The Impact of Corporate Governance on Financing Decision of Listed Firms in S&P EGX/ESG Index

تأثير حوكمه الشركات على قرار التمويل للشركـــات المدرجـة فـــي مؤشـــر S&P EGX/ESG

A Thesis Submitted in Partial Fulfillment of the Requirements for the Master of Science in Business Administration

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2019

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Date of Dissertation Defense: 7th of December 2019

Approved by Faculty Council on / /

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Acknowledgement

I would like to express my deepest thanks and sincere gratitude to my supervisor, **Prof. Hayam Hassan Wahba,** *for her time, unlimited support, guidance, assistance and constructive feedback throughout writing this thesis.*

Also, I would like to thank my supervisor **Prof. Waleed Youssef,** *for his consistent support and guidance, throughout writing this thesis.*

As well as, I would like to thank **Prof. Tarek Eldomiaty,** *for his participation in the examination committee and for his constructive feedback.*

I would like to thank **Prof. Sahar Mahran,** *for her participation in the examination committee and for her constructive feedback.*

I must express my very profound gratitude to my parents and to my husband for providing me with unfailing support and continuous encouragement throughout my study and writing this thesis. This accomplishment would not have been possible without them. Thank you.

Abstract

This study aims to investigate the relationship between corporate governance mechanisms and financing decision. Corporate governance mechanisms are represented by board size, board composition, CEO duality and firms' weight in S&P EGX/ESG index. While financing decision is represented by leverage ratio (total debt to total assets ratio).

The researcher used 30 non-financial firms which are listed in S&P EGX/ESG index, during the period from 2013 to 2018 and entered the index more than one time.

The researcher used both qualitative and quantitative analysis to figure out this relationship. First, the researcher carried out descriptive analysis to highlight the main features of each variable. Second, correlation analysis to discover the association among explanatory variables as well as to find whether there is relationship between dependent variable and the independent variables. Third, Random effect regression analysis which examined the effect of corporate governance mechanisms on financing decision. The analysis showed that board size and firm's weight in S&P EGX/ESG index have negative significant impact on debt ratio, while CEO duality and board composition have insignificant impact on debt ratio.

Keywords: Financing decision, Capital structure, Debt ratio, Board of directors, Internal corporate governance mechanisms, Panel data analysis.

Table of Contents

List of Tables

List of Figure

Chapter One

Introduction

1.1 Introduction

Financing decision is one of the pivotal decisions that is made in any corporation. It is to decide between employing debt and equity to finance investment and create financing mix that increases firm's value for the shareholders. This decision, which is made by the managers, should be in line with the interest of shareholders. The separation of ownership and management may lead to the rise of agency problem (managers use firm's resources for their own benefits and according to their risk-preference regardless the interest of shareholders (Jensen and Meckling, 1976). Namely, managers prefer less risky investments and lower financial leverage to reduce the probability of bankruptcy as well as to increase free cash flow which can be employed to serve their private interest. That can be handled by employing a high level of debt but using too much debt can affect liquidity and solvency of the firm which may cause harm to firms' value (Meckling and Jensen, 1986).

To reduce this conflict of interest, shareholders elect board of directors and delegate the monitoring function to them. Board of directors tries to make sure that shareholder's interests are well accomplished. Those directors should have special characteristics to perform their roles well. These characteristics are stated by corporate governance code.

Therefore, the research is an attempt to investigate the relationship between corporate governance mechanisms (using board of directors' characteristics and S&P/EGX ESG index as a proxy) and financing decision in Egypt.

1.2 Research Gap

In this part, the researcher divided into two parts. First part is about what differentiate this study from other studies that examined financing decision. Second part is about the contradicting results.

First, the researcher controlled the effect of firm- specific characteristics, industry characteristics and country-specific characteristics while examining the effect of board of directors' characteristics and firms' weights in S&P/EGX ESG index. Furthermore, to the best of my knowledge, it is the first study which examined the effect of corporate governance and corporate social and environmental responsibility on financing decision in Egypt, throughout using firms' weights in S&P/EGX ESG index.

Second, the relationship between board characteristics and debt ratio is also contradicting for instance, Wen et al (2002), Hasan and Butt (2009), and Brenni (2014) showed a negative relationship between board size and debt level in contrast, Kyereboah-coleman and Biekpe, (2006), Abor (2007), Alnodel and Hussainey (2010), and Wellalage and Locke (2012) revealed a positive relationship.

