The impact of corporate governance on firm value: Evidence from listed manufacturing companies in Sri Lanka

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Abstract

Good corporate governance is directly linked with the shareholder wealth creation and thereby influence the overall economic prosperity of entities. Firm value is regarded as one of the indicators for the creation of a wealth of an entity. Hence, the purpose of this study is to examine how corporate governance practices impact on the firm value. Data was collected through reviewing the annual reports of 27 Sri Lankan manufacturing firms listed on the Colombo Stock Exchange from 2012 to 2016. The study used descriptive statistics and multiple regression analysis to analyze data.

Findings revealed that the number of board meetings of listed manufacturing companies capable of improving firm value. Further, we identified that the control and risk management system of manufacturing entities positively impact firm value while board size and the board committees do not contribute significantly to improve the firm value of manufacturing sector entities in Sri Lanka.

The study has social and policy impact as it highlights the importance of corporate governance practices on improving the firm value of the Sri Lankan manufacturing sector. Focusing on one industry sector is an inherent limitation of the study, and industry sector comparison would be a potential future research area.

Keywords - *corporate governance, firm value, manufacturing sector, Sri Lanka*

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1. Introduction

Increasing firm value in terms of shareholders' wealth maximisation is the ultimate objective of every profit motive firm. Organisational strategies, structures, and processes are there to achieve the said objective within which organised structures of formal (regulations and laws) and informal (norms, values, and assumptions) that create constraints on the behavior of a related party (Cheffins, 2013). According to Cadbury (1992), Corporate Governance (CG) is the system by which companies are directed and controlled has succeeded in attracting a good deal of public interest over the years because of its ostensible importance for the economic health of companies and society in general in both developed and developing countries.

The firms in developed countries have dispersed shareholders and operate within stable political and financial systems, well developed regulatory frameworks, and effective CG practices (Heenetigala & Armstrong 2011; Yurtoglu, 2003). However, firms that operate in developing countries may be affected by political instability resulting in severe economic disruption, which results in a widening fiscal deficit (Harrison, 1981). Therefore, the capital markets which are exposed to economic and political instabilities may result in

weaker CG resulting in negative value creation. Supporting to this argument, in the context of Sri Lanka, changes in governments that fluctuate between two major political parties, their different ideological perspectives, and ad-hoc changes on its governance mechanism in Sri Lanka has been adversely affected the economic development of Sri Lanka (Nagirikandalage & Binsardi, 2017).

Additionally, political transformation in 2015 with the theme of "good governance" paved the way to discuss and to highlight the importance of CG in Sri Lanka. Over last four years, the new government established the Financial Crime Investigation Division (FCID) intending to investigate major financial crimes, (e.g., frauds and illegal financial transactions) and the 19th amendment to the constitution established an Independent Audit Commission providing a legal assistance for financial investigations provided the necessity of sound CG system for all public and private sector companies. Further, recent business collapses such as Pramuka bank, Golden key, and Central bank bond scam are the wakeup calls that rejuvenated the interest of good governance practices in Sri Lankan private and public entities. Several public and private entities (e.g., Sri Lankan Air Lines, EAP, Perpetual treasuries) were accused by recent investigations conducted by the

government on the poor CG. Therefore, all the public and private entities, government as well as the general public are interested in examining how the companies in Sri Lanka comply with good governance in controlling their business entities.

CG initiatives in Sri Lanka commenced in 1997 with the introduction of the first report on voluntary code of best practice on matters relating to the financial aspects of CG. The Institute of Chartered Accountants of Sri Lanka set up a committee to form recommendations regarding the financial aspects of CG, with the support of the Colombo Stock Exchange (CSE), and Securities and Exchange Commission (SEC). The code directed towards all listed companies, unit trusts, fund management companies, finance companies, banks, and insurance companies for voluntary compliance. The code provided a broader operational structure for carrying out CG activities. The rules embedded in the code were primarily based on the Cadbury committee report (Senaratne & Gunaratne, 2008). After several amendments, the revised code standard on CG for listed companies incorporated into the listing rules of the CSE, from 1st of April 2007 and subsequent amendments were made (e.g., 2013 revisions) to cater timely needs of business and organizational

environment in locally as well as internationally.

