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# CORPORATE GOVERNANCE AND CORPORATE PROFITABILITY OF LISTED HOTELS & TRAVELS COMPANIES IN SRI LANKA: MODERATING ROLE OF FINANCING DECISION

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## ABSTRACT

*Strong corporate governance is necessary for all the business organizations because it plays an important role in the management of organizations in both developed and developing countries. The purpose of the study is to find out the moderating role of financing decisions on corporate governance and corporate profitability of listed Hotels & Travels companies listed in Colombo Stock Exchange. A survey was carried out on all the 19 companies during the period 2011to 2015. The moderating effects of financing decisions on the relationship between corporate governance and corporate profitability were tested. In this study board size and board composition, were considered as independent variables and Return on Total Assets was used as profitability measurement. Further debt to Equity ratio was used to represent the financing decision as moderating variable. Hypotheses were tested using regression analysis. Descriptive statistics were computed for the Hotels and Travels companies and the main characteristics of the study variables. The findings revealed that the influence of corporate governance on corporate profitability was statistically significant. Debt to Equity ratio also significantly impact on corporate profitability. There was a significant moderating effect of financing decision on the association between corporate governance and Corporate profitability. The study brings out an increased understanding that the combinative effect of the study variables is greater than the individual effects therefore organizations can enhance their performance by implementing good corporate governance practices.*

**Keywords:** *Corporate Governance , Corporate Profitability, Financing Decision*

## 1.0 INTRODUCTION

Corporate governance defines the structure of rights and responsibilities of the board and management and the related parties that have a stake in a firm. Corporate governance mechanism in the operation of a firm is perceived as a vital role in guiding company's daily business. Companies in countries around the world must adhere to basic common principles of good practice in all areas of corporate governance in order to attract foreign investment. Corporate Governance is basically concerned with ways in which all parties interested in the well-being of the firm (the stakeholders) attempt to ensure that managers and other insiders are always taking appropriate measures and adopting mechanisms that safeguard the interests of the stakeholders.

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Having a regular and recognized plan called corporate governance is one of the factors by which the corporations are able to utilize the globalization benefits and supply their stocks in the verified stock exchanges around the world. By doing so, the long-term and low cost equities might be attracted. Following the appropriate principles and methods of corporate governance supports to increase the confidence of the investors and reduce the cost of equity and reinforce the capital markets (Williamson 1988).

Corporate governance includes different types of organizational mechanisms and the balance trends in the power hierarchy and the responsibility of the shareholders, managers, board of directors and employees (Lin & Liu, 2009). Ownership structure, board size, the board independence and CEO duality are the most important factors affecting the corporate governance.

The importance of financing decisions cannot be over emphasized since many of the factors that contribute to business failure can be addressed using strategies and financial decisions that drive growth and the achievement of organizational objectives (Salazar, Soto & Mosqueda, 2012). The finance factor is the main cause of financial distress (Myers & Majluf (1984)). Financing decisions result in a given capital structure and sub optimal financing decisions can lead to corporate failure. The objective of all financing decisions is wealth maximization and the immediate way of measuring the quality of any financing decision is to examine the effect of such a decision on the firm's performance. After the peace atmosphere in 2009 in Sri Lanka, The CSE has made significant contribution to the economic development of Sri Lanka. The Colombo Stock Exchange (CSE) has 296 companies representing 20 business sectors as at 04th April 2017, with a Market Capitalization of Rs. 2,703.8 Bn.

Few studies examined corporate governance in emerging markets like Sri Lanka. However most of the research work carried out in developed countries and very little is known about the impact of corporate governance on financial decisions and firms' profitability in developing economies. Thus this study intends to fill this research gap.

## 1.1 Research Problem

The impact of CG on firm performance has been a subject of great empirical investigations in finance. Most empirical research has focused on the impact of corporate governance on performance. Furthermore, finance decisions are associated with the agency costs and corporate governance mechanisms. In the present study, the corporate governance and corporate profitability of the Hotels and travels companies in CSE has been investigated in terms of the moderating role of financing decision. Several research were undertaken to ascertain how corporate governance has an impact on dividend decision, Capital structure and performance. Several researches have expressed their findings as to how corporate governance had an impact on corporate performance, corporate profitability and firm's value. However such researches are very rarely carried out in Sri Lanka. No such study has been conducted to investigate between corporate governance and corporate profitability through moderating role of financing decisions. . Therefore the research problem could be stated as follows." To what extent the corporate governance have significant impact on corporate profitability through moderating role of financing decision."

