

EFFECT OF CORPORATE GOVERNANCE ON CAPITAL STRUCTURE: CASE OF THE SRILANKAN LISTED MANUFACTURING COMPANIES

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ABSTRACT

The issue of corporate governance has been a growing area of management research especially among large and listed firms. Companies need financial resources to promote their objectives. Therefore, factors may affect the capital structure of companies should be considered carefully. The purpose of the present is to investigate whether there is any relationship between some specific features of corporate governance and capital structure of listed manufacturing firms in Colombo stock exchange. To do so 28 manufacturing companies were selected from those which were listed in Colombo stock exchange during the period of 2009 until 2011 as the sample of the study. The independent variables of the study included 'board size', 'board structure' 'board meeting' and 'proportion of independent non executive directors' while the dependent variable was decided to be 'debt ratio' (as a criterion for capital structure). The variables were empirically tested by multiple regression analysis. This found that corporate governance practices have 34% impact on capital structure and among the corporate governance variables board committee has a significant effect on firms' capital structure.

Keywords: Corporate Governance, Capital Structure, Colombo Stock Exchange, Multiple Liner Regression.

INTRODUCTION:

Key mechanisms that protect the interests of the shareholders are known as Corporate Governance. The need for strong governance is evidenced by the various reforms and standards developed by both national and international level (e.g: Code Of Best Practice On Corporate Governance In Srilanka, the Organization For Economic Development [OECD] Code and etc). In general, corporate governance is considered as having significant implications for the growth prospects of an economy, because proper corporate governance practices reduce risk for investors, attract investment capital and improve performance of companies (Spanos 2005).

Modigliani and Miller (1958) had developed a theory of capital structure. Although many Experts in the field have extended their capital structure theory, very few examined the relationship between corporate governance and capital structure. Since Modigliani and Miller (1958) capital structure irrelevance propositions, academic researchers have advanced a number of capital structure theories. These theories are extensive and can be classified into two groups: tax-based theories and non-tax based theories. Tax-based theories include both bankruptcy and trade-off theories; while non-tax based theories include agency, signalling, pecking order and transaction cost theories (Khaled Hussainey and Khaled Aljifri). The present paper reviews relevant capital structure theories and attempts to relate the different theoretical attributes to the Srilankan business environment in order to formulate our research hypotheses.

The issues of corporate governance have usually been associated with large and listed firms.

During recent years there has been an increasing awareness of corporate governance in Sri Lanka. As a result of that, it is now mandatory for companies to comply with the corporate governance rules that formed part of the listing rules of the CSE, which took effect from the April 2008. Sri Lanka's code of best practice on corporate governance (2008) recommended boards include at least two non-executive directors or that non-executive directors make up a one third of the board.

Good corporate governance is the rules and practices that govern the relationship within the managers and shareholders of corporations, as well as stakeholders such as employees and creditors, which contribute to growth and financial stability by underpinning market confidence, financial market integrity and economic efficiency (OECD 2004). The present study focuses on the link between corporate governance and capital structure of listed manufacturing companies in srilanka

LITERATURE REVIEW:

Capital structure decision is the vital one since the profitability of an enterprise is directly affected by such decision. The successful selection and use of capital is one of the key elements of the firms' financial strategy (Velnampy & Aloy Niresh, 2012). The existence of a well developed capital market, financial intermediary, corporate governance and the legal protection offered by a country assist the effectiveness of debt. Due to Sri Lankan economy experience on double-digit interest rate in the last few decades, therefore, most of Sri Lankan CEOs are reluctant to have debt with high interest rates (Colombage, 2007). The financial condition of a business organization would depend on the resources it owns and the obligations it has to meet. Companies carry out various activities to make profits, and to generate wealth for further growth. Finance is considered as the most important for these activities (Velnampy, 2006). Management of the project failed to achieve the budgetary results. Even though, the Net Present Value (NPV), Internal Rate of Return (IRR) and benefit cost ratio shows the project as worthwhile. Profitability should be re invested into the business for its survival (Velnampy, 2006).

