

Corporate Governance and Corporate Profitability of Listed Diversified Holding Companies in Sri Lanka

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Abstract

Corporate Governance is basically concerned with ways in which all parties interested in the well-being of the firm (the stakeholders) attempt to ensure that managers and other insiders are always taking appropriate measures and adopting mechanisms that safeguard the interests of the stakeholders. The purpose of the study is to find out the impact of corporate governance on corporate profitability of Diversified Holding companies listed in Colombo Stock Exchange. Secondary data were used for the study. 17 companies out of 20 were selected based on the availability of the data during the study period. In this study board size and board composition and CEO duality were considered as independent variables and Return on Assets (ROA) was used as profitability measurement. Further debt to equity ratio and firm size were considered as control variables. Hypotheses were tested using panel Least Square regression analysis. Descriptive statistics were computed for the Diversified Holding companies to represent the main characteristics of the study variables. The findings revealed that the influence of corporate governance on corporate profitability was statistically significant while debt to equity ratio and firm size have insignificant impact on corporate profitability.

Keywords: Corporate governance, Corporate profitability

1. Background of the Study

Corporate governance is the important factor in economic development. For business globalization economics, implementation of good corporate governance principle is necessary. Due to increasing pace of globalization, corporate governance concept has attracted attention and become an area of discussion. Besides securing interest of shareholders; it is also proposed that corporate governance practices enhance shareholders' value. The purpose of corporate governance is to enhance reliability, transparency and accountability which are essential elements for nurturing investment environment and financial stability. Corporate governance policy defines relationships among management, board, shareholders and other stakeholders. Strong corporate governance is necessary for all the business organizations because it plays an important role in the management of organizations in both developed and developing countries. Developed countries differ from developing countries in many ways.

The reason for the existence of any organization is achieving profit. According to Pandey (2002) the objective of the financial management is increasing the value of the firm work through maximizing the profit while maximizing the wealth of the shareholders. To attain this objective, the organizations must take appropriate financial decisions through undertaking the apposite financial decisions the risk as well as the income get trade off. The target of the financial management could be attain through augmenting the earning per share of the company.

The researches already undertaken revealed the corporate governance impact on corporate profitability in Sri Lanka. (Kumuthini 2011 and Azeez 2015) However most of the research work carried out in developed countries and very little is known about the impact of corporate governance on profitability in developing economies like Sri Lanka. Thus this study intends to fill this research gap.

1.1 Statement of the Problem

The impact of corporate governance on firm performance has been a subject of great empirical investigations in finance. Most empirical research has focused on the impact of corporate governance on performance. Furthermore, finance decisions are associated with the agency costs and corporate governance mechanisms. In the present study, the corporate governance and corporate profitability of the listed Diversified Holding companies in CSE has been investigated. Several researches have expressed their findings as to how corporate governance had an impact on corporate performance, corporate profitability and firm's value. However such researches are very rarely carried out in Sri Lanka. Few studies have been conducted to investigate between corporate governance and corporate profitability of listed companies in Sri Lanka. Therefore the research problem could be stated as follows." To what extent the corporate governance has significant impact on corporate profitability of listed Diversified Holding Companies Listed in CSE.

1.2 Objectives of This Study

The objective of this study is to investigate the impact of corporate governance on the corporate profitability of Listed Diversified Holding Companies in Sri Lanka.

1.3 Significance of the Study

Nowadays the significance of corporate governance is well recognized both nationally and internationally. The importance of this study stems from the following points:

The investors are able to know the corporate governance mechanism adopted by the listed Diversified Holding companies in the Colombo stock Exchange (CSE).

This study provides evidence of whether or not the corporate governance affects the Corporate profitability of the listed Diversified Holding companies in the Colombo stock Exchange (CSE).

2. Literature Review

Kumuthini (2011) undertook a research in Sri Lanka on the topic related to corporate governance and firm performance of listed companies in Sri Lanka and submitted her research work to the University of Victoria, Melbourne. In the course of her research, she made a comparative as well as an analytic study of the changes that occurred code of ethics of corporate governance between the year 2003 and 2007.

Senaratne (2007) undertook a study on the topic of Corporate governance reforms in Sri Lanka. In this context, the objective of this study was to examine how corporate governance reforms had taken place in Sri Lanka, their salient characteristics and their implications on the corporate sector. This study had been carried out as an exploratory study of corporate governance reforms introduced from 1997 to 2008, the period in which the main reforms had taken place in the country.

Senevadane and Gunaradane (2007) analyzed corporate governance development in Sri Lanka regarding prospects and problems.