Many previous scholars(Black, Tang, & Kim, 2003; Brown & Caylor, 2006; Carter, Simkins, & Simpson, 2003; Kommunuri, Jandug, & Vesty, 2014; Lemmon & Lins, 2003) attempted to identify how the CG impact on the value generation process in firms. Those studies used different aspects of CG, various measures in firm performance and value, samples, methods, and methodologies. However, the findings are inconclusive. As an example, some studies found board size has a positive impact on the firm value (Dalton, Daily, Ellstrand, & Johnson, 1998; Pearce & Zahra, 1992) while some studies found a negative effect (Cheng 2008; Forai & Amedro, 2004; Shakir, 2008) on the same. Beiner, Drobetz, Schmid, and Zimmermann (2004) did not detect any significant relationship between board size and firm value.

The Firm value is often referred to as an alternative to equity market capitalization. It is a figure that theoretically represents the entire cost of a company if someone were to acquire. Enterprise value is a more accurate estimate of takeovercost than market capitalization because it includes several important factors such as preferred stock, debt (including bank loans and corporate bonds), as well as

backing out cash reserves(Brigham & Ehrhardt, 2002). Firm value is used regularly in business valuation, portfolio analysis, accounting, financial modelling, and risk analysis. It has become a fundamental economic measure that reflects the total value of the firm (Forai & Amedro, 2004).

The most common methods of measuring company value are market capitalization and price-earnings ratio. Investors sometimes use economic value to compare returns between similar companies on a risk-adjusted basis. Some investors, particularly those who subscribe to a value investing philosophy, look for companies that are generating a lot of cash flow about enterprise value. Businesses that tend to fall into this category are more likely to require little additional reinvestment. Therefore, the literature provided divergent conclusions about the relationship between CG and firm value, with different models to measure firms' value.

The current study examined relevant previous Sri Lankan studies on CG and its impact on different corporate aspects. It is observed that the majority of studies have focused on CG and firm performance (Achchuthan & Rajendran, 2013; Azeez, 2015; Velnampy, 2013). However, many of the findings are inconclusive. Examples; Heenetigala

and Armstrong (2011) found a positive relationship between CG and firm performance, while Velnampy (2013) found that determinants of CG are not correlated to firm performance. One of the recent studies (Danoshana & Ravivathani, 2019) has also focused on the impact of CG and firm performance and revealed a positive impact on forms performance. Annexure 1 summarizes some of the relevant studies on CG and firm performance in the Sri Lankan context. Thus, it is observed that there is a dearth of studies on CG and firm value. The lacuna of literature on CG and firm value creates a need for further studies with the most relevant firm value measurement like MVA.

Accordingly, the main objective of this study is to examine how the CG practices impact on the firm value in Sri Lankan manufacturing firms. The rest of the paper is organized as the literature review, methodology, data analysis, findings, and conclusion.

2. Literature review

This section explains previous findings relating to the selected CG variables and the firm value, namely, the board size, board meetings, board committees, the internal control system and risk management, and the hypothesis of the study. It also highlights prior insights on the firm value.

2.1. Board size and firm value

Previous studies (Cheng 2008; Forai & Amedro, 2004; Kumar & Singh, 2013; Shakir, 2008) recognized that the board of directors as a significant aspect of sound CG mechanism. The role of the board of directors is crucial for the organizations, as they are the primary change agents of the organization (Shakir, 2008). Some previous studies have found a negative relationship between board size and firm value (Cheng 2008; Forai & Amedro, 2004; Kumar & Singh, 2013; Shakir, 2008; Yermack, 1996).

