

## Corporate Governance Practices and Its Impact on Working Capital Management: Evidence from Sri Lanka

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### Abstract

The main objective of the study is to find out the impact of corporate governance practices on Working capital management. Secondary literature reviews and Secondary data collection methods were used to conduct the study. Twenty five listed manufacturing firms were selected as sample size in Colombo Stock Exchange for the period from 2007 to 2011. Multiple Regression Analysis was utilized to find out the significant impact of corporate Governance practices on the Working Capital Management. The results revealed that there is a significant impact of corporate Governance practices on current liabilities to total assets in working capital management. In contrast, the cash conversion cycle and the current assets to total assets are not influenced by the corporate governance practices. Based on the findings, we recommended to the policy makers in the corporate governance practices to establish the models of corporate governance that must be suitable to the manufacturing sector in Sri Lanka to ensure the survival, solvency, and profitability of the business.

**Keywords:** Corporate Governance practices, Manufacturing companies and Working Capital Management Efficiency.

### 1. Background of the study

Global financial crisis points out the importance of a strong corporate governance and financial management for the companies in international level. Effective financial management decisions in the field of horizontal and vertical structure of capital, insurance of short-term and long-term capital, maintaining liquidity and solvency are viewed as a key function in the creation of competitive advantages ( Ivanovic, Baresa and Bogdan, 2011). Corporate governance is about putting in place the structure, processes and mechanism that ensure that the firm is being directed and managed in a way that enhances long term share holder value through accountability of managers and enhancing organizational performance (Velnampy, 2013). Australian Standard, on the corporate governance principles (2003) viewed the corporate governance as the process, by which organizations are directed, controlled and held to account. This implies that corporate governance encompasses the authority, accountability, stewardship, leadership, direction and control exercised in the process of managing organizations. Further, Morin and Jarrell (2001) argued that the corporate governance mechanism is a framework that controls and safeguards the interest of the relevant players in the market which include managers, employees, customers, shareholders, executive management, suppliers and the board of directors. Comparing with the approach of Australian Standard, Morin and Jarrell (2001) have jointly approached the corporate governance in the holistic way; it implies that, corporate governance practices are the strategies which should be formulated, in line with the short, medium and long term objectives of the company with the interest of stakeholders.

In the short term objective of the companies, the working capital management is viewed as one of the key mechanism. And also working capital management is considered to be a vital issue in financial management decision and it has its effect on liquidity as well as on profitability of the firm. Moreover, an optimal working capital management positively contributes in creating firm value ( Bagchi and Khamrui, 2012). In this context, the main responsibilities of the board in the corporate governance practices are viewed as (1) ensuring effective systems to secure integrity of information, internal control and risk management; (2) ensuring that the company's values and standards are set with emphasis on adopting appropriate accounting policies and fostering compliance with financial regulations (Code of best practice on corporate governance, 2008). Furthermore, working capital management is vital especially for manufacturing firms, where a major part of the assets is composed of current assets. It directly affects the profitability and liquidity of the firms. Also profitability liquidity tradeoff is important because if working capital management is not given due consideration then firms are likely to fail and face bankruptcy ( Raheman, Afza, Qayyum and Ahmed bodla , 2010; Raheman and Nasr,2008). In this context, the working capital is known as life giving force for any economic unit and its management is considered among the most important function of corporate management. Due to that, every organization whether, profit oriented or not, irrespective of size and nature

of business, requires necessary amount of working capital for smooth functioning of the organization. Working capital is the most crucial factor for maintaining liquidity, survival, solvency, and profitability of the business (Raheman et al., 2010; Mukhopadhyay, 2004). Therefore the manufacturing firms in the globalised level should take the action to get the better frame work in the working capital management through the corporate governance practices to achieve goals as survival, solvency, and profitability of the business. Finally A study on Corporate Governance practices and Working Capital Management among manufacturing firms from an emerging market like Srilanka, in the South Asian Context, can be fruitful empirical work, which may likely to differ from other developing countries in world wide. Due to that, this study is focused to answer the research question as:

### **What extent the Corporate Governance Practices influence on the Working Capital Management**

#### **2. Objectives of the study**

The main objective of the study is to find out the significant impact of corporate governance practices on Working capital management.

