CORPORATE GOVERNANCE AND FIRM PERFORMANCE: A STUDY IN SRI LANKA

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ABSTRACT

With the increasing interest in corporate governance, this study aims to observe the relationship between corporate governance practices and firm performance of listed companies in Sri Lanka. It analyzed the association between firm performance and board characteristics plus audit committee characteristics because board of directors and audit committee are integral in corporate governance. A sample of 50 listed companies were selected from the population of 314 companies listed in Colombo Stock Exchange (CSE) in Sri Lanka for the period of 2015-2017. The measurements of firm performance are Return on Equity (ROE), Return on Assets (ROA) and Earnings per Share (EPS) which are dependent variables. CEO duality, board independence, board size, frequency of board meetings, board of directors with financial expertise, audit committee size, audit committee independence, frequency of audit committee meetings and audit committee members with financial expertise were used to measure the independent variable; corporate governance. Proportion of Board members with financial expertise and audit committee independence have significant negative relationship with the firm performance whereas all the other independent variables of corporate governance measures were not significantly correlated with ROE, ROA and EPS as the performance measures.

Outcome of the study will help the interested parties of the firm's to know the level of compliance of corporate governance best practices and will contributes to the prevailing literature related to corporate governance and firm performance.

Keywords: *Corporate Governance, Firm Performance, Board of Directors, Audit Committee*

1. INTRODUCTION

Corporate governance refers to a set of rules and incentives by which the management of a company is directed and controlled. Corporate governance has come into action in order to address the accounting scandals and business failures which occurred all over the world in the recent past. Corporate governance was initiated in developing countries like Sri Lanka with the recent corporate collapses. Corporate governance is sometimes viewed as a business culture fostering economic growth by building up confidence of investors (Robert et al. 2013). La Porta et al. (2000) view corporate governance as a set of mechanisms through which outside investors protect themselves against expropriation by insiders.

Various definitions for firm performance can be observed in prior literature. Mainly firm performance is measured by the financial performance. Different accounting ratios are often used to measure financial performance. The study of Velnampy, (2013) explores the impact of corporate governance on firm performance in Sri Lankan manufacturing companies using the return on equity (ROE) and return on assets (ROA). Therefore this study examines the relationship between corporate governance characteristics, including board characteristics and audit committee characteristics, and firm performance in Sri Lanka. CEO duality, board independence, board size, frequency of board meetings, board of directors with financial expertise, audit committee size, audit committee independence, frequency of audit committee meetings and audit committee members with financial expertise are used as corporate governance variables and ROA, ROE, and EPS as measures of firm performance. This research has used the corporate governance provisions established by the Code of Best Practice on Corporate Governance issued by Institute of Chartered Accountants of Sri Lanka as benchmark practices.

It is considered that corporate governance is crucial to build marketplace trust and attract customers to the corporation (Guo & Udayakumara, 2012). As many corporate collapses (enron, worldcom etc.) occurred around the world, corporate governance has become a popular topic during the 21st century. Even Sri Lanka had several corporate collapses such as Pramukha bank and Golden key company collapses. Even though, several studies have been conducted to investigate the relationship between corporate governance and firm performance, there is a lack in incorporating audit committee characteristics into corporate governance variables in Sri Lankan context. Therefore this study focused on exploring the relationship between firm performance and corporate governance including board characteristics and audit committee characteristics in Sri Lanka. This study will contribute to the existing knowledge concerning corporate governance practices on firm performance of listed companies in Sri Lanka. Also, the result of this study will help interested parties to identify the level of compliance with the recommendations made in the Code of Best Practices.

2. LITERATURE REVIEW

"The system by which the company is controlled and directed" is the most common definition about the corporate governance. Finance Committee on Corporate Governance in Malaysia has defined corporate governance as "the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective."

'Corporate governance can be defined as a mechanism that is employed to reduce the agency cost that arises as a result of the conflict of interest between managers and shareholders' (Uwuigbe et al. 2014, p. 161). Corporate governance is a set of mechanisms through which outside investors protect themselves against expropriation by insiders (La Porta et al., 2000).

2.1 Independent Variables

Various corporate governance variables are identified in other studies, which associate with earnings management practices in firms. Therefore CEO duality, Board independence, Board members with financial expertise, frequency of Board meetings, Board size, Audit committee size, audit committee independence, frequency of Audit committee meetings and Audit committee members with financial expertise are taken as independent variables for this study.

2.1.1 CEO Duality

CEO duality is where the chairperson of the board and the CEO of the company being held by separate persons. Good governance principles by many governance codes highlight the fact that the roles of CEO and chairman of the company should be held by separate individuals to eliminate unvested power over one individual and for better performance of the company.