## 2 OBJECTIVES OF THE STUDY

The following can be mentioned as the objectives of this study.

- To find out the impact of corporate governance mechanisms on the profitability of the Hotels and Travels companies in Sri Lanka.
- To find out the impact of financing decisions on corporate profitability of the Hotels and Travels companies in Sri Lanka.
- To find out the impact of corporate governance on corporate profitability through the moderating role of financing decisions.

## 3 SIGNIFICANCE OF THE STUDY

Nowadays the significance of corporate governance is well recognized both nationally and internationally. The importance of this study stems from the following points:

- The investors are able to know the corporate governance mechanism adopted by the selected companies.
- This study provides evidence of whether or not the corporate governance affects the corporate profitability of Hotels and Travel companies in Sri Lanka.

## 4 DATA COLLECTION AND SAMPLING

This study utilizes the listed companies in Sri Lanka as its population. As the sampling methods differ in the type of study to be conducted, the research technique applied to get the sample of this study is the random sampling. Hotels & Travels Sector was chosen because it is one of the largest sectors of Sri Lanka in term of number of companies. .The Sample size of the study is 19 companies randomly selected from Hotels & Travels companies listed in Colombo Stock Exchange . The research is based on secondary data. Corporate governance and reporting information were collected from annual reports, *Handbook of Listed Companies and CSE official website*. For the purpose of this study data were collected during the period from 2011 to 2015. Data analysis is done with the help of software packages Eview .

## 5 LITERATURE REVIEW

### 5.1 Theoretical Foundation

The theoretical framework upon which corporate governance and capital structure are based includes the agency theory and free cash flow theory. Evidence from previous empirical studies has sought to confirm the effect of corporate governance on firm performance.

#### Agency Theory

Corporate governance has traditionally been associated with the "principal-agent" or "agency" paradox. A "principal-agent" relationship arises when the person who owns a firm is not the same as the person who managers or controls it. Agency theory has its roots in economic theory and was

developed by Jensen. Principals of the company delegate the running of business to the managers or agents. The shareholders expect the agents to act and make decisions in the principal's interest but the agents may make contrary decisions.

Jensen and Meckling (1976) argued that the separation of ownership and control has resulted in an agency problem as the managers who act as agents might not always act in the best interests of the shareholders or owners, who are the principals of the firm. This might be due to the interests of both parties which are not aligned. Agency problem results in agency costs, which are the costs of the separation of ownership and control. Agency costs have been defined as the sum of the monitoring expenditures by the principal, the bonding expenditures by the agent and the residual costs.

**Free Cash Flow Theory**

According to free cash flow theory (Jensen, 1986), leverage itself can also act as a monitoring mechanism and thereby reduces the agency problem hence increasing firm value by reducing the agency costs of free cash flow. There are some consequences derived if a firm is employing higher leverage level in that managers of such firm will not be able to invest in non-profitable new projects, as doing so the new projects might not be able to generate cash flows to the firm, hence managers might fail in paying the fixed amount of interest on the debt or the principal when it's due. It also might cause the inability to generate profit in a certain financial year that may result in failing to pay dividends to firm shareholder

## 5.2 Empirical Review on Corporate Governance, Capital Structure and Corporate Profitability

Kumuthini (2011) undertook a research in Sri Lanka on the topic related to corporate governance and firm performance of listed companies in Sri Lanka and submitted her research work to the University of Victoria, Malbourne. In the course of her research, she made a comparative as well as an analytic study of the changes that occurred code of ethics of corporate governance between the year2003 and 2007.

Senaratne (2007). undertook a study on the Topic of Corporate governance reforms in Sri Lanka. In this context, the objective of this study was to examine how corporate governance reforms had taken place in Sri Lanka, their salient characteristics and their implications on the corporate sector. This study had been carried out as an exploratory study of corporate governance reforms introduced from 1997 to 2008, the period in which the main reforms had taken place in the country. Senevadadne and Gunaradne(2007) analyzed corporate governance development in Sri Lanka regarding prospects and problems. Velnampy(2013) investigated about Corporate Governance and Firm Performance: A Study of Sri Lankan Manufacturing Companies. . He found that determinants of corporate governance were not correlated to the performance measures of the organization. Regression model showed that corporate governance has no effect on companies' ROE and ROA.