Furthermore, weak legal protection and the uncertainty of the environment, most Sri Lankan large companies do not depend on the debt market (Samarakoon, 1999). However, recent development of corporate governance practices and regulatory framework in Sri Lanka may have effects on capital structure choice and decisions in listed manufacturing companies. Modigliani and Miller (1959) maintained that based on some specific assumptions including the existence of perfect capital market, lack of income taxes, lack of bankruptcy costs, lack of agency costs and the existence of information symmetry among those who are active in capital market, managers cannot provide any change in firm's value, only because they have altered the structure of financing sources. In other words, the value of firm is independent from its capital structure. After the first studies done by Modigliani and Miller (1959), many researchers decided to investigate the factors effective on firms' capital structure. Leland (1994) and Suhaila and Mahmood (2008)

examined the factors signifying capital structure and concluded that the variables effective on firms' financing decisions include the size of firm, profitability, the amount of tangible fixed assets and interest rates. Mackay and Phillips (2001), Hunag and Song (2006) investigated if kind of industry can have any effect on capital structure decisions and concluded that it can be effective on the use of debt and the performance of firm. After the destruction of big firms including Enron, World Com, and Adefi which led to the losses of many investors, and which was due to the weak Corporate Governance, the concept of corporate governance was increasingly taken into consideration.

Many definitions are provided by several committees and organizations and mostly every country has developed code of best practices on corporate governance based on the committees reports and research conclusions. For example 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 (Pass 2004). It is also defined as a “process through which shareholders induce management to act in their interests, providing a degree of investor confidence that is necessary for the capital markets to function effectively” (Rezaee 2009). Good corporate governance practices are important in reducing risk for investors, attracting investment capital and improving the performance of companies (Velnampy and Pratheepkanth, 2012). There is no globally accepted set of corporate governance principles that can be applied to board structures as they depend on business practices and the legal, political and economic environment. However, the Cadbury Committee (1992) considered board structure as an important corporate governance mechanism, which would result in improved performance. They addressed board structures, separation of the roles of Chief Executive Officer (CEO) and Chairman, non-executive directors' representation and board committees. These were also addressed in the code of best practice on corporate governance issued in Sri Lanka.

Another mechanism for Corporate Governance which is investigated in different studies is 'board size'. Most researchers have found that board size can in two ways lead to the improvement of performance more need on the part of firm to make connections with the environment out of firm and more executive responsibility in firms (Krivogorsky, 2006).

A limited list of international empirical studies on the relationship between corporate governance and capital structure is described below:

- According to Pfeffer and Salancick (1978) and Lipton and Lorsch (1992), there is a significant relationship between capital structure and board size.
- The results of Wen, Rwegasir and Bilderbeek (2002) and Abor (2007) also show a positive relationship between board size and financial leverage (capital structure).
- Berger, Ofek and Yermack (1997) found that firms with larger board membership have low leverage or debt ratio. They assume that larger board size translates into strong pressure from the corporate board to make managers pursue lower leverage or debt ratio rather than have larger boards.
- Bodaghi and Ahmadpour (2010) collected data from 50 Iranian firms listed at Tehran Stock Exchange to examine the relationship between corporate governance and capital structure. They concluded a negative relationship between board size and debt to equity ratio. Authors also found that CEO duality does not significantly influence corporate financing behavior.
- Saad (2010) carried out a sample of 126 Malaysian publically listed companies from four industries i) consumer products, ii) industrial products, iii) trading/services, and iv) plantations for the period from 1998 to 2006. Through multiple regression analysis, Saad found a negative relationship between CEO duality and capital structure, and positive relationships between board size and capital structure.
- Rehman, M. A., Rehman, R. U., and Raoof, A.. (2010) investigated the relationship between corporate governance and capital structure of randomly selected 19 banks of Pakistan from 2005-2006. They found a positive relationship between board size and capital structure.
- Vakilifard, Gerayli, Yanesari, and Ma'atoofi, (2011) took data from Tehran Stock Exchange (TSE), Iran over the over the period 2005–2010. They found a positive relationship between CEO duality and leverage, and a negative relationship between board size and leverage.
- Gill, Mand, , Sharma, and Mathur. (2012) sampled small business owners from India and found that small business growth and family positively influence capital structure of small business firms.
- Coles et al. (2005) found a positive relationship between board size and debt ratio in the US context.

