

## **Impact of Corporate Governance Best Practice Code on Financial Performance of Companies Listed on the Colombo Stock Exchange**

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### **Abstract**

Corporate governance is considered to have significant implications for the growth prospects of an economy. Good corporate governance practices are regarded as important in improving the performance of companies. The purpose of this study is to investigate the impact of corporate governance on financial performance of Sri Lankan listed firms. A number of aspects related to corporate governance, including board of directors, chairman and chief executive officer, board balance and appraisal of performance, disclosure of remuneration of directors, shareholders, accountability and audit, institutional investors and other investors and disclosure of sustainability reporting were examined in order to explore their influence on financial and market performance measured in terms of Return on Assets, Return on Equity, Tobin's Q and Market to Book Ratio. Correlation analysis and panel regression analysis is used to analyze the data gathered from a sample of 96 publicly listed firms in 19 industries in the Colombo Stock Exchange in Sri Lanka. The findings of the correlation analysis results revealed that, there is no significant relationship between the overall governance scores and Return on Assets. In the case of Return on Equity, there is no significant relationship with the level of compliance of Corporate Governance. Further, there is no significant relationship between the overall governance scores and Tobin's Q. Market to Book Ratio shows insignificant relationship with the overall corporate governance scores. Panel regression analysis results indicated that there is no systematic relationship of governance scores and Return on Assets. Further, overall governance score has revealed a significant positive coefficient with Return on Equity. The overall governance score has not systematically related with Tobin's Q. Further results show that, there is no systematic relationship of overall governance score and the Market to Book Ratio. The results will assist regulators and policy-makers to better understand the impact of corporate governance on the financial performance of different types listed firms in Sri Lanka.

**Keywords:** Corporate governance codes, Corporate governance practices, Return on Assets, Return on Equity, Tobin's Q, Market to Book Ratio

### **1. Introduction**

#### *1.1. Introduction to the Problem*

In Sri Lanka, there seems to be a wide acceptance generally and compliance with the Corporate Governance practices originating in the developed countries, especially British practice

recommendations of the Cadbury and Combined Code. It is noted, that more than 25 years after the introduction of the Cadbury Code in 1992, there have been compliance of the CG best practice code, despite the fact that there are vast differences in their business and governance environment compared to those of Sri Lanka. Claessen and Fan (2002) and Farinha (2003) stated that the theory derived from the studies of developed countries is limited in applicability to emerging markets. Manawaduge (2012) indicated that the CG reforms of the Sri Lankan market, which are influenced by the practices of the market informed UK model, due to reasons of their historical and economic links with the developed economies has limited effectiveness in the emerging markets, as most of these economies have governance systems with weak institutional framework, poor property rights and PLCs subject to concentrated ownership.

Furthermore, corporate governance practices are largely recommended through the voluntary codes. As a result, managers of public listed companies in Sri Lanka had considerable discretion in deciding the types and the extent of corporate governance practices implemented in their companies. Further, efficiency of corporate governance mechanisms, especially internal governance mechanisms of public listed companies is an important aspect to be examined in governance reforms. The relative efficiency of alternative corporate governance models and systems, especially relative efficiencies between the market model and the relationship-based model of corporate governance, is an important issue for many corporate governance researchers (John & Senbet, 1998; Manawaduge, 2012). This issue attracts more attention when emerging markets seek to implement suitable corporate governance systems for their economies as there is a dearth of research on firm level corporate governance practices in these markets.

CG practice in Sri Lanka is in a position to make further developments to its frame in the context of a well more adapted Sri Lankan culture than a set of fully convergence of developed countries' practices. Meanwhile, the contextual settings of developed countries differ vastly from those of the emerging markets and therefore the results of these studies cannot be generalized without paying thorough attention to contextual idiosyncrasies (Classens et al., 2000). The existing literature reveals that a noteworthy of the studies have been conducted in Sri Lanka (Azeez, 2015; Danoshana & Ravivathani, 2013; Guo & Kumara, 2012; Heenetigala, 2011; Kajanathan, 2012; Manawaduge, 2012; Siriwardhana, 2008; Velnampy, 2013) measuring the CG variables such as CEO duality, board composition, board committees and firm's performance based on the Code of Best Practice on CG (2003 & 2008), and SLCGC 2013. Especially, the researches have been conducted in the period of up to 2010 in which it disclosed a highly volatile economic era in Sri Lanka subsequent to violent war conflict and the Tsunami disaster aftermath in 2004. This may have had an adverse impact on the behavior of PLCs and for the deviation of the actual performance on the findings.

