6th International Conference for Accounting Researchers and Educators
04th December 2020
University of Kelaniya, Sri Lanka

Corporate Transparency and Firm Value: Evidence from Sri Lanka

Niruja Rajakulanajagam[1] and Balasundaram Nimalathasan[2]

1,2, Department of Accounting, Faculty of Management Studies and Commerce, University of Jaffna

Abstract

The aim of this study is to investigate the impact of corporate transparency and firm value. Although managers are getting allowances to disclosure more, existing literature reveal that the disclosure brings negative effects and additional cost. However, being transparent is better way to boost up investors' confidence through that firms could enhance their value. To clear out these conflicts current study empirically investigates the problem using three proxies of firm value such as return on equity, modified Tobin's Q and share price. Corporate transparency were measured based on the adjusted S&P disclosure and transparency items under three aspects namely, financial transparency and information disclosure, board and management structure and processes and ownership structure and investor rights. The study considered all the listed firm in Colombo stock exchange as the population and after the careful elimination, total of 126 Sri Lankan listed companies were selected to the empirical analysis. Hypotheses of the study were tested based on the multiple regression. The result of the study reveal that the corporate transparency positively influence on firms' value in Sri Lankan setting. This result could be practicable by disclosing more information voluntarily. This study contributes to the existing literature by examining the corporate transparency through modified disclosure index.

Keywords: Colombo stock Exchange, Corporate transparency, Modified Tobin's Q, Share price.

Introduction

The continuous worldwide business scandals have led to a global awareness that sound corporate governance (CG) practices including transparency are important for long-term sustainability of companies as well as for efficient allocation of capital in the international financial markets. Moreover, increasing stakeholder including shareholders concentration on the organization matters requires full disclosure of companies. Based on the agency theory, agent (managers) should pay more consideration to disclose all material information to the principals (shareholders) in order to reduce

the information asymmetry between insiders and outsiders (Jensen & Meckling, 1976 cited in Needle (2015)). By means of such full disclosure, the shareholders can monitor whether managers' behaviour is maximally aligned with the interest of the shareholders. As a result, best practices on corporate governance codes have been developed by national and international regulators. According to OECD (1999), full disclosure and transparency of financial information are vital components of the corporate governance framework. Beeks and Brown (2006) find that firms with higher CG quality make more informative disclosures and which helps to attract more investment. Increased transparency also reduces information asymmetry, and lowers the firm's cost of capital (Poshakwale & Courtis, 2005), since investors will pay less for information disseminated under disclosure rules.

On the contrary, Chhaochharia and Grinstein (2007) reveal that companies that are less compliant with the provisions of the Sarbanes-Oxley Act earn positive abnormal returns compared to companies that are more compliant. These emerging events have cast doubt on the effectiveness of promoting corporate governance and have raised questions concerning whether increasing firms' transparency through corporate governance mechanisms can help to reveal the true value of a firm. As well, the increased transparency requires some organisational change, which is to form a team dealing with production of information to the investing community, and thus this change has operational and financial costs.

Today, companies are operating in dynamic environment where information are valuable and competitive advantage may dissipate quickly (Chahine & Filatotchev, 2008). Therefore, the validity of management's unwillingness to share proprietary information should be considered by shareholders. Therefore, the shareholders may face problem to demand full disclosure of information in order to reduce agency cost. The initial step to overcome this issue is to clarify whether transparent information could reveal the true value of a firm.

There are number of studies to prove this issue mainly based on data from Anglo-American firms (e.g. Chhaochharia & Grinstein, 2007; Chahine & Filatotchev, 2008 and Bushee & Noe, 2000). But, few authors have only studied based on Asian firms (Cheung et al., 2007; Chiao et al., 2015; Mustafa, 2009). The business and institutional environments, ownership structure and organization culture are differ from Asian firms to Anglo-American firms (Claessens, Djankov & Lang, 2000). Thereefore, the findings of studies based on Anglo-American firms cannot be generalise to firms which are operates in Asian countries. Further, several corporate scandals taken place in Sri Lanka have caused great confusion in the stakeholders of the companies (e.g. The bankruptcy of Pramuka Bank, Vanic Incorporation, Lanka Marine Services Ltd, Sri Lanka Insurance Corporation and the Golden Key

Credit Card Company (GKCC)). It seems from the facts revealed so far that the collapse of GKCC is associated with both mismanagement and misappointment of funds by directors and managers of the company. These corporate scandals raise the obvious question as why such incidents take place and who is accountable for these incidents (Senaratne, 2009). This collapse reveals that the failures of information transparency. These failures are not limited to the entities and stock market, but it could also affect entire economy and social system of the country. Following this issues, Chartered Accountants of Sri Lanka issued the best practices of corporate governance 2013 and 2017. However, Sri Lankan stock market is still known as weak form market where firm value is not affected by publicly available information (Dayaratne, 2014). Therefore this study ascertain whether the corporate transparency impact on its firm value in Sri Lanka.