Velampy (2013) investigated about Corporate Governance and Firm Performance: A Study of Sri Lankan Manufacturing Companies. He found that determinants of corporate governance were not correlated to the performance measures of the organization. Regression model showed that corporate governance has no effect on companies' ROE and ROA.

Vakilifard et al (2011) analyzed effect of corporate governance on capital structure: Case of the Iranian Listed Firms. The results obtained from testing the research hypotheses indicate that in firms where the duties of the chairman of the board is separated from those of CEO and also in firms the benefit from fewer members of the board, the tendency to utilize debt increases. However, no significant relationship was found between 'proportion of outside directors' and 'capital structure'.

Jaradat (2015) investigated about corporate governance practices and capital structure: a study with special reference to board size, board gender, outside director and CEO duality. The result approved that board size, board diversity and outside director are positively related to the leverage. While, CEO duality had no significant relationship with leverage. The control variable like: Managerial ownership, Profitability and return on Assets were negatively and significantly related to leverage, while, firm size was positively related to the leverage.

Abdul (2012) conducted a similar study to determine the relationship between capital structure decisions and the performance of firms in Pakistan. The study concluded that financial leverage had a significant negative relationship with firm performance as measured by ROA, GM, and Tobin's Q. The relationship between financial leverage and firm performance as measured by the return on equity (ROE) was negative but not statistically significant.

Kaumbuthu (2011) carried out a study to determine the relationship between capital structure and return on equity for industrial and allied sectors in the Nairobi Securities Exchange during the period 2004 to 2008. Capital structure was proxied by debt equity ratio while performance focused on return on equity. The study applied regression analysis and found a negative relationship between debt equity ratio and ROE.

Ebaid (2009) carried out a study to investigate the impact of choice of capital structure on the performance of firms in Egypt. Performance was measured using ROE, ROA, and gross profit margin. Capital structure was measured by short-term debt to asset ratio, long-term debt to asset ratio, and total debt to total assets. Multiple regression analysis was applied to estimate the relationship between the leverage level and performance. The study concluded that capital structure had little to no impact on a firm's performance.

Based on the above empirical view for achieving the research objective, following hypothesis has been developed.

H₁: Corporate Governance mechanisms significantly impact on corporate profitability of Listed Diversified Holding Companies in Sri Lanka.

3. The Conceptual Frame Work

- After the careful study of review of literature the following conceptual model is developed by the researcher.

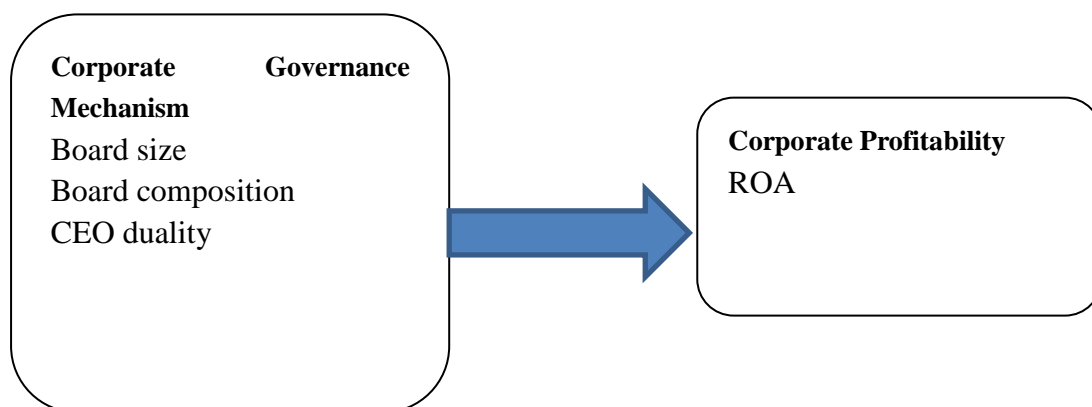


Figure 1

Source: Developed by researcher

4. Methodology

4.1 Data Collection and Sampling

This study utilizes the listed companies in Sri Lanka as its population. Diversified Holding Sector was chosen because it is one of the largest sectors in term of market capitalization of the company. All companies are selected as sample excluding two companies which companies data are not available. The research is based on secondary data. Corporate governance and reporting information were collected from annual reports from CSE official website. For the purpose of this study data were collected during the period from 2011 to 2016. Data analysis is done with the help of software packages Eview 08.

4.2 Measurements of the Study

Dependent Variable (Profitability)

Even though, there are several profitability ratios based on the investment and turnover. Return on Assets was taken into account in the study.

Return on Assets: A ratio that measures a company's earnings before interest and taxes (EBIT) against its total net assets.