It is clear that there is attentiveness on power in a company when the same person is holding the role of Chief Executive Officer and President of the board (Gonzalez and Meca, 2013). According to Azeez (2015), separate leadership structures lead to better performance of the listed companies in Sri Lanka. However, in contrast there was no significant relationship between CEO duality and firm performance (Guo and Udayakumara, 2012).

H1: There is a positive association between firm performance and CEO duality where chairperson and CEO are two separate persons.

2.1.2 Board Independence

Code of best practice on corporate governance in Sri Lanka specifically mentioned that the number of non-executive directors in the board should be at least two or one third of total number of directors whichever is higher. Higher number of independent directors in the board in the companies can enhance the decision credibility and objectivity (Ali, 2016).

H2: The proportion of non-executive directors in the board is positively associated with firm performance

2.1.3 Board Size

And also, a larger Board size assumes a superior supervision of the management team and a higher quality of corporate decisions (Pearce & Zahra, 1992). In contrast, Jensen (2012) states that large board would lead to higher amount of agency problems and would lead to ineffective management of the company.

H3: Board Size is negatively associated with firm Performance

2.1.4 Board Meetings

Code of best practice on Corporate Governance has stated to hold the Board meetings at least once in every quarter of a financial year in order to effectively execute board's responsibilities.

According to Menon and Willioms (1994), boards that do not meet or meet only a few times are not likely to be effective monitors. As a conflicting opinion, it is argued that Board meetings are not essentially useful because routine tasks take much of limited time that directors and CEO waste together to set the agenda for Board meetings (Lorca, Sanchez-Ballesta & Gracia-Meca, 2011).

H4: There is a positive relationship between Board meetings and firm performance

2.1.5 Board Members with Financial Expertise

In this study, if a Board member has obtained at least one accounting or finance qualification, that person was considered as a financial expertise.

H5: There is a positive relationship between Board members with financial expertise and firm performance

2.1.6 Audit Committee Size

In order to make an audit committee effective in controlling and monitoring top management actions, the audit committee must have adequate members to perform their tasks (Vinten and Lee, 1993). Audit committees become ineffective if their size is either too small or too large. An audit committee of the right size would allow members to serve for the best interest of stakeholders (Dalton et al., 1999).

H6: Audit Committee size has a significant relationship with firm performance

2.1.7 Audit Committee Independence

Some of the prior studies showed a positive relationship between audit committee independence and firm performance. Independent audit committee directors ensure better financial reporting (Abbott et al., 2000; Beasley et al., 2000).

H7: There is a positive relationship between audit committee independence and firm performance

2.1.8 Audit Committee Meetings

A more active audit committee is expected to provide an effective monitoring mechanism. Findings of Menon and Williams (1994) suggest that an audit committee that meets more often provides a more effective monitoring mechanism on financial activities. However, it is argued that meetings are not essentially useful because they waste time for routine tasks (Lorca, Sanchez-Ballesta & Gracia-Meca, 2011).

H8: Audit committee meetings are negatively related with firm performance.

2.1.9 Audit Committee Members with Financial Expertise

The results of Balagobei and Velnampy (2018), illustrates that there is a significant positive impact of audit committee experts on organizational performance. Abbott et al. (2004) reported a negative association between the audit committee's financial expertise and occurrence of earnings restatement.

H9: There is a positive relationship between audit committee financial expertise and firm performance

Mainly firm performance is measured by the financial performance. The study of Velnampy, (2013) investigated the impact of corporate governance on firm performance in Sri Lankan manufacturing companies using the return on equity (ROE) and return on assets (ROA). Also Mardnly et al. (2018) used Earnings per Share (EPS) and Return on Assets (ROA) to measure the dependent variable (firm performance). The Return on Assets (ROA) and Tobin's Q were used as performance measurements in the study of Guo and Udayakumara, 2012. Return on assets is computed as operating profit after tax, divided by total assets. Return on equity is defined as operating profit after tax, divided by total equity. Earnings per Share Net income divided by total number of shares (Azeez, 2015).

By referring to the above literature, this study focused on identifying the relationship between corporate governance and firm performance in Sri Lanka. Corporate governance aspects included Board Characteristics and Audit committee characteristics whereas firm performance was measured using ROA, ROE and EPS.