The rest of the paper is organized as follows. Section 2 review the theories and empirical findings while section 3include the hypothesis development. Section 4 discusses research methodology. Section 5 presents the empirical results, and Section 6 concludes this paper.

Literature review

The term corporate transparency is defined as *"the extent of "adopting, promoting, and developing new analytical methodologies those bring clarity and consistency to the information available to investors and analysts"* (Patel and Dallas, 2002, p.14). It also refers to the availability of firm specific information to those outsiders of public listed companies (Bushman, Piotroski & Smith, 2003). Availability of firm specific information to current and potential investors is one of the key drivers in firm and economic growth (Levine, 2005). It could be achieved through the negative relationship of disclosure quality and information asymmetry (Brown & Hillegeist, 2007). High level of corporate transparency would reduce cost of information asymmetry that exists between agent and principal. To reduce the information asymmetry, stock markets play a vital role in the economy by motivate to transfer funds from surplus unit to deficit unit. In theory, the stock market offers the signals for investors to help them to make the effective investment decisions (Berk & DeMarzo, 2009).

In line with that, Agency Theory suggests that the agent should fulfil the interest of shareholders. They need to disclose all the material information which helps to eliminate information asymmetry. Findings of the previous studies with large and active equity markets shows that corporate transparency can have a powerful influence on the performance of companies and on protecting shareholders. A full and strong disclosure of a firm can increase the confidence of stakeholders. Therefore it helps to attract investment and strengthen the capital market (Chahine & Filatotchev, 2008). Hence OECD principles of corporate governance note that *"The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters*

regarding the corporation, including the financial situation, performance, ownership, and governance of the company."

Cheung, Connelly, Estanislao, Limpaphayom and Lu (2014) recognized the importance of disclosing firm information to investors and other stakeholders. After the collapse of world best corporations, disclosure practices became an important corporate governance mechanisms. Firms provide transparent information on their decisions by adopting effective corporate governance structures. Certainly, OECD (2015) advocates for a corporate governance framework that ensures timely and accurate disclosure of material information to a firm's shareholders. Consequently, firms that accurately disclose information are expected to benefit from positive investor perceptions leading to higher firm value (Esther, Danson & Ken, 2017).

However, Botosan and Stanford (2005) suggests that a company's disclosure decision may be affected by the desire to conceal profitability from its competitors, so such companies may choose to withhold or delay disclosure of sensitive information. But, some researchers argue that managers of larger companies have incentives to reduce audit and reporting delays because they may be monitored more closely by investors, unions, and regulatory agencies, thereby facing greater external pressure to disclose earlier (Abdulla, 1996). Due to that, there is a debate on the causal direction of company financial performance and increased transparency and disclosure level. Botosan and Stanford (2005) evidenced that managers of firms may withhold segment information to protect profits and the proprietary costs of segment disclosure exist. Bushee and Noe (2000) argued that disclosure also attracts transient institutions, which exacerbate a firm's stock return volatility because of those firms' short investment horizons and aggressive trading strategies. Chahine and Filatotchev (2008) examined the effect of information transparency on French firms and found that extensive disclosure may damage the firm's competitive advantage. In contrast, a firm where a weak transparency and disclosure policy is practiced managers may use their information advantage to pursue their self-interests (Chen, Chung, Lee & Liao, 2007). Therefore, the firms that are able to control and reduce the agency costs by increasing corporate transparency; might also be able to increase the shareholders' value. To prove that, Gelos and Wei (2002) provide evidence that emerging market equity funds hold relatively smaller amount of assets in less transparent markets and emerging market funds took their investments more quickly from less transparent countries.

At the same time, most researchers have argued that introducing more timely and accurate disclosure mechanisms for firms will facilitate deterrence and detection of fraud and manipulation and will improve the efficiency of the stock market, leading to higher firm value (Hunton et al., 2006). However, more disclosures could not increase the market value of a firm with any certainty (Langberg & Sivaramakrishnan, 2008).