Azeez (2015) study conducted on 'Corporate Governance and Firm Performance: Evidence from Sri Lanka' stated that, Sri Lanka is an emerging market economy striving for economic growth. In recent years CG has emerged as an important issue for Sri Lanka due to corporate scandals in recent past such as collapse of certain financial institutions including Pramuka and Golden Key and the ongoing effects of globalization, as the domestic economy integrates with the global

economy and firms strive to gain international competitiveness after the end of civil- war in 2009. Therefore, it has become essential to revisit the existing governance system to examine its impact on firm performance and suggest ways to bring about changes if necessary. Further, researcher stated that Corporate Governance and its impact on corporate performance is a widely debated area. Therefore, it is arguable that aligning interest of owners and managers through adhering to good Corporate Governance practices would lead to reduced agency conflict between owners and managers and thereby would lead to enhance performance of the company. The finding is advocated by Klein, Shapiro and Young (2005) identified that there is no universal evidence to suggest that better governance enhances firm performance. As a result, investors are still much skeptic about the existence of the link between good governance and firm performance. So, the impact of Corporate Governance on firm's performance is still inconclusive.

In the Sri Lankan context, most researchers had made their studies focusing on firm's performance; even those studies also based on limited selected CG variables and sample companies and findings are contradictory (Pathirawasam & Siromi, 2017). Based on the Code of Best Practice on CG (2008 & 2013), authorized or trade review of compliances and systematic researches have been conducted to gather empirical data apropos of this title by PLCs. Nonetheless, there are not many of the empirical studies published in Sri Lanka measuring the compliance with the SLCGC (2013) and UK CG code (2014) and, as per the researcher's observes, the researcher did not find a study which has been covered all the eight CG dimensions of board and directors, chairman and CEO, board balance and appraisal of performance, directors' remuneration and disclosure, shareholders, accountability and audit, institutional investors and other investors and disclosure of sustainable reporting in one study in Sri Lankan context, in which, this is considered as one of the emerging market country experiencing distinctive situations under political and economic instabilities. Hence, this methodological uniqueness provides the opportunity to conduct this original research in Sri Lanka.

### *1.2. Research Problem*

When consider the Sri Lankan context the country has faced some difficult economic situations particularly in the finance sector. The banking crisis occurred in Sri Lanka during 1860s and 1870s required the intervention of the government to bail-out some affected banks (Karunatilake, 1986). Several financial companies in the country collapsed during 1988 and 1989. The Central Bank of Sri Lanka responded to this crisis by extending financial support for distressed finance companies (CBSL Annual Report, 1989). Financial assistance was made available to finance companies in distress in order to pay the depositors. Some of the collapsed finance companies were closed and some were rehabilitated.

The collapse of financial markets of the US had an effect on the Sri Lankan equity market as well, which is highlighted in the market indicators. The market capitalization of the CSE decreased from Rs.827 Billion to Rs.534 Billion during the year 2009. The market P/E from 11.3 times has come down to 5.8 times during the period of review, thus making Colombo one of the cheapest markets in the South Asian region on P/E multiples. With India trading at a P/E

multiple of 14.3X times and Pakistan 8.9 X times in 2009. As a result of the financial crisis, many foreign investors who had invested in short-term investments repatriated their investments back to their countries for meeting rising liquidity requirements in their countries. Investors' protection in Sri Lanka ranked as 52 out of 187 countries. It is not provided confidence to investors to make more and more capital in Sri Lanka. The strength of investor protection index was 6.0 out of 10, it was little lower than OECD countries and higher than South Asian countries (Ceylon Guardian Investment Trust PLC Annual Report, 2008/09).