Vakilifard et al (2011) analyzed effect of corporate governance on capital structure: Case of the Iranian Listed Firms.. The results obtained from testing the research hypotheses indicate that in firms where the duties of the chairman of the board is separated from those of CEO and also in firms the benefit from fewer members of the board, the tendency to utilize debt increases. However, no significant relationship was found between 'proportion of outside directors' and 'capital structure'.

Jaradat (2015) investigated about corporate governance practices and capital structure: a study with special reference to board size, board gender, outside director and CEO duality. The result approved that board size, board diversity and outside director are positively related to the leverage. While, CEO duality had no significant relationship with leverage. The control variable like: Managerial ownership, Profitability and return on Assets were negatively and significantly related to leverage, while, firm size was positively related to the leverage.

Abdul (2012) conducted a similar study to determine the relationship between capital structure decisions and the performance of firms in Pakistan. The study concluded that financial leverage had a significant negative relationship with firm performance as measured by ROA, GM, and Tobin's Q. The relationship between financial leverage and firm performance as measured by the return on equity (ROE) was negative but not statistically significant.

In another study, Javed and Akhtar (2012) explored the relationship between capital structure and financial performance. They concluded that there is a positive relationship between financial leverage, financial performance, and growth and size of the companies.

Kaumbuthu (2011) carried out a study to determine the relationship between capital structure and return on equity for industrial and allied sectors in the Nairobi Securities Exchange during the period 2004 to 2008. Capital structure was proxied by debt equity ratio while performance focused on return on equity. The study applied regression analysis and found a negative relationship between debt equity ratio and ROE.

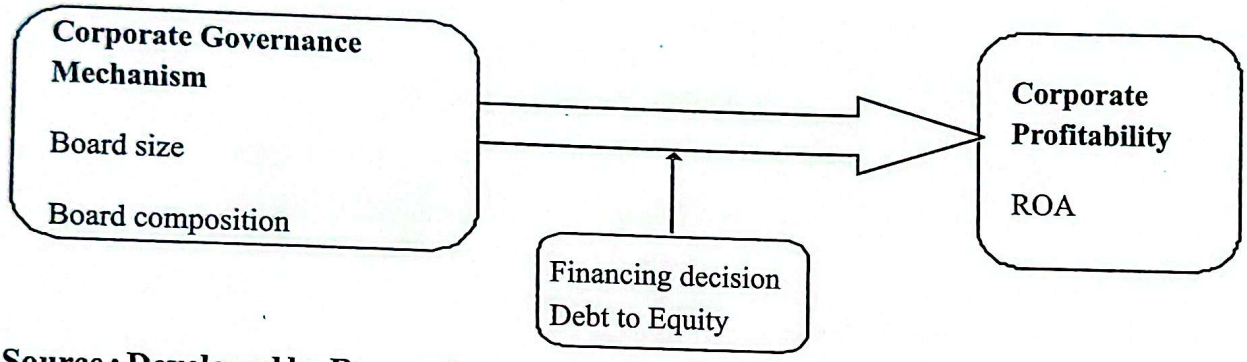
Ebaid (2009) carried out a study to investigate the impact of choice of capital structure on the performance of firms in Egypt. Performance was measured using ROE, ROA, and gross profit margin. Capital structure was measured by short-term debt to asset ratio, long-term debt to asset ratio, and total debt to total assets. Multiple regression analysis was applied to estimate the relationship between the leverage level and performance. The study concluded that capital structure had little to no impact on a firm's performance.

Adekunle (2009) used debt ratio to proxy capital structure while return on asset and return on equity were used as measures of firms' performance. The study used the Ordinary Least Squares method of estimation. The result of the study indicated that debt ratio had a significant negative impact on the firm's financial measures of performance. The study, however, did not consider other financing decisions in the analysis, including the mediating effect of internal cash flow available.

Okiro et al(2015) analyzed the effect of corporate governance and capital structure on performance of firms listed at the east African community securities exchange. The findings revealed that the there was a significant positive relationship between corporate governance and firm performance. The study also confirmed that there is a positive significant intervening effect of capital structure (leverage) on the relationship between corporate governance and firm performance.

## 6. CONCEPTUAL FRAMEWORK

After the careful study of review of literature the following conceptual model is developed by the researcher.