In agreement with that, some studies (see: BaekKang & Park, 2004; Bubbico, Giorgino, & Monda, 2012; Cheung et al. 2014; Klein, Shapiro & Young, 2005), report a positive effect between disclosure practices and firm value. On the contrary, Ficici and Aybar (2012) and Siagran, Siregar, and Rahadian (2013) document a negative effect of disclosure practices on the firm value.

These contradictions let the researcher to focus on the impact of corporate transparency on firm value in Sri Lanka.

Hypotheses Development

Agency theory suggest that the agent should fulfil their owners. In this line, stewardship theory said managers should be responsible to their owners. Based on these theoretical background, it can be understandable that trust of the owners will be enhanced when the firms are transparent. Conforming to that, Some studies (see: Baek, Kang & Park, 2004; Bubbico, Giorgino & Monda, 2012; Cheung et al. 2014; Klein, Shapiro & Young, 2005), report a positive effect between disclosure practices and firm value.

Empirical result shows various outcomes between different aspects of corporate transparency. For instance, Suchada (2007) proved that the higher the transparency and disclosure in financial information the lower the asymmetry of information between management and shareholders and thus lower cost of capital and higher the firm value. Further, Ndungu (2012) identified that firm value was positively correlated to financial information disclosure, ownership disclosure and investor relations. Which explain that the degree of financial information disclosed by a firm had an impact on how the investor identify a company they want to invest in. Based on these findings, following hypotheses were develop to test empirically:

H_1:Transparency in ownership structure and investor rights significantly impact on Tobin's Q.

H_2: Transparency in ownership structure and investor rights significantly impact on Share price.

H_3: Transparency in ownership structure and investor rights significantly impact on ROE.

H_4: Financial transparency and information disclosure significantly impact on Tobin's Q.

H_5: Financial transparency and information disclosure significantly impact on Share price.

H_6: Financial transparency and information disclosure significantly impact on ROE.

H_7: Transparency in Board and management structure and processes significantly impact on Share price.

H_8: Transparency in Board and management structure and processes significantly impact on ROE.

H_9: Transparency in Board and management structure and processes significantly impact on Tobin's Q.

Research design

The study is based on positivism since it attempt to prove the impact of corporate transparency on firm value in Sri Lankan context. Further, it relies on the deductive approach as it tested the hypothesis which was developed based on the existing literature. To conduct the analysis, the study adopts quantitative research approach using secondary data.

Sample Selection and data sources

Source of finance makes the difference between organisations. Public listed companies are unique kind of organisation since it raise finance through stock exchanges by issuing their shares to the general public. Therefore, all the investors become the owners of the company who do not directly involve in the regular business activities. Instead, they appoint the directors with certain responsibilities. Therefore, Public listed companies are obliged of disclosing information that help investors and other stakeholders to make economic decisions under the rules and regulations of securities markets. Further, these disclosure helps to reduce the agency conflict (Brown & Hillegeist, 2005). Therefore, this study considered all the public listed companies in Colombo Stock Exchange (CSE) as the population of the study. CSE has 290 companies representing 20 business sectors as at 30th September 2019. Out of that, financial companies such as banks finance and insurance companies were excluded because of their specific financial characteristics, affect their information disclosure (Hassan et al., 2009) and liquidity requirements (Bokpin, 2013). Further, Firms listed after 2018, firms with incomplete or missing data and firms which failed to publish their financial statements on CSE website were also excluded. After this adjustment, a total of 126 Sri Lankan listed companies were selected to the empirical analysis.

All the data were obtained from secondary sources i.e. annual report published in CSE website for the financial year 2018/2019. The reason for choosing this period was because Chartered Institute of Sri Lanka publish Code of Best Practice on Corporate Governance 2017 with the aim of enhancing firms' transparency in Sri Lanka. The study's time frame corresponds to the post formal adoption period of this codes.

Variables Measurement

Measures of Corporate transparency

One general measurement of information transparency is the disclosure index. The disclosure index may result from the disclosure grade assigned by professional ranking institutions or from content analysis. Several professional rating agencies measure corporations' information transparency, including the Financial Analysts Federation (FAF), PricewaterhouseCoopers (PWC), Standard & Poor's (S&P), and Credit Lyonnais Securities Asia (CLSA).

But, In Sri Lanka there are no such professional ranking institutions to give disclosure grade. Therefore content analysis were used in this study to measure the corporate transparency with the support of Standard & Poor’s 500 companies’ disclosure index items (Aksu & Kosedag, 2006; Mustafa, 2009; Njeri, 2013). This index includes 138 items into three categories. Those are, financial transparency and information disclosure, board and management structure and processes and ownership structure and investor rights. This index was adjusted for non-applicable items and reconciled with Sri Lankan financial reporting standards for conformity and compliance. Code of Best Practice on Corporate Governance 2017 was also reviewed to confirm the applicability of Standard & Poor’s 500 companies’ disclosure index items. After the filtering, Ownership and investor relations transparency has 32 attributes, financial transparency and information disclosure has 36 attributes and board and management structure and process has 37 attributes.