Large boards suffer from the dissemination of responsibility and aversive attitude towards monitoring managerial performance and risk-taking (Hermalin & Weisbach 2001). However, with many members, the board may also find it challenging to staff various sub-committees such as the audit committee or remuneration committee. In large boards, members with diverse backgrounds bring knowledge and intellect to the board room (Dwivedi & Jain, 2005). The ideal size of a board is often recommended to be between seven, eight (Eisenberg, Sundgren, & Wells, 1998) or ten (Lipton & Lorsch, 1992). They argued that large boards might be less effective than small boards. Board size varies depending on the size and requirement of a company,

and some studies establish a positive association between board size and firm performance (Dalton et al., 1998; Pearce & Zahra, 1992). However, Beiner et al. (2004) did not detect a significant relationship between board size and firm value for a sample of Swiss firms. Based on the literature, the first hypothesis that will be tested for the study is;

H1: There is a positive impact of board size on the firm value

2.2. Board meetings and firm value

Vafeas (1999) indicated that the board meeting frequency influences firm performance and firm value. A higher frequency of meetings is likely to result in superior performance (Lipton & Lorsch, 1992), enhance board oversight of senior management (Davila & Penalva, 2006), and it is a good proxy for the monitoring effort of directors (Vafeas, 1999). Frequent meetings also make faster the recovery from poor firm performance (Vafeas, 1999). To the opposite, Jackling and Johl (2009) found no relationship between board meetings and firm performance in a sample of Indian firms. Therefore, the second hypothesis that will be tested in the study is;

H2: The is a significant positive impact of the number of board meetings on the firm value

2.3. Board committees and firm value

Cadbury (1992) recommended that boards should nominate sub-committees to address the following three functions: Audit committees to oversee the accounting procedures and external audits; Remuneration committees to decide the pay of corporate executives, and nominating committees to nominate directors and officers to the board. Bilimoria and Piderit (1994), stated that the board committees provide a means and structure for effective governance by facilitating crucial tasks and addressing critical corporate concerns. Jiraporn, Singh, and Lee (2009) argued that board effectiveness is accomplished through board committees.

Kesner (1988) stated that the most important decisions of the board are initiated at the committee level. García-Meca and Sánchez-Ballesta (2009) concluded that that audit committee independence is one of the primary mechanisms to constrain earnings management and assure the credibility of a firm's financial statements. Therefore, the third hypothesis that will be tested is;

H3: There is a positive impact of board committees on the firm value

2.4. The internal control system, risk management, and firm value

Jensen (1993) stated that internal control systems, such as managerial incentives, corporate charters, and boards of directors, however, may not be sufficient to ensure corporate transparency and the self-monitoring of firm behavior. Doyle, Ge, and McVay (2007) found no association of a CG quality index and the overall likelihood of disclosing material weaknesses. Given the normative theoretical prescriptions of early risk management theory, Smithson and Simkins (2005) found that company share prices do reflect the value of interest rate risk management in financial institutions, but the results are less clear when examining industrial companies. The risk management is beneficial to the firm because it reduces its tax payments (Smith & Stulz, 1985)financial distress costs (Stulz 1984), information asymmetry costs (Breeden & Viswanathan, 1998; DeMarzo & Duffie, 1991; Stulz 1990) and financing costs (Froot, Scharfstein, & Stein, 1993; Morellec & Smith, 2002).

The current study expects a positive relationship between risk management and internal control with the firm value and developed the fourth hypothesis as;
H4: There is a positive impact of risk and internal control systems on the firm value

2.5. Firm value

The firm value can be measured either by using Economic Value Addition (EVA) or Market Value Addition (MVA). Economic value added (EVA) is the difference between the firm's after-tax return on capital and its cost of capital. Stewart (1991) defined EVA as a residual return that subtracts the cost of invested capital from net operating profit after tax. EVA is equal to the economic book value of the capital at the beginning of the year and the difference between its return on capital and cost of capital. Stewart (1991) defines MVA as the excess of the market value of capital (both debt and equity) over the book value of capital. He suggested that, if the MVA is positive, the company has created wealth for its shareholders.

