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MODERATING ROLE OF FINANCING DECISION ON THE RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND CORPORATE PROFITABILITY: EVIDENCE FROM COMPANIES LISTED IN CSE

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Abstract

Good governance can contribute to better management practices, reduce the risks of fraud or mismanagement which could lead to improved profitability. Financing decisions are the choices a company makes regarding how it raises capital to fund its operations. The aim of this study is to analyze the impact of corporate governance on corporate profitability through moderating role of financing decision. The study sample consists of 208 non-financial companies and focused on data from the years 2015 to 2021. Corporate Governance Index was constructed in this study. The study measures profitability using the Net Profit Ratio. The findings of this study prove the fact that the corporate governance index has a positive impact on the corporate profitability of the listed companies in Sri Lanka. The debt to equity ratio has a negative impact on the Net Profit Ratio. Companies by maintaining optimum debt to equity ratio can reduce the negative impact on corporate profitability. On the contrary, Debt to Equity* CGI has brought about a positive impact on the corporate profitability of listed companies in Sri Lanka. Debt to equity, which is considered as moderating variable has had a great impact on the relationship between corporate governance and corporate profitability. This implies that corporate profitability is enhanced when there is good CG which will also influence the financing decisions of the companies listed in CSE. The agency theory stated that corporate governance with optimum financing decisions improves profitability, in that it mitigates agency conflicts between shareholders, managers, and debt holders.

Keywords: Corporate Governance Practices, Corporate Profitability, Corporate Governance Index, Debt to Equity, Net profit ratio.

1. Background of the Study

Corporate governance refers to the structures, policies, practices, and processes that define how a company is controlled and directed. It encompasses the relationships between the company's management, board of directors, shareholders, and other stakeholders (Bui and Krajcsok, 2024). Good corporate governance ensures transparency, accountability, and fairness in a company's operations, which can have a significant impact on its financial performance, including profitability (Georgakopoulos et al., (2022). The relationship between corporate governance and profitability is crucial in the context of business success and sustainability. Corporate governance includes different types of organizational mechanisms and the balance trends in the power hierarchy

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and the liability of the shareholders, managers, board of directors and employees. Ownership structure, board size, the board independence and CEO duality are the pivotal factors affecting the corporate governance (Ali.et al., 2021). Bechi et al., (2005) remarked that corporate governance is the frame work to protect the stakeholders via shareholders, the customers and lenders. Financing decisions of the companies have the impact of corporate performance. The use of the loan capital will increase the profit margin of the companies through the tax yield benefit (Addae, el al., 2013). However the use of the higher loan is faugh with risk. The corporate governance wields an influence the success of the companies. The companies which adopt the proper corporate governance mechanism show the splendid performance. Most of the researches that have been done in Sri Lanka are based on the corporate governance mechanism, corporate profitability and capital structure. In general the company which adopts the corporate governance mechanism properly can take the proper decision regarding the financial activities (Heenetigala, 2011). Company's growth and sustainability are prominently determined by the proper adoption of good corporate governance. A well-governed organization with clear accountability, effective risk management, and a focus on long-term goals is more likely to achieve sustainable profitability (Georgakopoulos et al., 2022). On the other hand, companies with weak governance structures may experience a decline in profitability due to inefficiency, mismanagement, and loss of investor confidence. Hence, firms that invest in improving their governance standards are likely to see better financial outcomes over time (Nugroho, 2021). Furthermore financing decision also plays pivotal role in the company's sustainability. One way to measure the quality of corporate governance is through a Corporate Governance Index (CGI), which is designed to assess the governance practices of firms. The Corporate Governance Index serves as an important tool for evaluating the strength of corporate governance practices and their potential impact on a company's financial outcomes. While a strong corporate governance framework can enhance profitability through better decision-making, reduced risks, and increased investor confidence, the relationship is not always straightforward. The benefits of good governance must be weighed against the potential costs of implementing such practices (Ahmed et al., 2024). Therefore, companies must strike a balance between effective governance and maintaining operational flexibility to maximize long-term profitability. Board characteristics and ownership structure are vigorous corporate governance mechanisms. In Sri Lankan context several researchers consider only board characteristics or ownership structure with performance of the firms for their studies. Present study considers both mechanisms along with financing decision to confirm that findings and give the new empirical evidence to future researchers.