Independent Variables (Corporate Governance)

A corporate governance structure is often a combination of various mechanisms. Those are Board size, Board composition CEO duality, No of auditors, no of female members of the Board and Number of board meeting. Board size, board compositions and CEO duality are taken into account in this study.

Board size (BS): The Total number of directors on the board.

Board composition (Bcom)

Board composition normally concerns issues related to board independence (including independence of board committees) of board members.

CEO duality indicates whether the company's CEO is also chairman of the board, Dummy variable equal to 0 if the two variables are separate.

Control Variables

Firm size (FS) The natural log of the total Assets.

Debt to Equity ratio was taken to represent the financial ratio.

(Debt to Equity Ratio): It indicates what proportion of equity and debt which the company is using to finance its assets.

4.3 Statistical Model Used in This Study

OLS panel regression model

Since the data is of panel in nature consisting of both time series and cross sectional data, so that the ordinary least square panel regression is used for the purpose of analysis.

The following regression equation is estimation:

$$CP_{it} = \alpha_{it} + \beta_1 BS_{it} + \beta_2 BCM_{it} + \beta_3 CEO_{it} + \beta_4 DEEQ_{it} + \beta_5 FS_{it} + \mu_{it} \quad (\text{Model 01})$$

In the above regression equation, CP_{it} represents the profitability of firm i at time t . BS_{it} , BCM_{it} , and CEO_{it} represents corporate governance variables of firm i at time t and $DEEQ_{it}$ and FS_{it} represent the control variables. α_{it} and μ_{it} stand for the intercept and error term respectively. β_1 to β_5 are the slope of the coefficients which influence the dependent and independent variables.

5. Data Analysis and Discussion

5.1 Descriptive Statistics

Preliminary analysis of the data was carried out for the years 2011 and 2016. Descriptive statistics are also useful to make general observations about the data. They report on the trends and patterns of data and provide the basis for comparisons between variables. Descriptive statistics of the Diversified Holding Companies variables appears on the Table 1 below.

Table 1. Descriptive statistics

	BOARD_SIZE	BCOM	CEO	DEEQ	FS	ROA
Mean	8.876289	0.446199	0.195876	79.70810	8.309940	7.467909
Median	9.000000	0.454545	0.000000	20.04149	8.016469	4.912534
Maximum	12.00000	0.714286	1.000000	78.9153	10.46912	64.42596
Minimum	5.000000	0.111111	0.000000	0.052590	5.482996	-14.72686
Std. Dev.	2.001342	0.138886	0.398935	124.2655	1.469018	12.32737
Skewness	-0.275755	-0.030019	1.532597	2.965086	0.045345	2.391405
Kurtosis	2.090342	2.325292	3.348853	14.65205	1.430756	10.63266
Jarque-Bera	4.573712	1.854462	38.46499	690.8711	9.985948	327.9116
Probability	0.101585	0.395648	0.000000	0.000000	0.006785	0.000000
Sum	861.0000	43.28128	19.00000	7731.686	806.0642	724.3871
Sum Sq. Dev.	384.5155	1.851785	15.27835	1482423.	207.1694	14588.55

The results showed that Board size had a mean value of 8.876289 with a minimum of 5, a maximum of 12, skewness -0.275755 and kurtosis of 2.090342. Board composition had a mean value of 0.446199, minimum of 0.111111, maximum of 0.714286 skewness of -0.030019 and kurtosis of 2.325292. Comparatively, Return on Assets had a mean value of 7.467909, minimum of -14.72686 , maximum 64.42596, skewness of 2.391405 and kurtosis

of 10.63266. Debt to equity had a mean value of 20.04149, minimum of 0.052590, maximum of 78.9153 skewness of 2.965086 and kurtosis of 14.65205. Skewness measures the degree and direction of asymmetry.

5.2 Unit Root Test

Unit root tests are tests for stationary in a time series. A time series has stationary if a shift in time doesn't cause a change in the shape of the distribution; unit roots are one cause for non-stationary.

The following Table 2 shows the unit root test summary for each variables.

Table 2. Unit root Test

Augmented Dickey-Fuller test statistic

Variable	Co efficient	Prob.**
Board size	-5.44870	0.0000
Bcom	-2.90132	0.0019
CEO	-3.92962	0.0000
DEEQ	-2.90132	0.0019
FS	-6.72817	0.0000
ROA	-5.03800	0.0000

Here all p values are equal to Zero. Thus the variables don't have the unit root.

5.3 Correlation Analysis

To find out the relationship among variables correlation analysis was carried out. The summary of the results are presented in the Table 3.

