in weak corporate governance firms, but not in the more active merger environments.

In conclusion, this theory suggests that leverage is vital in playing its role as corporate governance device. This is due to the higher the leverage level, the higher the probability of bankruptcy, and when this happens, managers might lose their jobs. As such it might motivate managers to work harder in order to avoid this risk by fulfilling the fixed obligation to the debt holders. In addition, as a consequence, it will reduce the managers' perquisites as they will be pressured not to waste the firm cash flows. This also will increase the efficiency of managers in making decisions especially in selecting new profitable projects. All of these consequences will increase the firm value. Hence, these consequences will make the interests of owners and managers aligned. This might be the reason why owners or shareholders prefer high leverage level, which is contradict to managers, as managers want to avoid the consequences derived in employing more leverage. In this situation, ownership concentration can play its role in forcing managers to choose higher leverage level Jensen (1986).

2.2.3 Trade-Off Theory

In relation to capital structure the study utilizes trade-off theory. The debate on capital structure started with propositions demonstrated by Modigliani and Miller (1958; 1963). At first, in the absence of corporate tax and bankruptcy costs, they concluded that firm value is independent of its capital structure. Later, they came out with other conclusion, in the existence of corporate tax; firm value will increase if the firm increase its leverage. Hence, they argued that the optimal debt level will be met based on the trade off between tax advantage of debt offset by the increased risk in bankruptcy and agency costs of debt. The optimal debt-equity ratio is the point at which firm value is maximized (Jensen 1986).

Even though Miller (1977) argued that firm value is independent of its capital structure and there is no optimum debt ratio for any individual firm, Myers (1984) concluded that regardless of which theory holds, the effective tax rate is positively related to the net tax gain of debt, suggesting that the tax advantage of using debt. Theoretically, Stulz (1990) and Harris and Raviv (1990) found that leverage is positively correlated with firm value.

It is supported by Berger, Ofek and Yermack (1997) which states that many corporate governance theories came to a conclusion that capital structure can be used to reduce agency costs and as a result increase firm value. It has been empirically proven, among others by Simerly and Li (2000) and Berger and Patti (2006) who found a positive relationship between leverage and firm performance.

Most theoretical contributions on the relation between capital structure and value indicate that there is a substantial difference between the early theories and the more recent ones. Modigliani and Miller (1958), who had originally asserted that there was no relationship between capital structure and value; in 1963, instead, reached the paradoxical and provocative conclusion that a maximum level of debt would mean a maximum level of firm value, due to the fact that interest is tax deductible. Many later contributions pointed out that this effect is compensated when considering personal taxes (Miller, 1977), an eventual lack of tax capacity, due to the presence of economic loss, the effect of other types of tax shields (De Angelo and Masulis, 1980), as well as the introduction of the costs (direct and indirect) of financial distress; all these situations end up creating a trade-off between debt costs and benefits.

The introduction of personal taxes and the costs of financial distress indicate that there is an optimal level of debt, beyond which any rise in leverage would cause an increase in the benefits of debt that would be less than proportional with respect to the costs of financial distress. Furthermore, this non monotonic relation would be modified even more when considering agency costs as well as the costs of financial distress. Finally, one last stream of research (Myers, 1984, Myers and Majluf, 1984) points out managerial preferences when choosing financing resources. In this case no optimal level of debt becomes “objectively” evident, but this is due to the various situations the manager had to deal with over time. The function of managerial preference has particular relevance due to information asymmetries, therefore the level of firm indebtedness will be determined by the tangent between the firm value function and the curve of manager indifference. In general, the study done by Harris and Raviv (1991) is most certainly the best departure point for an overview of the research done since then on the state of the art

of capital structure, as Rajan and Zingales (1995) point out. This study, in fact, synthesizes the knowledge acquired up until 1990, both from an empirical and theoretical point of view.

Many theoretical hypotheses have been made and there is also a large amount of contradictory empirical evidence. In particular, synoptic tables presented by Harris and Raviv (1991) evince that leverage is high and growing when: according to the trade-off theory: taxable income is high and the costs of financial distress are low; for the agency theory: growth opportunities are low and/or there is a large amount of cash flow available; and for the information asymmetry theory: information asymmetries are low and firm profit is high (as a sign of success).

Furthermore, it can be observed that debt increases in correspondence with the better the firm's reputation is on the market (Chevalier, 1995). Research has shown similarities between firms that belong to the same sector (Titman and Wessels, 1988); in other words, capital structure tends to be industry-specific.

The empirical comparison between the trade-off theory and the pecking order theory seems to be controversial. On one hand, empirical evidence shows moderate coherence with the trade-off theory, when revenue and agency problems are taken into consideration contextually; on the other hand, the negative relation between leverage and firm profit does not seem to support the trade-off theory, as it confirms a hierarchical order in financial decision making. It is, thus, clear that the topic of capital structure is anything but defined and that there are still many open problems regarding it.

The observations of Jensen (1986), made throughout his many contributions on corporate governance, as well as those of Williamson (1988), have encouraged a line of research that, revitalized in the second part of the nineties, seems to be quite promising as a means to analyze how corporate governance directly or indirectly influences the relation between capital structure and value (Fluck, 1998, Zhang, 1998, Myers, 2000, De Jong, 2002, Berger and Patti, 2003, Brailsford et al., 2004, Mahrt-Smith, 2005). In synthesis, it

is possible to affirm, as it follows, that a joined analysis of capital structure and corporate governance is necessary when describing and interpreting the firm's ability to create value (Zingales, 2000, Heinrich, 2000, Bhagat and Jefferis, 2002). This type of consideration could help overcome the controversy found when studying the relation between capital structure and value, on both a theoretical and empirical level.

2.3 Role of corporate Governance

The aim of corporate governance is to ensure that opportunistic behavior does not occur, by mitigating and moderating agency problems that could involve an agent (manager) and various principals (shareholders, debt holders, employees, suppliers, clients etc.) or else a principal (the main entrepreneur) and various agents (managers, employees, investors etc.). Moreover, it facilitates the creation of special skill required in strategic decisions (incentive to firm-specific investment) and limit problems of asymmetric information.

Corporate governance is a broad, complex and problematic concept that is extremely relevant, while difficult to define, due to the various dimensions that it comprises (Zingales, 1998, Becht et al., 2002). The expression corporate governance can take on two meanings, depending on whether greater emphasis is placed on the instruments used to allocate and manage power within a firm, or on the role of external institutions and mechanisms that control firm activity efficiency. It can be defined as: a system of how decision making power is distributed within the firm, so to overcome problems of contract incompleteness between different stakeholders (Lazzari, 2001; Zingales, 1998; Williamson, 1988); and also as a set of rules, institutions and practices developed to protect investors from entrepreneurial and managerial opportunistic behavior (Shleifer and Vishny (1997); Jensen, 1986; Chevalier, 1995).

A literature review of those mechanisms that have been traditionally used is offered by Shleifer and Vishny (1997) and by Denis (2001). In this light, management or internal instruments represent coordination mechanisms that can be used in bilateral contracting processes between management and ownership, or else between management and the

other stakeholders. Institutional or external instruments are mechanisms of collective coordination that operate through the financial markets, through the legal system, the judicial system and the manager job market. Conflicts of interest and the risk of opportunistic behavior increase the firm's cost of capital. Investors will be hesitant to trust management and to thus offer their financial resources to such firms. To the contrary, efficient governance that increases the firm's trustworthiness generates market appreciation and investor trust. This means that capital can be found more easily and the value creation process is highly favored. Management participation in the equity of the firm, the presence of external and independent members in the Board of Directors, the presence of institutional investors and the efficiency of the financial system, the legal system and enforcement are only some of the "levers" of both managerial and institutional corporate governance, that must be integrated together with the role of capital structure so that the firm's ability to create value can be understood.