2. Research Problem

The overall performance of the CSE is estimated by All Share Price Index (ASPI), when the companies function in a profitable manner, the market price of the shares rise. Because of the rising of price of the shares the ASPI rise. The earning of the shares depend on the market price of the shares. Only when the companies achieve the appropriate profitability it can pay the proper dividend for the shareholders. The Table given below gives all share price index from the year 2014 to 2020.

Table 1: ASPI Index

Year	2014	2015	2016	2017	2018	2019	2020
ASPI Index	7299.00	6894.50	6228.30	6369.30	6052.40	6129.20	4571.63

(Source: Central Bank Report)

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Besides the Table 1 shows the trend of the All Share Price Index has the successive declining trend during the period 2014 to 2020. During this period when the ASPI observed, ASPI index was higher in 2014. Afterwards ASPI has decreasing trend. The declining the profitability of the companies is the cause assignable to the deduction of the ASPI. The downfall of the ASPI will produce an impact of the economic growth. Corporate Governance Index was constructed in this study by adding the four sub-indices via board size index, board composition index, CEO index and Institutional ownership index. This study investigate whether the financial decision has the moderating role on the relationship between corporate governance and corporate profitability.

3. Literature Review and Hypotheses development

Board Structure and Corporate profitability

The relationship between board structure and corporate profitability has been a significant topic in corporate governance literature. Scholars have explored how different aspects of board composition and structure influence a company's financial performance (Nugroho, 2021). One of the most widely studied aspects of board structure is its size. The relationship between board size and corporate profitability is complex. Some studies suggest that larger boards bring a diversity of perspectives, which can improve decision-making and profitability. However, other studies argue that too large a board can be inefficient, with more coordination problems and less effective decision-making, potentially reducing profitability (El-Dyasty & Elamer, 2021). The size of the board can impact its ability to perform effectively. Too small a board may lack the necessary expertise, while too large a board may become unwieldy and inefficient. Research suggests that boards with 7-9 members tend to be the most effective in terms of decision-making and performance (Delima, 2021).

The function of board can be effectively influenced by number of directors in the board. As a result, most of the researches about board size, have been made by directors on the board but the point of views varies survey to survey. In contrast directly proportional relationship between the board size and the company's performance has been found by some policy makers. This has strengthened by the research of Kapoor & Goel (2017), who implied that the directors can directly influence the administrative activities. In order to coincide the interest of shareholders with the deeds of managers, board of directors assist the managers on behalf of shareholders. So through this the board can determine the strength and weakness of the managers. Especially, the survey on board structure focuses on three prominent features such as board size, board composition and CEO duality (Ahmed & Hamdan, 2015).

In order to avoid the supremacy effect of managers over a firm, the higher fraction of board should contain independent directors. According to the stance of Outa & Waweru (2016), a high level achievement is acquired by the company which is having higher fraction of independent directors. On the other hand some scholars state that higher number of independent directors on boards would not enhance the growth of firm (Andrews et al., 2017).

The act of enrolling both CEO of the company and the board chairman is called CEO duality. In relation to agency theory there is an opinion that, for the effective functioning of the firm the two roles CEO and chairman should not be merged or else it will lead to the origin of threads in relation to the directors' duty of good faith. Meanwhile other wise men support the CEO duality. They believe that, by only having the CEO duality the company can take firm decisions in relation to the growth of it (Kowalski, 2016)

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There has always been an argument about the relationship between corporate governance structure and firm performance. There are many researches enrich the fact, the components of corporate governance structure acts as independent variable which eventually results in efficient output, that is corporate governance process which actually acts as the bridge between corporate governance structure and firm performance (Ali et al.,2021).

