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Corporate Governance Practices and Capital Structure: Special Reference to Listed Companies in Sri Lanka

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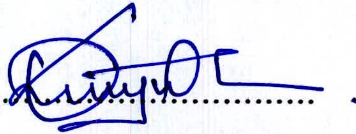

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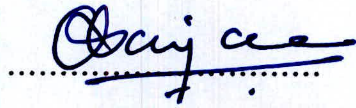

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Dr. A.H.N. Kariyawasam Date

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ABSTRACT

The purpose of the study is to examine to what extent corporate governance practices influence on the capital structure in the Sri Lankan context and to find the significant mean difference in the capital structure among the corporate governance practices, and secondary objective of the study is to suggest the listed companies in the Sri Lankan context to adopt corporate governance practices towards the capital structure. In this view, seventy nine companies from fourteen different sectors listed on Colombo Stock Exchange in Sri Lanka were selected as sample size for the study period of five years from 2010 to 2015. The one–way Anova (f-test) and independent sample t-test were used to find out the out the significant difference in capital structure among corporate governance practices. Findings revealed that, Corporate Governance Practices contributes significantly to Capital Structure. Board size and board leadership structure in the Corporate Governance Practices contribute significantly to Capital Structure. And also Capital Structure is not contributed significantly by Board composition, Board Meeting, and Board committee in Corporate Governance Practices. Meantime, there is significant mean difference in the capital structure in terms of leverage among different sectors of the listed companies in Sri Lanka. Due to that, further study should focus on the determinants of capital structure in the listed companies to take cues in the financial leverage of the particular companies. Further, suggestion was made that corporate governance rules should be strictly mandated by the Securities and Exchange Commission of Sri Lanka. In addition, political, economic, technological and social & cultural aspects of the Sri Lanka should be considered in the policy framework of the corporate governance.

Keywords: Capital Structure, Corporate Governance Practices and Listed Companies

Acronyms

ANOVA	Analysis of Variance
CEO	Chief Executive Officer
OECD	Organization for Economic Co-operation and Development
CG	Corporate Governance
CS	Capital Structure
CSE	Colombo Stock Exchange
CSR	Corporate Social Responsibility
NYSE	New York Stock Exchange
GSE	Ghana Stock Exchange
ICASL	Institute of Chartered Accountant of Sri Lanka
DR	Debt Ratio
DER	Debt Equity Ratio

CHAPTER 1

INTRODUCTION

1.1. BACKGROUND OF THE STUDY

Relations among corporate governance, management turnover, corporate performance, corporate capital structure, and corporate ownership structure have been tested by the various techniques in the significant body of theoretical and empirical literature in accounting and finance (Bhagat and Bolton, 2008) . In this context, this study focuses on the corporate governance and capital structure in the Sri Lankan perspective. According to the Australian Standard (2003), the corporate governance is considered 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 corporate governance mechanism is a framework that controls and safeguards the interest of the relevant players in the market which includes 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.

There has been a great deal of empirical work providing evidence that corporate governance (CG), corporate financial decisions and firm performance are affected by the presence of agency conflicts between managers and shareholders. Corporate governance (CG) activities enhance the

efficiency and effectiveness of organizations with the help of proper supervision and control; thereby playing a very important role in aligning the interest of shareholders and management to reduce agency conflicts (Shleifer and Vishny, 1997). With sound governance structure, it is much easier for organizations to obtain loans from investors as a functional corporate structure protects the interest of shareholders, increases transparency and reduces the agency conflicts. Firms with poor governance practices face more agency problems as managers of those firms can easily obtain private benefits due to poor CG structure.

According to the free cash flow theory, Capital structure (CS) acts as strong mechanism to reduce the agency problem hence reducing the agency costs of free cash flow and if the interests of managers are not aligned due to the absence of strong CG, they tend to prefer lower than optimal leverage, hold large amounts of cash and hence exhibit significant underperformance. Accordingly, several elements of firms' board structure, ownership structure and corporate financial policies have been suggested as potential mechanisms to control for agency problems arising from dispersed ownership (Jensen, 1986). The study integrates CG theories as well as the CS theories; the agency theory evaluates the role of the monitoring to reduce agency costs and conflict while capital structure theories discusses the potential of the debt/equity mix to maximize the value of the firm. However, despite the substantial evidence on the influence of CG on firm performance prior research has focused mainly in developed countries where the capital markets are well developed.

Global financial crisis points out the importance of a strong corporate governance and financial management for a company that has to deal with effects of unexpected crises and uncertainties that bear future business events. 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 (Mulili and Wong, 2011; Bebchuk and Weisbach , 2010). In this way, Capital structure decision is also 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. Further, Debt creation enables managers to effectively bond their promise to pay out future cash flows. Thus, debt can be an effective substitute for dividends, this issue generally is not recognized in the finance and accounting literature. When firms take the strategic decision as issuing debt in exchange for stock, firms should have the responsible to pay the interest from the future cash flows. Meantime, increased leverage also has costs. As leverage increases, the usual agency costs of debt rise, including bankruptcy costs. Therefore, the firms should focus on the optimal debt- equity ratio; it is the point at which firm value is maximized, the point where the marginal costs of debt just offset the marginal benefits (Jensen, 1986). Therefore, the study on the corporate governance and capital structure will give the tremendous strategic framework to the decision on the optimal debt – equity context. Generally the corporate governance practice is linked with the firm performance. And also, the corporate governance practice recently is linked with the concept as capital structure. Further, in the financial literature, the corporate governance practice and capital structure have not been focused fruitfully yet now (Bhagat and Bolton, 2008). In the Sri Lankan context, concept as corporate governance practice is emerged as an important financial concept in the recent years. Therefore, the study on the corporate governance practices and capital structure will give benefits to the Sri Lankan society in terms of social, political, economic perspective.

1.2. CORPORATE GOVERNANCE

CG is the system by which companies are directed and controlled. It specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. It also provides the structure through which company objectives are set and monitoring performance attained (OECD,1999). Keasey and Wright (1993) define CG as a framework for effective monitoring, regulation and control of companies which allows alternative internal and external mechanisms for achieving the laid down objectives. The internal mechanisms include the board composition, managerial ownership, and non-managerial shareholding including the institutional shareholding while external mechanisms includes; the statutory audit, the market for corporate control and stock market evaluation of corporate performance. Shleifer and Vishny (1997) define CG as a process in which suppliers of finance to firms assure themselves of getting a return on their investment. The authors posit that CG is mainly concerned with principal agency problem between ownership and control and it is seen as a set of mechanisms through which outside investors protect themselves against expropriation by insiders. Cadbury (1992) defines 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). 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