**Source : Developed by Researcher**

In the above model corporate governance mechanism variables are considered to be independent variable and corporate profitability is considered to be dependent variable and financing decision is considered to be moderating variable. . This model was developed on the basis of the research undertaken by Kennedy in Nairabi.

## 7. DEFINITION OF VARIABLES

### Dependent Variable (Profitability )

Profitability ratios are frequently used to measure management's effectiveness in achieving profitability. Even though, there are several profitability ratios based on the investment and turnover. Return on Assets was taken into account in the study.

Return on Assets: A ratio that measures a company's earnings before interest and taxes (EBIT) against its total net assets.

Moderating Variable (Financing decision): The Financing Decision is a crucial decision made by the financial manager relating to the financing-mix of an organization. It is concerned with the borrowing and allocation of funds required for the investment decisions. Debt to Equity ratio was taken to represent the financial ratio.

(Debt to Equity Ratio): It indicates what proportion of equity and debt which the company is using to finance its assets.

**Independent Variables (Corporate Governance)**

A corporate governance structure is often a combination of various mechanisms. Those are Board size, Board composition, CEO duality, No of auditors, no of female members of the Board and Number of board meeting. Board size and board compositions are taken into account in this study.

Board size (BS) :The Total number of directors on the board.

**Board composition (Bcom)**

Board composition normally concerns issues related to board independence (including independence of board committees) of board members

**Control Variables**
**Firm size (FS)** The natural log of the total Assets.

## 8. HYPOTHESES OF THE STUDY

Based on theory, previous studies and the research model outlined, this study has formulated the following hypotheses to examine the relationship between variables.

$H_1$. Corporate governance mechanisms significantly impact on corporate Profitability as Measured by ROA

$H_2$: Corporate governance mechanisms have significant impact on corporate profitability as measured by ROA through moderating role of Financing decision.

## 9. REGRESSION MODELS USED IN THIS STUDY

To investigate the impact of corporate governance on corporate profitability, the model used for the regressions analysis is expressed in the general form as given in equation 1 .

$$ROA = f(, \text{board size}, Bcom, LE, FS) \quad \text{Equation 1}$$
$$ROA = \beta_{0+}\beta_1 BS + \beta_2 Bcom + \beta_3 LE + \beta_4 Fs + E_{it} \quad \text{model 1}$$

To investigate the impact corporate governance on corporate profitability as measured by ROA through moderating role of financing decision , the model used for the regressions analysis is expressed as follows.

$$ROA = \beta_{0+}\beta_1 BS + \beta_2 Bcom + \beta_3 LE + \beta_4 BS*LE + \beta_5\beta_6 Bcom*LE + \beta_6 Fs + E_{it} \quad \text{model 1}$$

## 10. RESULTS OF THIS STUDY

### Descriptive Statistics

Preliminary analysis of the data was carried out for the years 2011 and 2015. Descriptive statistics are also useful to make general observations about the data collected. They report on the trends and patterns of data and provide the basis for comparisons between variables. General description of these variables appears on the Table 01 below.

Table 01 - Descriptive Statistics

| | BOARDSIZE | Board COM | LEVERAGE | FIRM_SIZE | ROA |
|---|---|---|---|---|---|
| Mean | 8.53000 | 0.402059 | 0.223457 | 21.74095 | 4.476919 |
| Median | 8.000000 | 0.428571 | 0.158427 | 21.90149 | 3.638673 |
| Maximum | 15.00000 | 0.843714 | 0.886360 | 23.86518 | 39.60312 |
| Minimum | 4.000000 | 0.202319 | 0.000231 | 19.48900 | -11.57596 |
| Std. Dev. | 2.534000 | 0.154256 | 0.208252 | 1.042338 | 6.880970 |
| Skewness | .5120000 | -0.752804 | 1.224967 | -0.289645 | 1.294437 |
| Kurtosis | -.1450000 | 5.246509 | 3.981170 | 2.628323 | 8.853958 |
| Jarque-Bera | 501.5171 | 28.94990 | 27.56927 | 1.875149 | 162.1773 |
| Probability | 0.000000 | 0.000001 | 0.000001 | 0.391576 | 0.000000 |
| Sum | 753.3021 | 38.19560 | 21.22844 | 2065.391 | 425.3073 |
| Sum Sq. Dev. | 1115.628 | 2.236721 | 4.076692 | 102.1281 | 4450.688 |
| Observations | 95 | 95 | 95 | 95 | 95 |

