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CORPORATE GOVERNANCE AND FINANCING DECISIONS OF SRI LANKAN LISTED FIRMS

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ABSTRACT

The purpose of this paper is to evaluate the association between corporate governance and financing decisions in Sri Lanka as an example of emerging market. Data are drawn from a sample of 150 listed firms from the Colombo stock exchange (CSE). Multiple regression analysis is used in the study in estimating the relationship between the corporate governance and financing decisions. Corporate governance was proxied by board size, independent directors, board meeting and CEO duality. Financing decisions was measured by Debt ratio.

The empirical results show statistically significant and positive associations between board size, independent directors, firm size and growth and financing decisions (debt ratio), suggesting that Sri Lankan listed firms pursue high debt policy with a larger board size and higher percentage of independent directors. The results also indicate an insignificant relationship between the board meeting, CEO duality and financing decisions. Accordingly, the results recommend that firms with well-established corporate governance structures are able to gain easier access to debt financing at lower cost since such firms are able to repay their debt on time. The main value of this paper is the analysis of the effect of corporate governance on financing decisions from the Sri Lankan perspective.

Keywords: corporate governance, financing decisions, debt capital

INTRODUCTION

The financing decision is associated with the flow of funds from capital markets to the corporation and how financial managers make choices between the use of debt and equity in financing investment and opportunities. An important financial decision facing firms is the choice between debt and equity capital (Glen & Pinto, 1994).

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The financial decision set by management is very important in determining the optimal capital structure (Berger & Di Patti, 2006). The capital structure of a firm is a specific mixture of debt and equity the firm uses to finance its operations. Wen, Rwegasira, and Bilderbeek (2002) state that institutions may significantly influence firms' capital structure decision and that agency and monitoring problems, while existing in every country, may create different outcomes. Corporate governance is a framework to build an environment of accountability, trust and transparency.

Corporate governance deals with the agency problem, because of the separation of agents (e.g., managers) and shareholders. 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 (Detthamrong, Chancharat, & Vithessonthi, 2017). Corporate governance is an important tool to reduce conflicts between agents and that may have an influence on a firm's capital structure. Claessens, Djankov, Fan, and Lang (2002) note that better corpoarte governance frameworks benefit firms through greater access to financing, lower cost of capital, better performance and more favourable treatment of all stakeholders.

Corporate governance has been identified in previous studies to influence firms' financing or capital structure decisions which also affect performance (Berger, Ofek, & Yermack, 1997; Friend & Lang, 1988). These empirical studies tended to focus mainly on developed economies. The studies conducted in this area, have been inconclusive (i.e. mixed results). The mixed outcomes of that research suggest that a significant gap exists in understanding the nature, intensity and direction of the relationship between corporate governance and financing decisions. This study expands extant work on the effect of the corporate governance on financing decisions by providing of firms in an emerging nation. As such, the main research question is '….what is the association between corporate governance and financing decisions within Sri Lankan listed firms?' Sri Lanka has recently experienced rapid economic growth after emerging from decades of civil war. While Sri Lanka's recent economic reforms are potentiating the gains from peace, Sri Lanka is still an emerging country with gaps in its development and market regulations.

Moreover, this study would hopefully benefit academics, researchers, policy-makers and practitioners of both countries and other similar countries through exploring the relationship between corporate governance and financing decisions, and pursuing strategies to improve the current status of it. This paper is organised as follows: Section 1.2 presents a review of the empirical studies that investigate the association between corporate governance and financing decisions; Section 1.3 addresses research methods; Section 1.4 reports the results and discussion; and Section 1.5 summarises the conclusion.

Literature Review and Hypotheses Development

In this section reviews the empirical foundations for the association between corporate governance and financing decisions. This study develop hypotheses regarding the corpoarte governance (board size, independent directors, board meeting and CEO duality) and financing decisions (debt ratio).