The foreign funds which were invested in debt instruments, such as Treasury bills and long-term bonds in Sri Lanka were withdrawn from the country partly as a result of the global financial crisis. At the end of 2008, there was a sudden reversal of short-term capital inflows to Sri Lanka. The net outflow amounted to US \$ 213 million due to withdrawal of US \$ 430 million in the last quarter of 2008. Extend of disclosure index, Extend of Director Liability Index, and Ease of Shareholders Suits Index were also little bit higher than the South Asian countries. This world-wide comparison showed that there was a need to protect investors in Sri Lanka (Kalainathan & Vijayarani, 2014). The impact of the global crisis through the channels as explained above ultimately resulted in a slow rate of economic growth in Sri Lanka. The impact on economic growth due to crisis and recession in the world was severely felt during last quarter of 2008 and first half of 2009. The lowest economic growth of 1.6 percent in the first quarter 2009 indicated the adverse effects of the global crisis on the Sri Lankan economy. Economic growth in 2009 was 3.5 percent compared to 6.0 percent in 2008 (Ceylon Guardian Investment Trust PLC Annual Report, 2008/09).

Several corporate scandals taken place in Sri Lanka have caused great confusion in the stakeholders of the companies. The liquidity problems of some of the domestic banks and some finance companies arose partly due to drying up of external credit lines for their operations were resolved by measures directing them to issue shares and banks to get listed in the CSE (Hemachandra, 2005). The bankruptcy of Pramuka Bank, Seylan Bank, Vanic Incorporation, Lanka Marine Services Ltd, Sri Lanka Insurance Corporation and the Golden Key Credit Card Company (GKCC) are the most reviewed corporate collapses of Sri Lanka.

Ranasinghe (2009) has explained the situation at Seylan Bank, with the Golden Key Credit Card Company, that was about the mismanagement of the financial market in Sri Lanka. The author further said the CBSL is the only authority that can handle situations such as that. At the same time, given the global changes that have taken place in financial markets over the years and the thousands of new instruments and innovations entering the market, that time Monetary Act was not sufficient and did not give enough authority to the CBSL to regulate the industry. Therefore, Seylan Bank crisis was more about overall financial market management.

Abey Suriya (2009) said GKCC, a Ceylinco group firm, in 2008 ran into severe liquidity problems, with estimated customer liabilities in over Rs.78 billion. The fallout of the GKCC has led to a slowdown in the finance leasing industry which supports all the vehicle hiring. The company that was offering interest like - 24 to 28% returns to investors – would have been in

difficulty as it had to generate much more to cover their overheads through very high risk investments without being a Licensed Financial Institution approved by the CBSL. The author said there were problems for the Ceylinco Group which had a huge impact on the financial system. There were serious doubts being expressed about the mechanism through which deposits have been taken by GKCC. Due to the fact that there were a lot of private companies which made up the Ceylinco Group, its exposure was high. There were also problems when companies charged high interest rates in the range of 20 to 24% because they simply do not have a mechanism to get 30 to 40% returns except in leasing. Silva (2009) said that GKCC has mismanaged its funds and gone on an investing spree. It is apparent from the facts revealed so far that the collapse of GKCC is associated with both mismanagement and mis - appointment of funds by directors and managers of the company.

Abeysinghe (2008) explained the main problem of the Pramuka Bank had to face was the incomplete regulation and the bank's board did not have "parate execution" rights. With considering the major issues, CBSL decided to suspend the banking business of the Pramuka bank immediately in October 2002 due to the high non-performing ratio- in excess of 75%, negative net worth of Rs. 230 million as at September 2002 and inability to maintain the minimum statutory liquid assets ratio of 20. The collapse of GKCC, Seylan and Pramuka Banks revealed the failures of the preceding CG system and CG theories. The core company of Sri Lanka's well known family controlled entity, EAP Edirisinghe Group is presently facing a severe strain in its capital adequacy ratio (CAR) and hence undergoing a major restructuring exercise. These corporate scandals raise the obvious question as why such incidents take place and who is accountable for these incidents (Senaratne, 2009). These failures are not limited to the entities and stock market, but it could also affect entire economy and social system of the country (Kalainathan & Vijayarani, 2014).

Many researchers (Gunathilake et al., 2011; Weerakoon, 1995; Wickramasinghe, Hopper and Rathnasiri, 2004; Ratnayakara, 2006) argued that the political influence affect the implementation of rules and regulations in a proper way in Sri Lanka. Country economy shifted to market-oriented policies in 1977 as a result of this market-oriented policies and privatization public enterprise ownership has switched to private ownership, though ultimately this private ownership has ended up with a few concentrated family owners, individuals, institutions and political leaders. Still, there is no proper governance system to reduce this influence. The study identified that the CSE needs further improvement in the corporate governance system to protect investors in the capital market (Kalainathan & Vijayarani, 2014).