Brigham and Ehrhardt (2002) stated that MVA represents the difference between the total market of a firm and the total amount of investor-supplied capital. Invested capital, also known as capital employed, and it is the summation of equity and debt capital supplied by the firms' shareholders and debt holders to finance assets. Positive MVA is a sign of shareholder value creation. Niresh and Thirunavukkarasu (2014) also stated that MVA is a wealth measurement tool in determining the return on the money invested in the company. There fore, positive MVA reflects that the money invested by the shareholder's yield returns, while the negative MVA is the vice versa. The current study used MVA as a proxy for firm value.

3. Methodology

This study focused on a positivist paradigm that seeks facts or causes of social phenomena, using deductive reasoning with quantitative techniques. The reasoning is deductive because the hypotheses were derived first, and the data were collected later to confirm or contradict the propositions.

The largest industry sector in CSE is the bank, finance, and insurance sector that has been double regulated and significantly different from other sectors (Imam & Malik, 2007; Kalainathan & Kaliaperumal, 2014) in reporting in Sri Lanka. Therefore, the current study focused on the second-largest industry sector, i.e., the manufacturing sector, which has a significant contribution to the Sri Lankan economy.

There were 38 listed manufacturing companies by 2017, and a total of 11 companies have not published their annual reports (2012-2016) on the CSE website. Based on data availability (Kalainathan, 2015, p. 382), the study considered those 27 companies as the sample of the study, which represents 71% of the total listed manufacturing companies.

Annual reports of the sample companies were examined (Ryan & Ng, 2000) in order to identify the relevant disclosures on selected CG variables. Accordingly, disclosures relating to the number of directors of the company, the number of board meetings, availability of board committees, internal controls and risk management were identified.

To make sure the accuracy and reliability of the identified disclosures, two raters (participants) were employed to examine annual reports to gather CG data. Two participants examined each of the annual reports. It helped to check the initial inter-rater reliability of collecting data form annual reports. When there are variances in collecting CG information, participants discussed each other and identify the problems and rectify the data in the inaccurate form. This process improved the accuracy and reliability of the CG measurement index and the collecting of data.

As discussed in developing hypotheses, CG, i.e., the independent variable, was measured using four variables. Board size, board meetings, board committees, and Internal control system and risk management. The board size was measured by counting the total number of directors serving on the board (Cheng 2008; Forai & Amedro, 2004; Kumar & Singh, 2013; Ntim, Opong, & Danbolt, 2012; Shakir, 2008; Yermack, 1996).

Studies measured the board size in different scales . The minimum number of directors for a company as per companies act No.7 of 2007 is given as one director in the Sri Lankan context. We further observed that the mean board size in manufacturing companies is six. Previous studies have found that there is a positive relationship between board size and firm value (Dalton et al., 1998; Pearce & Zahra, 1992). Hence, the marks are given as 1-5 = 1, 6-10=2, >10 = 3 (see, table 2). In terms of Board meetings, the minimum number of meetings as per CG-Code (2017) is four meetings per year. Thus, it was considered as the cutoff to award marks. The presence or absence of committees is counted by the dichotomous approach in previous studies (Cheng & Courtenay, 2006; Heenetigala, 2011; Laing & Weir, 1999). If the company annual report disclosed that the internal control and risk management system is available, 1 mark was awarded. As required by CG-Code (2017), if all the committees such as audit committee, nomination committee, and remuneration committees are available in a company one mark was awarded (Cheng & Courtenay, 2006)

The dependent variable of the study is the firm's value, which is measured using Market Value Added (MVA). Original value or book value is retrieved from annual reports, and the market

prices extracted from the Colombo Stock Exchange (CSE). Operationa-

lization of variables is summarized in Table 1.

