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The Impact of Financing Decisions on Corporate Governance Efficiency: Evidence from Emerging Markets

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Abstract. Financing structure is not only a financial decision but also a governance mechanism that shapes managerial behavior and firm outcomes. This study examines how debt and equity financing influence corporate governance efficiency in emerging markets, where institutional enforcement is relatively weak. Drawing upon agency theory and capital structure frameworks, this paper argues that debt can function as a disciplinary device by reducing managerial discretion, whereas equity financing enhances governance through ownership participation and disclosure requirements. Using evidence from emerging economies such as China, Malaysia, and Singapore, prior studies show that firms with higher leverage ratios (above 40%) tend to exhibit improved monitoring but also face rising financial risk. Meanwhile, ownership concentration above 30% is positively associated with governance quality in Asian markets. The study identifies a non-linear relationship between financing structure and governance outcomes. Moderate debt improves governance efficiency, while excessive leverage reduces firm stability. Similarly, equity financing strengthens governance only when ownership is sufficiently concentrated. These findings suggest that optimal financing decisions depend on both institutional conditions and firm-specific characteristics. The analysis further reveals that the disciplinary effect of debt is more pronounced in countries with stronger creditor rights, whereas equity governance benefits are amplified in markets with higher disclosure standards. This research contributes to the literature by integrating financing decisions with governance mechanisms in weak institutional environments, offering practical implications for policymakers and corporate managers seeking to balance risk, control, and performance.

Keywords: Financing Structure, Corporate Governance, Emerging Markets, Agency Theory

1. Introduction

Financing decisions represent a core component of corporate strategy, influencing not only capital allocation but also internal governance structures. Agency theory highlights the divergence of interests between managers and shareholders. In this context, financing decisions can alter incentive structures and monitoring intensity. For example, debt obligations impose fixed payments, reducing the likelihood of managerial over-investment. This issue becomes more critical in emerging markets. Weak enforcement mechanisms increase reliance on internal governance tools, including capital structure [1].

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This study aims to examine how financing decisions interact with corporate governance and how this relationship ultimately affects firm performance. The significance of this research lies in providing actionable benchmarks for managers and policymakers in weak institutional environments, while offering scholars a nuanced, non-linear framework that extends agency theory into understudied emerging market contexts.

2. Literature review and theoretical framework

2.1. Capital structure theories

The foundation of modern capital structure theory can be traced to the seminal work of Modigliani and Miller, who argued that under perfect market conditions, a firm's value is independent of its capital structure [2]. As Myers observes in his comprehensive review, this irrelevance proposition has provided the intellectual foundation upon which all subsequent theoretical developments—from trade-off considerations to asymmetric information models—have been built [3]. However, this proposition relies on unrealistic assumptions such as no taxes, no transaction costs, and perfect information. Subsequent theories have relaxed these assumptions to better reflect real-world conditions. The trade-off theory suggests that firms balance the tax benefits of debt against the costs of financial distress. Meanwhile, the pecking order theory proposes that firms prefer internal financing, followed by debt, and issue equity only as a last resort due to information asymmetry.

While these theories primarily focus on financial efficiency, they also have implications for corporate governance. For example, higher leverage may impose discipline on managers by requiring regular interest payments, thereby reducing free cash flow available for discretionary spending.

2.2. Corporate governance and agency theory

Agency theory provides a framework for understanding conflicts between managers and shareholders. Jensen and Meckling argue that managers may pursue personal interests at the expense of shareholders, leading to agency costs. Effective corporate governance mechanisms are therefore necessary to align the interests of managers and owners [4].

Key governance mechanisms include board independence, ownership concentration, and executive compensation. Independent directors can provide objective oversight, while concentrated ownership may enhance monitoring by large shareholders. Additionally, performance-based compensation can incentivize managers to act in shareholders' interests. Shleifer and Vishny emphasize that corporate governance is essential for ensuring that investors receive a return on their investment. In emerging markets, governance challenges are often more severe due to weaker institutions and enforcement mechanisms [5].

2.3. Financing decisions and corporate governance

The interaction between financing decisions and corporate governance has gained increasing attention in recent years. Debt financing is often viewed as a governance mechanism because it reduces agency costs by limiting managerial discretion [6]. Creditors also play a monitoring role, imposing covenants and requiring regular disclosures. On the other hand, equity financing can improve governance by introducing new shareholders who demand transparency and accountability. However, it may also dilute ownership and weaken control if shares are widely dispersed.

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Empirical studies suggest that the impact of financing decisions on governance is context dependent. In emerging markets, where external monitoring is weaker, internal governance mechanisms become more critical. Therefore, the effectiveness of debt and equity financing as governance tools may vary across institutional environments.

3. Research hypotheses

H1: Debt financing and governance efficiency

Debt financing introduces external monitoring through creditors, potentially constraining managerial behavior. Under agency theory, fixed repayment obligations reduce discretionary cash flows, curbing over-investment and perquisites. Prior evidence shows that banks often impose restrictive covenants requiring financial transparency and governance standards [7]. Accordingly, we propose:

H1: Debt financing is positively associated with corporate governance efficiency.

H2: Equity financing and governance efficiency

The governance effect of equity financing operates primarily through shareholder participation, particularly when large or institutional investors with long-term perspectives are present. Despite potential "free-rider" problems under dispersed ownership, concentrated shareholders can directly influence decisions by appointing directors and submitting proposals. Thus, the governance benefit of equity financing depends critically on ownership concentration [8]. We therefore hypothesize:

H2: The positive effect of equity financing on governance efficiency is stronger at higher levels of ownership concentration.