2.4 Corporate Governance and Firm value

There were mixed results from previous researches pertaining to the relationship between ownership concentration and firm value. Among others, Gedajlovic and Shapiro (1998) found a positive and significant relationship between ownership concentration and performance after taking into consideration the interaction between ownership concentration and diversification, whereas Mehran (1995) found a positive relationship between insider ownership and performance after outside and board monitoring variables have been controlled. Contrary to this, Demsetz and Villalonga (2001) found there is no significant relation between ownership structure and firm performance. This finding supports the study previously done by Demsetz and Lehn (1985) who found no significant relationship between ownership concentration and firm performance. A positive relationship has been found out between firm performance and non-managerial owners (Lins 2003), managers-owners (Balatbat, Taylor and Walter 2004; Gugler, Mueller and Yurtoglu 2008), institutional shareholders (Balatbat et al. 2004; Gugler et al. 2008), and family-owners (Andres 2008). Bajaj et al. (1998) documented that insider ownership and firm value are positively correlated, with a possible 'reverse causality' relationship which runs from performance to ownership. This has been demonstrated by

their use of a signaling model. On the other hand, a negative relationship has been found out between firm performance and financial institutions ownership (Gugler et al. 2008), and family-owners in old firms (Morck, Shleifer and Vishny 1988). In addition, Morck et al. (1988) found a significant non-monotonic relationship when firm performance increased if the insider ownership is less than 5%, decreased in between ownership of 5%-25%, and increased again when the ownership is above 25%. Although McConnell and Servaes (1990) failed to replicate these findings, they found a curvilinear relationship between these two variables, where at a lower percentage of ownership, every 10% increased in ownership, firm value will increase by 30%. However, at more than 30% of ownership, a negative relationship has been found between insider ownership and firm value. Endogeneity and causal relationships have been ignored in the studies cited above except for Demsetz and Villalonga (2001) who documented that ownership structure is endogenous, and Gugler et al. (2008) who found that the estimated causal relationship runs from ownership to performance.

2.5 Capital Structure and Firm Value

Previous research that attempted to determine the relationship between capital structure and firm value revealed mixed results. By using equity capital ratio to proxy for the capital structure, Berger and Udell (2006) found that lower equity capital ratio is associated with higher firm performance. Firm value is documented to have a positive (negative) relationship with leverage for firms in stable environments (dynamic environments) (Simerly and Li 2000), and low-growth firms (high-growth firms) (McConnell and Servaes 1995). Profitability and market-to-book ratio can also be the proxies for the firm performance as the higher the value of these two variables is associated with a good performance. Among others, Fama and French (2002), Hovakimian, Opler and Titman (2001), Fischer, Heinkel and Zechner (1989), and Leland (1994) found a positive relationship between profitability and leverage. Meanwhile Baker and Wurgler (2002), and Hovakimian, Hovakimian and Tehranian (2004) found a negative relationship between market-to-book ratios on firm leverage.

2.6 Corporate Governance and Capital Structure

Corporate governance correlates with the financing decisions and the capital structure of firms (Graham and Harvey, 2001; Litov, 2005). Jensen (1986) postulates that large debt is associated with larger boards. Though Berger et al. (1997) concludes on a later date that larger board size is associated with low leverage; several other studies conducted in recent times have refuted this conclusion. Wen et al. (2002) posit that larger board size is associated with higher debt, either to improve the firm's value or because the larger size prevents the board from reaching a consensus on decisions, indicating a weak corporate governance system. Anderson et al. (2004) further indicate that larger board size results in lower cost of debt, which serves as a motivation for using more debt, and this has been confirmed by Abor (2007) who concludes that capital structure positively correlates with board size, among Ghanaian listed firms. In relation to the presence of external directors on the board, Wen et al. (2002) conclude that the presence of external directors on the board leads to lower leverage, used by the firm, due to their superior control. However, Abor (2007) concludes that capital structure positively correlates with Board composition among Ghanaian listed firms. And this is consistent with Jensen (1986) and Berger et al. (1997) who had earlier on concluded that firms with higher percentage of external directors utilize more debt as compared to equity. Berger et al. (1997) found less leverage in firms run by CEOs with long tenure and this was confirmed by Wen et al. (2002), who conclude that the tenure of CEO is negatively related to leverage, to reduce the pressures associate with leverage. Kayhan (2003) finds that entrenched managers achieve lower leverage through retaining more profits and issuing equity more opportunistically. Further, Litov (2005) supports this claim that entrenched managers adopt lower levels of debt. Abor (2007) also asserts that entrenched CEOs employ lower debt in order to reduce the performance pressures associated with high-debt capital. However, Bertrand and Mullainathan (2003) refuted this fact by showing in their study that entrenched managers "enjoy the quiet life" by engaging in risk-reducing projects, indicating a positive relationship between managerial entrenchment and leverage. Fosberg (2004) relates that firms with a two-tier leadership structure have high-debt/equity ratios. This was supported by Abor (2007), who concludes that capital structure positively correlates

with CEO duality, which shows that firms on the NSE use more debt as the CEO duality increases.

2.7 Corporate Governance, Capital Structure and Firm Value.

According to Rocca (2007), the influence of corporate governance on the relation between capital structure and value Capital structure can be analyzed by looking at the rights and attributes that characterize the firm's assets and that influence, with different levels of intensity, governance activities. Equity and debt, therefore, must be considered as both financial instruments and corporate governance instruments (Williamson, 1988): debt subordinates governance activities to stricter management, while equity allows for greater flexibility and decision making power. It can thus be inferred that when capital structure becomes an instrument of corporate governance, not only the mix between debt and equity and their well known consequences as far as taxes go must be taken into consideration. The way in which cash flow is allocated (cash flow right) and, even more importantly, how the right to make decisions and manage the firm (voting rights) is dealt with must also be examined. For example, venture capitalists are particularly sensitive to how capital structure and financing contracts are laid out, so that optimal corporate governance can be guaranteed while incentives and checks for management behavior are well established (Zingales, 2000).

Coase (1991), in a sort of critique on his own work done in 1937, points out that it is important to pay more attention to the role of capital structure as an instrument that can mediate and moderate economical transactions within the firm and, consequently, between entrepreneurs and other stakeholders (corporate governance relations).

2.8 Empirical Studies

Many empirical analyses have dealt with capital structure, corporate governance and firm value, but most of them have concentrated on only one of the five relations described in Figure 1. Thus only one aspect of the relation has been taken into account and the presence of reciprocal causations and complementarity between capital structure and other governance instruments have not been considered important in determining firm

value (Jensen and Warner, 1988, Borsch-Supan and Koke, 2000, Heinrich, 2000, Bhagat and Jefferis, 2002).

As Shleifer and Vishny (1997) have pointed out, while in the past researchers attempted to define the best governance mechanism to solve problems of opportunism, today it has become clear that what must be identified is rather the best possible combination of governance mechanisms. In the past corporate governance mechanisms were considered “substitutions”; instead, they actually seem to be “complementary”. It would seem that a concerted use of financing choices with relation to the firm’s particular governance structure and to the institutional context it operates in would be most opportune (Heinrich, 2000). Put differently, capital structure make-up can offer a valid contribution in creating both efficient governance and firm value.

Jensen and Meckling (1976) argued that the separation of ownership and control has resulted in an agency problem as the managers who act as agents might not always act in the best interests of the shareholders or owners, who are the principals of the firm. This might be due to the interests of both parties which are not aligned. Agency problem results in agency costs, which are the costs of the separation of ownership and control. Agency costs have been defined as the sum of the monitoring expenditures by the principal, the bonding expenditures by the agent, and the residual costs; which the latter is the dollar equivalent of the reduction in welfare experienced by the principal due to the divergence of interests between the owners and managers (Jensen and Meckling 1976).

Goergen and Renneboog (2001) argued that if there are insufficient corporate governance devices in a firm such as having a diffuse ownership structure (which is the opposite of the ownership concentration structure), it may lead to high managerial discretion which may increase the agency costs. As has been argued in the literature, the level of monitoring is a function of such variables as institutional ownership, block ownership by outsiders, the technology in place to monitor the managers Bajaj, Chan and Dasgupta (1998) and forecasted profit gain derived from the monitoring Demsetz and Lehn (1985).

