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Corporate governance, capital structure and firm performance: Evidence from Thailand

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ABSTRACT

We examine the relationship between corporate governance and firm performance for a panel sample of 493 firms of non-financial firms in Thailand during the period 2001–2014. We find that for the full sample, corporate governance is not associated with financial leverage and firm performance. Leverage has a positive effect on firm performance. When we split firms into small and large firm subsamples, we observe some influence of corporate governance. The negative effect of audit committee size on firm performance is evident for large firms while the effect of audit reputation on firm performance is evident for small firms only. Furthermore, financial leverage mediates the effect of audit committee size on firm performance for the large firms.

1. Introduction

Is financial leverage a mediating variable between corporate governance and firm performance? To the best of our knowledge, this question has not been addressed in the literature. The extant literature focuses mainly on (1) the effect of corporate governance on firm performance (Chen et al., 2005; Hossain et al., 2001), (2) the effect of corporate governance on financial leverage (Connelly et al., 2012; Jiraporn et al., 2012), and (3) the effect of financial leverage on firm performance (González, 2013; Vithessonthi and Tongurai, 2015). Addressing the question of whether financial leverage mediates the effect of corporate governance on firm performance is important for the following reasons. First, corporate governance may not have a direct effect on firm performance. If the influence of corporate governance on firm performance is indirect, examining the mediating effect of financial leverage on firm performance could explain the mixed results regarding the effect of corporate governance on firm performance. Second, by looking at financial leverage as one of potential mediators, we would have a better understanding of how changes in corporate governance may affect firm performance.

Without good corporate governance, a country may experience a crisis. For instance, when many firms become too leveraged and/or have a high level of short-term debt (e.g., due to weak corporate governance practices/systems), a financial crisis may occur. The Asian Financial Crisis of 1997 and the Global Financial Crisis of 2007 are two prime examples of a financial crisis arguably originating from the firms' financing decisions. The literature on the effect of corporate governance and firm performance has been expanding in recent years. While some studies (Bhagat and Bolton, 2008; Duffhues and Kabir, 2008; Yang and Zhao, 2014) indicate that there is a direct relationship between these two variables, several studies show the indirect effect of corporate governance on firm performance. For example, Mcdonald et al. (2008) find that CEOs' external advice network mediates the effect of CEO stock

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ownership on firm performance for a sample of US firms. Zhang et al. (2014) find that research and development (R & D) investment mediates the relationship between ownership concentration and firm performance for a sample of Chinese IT firms.

It is important to note that firms behave differently, depending on the context in which they operate. For example, the one-tier board model is adopted in the US whereas the two-tier board model is used in countries such as Germany. Historically, the one-tier board system has been used in Thailand, but there is an ongoing discussion of a change from the one-tier board system to the two-tier board system. Laws and regulations arguably play an important role in shaping the firm's behaviors. Unlike the US where firms have to comply with different sets of laws and regulations at the state and the federal levels, firms in Thailand generally have to comply with laws and regulations at a country level. Therefore, it can be argued that at any point in time, firms in Thailand deal with a less diverse set of laws and regulations than those in the US.

We have two primary objectives in this paper. First, we examine the influence of corporate governance on financial leverage and firm performance in an emerging market country that has undertaken several reforms following a financial crisis. Second, we investigate whether financial leverage mediates the relationship between corporate governance and firm performance. To address the two objectives, we examine a sample of publicly listed firms in Thailand for three reasons. First, Thailand has implemented many reforms following the Asian Financial Crisis in 1997–1998. Thailand began its corporate governance reforms process by requiring and recommending a series of good corporate governance practices in 2000s. Second, Thailand is one of major emerging market countries in Asia. Third, the listed firms in Thailand operate in one-tier board system. In many ways, the development of corporate government systems in Thailand follows that of Hong Kong, which is one of emerging market countries in Asia. In the context of studies on corporate governance in Asia, this article is closely related to that of Chen et al. (2005), Connelly et al. (2012), and Prommin et al. (2014).

