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Corporate Governance Practices, Capital Structure And Their Impact On Firm Performance: A Study On Sri Lankan Listed Manufacturing Companies.

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Abstract

Purpose: 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. Corporate governance refers to a set of rules and incentives by which the management of a company is directed and controlled. Hence good corporate governance and capital structure maximizes the profitability and long term value of the firm for shareholders. There is a great awareness among the researchers to carry out the researches in "corporate governance'. Very little researches on "corporate governance" are available in Sri Lanka and need to be empowered companies to pay a special attention on corporate governance. The main objective of this study is to examine the relationship between corporate governance practices, capital structure and firm performance in listed manufacturing firms in Sri Lanka.

Design: In a way, the present study is initiated on "corporate governance practices, capital structure and firm performance "with the samples of 25 manufacturing companies using the data representing the periods of 2008 – 2012. Leadership structure, board committee, board meeting, board size, board composition, were used as the determinants of corporate governance practices whereas debt equity ratio (DER) were used as the measures of capital structure and return on equity (ROE) and return on assets (ROA) were used as the measures of firm performance. The statistical tests were used includes: descriptive statistics, correlation and regression analyses.

Findings: The study found that determinants of corporate governance are not correlated to the capital structure and firm performance measures of the organization. Regression model showed that corporate governance don't affect companies' DER, ROE and ROA. Further recommendations are also put forwarded in the research.

Research Limitations/Implications: The study only used data from the 2008-2012 annual reports. However, the findings have highlighted the effects of corporate governance of the performance and capital structure.

Originality/Value: The study contributes to literature in Sri Lanka. Furthermore, the finding of the paper can be considered as helpful for managers and users that are anxious to develop financial description quality and practices of corporate governance.

Keywords: Corporate Governance, Firm Performance, Capital Structure, Leadership Structure, Board Committee, Board Meeting, Board Size, Board Composition, Sri Lanka.

Introduction

Corporate governance is now an international topic due to globalization of businesses. It is acknowledged to play a major role in the management of organizations in both developed and developing countries. Corporate governance is concerned with ways in which all parties interested in the well- being of the organization attempt to ensure that mangers and other insiders take measures or adopt mechanisms that safeguard the interests of the stakeholders. Corporate governance refers to a set of rules and incentives by which the management of a company is directed and controlled. At the same time, Developing countries differ from developed countries in a wide variety of ways. Therefore, there is need for developing countries to develop their own corporate governance models that consider the cultural, political and technological conditions found in each country (Mulili and Wong, 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).

In Sri Lanka, effective corporate governance is considered as ensuring corporate accountability, enhancing the reliability and quality of financial information, and therefore enhancing the integrity and efficiency of capital markets, which in turn will improve investor confidence (Rezaee 2009). Good corporate governance practices are important in reducing risk for investors; attracting investment capital and improving the performance of companies (Velnampy & Pratheepkanth, 2012).

Shleifer & Vishny, (1997) defines corporate governance that "it deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment". Cadbury (1992) defined corporate governance as "the system by which companies are directed and controlled". It is concerned with the duties and responsibilities of a company's board of directors to successfully lead the company, and their relationship with its shareholders and other stakeholder groups.

The main focus of this paper is to find the corporate governance practices currently practiced in Sri Lankan listed manufacturing companies. And to find the relationship between corporate governance and capital structure and corporate governance and firm performance in Sri Lankan listed manufacturing companies.

Several studies have tested the hypothesis of finding relationship between characteristics of corporate governance and capital structure and between characteristics of corporate governance and performance.

However, very few studies have in conducted in context of Sri Lanka or Sri Lankan listed manufacturing companies and is limited in finding the relationship with few characteristics and structures of Corporate Governance.

This paper is organized as follows: the next section provides literature review and development of hypothesis. The fourth section describes the methodology used. The penultimate section discusses the results. Finally, the last section concludes the results and concludes the discussion.