In their study, Berle and Means (1967) argued that large corporations are more profitable due to the great increasing in their proportion of wealth and income. They found that corporations increased their wealth by reinvesting its earnings, by raising new capital through the sale of securities in the public markets, and by acquiring control of other corporations through purchase or exchange of securities. In that century, they also found that industry by industry has increased its wealth, as what they called as “corporate sway”. However, they revealed that most of the corporations have growth through funding their new capital by issuing securities in the public markets. They witnessed that the tendency of the dispersion will be higher when the size of the corporation is larger. Factor that contributed to the increment of the number of stockholders during that time was the ownership offered to customers and employees. As such, dispersion has been seen as a continuous process.

Means (1967) statistically revealed that in within thirty-five years, there was an increase in the number of large corporations that have been controlled by management. In contrast, there was a decreased in the corporations which was privately owned or corporations which was controlled by majority shareholders. Hence, he concluded that corporate revolution happened in form of concentration of economic power, dispersion of stock ownership, and separation of ownership and control. The dispersion of stock ownership has resulted into a change in the wealth character itself, such as the individual and his wealth relationship, the wealth value, and the nature of the property used in the operations of the corporation (Berle and Means 1967). As such, it can be seen that the evolution of separation between owners and managers of corporations not only happened because of the needs in finding the external sources, but also as a result of the ownership that has been widely dispersed. An interesting question can be raised here, that is, if the corporation’s external non-managerial ownership is concentrated, will the separation between owners and managers still happened?

Ngugi (2008) study investigated the determinants of capital structure for a sample of 22 firms listed on the Nairobi Stock Exchange during the period 1991-1999. Reduced form equations derived from the static trade-off model and the pecking order hypothesis were

estimated and tested using panel data techniques. The results show that a pecking order model with an adjustment process cannot be rejected. Specifically, it is found that the main determinants of capital financing behavior consist of information asymmetries, non-debt tax shields and local capital market infrastructure.

Tomo (2008) study focused on role of NSE in raising equity capital among 49 listed firms in the exchange between 1998-2004. The findings indicate that although the company's listed in the NSE have registered an enormous growth during the period under review, much of this has been financed through borrowed capital and retained profits. The researchers conclude that the NSE has failed in its primary objective of helping investors to raise capital. Furthermore there is little evidence to suggest that the NSE has contributed to the economic development of Kenya. These findings confirm earlier finding by Kimura and Amoro (1999), who concluded that there was no significant correlation between economic growth and the growth of the NSE.

Musyoka (2009) examined how corporate governance indicators such as board size, board composition and CEO duality impact on financing decisions of firms. Random-effects GLS regression framework analysis was done on a panel data covering the five year period 2001/2002 to 2006/2007 from forty-seven (47) listed firms on the Nairobi Stock Exchange (NSE) and the findings indicate that firms with larger board sizes employ more debt irrespective of the maturity period and also the independence of a board negatively and significantly correlates with short-term debts. Again, when a CEO doubles as board chairperson, less debt is employed, in resonance and re-affirmation of the notion that the firm governance structure affects its financing choices.

Kumar (2005) study shows that the debt structure is non-linearly linked to the corporate governance (ownership structure). In his study he found that firms with weaker corporate governance mechanisms, dispersed shareholding pattern tend to have a higher debt level while firms with higher foreign ownership or with low institutional ownership tend to have lower debt level. Similarly, Chiyachantana, Jiraporn and Kitsabunnarat (2005) found that the association is not only non-linear but also parabolic and convex. Leverage

is negatively related to governance quality up to a certain point. Then, the relationship reverses and becomes positive as governance quality improves further.

Abor (2007) study on how corporate governance affects the capital structure found a significantly negative relationship between board size and capital structure and opposite finding on the association between CEO duality and leverage where it implies that larger boards adopt low debt policy and CEO as the board chairman tend to employ high proportion of debt. Similar findings done by Pfeffer and Salancick (1978), Lipton and Lorsch (1992), Berger et al (1997) and Wen et al (2002) on the relationship between corporate governance and capital structure was come out with the decision of corporate governance influenced the capital structure decision of firms. These however, contradict with Jensen (1986) where, high leverage or debt ratio because of larger boards.

A study done by Zong-Jun (2006), using a sample of ninety-six financially distressed companies and 96 healthy companies find that large shareholder ownership, state ownership, and the proportion of independent directors are negatively associated with the probability of distress. Additionally, managerial agency costs are badly detrimental to a company's financial status. However, the degree of balanced ownership, managerial ownership, board size, and CEO duality do not significantly affect the probability of default. Furthermore, they test the influence of state-controlling right by sub-grouping the sample into state-controlled and non-state-controlled companies. The results indicate that corporate-governance attributes act differently on the status of financial distress between the two sub-samples.

The evidence on the ultimate effect of corporate governance compliance to high level of debt by company is mixed. For instance, Abor and Biekpe (2008) tested on small and medium enterprises (SMEs) indicate that is positive relationships between capital structure and board composition, board skills and CEO duality and the result imply that SMEs pursue lower debt policy with larger board size. Another key result that should be highlight is SMEs with higher percentage of outside directors, highly qualified board members and one-tier board system rather employ more debt.

Fama and Jensen (1983) found CEO duality also influences the financing decision of the firm but the relationship is not statistically significant. Another study by Wen.Y, Rwegasira, K. and Bilderbeek,J. (2002) on corporate governance and capital structure decisions of the Chinese listed firms found that manager tend to pursue lower financial leverage when they face stronger corporate governance from the board. However, their finding only shows a significant value of board composition and CEO tenure and insignificant results for board size and fixed CEO compensation.

Du and Dai (2005) in a survey of 1479 East Asian firms (1994-96) focused on Ownership and capital structure and found that controlling owners with little shareholding choose higher debt and that weak CG and crony capitalism contributes to risky capital structure. Kumar (2005) in a survey of 2,000 Indian firms (1994- 00) focused on CG and firm financing and found that firms' with dispersed shareholding have higher leverage and that firms' with higher FS and lower institutional shareholding have lower debt. Moreover, no relationship between directors shareholding and debt was found.

Jiraporn and Gleason (2005) in a study of 4,638 firms found that shareholder rights and capital structure and that firm with more restricted shareholder rights have higher leverage, supporting the view that leverage helps alleviate agency problems. Black et al. (2006) in a survey of 515 Korean firms (2001) focused on CG and firm value and found that CG has a positive influence on firm value and that better CG is less likely to predict higher firm profitability.

Drobetz et al. (2004) in a survey of 91 firms in Germany focused on CG and expected stock returns and found that CG is positively associated with firm value and stock returns. Klapper and Love (2004) survey 374 firms in 14 emerging economies and found that better CG is highly correlated with better profitability and firm Valuation. Gompers et al. (2003) surveyed 1,500 large firms in SandP and found that firms with stronger shareholder rights have higher firm value, higher profits and higher sales growth. Thompson and Hung (2002) in a survey of 83 firms in Singapore found that a positive

relationship between ownership concentration (OC) and profitability and that both CGI and non-executive chairman are negatively associated with profitability.

Oyvind and Priestley (2007) found out that well-governed companies receive higher market valuations, which increase the inflow of capital from both domestic and foreign sources in the form of debt and equity. A study of Russian firms shows that a worst-to-best improvement in corporate governance predicted a huge 700-fold (70,000%) increase in firm value (Black, 2002).

Gompers and Metrick, A., (2003), study shows that if an investor bought shares in US firms with the strongest shareholder rights, and sold shares in the ones with the weakest shareholder rights, that investor would have earned abnormal returns of 8.5 percent per year.