#### **3. Theoretical and empirical perspective: corporate governance practices and working capital management.**

Corporate governance received much attention during the last two decades owing to certain economic reforms in countries and accidents of economic history such as regional market crisis and large corporate debacles ( Senaratne and Gunaratne,2008). Corporate governance is considered as the significant implications for the growth of an economy. Good corporate governance practices are important in reducing risk for investors; attracting investment capital and improving the performance of companies (Velnampy & Pratheepkanth, 2012) .Scholars normally describe the evolution of the corporate governance in terms of changes in relationship between ownership and control (Chandler, 1977; Fligstein, 1990). The idea of corporate governance was quickly adopted in different parts of the world but with some major variations because circumstances vary from country to country (Mulili and Wong, 2011). In this context, two main approaches of corporate governance can be identified as Agency theory and Stewardship theory. According to the Kiel and Nicholson (2003), Agency theory is viewed as the separation of control from ownership. It implies that the professional managers manage a firm on behalf of the firm's owners. Further , a solution was given to the agency conflict that a firm's top management should have a significant ownership of the firm in order to secure a positive relationship between corporate governance and the amount of stock owned by the top management (Mulini and Wong, 2011; Mallin, 2004). In contrast the Stewardship theory is considered as stake holder's theory. The theory suggests that a firm's board of directors and its CEO, acting as Stewards, are more motivated to act in the best interests of the firm rather than for their own selfish interests ( Mulini and Wong, 2011). Furthermore, Kajanathan (2012) have identified the dimensions of the corporate governance practices as leadership style, board committee, board size, board meeting, and board composition in the SriLankan Manufacturing firm's perspective.

In finance literature there is a common opinion about the importance of working capital management (Raheman and Nasr, 2008). Working capital is important factor and considered as the factor which is affecting capital investment. (Velnampy,2005 & 2005), Efficient working management includes planning and controlling of current liabilities and assets in a way it avoids excessive investments in current assets and prevents from working with few current assets in sufficient to fulfill the responsibilities ( Mehmet and Eda , 2009). Cash conversion cycle is considered as key measure to determine the efficiency in working capital management. Further, cash conversion cycle for a firm is the period during which it is transited from money to good and again to money ( Deloof, 2003; Raheman and Nasar, 2008; Mehmet and Eda, 2009). According to Harris (2005) working capital management is a simple and straight forward mechanism of ensuring the ability of the firm to fund the difference between the short term assets and short term liabilities. And also , it has been covered by the activities of the company related to the vendors, customers and products (Hall, 2002; Azam and Haider, 2011). Due to that, now a day, working capital management has been considered as the main central issues in the financial management by the executive / managers (Azam and haider, 2011; Lamberson, 1995).

Generally corporate governance practices were linked with firm performance, capital structure and share holder value (Kajanathan, 2012; Kumudini, 2011). Mean while working capital management is connected with profitability, firms performance, firm size. But, we have linked the both concept as corporate governance practices and working capital management in our study. In the desk study, we have found the literature gap in the studies on corporate governance practices and working capital management. Hawawini, Viallet and Vora (1986) have approached the influence of a firm's industry on its working capital management. They concluded that there is a

substantial industry effects on firm working capital management practices. In this context, Moussawi, Laplante, Kieschnick and Baranchuk (2006) have approached corporate working capital management and its determinants & consequences. They have focused on the U.S public corporation from 1990 to 2004 and concluded that industry practices, firm size, future firm sales growth, the proportion of outside directors on a board, executive compensation, and CEO share ownership significantly influence the efficiency of a company's working capital management. Further, they have pointed that the larger the proportion of outsiders on firm's board, the better its working capital management performance. And the larger the CEO's current compensation the better the firm's working capital management performance. Harford, Mansi and Maxwell (2008) have focused on the study on the corporate governance and firm cash holdings in the U.S context; they have found that, firms with weaker corporate governance structures actually have smaller cash reserves. When distributing cash to shareholders, firms with weaker governance structures choose to repurchase shares instead of increasing dividends, avoiding future payout commitments. The combination of excess cash and weak shareholder rights leads to increases in capital expenditures and acquisitions. Firms with low shareholder rights and excess cash have lower profitability and valuations. (Harford, Mansi, and Maxwell, 2008).