A score of 1 is assigned to an item if it is disclosed (disclosure index), and a score of 0 otherwise (Bokpin, 2013). The total score of a company is obtained as: $TDS = \sum_{i=1}^{m} di$ Where di is 1 if item i is disclosed, and 0 if otherwise; m is the maximum number of items.

Measures of firm value

All of the evaluation models of firm value have their own assumptions, advantages and weaknesses; no single evaluation model of firm value can be applicable to all research and circumstances. Thus, the variables of firm value in the study focus on modified Tobin’s Q (Ammann et al., 2011; Ficici & Aybar, 2012; Gompers et al., 2003; Henry, 2008; Krafft et al. 2013; Lightfoot, 2017), share price (Bokpin, 2013;Chin, Chung & Ho, 2010), and Return on Equity (ROE) (Aksu & Kosedag, 2006; Chin, Chung & Ho, 2010). Tobin's Q is defined as a firm’s equity capitalization plus book value of debt divided by book value of total assets (Lightfoot, 2017). Logarithm of share price was used to reduce the deviation. ROE calculated by dividing net income by shareholders' equity.

Measures of control variables

In line with Creswell (2014), control variables were included in the model as they may potentially affect the firm value. Further, these control variables reduce the omitted variable bias (Wooldridge, 2002). The study consider Firm size (FS), Firm Age (FA), Leverage (LEV) and Return on Assets (ROA) as control variables in line with existing empirical literature (Bhagat& Bolton, 2008; Dharmapala&Khanna, 2012; Ficici&Aybar, 2012; Gupta,Kennedy & Weaver, 2009; Krafft et al., 2013; Oesch, 2011). Firm size was measured by the logarithm of total assets while FA were represented by the total years from the establishment to present. Firm leverage was calculated as the ratio of total debt to total assets whereas RoA measured as net income divided by total asset.

Statistical Analysis

In order to fix the right statistical analysis, normality test was done to ensure the normal distribution of the data of dependent variable. As all are normally distributed, all the hypotheses were tested through multiple linear regression.

Result and Discussion

This section discuss on the descriptive summary statistics and the results of the regression. Table 1 summarize the descriptive statistics for the variables used in the regression models. The dependent variables of the study are Tobins'Q, Return on equity and stock price. These variables records overall mean of 2.38, 0.087 and 41.825 respectively. Due to the political and economic instability of the country during the study period, standard deviation of share price is comparatively high. The explanatory variable of the study is transparency which measured through four proxies namely, Overall transparency (OT), Financial transparency and information disclosure (FinT), Board and management structure (BodT) and Ownership structure and investor rights (OwnT). In Sri Lanka, the listed firms disclose 85.8 percent of information in average. This result is similar to the findings of (Tsamenyi et al., 2007) based on a developed nation. This indicates that the Sri Lankan firms guide by regulatory bodies compare to some developing countries where the level of transparency is low (See. Munisi & Randoy, 2013; Black et al., 2010; While Black et al., 2010). Further, all three aspects of corporate transparency also indicate more than 82 percent of disclosure level. This is might be the result of the guidance provided through code of best practice on corporate governance 2017.

The table further describe the control variables of the study. Firm age indicate the numberof years from the establishment of the firms and average age of the Sri Lankan firms is forty one year where there are some old firms and newly established firms. Mean value of leverage evidences that the Sri Lankan listed firms have healthier financial position. The average profitability of the firm is 6.7 percent which measured through ROA. Further, the ROA figures indicates there are some firms suffer from negative return in Sri Lanka.

Table 1 also shows the value of Jarque-Bera and its probability which help to test the normal distribution of dependent variables of the study. Based on the figure, it can be concluded that all three dependent variables namely, Tobin's Q, Share price and ROE are normally distributed as these probability value of Jarque-Bera are above than 0.01. This permit the researcher to conduct the linear regression analysis to test the hypotheses of the study.