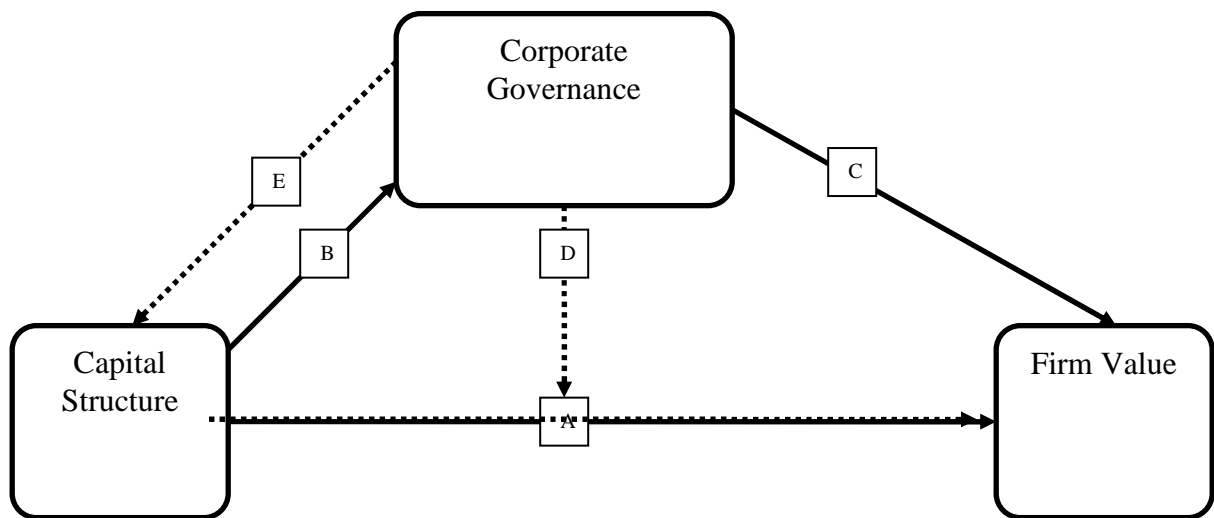
2.9 Conceptual Framework.

As explicitly pointed out by Bhagat and Jefferis (2002), when they pay particular attention to the relations between cause and effect and to their interactions recently described on a theoretical level (Fluck, 1998, Zhang, 1998, Heinrich, 2000, Brailsford et al., 2004, Mahrt-Smith, 2005), future empirical studies should evaluate how corporate governance can potentially have a relevant influence on the relation between capital structure and value, with an effect of mediation and/or moderation.

Consequently, this study adopts the framework proposed by Rocca (2007). The researcher identifies five relations in the study of the three research constructs (capital structure, firm value and corporate governance): the relation between capital structure and firm value (relation A) through a role of corporate governance “mediation” (relation B-C); the relation between capital structure and firm value (relation A) through the role of capital governance “moderation” (relation D); and the role of corporate governance as a determining factor in choices regarding capital structure (relation E).

All five relations are particularly interesting and show two threads of research that focus on the relations between: capital structure and value, mediated (indirect relation through the intervention of another variable – relation B-C-A) and/or mitigated (direct relation but conditioned by another variable – relation A-D) by the corporate governance variable; and corporate governance and capital structure, where the dimensions of the corporate governance determine firm financing choices, causing a possible relation of co-causation (relation E-B).

Figure 1: Conceptual Framework



Source: Adopted from Rocca (2007)

Rocca (2007) posits that whether management voluntarily chooses to use debt as a source of financing to reduce problems of information asymmetry and transaction, maximizing the efficiency of its firm governance decisions, or the increase in the debt level is forced by the stockholders as an instrument to discipline behavior and assure good corporate governance, capital structure is influenced by corporate governance (relation E) and vice versa (relation B). On one hand, a change in how debt and equity are dealt with influences firm governance activities by modifying the structure of incentives and managerial control. If, through the mix debt and equity, different categories of investors all converge within the firm, where they have different types of influence on governance decisions, then managers will tend to have preferences when determining how one of

these categories will prevail when defining the firm's capital structure. Even more importantly, through a specific design of debt contracts and equity it is possible to considerably increase firm governance efficiency.

On the other hand, even corporate governance influences choices regarding capital structure (relation E). Myers (1984) and Myers and Majluf (1984) show how firm financing choices are made by management following an order of preference; in this case, if the manager chooses the financing resources it can be presumed that she is avoiding a reduction of her decision making power by accepting the discipline represented by debt. Internal resource financing allows management to prevent other subjects from intervening in their decision making processes. De Jong (2002) reveals how in the Netherlands managers try to avoid using debt so that their decision making power remains unchecked. Zwiebel (1996) has observed that managers don't voluntarily accept the "discipline" of debt; other governance mechanisms impose that debt is issued. Jensen (1986) noted that decisions to increase firm debt are voluntarily made by management when it intends to "reassure" stakeholders that its governance decisions are "proper". In this light, firm financing decisions can be strictly deliberated by managers-entrepreneurs or else can be induced by specific situations that go beyond the will of the management.

Controversial evidence on the relation between capital structure and value (Harris and Raviv, 1991 – relation A) and the ambiguous results that have emerged regarding the existence of a relation of optimal debt are thus connected to the necessity to take the specific structure of corporate governance into consideration (Heinrich, 2000, Mahrt-Smith, 2005). The causal model represents a complex phenomenon that nevertheless could stimulate a promising thread of future research. Corporate governance, in fact, could become crucial in explaining the relation between capital structure and value in its function as a variable that "intervenes" in the above mentioned relation (mediation effect – relation B-C-A) or as one that "conditions" the meaning and the intensity of such a relation (moderation effect – relation A-D); in this last case a phenomenon of "interaction" between variables would be found (Corbetta, 1992).

The B-C-A relation that indicates the relation between capital structure and value is actually explained by corporate governance that “intervenes” (and for this reason is called an “intervening variable”) in the relation between capital structure and value. This would create a “bridge” by mediating between leverage and value, thus showing a connection that otherwise would not be visible. It can not be said that there is no relation between capital structure and value (Modigliani and Miller, 1958), but the connection is mediated and, in an economic sense, it is formalized through a causal chain between variables. In other words, it is not possible to see a direct relation between capital structure and value, but in reality capital structure influences firm governance that is connected to firm Value.

Corbetta (1992) says that the introduction of an intervening variable could reveal, besides the presence of an indirect relation, relation B – C. In this case, capital structure would contribute to how governance is organized and thus, as a consequence, to the creation of value together with the other governance instruments (relation B-C-A). In essence, by keeping the effect of corporate governance under control, that is, by considering the dimensions of corporate governance using an econometric model, the actual relation between capital structure and value (relation A) could be seen, whereas it was previously absent, distorted or not statistically supported. To the contrary the relation A-D represents a complex phenomenon of “interaction” between variables, that is difficult to deal with in terms of mathematical formulae of causal connections, since here we are dealing with non linear relations. In this case the relation between financial structure and value is conditioned (moderated) by corporate governance that interacts with the first one.

The possibility that corporate governance has an effect of moderation does not exclude that this variable can mediate the relation between capital structure and value. It is also equally important to observe how capital structure influences firm value through the interaction of many dimensions of corporate governance (relation A-D). In this sense the corporate governance variable plays the role of moderating the relation between capital structure and value, that can have either an amplifying effect (+) or one of reduction (-) of

the basic relation (relation A); as debt increases firm value could increase or diminish depending on the role of other corporate governance instruments.

2.10 State of Corporate Governance in Kenya

Corporate governance has emerged as a major policy concern for many developing countries following the financial crisis in Asia, Russia, and the recent global financial crisis that heralded in the USA. Corporate governance has therefore become a subject of heightened importance and attention in government policy circles, academia, and the popular press throughout Kenya. Various reasons explain the current prominence of this phenomenon. The main concerns on poor governance in the public sector particularly in early 1990s in which heightened wastage and misuse of public resources and the recent financial scandals and the collapse of major stock brokerage firms and the near collapse of some renowned Kenyan companies such as Uchumi Supermarkets and Finance Bank, National Social Security Fund, Kenya Pipeline Corporation, Triton Petroleum Company, Nyaga Stockbrokers and others within the Banking Sector all show that financial fraud is rampant in Kenya (Njane, 2007).

Weaknesses in corporate governance in Kenya practices were initially highlighted in the 2001 World Bank review of accounting and auditing practices in the Report on the Observance of Standards and Codes (ROSC), but it is the recent corporate failures that have further heightened attention on the need to strengthen the regulatory framework of key financial market regulators to enforce corporate governance compliance. Kenya has witnessed the collapse of many business enterprises and incurred tremendous costs due to weak corporate governance structures within the organizations. Despite the good laws that exist in theory, there is still a window for senior managers to misappropriate shareholders wealth mainly through excessive compensation, improper loans, self-dealing, under performance or shirking as crucial pointers of sinister motives (Wahome, 2009), thus resulting low investor confidence levels (NSE, 2009).

