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The Relationship Between Capital Structure and Firm Performance of French Firms: Under the Moderating Role of Corporate Governance

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Abstract

This article studies the moderating effect of the corporate governance in relationship between the capital structure and the financial of listed French companies. To achieve this objective, we performed a regression on panel data relating to 57 listed companies over the period 2010-2020. First, the results of this study suggest that the debt ratio has a significantly negative effect on the financial performance of firms. Second, our sample confirmed a significantly positive relationship between corporate governance and corporate financial performance. Third, the results reveal that corporate governance can moderate the relationship between corporate debt and financial performance.

Keywords: capital structure, corporate governance, financial performance, ROA ,governance score .

1. Introduction

The theory of capital structure is an important issue in western contemporary finance research, especially after the famous MM Theory by Modigliani and Miller (1958), who pointed out that in the world of no tax (a perfect capital market), the firm's value would not be affected by the capital structure. However, the perfect capital market does not exist, as income is taxed for every firm.

Given the limitation of the MM Theory, capital structure and its association has increasingly attracted great attention. Different scholars started to re-define the relationship between them from different perspectives and many scholars have begun to conduct empirical research on their relationship since Jensen and Meckling (1976) put forward the Agency Theory of capital structure being related to the firm performance (Ahmed Sheikh and Wang, 2013). Therefore, the relationship between capital structure and firm performance has become a controversial issue in today's modern finance study.

Furthermore, due to the different findings on the relationship between capital structure and firm performance, Faulkender et al. (2012) suggested that direct effects of the capital structure on firm performance may not yield reliable results because their interaction may be impacted by other factors.Therefore, this paper aims to examine the relationship between capital structure and firm performance under the moderating role of corporate governance. Understanding their relationship helped french firms to comprehensively consider the influencing factor of governance and apply appropriate methods to determine the optimal capital structure to achieve the purpose of improving firm performance.

The overall structure of this paper takes the form of five sections, including introduction, literature review and hypothesis development, research methodology, empirical analysis as well as conclusion and discussion. The first section provides the background, problem statement and the overall structure of this paper. Based on the previous literature reviews, the second section states key ideas and theories related to the relationship among capital structure, corporate governance and firm performance and proposes the hypothesis. The third section explained the procedures on how this study was carried out in order to get reliable results. The fourth section presents the process of empirical analysis. The last section concludes the main findings and discusses the implication of these findings to french firms.

2.Literature review and hypothesis development

2.1.The impact of debt on the financial performance of firms

The literature has predominantly focused on studying the effect of debt on a firm's financial performance. A review of the economic and financial research indicates that the relationship between debt and financial performance yields conflicting results, with no definitive consensus.

Holz (2002) discovered a positive relationship between the debt ratio and financial performance, interpreting this finding to suggest that managers are inclined to borrow money to fund projects and effectively use these funds to "maximize performance." Similarly, Dessi and Robertson (2003) found that debt positively impacts financial performance. They explained that low-growth firms tend to borrow in order to seize anticipated growth opportunities, thereby investing the borrowed capital in profitable projects, which enhances business performance. Margrates and Psillaki (2010) also demonstrated that debt ratios are positively and significantly associated with financial performance.

In a similar vein, Endri, Ridho, and Harahap (2019) used three performance indicators—ROE, ROA, and EPS—as dependent variables and concluded that the most profitable mining companies from 2014 to 2018 were those with higher debt ratios. Additionally, Taqi, Khan, and Anwar (2020) explored how debt impacts profitability in the Indian oil industry between 2008 and 2017. They assessed debt using debt-to-equity and debt-to-total asset ratios, with ROA as the measure of profitability. The study found a positive correlation between leverage and the performance of Indian oil companies, recommending that financial managers make optimal use of leverage to enhance performance.