Regarding board composition, high proportion of non-executive directors leads to less use of debt (Butt & Hasan, 2009; Heng et al., 2012; Alves et al., 2015; Badru et al., 2017). Whereas other studies argued that proportion of non-executive directors is positively correlated with debt ratio (Wen, Rwegasira, & Bilderbeek, 2002; Abor & Biekpe, 2005; Abor, 2007; Brenni, 2014).

Regarding CEO duality, Hasan and Butt (2009) revealed that it doesn’t affect financing decision. On the other hand, Abor (2007) and Wellalage and Locke (2012) found that it causes employing debt in capital structure while Kyereboah-coleman and Biekpe (2006), and Brenni (2014) proved that if the CEO is the chairman, the use of debt will be less.

The following table illustrates the contradicting studies regarding the effect of board size, CEO duality, board composition and firms’ weight in S&P EGX/ ESG index on financing decision (total debt to total asset ratio).

Table (1.1): Research gap

Variable	Effect	Empirical studies
Board size	Negative	(Abor & Biekpe, 2005; Butt & Hasan, 2009; Heng, Azrbaijani, & San, 2012; Brenni, 2014; Dimitropoulos, 2014; Abobakr and Elgiziry, 2015; Alves, Couto, & Francisco, 2015; Badru, Ahmad-Zaluki, & Wan-Hussin, 2017)
	Positive	(Abor, 2007; Bokpin & Arko, 2009; Al-Nodel & Hussainey, 2010; Sheikh and Wang, 2012; Mohamed and Elbadry,2017; El-Habashy, 2018)
	No	(Wen, Rwegasira and Bilderbeek, 2002; Hussainey and Aljifri, 2012; Megeid, 2015)
CEO duality	Positive	(Abor & Biekpe, 2005; Abor, 2007; Hewa Wellalage & Locke, 2012; Dimitropoulos, 2014; Alves et al., 2015; El-Habashy, 2018)
	Negative	(Kyereboah- coleman & Biekpe, 2006; Heng et al. 2012; Brenni, 2014; Liao, Mukherjee and Wang, 2015; Badru et al., 2017)
	No	(Bokpin & Arko, 2009; Butt & Hasan, 2009; Ahmed Sheikh & Wang, 2012; Abobakr and Elgiziry, 2015; Elbadry, 2017)
Board composition	Negative	(Butt & Hasan, 2009; Heng et al., 2012; Alves et al., 2015; Badru et al., 2017)
	Positive	(Wen, Rwegasira, & Bilderbeek, 2002; Abor & Biekpe, 2005; Abor, 2007; Brenni, 2014)
	No	(Kyereboah- coleman & Biekpe, 2006; Hewa Wellalage & Locke, 2012)
ESG index	Negative	Arping and Sautner (2010) found that the more the quality of corporate governance increases, the less the firm uses debt. As well as, Mande, Park, & Son (2012) found that firms with strong corporate governance system tends to use equity. Other studies supported the same findings (Jiraporn, Kim and Kitsabunnarat, 2012; Haque, 2015)
	Positive	Al-Nodel & Hussainey (2010) discovered that in Saudi firms with strong corporate governance mechanisms prefer to finance their projects by debt.

Source: Developed by the researcher

1.3 Research Problem

As illustrated, there are contradicting findings regarding the relationship between corporate governance practices and making a financing decision which lead to confusion in understanding the relationship between them. Therefore, the research is going to answer the following question:

Do corporate governance mechanisms affect financing decision in Egypt? And to what extent?

1.4 Research Methodology

1.4.1 Sample

Using 30 non-financial firms frequently listed in the S&P/EGX ESG index over the period of 2013-2018. The index has been created by the Egyptian institute of directors with the assistance of the Egyptian stock exchange, S&P Dow Jones indices and crisil. The index is conducted by giving scores to the firms in the three parameters of environmental, social and corporate governance responsibility also is taken into consideration the size and liquidity of the firms. It consists of 30 stocks chosen from EGX100.