3. RESEARCH METHOD AND HYPOTHESIS DEVELOPMENT

3.1 Sample

A sample of 50 listed companies were selected from the population of 314 companies listed in Colombo Stock Exchange (CSE) in Sri Lanka. The sample was selected based on the market capitalization. Therefore listed companies with the highest market capitalization were selected to the sample based on judgmental sampling technique. However the companies under the Bank, Finance and Insurance sector were excluded from the sample because this industry is strictly regulated and adhering to the governance mechanism is mandatory and is likely to have fundamentally different cash flows and accrual processes (Roodposhti & Chamshmi 2011). Therefore 50 companies for 3 years (2015-2017) resulting 150 firm-year observations were considered under this study. Annual reports of selected listed companies were taken as the source of data collection.

CEO duality (CD), board independence (BDIN), board size (BDSIZE), frequency of board meetings (BDMEET), board of directors with financial expertise (BDFX), audit committee size (ACSIZE), audit committee independence (ACIND), frequency of audit committee meetings (ACMEET) and audit committee members with financial expertise (ACFX) were used to measure the independent variable; corporate governance.

The dependent variable; firm performance is measured using three proxies, Return on Equity (ROE), Return on Assets (ROA) and Earnings per Share (EPS).

3.2 Conceptual Diagram

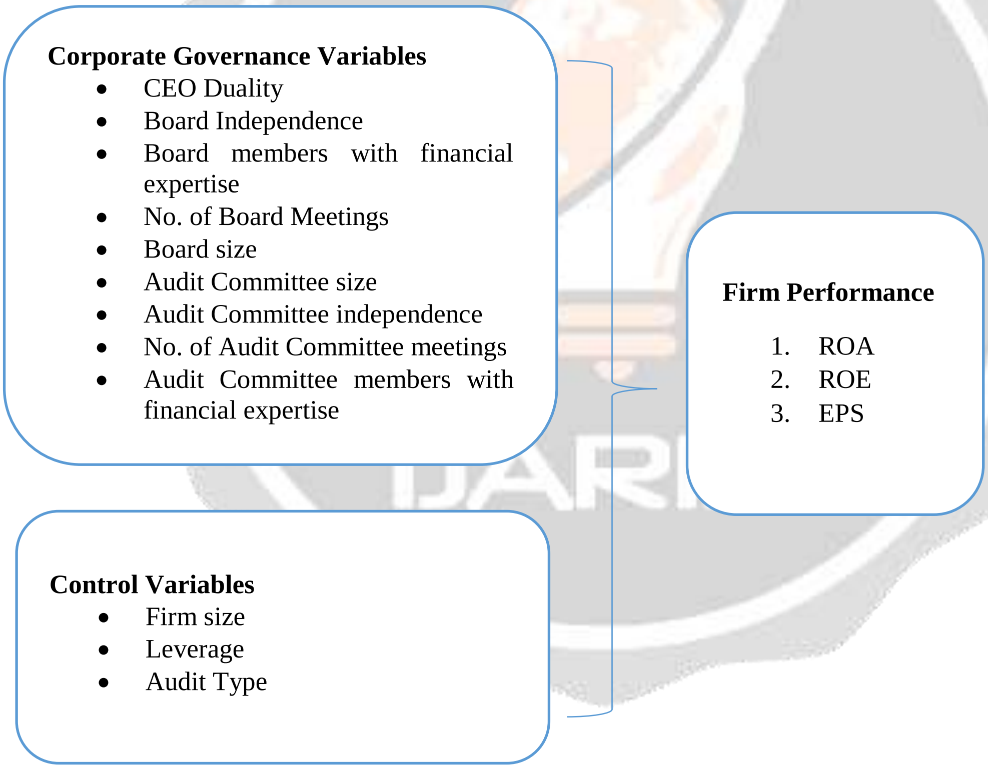

Figure 01: Conceptual diagram

3.3 Regression Model

This study uses multiple regression model to examine the relationship between the Corporate Governance variables and their relationship with corporate performance. This method of analyzing the relationship is supported by Azeez (2015), Velnampy (2013) and Mardnly et al. (2018). The multiple regression analysis is performing on the dependent variables, ROE, ROA and EPS to test the relationship between the independent variables with firm performance.

$$\frac{\frac{ROA}{ROE}}{EPS} = \alpha_0 + \alpha_{1CD} + \alpha_{2BDIN} + \alpha_{3BDSIZE} + \alpha_{4BDMEET} + \alpha_{5BDFX} + \alpha_{6ACSIZE} + \alpha_{7ACIND} + \alpha_{8ACMEET} + \alpha_{9ACFX} + \alpha_{10SIZE} + \alpha_{11LEV} + \alpha_{12BIG3} + \epsilon$$