#### 4. Conceptualization

Based on the research question and objectives of the study, the following conceptual model has been constructed.

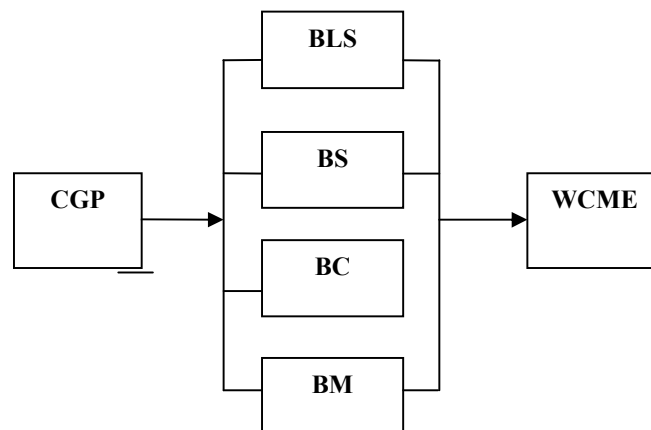


Figure no 1: Conceptualization Model (Authors constructed model)

#### Where:

- CGP: Corporate Governance Practices
- WCME: Working Capital Management
- BLS: Board Leadership Structure
- BS: Board Size
- BC: Board Committees
- BM: Board Meeting

## 5. Design of the variables: operationalisation and measurement of variables

Table No 1: Design of the variables

Concept	Variables	Measures	Symbols
Corporate Governance Practices	Board Leadership Structure	1 for separate Leadership and 2 for combined Leadership	BLS
	Board Size	Number of Directors	BS
	Board Committees	Number of Committees	BC
	Board Meeting	Number of Meeting	BM
Working Capital Management Efficiency	Cash Conversion Cycle	Accounts receivable period + Inventory turnover period - Accounts Payable Period)	CCC
	Current Assets : Total Assets	Current Assets / Total Assets	CA/TA
	Current Liabilities: Total Assets	Current Liabilities/ Total Assets	CL/TA

Board Leadership structure, Board size, Board committees and Board meeting are considered as the key variables to determine the corporate governance practices (Kumudini, 2011; Kajanathan, 2012). And also, Cash conversion cycle, Current Assets to Total Assets, Current Liabilities to Total Assets are viewed as the key dimensions to determine the working capital management ( Mehmet and Eda, 2009; Azam and Haider, 2011; Raheman, Afza, Qayyum and Bodla, 2010).

## 6. Hypotheses of the study

H1: There is a significant impact of corporate Governance practices on the Cash Conversion cycle.

H2: There is a significant impact of corporate Governance practices on the Current Assets to Total Assets.

H3: There is a significant impact of corporate Governance practices on the Current Liabilities to Total Assets.

## 7. Methodology

### 7.1. Data Collection

Data on corporate governance and working capital management were collected from secondary sources as Annual reports of the manufacturing companies, Colombo stock exchange publications and universal resource locator of the Colombo stock exchange.

### 7.2. Sample Selection

Twenty five listed manufacturing firms were selected as sample size in Colombo Stock Exchange. Data on the corporate governance practices and working capital management from the year 2007 to 2011 were collected for the study purpose. Further, earlier mentioned firms have been selected based on the availability of data on the corporate governance practices and working capital management of the listed manufacturing firms in Sri Lanka.

### 7.3. Data Analysis Method

Various Statistical methods have been utilized to compare the data collection from twenty five listed manufacturing firms in Colombo Stock Exchange on corporate governance practices and working capital management.

Descriptive statistics used to test the sample characteristics. Inferential statistics which involves in drawing conclusions about a population based only on sample data. It includes regression analysis. Regression analysis is used to find out the significant impact of corporate governance practices on the working capital management.

