CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE: CASE STUDY OF SELECTED MANUFACTURING COMPANIES IN SRI LANKA

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Abstract

Manufacturing companies serve as the backbone of the economy. The segment provides support, not only for the economic development of the country by showing positive trends towards the sectorial growth, but also serves as a steering wheel for all of the sectors. It is possible that corporate governanceis important in manufacturing companies due to the nature of business and the effect of government regulations, both of which limit managerial discretion. This study examines the relation between corporate governance and financial performance among selected manufacturing companies in Sri Lanka. The paper covered selected manufacturing companies in Sri Lanka over a period of past 5 years from 2008 to 2012. Correlation and regression analysis were used in the analysis. This paper found that CEO duality is significantly correlated with ROA and also BI is significantly correlated with NPV at 1 percent significance level. Other variable is not correlated with any financial performance factors.

Keywords: Corporate governance, financial performance, Manufacturing Companies

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Introduction

Corporate governance refers to the system by which corporations are directed and controlled. The governance structure specifies the distribution of rights and responsibilities among different participants in the corporation (such as the board of directors, managers, shareholders, creditors, auditors, regulators, and other stakeholders) and specifies the rules and procedures for making decisions in corporate affairs. Governance provides the structure through which corporations set and pursue their objectives, while reflecting the context of the social, regulatory and market environment. Governance is a mechanism for monitoring the actions, policies and decisions of corporations. Governance involves the alignment of interests among the stakeholders

This research conducts empirical analysis to examine the effect of corporate governance mechanism upon financial performance among listed and manufacturingcompanies in Sri Lanka. Board SizeGoverning body of a corporation, elected by shareholders to represent their interests in managing the firm.

An independent board of directors is normally made of members who have no material interests in a company. Most companies with such boards are publicly listed. The purpose of an independent board is to make sure members are not influenced by interests in the company. They are there specifically to help a company run honestly and efficiently. CEO duality refers to the situation when the CEO Duality also holds the position of the chairman of the board.Return on assets (ROA) Return on equity (ROE) is the measurement of the rate of return of the stockholders' investment in a publicly owned company.

The purpose of this research is to examine the impact of corporate governance mechanism upon financial performance.

Significance of the study

The study shall enable policy makers, institutions, senior managers and regulators to incorporate good corporate governance practices and principles in organizations in order to build strong companies that are competitive, capable of ensuring social responsibility while at the same time having sound financial performance like the model firms such as Wal-Mart.

Corporate governance is a set of rules that define the relationship between stakeholders, management, and board of directors of a company and influence how that company is operating. At its most basic level, corporate governance deals with issues that result from the separation of ownership and control. But corporate governance goes beyond simply establishing a clear relationship between shareholders and managers.

The presence of strong governance standards provides better access to capital and aids economic growth. Corporate governance also has broader social and institutional dimensions. Properly designed rules of governance should focus on implementing the values of fairness, transparency,

accountability, and responsibility to both shareholders and stakeholders. In order to be effectively and ethically governed, businesses need not only good internal governance, but also must operate in a sound institutional environment. Therefore, elements such as secure private property rights, functioning judiciary, and free press are necessary to translate corporate governancelaws and regulations into on-the-ground practice.

Good corporate governance ensures that the business environment is fair and transparent and that companies can be held accountable for their actions. Conversely, weak corporate governance leads to waste, mismanagement, and corruption. It is also important to remember that although corporate governance has emerged as a way to manage modern joint stock corporations it is equally significant in state-owned enterprises, cooperatives, and family businesses. Regardless of the type of venture, only good governance can deliver sustainable good business performance.

Objectives

The main objective of the study is to find out the impact of corporate governance and financial Performance of listed manufacturing Companies in Sri Lanka
. Sub objectives are as follows.

- To identify the factors which are significantly contribute to the corporate governance and financial performance.
- To find out the relationship between corporate governance and financial performance.
- To suggest appropriate measures to improve the corporate governance of the Manufacturing companies.

Literature review and hypothesis development

Metincoşkun(2012) reveled that corporate governance and firm valuation, CG is not found to have a statistically significant relationship with Tobin’s Q. Regarding corporate governance and profitability, CG is not found to have a statistically significant relationship with ROE or ROA. The findings of the study do not support the hypothesis that better corporate governance is associated with higher firm values and better performance.