One of the most recent irregularities in Kenya involved Nyagah Stockbrokers. A stockbrokerage firm put on statutory management in 2008 after failing to meet its

financial obligations. Consequently, over 25,000 investors lost vast amounts of money, lodging claims to the Capital Markets Authority for compensation through the Investor Compensation Funds (ICF). The CMA spent Shs 302 million to pay investors a maximum of Shs50, 000, since the State cannot afford to compensate the full amount invested, Nyagah stockbrokers top management (owners and directors) assets must be sold in order to compensate each and every investor of the firm. PricewaterhouseCoopers (PwC) reported the firm might have gone down with about Shs1.3billion of public funds and in addition to this diversion of funds by management, fraud by the staff, occurrences of collusion by other stockbrokers in the NSE, and even office of the regulator (Musyoka, 2009).

However, cases of capital market fraud and collapses are still on the rise, with firms implementing corporate governance practices at varying degrees (Mwangi, 2009). The failure by some firms in the exchange to comply with required corporate governance mechanism is like to reduce investor confidence and equity investment flows into the financial market, in the face of global competition for foreign capital investments.

The concept of capital structure as used in Kenya refers not only to choices regarding capital structure (or the mix debt/equity) but also to the kind of securities used to structure the equity and the debt that is influenced by the outside context. In other words, it attempts to understand why certain choices regarding debt and equity are made (capital structure in a strict sense), while observing the ownership structure and debt structures. For this reason, some authors don't believe it is justifiable to analyze only capital structure as the mix of debt and equity, since it is strictly related to other aspects concerning the structure of equity and debt (Fluck, 1998, Heinrich, 2000).

Relation between capital structure and corporate governance becomes extremely important when considering its fundamental role in value generation and distribution (Bhagat and Jefferis, 2002). Through its interaction with other instruments of corporate governance, firm capital structure becomes capable of protecting an efficient value creation process, by establishing the ways in which the generated value is later distributed (Zingales, 1998); in other words the surplus created is influenced (Zingales, 2000).

Therefore, the relation between capital structure and value could be set up differently if it were mediated or moderated by corporate governance. Nonetheless, capital structure could also intervene or interact in the relation between corporate governance and value. In this manner a complementarity relationship, or one where substitution is possible, could emerge between capital structure and other corporate governance variables. Debt could have a marginal role of disciplining management when there is a shareholder participating in ownership or when there is state participation. To the contrary, when other forms of discipline are lacking in the governance structure, capital structure could be exactly the mechanism capable of protecting efficient corporate governance, while preserving firm value (Rocca, 2007).

2.11 Discussion on the Motivation of the study

Any study pertaining to corporate governance by itself cannot be isolated. The isolation needs to be avoided if the study relates to the other fields of finance generally, and with corporate finance in particular. In the case of investigating the corporate governance, it is important to take into consideration the interaction with other important variables that determine value creation. In this study, the capital structure decision has been chosen, as leverage, may itself act as a mediating variable. The capital structure study is also one of the important areas that are continuously debated in the corporate finance field, especially its relation with firm value. In addition, the problems of endogeneity and causal relationships have always been raised in the discussion of the relationships between two of these variables; between corporate governance and capital structure; between corporate governance and firm value; or between capital structure and firm value. Hence, it is important to empirically investigate the interrelationships between them, as these three variables are highly significant to corporations, and play a pivotal role in corporate decision making.

Existing literatures discussed in section 2.1 until 2.11 provide evidence of the relationships between corporate governance mechanisms and firm value, between corporate governance and capital structure, between capital structure and firm value, and

the relationship among these three variables. This study attempts to extend knowledge of how these three variables interact. Hence, the major aim of this study is to investigate whether there is a dynamic interrelationship between these three variables. Specific objectives of this study are to: investigate whether there is a causal relationship between corporate governance and firm value, between corporate governance devices and capital structure, and between capital structure and firm value; by taking into account endogeneity issues; numerous studies in corporate finance examine the interrelationships between corporate governance, capital structure and firm value. However, most of the existing literature investigates direct relationship among these three variables. If an investigation on the causal relationship is being conducted, it only considers the relationship between two of these variables at a time, ignoring the interaction that might exist between them. As it becomes apparent that corporate governance, capital structure and firm value are interrelated; this study plans to fill the gap by directly investigating the causal relationships between them, by taking into account endogeneity issues. Thus, the proposed study will make an original contribution to the literature as it will comprehensively investigate the interaction between these three variables.

This study has significant practical importance as the findings of the study will empirically and theoretically suggest which one out of these three variables that should be given priority in corporation's policy of decision making and the best monitoring mechanism that should be taken into consideration by corporations. As such, this study considers answering questions that have received important attention in the literature and significant policy consequences. Corporate governance monitoring mechanisms and capital structure are part of corporate governance structure. Bhagat and Bolton (2008) suggested the endogenous relationship between corporate governance and firm performance that might need an explanation on the causality issue. From the review of past research pertaining to the monitoring role played by equity blockholders, roles of leverage as one of the monitoring mechanisms as well as its affect on firm value, and the impact of the firm value on both variables, there are no extensive studies that have been conducted to investigate the relationships between these three variables at the time. The present study is expected to contribute to the ongoing debate about the endogeneity

and causal relationship issues between these three variables. Figure 2.1 shows the proposed theoretical framework of this study.

2.12 Summary of Literature Review

In summary, the literature review has attempted to trace the theoretical underpinnings on the relation between capital structure, corporate governance and firm value. Capital structure represents one of many instruments that can preserve corporate governance efficiency and protect its ability to create value. This is particularly true as most of the previous empirical studies have been quite incomplete, in that they stop at the analysis of how single governance mechanisms create value instead of investigating the results of a concerted application of different ones all together. Therefore, the review affirms that if investment policies allow for value creation, financing policies, together with other governance instruments, can assure that investment policies are carried out efficiently while firm value is protected from opportunistic behavior. In other words, a number of authors (Borsch-Supan and Koke, 2000, Bhagat and Jefferis, 2002 and Berger and Patti, 2003) point out the necessity to analyze the relation between capital structure and value by always taking into consideration the interaction between corporate governance variables such as ownership concentration, management participation in the equity capital, the composition of the Board of Directors.

CHAPTER THREE

3.0 RESEARCH METHODOLOGY

3.1 Introduction

This chapter sets out various stages and phases that were followed in completing the study. It involves a blueprint for the collection, measurement and analysis of data. In this section the research identified the procedures and techniques that were used in the collection of the information on study constructs. The chapter also presented the processing and analysis procedure of the data. Specifically the following subsections were included; Research Design, Target Population, Data Collection instruments, Data Collection Procedures, Data Reliability and Validity and Data Analysis.

3.2 Research Design

Research design is a plan, blue print or guide for data collection and interpretation (Adams and Shvaneveldt (1991), Talbot and Edwards (1994). In this study the cross-sectional descriptive survey design was used. Descriptive research involves acquiring information about one or more groups of people – perhaps about their characteristics, opinions, attitudes, or previous experiences – by asking them questions and summarizes their responses with percentages, frequency counts, or more sophisticated statistical indexes; and then draws inferences about a particular population from the responses of a representative sample (Mugenda and Mugenda, 1999). Cross-sectional survey designs survey a single group of respondents at a single point in time.

3.3 Population

The population for this study covered the public quoted companies on the Nairobi Stock Exchange from year 2005 to 2009. This period is considered long enough to provide sufficient data to assist in estimating a reliable regression models for the study.

3.4 Data Collection

Both primary and secondary data were used for this study. The former was collected from CEOs of listed companies while the latter was collected from annual financial statements

of target firms. The researcher used a validated semi-structured questionnaire for primary data survey. Drop and pick latter approach was adopted. Data on the following variables are to be collected:

- i. CG variables to include; board independence, CEO duality, audit committee independence and equity blockholders.
- ii. Leverage is to be measured using debt to equity ratio (ratio of long-term debt to equity).
- iii. Firm value will be measured using Tobin's Q, defined by $Tobin's\ Q = (MVE + PS + DEBT)/TA$.
- iv. Control variables to include log of total assets, stock return, and ROA.