Review of Literature

Corporate governance is concerned with ways in which all parties interested in the well- being of the organization attempt to ensure that mangers and other insiders take measures or adopt mechanisms that safeguard the interests of the stakeholders. Corporate governance refers to a set of rules and incentives by which the management of a company is directed and controlled. From the beginning of 21st century capitalism have sprung a collection of different economic systems. According to Alchian (1950) and Stigler (1958), competition among firms takes care of corporate governance. In the long run, the product market forces the competitors to minimize cost. In order to minimize cost, external finances are generated at lower costs. Monopolies are illegal. Corporate policies and strategies are dependent upon a single decision making authority: the Chief Executive Officer (CEO). Other shareholders seem powerless in these systems. Good corporate governance practices are important in reducing risk for investors, attracting investment capital and improving the performance of companies (Velnampy and Pratheepkanth, 2012)

Shleifer and Vishnvy (1997) defined corporate governance as a way in which suppliers of finance to corporations assure themselves of getting a return on their investment. Irrespective of the particular definition, the importance of corporate governance arises in a firm because of the separation between those who control and these who own the residual claims (Epps and Cereola, 2008). Berger et al (1997) conducted a study to find the relationship between board size and capital structure decision and found that there is a negative relationship between board size and leverage and also found a positive relationship between the presences of outside directors on boards with debt in the capital structure. Lipton & Lorsch (1992) argued that there is a significant relationship between board size and capital structure.

According to Sanders & Cornett, M.M (2004), a minimum capital requirement effectively constrains the leverage of banking institutions and reduces the risk of failure. This is because highly leverage banks may be more susceptible to credit, interest rate and other shocks in the economy which investors must be insulated against.

Corporate governance and capital structure has succeeded in attracting a good deal of public interest because it is a tool for socio-economic development. Also when there is good corporate governance and capital structure, there will be proper and efficient practice in the administration of business entities. This will ultimately lead to reduction in the incidence of corporate failures, poor internal control system, poor corporate structure, indiscipline both on the part of management and workers. Poorly governed corporations do not only pose a risk to themselves, they do to others and could indeed pull down capital market. For instance, the poor governance of a systematically important firm would pose a threat to the economy. Irrespective of how sound macroeconomic policies are, if entities are not well governed, the macro-economic objectives may not be attained. Velnampy (2013), Kumudini & Anona (2010), Kajananthan (2012), and Achchuthan & Kajananthan (2013) examined the relationship between Corporate Governance practices and firm performances. Study confirmed the positive

relationship between governance practices (separate leadership, board composition and firm performance). The concept of optimal capital structure is expressed by Myers (1984) and Myers and Majluf (1984) based on the notion of asymmetric information. The existence of information asymmetries between the firm and likely finance providers causes the relative costs of finance to vary among different sources of finance. For example, an internal source of finance where the funds provider is the firm will have more information about the firm than new equity holders, thus these new equity holders will expect a higher rate of return on their investments. Irrespective of the particular definition, the importance of corporate governance arises in a firm because of the separation between those who control and these who own the residual claims (Epps and Cereola, 2008). Barnhart and Rosnstein (1998) further elaborated that institutional ownership and board composition are substitutes for ownership structure. Lipton & Lorsch (1992) argued that there is a significant relationship between board size and capital structure. there are no universal theory of debt-equity choice and no reason to expect one. All the same, there are several useful conditional theories, each of which helps to understand the financial structure that firm's choose (Olayinka, 2011; Velnampy, 2005; Velnampy, 2010; Niresh & Velnampy, 2012). Achchuthan, Kajananthan & Sivathaasan (2013) found in their study that, Corporate Governance Practices contributes significantly to Capital Structure. Board Committee in the Corporate Governance Practices contributes significantly to Capital Structure. And also Capital Structure is not contributed significantly by Board composition, Board Size, Board Meeting, and Leadership Structure in Corporate Governance Practices. Meantime, there is no significant difference in the capital structure in terms of leverage among corporate governance practices of the listed manufacturing companies in Sri Lanka.