Ownership Structure and Corporate profitability

The ownership structure of a company refers to the way in which the company is owned and controlled. This structure can influence many aspects of the business, including profitability. Corporate governance structure provides the way to safeguard the shareholders and their rights by aligning same interest to both managers and shareholders (Aggarwal, 2013). This is possible via the central control mechanism which observes the actions of managers. According to Shieifer and Vishny (1997) the corporate governance structures are incompatible for the developing countries as most of its basics are from western developed countries. Furthermore they concluded that self-centered ownership can minimize the free rider problems as small owners don't care about the growth of administration in a company which beholds minority shareholders abundantly. A perfectly built ownership structure is an inevitable tactic to dominate the operating strategy and then enhance the firm's value. According to Zahra and Pearce (2008) shareholders of a company in which the ownership is scattered, will not have the intention to allocate sufficient resources to supervise the administration team. Thus, the ownership concentration is directly proportional to the performance of the company .On the other hand, some scholars emphasize that the self-centered ownership shows a negligible impact on firm's performance as those who owns the majority of shares directs the resources outside of the company to expand their interest by dominating the other shareholders (Farhan et al., 2017). Institutional ownership refers to the ownership of a firm's shares by institutional investors such as mutual funds, pension funds, insurance companies, hedge funds, and other large entities that manage substantial pools of capital (Ahmed et al., 2024). This type of ownership is often contrasted with individual or retail ownership, and it can have significant effects on a firm's performance (Georgakopoulos et al., 2022).

This research constructs the corporate governance index on the basis of board structure and ownership structure (Bhagat & Bolton, 2019). In order to measure board structure; board size, board composition and CEO duality are the three major variables focused in this study. Furthermore, to measure the ownership structure, institutional ownership was taken into account and in order to measure the performance or profitability of the firm, net profit ratio was considered. As per the above-mentioned literature, the following hypothesis has been developed.

H_1: Corporate Governance significantly impact on corporate profitability through moderating role of financing decision.

4. Research Methodology

Population of this Study

The population of this research consists of 288 companies listed on the Colombo Stock Exchange (CSE) in 2024, categorized under twenty distinct sectors. Only non-financial companies are taken under consideration in this study as the financial institutions follows various corporate governance mechanism (Aggarwal, 2013).

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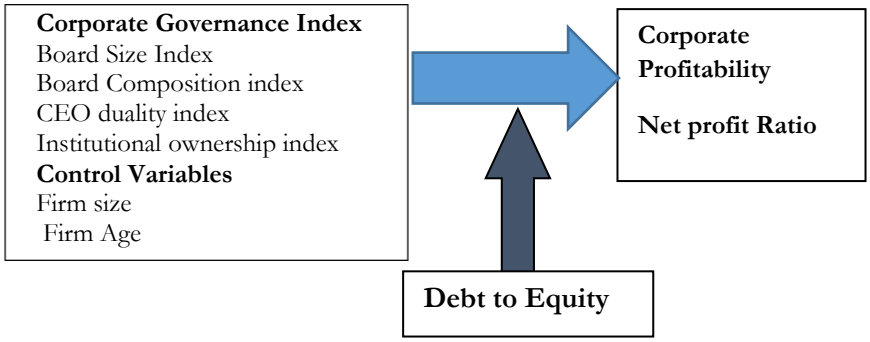
Data Collection

The data were collected from the annual reports which were available from the official web page of listed companies in Sri Lanka. The sample to this study was made up of 208 non-financial companies. The data for this survey is collected from the annual reports published by the listed companies. The banking sector has been excluded from this study due to its unique corporate governance mechanisms. Besides the data from the year 2015 to 2021 were subjected to this study.

Conceptual Model

On the basis of research gap available in Sri Lanka, the researcher used the corporate governance index to measure the adoption of the corporate governance mechanism, which is implemented by the companies. Even there are many mechanisms available to measure the corporate governance, board structure and ownership structure were taken for the calculation of corporate governance index. In relevant to the literature review made about corporate governance, the given conceptual model is established by the researcher.

Figure 1: Conceptual Model



Source: Developed by Researcher

Operationalization

Table 2 indicated the operationalization of the measures which were taken in this study.

Table 2: operationalization of the measures

Concept	Variable	Indicator	Measurement
	BSI	Individual counting of the board of directors.	Firm which has the number of directors with in the range 6-13 is indicated by the BSI index 1 and if out of range then considered as 0.