Table 1: ***Descriptive Statistics***

	Mean	Median	Maximum	Minimum	Std. Dev.	Jarque-Bera	Probability

Tobin's Q	2.379	2.487	3.951	0.192	0.978	6.901	0.031
SP	41.825	36.500	152.000	7.000	25.295	163.478	0.000
Logarithm of SP	3.583	3.597	5.023	1.945	0.548	6.023	0.049
RoE	0.087	0.105	0.372	-0.201	0.124	1.647	0.438
OT	0.858	0.866	0.983	0.675	0.064	6.290	0.043
FinT	0.888	0.920	1.000	0.640	0.083	17.416	0.001
OwnT	0.855	0.862	0.965	0.655	0.056	6.459	0.039
BodT	0.825	0.829	1.000	0.609	0.088	3.432	0.179
FA	41.825	36.500	152.000	7.000	25.295	163.478	0.000
FS	8.253	8.688	10.447	5.952	1.353	13.274	0.001
LEV	0.265	0.117	1.891	0.000	0.359	276.409	0.000
RoA	0.067	0.039	1.408	-0.425	0.182	5885.877	0.000

Source: Author's Compilation, 2019.

Table 2 shows the output of regression analysis. All three model were tested with all the dependent and control variable first and final model were obtained with all significant variable. Model 1 is based on Tobin's Q as the dependent variable. The result suggest that financial transparency and information disclosure, board and management structure and processes and ownership structure and investor rights significantly correlated with Tobin's Q at 1 percent significance level. Further, it proves that improvement in corporate transparency will increase the Tobin's Q. However, leverage is negatively correlated with Tobin's Q. R square shows the model fitness and 52.5 percent of R square value indicates that the 52.5 percent of variation in Tobin's Q explained by corporate transparency.

Model 2 represent the regression output based on the ROE as the dependent variable. The result suggest that financial transparency and information disclosure, board and management structure and processes significantly correlated with Tobin's Q at 1 percent significance level whereas, ownership structure and investor rights is not significantly correlated. In addition to these two variables, firm size also significantly influence on ROE. Further, Adjusted R squared suggest that the 49 percent of variation in ROE is explained by corporate transparency except ownership structure and investor rights.

In model 3, financial transparency and information disclosure, board and management structure and processes and ownership structure and investor rights significantly correlated with share price at 99 percent confidence level. Besides, Firm age also significantly effects on share price. Adjusted R squared suggest that the 50 percent of variation in ROE is explained by corporate transparency except

ownership structure and investor rights. Probability of F-statistics of all three models show that the models are significant at 1 percent significant level. In addition to that all the assumptions of regression were statistically tested and the study find that there are no homoscedastic and autocorrelation issues.

Table 2: *Regression output*

Dependent Variable	Tobin's Q		ROE		Logarithm of Share price	
	Model 1		Model 2		Model 3	
FinT	4.333***	4.270***	0.595***	0.591***	0.594***	4.270***
OwnT	3.49***	3.589***	0.085	-	0.08	3.589***
BodT	2.900***	2.906***	0.466***	0.482***	0.0466***	2.906***
FA	-0.009***	-0.009***	-0.001	-	-0.001	-0.009***
FS	0.017	-	-0.01**	-0.013**	-0.013**	-
LEV	-0.3138*	-0.3033*	-0.01	-	-0.016	-0.3033*
RoA	-0.154	-	0.060	-	0.0606	-
Constant	-6.4878***	-6.386***	-0.78***	-0.72***	-0.7817***	-6.386***
R-squared	0.525	0.523	0.52	0.508	0.52	0.523
Adjusted R-squared	0.497	0.504	0.49	0.490	0.49	0.504
F-Statistic	18.66	26.416	18.33	42.01	18.66	26.416
Probability	0.000	0.000	0.000	0.000	0.000	0.000

** Statistical significance at 10% level. ** Statistical significance at 5% level. *** Statistical significance at 1% level*

Source: Author's Compilation, 2019.

Based on the above result all the hypotheses were tested and all the hypotheses were supported except H_3. Transparency in ownership structure and investor rights is not significantly impact on ROE since the hypotheses is not supported by the result.

Overall the study finds that the corporate transparency significantly impact on firm value. This is in line with previous results that are revealed by Diamond and Verrecchia (1991) and Healy and Palepu (2001) and Bhushan (1989) and Lang and Lundholm (1996).

Conclusion

This paper analyzes the impact of corporate transparency firm value in Sri Lanka. The study tested three models with three proxies of firm value. Findings of the study explore that the corporate transparency significantly impact on firm value. Therefore, listed firms in Sri Lanka could increase their disclosure voluntarily to boost their firm value. However, this finding cannot be generalize to the finance industry since the study completely exclude that. Therefore, future researcher could use the model to test the result in financial industry as disclosure and transparency is the common issue of every publicly listed firms.

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