According to Brander & Lewis (1986) firms in the oligopolistic market will follow the strategy of maximizing their output for improving profitability in favorable economic conditions. In unfavorable economic conditions, they would take a cut in production and reduce their profitability. Shareholders enjoy increased wealth in good periods, but they tend to ignore decline in profitability in bad times as unfavorable consequences are passed on to lenders because of shareholders' limited liability status. Barnhart and Rosnstein (1998) further elaborated that institutional ownership and board composition are substitutes for ownership structure.
Furthermore, Velnampy and Niresh, (2012) investigated the association between capital structure and profitability of listed Sri Lankan banks over the period of 8 years from 2002 to 2009. Results of their analysis show that, there is a negative association between capital structure and profitability except the association between debt to equity and return on equity. Velnampy and Pratheepkanth (2012), revealed the relationship between portfolio management and profitability.

Objectives of the Study

The following objectives are taken for the study.
1. To identify the relationship between corporate governance and capital structure.
2. To identify the relationship between corporate governance and firm performance.
3. To identify the relationship between capital structure and firm performance.
4. To find out the impact of corporate governance on capital structure.
5. To find out the impact of corporate governance on firm performance.
6. To find out the impact of capital structure on firm performance.
7. To suggest the organization to adopt good governance practices towards the performance.

Data Collection

Data on corporate governance practices, capital structure and firm performances were collected from secondary sources as Annual reports of the manufacturing companies, Colombo stock exchange publications and URL of the Colombo stock exchange for the period of 2008 to 2012.

Sampling

The Colombo Stock Exchange (CSE) has 287 companies representing 20 business sectors as at 31st January 2013. Out of 37 Manufacturing companies 25 companies were selected for the present study.

Methodology

The purpose is to describe the research methodology of this study. Since the aim of the study was to test the effect of corporate governance practices, capital structure on firm performance, the design of the methodology was based on prior research into these relationships. This section describes the method of data collection, the

variables used to test the hypothesis and statistical techniques employed to report the results. The regression models utilized to test the relationship between the determines of corporate governance such as leadership style (LSS), board committee (BC), board meeting (BM), board size (BZ) and board composition (PNED), capital structure such as and firm performance such as return on equity (ROE), and return on assets (ROA) are as follows.

$DER = \alpha_o + \alpha_{1LSS} + \alpha_{2BC} + \alpha_{3BM} + \alpha_{4BZ} + \alpha_{5PNED} + \epsilon$
$ROE = \alpha_o + \alpha_{1LSS} + \alpha_{2BC} + \alpha_{3BM} + \alpha_{4BZ} + \alpha_{5PNED} + \epsilon$
$ROA = \alpha_o + \alpha_{1LSS} + \alpha_{2BC} + \alpha_{3BM} + \alpha_{4BZ} + \alpha_{5PNED} + \epsilon$
$DER = \alpha_o + \alpha_{1ROE} + \alpha_{2ROA} + \epsilon$
$ROE = \alpha_o + \alpha_{1DER} + \epsilon$
$ROA = \alpha_o + \alpha_{1DER} + \epsilon$

Conceptual Frame work

The following conceptual model was formulated through the extensive literature.