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Corporate Governance Index	BCI	Ratio between independent directors and total number of directors in the board.	Ratio of independent director on the board of directors is equal or above the legal requirement of Code of corporate governance practices 2017) (33%); then it is considered as 1 or otherwise 0.
	CEOI	If the both roles, chief executive officer and the manager, are played by the same person then it is called as CEO duality.	If the CEO duality is present in the firm then it is considered as 0 if not 1.
	INOWI	Generally The ratio between the institutional ownership to the total investment.	If the percentage of institutional ownership is 30% or greater than 30% then index is 1 or else 0.(Guo, 2011 and Pathirawasam,&Wickremasinghe 2012)
	CGI	By adding Four sub index (BSI+BCI+CEOI+INOWI)	CGI index will lie with the range from 0 to 4
Corporate Profitability	Net profit	Generation of profits with each rupees of net sales	(Net profit after tax / Net sales) × 100
Financing Decisions	Debt to Equity	Utilization of debt financing	Debt/Equity
Control Variables	Firm size	Dimension of the firm	Logarithm value of Assets of the firm.
	Age of the firm	Years of establishment	Research period minus establishment year of the company.

Hierarchical regression

Hierarchical regression is a statistical method used to examine the relationship between variables while controlling for the influence of other variables in a stepwise manner. The mechanism of inserting or deleting one variable from the regression model as step by step is called as Hierarchical regression .To find out the moderating effect of financing decisions on the corporate governance on corporate profitability, corporate

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governance index is calculated .The following models will be used to find out the moderating role of financing decisions on corporate governance and corporate profitability.

5. Results and Discussion

Descriptive Statistics

Various researches have utilized the different methods to measure the corporate governance index. In this study, corporate governance index is calculated on the basis of the study done by Guo (2011).

Table 3: Descriptive Statistics

	BSI	BCI	CEOI	INSIN	CGI
Mean	0.7843	0.7421	0.7324	0.81317	3.164251
Median	1.000000	1.000000	1.000000	1.000000	3.000000
Maximum	1.000000	1.000000	1.000000	1.000000	4.000000
Minimum	0.000000	0.000000	0.000000	0.000000	1.000000
Std. Dev.	0.371402	0.431945	0.434759	0.379954	0.860163
Skewness	-1.812393	-1.177177	-1.147281	-1.720618	-0.780062
Kurtosis	4.284767	2.385747	2.316253	3.960526	2.853260
Jarque-Bera	127.5611	51.06253	49.44300	110.0957	21.17887

When the corporate governance index data is taken into account, the corporate governance index maximum is 4, the minimum corporate governance is 1. Furthermore both the mean and median are found to be 3.164251 and 3 with the standard deviation of 0.860163.

Hierarchical Regression Model (Step 1)

In compliance with the summary of the regression, coefficient value of the constant is 1.122504 and the t statistic and the P value are respectively 16.34947 and 0.0000. P value is less than 0.05. The above mentioned facts show when other variables taken in this study are in the position of zero, the net profit is 1.122504. . The coefficient of the corporate governance index is 0.0355 with the p value of 0.0005. Researcher concluded that the corporate governance index is increased by 1, it will increase the net profit by 0.03550. The co efficient value of firm age and firm size are respectively -0.25655 and 0.03244 while the P values of those are 0.0002. Researcher can conclude that firm age negatively impact on net profit ratio while firm size positively impact on net profit ratio. R^2value of this model is approximately 13%. This reveals that 13% variation only explained in this model the remaining reflect the influence of other factors which are not taken in this study. This conclusion is found to be an agreement with the findings of Andrews et al., (2017) and Aggarwal (2013).According to the results, the CGI carries the lowest positive co efficient value in this model. The reason for this may be the

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majority of the company consists of lower value of sub index such as board size index, board composition index, CEO duality index and Institutional ownership index. The descriptive statistics of CGI of this study also confirm this fact.