- Jensen (1986), Berger et al. (1997) and Abor (2007) find a significant positive relationship between non-executive directors' percentage on the board and firm leverage ratio
- Shijun (2007) examined the relationship between board composition and firm's performance. The sample included 1252 firms during the years 1996 to 2006. In this research, he used the return of assets (ROA) and that of shares as criteria for measuring performance and also the variables board size and proportion of outside directors for measuring board composition. The results showed that there is a positive relationship between board size and proportion of outside directors with the performance of firm.
- Pfeffer (1973) and Pfeffer & Salancick (1978) who explain that when firms have more outside directors, they increase protection against uncertainties and this increases the firm's ability to raise external debt.

CONCEPTUALIZATION:

Based on the purpose of the study, the following conceptual model has been constructed. This model of corporate governance and capital structure introduces new constructs and uniquely combines them in specifying that the capital structure is a function of Leadership style, Board committee, Board size, Board meeting and Board composition.

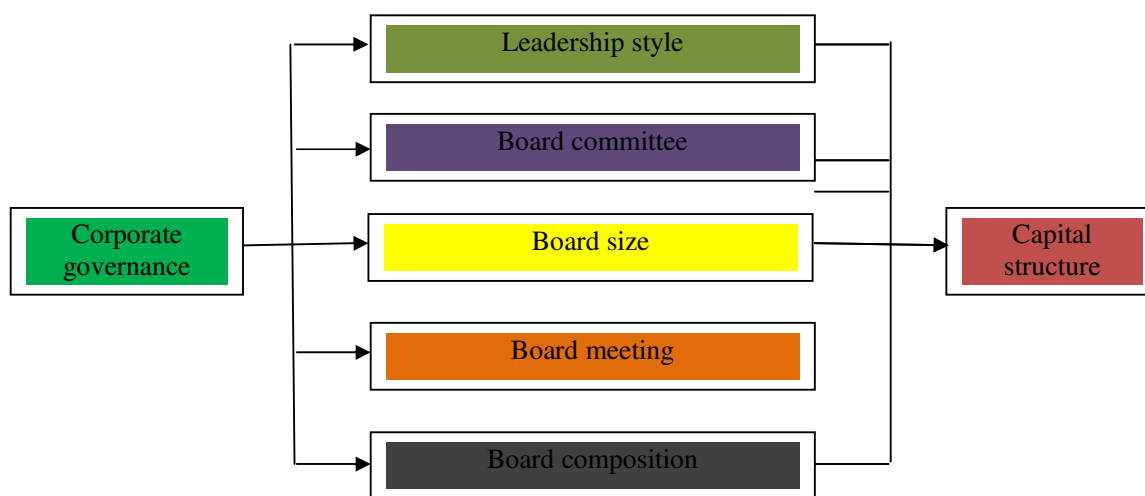


Figure No-01: Conceptualization Model

HYPOTHESES OF THE STUDY:

The following are the hypotheses formulated for the study.

Table -01

H1	There is a significant relationship between leadership style and firms 'capital structure
H2	There is a significant relationship between board committee and firms 'capital structure
H3	There is a significant relationship between board size and firms 'capital structure
H4	There is a significant relationship between board meeting and firms 'capital structure
H5	There is a relationship between board composition and firms 'capital structure
H6	There is a significant relationship between corporate governance practices and firms 'capital structure

RESEARCH 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 on firm performance, the design of the methodology was based on prior research into these relationships. This chapter describes the method of data collection, the variables used to test the hypothesis and statistical techniques employed to report the results.

