Corporate Governance Practices and Profitability with Moderating effect of Financing Decisions

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Abstract

The aim of the study is to examine the moderating effect of financing decisions on the relationship between corporate governance practices and the profitability of listed firms in Sri Lanka for the period from 2016 to 2020. For data analysis, 100 listed companies from the food, beverage, tobacco, capital goods, materials, and sectors of consumer services were selected as the sample, and a quantitative method and deductive approach were employed. Board size, board composition, CEO duality, board gender diversity, board meeting, and audit committee were proxies for corporate governance practices while profitability was measured through return on equity and return on assets of listed firms. The moderating variable and financing decisions were measured through long-term debt to total assets whereas firm size and firm age were considered as control variables. Panel data regression analysis was used for data analysis. The empirical findings reveal that board composition and audit committee have a direct negative impact on return on equity. Nevertheless, with the moderating effect of financing decisions, corporate governance variables, CEO duality, board gender diversity, board meetings and audit committee have a positive impact on return on equity. Moreover, the results show that board size and board meetings have a direct positive impact on return on assets. But, when moving to moderating effect of financing decisions, board size, board composition and audit committee have a positive impact on return on assets. However, board meeting has a negative effect.

Keywords: corporate governance, financing decisions, profitability

01. Introduction

Corporate governance (CG) is considered essential in many Asian countries, especially in light of the 1997 financial crisis (Mohamed et al., 2016). Due to the confluence of technical advancement, sociopolitical shifts, and economic trends toward globalization, corporate governance is a subject that gains importance in developing nations. Many businesses undergo substantial changes. The aforementioned financial scandals have increased concern about corporate governance in developing nations, resulting in a need for improved standards (Makhlouf et al., 2018; Kachouri & Jarboui, 2017).

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Several multinational corporations collapsed due to inefficient and ineffective CG (Sorensen & Miller, 2017). Sri Lankan corporations also endured corporate failure. Large organizations namely Pramuka Savings and development bank, Golden key credit card company, Vimukthi Corporation and Lanka Marine Services Ltd collapsed as a result of poor CG practices (Senarathne & Gunarathne, 2008). Hence, it has become imperative to revisit the existing CG mechanisms to investigate their effect on EPVA and recommend ways to bring about changes if necessary. In addition, recent government investigations into the poor CG have implicated a number of public and private companies (e.g., Sri Lankan Air Lines, EAP, and Perpetual Treasury). As a result, all public and private entities, as well as the government and the general public, are interested in learning how Sri Lankan businesses adhere to good corporate governance in their operations.

Merendino and Melville (2018) investigate the board of directors and firm performance of Italian listed companies over the period 2003-2015. Results showed that while independent directors do have a non-linear impact on performance, minority shareholders' ability to nominate directors does not allow them to do so. Lower levels of board size have a positive impact on firm performance. Puni and Anlesinya (2020), examine the influence of corporate governance mechanisms recommended by the Securities and Exchange Commission (SEC) of Ghana on firm performance using a sample of 38 listed firms in Ghana from 2006 to 2018. According to a study, the corporate board's financial performance was enhanced by the inclusion of both insiders and outsiders. Similarly, the board size, board meeting frequency, and shareholder concentration all had a positive effect on financial performance. However, CEO duality had no impact on financial performance, whereas the presence of board committees had a negative impact. However, Wang, Abbasi, Babajide, and Yekini (2019) examine the extent to which board characteristics and ownership structure affect firm performance using a sample of non-financial firms listed on the Pakistan Stock Exchange (PSX)-100 index for the years 2011-2014. The findings indicate that board independence, board diversity, board meetings, and board size do not significantly affect firm performance. Here most of the studies analyze the CG practices' systematic relationship to profitability and don't consider the other aspects such as moderating and mediating effects of variables into account. As a result, it is worthwhile to study what the researchers have previously neglected in order to get new insights into corporate governance (CG) beyond the narrow perspective. Financing decisions play a vital role in the firm's performance making good financing decisions about the financing sources to the company with reasonable risk, cost and , effect on the firm's value has an effect on the firm's profitability in terms of financial expenses. Thus, the financing decisions made by the management change the relationship between corporate governance and profitability. Thus, the study provides the answer to the research question: what is the moderating effect of financing decisions on the relationship between CG practices and profitability of listed companies? Therefore, the objective of the study is to examine the moderating effect of financing decision on the relationship between CG practices and the profitability of the listed companies in Sri Lanka.