Contrarily, Majumdar and Chhibber (1997) and Ghosh (2007) showed that higher debt levels are negatively related to firm performance. This finding is particularly relevant for creditors who use debt as a disciplinary measure. Creditors often impose restrictions, such as raising interest rates or limiting lending, to prevent firms from distributing profits to shareholders. These constraints force companies to focus on debt repayment rather than profitability. Additionally, Rao, Hamed, Al-yahee, and Syed (2007) found a negative relationship between debt and the financial performance of Omani firms, attributing this to high borrowing costs and low activity in Oman's debt market.

Rao, Hamed, Al-yahee, and Syed (2007) further noted that tax savings from debt usage in Oman are insufficient to offset the costs of debt, leading to a situation where the cost of debt surpasses the rate of return. Similarly, Kithandi (2020) examined the effect of debt on the financial performance of five oil companies listed on the Nairobi Stock Exchange. Using the leverage ratio to measure debt and ROA to gauge performance, the study employed regression analysis and found a negative and significant impact of leverage on the firms' performance.

It is wise to test the findings of these studies by the following hypothesis:

H 1:Debt negatively affects the financial performance of firms.

2.2.The impact of governance on the financial performance of companies

Several authors attribute the differences in company performance to variations in governance structures (Mayer, 1996; Charreaux, 1996). In discussions of corporate governance, many scholars emphasize its crucial role in creating value, whether for shareholders or stakeholders. Specifically, governance operates through various mechanisms aimed at enhancing the firm's value. Since corporate governance primarily focuses on controlling managerial behavior and limiting managerial discretion—both of which significantly influence financial performance—it is clear that effective governance positively impacts company performance. Therefore, any firm aiming to survive and remain competitive must prioritize governance and seek to strengthen its governance system.

A substantial body of literature has explored the relationship between governance and performance, with the majority of studies indicating that governance significantly affects firm performance and market value across different contexts and performance indicators. For instance, Bauer et al. (2008) used data from Governance Metrics International (GMI) to classify Japanese companies based on six governance dimensions. Their study demonstrated that companies with higher governance quality were more profitable.

Similarly, Gruszczynski (2005) examined this relationship in the Polish context, finding a significant association between governance scores and the performance of Polish firms, particularly regarding operating profit margins and debt ratios.

In the same vein, Black, Jang, and Kim (2005) developed a governance index for a sample of 515 South Korean state-owned enterprises. Their findings showed a strong correlation between this index and market value. This effect is linked to the increasing pressures from shareholders and market forces for robust corporate governance systems. Investors are progressively demanding that companies adhere to strict governance principles to ensure better returns on their investments. As a result, many investors are willing to pay a premium for companies with high governance standards. Consequently, implementing strong governance mechanisms provides a competitive advantage by attracting capital, reducing financial risks for investors, and lowering the cost of capital (Louizi, 2007).

Additionally, KOLSI et al. (2011) studied the relationship between governance mechanisms and financial performance in 134 Canadian companies in 2007. The authors sought to determine the impact of four governance mechanisms—board structure, executive compensation, shareholder rights, and disclosure—on financial performance. Governance was measured using an index calculated by the Canadian newspaper The Globe and Mail, called the "Corporate Governance Index." However, the study revealed that the relationship between governance and performance is non-linear. Specifically, the results indicated that a certain threshold of disclosure must be surpassed for governance to positively impact financial performance. Thus, disclosure plays a critical role in improving the financial performance of Canadian companies.

The hypothesis that will be tested to study this correlation is, therefore, the following:

H2: Governance positively affects the financial performance of companies.

2.3.The moderating effect of governance between debt and corporate financial performance

In order to reconcile the different points of view, the researchers study the moderating factors in the relationship between debt and performance of companies.

Several authors examined the moderating role of governance. To this extent, Okiro and al. (2015) examine the impact of governance and the capital structure on the performance of listed African companies from

2009 to 2013 and find that governance positively moderates the relationship between capital structure and financial performance.

In the same vein, Iqbal and Javed (2017) investigated the moderating effect of corporate governance between capital structure and financial performance, using companies listed on the Karachi Stock Exchange. They demonstrated that the mechanisms of governance plays an imperative role in controlling and monitoring the capital structure for maximize profits.