Board size

The number of directors may influence the board functioning and hence corporate performance (Van den Berghe & Levrau, 2004). Expanding number of directors provides an increased pool of expertise because larger boards are likely to have more knowledge and skills at their disposal. Besides, large boards may be able to draw on a variety of perspectives on corpoarte strategy and may reduce domination by CEO (Forbes & Milliken, 1999; Goodstein, Gautam, & Boeker, 1994). On the other hand, the board-size effect: increased problems of communication and coordination as group size increases, and decreased ability of the board to control management, thereby leading to agency problems stemming from the separation of management and control (Yermack, 1996). Empirical studies provide mixed outcome on the role of board size on financing decisions. Some studies find larger board size to be associated with higher leverage (Wen, Rwegasira, & Bilderbeek, 2002), whilst leverage is lower when board of directors is larger (Berger, 2017). Based on this discussion, Hypothesis 1 is:

H1: There is a significant relationship between the size of the board and financing decisions

Independent directors

According to the CSE (2013) listing guidelines, independent board members should not relate to a key employee, are independent from management, and have never worked at the firm or its subsidiaries, or for its consultants or major stakeholders. The ASX Corporate Governance board notes that a majority of the board should be independent directors. Similarly, the New York stock exchange (2003) requires all listed firms to have a majority of independent directors on their boards. The UK Combined code of 2004 provides that at least half of the Board members be independent directors.

The Malaysian code on corporate governance (2000) recommends that there needs to be balance on the board of directors with at least a third of the board directors should be independent directors. It is consistency with corporate goverance rules as required by section 7.10 of the listing rules of the Colombo Stock Exchange (CSE). In India, the Birla committee (2004) requires the board of directors of a firm to have a mix with not less than half of the being independent. Agency theory suggests that a board comprised of a greater proportion of independent directors, due to their presumed independence, may theoretically lead to better financing decisions (Berger, 2017). The top managers generally face more rigorous monitoring when the board of directors is controlled by independent directors.

The independent directors monitor managers more actively, causing these mangers to adopt lower leverage to avoid the performance pressures associated with commitments to disgorge large amounts of cash (Wen et al., 2002). Based on this discussion, Hypothesis 2 is:

H2: There is a significant relationship between the proportion of independent directors and financing decisions.

Board Meeting

The boards of directors carry out critical roles, and thus deemed to be an important corporate governance mechanism (Lipton & Lorsch, 1992). The Sri Lankan best practices on corporate governance (2017) in recent times suggest that board meetings should be held at least once in every quarter of financial year. Lipton and Lorsch (1992) suggest that the greater frequency of meetings is likely to result in superior performance. Conversely, Jensen (1993) is that routine tasks engage much of a board's meeting time and thus limit the opportunities for independent directors to exercise meaningful control over management.

Jensen also suggests that boards should be relatively inactive and evidence of higher board activity is likely to symbolise a response to poor performance. The literature advises that there are various aspects of board meetings such as quality, role of the chairman and way the decisions that need to be considered in terms of the impact on firm activities (Van den Berghe & Levrau, 2004). Based on this discussion, Hypothesis 3 is:

H3: There is a significant relationship between number board meetings and financing decisions.

CEO Duality

There has been extensive debate in both academic and practitioner forums over the effect of CEO duality on financing decisions. Duality offers the clear direction on a single leader, and a concomitantly faster response to external events (Boyd, 1995). Manager with accurate and timely decisions can minimise the cost of corporate capital and increase the value of the firm through it. The adequate and appropriate investment and financing increase the value of the firm and will result in an increase in shareholder wealth (Emamgholipour, Ramezani, Behzadnia, & Abedi Rekabdarkolaei, 2013).

Prior literature acknowledges that the type of board leadership and role of the CEO can have an influence on financing decisions (Wen et al., 2002). Fosberg (2004) illustrated that there is a negative and significant relationship between CEO duality and the amount of corporate debt. Conversely, Abor (2007) revealed that there is a positive and significant relationship between debt ratio of firm and the CEO duality.