## 8. Results and analysis

### 8.1. Descriptive Statistics

Table No 2: Descriptive Statistics of the study

Dimension	Mean	Standard Deviation
Board Leadership Structure	1.40	.50
Board Committee	2.00	0.64
Board Meeting	7.64	3.92
Board size	7.48	2.10
Cash Conversion Cycle (days)	126	156
Current Assets : Total Assets	0.50	0.18
Current Liabilities: Total Assets	0.36	0.26

Based on the mean value in the descriptive studies, Cash Conversion Cycle is not line with the standards. According to the Chartered Institute of Management Accountants(Improving cash flow using credit Management), Over 85 days denote the high risk in the working capital management. In this study, Cash Conversion Cycle has the period which is beyond the standard days. Due to that, we are able to come to the conclusion that extension of cash conversion cycle can increase the sales, thus profit of the firm. But increasing the need for working capital in parallel with the extension of the conversion cycle brings together an additional financing cost ( Deloof, 2003; Raheman and Nasar, 2007; Mehmet and Eda, 2009).

### 8.2. Multi-Co Linearity

Two major methods were used in order to determine the presence of multi-co linearity among independent variables in this study. These methodologies involved calculation of a Tolerance test and variance inflation factor (VIF) (Ahsan et al., 2009). Test of Co linearity, None of the tolerance level is < or equal to 1; and also VIF values are perfectly below 10. Thus the measures selected for assessing independent variable in this study do not reach levels indicate of multi-co linearity and also the acceptable Durbin Watson range is between 1.5 and 2.5 .

### 8.3. Regression Analysis

The purpose of regression analysis is to find out the significant impact or influence of independent variable on dependent variable (Ndubisi,2006).In this study, corporate governance practices is considered as independent variable or predictor variable, and the working capital management efficiency is considered as dependent variable.

**Corporate Governance Practices on Cash Conversion Cycle**

Table No 03: Multiple regression analysis for corporate governance practices on cash conversion cycle.

Variable	Beta	t-value	p-value	Model summary		
				R square	F-value	Sig
Constant		.291	.774	0.182	1.113	0.378
Board Leadership Structure	-.267	-1.223	.236			
Board Committee	.388	1.741	.097			
Board Meeting	.012	.051	.960			
Board size	-.030	-.128	.900			

NOTE: Significant at 0.05 levels.

The results of the regression analysis summarized in table no 03 show that cash conversion cycle is not influenced by corporate governance practices (F=1.113; P > 0.05) . Based on the R square value, we are able to come to the point that, the predictor power of the corporate governance practices on the cash conversion cycle is in the lowest level (R<sup>2</sup> = 0.182). It implies that, 18 percentage of variation has been found.

**Therefore the hypothesis one is rejected**, it means that, there is no significant impact of corporate Governance practices on the Cash Conversion cycle.

**Corporate Governance Practices on Current Assets to Total Assets**

Table No 04: Multiple regression analysis for corporate governance practices on Current Assets to Total Assets

Variable	Beta	t-value	p-value	Model summary		
				R square	F-value	Sig
Constant		1.694	.106	0.093	0.510	0.729
Board Leadership Structure	.276	1.199	.244			
Board Committee	-.135	-.576	.571			
Board Meeting	-.099	-.404	.691			
Board size	-.048	-.190	.851			

NOTE: Significant at 0.05 levels.

The decision on the current assets to total assets is not influenced by corporate governance practices (F=0.510; P > 0.05) . Based on the R square value, we are able to come to the point that, the predictor power of the corporate governance practices on the current assets to total assets is in the weakest level (R<sup>2</sup> = 0.093). It implies that, only the 9 percentage of variation has been found.

**Therefore the hypothesis two is rejected**, it means that, there is no significant impact of corporate Governance practices on current assets to total assets.

**Corporate Governance Practices On Current Liabilities To Total Assets**

Table No 05: Multiple regression analysis for corporate governance practices on Current Liabilities to Total Assets

NOTE: Significant at 0.05 levels.