Table 4: Results of Regression summary

Dependent Variable: NPR

Method: Least Squares

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1.122504	0.080890	16.34947	0.0000
CGI	0.03550	0.001019	3.483830	0.0005
FA	-0.25655	0.006942	-3.695532	0.0002
FS	0.03244	0.000879	3.690465	0.0002

R-squared	0.133798	Mean dependent var	1.239754
Adjusted R-squared	0.130873	S.D. dependent var	0.821829
S.E. of regression	0.809043	Akaike info criterion	2.418083
Sum squared resid	648.6602	Schwarz criterion	2.437793
Log likelihood	-1198.997	Hannan-Quinn criter.	2.425576
F-statistic	11.55528	Durbin-Watson stat	1.607943
Prob(F-statistic)	0.000000		

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Hierarchical Regression Model (Step 2)

OLS Regression shows the impact of corporate governance on corporate profitability without considers the financing ratio. According to the Hierarchical regression model, When the Debt to equity ratio is incorporated in the model 1. The following Table 6 shows the results of the regression summary of the model 2.According to the regression results given in the Table 6 coefficient value of constant is 0.291228 t Statistics and p value are respectively 5.447458and 0.000. This shows that when other variables taken in this study are in the position of zero, the net profit ratio is 0.291228. The Co efficient value of corporate governance index is 0.263043, the t statistics and p value are respectively 13.74761 and 0.0000.P value is less than 0.05. That is Corporate governance significantly impact on corporate profitability of listed companies. The corporate governance index is increased by 1; it will increase net profit by .0.263043. The coefficient value of the debt to equity ratio is 0.000334 whereas the t statistics and p value are respectively3.130332 and 0.0018. P value is less than 0.05, and then researcher can conclude that debt to equity ratio is negatively impact on net profit ratio. This finding agree with the findings of Abor and Biekpe (2007) and Kowalewski, (2016).The co efficient value of firm age and firm size are respectively -0.001773 and 0.02559 while the p value of those are respectively 0.0005 and 0.000. Researcher can conclude that Firm age negatively impact on net profit ratio while firm size positively impact on net profit ratio. R^2value of this model is approximately 18%. This reveals that 18% variation only explained in this model the remaining reflect the influence of other factors which are not taken in this study.

Table 5: Results of Regression of Model 2

.Dependent Variable: NPR Method: Least Squares				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.291228	0.053461	5.447458	0.0000
CGI	0.263043	0.019134	13.74761	0.0000
DEEQ	-0.000334	0.000107	-3.130332	0.0018
FA	-0.001773	0.000505	-3.512694	0.0005
FS	0.025599	0.003845	6.657835	0.0000
R-squared	0.182811	Mean dependent var		0.825311
Adjusted R-squared	0.182461	S.D. dependent var		0.504763
S.E. of regression	0.456396	Akaike info criterion		1.274191
Sum squared resid	202.4646	Schwarz criterion		1.299188

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Log likelihood	-617.4423	Hannan-Quinn criter.	1.283702
F-statistic	55.45658	Durbin-Watson stat	1.907014
Prob(F-statistic)	0.000000		

Hierarchical Regression (Step 3)

This model tries to find out the moderating role of financing decision on the relationship between the corporate governance and corporate profitability. In model 2, interaction variable (DeEq* CGI) is incorporated to represent the moderating role in the previous model. According to the regression results given in the Table 6 coefficient value of constant is 1.399437, t statistics and p value are respectively 17.94747 and 0.000. This shows that when other variables taken in this study are in the position of zero, net profit ratio is 1.399437. The Co efficient value of corporate governance index is 2.85E-08, the t statistics and p value are respectively 9.473127 and 0.0000.P value is less than 0.05. That is Corporate governance significantly impact on net profit ratio of listed companies. The corporate governance index is increased by 1, it will increase NPR by 2.58E-08. The coefficient value of the debt to equity ratio is -0.003221 whereas the t statistics and p value are respectively.-3.948374 and 0.0001. P value is less than 0.05. In this model debt to equity ratio negatively impact on net profit ratio .In this model the coefficient value of the moderating variable (De.Eq*CGI) is 0.000617 whereas the t statistic and the p values are respectively 2.693530 and 0.0072. Hence researcher can conclude that there is positive impact of moderating role of financing decisions on the relationship between corporate governance and corporate profitability. So H_1 is accepted. That is Corporate governance significantly impact on NPR through moderating role of financing decisions. In this model Durbin Watson statistics is 1.63. The co efficient value of firm age and firm size are respectively –0.019516 and 0.0.002903 while the p values of those are respectively 0.0024 and 0.0005. Researcher can conclude that firm age negatively impact on net profit ratio while firm size positively significantly impact on net profit ratio. R^2value of this model is approximately 18%. This reveals that 18% variation only explained in this model the remaining reflect the influence of other factors which are not taken in this study. This study is consistent with the findings of Kapoor & Goel (2017) and Guo (2011).