3.5 Data Analysis

Initial investigation of the issue raised in this study employed basic ordinary least square (OLS) regression which is fairly standard in exploring relationships between two sets of variables such as firm value and leverage, firm value and ownership, and leverage and ownership. This regression also allowed for the potential endogeneity, where generally if the explanatory variables are correlated with the equation's error term ϵ_i , these variables are said to be endogenous (Verbeek 2008). This study may also consider using Hausman test for endogeneity and the Anderson-Rubin test for the joint significance of the set of endogenous variables in the equations system (Bhagat and Bolton 2008).

The OLS regression model can be expanded to include interaction effects of leverage and corporate governance on firm value. To further investigate the dynamics of the relationships and in order to the objective, this study follows Bhagat and Bolton (2008), which suggests the formulation of the following system of Ordinary Least Squares equation:

$$Tobin\ Q = f_1 (CG, Leverage, Z_i, \epsilon_1) \dots \dots \dots (1)$$

Where:

- i. Tobin's Q will be used to measure both the firm value and the capital structure
- ii. CG is the vector of corporate governance variables viz; board independence, CEO duality, audit committee independence and equity blockholders.
 - a. Board independence is measured by two dummy variables, the first taking a value of 1 if the board of directors is comprised of majority of non-executive directors and 0 otherwise.
 - b. CEO duality takes value of 1 if the roles of the chairperson and CEO are separated and 0 otherwise.
 - c. Audit committee independence takes the value of 1 when the committee is comprised of a majority of non-executive directors and 0 otherwise.
 - d. Equity blockholders is as shareholders who hold at least 5% of the firm shares.
- iii. Leverage is to be measured using debt to equity ratio (ratio of long-term debt to equity).
- iv. Z_i are the control variables vectors: Control variables to include log of total assets, stock return, and ROA.
- v. ε_i are the residual error terms.

Causality means the direction of influence. Hence, the Granger Causality Test will be conducted on the regression model. But before conducting the Granger Causality Test, tests for unit (Augmented Dickey-Fuller test or Phillips-Perron test) and for co-integration (The Augmented Engle-Granger test or Co-integrating Regression Durbin-Watson) will be done for the variables used in this study. In addition, the Akaike or Schwarz information criterion will be used to identify the number of lags for the co-integration test.

3.6 Data Reliability and Validity

Reliability is a measure of the degree to which measures will yield the consistent results, free from error (Garson, 2002). Reliability is the ratio of the true measure to the observed (true plus error) measure. It is a necessary but not sufficient condition for validity. Error

may affect the observed measure through the methodology used (method error) and randomly (random error). When random error is due to random traits of the subjects it may also be called trait error. The extent of error may be detected by examining the data for reliability. The results of the main survey were analyzed for internal consistency, using Cronbach's alpha method. In addition, confirmatory factor analysis and structural equation modelling was used to test internal consistency.

Internal validity refers to the extent to which variables other than the independent variables may be responsible for some or all of the observed effects on the dependent variable. The control variables listed in 3.6 was used to promote internal validity. Another potential threat to internal validity is evaluation apprehension. Evaluation apprehension is the natural reluctance of test subjects to share information about their beliefs and activities, and to provide self-aggrandizing answers. This was minimized by excluding any potentially emotion-laden or value-laden questions from the test instrument.

Construct validity depends on the clarity of the operational definition of the constructs (Garson, 2002). Clarity of definition allows specific indicators to be selected for the constructs. Statistical tests also conducted to test that the items selected for each construct are at least moderately correlated among themselves (convergent validity) and that for different constructs items are not so highly correlated as to conclude they measure a similar construct (discriminant validity) (Garson, 2002).

Content validity refers to the degree to which the items of the measure represent a proper sample of the theoretical content of the construct (Nunnally and Bernstein, 1994). Content validity was promoted in this study by conducting pilot study to modify the test instrument to advance only those items that related to the content they seek to measure.

Statistical validity is concerned with the conclusions drawn from the research (Garson, 2002). Type I errors (rejection of the null hypotheses and acceptance of a non-existing relationship) was minimized in this study by testing a priori hypotheses, rather than

attempting to fit data to a large number of possible relationships posterior in search for significance. Statistical significance tests was reported despite the suggestion by some that doing so may be detrimental or even dangerous to scientific progress (for a list of researchers, see Armstrong, 2007). Statistical significance measures the probability of the data given the null hypothesis, and not the converse. If a sufficiently large sample size is used almost any variable may be found to be significant. The effect size, however, may be so small that the magnitude of the relationship is insubstantial. Therefore, this study generally report both the risks of Type II error as well as Type I error.

CHAPTER FOUR

4.0 DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents the data findings and analysis on the mediation role of corporate governance on the relationship between capital structure and firm value of firms listed at the NSE. The study targeted all 45 firms that had consistently operated in the NSE from 2005 to 2009.

4.2 Practicing Corporate Governance Standards.

Table 1: Company consistence in practicing corporate governance standards

Indicators	2005	2006	2007	2008	2009	Average
There exist an operational audit committee	100.00	100.00	100.0	100.00	100.0	100.0
The audit committee is comprised entirely of non executive directors	35.60	42.20	35.60	37.80	40.00	38.24
The audit committee is comprised of majority of non executive directors	64.40	57.80	46.70	62.20	60.00	58.22
Indicate the percentage of independent non executive managers in the audit committee who are not managers in other firms	35.00	35.00	35.00	35.00	35.00	35.00
Does one member of the audit have financial expertise	100.00	100.00	100.0	100.00	100.0	100.0
Number of committee meeting held during the year was more than two	100.00	100.00	100.0	100.00	100.0	100.0
Please indicate whether the audit committee is responsible for the oversight of both the financial statement and external audit	100.00	100.00	100.0	100.00	100.0	100.0

supervision						
The company employs the service of renowned auditors	100.00	100.00	100.0	100.00	100.0	100.0
Board of directors is comprised of a majority of non executive directors	100.00	100.00	100.0	100.00	100.0	100.0
Chairman and CEO roles are separate	100.00	100.00	100.0	100.00	100.0	100.0
Indicate the ration of stock options held by non executive directors	33.30	35.00	33.00	36.00	30.00	33.46
Indicate the percentage of independent executive managers in the board	33.30	38.00	31.00	30.00	30.00	32.46

Source, Research Data

The study sought to establish whether companies listed at NSE were consistent in practicing corporate governance standards. The results were on various indicators of corporate governance shown in the table above. From the result, the study found that in all the companies, there exist an operational audit committee. In 38.24% of the companies, the audit committee is comprised entirely of non executive directors, 58.22% of the companies' audit committee is comprised of a majority of non executive directors, 35% of the companies indicate the percentage of independent non executive managers in the audit committee who are not managers in other firms. All the companies have one member of the audit committee with financial expertise, the number of committee meetings held during the year was more than two, the audit committee is responsible for the oversight of both the financial statement and external audit supervision, the company employs the service of renowned auditors, the Board of directors is comprised of a majority of non executive directors and the Chairman and CEO roles are separate.

Further, the study found that 33.46% of the companies indicate the ratio of stock options held by non executive directors and 32.46% indicate the percentage of independent executive managers in the board.