Table 1. Operationalization of the variables

Variables investigated	Measurement	Operationalization
Independent Variables		
Board Size (BS)	Number of directors in the company	1-5 = 1, 6-10=2, >10 = 3
Board Meetings (BM)	The number of meetings held per year.	<4 = 1, 4= 2, >4 = 3
Board Committees (BC)	Availability of Audit committee, Nomination Committee, and Remuneration committee	If yes 1, otherwise 0
Internal control and risk management (IC)	Availability of internal control system and risk management framework	If yes 1, otherwise 0
Dependent Variable		(Market value – Book value)* No. of shares issued
Firm Value (FV)	Market Value Added (MVA)	

4. Analysis and findings

Descriptive summary statistics of the firm value and the related CG variables for the companies in Sri Lanka are presented in Table 2. Descriptive statistics in the table can be viewed in terms of location (mean, median and mode) statistics, dispersion (standard deviation, interquartile range, and range) statistics and shape (skewness and kurtosis) statistics. As depicted in Table 2, the firm value is generated by finding the difference between the market value (MV) and the invested capital.

Table 2 shows the center of the firm value ranges from 28.55 (median) to 70 (mode). The interquartile range of the firm value is 60.52, suggesting the middle 50% of the data set ranges from lower quartile (3.49) and upper quartile (64.01). An overall marginal positive skewness of 0.97 exist although mode > mean > median (suggesting a negative skewness). Also, descriptive statistics evident that average bard size (mean of 2) of manufacturing entities in Sri Lanka is 6 to 10 directors. The mean, median, and mode concerning board meetings recording below Table 2 show that manufacturing companies hold less than

four meetings per year. The same measures concerning board committees revealed that, on average, manu facturing entities have a minimum of two subcommittees to the board. Data shows that all the manufacturing companies have formed internal control and risk management framework in their companies as part of good governance. However, in time-series analyses, we noted that the compliance level of all three variables relating to CG had been improved from 2012 to 2016

Table 2. Descriptive summary statistics

	Firm value	Board size	Board meetings	Board committees	Internal control & risk management
Mean	38.73	1.9	1.63	1.76	1
Median	28.55	2	1.5	1.67	1
Mode	70	2	1	1.67	1
Skewness	0.97	-0.48	0.92	-0.03	1.23
Standard deviation	38.57	0.45	0.67	0.37	0.28
Count	135	135	135	135	135

The data used in the analysis consist of both cross-sectional variations as well as time-series variation. For example, firm value has data ranging from 2012 to 2016 for 27 different companies. Such data are known as panel (longitudinal) data, and we have used EViews to generate the Panel Least Squares Regression (PLSR) to incorporate the panel characteristics that exist in our data set. The PLSR for firm value is presented in Table 3. The adjusted R^2 is 77%, suggesting that the estimated regression cannot explain only 23% of the total variation. The P-value of the F-statistic (0.0000) justifies the overall significance of the PLSR on the firm value.

Table 3. Panel Least Squares Regression on Firm value

Variable	Coefficient	Std.error	t-statistics	Prob.
C	32.24388	12.93082	2.493568	0.0143
Board committees	-8.883338	7.581350	-1.171736	0.2441
Board meetings	8.195513	3.792154	2.161176	0.0331
Board size	-0.061673	3.905200	-0.015792	0.9874
Intcontro & RM	30.17665	10.48107	2.879156	0.0049

R squared	0.829682
Adjusted R squared	0.771777
Prob (F statistic)	0.000000
Durbin Watson stst.	1.167716
Akaike	8.883818
Schwartz	9.637038
Hannan-Quinn	9.189906

The lowest Akaike, Schwartz, Hannan-Quinn info criteria are used to pick the best model presented in Table 3 the explanatory variables in the estimated PLSR regression are the board committees, board meetings, board size, and internal control and risk management. Out of these four independent variables, only two are statistically significant. They are board meetings (with a P-value of 3.31%) and internal control and risk management (with a P-value of 0.49%). Accordingly, only hypotheses 2 and 4 can be accepted. The most significant explanatory variable of the firm value is the internal control and risk management (with the lowest P-value).