According to the trade-off theory of capital structure, firms choose the optimal composition of debt in their capital structure in order to maximize the benefits from the interest tax shield (against the costs of future financial distress, which increases with the use of debt financing). One of key reasons for the Asian Financial Crisis of 1997 is that firms became highly leveraged. To demonstrate the potential importance of this issue, we graphically plot a time-series pattern of financial leverage (LEV), measured as the ratio of total debt to total assets, and of firm performance, measured as return on equity (ROE), which is computed as the ratio of earnings before interest and taxes to total equity, for a sample of non-financial listed firms in Thailand over the period 2001–2014 in Fig. 1. As a simple matter of interpretation, Fig. 1 suggests that the average degree of financial leverage has decreased in recent years (i.e., from 32.16% in 2001 to 24.04% in 2014) and that firm performance has deteriorated over the same period (i.e., from 16.67% in 2001 to 11.79% in 2014). This pattern implies a positive relationship between financial leverage and firm performance (that is, as financial leverage decreases, firm performance also declines).

We use a panel data set of non-financial firms in Thailand to empirically test the extent to which financial leverage mediates the relationship between corporate governance and firm performance. With this data set, we apply an OLS regressions estimation technique and use alternative measures of firm performance to assess the robustness of the results. Overall, we contribute to the literature on corporate governance of firms by examining conditions under which corporate governance affects firm performance from a large panel that covers all publicly listed non-financial firms in Thailand during the period 2001–2014. This paper is closely related to prior studies that examine the effect of corporate governance on firm performance in developing economies (e.g., Connelly et al., 2012; Elsayed, 2007; Jackling and Johl, 2009) and to those addressing the similar issue in the context of advanced economies (e.g., Bhagat and Bolton, 2008; Erhardt et al., 2003; Margaritis and Psillaki, 2010).

Several key findings in this article can be briefly summarized as follows. First, the results show that financial leverage partially

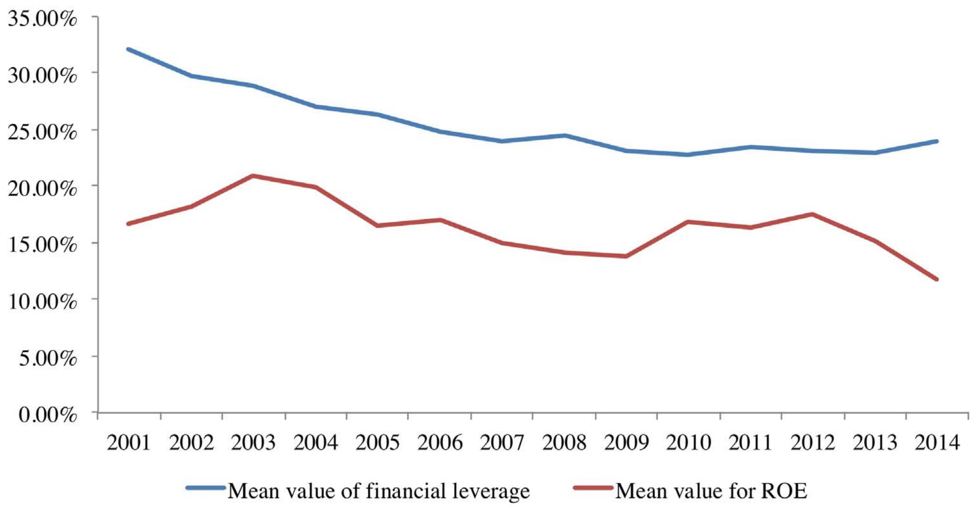

Fig. 1. Financial leverage and firm performance.
This figure presents the yearly time series of the mean values of financial leverage (measured as the ratio of total debt to total assets) and of firm performance (measured as the ratio of earnings before interest and taxes to total equity) from a sample of 3853 firm-year observations over the period 2001–2014.