IMPACT OF CORPORATE GOVERNANCE ON FIRM'S CAPITAL STRUCTURE: EVIDENCE FROM LISTED BANKS AND DIVERSIFIED FINANCIAL COMPANIES IN SRI LANKA

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INTRODUCTION

Associations among corporate governance (CG), management turnover, corporate performance, and corporate capital structure have been established by various theoretical and empirical techniques in the substantial body of theoretical and empirical literature in Accounting and Finance (Achchuthan et al., 2013). CG refers to the processes, customs, policies, laws, and organizations affecting a corporation's direction (Ajanthan, 2013). The CG system of organization tools, property rights structures, use of accounting standards, and a legal system that resolves disputes in contracts, protects consumers, promotes competitive advantage, and strengthens the firm's ownership structure (Tanui et al., 2021). In this notion, reasonable CG procedures are crucial for a country's economy to expand and develop sustainably. Mainly, nations that have adopted sound CG procedures typically saw a brisk expansion of their corporate sectors and have improved abilities to attract capital to lubricate their economies. Furthermore, effective governance enhances a company's performance by lowering the cost of capital and creating and sustaining a corporate culture that encourages management to act in ways that maximize shareholder wealth (Sheikh & Wang, 2011). Accordingly, managers can use debt to equity effectively to bind their pledges to pay out future cash flows. As a result, debt can be a good alternative for dividends. However, this problem is rarely discussed in the finance and accounting literature. When firms make strategic decisions like issuing debt in return for equity, they should be held accountable for paying interest from future cash flows (Achchuthan et al., 2013). Examining CG practices in the Sri Lankan context is more crucial because there have been numerous CG issues in the past five years in Sri Lankan firms. CG, the primary internal governing body of a firm, is essential to the smooth operation of any business. In such a scenario, investigating the impact of CG on the capital structure decision will add value to the extant literature. Additionally, the association's findings were inconclusive, which leaves a potential for further research on this topic. Additionally, limited studies examined the relationship between disclosure of CG and capital structure in listed banks and diversified financial sector firms. Most researchers ignored this sector when they studied the impact of CG disclosure on capital structure. However, this sector is pivotal in the Sri Lankan financial system. So, considering this sector for the present study would be worthwhile. On the other hand, empirical evidence of this relationship has ended with inconclusive findings locally and globally. Thus, still, there is room for conducting a study on the theme. At this juncture, the present study attempts to fill the above mentioned gaps by illuminating the significant link between CG and firms' capital structure in listed banks and diversified financial sector firms in Sri Lanka. The study has a few inevitable limitations. Mainly, the study was limited only to listed banks and diversified

financial sector firms which will not be able to generalize the findings of this study to the rest of the listed sectors or non-listed companies in Sri Lanka. With the time constraints, the study was confined to selected CG characteristics. Therefore, future researchers can strengthen the study by addressing these limitations accordingly.

METHODOLOGY

This study used the deductive approach as the research approach where the quantitative analyses were performed. For the CG characteristics, board size (BS), board independence (BIND), CEO duality (DUAL), board meeting (BM), and board committee (BC) were used. In contrast, the debt-to-equity ratio (DE ratio) was used as the proxy for capital structure. Additionally, firm size (FS) and return on assets (ROA) were used as this study's control variables. The population of this study consisted of 66 firms in banks and diversified financial companies listed on the Colombo Stock Exchange. Although banks and diversified financial sector companies have been identified as having a substantial impact on the Sri Lankan economy, they have been disregarded in most previous studies. As a result, banks and diversified financial companies were chosen for the study. As on 12th March 2022, there were 16 banking and 50 diversified financial companies, and all of these companies were selected as the study's sample. The period considered in the present study was the recent five years from 2016 to 2021, which resulted in 330 observations. The primary data source of this study was secondary, which was extracted through the audited financial statements of the selected companies. The collected data was analyzed by using the statistical software package of E-views. Descriptive statistics were performed to identify the CG practices, including mean, maximum, minimum, and standard deviation, along with kurtosis and skewness. Data screening and cleaning were carried out before the primary analyses and confirmed the suitability of the data for the primary analyses. Apart from the descriptive statistics, correlation analysis and regression analysis on panel data were employed to achieve the study's objective.

RESULTS AND DISCUSSION

According to Table 1, the mean value of the DE ratio is 5.12, which indicates the average ratio of the debt capital usage of the sample companies is 512%, its standard deviation is 4.14, and SD indicates that data is more spread out. BS of a company ranges from 5 to 15, with a mean value of 8.49. More than half of companies (0.56) maintain the separation of leadership from the CEO's position.