ElviaSunityo-Shauki, Sylvia (   ) examined that Companies’ size and market capitalization have strong influenced to companies’ financial And CG performances. Interestingly, leverage influenced positively towards companies’ financial performance as measured by PBV, adjusted corporate governance index contributes negatively towards company’s financial performance as measured by TQ and Board size influence positively towards the financial performance of the companies as Measured by ROA. ROA and PBV influenced positively towards governance indices of the companies. Board components have no impacts towards both financial and

CGCompany's performance. This study addresses issues relevant to corporate and public governance and could open further research in similar fields. The findings suggest that Better practices of corporate governance will enable companies in Indonesia to retain their competitive edge.

Good and bad corporate governance practices could exist either in good or poor governance systems. Cornelius (2005) notes that individual firm attributes in maintaining sound governance practices even where public institutions are relatively weak, factors such as: corporation's ownership structure, its relationships with stakeholders, financial transparency, information disclosure practices, and configuration of its managing boards. While bad corporate governance practices could exist in good governance system like in the case of the US (Enron's case) and the demise of HIH (in the case of Australia).

Thomsen, (2005) reveledcorporate ownership, board and stakeholder structure are found to influence corporate Values, however when value determinants are taken into account, there is no significant relationship between values and profitability. While Davis-Friday et al (2006) say that level of corporate governance mechanism has an important role to the extent of changes in the value relevance of book values but not on earnings especially during an economy-wide financial crisis. This is also supported by Feng et al (2005), board structure plays an important role in financial performance of the firm with small size boards, majority outside directors, and not chaired by the CEO are assigned to get higher score to board index with good governance. With the issues which are not encountered in developed countries, such as a range of cultural, legal, structural.

Ahmad, Mansur. (2012) pointed that study has the objective of studying the impact of compliance with corporate governance code on the performance of the banks considered healthy by the Central Bank. The twelve banks considered healthy are the study sample. Data covering the period 2006-2010 were extracted from their financial statements. The study employed two techniques (t-test and ANOVA) to test for the three hypotheses formulated from the mathematical model outlined for the study. Findings revealed an impact of dispersed equity on the profitability of banks. However for board size, findings are mixed; a large board size relates to profitability but does not significantly impact on financial performance. It is recommended that there is the need to strengthen managerial policies so that both operational and financial performance can be improved.

Boards of directors may have a difficulty communicating with each other in a large size board, which causes great detriment to firm performance. Yermack (1996), Eisenberg et al. (1998) and Singh and Davidson (2003) prove that board size has a negative relation with firm performance.

As the chairman serves as the executive, playing roles of decision-maker and supervisor simultaneously, the board could lose its independence and monitoring power, consequencely performing a weak function as a bulwark against agency problems. Daliy and Dalton (1993), Dahya et al. (1996) attest to that CEO duality seems to deteriorate firm performance.

As for the relation between board independence and firm performance, if outside directors are independent and have professional ability, they could be more objective to make decisions and monitor managers. Empirical research by Weisbach (1988), Rosenstein and Wyatt (1997) and Huson et al. (2001) corroborate that the higher ratio of independent directors accounts for boards, the better firm performance could be.
From the literature review the following hypotheses are formulated for the study purpose.

H1: Corporate Governance has an impact on Financial Performance.

H2: Corporate Governance and Financial Performance is significantly correlated.

H3: All factors determine the Corporate Governance is significant.

Conceptual frame work

Based on the literatures, the following conceptual frame work is formulated.