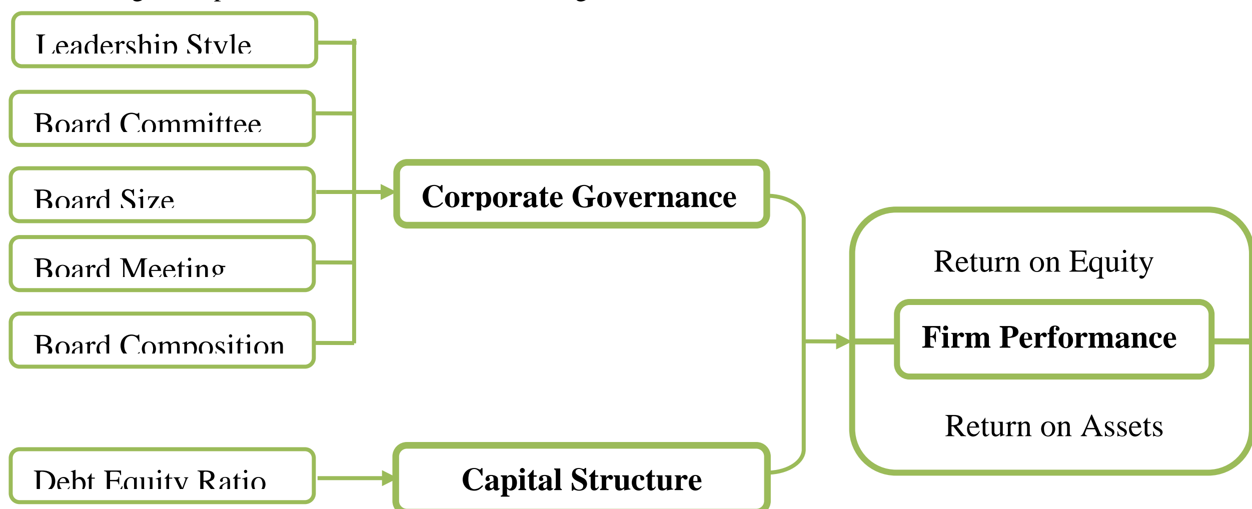

Figure 1: Conceptualization Model

The above model shows the relationship between the determinants of the corporate governance, capital structure and firm performance.

Hypotheses

The following are the hypotheses formulated;
H_1: There is a significant relationship between of firm performance across the corporate governance and capital structure.
H_1a: There is a significant relationship between corporate governance and firm's performance.
H_1b: There is a significant relationship between corporate governance and capital structure.
H_2: There is a significant impact of corporate governance and capital structure on firm's performance.
H_2a: There is a significant impact of corporate governance on firm's performance.
H_{2b}: There is a significant impact of capital structure on firm's performance.

Analysis and Interpretation

Descriptive statistics were carried out to obtain sample characteristics. Output of the descriptive statistics is presented in table 01

Table 01- Descriptive Analysis

	N	Range	Minimum	Maximum	Mean	Std. Deviation
Leadership Structure	25	1	0	1	.40	.500
Board Committee	25	2.00	1.00	3.00	2.0400	.45461
Board Meeting	25	10.00	2.00	12.00	7.6400	3.45060
Board Size	25	9.00	2.00	11.00	7.6800	2.42762
Board Composition	25	.56	.00	.56	.3824	.13800
Debt Equity Ratio	25	231.23	.25	231.48	30.0760	46.57836
Return on Equity	25	106.65	-47.25	59.40	8.9894	18.55674
Return on Assets	25	97.01	-8.25	88.76	14.3020	18.58527

According to the Descriptive statistics in table 01 for the independent variables indicate that average number of leadership structure, board committee, board meeting, board size, and board composition. The Descriptive Statistics, data are well set, further leadership structure, board committee, board meeting, board size, board composition, debt equity ratio, return on equity and return on assets are in the same level approximately among all the listed manufacturing companies in Sri Lanka.
Correlation analysis was carried out to find out the relationship between determinants of corporate governance and capital structure and the measures of firm performance.

Table 02- Correlation Matrix for manufacturing companies

Variables	LSS	BC	BM	BS	PNED	DER	ROE	ROA
LSS	1	.477** (.008)	.135 (.260)	-.062 (.385)	-.292 (.078)	.367* (.035)	-.136 (.258)	-.097 (.321)
BC		1	-.123 (.279)	-.026 (.452)	-.128 (.271)	.102 (.313)	-.192 (.180)	.016 (.469)
BM			1	.160 (.223)	.145 (.245)	.168 (.211)	-.155 (.230)	.060 (.388)
BS				1	.190 (.181)	-.030 (.443)	-.056 (.395)	.112 (.297)
PNED					1	-.090 (.335)	.097 (.323)	.208 (.159)
DER						1	-.595** (.001)	-.101 (.315)
ROE							1	.480** (.008)
ROA								1

**. Correlation is significant at the 0.01 level (1tailed).

*. Correlation is significant at the 0.05 level (1-tailed).