The lack of separation of chairman and CEO duties may lead to reduce the effectiveness of the supervisory role of board and provide the field of the violation of the beneficiaries' rights. An agency perspective the roles of CEO and chair of the board should be separated. The stewardship theory argue that authoritative decision-making under the leadership of a single individual (as both chairman and CEO) leads to higher firm performance (Donaldson & Davis, 1991). Based on this discussion, Hypothesis 4 is:

H4: There is a significant relationship between CEO duality and financing decisions

Control Variable

The potential interaction between corporate governance and financing decisions can be influenced by other firm factors including the ownership structure, firm size, profitability and other governance-related indicators such as leverage (Bhagat & Bolton, 2008). As a result, in addition to corporate governance proxies, this study controls for other variables such as firm size, profitability and growth according to the prior research.

Research Methodology

The population of interest in this study is (initially) the 291 listed firms on the Colombo Stock Exchange (CSE), as at February 2015. In selecting the population, this study excludes financial, investment and securities sector firms because their unique financial attributes, intensity of regulation, and/or intensive use of leverage are likely to confuse and/or foul the outcomes being studied. Also, the risk of missing data was minimised by excluding firms that were not listed the review period. After the eliminations, 150 Sri Lankan listed firms remained in the population. Data on corporate governance and financing decisions were collected from secondary sources which were extracted from annual reports and the database from CSE.

The quantitative data were analysed using SPSS (version 23.0) to produce descriptive statistics and regression analysis. In the empirical analysis, the data for independent variables are collected for 2016, providing for a one-year lag to the 2017 financing decisions data. Thus, 2017-full-year data are used for financing decisions data of Sri Lankan firms. Financing decisions which is the dependent variable is defined as the debt ratio. This is given as total debt divided by total equity plus total debt. In independent variables, board size, proportion of independent directors, board meetings and chief executive officer (CEO) duality are used to measure corporate governance. In control variable, the potential interaction between corporate governance and financing decisions can be influenced by other organisational elements (Lemmon & Lins, 2003).

As a result, in addition to corporate governance proxies, this study controls for other proxies such as firm size, profitability (ROA) and growth.

Table 1 – Variable Measures

Variables	Measures	Symbols
Corporate governance		
Board size	Number of directors	BS
Independent directors	Non-Independent directors/total directors	ID
Board meetings	Frequency of annual meetings	BM
CEO duality	Dummy variable equals 1 when CEO doubles as board chair and 0 otherwise.	CEO *dual*
Financing decisions		
Debt ratio	Total debt/ (total equity + total debt)	DR
Control variables		
Firm size	Size of the firm (log of total assets)	FS
Profitability	Earnings before interest and taxes/ total assets	ROA
Growth	Growth in sales for firm	GROW

Results and Discussion

Board Size

As reported in Table 2, the average is 11.66, with a minimum of two and a maximum of 32. In Sri Lanka, the last code of best practice on corporate governance published by CA Sri Lanka (2017) recommends that every public firm should be headed by an effective board, which should direct, lead and control the company. Although there is no precisely recommended size for a board in Sri Lanka. The Australian code of corporate governance (2014) recommends that a listed firms should have a board of an appropriate size, however, the Spain regulatory requirements seem to suggest five to 15 members (Rodriguez-Fernandez, Fernandez-Alonso, & Rodriguez-Rodriguez, 2014). Lipton and Lorsch (1992) who argued that preferred board size is eight or nine with ten being the limit in order for a board to be effective. From a resource availability perspective, bigger boards should be relatively more effective. Van den Berghe and Levrau (2004) suggest that increasing the number of board directors provides an increased pool of expertise and thus larger boards are likely to have more knowledge and skills at their disposal.

Similarly, resource dependence theory suggests that larger boards may have a better ability to form environmental links and secure critical resources (Goodstein, Gautam, & Boeker, 1994). Conversely, overly large boards can experience such issues as a lack of cohesion, coordination issues, and fractionalisation (Pratheepkanth, Hettihewa, & Wright, 2016).