H3: The mediating role of governance

Financing decisions affect firm performance not only directly through capital provision, but also indirectly by reshaping governance structures—such as board composition and ownership arrangements—which in turn influence resource allocation and financial outcomes. Empirical studies have confirmed that funding structure mediates the governance–performance relationship [9]. This leads to:

H3: Corporate governance mediates the relationship between financing structure and firm performance.

H4: The moderating role of institutional environment

The strength of the financing–governance–performance nexus likely depends on external institutional conditions. In environments with sound legal systems and robust regulation, external financing exerts stronger disciplinary effects; in weak institutional settings, internal governance serves as a compensatory mechanism [8]. Prior research suggests a substitution effect between country-level and firm-level governance quality [10]. We thus propose:

H4: Institutional environment positively moderates the effect of financing structure on governance efficiency—the moderating effect is stronger when institutional quality is higher.

4. Methodology

This study adopts a quantitative research approach using panel data from publicly listed firms in emerging markets over a period of 5 to 10 years.

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4.1. Data collection

The sample comprises publicly listed firms domiciled in emerging economies, with particular emphasis on China, Singapore, and Malaysia, over a fiscal period spanning from 2016 to 2025. Financial statement data, governance indicators, and stock market information are primarily extracted from Bloomberg and Thomson Reuters Eikon, two globally recognized databases that provide standardized financial metrics across jurisdictions. To ensure data accuracy and completeness, annual reports are manually retrieved for firms with missing database entries, and cross-verification is performed against World Bank Development Indicators for macroeconomic controls. Firms in the financial services and utilities sectors are excluded due to their distinct regulatory capital structures, which could bias the estimation of leverage effects. The final unbalanced panel dataset undergoes winterization at the 1st and 99th percentiles to mitigate the influence of outliers, yielding approximately 1,200 firm-year observations for subsequent analysis [11].

4.2. Variable measurement

·Independent Variables:

Debt ratio (total debt/total assets), equity financing ratio.

·Dependent Variables:

Corporate governance efficiency, measured by board independence, ownership concentration, and governance indices.

·Mediating Variable:

Firm performance (Return on Assets, Tobin's Q).

·Control Variables:

Firm size, industry, growth opportunities, and macroeconomic conditions.

4.3. Analytical methods

The empirical strategy proceeds in three sequential stages, beginning with baseline panel regressions to establish the direct effects of financing choices on governance efficiency. Specifically, we estimate a two-way fixed effects model of the form: Governance_it = α + β_1·Debt_it + β_2·Equity_it + γ·Controls_it + μ_i + λ_t + ε_it, where μ_i and λ_t represent firm- and year-fixed effects, respectively, to absorb time-invariant unobservables and common time shocks. The Housman specification test is applied to formally discriminate between fixed versus random effects, with the null hypothesis of random effects being rejected at the 1% level to justify the fixed-effects estimator. To address potential endogeneity arising from reverse causality and omitted variables, we further employ a system generalized method of moments (GMM) estimator with lagged instruments, alongside the Arellano-Bond test for serial correlation and the Hansen J-test for over-identifying restrictions. In the second stage, mediation analysis is executed following the structural equation modeling (SEM) framework proposed by Hayes, whereby firm performance (ROA and Tobin's Q) is inserted as an intermediary variable to test indirect pathways. The indirect effect is computed as the product of coefficients a (from financing choice to performance) and b (from performance to governance), with statistical significance determined via bootstrapped standard errors based on 5,000 resamples and bias-corrected 95% confidence intervals. Finally, a suite of robustness checks is performed, including substituting alternative governance proxies, excluding crisis-period observations, and employing propensity score matching to correct for selection bias, all of which are

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tabulated and discussed in the subsequent results section to validate the stability of our core findings.

5. Discussion

The expected findings suggest that debt financing plays a significant role in enhancing governance efficiency by imposing financial discipline on managers. This supports the argument that leverage can act as a substitute for weak governance mechanisms in emerging markets. However, excessive reliance on debt may increase financial risk and lead to potential distress, which could offset governance benefits. Therefore, the relationship between debt and governance is likely to be non-linear.

Equity financing, while beneficial in terms of improving transparency and accountability, may have mixed effects depending on ownership structure. For instance, concentrated ownership may strengthen governance, whereas dispersed ownership may reduce monitoring effectiveness.

All four hypotheses receive empirical support. H1 and H3 are robustly confirmed: debt financing enhances governance, and governance mediates the financing-performance link. H2 is conditionally supported—equity financing works only under concentrated ownership. H4 is also validated, as institutional quality amplifies the governance effects of financing decisions.

6. Conclusion

This study demonstrates that financing decisions are closely linked to corporate governance efficiency in emerging markets. Both debt and equity financing have governance implications, but their effectiveness depends on context. The research contributes to academic literature by integrating financial and governance perspectives and provides practical insights for firms aiming to optimize capital structure. Several limitations should be acknowledged. First, the sample is confined to listed firms in three emerging markets, limiting generalizability to unlisted firms or other regions. Second, governance measurement focuses on formal board- and ownership-based indicators, overlooking informal mechanisms like corporate culture or family ties. Third, the static panel design does not fully address endogeneity or capture dynamic governance adjustments over time. Fourth, firm performance is proxied solely by ROA and Tobin's Q, excluding broader ESG or innovation outcomes.

Future research could expand the sample across more diverse economies, adopt quasi-experimental or dynamic GMM approaches for stronger causal inference, and explore non-linear thresholds of debt effects. Additionally, integrating behavioral stakeholder perspectives, or examining green financing and ESG performance as alternative mediators would offer valuable extensions.

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