02. Research Design

The population has been defined in terms of the number of companies listed under food, beverage and tobacco, material, consumer services, and material sectors on the Colombo Stock Exchange (CSE) for the period from 2016 to 2020. 135 companies, are considered as the population for the study. Researchers selected 100 companies as the sample, based on the availability of the data. The audited annual reports of the selected companies are used as the main secondary sources of data. In order to achieve the purpose of the research, panel data

regression analysis, correlation analysis, and descriptive statistical methods are used. The panel regression model is employed to estimate the association between CG characteristics and profitability with the moderating effect of financing decision.

Table 1: Summary of Sample

No	Sector	No of companies in the population	No of companies in the sample
1	Capital Goods	29	29
2	Food, Beverage & Tobacco	47	22
3	Consumer Services	37	31
4	Materials	22	18
Total		135	100

Table 2: Measurements

Variables	Acronym	Measurement
Corporate Governance		
Board Size	BSIZ	Number of directors on the board
Board Composition	BCOM	$\frac{\text{Independent non} - \text{executive directors}}{\text{total number of directors on the board}}$
Board Gender diversity	BGD	$\frac{\text{Number of Women on Board}}{\text{Total Directors on Board}}$
CEO Duality	CEOD	1 = chairman also holds the position of CEO 0 = Otherwise
Board meeting	BMEET	Number of board meetings
Audit Committee	ACOM	Number of members in Audit committee
Profitability		
Return on Equity	ROE	$\frac{\text{Profitaftertax}}{\text{Shareholder's Equity}}$
Return on Assets	ROA	$\frac{\text{Earnings Before Interest and Tax}}{\text{Total Assets}}$
Moderating Effect		
Long term Debt to total assets	FIDES	$\frac{\text{Longtermdebt}}{\text{totalassets}}$
Control Variables		
Firm size	FSIZE	Natural logarithm of total asset
Firm age	FAGE	Natural logarithm of number of years firm incorporated

To examine the impact of corporate governance practices on firm performance, the following empirical model is used:

$$ROE = \beta_0 + \beta_1 BSIZ + \beta_2 BCOM + \beta_3 BGD + \beta_4 CEOD + \beta_5 BMEET + \beta_6 ACOM + \beta_7 BSIZ \times FIDES + \beta_8 BCOM \times FIDES + \beta_9 CEO \times FIDES + \beta_{10} BMEET \times FIDES + + \beta_{11} ACOM \times FIDES + \beta_{12} FSIZ + \beta_{13} FAGE + \varepsilon$$

$$ROA = \beta_0 + \beta_1 BSIZ + \beta_2 BCOM + \beta_3 BGD + \beta_4 CEOD + \beta_5 BMEET + \beta_6 ACOM + \beta_7 BSIZ \times FIDES + \beta_8 BCOM \times FIDES + \beta_9 CEO \times FIDES + \beta_{10} BMEET \times FIDES + + \beta_{11} ACOM \times FIDES + \beta_{12} FSIZ + \beta_{13} FAGE + \varepsilon$$

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03. Results and Discussion

Table 3: Descriptive Statistics

	Mean	Median	Maximum	Minimum	Std. Dev.
BSIZ	8.208	8.000	15.000	3.000	2.231
BCOM	0.395	0.400	1.000	0.182	0.109
BGD	0.082	0.071	0.667	0.000	0.105
CEOD	0.880	1.000	1.000	0.000	0.325
BMEET	5.268	4.000	14.000	2.000	2.797
ACOM	3.186	3.000	6.000	2.000	0.721
FSIZ	8.239	8.617	10.568	5.508	1.380
FAGE	1.389	1.000	2.000	0.000	0.278
ROE	0.076	0.061	0.461	-0.332	1.261
ROA	0.087	0.084	0.442	-0.451	5.075
LDTA	0.061	0.013	0.458	0.000	0.091