INDEPENDENT DIRECTORS

The average proportion of independent director is 77.08 percent, suggesting that board directors in the majority of firms are comprised of directors who are independent. Also, firms seem to have met the requirements of the code of best practice on corporate governance, sample firms independence ranging from 18 to 89 percent. Whilst, the ASX corporate governance board notes that a majority of the board should be independent directors. Similarly, the New York stock exchange (2003) requires all listed firms to have a majority of independent directors on their boards. The UK combined code (2004) provides that at least half of the Board members be independent directors. The Malaysian code on corporate governance (2000) recommends that there needs to be balance on the board of directors with at least a third of the board directors should be independent directors.

BOARD MEETINGS

For the number of annual meetings, the average is 4.91 with a maximum and minimum of 9 and one, respectively. The Sri Lankan code of best practices on corporate governance (2017) recommends firms to hold at least one board meeting once in every quarter of a financial year. The boards that meet more frequently would have more time to perform the role of monitoring the management process efficiently. In order to have an effective and constructive board meeting, several conditions need to be fulfilled including information, quality, role of the chairman and way the decisions (Van den Berghe & Levrau, 2004). Overall, the results show that the sample firms comply with the board meetings mandatory requirements detailed in the 2017 code of best pratices on corpoarte governance except one firm didn't meet the requirements embedded in the Sri Lankan best practices.

CEO Duality

As for the leadership of the board, in 60 percent of the firms, there exists duality between the chairperson and the chief executive officer (CEO) of the firm. The code of best practices on corporate governance (2017) makes no recommendation on whether or not both posts should be held by the same person, but it does recommend that in case of duality, a decision to combine both posts of chairman and CEO in one person should be justified and highlighted in the annual reports. Similarly, Hampel Report (1998) points out that, in some circumstances, the top two roles can be combined, but it recoomends that the reasons for combining the roles be publicly disclosed.

However, the Cadbury Report (1992) recommeds that the role of the board chairman and the CEO be seprated. The Malaysian Code on Corpaorte Governance (2011) also recommends a similar board strcuture. Proponents of the CEO duality structure arugue that combining these two roles (chairman and CEO) provide a clear focus for objectives and operations (Anderson & Anthony, The new corporate directors: Insights for board members and executives, 1986).

Separate individuals for the post of chairman and CEO leads to a better corpaorte governance, the real issue is whether this leads the board to be a better monitor and thus, is capable of increasing the value of the firm as conferred by Abdullah (2004).

Control Variable

In terms of the control variables, firm size, determined as the natural logarithm of total assets has a mean of 14.11. Profitability, given as the ratio earnings before interest and tax (EBIT) to total assets, a mean value of 0.092 suggesting a ROA of 9.2 percent. The mean growth (measured as growth in sales) is 0.39 which indicates that on average, growth rate is sales is 39 percent.

Table 2 – Descriptive Analysis

	Minimum	Maximum	Mean	SD
Board size	2	32	11.66	4.97
Independent directors (%)	18.18	88.89	77.08	1857
Board meetings	1	9	4.91	1.95
CEO duality	0	1	0.60	0.492
Firm size	13.25	26.51	14.11	1.66
Profitability	0.015	0.33	0.092	0.11
Growth	0.62	3.74	0.39	0.33

Multiple Regression Results

Table 3 presents findings of regression analysis with information on the impact of an independent variable on the dependent variable. The model R2 value of debt ratio indicate that 65.4 percent of the observed variability in financing decision can be explained by the corporate governance. The F-statistics and significance levels (Table 3) show that regression model (debt ratio) generate statistically significant outcome.

Table 3 – Multiple Regression

	Debt
Constant	6.081
	(0.000)
Board size	2.079
	(0.021)
Independent directors	2.235
	(0.03)
Board meetings	0.965
	(0.635)
CEO duality	0.565
	(0.334)
Firm size	6.139
	(0.000)
ROA	0.373
	(0.710)
Growth	7.112
	(0.000)
R	0.809
R Square	0.654
F	24.877
Sig	0.000

In Table 3, the regression results of the relationship between the corporate governance and financing decision are presented. The results indicate that there are statistically significant relationships in the case of board size and independent directors. The impact of board size on debt ratio is significant at the 5 percent level, suggesting that Sri Lankan firms have more directors (refer to Table 2 for descriptive statistics) on their boards, and that larger boards adopt high debt policy to raise the value of the firm. The independent directors is significantly impact on debt ratio which implies that firms with more independent directors on the boards tend to pursue high debt policy.