Table 1 Result of Descriptive Statistics

	Mean	Maximum	Minimum	Std. Dev.	Skewness	Kurtosis
DE ratio	5.12	21.05	-1.13	4.14	0.49	2.91
BS	8.49	15.00	5.00	2.47	0.52	2.40
BS (Ln)	2.10	2.71	1.61	0.29	0.08	2.01
BIND	0.40	0.89	0.00	0.15	0.77	3.82
DUAL	0.56	1.00	0.00	0.50	-0.25	1.06
BM	10.54	25.00	2.00	4.41	-0.29	2.94
BC	4.73	11.00	2.00	1.85	1.05	3.94
FS (Ln)	20.06	26.08	13.37	3.66	-0.16	1.82
ROA	0.07	0.40	-0.60	0.08	-3.22	27.15

The correlation coefficient between BS (Ln) and DE ratio was 0.48 and was significant at 0.01 (p =0.01), as shown in Table 2. Therefore, it can be said that the correlation between BS and capital structure was moderately positive and significant. The correlation between the DUAL and DE ratio was 0.390, significant at 0.01 (p<0.01). Therefore, it can be concluded that there was a moderate positive and significant correlation between DUAL and capital structure. The correlations between the DE ratio and other CG characteristics except for BIND indicated a significant association at a 0.01 level.

Table 2 Result of Correlation Analysis

	DR	BS	BIND	DUAL	BM	BC	FS	ROA
DE ratio	1.00							
BS	0.48**	1.00						
BIND	0.05	-0.07	1.00					
DUAL	0.39**	0.29**	0.16**	1.00				
BM	0.64**	0.40**	0.14**	0.46**	1.00			
BC	0.60**	0.62**	0.17**	0.41**	0.54**	1.00		
LNFSIZE	0.51**	0.27**	0.07	0.48**	0.66**	0.33**	1.00	
ROA	0.26**	0.15*	-0.01	0.13*	0.35**	0.14*	0.39**	1.00

Note: N = 330, ** Correlation is significant at the 0.01 level and the * Correlation is significant at the 0.05 level respectively (2 – tailed).

The panel regression was run to achieve the study's objective. Accordingly, the Hausman test was employed to select the appropriate specification between the fixed-effect and random-effect models. The null hypothesis of the Hausman test indicates that the random-effect model is more appropriate than the fixed-effect model. When the p-value exceeds the significant value (0.05), it accepts the null hypothesis and concludes that the random-effect model is more appropriate. The results provided in Table 3 show a significant p-value with a larger Chi-sq. value (20.38; < 0.01) which rejects the null hypothesis of random effects. Hence, it was confirmed that the fixed effect was the fitting model to explore the relationship between CG characteristics and capital structure.

Table 3 Result of Regression Analysis

	Model 01 (Fixed Effect Model)		Model 02 (Fixed Effect Model)	
Variable	Coefficient	Prob.	Coefficient	Prob.
C	5.11	0.09	2.11	0.62
BS	-1.23	0.21	-1.18	0.23
BIND	3.72	0.02	3.74	0.02
DUAL	1.45	0.47	1.45	0.47
BM	-0.06	0.48	-0.05	0.54
BC	0.38	0.09	0.35	0.12
FSIZE	-	-	0.15	0.33
ROA	-	-	-1.83	0.31
R-squared	0.86		0.86	
Adjusted R-squared	0.83		0.83	
Hausman Test Summary	Chi-Sq. Statistic		Prob.	
Cross-section Model 01	27.06		0.00	
Cross-section Model 02	20.38		0.01	

As per Table 3, one of the selected CG variables significantly impacted the dependent variable. Only independent variables are included in model 01, and independent and control variables are included in model 02. Consequently, the study's results revealed a positive and significant impact of BIND on the DE ratio, which was consistent with the findings of the extant literature (Abor, 2007; Ajanthan, 2013; Bokpin & Arko, 2009; Feng et al., 2020; Guo & Kga, 2012; Abdullah, 2004; Sheikh & Wang, 2011). This finding implies that a board with more independent directors can actively monitor the management, forcing it to make decisions that maximize shareholder wealth. The current finding, however, contrasts with previous studies, which reported an insignificant impact of BIND on the DE ratio (Al-Saidi, 2020). BC positively impacted the DE ratio in model 01, whereas it did not report a significant impact in Model 02. Surprisingly, none of the other independent (BS, DUAL, and BM) or control variables

FSIZE and ROA indicated a significant impact on the DE ratio. As a result, the hypotheses made concerning these variables were not supported. Finally, this research finding presented an insignificant impact of CG on a firm's capital structure of listed banks and diversified financial companies in Sri Lanka.

CONCLUSIONS AND IMPLICATIONS

This study investigated the impact of CG on the capital structures of listed banks and diversified financial companies in Sri Lanka. BIND showed an effect on capital structure from the five selected independent variables, whereas others have no impact on the capital structure of the selected companies. The impact of BIND is positively significant on capital structure. The findings imply that because of efficient monitoring, banks and diverse financial companies find it advantageous to make loans under favourable conditions to companies with more independent directors. Therefore, banking and diversified financial companies should value independent directors' influence. Overall, the study's findings reported no substantial impact of CG on the capital structure of listed banks and diversified financial companies in Sri Lanka.

Keywords: Bank and diversified financial companies, capital structure, corporate governance.

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