Table 3 shows the descriptive statistics of corporate governance practices, profitability, and firm variables. The average ROE of the listed firm is 0.076 and ROA is 0.087. The average long-term debt to total assets (LDTA) in the listed firms in Sri Lanka is 0.061 within the range between 0.458 and 0.000. Board size (BSIZ) for the Sri Lankan selected firms averaged 8 members among them 39.5% of directors are independent non-executive directors. Board gender diversity (BGD) ranges from 0 to 0.667 and the mean value is 0.082. CEO duality (CEOD) has a mean value of 0.880. Board meeting (BMEET) has a standard deviation of 2.797 with ranges from 2 to 14. The mean value of the audit committee (ACOM) is 3.186, which ranges from 2 to 6. Firm size (FSIZ) has a mean value of 8.239 and firm age (FAGE) has a mean value of 1.389. Firms have an average of 8 directors among them 39% of directors are independent. While 8% of directors are women on board. During the financial year average of 5 board meetings are held. In the firm's performance, the average return on equity is 7.6% and the return on assets is 8.7% of the sample firms.

Table 4: Correlation Analysis

Variable	BSIZE	BCOM	BGED	CEOD	BMEET	ACOM	FSIZ	FAGE	ROE	ROA
BCOM	-0.20**									
	0.00									
BGEN	-0.02	-0.03								
	0.62	0.38								
CEOD	0.03	-0.13**	0.06							
	0.372	0.001	0.160							
BMEET	0.06	0.10**	-0.05	0.12**						
	0.126	0.023	0.204	0.004						
ACOM	0.26**	0.05	-0.11	0.21**	0.14**					
	0.000	0.262	0.012	0.000	0.001					
FSIZ	0.113**	-0.082	-0.082	0.033	-0.062	0.034				
	0.010	0.064	0.066	0.449	0.166	0.443				
FAGE	-0.04	0.09**	0.23**	-0.044	0.027	0.100**	0.049			
	0.265	0.031	0.000	0.316	0.546	0.024	0.271			
ROE	-0.03	-0.05**	0.04	-0.013	-0.01	0.04**	0.06	0.03		
	0.380	0.042	0.352	0.763	0.696	0.021	0.029	0.476		
ROA	-0.02	-0.07	-0.001	-0.01	0.008	-0.03**	-0.05	0.07	-0.01	

	0.546	0.115	0.978	0.668	0.850	0.04	0.198	0.099	0.694	
LDTA	0.14**	0.04	-0.14**	-0.11**	0.17**	0.29**	0.09**	0.18**	0.04	0.01
	0.001	0.305	0.001	0.010	0.000	0.00	0.034	0.00	0.32	0.79

**Significant at 5%

Table 4 shows the Pearson correlation coefficient between CG practices and the profitability of listed companies in Sri Lanka. According to the findings, the correlation coefficient between BCOM and ROE is -0.05 which is significant at 0.05 levels; represents the negative association between BCOM and ROE. Likewise, ACOM has a significant positive relationship with ROE at 5% significant level (r= 0.04; p< 005). ACOM has a weak negative relationship with ROA, which is significant at 0.05 levels with a correlation coefficient of -0.0.3. Other CG variables are not significantly associated with profitability.