The impact of board meetings on debt ratio is insignificant at the 5 percent level, suggesting holding number meeting does not guarantee greater financing decision; the board can effectively establish its strategic lines of business by meeting at least one board meeting once in every quarter of a financial year as recommends by the Sri Lankan code of best practices on corporate governance (2017). However, the other variable CEO duality is statistically insignificant on debt ratio with positive sign which suggests that separate individuals for the post of CEO and chairman (non-duality structure) leads to employ low proportion of debt.

Firm size is found to be significant at the 1 percent level with debt ratio, suggesting that the larger firm, the more debt it employs in its financing decision. There is an insignificant relationship between ROA and debt ratio. The results suggest that higher profits increase the level of internal financing. At the same time, there is a significant relationship exists between growth and debt ratio at the 1 percent level which implies that high growth firms place a greater demand on more debt.

Concluding Remarks

This study examines the relationship between corporate governance and financing decisions of listed firms in Sri Lanka. The attributes of corporate governance used for this study include board size, independent directors, board meeting and CEO duality. The result of this study illustrates that there is a significant relationship between board size, independent directors, firm size and growth and financing decisions (debt ratio).

This study results indicate that Sri Lankan listed firms pursue high debt policy with a larger board size and higher percentage of independent directors. This research aspirations and intent of this study are summarised in the following hypotheses that are first presented in literature review and hypotheses development section:

H1: There is a significant relationship between the size of the board and financing decisions. The study finds size of board to be significantly and positively related to financing decisions (debt ratio). This findings confirm by: Jensen (1986); Wen, Rwegasira, and Bilderbeek, (2002) but contrary to a study Berger, Ofek and Yermack (1997). On balance, this study confirms the H1 assertion of: there is a significant relationship between the size of the board and financing decisions.

H2: There is a significant relationship between the proportion of independent directors and financing decisions.The findings of significant impact the proportion of independent directors and financing decisions (debt ratio) are consistent with prior studies including Jensen (1986); Berger, Ofek and Yermack (1997) who revealed that firms with higher leverage have relatively more independent directors. However, this outcome contrast with Wen, Rwegasira, and Bilderbeek, (2002) who illustrated that there is a negative relationship between the proportion of independent directors and debt. Overall, these results affirm the H2 assertion that: there is a significant relationship between the proportion of independent directors and financing decisions.

H3: There is a significant relationship between CEO duality and financing decisions.
The study notes that CEO duality is not significantly associated with financing decisions (debt ratio). it suggests the importance of avoiding conflict which could occur between a CEO and a board chairman, where the two personalities are different. It could be explained that the absence of this conflict enables the CEO in a one-tier system to pursue an effective debt strategy based on the advice of the board (Abor, 2007).

However, Fosberg (2004) who reveals that a two-tier leadership structure results in higher debt/equity ratio. Hence, H4: There is a significant relationship between CEO duality and financing decisions is not supported. The findings of this study provide a number of interesting implications for policy makers and acedemics. As, resource dependence theory suggests that larger boards may have a better ability to form monitoring and regulatory mechanism, to pursue high debt policy to increase the value of the firm.

The increase in board size should also be complimented with having independent directors because monitoring is more effective with a larger percentage of independent directors. Generally, a well-established corporate governance system suggests effective control and accounting systems, stringent monitoring, effective regulatory mechanism and efficient utilisation of firms' resources resulting in improved performance. Accordingly, firms with well-established corporate governance structures are able to gain easier access to debt financing at lower cost since such firms are able to repay their debt on time. Future research should consider including many countries. The effect of corporate governance on financing decisions should be more fully examined in future research.

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