# The Relationship between Corporate Governance Disclosures and Balance Sheet Ratios

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ABSTRACT

*One of the major issues raised during the financial crisis in 1997-1998 was corporate governance practice. As a result, corporate governance reforms were then instituted and efforts were made to improve the corporate governance practices by the corporate sector. In the year 2000, The Malaysian Code of Corporate Governance was launched with a view to promote better disclosure and transparency, board effectiveness and independence and shareholder rights and activism. This paper attempts to discuss relationships between corporate governance disclosures and key balance sheet ratios among Malaysian listed companies.*

**Keywords**: *corporate governance, financial ratios*

## Introduction

The financial crisis brought to the foreground the weak corporate governance practices. The economic crisis that hit Malaysia and other Asian countries in late 1990s was originated from the prolonged recession in Japan in the early 1990s (Miller, 1998; Sachs, 1998). The weak governance structures among corporate sectors were found to be one

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of the contributing factors to this economic turmoil (Kim, 1998; Khas, 2002).

Since then, corporate governance in Malaysia has started to gain much attention. That was when share prices nose-dived and investors were stuck with huge paper losses. The disasters forced the Malaysian government to take immediate action to prevent similar catastrophes from reoccurring in the future. As a result, the Malaysian Code of Corporate Governance was issued in 1999. Even though the compliance to most of the codes is voluntary, there has been a move towards regulating companies to be more transparent and accountable in making business decisions.

A benchmark survey by the Kuala Lumpur Stock Exchange and Price Waterhouse Coopers in 1998 showed that improved corporate governance would enhance investors' confidence as well as contribute to the effectiveness and attractiveness of our local market.

## Literature Review

Corporate governance has been defined as

> '*a set of relationships between a company's management, its board, its shareholders and other stakeholders. It provides the structure through which the objectiveness of the company is set, and the means of attaining those objectives and monitoring performance are determined*'
>
> (OECD Ad Hoc Task Force on Corporate Governance, 1999, p. 2).

Financial ratios are the indicators to evaluate companies' performance for a certain time period. These ratios are based on either an income statement or balance sheet. From the balance sheet, users can calculate the financial ratios that describe the capital structures of a particular company.

Jensen (1986) argues that capital structure affects corporate governance. Williamson (1988) claims that equity and debt can be considered as an alternative to governance mechanisms to monitor and evaluate managerial actions. Firth (1995) asserts that the presence of major outside shareholders will restrict the management's ability to control debt financing.

Investors prefer stronger governance of assets that require company-specific actions to generate value (Kochhar, 1996). The Board of directors' governance authority reduces the risk of the investors and thus equity is more suitable than debt for financing high-risk projects (Kochhar, 1996; Williamson, 1998).

## The Study

The objective of this study is to identify any relationship between corporate governance and balance sheet ratios of Malaysian listed companies. It hopes to find out whether the capital structure has any relationship with the corporate governance practices. The hypotheses of the study are, therefore,

$H_0$ = There is no linear relationship between the selected balance sheet ratios and corporate governance disclosures

$H_1$ = There is a linear relationship between the selected balance sheet ratios and corporate governance disclosures

### Methodology

This study relied on secondary data. The source for the data was the companies' annual reports for the 2004 financial year. Only four sections of the annual report were studied: i) Statement on Corporate Governance, ii) Statement of Internal Control, iii) Audit Committee Report, and iv) Financial Report.

The systematic sampling approach was used to select the companies. The population was all companies listed by the Bursa Malaysia (Malaysia Stock Exchange) on 27 October 2004. The sample consisted of 114 companies out of the 902 companies listed on that date. There were 61 and 53 companies from the main and the second board of exchange respectively.

To gather the data, the study used a standardised checklist. This checklist lists the principles of corporate governance and best corporate governance practices as per recommended by the Malaysian Code of Corporate Governance. A Likert scale was assigned to each item in the checklist. The Likert scales used are as follows;

'3' if the corporate governance disclosures were adequate, i.e. according to Part II of Malaysian Code of Corporate Governance.

'2' if the required corporate governance practices were moderately disclosed.

'1' if the corporate governance practices were inadequately disclosed.

'0' is assigned if the required corporate governance practice was not disclosed at all.

The statistical tool to run the statistical tests and analysis for this study was the SPSS or Statistical Package for Social Science or SPSS version 12.

## Results and Findings

A correlation coefficient was used to measure the degree of linear association between corporate governance and balance sheet ratios. Based on the Pearson correlation coefficient, the results showed that the data were normally distributed.