Likewise, Elmagrhi and al. (2018) demonstrated that governance mechanisms positively moderate the relationship between capital structure and financial performance.

From these studies we can make the following assumption:

H3:Governance mechanisms moderate the relationship between capital structure and the financial performance of companies.

3.Research methodology

3.1.Data and sample

The study was conducted on a sample of 57 French companies belonging to the SBF120 index over the period 2010-2020. We excluded banks, insurance companies and financial firms (SIC codes 6000-6900). We also excluded companies with incomplete financial information during the analysis period.Thus, the moderating role of governance in this relationship has not been sufficiently developed in previous researches and to our knowledge no research has studied the moderating effect of governance between capital structure and financial performance in the French context.

3.2.The analysis model

In order to study the moderating effect of governance on the relationship between capital structure and firm financial performance, we will perform an econometric regression on panel data covering 57 French listed firms during the period 2010-2020. Thus, this two-dimensional model that can be tested is as follows:

$$ROA_{it} = \beta_0+\beta_1 Endet_{it}+\beta_2 Gov_{it}+\beta_3 Endet*Gov_{it}+\beta_4 TE_{it} +\beta_5 Liq_{it} +\varepsilon_{it}$$

Where i = 1...57 denotes the firms and t = 2010...2020denotes the period.

Thus for each firm i and each period t, we have:

ROA : Financial performance

Debt:Debt ratio

GOV: Governance score

TE: Size of the firm

Liq: Firm's liquidity

β_0 : the constant for firm i

(β_1.. β_5): is the vector of coefficients of the exogenous variables

ε_{it}: represents the error term

3.3.Variables

Table 1 : Definition and measurement of variables

Variables	Authors	Measurement of variables
ROA	Frooman (1997) ;Simionescu and Gherghina (2014); Jianwei (2015) ; Rodriguez-Fernandez (2015) ;Choi and al. 2018 ; Ngoc (2018) ; Ta and Bui (2018).	ROA=Net income/net assets

The debt ratio	John and Litov (2010) ; Jiraporn and al. (2012) and Precions Angelo Brenni (2014= .	The debt ratio =total debt/total assets
Governance	Black et al (2005) et Bauer et al (2008)	GOV=Score gouvernance
Firm size	Brown and Caylor (2006) ; Ben Cheikh and Zarai (2008) ;Setiadharma et Machali(2017) and Hirdinis(2019)	FS = Log (book value of total assets)
Liquidity	Adams et Buckle (2003), Goddard and al. (2005), (Serrasqueiro, 2009) and Rahaman (2011).	Current Ratio = Current Assets/Current Liabilities

Dependent variable

Return on Assets (ROA) : It measures the ratio of net profit (a tool used to determine whether a business is making a profit or loss) to total assets (all items that generate resources). It expresses the ability of a company to generate income from its resources. Financial analysts often consider a low ROA (below 5) to indicate that a company is not making enough money from its physical and financial resources. This measure has been used by numerous authors such as Aupperle et al. used. (1985); Wood and Jones (1995); Fruman (1997); Simonescu and Gergina (2014); Jianwei (2015); Rodriguez-Fernandez (2015); Choi et al. . 2018; Jade (2018); Tower and Bui (2018). It is one of the most widely used and accurate measures of financial performance (Boaventura et al., 2012; Griffin and Mahon, 1997).

It is calculated as follows:

ROA =Net income/net assets

Independent variables

The debt ratio (Debt): The debt of a firm is an indication of the debt burden undertaken by the firm, which can affect management discipline (P. Andres, Azofra, and Lopez (2005); Peter, Young, and Shapiro (2005); Hergli, Bellalah, and Abdennadher (2007).). To explain the effect of debt on performance, we use the ratio of book value of debt to total assets. This approach has been used by several authors including John and Litov (2010); Girapong et al. (2012) and Precions Angelo Brenni (2014).

The measure we will use is the following:

The debt ratio =total debt/total assets

Governance (Gov): as in the work of Black et al (2005) and Bauer et al (2008), we will adopt a governance score. This score developed by ASSET4 is composed of a series of elements that represent corporate governance mechanisms.