In contrast to the other researches that have been made in Egypt, Hafez (2017) used sample of 50 non-financial highly active firms in EGX100 over the period of 2007-2016, Mohamed and Elbadry (2017) used sample of 35 firms and covering the period from 2006 to 2013, Megeid (2015) applied his study on a sample of 52 manufacturing firms from2006 to 2010. While Abobakr and Elgiziry (2016) chose a sample of 36 of non-financial firms over the period 2007-2011.

1.4.2 Variables

- Dependent variable: financing decision

Financing decision is a dependent variable in this study which will be measured by total debt ratio (total debt divided by total asset). Following Fama and French (2002) and Frank and Goyal (2009), using book value of total debt ratio is better than market values because of swings in financial market may lead market leverage to be unreliable as a guide to corporate financial policy. The following table illustrates how financing decision is measured and the empirical studies that used this variable.

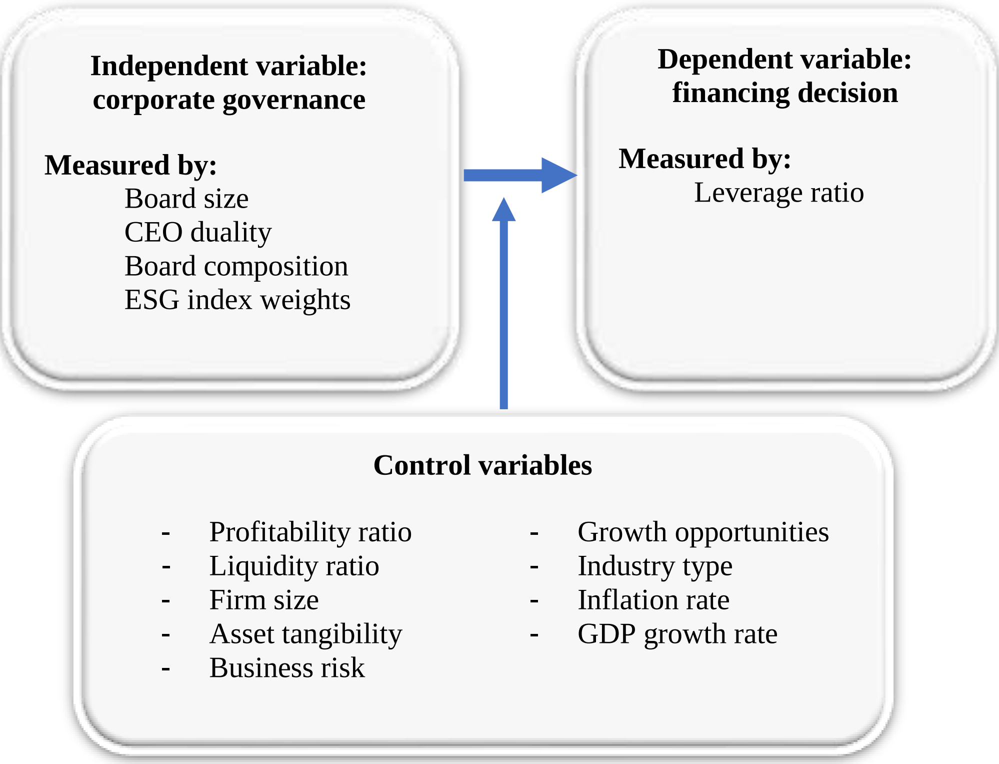
- Independent variable: corporate governance

Corporate governance represents the independent variable in this study which will be measured through board size, board composition, CEO duality and firms’ weight in S&P/ EGX ESG index. The researcher chose board characteristics as a proxy for corporate governance because of the role of board of directors in reviewing corporate strategy, ratifying the decisions made by managers and monitoring the implementation of these decisions, selecting and compensating the management and their role in reducing agency problems. The following table highlights how these variables are measured and the empirical studies that used them.

- Control variables

There are some firm specific characteristics, industry characteristics and country specific characteristics that affects financing decision. Therefore, the researcher is going to control the effect of those variables because they could confound the relationship between board characteristics and financing decision.

Figure (1): Illustrates the variables and their relationships.



Source: Developed by the researcher

1.4.3 Data Collection

The researcher uses secondary data, which is collected from annual financial statements, corporate governance information disclosure book included in the annual report loaded on Egyptian Exchange website and from Misr for central clearing depository and registry MCDR. While macroeconomic variables will be collected from World Bank and central bank websites.