The results showed that Board size had a mean value of 8.53 with a minimum of 4 , a maximum of 15, skewness .512 and kurtosis of -.1450000. Board composition had a mean value of 0.402059, minimum of 0.202319, maximum of 0.843714 skewness of -0.752804 and kurtosis of .246509 Comparatively, Return on Assets had a mean value of 4.476919, minimum of -11.57596, maximum of 39.60312, skewness of 1.294437and kurtosis of 8.853958 . Leverage had a mean value of 0.223457, minimum of 0.000231, maximum of 0.886360 skewness of 1.224967and kurtosis of 3.981170. Skewness measures the degree and direction of asymmetry. A symmetric distribution such as a normal distribution has a skewness of 0, while nearly normal distributions will have skewness values close to 0.Analysis of skewness shows that leverage, and ROA are asymmetrical to the right .

### Unit Root Tests

Unit root tests are tests for stationary in a time series. A time series has stationary if a shift in time doesn't cause a change in the shape of the distribution; unit roots are one cause for non-stationary. The Dickey Fuller Test (sometimes called a Dickey Pantula test), which is based on linear regression. Serial correlation can be an issue, in which case the Augmented Dickey-Fuller (ADF) test can be used. The following Table 2 shows the unit root test summary for each variables..

Table 02: Unit root Test

Augmented Dickey-Fuller test statistic

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| BOARDSIZE | -0.487996 | 0.102941 | -4.740530 | 0.0000 |
| Board COM | -0.490763 | 0.082769 | -5.929348 | 0.0000 |
| LEVERAGE | -0.404233 | 0.082637 | -4.891652 | 0.0000 |
| ROA | -0.441123 | 0.083490 | -5.283543 | 0.0000 |

Here all p values are equal to Zero. Thus the variables don't have the unit root.

**Multicolonearity Test**

Multi co linearity can be measured using Variance Inflation Factor or Tolerance test. In this study, VIF was used.

Table 03:

| Variable | Coefficient Variance | Centered VIF |
|---|---|---|
| C | 201.8214 | NA |
| BOARDSIZE | 0.045368 | 1.251836 |
| COM | 21.66144 | 1.198335 |
| LEVERAGE | 10.90520 | 1.099564 |
| FIRM_SIZE | 0.424679 | 1.072716 |

According to the Table 3 VIF values are below 10 and when VIF values are less than 10 then there is no multi-co linearity problem (Jing Yu LF 2003)

To find out the relationship among variables correlation analysis was carried out. The summary of the results are presented in the Table 04.

Table 04

Correlation Summary

| | BOARDSIZE | COM | LEVERAGE | FIRM_SIZE | ROA |
|---|---|---|---|---|---|
| BOARDSIZE | 1.000000 | | | | |
| Board COM | 0.317381 | 1.000000 | | | |
| LEVERAGE | -0.279506 | 0.006137 | 1.000000 | | |
| FIRM_SIZE | -0.075777 | 0.207386 | -0.001985 | 1.000000 | |
| ROA | 0.293209 | -0.098580 | -0.326540 | -0.040805 | 1.000000 |

Firm size and leverage have negative and weak relationship with ROA , but there is positive and weak correlation among Board size, Board com and ROA.. These weak relationships between the explanatory variables are also the indication that there is no severe issue of multi-co-linearity.

**Regression Summary Model I**

Table 5 demonstrates the findings of the regression analysis. Model 1 expresses the effect of independent variable (Board size , Board composition ) and moderator (Leverage ) on corporate profitability (ROA).