Table 5: Regression coefficient for Profitability in terms of ROE

	Pooled Ordinary Least Squares		Fixed effect		Random effect	
	Direct	Indirect	Direct	Indirect	Direct	Indirect
	Coef	Coef	Coef	Coeff	Coef	Coef
Main effects						
Constant	0.306	0.106	0.166	0.096	0.306	0.105
BSIZ	-0.017	-0.000	0.002	-0.001	-0.017	-0.008
BCOM	-1.236	-0.029	0.022	-0.024	-1.23**	-0.029
BGD	-0.474	-3.050	0.055	0.004	-0.474	0.002
CEOD	-0.078	-0.001	0.03	-0.042	-0.078	-0.002
BMEET	0.009	-0.001	-0.003	-0.000	0.009	-0.001
ACOM	-0.064	-0.004	0.006***	-0.007	-0.06**	0.004
Moderated effects						
BSIZ × FIDES		-0.044		-0.066**		-0.054
BCOM × FIDES		-0.007		-0.010**		-0.008
CEO × FIDES		0.029**		0.028		0.029**
BGD× FIDES		0.620**		0.006**		0.005**
BMEET × FIDES		-4.076**		0.051**		0.047**
ACOM × FIDES		1.871**		0.088**		0.089**
Control variable						
FSIZ	-0.167***	-0.008	0.0104	-0.008**	0.09**	-0.001
FAGE	0.098	-0.103	0.003	-1.310	-0.167	-0.0544**
R-squared	0. 8571	0.8896	0.8847	0.9934	0.869	0.8904
Ad. R-squared	0.8497	0.8762	0.8798	0.9915	0.8457	0.8842
F-statistic	6.132	11.447	3.5041	5.6257	4.224	3.554
Prob(F-statistic)	0.004	0.0000	0.0028	0.0000	0.0001	0.0000
Durbin Watson	0.866	0.903	2.358	2.667	1.570	1.782
Chi-Sq. Statistic						17.734
Prob. Chi-Square						0.1679

(*, **and *** statistically significant at 0.10, 0.05 and 0.01 levels)

The findings of the study's panel data regression analysis are presented in Table 5. According to the table 5, Hausman test probability of chi-square is higher than the significant level of 0.05, thereby random effect model is most suitable for the analysis. Consequently, the results of the random effect model were taken into consideration for the following discussion. The adjusted coefficient of determination (adjusted R^2) unveils that the explanatory variables in the

empirical model explained approximately 88% of the variation in the dependent variable, ROE. The overall p-value of F-test is statistically significant (3.554; $p < 0.05$). Consequently, the econometric model fits the data better than the intercept-only model.

In evaluating the model based on the results of the random effect regression model, the result shows that the BCOM has a negative and a statistically significant impact on ROE (b=-1.236, p< 0.05). This finding is similar with Zia et al. (2020) and Thavarasasingam et al. (2018). Moving to audit committee, the results divulge that the ACOM variable has a negative and statistically significant coefficient (b = -0.065; $p < 0.05$). This finding is similar with Shatnawi et al. (2021) and Awinbugri and Prince (2019). Moving to the moderating effect, the results expose no significant effect of the interaction between financing decisions and board size (b=-0.054, p> 0.05). There is an interactive effect between CEOD and financing decisions on ROE (b= 0.029, p< 0.05). The impact of CEOD was turned from insignificant to positive effect. BGD has a significant positive impact on the interaction between financing decisions and ROE (b= 0.005, p< 0.05). Further, BMEET has a significant positive impact on the interaction between financing decisions and ROE (b= 0.047, p< 0.05). ACOM also has a significant positive impact on the interaction between financing decisions and ROE (b= 0.089, p< 0.05). The impact of ACOM was turned from a negative to a positive effect.