### *Current Ratio*

A current ratio was calculated by dividing current assets by current liabilities. This ratio would indicate whether a company had sufficient current assets to meet its short term financial liabilities.

Table 1: Correlation Coefficient between Current Ratio and Corporate Governance Disclosures

| | | Current Ratio | Total Scores for Level of Disclosures |
|---|---|---|---|
| Current Ratio | Pearson Correlation | 1 | .067 |
| | Sig. (2-tailed) | | .479 |

The correlation coefficient between current ratio and corporate governance disclosures is 0.067, which does not indicate that a linear relationship between them exists. The level of corporate governance

disclosures is not positively correlated with current ratio. In addition, the study finds that there is no sufficient statistical evidence to reject the null hypothesis as the p-value is greater than 0.05. Therefore, it can be inferred that the current ratio has no linear relationship with corporate governance disclosures.

*Long-term Liabilities to Total Assets Ratio*

This ratio measures how much long-term debt is used to finance total assets. Higher long-term liabilities to total assets ratio means higher interest expense and other borrowing costs. Investors may perceive this as high risk and, thus, expect stronger corporate governance.

Table 2: Long-Term Liabilities to Total Assets Ratio and Corporate Governance Disclosures

| | | Total Scores for Level of Disclosures | Long-Term Liabilities to TA ratio |
|---|---|---|---|
| Corporate Governance Disclosures | Pearson Correlation | 1 | .147 |
| | Sig. (2-tailed) | | .119 |

The analysis shows that the correlation coefficient between the two variables is 0.147, indicating a positive weak relationship. However, it is not significant at 5% significant level as the p-value is greater than 0.05. This suggests that long-term liabilities to total assets ratio does not have any significant linear relationship with corporate governance disclosures.

*Total Debt to Total Assets Ratio*

The results shown in the Table 3 are consistent with the previous ratios. The correlation coefficient between total debt to total assets ratio and corporate governance disclosures is too low. Thus, the null hypothesis is accepted once again and it can be inferred that total debts to total assets ratio does not influence corporate governance disclosures at 5% significant level.

Table 3: Total Debts to Total Assets Ratio and Corporate Governance Disclosures

| | | Total Scores for Level of Disclosures | Total Debt to TA ratio |
|---|---|---|---|
| Corporate Governance Disclosures | Pearson Correlation | 1 | .070 |
| | Sig. (2-tailed) | | .463 |

*Total Equity to Total Assets Ratio*

The correlation coefficient as shown by Table 4 is only 0.138. This indicates that a very weak linear relationship exists between total equity to total assets ratio and corporate governance disclosures. The p-value is again greater than 0.05, which suggests accepting the null hypothesis. There is sufficient statistical evidence to say that total equity to total assets ratio does not have any linear relationship with corporate governance disclosures.

Table 4: Total Equity to Total Assets Ratio and Corporate Governance Disclosures

| | | Total Scores for Level of Disclosures | Equity to TA ratio |
|---|---|---|---|
| Corporate Governance Disclosures | Pearson Correlation | 1 | .138 |
| | Sig. (2-tailed) | | .146 |

*Share Capital to Total Asset Ratio*

This ratio reflects how much funds from the shareholders is used to finance the total assets. Table 5 shows that the correlation coefficient between this ratio and corporate governance disclosures is less than 0.29, indicating that the strength of relationship between share capital to total assets ratio and the total scores for corporate governance disclosures is also weak. The p-value is referred to determine whether there is any

Table 5: Share Capital to Total Assets Ratio and Corporate Governance Disclosures

| | | SC toTA ratio |
|---|---|---|
| Corporate Governance Disclosures | Pearson Correlation | 0.137 |
| | Sig. (2-tailed) | 0.147 |

sufficient statistical evidence to infer about their relationship. As the p-value is 0.147, the null hypothesis is accepted. There is sufficient statistical evidence to suggest that the linear relationship between share of capital to total assets ratio and corporate governance disclosures does not exist.

## Conclusion

The results of the analysis have indicated that there is no correlation between corporate governance disclosures and key balance sheet ratios. The level of corporate governance disclosures was not related to all five balance sheet ratios.

Before analysing the data, it was presumed that some of these ratios, particularly the debt ratio, could be positively correlated with corporate governance disclosures. Initially, the researchers were in the opinion that improving corporate governance would improve credit rating. However, the study has shown that none of the ratios has any significant correlation coefficients with corporate governance disclosures. It is, therefore, recommended that researchers embark on new research to determine any possible explanation as to why balance sheet ratios are not related to corporate governance disclosures.

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