Variable	Beta	t-value	p-value	Model summary		
				R square	F-value	Sig
Constant		2.999	0.007	0.385	3.133	0.037
Board Leadership Structure	.164	.865	0.397			
Board Committee	-.597	-3.089	0.006			
Board Meeting	-.248	-1.230	0.237			
Board size	-.196	-.950	0.354			

The decision on the current liabilities to total assets is influenced by corporate governance practices ( $F=3.133$ ;  $P < 0.05$ ). In which, the decision on the current liabilities to total assets is influenced by the Board Committee in the corporate governance practices. In contrast, the decision is not influenced by the board Leadership Structure, Board Meeting and Board size in the corporate governance practices.

Overall , Based on the Model summary, We are able to come to the point that, the predictor power of the corporate governance practices on the current liabilities to total assets is in the better level ( $R^2 = 0.385$ ). It implies that, 38 percentage of variation has been found. This is significant at 0.05 levels.

**Therefore the hypothesis three is accepted**, it means that, there is a significant impact of corporate Governance practices on current liabilities to total assets.

**9. Discussion and conclusion**

Based on the overall study findings, we are able to come to the point that, there is a significant impact of corporate Governance practices on current liabilities to total assets. In contrast, the cash conversion cycle and the decision on the current assets to total assets are not influenced by the corporate governance practices. According to the descriptive statistics, 50 percentage of the total assets is maintained in current assets by the listed manufacturing firms in the srilanka. And also, 36 percentage of total assets is considered as the current liabilities. With the help of these measures, we are able to come to the point that, the liquidity position of the listed manufacturing firms in the srilanka is in the favorable way. Further, the investment in the current assets is enough to fulfill the current liabilities of the firms successfully. In contrast, cash conversion cycle of the firms is in the question mark. Because, 126 days are needed to the listed manufacturing firms for transforming the goods in to cash or high liquid form (industry average is derived from the mean value of the cash conversion cycle). Over 85 days denote the high risk in the working capital management (Chartered Institute of Management Accountants). In this study, Cash Conversion Cycle has the period which is beyond the standard days. Furthermore, cash conversion periods are in the high fluctuation (Standard Deviation as 156 days). In which, each firms have the different policies in the collection and payment procedures. Due to that, effective policies in the working capital management must be formulated through the corporate governance practices in the listed manufacturing firms in SriLanka. Especially the financial management professionals should focus on the payment, collection and inventory management policies of the firms to give the better strategic solutions or alternatives in the dynamic and hyper competitive environment.

Finally, in the Srilankan context, corporate governance practices should be reviewed. In this context, board perspective should be adopted in future corporate governance reforms based on the stake holder approach to corporate governance rather than focusing only on the share holder primacy which gives a narrow connotation to corporate governance. Further greater independence and authority needs to be granted to oversight committees within the firm. In particular, the roles and functions of the remuneration and audit committees need to be strengthened. This will serve to facilitate both transparency and accountability within firm ( Senaratne and Gunaratne,2008).

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**Annexure 1:**

Listed Manufacturing companies in the Sri Lankan Context. ( Sample firms)

1. SAMSON INTERNATIONAL PLC
2. SIERRA CABLES PLC
3. CHEVRON LUBRICANTS LANKA PLC
4. DANKOTUWA PORCELAIN PLC
5. RICHARD PIERIS EXPORTS PLC
6. ROYAL CERAMICS LANKA PLC
7. PIRAMAL GLASS CEYLON PLC
8. LANKA WALLTILES PLC
9. KELANI TYRES PLC
10. CENTRAL INDUSTRIES PLC
11. ACME PRINTING & PACKAGING PLC
12. DIPPED PRODUCTS PLC
13. TOKYO CEMENT COMPANY (LANKA) PLC
14. SINGER INDUSTRIES (CEYLON) PLC
15. LANKA CERAMIC PLC
16. PRINT CARE PLC
17. SWADESHI INDUSTRIAL WORKS PLC
18. HAYLES EXPORTS PLC
19. KELANI CABLES PLC
20. BOGALA GRAPHITE LANKA PLC
21. REGNIS (LANKA) PLC
22. LANKA FLOORTILES PLC
23. ALUFAB PLC
24. CEYLON GRAIN ELEVATORS PLC
25. ACL CABLES PLC

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