4.3 Tobin Q of the Firms.

The study calculated the Tobin Q of firms listed at NSE,

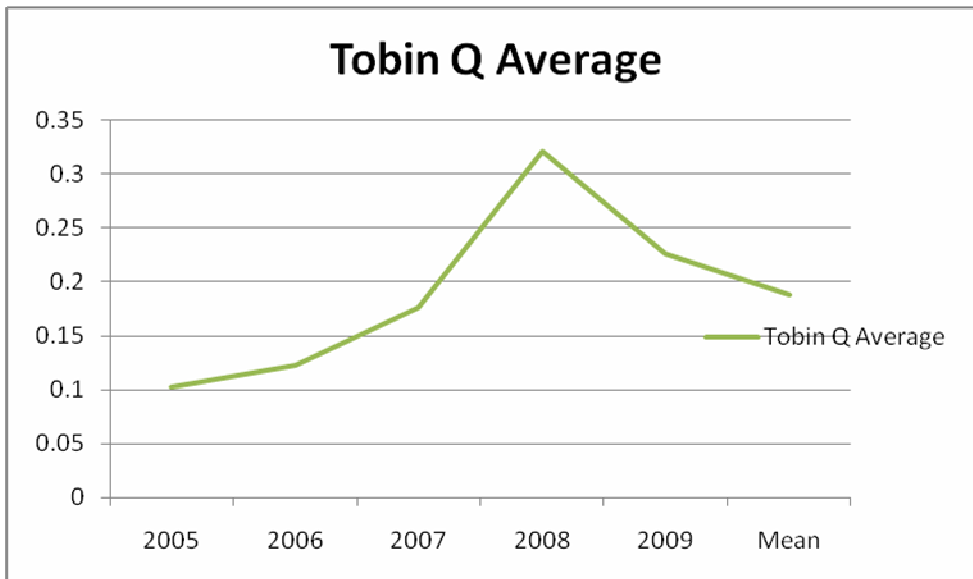
Table 2: Tobin Q of firms listed at NSE.

Firms listed at NSE	2005	2006	2007	2008	2009	Mean	Min	Max
Tobin Q Average	0.1325	0.1834	0.1657	0.3162	0.2423	0.1592	0.1325	0.3162

Source, Research Data

According to table above, the Q-ratio of all the companies were below 1. Since the Tobin's q is less than 1, then the market value is less than the recorded value of the assets of the company which suggests that the market may be undervaluing the firms listed at NSE. The same is presented in the figure below:

Figure 2: Tobin Q of firms listed at NSE



Source, Research Data

Taking a look at the variations in the Q ratio it shows that from year 2005 the Tobin Q increased up to the peak which was realized in year 2008 suggesting that firm were increasingly becoming valued only to fall in year 2009 tough slightly.

Table 3: Variation in the Tobin Q

Sector	2005	2006	2007	2008	2009	STDEV	GROUP
Agricultural	0.0734	0.2216	0.5723	0.3423	-0.0343	0.1034	Mixed
Commercial and services	0.1853	0.0932	0.2342	0.0423	-0.1473	0.3692	Mixed
Finance and investment	0.0924	0.1185	0.1673	-0.0345	-0.1753	0.0929	Mixed
Industrial and allied	0.2174	0.1433	0.3123	0.0184	-0.0836	1.0823	Mixed

Source, Research Data

Table 2 above shows that the variations in the companies Tobin Q were both positive and negative which point out that the companies could only fit in the mixed group meaning that the market valuation of the companies fluctuated over the years and were not consistent in their direction nor their magnitude.

Table 4: Price to book value of the companies

Year	Agricultural	Commercial and services	Finance and investment	Industrial and allied
2005	1.45	4.33	8.32	5.22
2006	4.49	6.23	21.54	1.79
2007	2.46	2.43	4.43	4.83
2008	1.83	7.58	12.05	3.67
2009	4.39	2.84	8.24	1.43
Average	2.92	4.68	10.92	3.39
Minimum	1.45	2.43	4.43	1.43
Maximum	4.49	7.58	21.54	5.22

Source, Research Data

The study further sought to establish the price-to-book value of the listed companies. The price-to-book value was a function of the ratio of market capitalization to the asset value of the companies. Price-to-book value measures the proportion of a company that can be claimed by the shareholders if the company is liquidated at that time. From the table above, the price-to-book values of the companies were above 1 meaning that the market values of the companies' equity were greater than the value of the net of their total recorded assets.

4.4 Regression Analysis

The study further regressed price-to-book values against corporate governance and presented the findings in the table below.

Table 5: Coefficients results

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	4.833	3.156		1.839	.017
	Board independence	1.771	.061	.017	.097	.038
	CEO duality	0.986	.038	.024	.061	.023
	Audit committee independence	2.358	.311	.011	.090	.078
	Equity block holders	0.116	.018	.023	.094	.023

Source, Research Data

Predictors: (Constant), Board independence, CEO duality, Audit committee independence and Equity block holders.

From the data in the above table, there is a positive relationship between price-to-book values of the companies and Board independence, CEO duality, Audit committee independence and Equity block holders. The study thus established regression equation to be:

$$\text{Tobin Q} = 4.833 + 1.771 \text{ Board independence} + 0.986 \text{ CEO duality} + 2.358 \text{ Audit committee independence} + 0.116 \text{ Equity block holders.}$$

From the above regression model, it was found that price-to-book values would be at 4.833 holding Board independence, CEO duality, Audit committee independence and Equity block holders constant at zero. A unit increase in Board independence would lead to increase in price-to-book by factor of 1.771, also unit increase in CEO duality would lead to increase in firms market performance by factor of 0.986, a unit increase in Audit committee independence would result to increase in firms market performance by a factor of 2.358, also unit increase in Equity block holders would result to increase in firms

market performance by factor of 0.116. This information shows that Board independence, CEO duality, Audit committee independence and Equity block holders affect the market performance, with the highest being that of Audit committee independence.

Table 6: Model Summary for 2004

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df1	df2	Sig. F Change
1	.580(a)	.336	.321	4.223	.009	.009	1	1	.248

Source, Research Data

Predictors: (Constant), Board independence, CEO duality, Audit committee independence and Equity block holders.

Adjusted R^2 is called the coefficient of determination and tells us how the firms' market performance varied with variation in Board independence, CEO duality, Audit committee independence and Equity block holders. From table above, the value of adjusted R^2 is 0.321. This implies that, there was a variation of 32.1% of firms' market performance with Board independence, CEO duality, Audit committee independence and Equity block holders at a confidence level of 95%. This means that 32.1% of the firms' market performance is attributable to the corporate government practices at the company. However, the model was insignificant in the prediction as the f significance was 24.8 meaning that the model might be 24.8 wrong in its prediction.

Table 7: Corporate governance scores

Year	Board independence	CEO duality	Audit committee independence	Equity block holders
2005	0.75	0.77	0.96	143.00
2006	0.82	0.88	0.92	151.00
2007	0.71	0.87	0.98	149.00
2008	0.76	0.84	0.94	147.00
2009	0.73	0.85	0.92	150.00
Average	0.75	0.84	0.95	148.00

Source, Research Data

The table above presents the corporate government scores for the companies. In most of the companies, the board of directors is comprised of majority of non-executive directors as shown by an average of 0.75, the roles of the chairperson and CEO are separated as shown by an average of 0.84, the Audit committee is comprised of a majority of non-executive directors as shown by an average of 0.95 and in most of them Equity blockholders average of 148.

4.5 Relationship between leverage and corporate governance**Table 8: Relationship between Leverage and Corporate Governance**

	Unstandardized Coefficients (B)	Std. Error	Standardized Coefficients (Beta)	t	Sig.
(Constant)	15.95558	13.41551		1.189	0.32
Corporate governance	19.0025	16.32038	-0.55789	-1.164	0.328

Table above shows that there was a positive relationship between leverage and corporate governance of the firm listed at NSE; this shows that an increase in corporate governance results to increase in leverage by a factor of 19.0025.

In order to establish the interaction between effects of leverage and corporate governance on firm value the study carried out a regression analysis, the results are shown in the table below.

Table 9: Leverage, corporate governance and firm value

	Unstandardized Coefficients (B)	Std. Error	Standardized Coefficients - Beta	t	Sig.
(Constant)	5.074	16.239		0.312	0.775
Corporate governance	0.080	0.572	0.081	0.140	0.897
Leverage	-0.693	0.169	-1.170	-4.109	0.026
Log of total assets	0.283	0.1476	0.0987	0.1916	0.8603
Stock return	0.339	0.202	0.477	1.674	0.193
ROA	0.681	24.067	0.135	0.236	0.829

The established regression equation for the study was:

$$\text{Tobin Q} = 5.074 + 0.080 \text{ CG} - 0.693 \text{ leverage} + 0.283 \text{ log of total assets} + 0.339 \text{ stock return} + 0.681 \text{ROA}$$

From the above regression equation the study found that holding corporate governance, leverage, log of total assets (size), stock return and ROA to a constant zero, firm value would stand at 5.074. The study further revealed that firm value had a positive relationship with corporate governance, size of the firm, stock return and ROA, while it had a negative relationship with leverage.