Table 3. Correlation

	BCOM	BOARD_SIZE	CEO	DEEQ	FS	ROA
BCOM	1.000000					
BOARD_SIZE	-0.113848	1.000000				
CEO	-0.306722	0.159648	1.000000			
DEEQ	0.231580	-0.277656	0.075132	1.000000		
FS	-0.227883	-0.013155	0.164765	-0.198378	1.000000	
ROA	0.248169	0.072782	-0.444434	-0.013020	-0.085065	1.000000

Firm size and Debt to equity have negative and weak relationship with ROA, but there is positive and weak correlation among Board size, Board com and ROA. These weak relationships between the explanatory variables are also the indication that there is no severe issue of multi-co-linearity.

5.4 Regression Summary

Table 4 demonstrates the findings of the panel least squares regression analysis. Model 1 expresses the effect of independent variable (Board size, Board composition, CEO) and control variables (Debt to equity and firm size) on corporate profitability (ROA).

Table 4. Regression summary

Dependent Variable: ROA				
Method: Panel Least Squares				
Date: 12/06/17 Time: 19:10				
Sample: 1 102				
Companies included: 17				
Cross-sections included: 6				
Total panel (unbalanced) observations: 100				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
BOARD_SIZE	3.338171	1.334369	2.501685	0.0141
BCOM	36.97140	21.79011	1.696706	0.0930
CEO	-37.81457	8.406131	-4.498451	0.0000
DEEQ	0.014795	0.026950	0.548979	0.5843
FS	1.291826	1.450905	0.890359	0.3755
R-squared	0.235703	Mean dependent var		50.63397
Adjusted R-squared	0.203522	S.D. dependent var		34.46229
S.E. of regression	30.75608	Akaike info criterion		9.738759
Sum squared resid	89863.96	Schwarz criterion		9.869018
Log likelihood	-481.9380	Hannan-Quinn criter.		9.791477
Durbin-Watson stat	1.397223			

The above table shows the estimated result of model 01. R square shows that the model explained 23.5703% of total variations of the dependent variable. It means that 23.5703% of the changes in dependent variable are described by both independent and control variables. As a point of focus, the hypotheses of this study states that the Corporate Governance significantly impact on corporate profitability of listed Diversified Holding Companies.

As observed, the results show that board size has a coefficient of 3.338171 with t statistics of 2.501685 with a p value of 0.0141. Thus, from the results, it can be stated that there is significant impact of board size on corporate profitability. Board composition has a coefficient of 36.97140 with t statistics of 1.696706 with a p value of 0.0930. Board composition has significant impact on corporate profitability at 10% level. CEO duality also has significant impact on corporate profitability at 1% level as measured by ROA. CEO duality has a coefficient value -37.81457 with t statistics of -4.498451 with a p value of

0.0000. Debt to Equity ratio and firm size don't impact on corporate profitability of listed diversified holding companies.

Durbin Watson test is a test used to detect auto correlation. From the Table 03 Durbin Watson stat value is 1.397223. This value less than 3 indicating that there is no auto correlation issues.

6. Conclusion

Sri Lanka is a developing country and Corporate governance concepts are more important for both developed and developing country because they faced more competition in Globalization of business. The aim of this study is to evaluate the impact of corporate governance on the corporate profitability of listed Diversified Holding companies in Sri Lanka. The OLS regression model was applied on the sample of 17 Diversified Holding companies. The empirical result showed that corporate governance mechanism play important role in the profitability of Diversified Holding Companies in Sri Lanka. Large board size may be in favor of diversified holding companies because they will increase the profitability. Board compositions also have a positive impact on the profitability but result is significant at 10 % level. It is observed that if the firms apply the good corporate governance principles then firm can achieve the firm's objectives and also the firms can raise the profitability. The similar results have also been found in study done by Dalton (1999) he suggested that a large board appears to be better for firm performance. In addition Jensen (1993) concluded that the CEO duality would reduce a board's supervision of the management of the company and this results in an increase of costs to an agency. Many researches (Lin and Liu 2009) concluded that firm with higher ratio independent directors in a board face less frequent financial pressure and firms with many independent directors have had lower probability of filing for bankruptcy. Based on the results, the authors propose some suggestions that are expected to be useful for the parties it may concern:

Corporate Governance is one of the factors that drive improved profitability of a company, because of corporate governance implementation in a company, the level of public confidence, especially investors will increase. Therefore, a company should always improve the quality of corporate Governance implementation.

In order to maximize profitability, a company has to improve the quality of corporate governance implementation, and should develop and implement the principles of corporate governance regularly to obtain positive results of the company.

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