5. Discussion and conclusion

Our finding of a significant positive relationship between board meetings and the MVA has complied with most of the previous studies. As an example, Vafeas (1999) and Lipton and Lorsch (1992) concluded that a higher frequency of meetings is likely to result in superior performance and a better

way to monitor efforts of directors as frequent meetings make faster the recovery from a poor firm performance. This finding also can be explained by using agency theory. Meetings are the primary space for the company's decision making on behalf of owners. High frequency of meeting suggests that directors have put more effort and time for better decision making helping to improve the operational and financial performance and ultimately enhance the company value.

The second significant finding for the internal control system and risk management also shows a significantly positive relationship on firm value. It provided evidence that the companies' firm value is increased by better internal control and risk management through less financial distress costs (Stulz 1984), less information asymmetry costs (Breeden & Viswanathan, 1998; DeMarzo & Duffie, 1991; Stulz 1990) and less financing costs (Froot et al., 1993; Morellec & Smith, 2002). On the other hand, internal controls are put in place to secure the organization from

inappropriate and harmful actions of the employees and managers. Therefore, internal controls safeguard the organization from the conflict of interests. Proper risk management helps the organization in better decision making. Thus, the positive impact of internal control and risk management can be rationalized through agency theory.

Summing-up,the findings board meetings, and internal control and risk management framework show a significant impact on firm value while board size and board committees show an insignificant impact on firm value. Consequently, this study provides a useful insight for firms in Sri Lanka that are attempting to improve or implement CG structures. Due to the challenges faced by the Sri Lanka economy, it is necessary to build confidence in investors and other international agencies through reforms in CG, financial reporting, and corporate laws. Future researches need to be more focus on other CG variables and firm value since it will be useful for the investors and stakeholders. Focus on a single industry sector can be identified as a limitation of this study, and industry comparison on CG and firm value would be another future research avenue.

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Annexure 1:
Recent related studies on Corporate Governance - Sri Lankan context

Study	Data source	CG variables	Other variables	Findings
Heenetigala and Armstrong (2011)	Sample of 37 companies selected from the top 50 listed companies in The Lanka Monthly Digest 50 (LMD) for the years 2003 and 2007.	Separate leadership Board composition Board committee and	ROA and Tobin's Q	A positive relationship between CG and firm performance.
Guo and Kga (2012)	Sample of 174 listed firms in CSE for the financial year 2010	Board size Proportion of non- executive directors in a board Director's shareholdings CEO duality	ROA Tobin's Q	board size and proportion of non-executive directors in the board showing a marginal negative relationship with firm value The proportion of non-executive directors in a board and financial performance of the firm showing a negative relation
Velnampy (2013)	Sample of 28 manufacturing companies using the data representing the periods of 2007 – 2011.	Board structure Board committee. Board meeting Board size	ROA ROE	Determinants of corporate governance are not correlated to the performance measures of the organization
Achchuthan and Rajendran (2013)	Sample of 28 listed manufacturing firms for the period of 2007- 2011.	Board Leadership Structure Proportionate of non-executive directors in the board Board Committees Board Meeting	ROE	No significant mean difference between the firm performance among corporate governance practices
Dharmadasa, Gamage, and Herath (2014)	Sample of 189 companies listed in CSE for the year 2012/2013	CEO duality Board size Board independence Family directors, Interlocking directorate Board diversity	ROA Tobin's Q	Larger boards are showing a negative impact on firm performance. A positive association between board independence and firm performance. CEO duality, family directors, interlocking directorate nor board diversity are not significant in increasing firm performance.
Azeez (2015)	Sample of 100 listed companies in the Colombo Stock Exchange for the 2010-2012 financial years	Board Size CEO duality Proportion of non-executive directors	EPS ROA ROE	Board size is negatively associated with firm performance. CEO duality showing a significant positive relationship with the firm performance Non-executive directors on the board are not associated with firm Performance
Danoshana and Ravivathani (2019)	Sample of 25 listed financial institutions in the Colombo stock exchange for 2008-2012	Board Size Audit committee Number of meeting	ROA	Board Size and audit committee are having a positive impact on forms performance while the number of meetings has a negative impact.