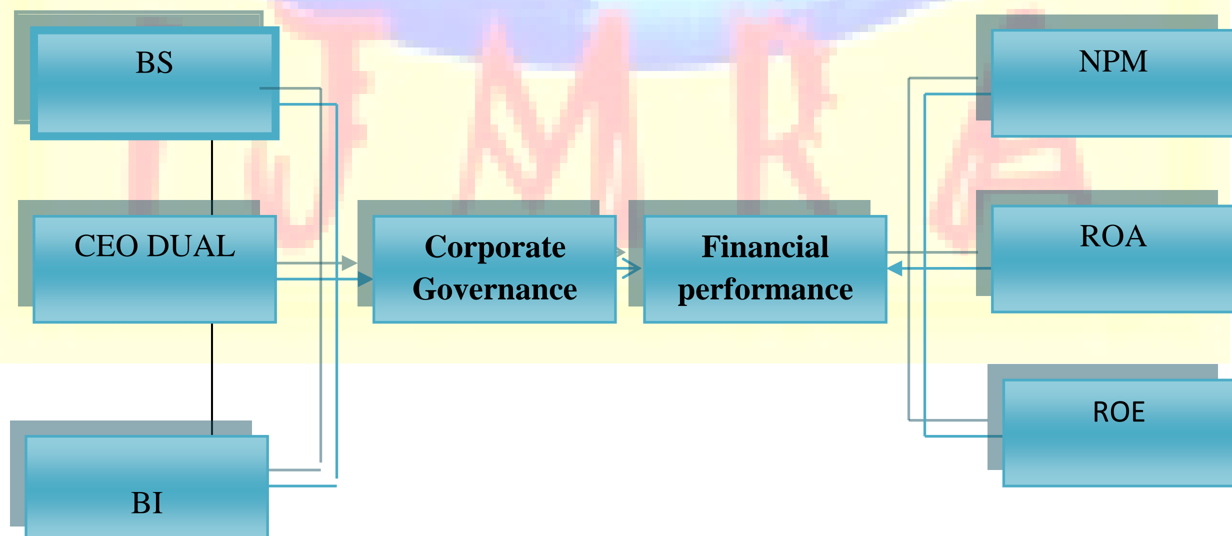

Figure-1: Conceptual Framework

Where,

BS	: Board Size	NPM	: Net Profit Margin
CEO DUAL	: CEO Duality	ROE	: Return on Equity
BI	: Board Independence	ROA	: Return on Asset

Methodology

A discussed by mouton (2001) research methodology focuses on the research process a kind of tools and procedures to be used. It describes research design, research approach, sampling procedure, data sources, instrumentation, reliability, validity and mode of analysis.

Research Design

This research will be an explanatory studies. The emphasis here is on studying a situation or a problem in order to explain the relationship between variables (i.e., corporate governance and Financial Performance)

Sampling Design

The sample of this study composed of listed manufacturing companies from Manufacturing Sector of Colombo Stock Exchange (CSE) for the period of 2008-2012. The scope of the study is listed manufacturing companies on Colombo Stock Exchange (CSE), Sri Lanka. Thirty one companies are listed under manufacturing sectors. Hence, out of thirty one, only fifteen companies are selected for the study purpose as random.

Data Sources

The research is totally based on secondary data, from the annual reports of sample companies. In some cases, some data and information have been collected from the websites of the sampled firms, different articles and papers.

Reliability and Validity of the Data

Reliability will be established with an overall Cronbach's alpha and other techniques. It will be compared our reliability value with the standard value alpha of 0.7 advocated by Cronbach (1951), a more accurate recommendation (Nunnally& Bernstein's, 1994) or with the standard value of 0.6 as recommended by Bagozzi& Yi's (1988). Secondary data for the study were drawn from audit accounts (i.e., income statement and balance sheet) of the concerned

companies; therefore, these data may be considered reliable for the purpose of the study. Necessary checking and cross checking were done while scanning information and data from the secondary sources. All these efforts were made in order to generate validity data for the present study. Hence researcher satisfied content validity.

Mode of Analysis

Table-1: Calculations of Corporate Governance and Financial Performance Ratios

The following corporate governance and financial performance ratios are taken into accounts

Corporate Governance Ratios	
Board Size	Total number of directors on the board.
CEO Duality	Dummy variable, taking a value of 1 for firms with the CEO as Chair, and 0 otherwise.
Board Independence	
Financial Performance Ratios	
Net Profit Margin	Profit after interest & tax / Sales X 100
Return on Equity	Profit after interest & tax / Equity capital X 100
Return on Asset	Return / Total Asset X 100

Multiple regression analysis is performed to investigate the impact of corporate governance on financial performance. It is important to note that the financial performance (NPM; ROE, and ROA) depend upon corporate governance (Board size, CEO Duality & Board independence). The following three models are formulated and presented here:

NPM= $\beta 0+ \beta 1$ BS+ $\beta 2$ CEODUAL+ $\beta 3$ BI+ ε...…........... (1)
ROE= $\beta 0+ \beta 1$ BS+ $\beta 2$ CEODUAL+ $\beta 3$ BI+ ε………….. (2)
ROA= $\beta 0+\beta 1$ BS + $\beta 2$ CEODUAL+ $\beta 3$ BI+ ε................. (3)

Data Analysis and Discussion

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, Abdullah, Gunfie, & Alam, 2009). The results of these analysis are presented in table. Test of Co linearity.