Table 6: Regression coefficient for Profitability in terms of ROA

	Pooled Ordinary Least Squares		Fixed effect		Random effect	
	Direct	Indirect	Direct	Indirect	Direct	Indirect
	Coeff	Coeff	Coeff	Coeff	Coeff	Coef
Main effects						
Constant	0.095	-0.692	3.520	1.383	0.097	-0.683
BSIZ	-0.005	0.060	-0.127	-0.002	0.004**	0.060
BCOM	-0.085	0.936	-2.507	-0.084	-0.069	0.929*
BGD	0.060	-0.123	-0.645	-0.111	-0.014	0.013
CEOD	-0.016	0.012	0.632	-0.042	0.056	-0.128
BMEET	0.002	-0.032	-0.038	-0.096	0.003**	-0.033*
ACOM	0.014	0.322	-0.276	0.047	-0.011	0.319*
Moderated effects						
BSIZ × FIDES		0.915		0.845		0.909**
BCOM × FIDES		0.255		0.352		0.258**
CEO × FIDES		-2.994**		-3.053**		-2.995
BGD× FIDES		0.620**		0.503		0.618
BMEET × FIDES		-4.076**		-4.321**		-4.083*
ACOM × FIDES		1.871**		1.980**		1.874**
Control variable						
FSIZ	0.007	-0.079**	-0.037	-0.079	0.006	-0.079
FAGE	0.015	1.871**	0.039	-0.026	0.012	-0.101**
R-squared	0.1857	0.7659	0.7732	0.8941	0.8431	0.8904
Ad. R-squared	0.1741	0.7568	0.7702	0.8875	0.8407	0.8862
F-statistic	16.030	7.4299	1. 0418	1.8077	1.734	4.1202
Prob(F-statistic)	0.000	0.0000	0.004	0.0019	0.0024	0.0000
Durbin Watson	0.866	2.164	2.137	2.055	1.902	2.489
Chi-Sq. Statistic					17.7347	
Prob. Chi-Square					0.1679	

(*, **and *** statistically significant at 0.10, 0.05 and 0.01 levels)

The findings of the study's multiple regression analysis are presented in Table 6. According to table 6, the Hausman test probability of chi-square is higher than the significant level of 0.05, thereby random effect model is most suitable for the analysis. Consequently, the results of the random effect model were taken into consideration for the following discussion. The adjusted coefficient of determination (adjusted R^2) unveils that the explanatory variables in our empirical model explained approximately 88% of the variation in the dependent variable, ROA. The overall p-value of the F-test is statistically significant (1.734; $p < 0.05$). Consequently, the econometric model fits the data better than the intercept-only model.

In evaluating the model based on the results of the random effect regression model, the result shows that the BSIZ has a positive and statistically significant impact on ROA (b= 0.004, p< 0.05). The finding implies that a greater board size resulted in a higher level of ROA. This finding is supported by Kalbuana (2022) and Zia et al. (2020). Moving to board meetings, the results divulge that the BMEET variable has a positive and statistically significant coefficient ($b = 0.003$; $p < 0.05$) which states that the higher the number of board meetings, the higher the degree of ROA for firms. This finding is supported by Buchdadi et al. (2019) and Petchsakulwong and Jansakul (2018).

Moving to the moderating effect, the results expose a significant positive effect of BSIZ on the interaction between financing decisions and ROA (b=0.909, p> 0.05). This denotes that when the proportion of directors in the boardroom increases the effect of the board size on the firm's ROA will be changed. Board composition unveils a positive coefficient, and significant influence of the interaction between board independence and financing decisions on ROA (b= 0.258, p< 0.05). There is a significant negative interaction between BMEET and financing decisions on ROA (b= -4.083, p< 0.05). The impact of BMEET was turned from positive to negative. Further, There is a positive interaction between ACOM and financing decisions on ROA (b= 1.874, p< 0.05).

04. Conclusion

This research study aspires to assess the impact of CG practices on the profitability of the listed companies in Sri Lanka and how is this moderated by financing decisions. The panel data regression analysis that was run between CG practices and profitability has been discussed; further moderation was tested with financing decisions. The empirical findings reveal that board composition and audit committee have a direct negative impact on return on equity. Nevertheless, with the moderating effect of financing decisions, corporate governance variables, CEO duality, board gender diversity, board meetings and audit committee have a positive impact on return on equity. Moreover, the results show that board size and board meetings have a direct positive impact on return on assets. But, when moving to moderating effect of financing decisions, board size, board composition and audit committee have a positive impact on return on assets. But, board meeting has a negative effect.

Therefore, when interacting with a high level of financing decisions, corporate governance is more likely to have a significant impact on firms' profitability. The study recommends improving monitoring processes and introducing and examining new methods that can help businesses draw in greater resources and create an optimal capital structure. It would also assist policymakers in various nations in determining the sufficiency of available corporate governance reforms to improve capital structure management.

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