LSS- Leadership Style, BC- Board Committee, BM- Board Meeting, BS- Board Size, PNED-Board Composition, DER- Debt Equity Ratio, ROE -Return on Equity and ROA- Return on Assets.
According to the Correlation in table 02 shows that the determinants of corporate governance such as Leadership Style, Board Committee, Board Meeting, Board Size, and Board Composition, are not significantly correlated with DER as the measures of capital structure and also are not significantly correlated with ROE and ROA as the measures of firm performance. It means companies are still not properly practiced corporate governance guidelines. Therefore Companies should pay an attention on the role of corporate governance measures.
The regression analysis was performed to recognize the impact of corporate governance on firm performance. The results of the analysis are given in Table 03 & 04

Regression Analysis

i) Impact of capital structure and firm performance on corporate governance

Table 03- Model Summary[a,b&c]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.391[a]	.153	-.070	48.17156
2	.285[b]	.081	-.160	19.99037
3	.239[c]	.057	-.191	20.28390

a, b & c Predictors: (Constant), leadership style, board committee, board meeting, board size, board composition
a. Dependent Variable: Debt Equity Ratio
b. Dependent Variable: Return on Equity
c. Dependent Variable: Return on Assets

The specification of the five variables is leadership style, board committee, board meeting, board size, and board composition in the model revealed the ability to predict capital structure and performance. R2 Value of 0.153, 0.081 and 0.057 which are in the models denote that 15.3%, 8.1% and 5.7% of the observed variability in capital structure and performance can be explained by the differences in both the independent variables namely leadership style, board committee, board meeting, board size, and board composition. Remaining 84.7%, 91.9% and 94.3% of the variance in capital structure and performance is related to other variable which is not explained, because they are not depicted in the model. R2 values of 15.3%, 8.1% and 5.7% indicate that there may be number of variables which can have an impact on capital structure and performance that need to be studied. Hence this area is indicated as a scope for future research

Table 4: Coefficients Table in Regression Analysis

Model	Unstandardized Coefficients						Standardized Coefficients			t			Sig.		
	B			Std. Error			Beta								
DV	DER	ROE	ROA	DER	ROE	ROA	DER	ROE	ROA	DER	ROE	ROA	DER	ROE	ROA
(Constant)	21.893	31.406	-6.719	66.183	27.465	27.868				.331	1.143	-.241	.744	.267	.812
LSS	35.700	.768	-3.419	24.114	10.007	10.154	.383	.021	-.092	1.480	.077	-.337	.155	.940	.740
BC	-6.873	-8.651	3.677	25.253	10.480	10.633	-.067	-.212	.090	-.272	-.826	.346	.788	.419	.733
BM	1.508	-1.033	.256	3.039	1.261	1.280	.112	-.192	.048	.496	-.819	.200	.625	.423	.843
BS	-.509	-.390	.523	4.169	1.730	1.756	-.027	-.051	.068	-.122	-.225	.298	.904	.824	.769
PNED	.813	15.190	23.304	76.956	31.935	32.404	.002	.113	.173	.011	.476	.719	.992	.640	.481

a. Dependent Variable: DER ,ROE and ROA

The results of the regression analysis in table 04 show that the coefficient for all five variables such as leadership style, board committee, board meeting, board size, and board composition are not significant. It can be inferred that board committee including independent non executive directors and executive director should have an effective and complete role in controlling the opportunistic behavior in management and also they should have regular meeting to discuss and monitor the activities of the firms. Further t values for all five variables of corporate governance are insignificant event at 5% level. It means that these variables are not contributing to the performance measures of DER, ROA and ROE.

ii) **Impact of capital structure on firm performance**

Table 5: Model Summary

a. Predictors: (Constant), DER

a. Dependent Variable: Return on Equity

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.595[a]	.354	.326	15.23054
2	.101[b]	.010	-.033	18.88714

b. Dependent Variable: Return on Assets According to the Correlation in table 5 Model Summary Table, the specification of the one variable is debt equity ratio in the model revealed the ability to predict performance. R2 Value of 0.354 and 0.010 which are in the models denote that 35.4%, and 1% of the observed variability in performance can be explained by the differences in both the independent variables namely debt equity ratio. Remaining 64.6% and 99% of the variance in performance is related to other variable which is not explained,

because they are not depicted in the model. R2 values of 35.4% and 1% indicate that there may be number of variables which can have an impact on performance that need to be studied. Hence this area is indicated as a scope for future research.