SAMPLE SELECTION:

The objective of the study was to conduct an investigation of the corporate governance practices of listed manufacturing companies in Sri Lanka and their effect on capital structure.

The sample was selected from the 28 manufacturing companies listed in the Colombo Stock Exchange for the period 2009 and 2010 based on the availability of data.

DATA COLLECTION:

The study assessed the relationship between corporate governance practices and capital structure of listed manufacturing companies in Sri Lanka. The data and information required for the study were collected from the Colombo Stock Exchange (CSE) websites, annual reports, and the Colombo Stock Exchange publication

DATA COLLECTION METHODOLOGY:

Data on corporate governance and practices and capital structure were collected from secondary sources.

TYPES OF DATA COLLECTION:

Corporate governance information and capital structure information were collected from annual reports. For the purpose of this study data were collected for the period between 2009 and 2010. Data reflects the corporate governance practices of firms after the issue of the mandatory code of best practices.

The data required for the study included board leadership (if the positions of chairman and the CEO were held by single person or two separate persons), composition of the board (number of non executive directors), board activity intensity (number of board meetings), board committees (number of board appointed committees), and board size (number of directors in the board). Capital structure data used in the study was debt ratio.

DESIGN OF THE VARIABLES: OPERATIONALISATION AND MEASUREMENT OF VARIABLES:

The variables used to operationalised the constructs include the corporate governance variables (board leadership (if the positions of chairman and the CEO were held by single person or two separate persons), composition of the board (number of non executive directors), board activity intensity (number of board meetings), board committees (number of board appointed committees), board size (number of directors in the board) and debt ratio. The corporate performance of this study was measured capital structure. Leverage ratio (Debt ratio), which is considered as proxies for capital structure in the study, and indicate the efficiency of financing decisions

Table 02: Variables used to study the corporate governance practices in Sri Lanka

Variables	Measures	Symbols
Corporate governance		
Leadership style	Dummy variables1 for combined leadership and 0 separate leadership	LSS
Board committee	Number of board committees	BC
Board size	Number of directors	BS
Board meeting	Number of meetings	BM
Board composition	Proportion of non executive directors in the board	PNED
Capital structure		
Debt ratio	Total debt/(Total debt + Equity)	DR

DATA ANALYSIS METHOD :

Various statistical methods have been employed to compare the data collected. These methods include cross-sectional analysis descriptive statistics and regression analysis.

RESULTS AND ANALYSIS:

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 Capital Structure is considered as dependent variable. Table No 3 presents the results of the regression analysis.

Table 03: Multiple Regression Analysis

Coefficients ^a								
Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics		
	B	Std. Error	Beta			Tolerance	VIF	
1 (Constant)	-1.956	.601		-3.257	.004			
Board Committee	.492	.175	.515	2.807	.010	.730	1.370	
Board Meeting	.012	.028	.083	.445	.660	.716	1.397	
Board Size	.065	.048	.235	1.347	.192	.805	1.242	
Leadership Structure	.079	.198	.069	.400	.693	.839	1.192	
Proportion Of Non Executive Directors	.666	.634	.187	1.051	.305	.780	1.282	
a. Dependent Variable: Debt Ratio								

NOTE: Significant at 0.05 levels.