Abbreviations

ROA = Return on Assets
ROE = Return on Equity
EPS = Earnings per Share
CD = indicator variable coded 1 if the positions of CEO and Board chair person is held by two person, 0 if otherwise
BDIN = percentage of independent directors of the board
BDSIZE =the number of board of directors
BDMEET =the number of board of directors' meetings
BDFX = the number of directors with a financial and accounting qualification as a percentage to the total number of directors of the board
ACSIZE = Number of members in the audit committee
ACIND = Percentage of independent directors in the audit committee
ACMEET = Number of audit committee meetings
ACFX = the number of members with a financial and accounting qualification as a percentage to the total number of members of the audit committee
SIZE =the natural log of total assets
ROA =rate of return on lagged total assets ratio
LEV = ratio of total debt to total asset
BIG3 = indicator variable coded 1 if the firm is audited by a Big3 auditor; 0 if the firm is audited by non- Big3 auditor

4. RESULTS AND DISCUSSION

Table 1 : Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Dependent Variables					
ROA	150	-3.064	.587	.084	.286
ROE	150	-31.3	3.7	.000	2.625
EPS	150	-233.4	410.0	12.66	52.21
Independent Variables					
CD	150	.0	1.0	.840	.367
BDIN	150	.222	.833	.425	.137
BDSIZE	150	5.0	13.0	8.587	1.907
BDMEET	150	2.0	21.0	6.087	3.544
BDFX	150	.100	.8	.296	.147
ACSIZE	150	2.0	5.0	3.233	.669
ACIND	150	.5	1.0	.836	.163
ACMEET	150	1.0	18	5.02	2.54
ACFX	150	.25	.75	.472	.144
Control Variables					
SIZE	150	14.4	18.77	16.31	.935
LEV	150	.001	9.225	.892	1.379
BIG3	150	.0	1.0	.980	.1405

Table 1 presents descriptive statistics of corporate governance characteristics and firm performance measures. In the overall sample for this study, 84% of the sample of firms has CEO duality (CD), which means most of the firms appointed individuals to assume the Chairman and CEO roles separately. It is noted that on average 42% of directors are independent (BDIN) in the sample taken for the study and on average 29% of the director board is with financial expertise (BDFX). As per the descriptive statistics on average director board of the companies meet (BDMEET) 6 times a year. As the average, there are 8 members in the board (BDSIZE) of the companies selected for the sample. Audit committee (ACSIZE) consists of 3 members while the committee meets (ACMEET) 5 times per year on average basis. Also, descriptive statistics show that 83% of the audit committee consists of independent directors (ACIND) where as 47% of audit committee members are financial experts (ACFX).

Table 2: Correlation Matrix for Dependent and Independent Variables

Variables	ROA	ROE	EPS	CD	BDIN	BDSIZE	BDMEET	BDFX	ACSIZE	ACIND	ACMEET	ACFX	SIZE	LEV	BIG3
ROA	1	.949** (.000)	.511** (.000)	.021 (.402)	-.012 (.443)	-.088 (.143)	.021 (.401)	.058 (.240)	-.007 (.467)	-.122 (0.68)	-.061 (.229)	.120 (.071)	-.093 (.128)	-.402** (.000)	-.008 (.460)
ROE		1	.425** (.000)	-.016 (.422)	.045 (.293)	-.040 (.312)	.069 (.202)	.019 (.411)	.013 (.440)	-.110 (.089)	-.005 (.477)	.106 (.098)	-.046 (.290)	-.416** (.000)	-.011 (.447)
EPS			1	.054 (.256)	-.107 (.096)	-.133 (.053)	-.061 (.231)	-.046 (.288)	-.039 (.319)	-.195** (.008)	-.101 (.110)	.082 (.158)	-.069 (.201)	-.179* (.014)	.019 (.408)
CD				1	-.116 (.079)	-.009 (.457)	-.061 (.228)	.099 (.114)	-.147* (.036)	-.244** (.001)	.032 (.348)	.130 (.057)	-.156* (.028)	-.106 (.099)	-.062 (.224)
BDIN					1	-.012 (.443)	.322** (.000)	.018 (.415)	.109 (.096)	.051 (.266)	.028 (.365)	.040 (.315)	.190** (.010)	.060 (.234)	.026 (.375)
BDSIZE						1	.349** (.000)	-.297** (.000)	.454** (.000)	.139* (.044)	.232** (.002)	-.053 (.262)	.201** (.007)	.052 (.262)	-.106 (.098)
BDMEET							1	-.186* (.011)	.068 (.205)	.030 (.358)	.222** (.003)	.088 (.141)	.058 (.242)	.015 (.430)	-.037 (.327)
BDFX								1	-.196** (.008)	-.32** (.000)	-.139* (.045)	.037 (.327)	.180* (.014)	.140* (.043)	.094 (.125)
ACSIZE									1	-.093 (.129)	.108 (.095)	-.083 (.157)	.197** (.008)	-.046 (.287)	-.093 (.129)
ACIND										1	-.099 (.114)	-.117 (.076)	-.043 (.301)	.087 (.146)	.002 (.488)
ACMEET											1	-.100 (.113)	.104 (.103)	-.037 (.325)	.058 (.242)
ACFX												1	-.205** (.006)	-.040 (.313)	-.083 (.158)
SIZE													1	.122 (.068)	-.055 (.253)
LEV														1	-.016 (.423)
BIG3															1