Table 6: Coefficients Table in Regression Analysis

Model	Unstandardized Coefficients				Standardized Coefficients		t		Sig.	
	B		Std. Error		Beta					
DV	ROE	ROA	ROE	ROA	ROE	ROA	ROE	ROA	ROE	ROA
(Constant)	16.123	15.519	3.648	4.524			4.420	3.430	.000	.002
DER	-.237	-.040	.067	.083	-.595	-.101	-3.554	-.489	.002	.630

a. Dependent Variable: ROE and ROA

The results of the regression analysis in table 06 show that the coefficient for capital structure such as debt equity ratio is not significant. It can be inferred that debt equity ratio including total debt and total equity should have an effective and complete role in controlling the opportunistic behavior in debt management and also they should have regular monitor the activities debt and equity of the companies. Further debt equity ratio impact on return on equity: Here the significant P value is less than the 0.05 significant levels (0.05>0.002) therefore hypothesis can be accepted at 5% level. Debt equity ratio impact on return on assets: Here the significant P value is more than the 0.05 significant levels (0.05>0.630) therefore hypothesis can be rejected at 5% level. It means that these variables are few contributing to the performance measures of ROA and ROE.

Conclusion and Recommendation

To conclude, listed companies under the Colombo stock exchange (CSE) are practicing corporate governance system. The results of the study provide evidence that the corporate governance measures are not significantly correlated with debt equity ratio as capital structure, ROE and ROA as the performance measures. So that hypotheses are rejected. R2 Value of capital structure and corporate governance and also ROE and ROA and corporate governance 0.153, 0.081 and 0.057 which are in the models denote that 15.3%, 8.1% and 5.7% of the observed variability in performance can be explained by the differences in both the independent variables namely leadership style, board committee, board meeting, board size, and board composition. Further corporate governance measures did not contribute to capital structure measures of DER and performance measures of ROE and ROA.

It can be find that the directors of the board should concentrate in playing their vital role properly for the activities of the companies and also advice the companies to have more independent directors within the benchmark for the number of directors. DER, ROE and ROA, the reason could be, as the company chairman will be there in the audit committee, he will serve as monitoring mechanism to the decisions of the board and he will keep close eye on the financials of the company and would deal with discrepancies in time.

This is supported by Velnampy (2013), Wyatt (1990) and Baysinger and Butler (1985). As per the study, average number of committees which companies had is two. It is better to have all relevant committees such as remuneration committee, audit committee and nomination committee to look after the activities and task of the companies. Some companies had no any meetings. So that the companies should have a regulate meeting. Further decisions made at the meetings are also important for the success of the company. In the Sri Lankan 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 (Kajananthan, 2012; Achchuthan, and Kajananthan ,2013 a; Kajananthan & Achchuthan, 2013 b; Achchuthan , Kajananthan, Sivathaasan, 2013)

It can be suggested that the directors of the board should concentrate in playing their vital role properly for the activities of the companies and also advice the companies to have more independent directors within the benchmark for the number of directors.

- ✓ As a result of the above recommendations, the corporate governance code should include following:
- ✓ The number of non-executive directors should be at least fifty percent of the total number of directors, not one third as stated in the code.
- ✓ Appointment of non-executive directors to the board must be from a register kept by a body such as the institute of directors.
- ✓ Include risk management committee, remuneration committee, audit committee and nomination committee.

Recognize the various stakeholders relevant to the business that will add value to the organization, and,

I. Consider aligning the CSR strategy with the objectives of the firm.
II. Define the CSR policies that determine the long-term value of the firm and supervise their implementation.
III. Communicate the CSR efforts by the firm.
IV. Disclose the CSR efforts by the firm.
V. Conduct and audit of CSR reporting

It is expected that these recommendations to the code will have an impact on firm performance and capital structure in relation to corporate governance practices in Sri Lanka.

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