CHAPTER FIVE

5.0 SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter presents the discussions drawn from the data findings analyzed and presented in the chapter four. The study was conducted by use of secondary sources such as published reports. Data was then tallied by computing percentages of variations in response as well as describing and interpreting the data in line with the study objectives and assumptions through use of statistical package for social sciences (SPSS) version 17.0. The chapter is structured into discussions, conclusions, recommendations and areas for further research.

5.2 Summary and Conclusions

The study findings show that companies listed at NSE were consistence in practicing in practicing corporate governance standards with all of them having an operational audit committee, one member of the audit with financial expertise, the number of committee meeting held's during the year was more than two, the audit committee is responsible for the oversight of both the financial statement and external audit supervision, the company employs the service of renowned auditors, the Board of directors is comprised of a majority of non executive directors and the Chairman and CEO roles are separate.

The findings shows that the market value is less than the recorded value of the assets of the company since the Q-ratio of all the companies were below one which suggests that the market may be undervaluing the firms listed at NSE. The variations in the Q ratio it shows that from year 2005 the Tobin Q increased up to the peak which was realized in year 2008 suggesting that firm were increasing becoming valued only to fall in year 2009 tough slightly.

The findings also show that the variations in the companies Tobin Q were both positive and negative which point out that the companies could only fit in the mixed group

meaning that the market valuation of the companies fluctuated over the years and were not consistent in their direction nor their magnitude. From the study findings, the price-to-book values of the companies were above 1 meaning that the market values of the companies' equity were greater than the value of the net of their total recorded assets.

The study thus established regression equation to be:

$$\text{Tobin Q} = 4.833 + 1.771 \text{ Board independence} + 0.986 \text{ CEO duality} + 2.358 \text{ Audit committee independence} + 0.116 \text{ Equity block holders.}$$

The results clearly show a positive and significant relationship between the corporate governance scores and Tobin's Q. The findings shows that Board independence, CEO duality, Audit committee independence and Equity block holders affect the market performance, with the highest being that of Audit committee independence.

The study found that, there was a variation of 32.1% of firms' market performance with Board independence, CEO duality, Audit committee independence and Equity block holders at a confidence level of 95%. This means that 32.1% of the firms' market performance is attributable to the corporate government practices at the company. In most of the companies, the board of directors is comprised of majority of non-executive directors, the roles of the chairperson and CEO are separated, Audit committee is comprised of a majority of non-executive directors and in most of them Equity block holders. In order to establish the interaction between effects of leverage and corporate governance on firm value the study carried out a regression analysis. The established regression equation for the study was:

$$\text{Tobin Q} = 5.074 + 0.080 \text{ CG} - 0.693 \text{ leverage} + 0.283 \text{ log of total assets} + 0.339 \text{ stock return} + 0.681 \text{ ROA}$$

From the above regression equation the study found that holding corporate governance, leverage, log of total assets (size), stock return and ROA to a constant zero firm value would stand at 5.074. The study further revealed that firm value had a positive relationship with corporate governance, size of the firm, stock return and ROA, while it had a negative relationship with leverage.

All the corporate governance mechanisms have an influence on the firm value and capital structure as shown by the Tobin Q. The study found that the corporate governance mechanisms have to be considered in understanding that capital structure influence firm value. The study found a theoretical approach that can contribute in clearing up the relation between capital structure, corporate governance and value, while they also promote a more precise design for empirical research. Capital structure represents one of many instruments that can preserve corporate governance efficiency and protect its ability to create value.

Further the study found that management voluntarily chooses to use debt as a source of financing to reduce problems of information asymmetry and transaction, maximizing the efficiency of its firm governance decisions, or the increase in the debt level is forced by the stockholders as an instrument to discipline behavior and assure good corporate governance, capital structure is influenced by corporate governance.

Furthermore, the relation between capital structure and corporate governance becomes extremely important when considering its fundamental role in value generation and distribution. Through its interaction with other instruments of corporate governance, firm capital structure becomes capable of protecting an efficient value creation process, by establishing the ways in which the generated value is later distributed.

The study revealed that there is a positive corporate governance and Tobin Q. Based on the study findings and conclusion, the study recommends that there should increase board compositions if the situation requires transparency and accountability. The study point out the necessity to analyze the relation between capital structure and value by always taking into consideration the interaction between corporate governance variables such as oard independence, CEO duality, Audit committee independence and Equity block holders. From the above discussion conclusion the study recommends that for companies to have better market performances should adopt better corporate governance practices since corporate governance practices affects the firm value of firms. The study

recommends that leverage of firms should be maintained at lower value as it negatively affect firm value.

5.3 Limitations of the Study

A limitation for the purpose of this research was regarded as a factor that was present and contributed to the researcher getting either inadequate information or responses or if otherwise the response given would have been totally different from what the researcher expected. The main limitations of this study were: Data collection was done from 33 out of the targeted 45 firms. Twelve firms did not respond. This reduced the population from where research data was collected. Perhaps with a higher population, the conclusion would have been different.

The time limit designed for completion of this study was quite short and some of the questionnaires were filled through interview. Some respondents perhaps did not give objective answers due to lack of preparation.

The targeted population were quoted companies at the Nairobi Stock Exchange. This excludes unquoted companies. The findings therefore may not have universal application to all companies in Kenya.

The study used Ordinary least Squares Regression analysis to measure relationships of the variables. Use of other measures of relationships may give findings different from the results obtained in this study.

5.4 Suggestions for Further Research

The relationship that came out in as far as performance is concerned was that there is a positive relationship between corporate governance and firm value. More studies should be conducted with larger samples to investigate moderating role of corporate governance on the relation between capital structure and firm value.

The researcher recommends that further studies should be done on the effect of corporate governance structures and practices on the financial performance of other institutions other than the companies listed in NSE since other firms have a different environment from the ones studied.

Further studies should also be done on the challenges of corporate governance and the effect of these challenges on the financial performance of the firms in Kenya.

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APPENDIX I: QUESTIONNAIRE

Firm name.....

Industry.....

Please indicate whether or not your company has consistently been practicing the following corporate governance standards for the years indicated.

	Indicator	2005	2006	2007	2008	2009
		1 2	1 2	1 2	1 2	1 2
1	There exist an operational audit committee (Indicate 1 if yes, 2 if otherwise).					
2	The audit committee is comprised entirely of non-executive directors (Indicate 1 if yes, 2 if otherwise).					
3	The audit committee is comprised of a majority of non-executive directors (Indicate 1 if yes, 2 if otherwise).					
5	Indicate the percentage of independent non-executive managers in the audit committee who are not managers in other firms					
6	Does (at least) one member of the audit committee have financial expertise? (Indicate 1 if yes, 2 if otherwise).					
7	Please indicate if the number of committee meetings held during the year was more than two (Indicate 1 if yes, 2 if otherwise).					
8	Please indicate whether the audit committee is					

	responsible for the oversight of both the financial statements and the external audit supervision (Indicate 1 if yes, 2 if otherwise).					
9	The company employs the services of renowned auditor(s) (Indicate 1 if yes, 2 if otherwise).					
	Board of Directors					
10	Board of directors is comprised of a majority of non-executive directors (indicate 1 if yes, 2 if otherwise).					
11	Chairman and CEO roles are separate (indicate 1 if yes, 2 if otherwise).					
12	Indicate the ratio of stock options held by non-executive directors					
13	Indicate the percentage of independent non-executive managers in the board					
	Block holders					
14	% of shareholders who hold at least 5% of the firm shares.					

APPENDIX II: SECONDARY DATA COLLECTION SHEET

	2005	2006	2007	2008	2009
Short-term debt/liabilities					
Long-term debt/liabilities					
Total liabilities					
Share price					
Total assets					
Book value of shareholders' equity					
Common stock shares outstanding					
Outstanding preferred stock					
Stock returns					
Return on assets					