Table-2: Test of Co Linearity

Variables	Tolerance	VIF
Board Size	.882	1.134
CEO Duality	.953	1.049
Board independence	.909	1.100

According to the table, 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.

Correlation

Table -3: Correlation Matrix

Variables	NPM	ROA	ROE	Board size	CEO duality	Board independence
Board Size	-.011 (.970)	-.088 (.754)	.004 (.988)	1		
CEO duality	-.086 (.762)	.649** (.009)	-.107 (.705)	0.182 (0.517)	1	
Board independence	-.665** (.007)	-.012 (.966)	-.206 (.462)	-0.280 (0.313)	0.062 (0.826)	1

*Correlation is significant at the 0.05 level (2-tailed)
** Correlation is significant at the 0.01 level (2-tailed)

It is found that from table-3 describes the correlation between corporate governance and financial performance. This indicates that CEO duality is significantly correlated with ROA and also BI is significantly correlated with NPV at 1 percent significance level. Other variable is not correlated with any financial performance factors.

Then a multiple regression analysis was performed to identify the predictors of financial performance variables as conceptualized in the models. A step wise variable selection was used in the regression analysis and Table-4 provides the summary measure of the models.

Table-4: Predictor of Financial Performance – Model Summary

Details	NPM	ROA	ROE
Board Size	-.922 (.376)	-1.083 (.302)	-.125 (.903)
CEO duality	-.009 (.993)	3.149 (.009)	-.288 (.779)
Board independence	-3.185 (.009)	-.550 (.593)	-.687 (.506)
Constant	1.695 (.118)	1.481 (.167)	2.763 (.018)
R	.695	.692	.229
R2	.484	.479	.053
Adjusted R2	.343	.337	-.206
Standard Error	5.94588	.20318	.64996
F Value	3.434 (.056)	3.371 (.058)	.204 (.892)

From the table-4; it is seen that the specification of the three predictor variables (Board Size, CEO Duality & Board Indepenance) in the above model reveals that the ability to predict the financial performance (R2 0.484, 0.479 and 0.053 respectively). In R2 value of 0.484 which is in the model 1 denotes that 48.4% %of observed variability in NPM can be explained by the differences in the independent variables. Remaining 51.6% variance in the net profit margin is attributed to other variables. In this model 2, R2 value of 0.479 which is denotes 47.9 % of observed variability in ROA can be explained by the differences in the independent variables.

Remaining 42.1% variance in the ROA is attributed to other variables. The examination of the model 3, R2 value of 0.053% which denotes that 5,3% of observed variability in ROE can be explained by the differences in the independent variables. Remaining 94.7% variance in the return on investment is attributed to other variables

In this models summary, that the value of an adjusted R2 0.343, 0.337 and -0.206 slightly less than the value of adjusted R2. An examination of the model summary in conjunction with ANOVA (F–value) indicates that the model explains the most possible combination of predictor variables that could contribute to the relationship with the dependent variables.

Hypothesis Testing

No	Hypothesis	Tools	Accepted/Rejected
1	Corporate Governance has an impact on Financial Performance.	Regression	Partially Accepted
2	Corporate Governance and Financial Performance is significantly correlated.	Correlation	Partially Accepted
3	All factors determine the Corporate Governance is significant.	Correlation	Partially Accepted

Conclusion

Corporate governance is important part in management decision. This research study addresses issues that are relevant for corporate and public governanceand could open further research in similar field. Implications of the findings are discussedfor a better practice of corporate governance in SriLanka, Board size, CEO duality and board independence are crucial in determining corporate performances based on financial and/orcorporate governance measurements. Based on the findings, the study concludes that CEO duality is significantly correlated with ROA and also BI is significantly correlated with NPV at 1 percent significance level. Other variable is not correlated with any financial performance factors.

There are some limitations regarding data collection, sample size and periods. For example the data of this study comprises only observations of 15 companies for different periods (2008-2012).Based on the limitation indicated above, this research could be further enhanced by looking into diversifying the sample collection by including all manufacturing companies in SriLanka and consider different period for data collection Because further analysis may give good and valuable results to us.

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