GOV = Governance score

Control variables

Firm size (FS): Firm size was also identified as a key variable in explaining performance. This variable can have both direct and indirect effects on performance. A number of measures were selected to assess firm size. S Bahagat and Black (2001), Durnev and Kim (2003), P Andres et al. (2005) and Hergli et al.

(2007) use the "log(sales)" measure. Other authors such as Brown and Caylor (2006), Ben Cheikh and Zarai (2008), Setiadharma and Machali (2017), and Hirdinis (2019) have used "log (total wealth)" values.

We adopt the following measure:

FS = Log (book value of total assets)

Liquidity (Liq): Liquidity measures a firm's ability to meet its short-term obligations (Raykov, 2017; Abubakar, Sulaiman, & Haruna, 2018; Lyndon & Payeur, 2016; Syed, 2015; Bragg, 2018; Ejike & Agha, 2018; Burke, 2019). The liquidity indicators used in this study are current indicators. This measure is taken from Adams and Buckle (2003), Goddard et al. used. (2005), (Serrasqueiro, 2009), Rahman (2011). According to Weston and Copeland (1997), the current ratio is the ratio of current assets to current liabilities. The current ratio reflects a company's ability to pay its current liabilities with its current assets. Current assets generally include cash, marketable securities, accounts receivable and inventories, and current assets include short-term bank loans or other debts with a maturity of less than one year. The higher the current ratio, the better the company's ability to meet its short-term financial obligations.

Current Ratio = Current Assets/Current Liabilities

4.Findings

4.1.Descriptive Statistics

Table 2 :Descriptive statistics

Variable	Average	Standard deviation	Minimum	Maximum
ROA	4,320558	4.963651	-22,16	37,61
Debt	28.30	0.1452	0.71	75.84
Gov	54.50	0.2174749	4,5	97.73
FS	16,66	1.1374	14,11	19,28
Liq	1,341451	0,5204774	0,55	3,62

According to the table, which describes the descriptive analyses of ROA, we find that the average of financial profitability measured by ROA is about 4.32%, which indicates that the companies in our sample withdraw a sufficient profitability in relation to their resources. The minimum is -22.16%, which is an alarming negative percentage that shows that on the contrary, some companies are deficient in relation to the use of their resources to generate profits. The maximum is 37.61%.

The debt ratio has an average level of 28.30% and a minimum of 0.71%.The highest level of debt is about 75.84%.

It appears from the table of descriptive statistics that the governance score presents a minimum of 4.5 and a maximum of 97.73 with an average of 54.50.

As for the size of the company, it has a maximum of 19.28 and a minimum of 14.11 with an average of 16.66.

The table also shows that the average liquidity ratio of the companies is 1.3414 with a maximum of 3.62 and a minimum of0.55.

4.2.Correlations

Table 3: Pearson correlation matrix

	ROA	Debt	Gov	FS	Liq
ROA	1.0000				
Debt	-0.3851	1.0000			
Gov	0.0651	0.0572	1.0000		
FS	-0.1530	0.0884	0.1722	1.0000	
Liq	0.2122	-0.0932	0.1259	-0.2613	1.0000

Table 4: Multicolinerality test

Variable	VIF	1/VIF
Debt	1.02	0.983716
Gov	1.07	0.935932
FS	1.13	0.886433
Liq	1.12	0.895529
Mean VIF	1.08	

To test for multicolinearity, two techniques are typically used: performing a correlation matrix and calculating VIFs (De Bourmont, 2012).

To test for the absence of multicolinearity between independent variables, we calculated the Pearson correlation coefficients between the independent variables and also calculated the "variance Inflation Factor" (VIF). Examination of the Pearson correlation coefficients in Appendix 2 shows that no critical correlation can be found from this table. In fact, according to Kevin (1992), in order to decide on a serious collinearity problem between the independent variables included in a regression model, r>=0.8 is required. Moreover, Appendix 6 shows that none of the VIFs exceed 5, which leads us to conclude that there is no multicollinearity problem.