Table 04

ANOVA ^b						
Model	Sum of Squares	df	Mean Square	F	Sig.	
1 Regression	4.196	5	.839	3.737	.013 ^a	
Residual	4.940	22	.225			
Total	9.137	27				
a. Predictors: (Constant), Proportion of Non Executive Directors, Board Meeting, Leadership Structure, Board Size, Board Committee						
b. Dependent Variable: Debt Ratio						

Table 05

Model Summary ^b					
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.678 ^a	.459	.336	.47388	2.180
a. Predictors: (Constant), Proportion Of Non Executive Directors, Board Meeting, Leadership Structure, Board Size, Board Committee					
b. Dependent Variable: Debt Ratio					

The results of the regression analysis summarized in table no 03. It shows that Corporate Governance Practices contributes significantly to Capital Structure ($F=3.737$; $P < 0.05$) and predicts 34 percent of the variation found.. Board Committee in the Corporate Governance Practices contributes significantly to Capital Structure. And also Capital Structure is not contributed significantly by Proportion of Non Executive Directors, Board Meeting and Leadership Structure in Corporate Governance Practices.

MULTI-COLLINEARITY:

Two major methods were used in order to determine the presence of multi-collinearity among independent variables in this research. These methodologies involved calculation of a Tolerance test and variance inflation factor (VIF) (Ahsan et al., 2009 and Velnampy(2011)).The results of theses analysis are presented in table no 03 & 05..

According to the table no 03, 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-collinearity and also the acceptable Durbin Watson range is between 1.5 and 2.5 .In this analysis Durbin Watson value of 1.883, which is between the acceptable ranges, Show that there were no auto correlation problems in the data used in this research.

Table 06: Hypothesis Testing

No	Hypotheses	Results	Tools
H1	There is a significant relationship between leadership style and firms 'capital structure	Rejected	Regression
H2	There is a significant relationship between board committee and firms 'capital structure	Accepted	Regression
H3	There is a significant relationship between board size and firms 'capital structure	Rejected	Regression
H4	There is a significant relationship between board meeting and firms 'capital structure	Rejected	Regression
H5	There is a relationship between board composition and firms 'capital structure	Accepted	Regression
H6	There is a significant relationship between corporate governance practices and firms 'capital structure	Accepted	Regression

CONCLUSION:

Firm financing decisions one of most fundamental issues managers have to face. According to new theories of capital structure, such decisions can be affected by various factors, among which corporate governance is one. In that way, six hypotheses were used to examine the relationship between corporate governance practices and firms' capital structure. This study has been able to investigate the impact of corporate governance on capital structure of Srilankan manufacturing firms, and examine the corporate governance mechanism driving firm's choice of capital structure. The empirical result shows statistical significant and positive relationship. This study shows a positive relationship between leverage and board size, board meeting, proportion of non-executive directors and leadership style. This indicate that more board committees could make manufacturing companies to be more prone to gearing by taking chances on external source of capital for modernization, expansion and aggressive exploitation of investment opportunities.

The implication of these findings indicate that the management artistry displayed by the board will significantly drive down the gearing position of the manufacturing sector while the more number of board committees base, the higher the gearing position. Clearly, corporate governance issue impact capital structure because Traditional determinants of corporate governance like board committees , proportion of non-executive directors, leadership style, board meeting and board size have effect on capital structure decisions. Board size has positive relationship this suggest that large board size adopt high debt policy. Therefore we can conclude that corporate governance has important implications on the financing decisions of srilankan manufacturing firms.

Corporate governance can greatly assist Companies by infusing better management practices, effective control and accounting systems, stringent monitoring, effective regulatory mechanism and efficient utilization of firms' resources resulting in improved performance. Firms should embrace a well established corporate governance structures that will assist them to gain easier access to credit at lower cost since such firms are able to repay their debt on time. The issue of corporate governance and capital structure decisions of firms however needs further research in order to further develop some of the insights delivered by this study especially looking at other firms in other sector of the Srilankan economy.

LIMITATIONS AND FUTURE RESEARCH:

The sample size of this study is small. This study is limited to Srilankan manufacturing firms. Therefore, the findings of this study could only be generalized to firms similar to those that were included in this research. The current study uses only a few aspects of corporate governance practices. Further studies could consider other corporate governance variables. Second, the findings are based on research in a single country and may not be generalisable. Further studies in both mature and emerging markets will be helpful in terms of international comparability.

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