Table 2 presents the Pearson correlation matrix for the dependent and independent variables for the sample. There is a positive correlation between the separation of the roles of CEO and Chairman and firm performance as measured by ROA and EPS whereas the correlation is negative with EPS. Board independence and Board size are positively correlated with ROA, ROE and EPS. Frequency of Board meetings and proportion of Board members with financial expertise are positively correlated with ROA and ROE and negatively correlated with EPS. Audit committee independence and frequency of audit committee meetings show a positive correlation while proportion of audit committee members with financial expertise depicts a negative correlation with all 3 dependent variables; ROA, ROE and EPS.

Table 3: Multiple regression analysis

Variables	ROA		ROE		EPS	
	Coefficient	Sig.	Coefficient	Sig.	Coefficient	Sig.
Constant	0.501	0.334	2.117	0.653	101.922	0.304
CD	-0.062	0.455	-0.094	0.257	-0.009	0.920
BDIN	-0.004	0.965	0.048	0.571	-0.097	0.286
BDSIZE	-0.030	0.772	-0.001	0.995	-0.097	0.366

BDMEET	0.065	0.481	0.069	0.450	0.007	0.939
BDFX	0.110	0.231	0.082	0.372	-0.165	0.088
ACSIZE	0.013	0.890	-0.009	0.925	-0.034	0.733
ACIND	-0.059	0.508	-0.063	0.481	-0.234	0.014
ACMEET	-0.059	0.474	-0.017	0.840	-0.126	0.150
ACFX	0.077	0.342	0.078	0.337	0.046	0.588
SIZE	-0.056	0.523	-0.024	0.782	0.038	0.677
LEV	-0.410	0.000	-0.435	0.000	-0.127	0.131
BIG3	-0.022	0.781	-0.026	0.743	0.036	0.665

Table 3 shows ordinary least squares regression results for each of EPS, ROA and ROE on the independent variables. The results of the regression analysis reveal that the proportion of Board members with financial expertise and audit committee independence have a significant negative relationship with the firm performance as measured by EPS under 0.1 and 0.05 significant levels respectively. All the independent variables found to be less impact in determining ROA and ROE. This study verifies the results of Guo & Udayakumara, 2012, regarding CEO duality which provide evidence that the corporate governance measures are not significantly correlated with firm performance. Also, this empirical study fails to provide an empirical evidence to confirm the significant relationship between the board size and firm performance, however this shows a negative association between board size and firm performance which comply with the results of Azeez, 2015. Board independence and frequency of board meetings were insignificantly related with firm performance which agree with the results of Velnampy, 2013. All the audit committee characteristics except audit committee independence didn’t show a significant association with firm performance.

5. CONCLUSION, LIMITATIONS AND SUGGESTIONS

This study has examined the influence of Corporate Governance variables such as CEO duality, board independence, board size, frequency of board meetings, board of directors with financial expertise, audit committee size, audit committee independence, frequency of audit committee meetings and audit committee members with financial expertise on firm performance in Sri Lanka. ROA, ROE and EPS were used as measures of firm performance. To test these hypotheses, this study used a sample of 50 listed companies in Colombo Stock Exchange (CSE) in Sri Lanka, excluding Banking and Finance sector, for the 2015-2017 financial years.

According to the results of the regression analysis, only two variables (proportion of Board members with financial expertise and audit committee independence) have significant negative relationship with the firm performance. The results of the study provide evidence that all the other independent variables of corporate governance measures are not significantly correlated with ROE, ROA and EPS as the performance measures.

This paper reviews corporate governance characteristics including board characteristics and audit committee characteristics of listed firms in Colombo stock exchange and their relationship with firm performance. Therefore, this study contributes to the prevailing literature related to corporate governance and firm performance.

The results presented in this study were restricted to a sample of 50 companies from 314 companies listed in the Colombo Stock Exchange (CSE) and data concerning to years 2015, 2016 and 2017 were addressed, which limits the generalization of the findings.

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