Table 05

Dependent Variable: ROA
Method: Least Squares
Sample: 1 95
Included observations: 95

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| BOARDSIZE | 0.582388 | 0.205244 | 2.837538 | 0.0056 |
| Board COM | -8.709642 | 4.565941 | -1.907524 | 0.0596 |
| LEVERAGE | -8.029792 | 3.259161 | -2.463761 | 0.0156 |
| FIRM_SIZE | 0.236890 | 0.106760 | 2.218913 | 0.0290 |

| | | | |
|---|---|---|---|
| R-squared | 0.182179 | Mean dependent var | 4.476919 |
| Adjusted R-squared | 0.155218 | S.D. dependent var | 6.880970 |
| S.E. of regression | 6.324439 | Akaike info criterion | 6.567913 |
| Sum squared resid | 3639.866 | Schwarz criterion | 6.675444 |
| Log likelihood | -307.9759 | Hannan-Quinn criter. | 6.611364 |
| Durbin-Watson stat | 0.915955 | | |

The above Table shows the estimated result of model 01. R square shows that the model explained 18.2179 % of total variations of the dependent variable. It means that 18.2179 % of the changes in dependent variable are described by both independent and control variables. As a point of focus , the hypotheses of this study states that the Corporate Governance significantly impact on corporate profitability of listed Hotels and Tours companies.

As observed, the results show that board size has a coefficient of 0.582388 with t statistics of 2.837538 with a p value of 0.0056. Thus, from the results , it can be stated that there is significant impact of board size on corporate profitability. Board composition has a coefficient of -8.709642 with t statistics of -1.907524 with a p value of 0.0596. Board composition has significant impact on corporate profitability at 10% level. Leverage ratio and firm size also significantly impact on corporate profitability. Durbin Watson test is a test used to defect auto correlation. From the Table 03 Durbin Watson stat value is 0.915955. This value less than 3 indicating that there is no auto correlation issues.

## Regression Summary Model 2

To test the hypotheses(H2) , regression analysis (Model 02) was carried out. The summary is presented in the Table 06.

Table 06.

Dependent Variable: ROA

Method: Least Squares

Sample: 1 95

Included observations: 95

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| C | -9.019134 | 13.87921 | -0.649831 | 0.5175 |
| BOARDSIZE | 0.395994 | 0.346557 | 1.142653 | 0.2563 |
| BCOM | 0.526257 | 5.599470 | 0.093983 | 0.9253 |
| LEVERAGE | 11.41650 | 11.15221 | 1.023699 | 0.3088 |
| BS_LE | 2.438751 | 0.757217 | 3.220676 | 0.0018 |
| COLE | -10.62828 | 2.885588 | -3.683228 | 0.0004 |
| FIRM_SIZE | 0.532181 | 0.603726 | 0.881495 | 0.3805 |

| | | | |
|---|---|---|---|
| R-squared | 0.330051 | Mean dependent var | 4.476919 |
| Adjusted R-squared | 0.284373 | S.D. dependent var | 6.880970 |
| S.E. of regression | 5.820938 | Akaike info criterion | 6.431628 |
| Sum squared resid | 2981.732 | Schwarz criterion | 6.619809 |
| Log likelihood | -298.5023 | Hannan-Quinn criter. | 6.507667 |
| F-statistic | 7.225558 | Durbin-Watson stat | 1.132420 |
| Prob(F-statistic) | 0.000003 | | |

When incorporating the interaction term (Board Size*leverage and Boardcom*Leverage), the results have improved (Model 2). The board composition shows the positive and insignificant inspiration on corporate profitability (ROA)) Board size also shows positive and insignificant impact on corporate profitability. Financing decision also shows insignificant positive impact on corporate profitability. When incorporating the interaction term, it is observed that regression summary of Model II differs from the model I regression summary. In addition the explanatory capability of the model has increased significantly up to 33.0051 % . Model 2 is also specified as shown by the value of F-statistic, which is significant. As the value of Interaction term is significant and R2 change is also significant, which is the indication that hypothesis (H2) of the study is supported.

## 11. CONCLUSION

This study investigated the Impact of corporate governance and Corporate profitability through moderating effect of financing decision. . The result shows that Board size positively impact on the corporate profitability and Board composition negatively impact on the corporate profitability. Afterwards, the results confirmed that Interaction term (Board Size*leverage and Boardcom*Leverage ) have significant on the corporate profitability. Furthermore, when adding this interaction term, the explanatory power of the model (R-squared ) is also showing the significant change, which support the hypothesis of the research. Therefore, the hypothesis of the research that corporate governance significantly impact on corporate profitability through moderating role of financing decisions is accepted on the basis of the statistical results. The similar results have also been found in study done by Maliket and Naz (2016) and in this research the moderating effect of corporate governance was taken into account and leverage (Debt to equity ratio) was taken as independent variable.

The study has provided contribution to existing literature by adding the moderating effect of financing decision between the relationship of corporate governance and corporate profitability.

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