Table 6 Results of the Regression Model

Dependent Variable: NPR

Method: Least Squares

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1.399437	0.077974	17.94747	0.0000
CGI	2.85E-08	3.00E-09	9.473127	0.0000

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DEEQ	-0.003221	0.000816	-3.948374	0.0001
DEEQ_CGI	0.000617	0.000229	2.693530	0.0072
FS	0.002903	0.000834	3.482703	0.0005
FA	-0.019516	0.006409	-3.045222	0.0024

R-squared	0.183904	Mean dependent var	1.239415
Adjusted R-squared	0.183455	S.D. dependent var	0.821217
S.E. of regression	0.763972	Akaike info criterion	2.305435
Sum squared resid	577.8170	Schwarz criterion	2.334976
Log likelihood	-1142.107	Hannan-Quinn criter.	2.316665
F-statistic	31.93961	Durbin-Watson stat	1.631660
Prob(F-statistic)	0.000000		

Residual normality test

Residual normality is an important assumption, especially when the model involves regression or other parametric tests. To assess whether the residuals (are normally distributed, the Jarque-Bera test is commonly used. The following table display Jarque-bera test value for the Regression Models.

Table 7: Residual normality test

Hierarchical Regression	Jarque Bera statistics	P Value
Model I	5.43	0.21
Model II	3.26	0.23
Model III	2.41	0.41

If the p-value of the Jarque-Bera test is greater than 0.05, it suggests that there is no significant evidence to reject the null hypothesis. In other words, the residuals do not significantly deviate from normality, meaning that the residuals could reasonably be assumed to follow a normal distribution.

6. Conclusion and Recommendation

According to the OLS regression results, the CGI significantly effect on firm's profitability measured by net profit ratio. The results indicate that the debt-to-equity ratio has a negative effect on the net profit ratio. This

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finding aligns with both the tradeoff theory and the pecking order theory, which suggest that an increase in the level of indebtedness raises the risk of bankruptcy. Additionally, the study reveals that financing decisions play an intermediary role between corporate governance and the profitability of firms listed on the CSE. This implies that Companies with strong corporate governance are more likely to make sound financial decisions, including choosing appropriate financing methods, managing debt levels wisely, and investing efficiently. This can improve the overall profitability of the firm. The outcome coincides with the survey conducted by Farhan, Obtain and Azlan (2017) & Bui and Krajcsak. (2024) who elaborated that corporate governance had the positive impact on firm's profitability. Zahra and Pearce (2008) suggest due to the enacting of corporate governance it not only improve the performance of the company but also build good will about the company to the stake holders. Effective governance can help firms make more informed financing decisions, thereby reducing risks associated with excessive borrowing or inadequate capital, ultimately contributing to better profitability Indeed, it can be argued that they are generalizable to the companies Listed in CSE and other developing countries that might have similar business environment and social antecedents. This study would provide valuable insights into the interplay between corporate governance, financing decisions, and firm profitability in emerging markets like Sri Lanka. Financing decisions play a significant moderating role in the relationship between corporate governance and profitability. Effective governance can help firms make optimal financing choices, which can enhance profitability, while poor governance can exacerbate risks and limit profitability, regardless of financing decisions. By understanding the moderating role of financing decisions, firms and policymakers can better align their governance practices and capital structures to improve profitability and long-term sustainability.

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