4.3.Multivariate analysis

Table 5: Multiple Regression Analysis

Variable	Z	P>|z|
Debt	-1.97	0.016
Gov	5.89	0.000
Debt*Gov	-5.26	0.000
FS	-3.04	0.002
Liq	3.67	0.0

The debt ratio By estimating the model using appropriate methods, we can conclude that debt ratio has a significant negative impact on the financial performance of French companies, which is consistent with our predictions. These results are consistent with previous work done by Rajan and Zingales (1995) for G7 countries and with Booth et al. (2001) who studied 10 developing countries, where debt and financial performance measured by ROA consistently showed a negative relationship. They are consistent with both the financing hierarchy hypothesis (according to which profitable companies prefer self-financing to debt

financing) and the stakeholder theory, since the risk of major defaults and their consequences make external financing costly and encourage companies to use external financing. Limit their own resources.

Governance

It appears from the table that the governance has a significant positive effect on financial performance in the French context. Which brings us to confirm hypothesis 2.

This is in line with the work of Black and al (2005), Bauer and al (2008) and Kolsi M. and al. (2011) which connect the difference between companies in terms of performance with the difference in their governance arrangements (Mayer (1996), Charreaux (1996)). Indeed, by mentioning the notion of corporate governance, these authors insist on its essential role in the creation of value.

More precisely, governance acts through several mechanisms aimed at increasing the value of the company. Since corporate governance mainly aims at controlling the manager and minimizing his discretionary space and to the extent that the decisions of managers have a decisive influence on the performance of the company, it would therefore be obvious that a good governance positively influences corporate performance. It follows that all companies seeking to survive and compete must pay particular attention to the issue of governance .

The moderating effect of governance

The interaction coefficient is significant, which indicates that governance can moderate the relationship between capital structure and firm performance. More precisely, the increase in the score of governance can mitigate the negative effect of debt on financial performance.

This is consistent with the assertions of Iqbal and Javed (2017) and Elmagrhi and al. (2018) which stipulate that governance mechanisms play a moderating role between debt and financial performance. Since corporate governance aims mainly the control of the manager and the minimization of his discretionary space and to the extent that the decisions of managers have a determining influence on the performance of the company, it would therefore be obvious that good governance influences positively the performance of companies.

The size of the firm

As for the size of the company, the results reveal the existence of a negative correlation between company size and performance. This result joins the work of Hall and Weiss (1967) and Enqvist et al (2014) which prove that large companies with a very large size and more complex and diversified activities may have high costs due to asymmetry problems that negatively affects performance.

The liquidity of the firm

Liquidity has a clear positive effect on the performance of French companies. This is consistent with what Mehmet et al. (2018), Swagatika and Ajaya (2018), Ejike and Agha (2018), M. Mohammed and Yusheng (2019) find that firms with higher liquidity ratios achieve the best performance. In fact, there are many advantages to holding cash: On the one hand, it can ensure the payment of daily expenses such as wages, materials and taxes. On the other hand, holding cash can provide a margin of safety against a potential recession as future cash flows are uncertain. Finally, having cash guarantees profitable investments that require immediate payouts.

5. Conclusion

It is vital for a company to choose an optimal capital structure and to improve its corporate goverance practices. This attitude is the best guarantee of achieving good long-term financial performance. Indeed,

our research has attempted to examine empirically the moderating effect of corporate governance in the relationship between debt and corporate performance. First, the results of this study suggest that the debt ratio has a significantly negative effect on the financial performance of companies. Second, our sample confirmed a significantly positive relationship between corporate governance and corporate financial performance. Third, the results reveal that corporate governance can moderate the relationship between debt and the financial performance of the company. It will be useful to extend this analysis by studying not only the effect of total debt on profitability, but also through the different components of debt (long-term and short-term debt). It would also be better to carry out our research on other companies listed on the stock market within the EU to compare the moderating effect of governance between debt and the financial performance of companies in countries within the same region.

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