Over the past two decades corporate governance system and practices have gained great attention because of the corporate scandals taken place around the world. The issuance of some directions to financial institutions under the corporate governance ensured the improvements in common standards of their behavior improved the public confidence and thereby contributed positively towards financial stability despite the adverse experiences faced by western financial institutions. Asian financial crisis in 1997 showed that the region's need for legislative reform to strengthen corporate governance practices. Some corporate collapse in Sri Lanka made introduction of



corporate governance system and new Company Act No. 7 of 2007 (Kalainathan & Vijayarani, 2014). Application of the assessment of fitness and propriety to officers in executive grades of banks came under the corporate governance directions (Hemachandra, 2005, p.28).

The question therefore is whether the breach of corporate governance principles contributed to the above discussed collapses? Baring bank lacked effective internal control systems where it trusted one employee without properly monitoring his activities. Parmalat emphasized the likelihood of the board of directors of family owned companies getting influenced by family members being on the board. HIH pointed out the importance of having a proper risk management system, proper disclosures of risks and the directors' duty in ensuring that such controlling systems are in place. Accordingly, corporate collapses all over the world, though they occurred due to specific circumstances attached to each country's government and regulatory policies, goals and financial capabilities; there seems to be one common reason: failure to adopt good governance that has resulted in inefficient business decisions.

All these financial scandals have emphasized the importance of CG and researches have been conducted to test whether compliance with good CG directs to the better Financial Performance. The researchers have highly evidenced that good CG boots FP (Agrawal et al., 1996; Brickley et al., 2003; Brickley & James, 1987; Brown & Gorgen, 2009; Byrd & Hickman, 1992; Chung et al., 2003; Drobetz et al., 2004; Hermalin & Weisbach, 2003; Hossain et al., 2000; John & Senbet, 1998; La Porta et al., 1999; Lee et al., 1992; Pant & Pattanayak, 2010; Pass, 2004; Rezaee, 2009; Rosenstein & Wyatt, 1990; Shleifer & Vishny, 1997; Spanos, 2005; Tirole, 2006; Weisbach, 1988). The compliance with CG has been emphasized as a remedy for the financial scandals and the researches have been conducted to examine the impact of CG on FP in the Sri Lankan context (Danashana & Ravivathani, 2013; Guo & Kumara, 2012; Heenatigala, 2011; Kajanathan, 2012; Manawaduge, 2012; Siriwardhana, 2008; Velnampy, 2013).

The OECD Observer (2000) states that: 'In the 21st century, stability and prosperity will depend on the strengthening of capital markets and the creation of strong corporate governance systems'. This statement clearly emphasizes the importance of good governance principles and practices within an organization leaving us with the question: To what extent do corporate governance principles and practices result in corporate collapses and contribute to the financial crisis? (Kariyawasam, 2011, p. 175).

Therefore, the Problem Statement identified in this study is that, **whether the increase of the level of compliance on Corporate Governance will lead to better financial performance of Sri Lankan listed firms.**

In line with the perceived knowledge gap as aforementioned, specific question below has been identified in the discussion:

Does compliance with CG best practices have any impact on firms' financial performances of listed companies?

There has been a renewed interest about the CG in Sri Lanka with corporate scandals in recent past and with the regulatory measures taken by regulatory bodies in protecting the interest of the

shareholders. Collapse of certain financial institutions including Pramuka and Golden Key has stressed the importance of adopting good governance principles in Sri Lankan community and has enlightened the regulators in setting effective governance mechanism in protecting shareholders interest.

*The Objective of the Study*

The investigations of the study ascertained the objective specifically:

To examine the impact of compliance with CG best practices on firm performance, proposing that a higher level of compliance will enhance firm performance

*1.3. Review of Literature*

Many researchers have tested the relationship between corporate governance and financial performance showing that how good governance practices have increased the economic value to firms, higher productivity and lower risk. In the existing literature researchers have highly evidenced that good CG boots financial performance (Adjaoud et al., 2007; Brickley et al., 2003; Brickley & James, 1987; Brown & Caylor, 2004; Brown & Gorgen, 2009; Byrd & Hickman, 1992; Chung et al., 2003; Drobetz et al., 2004; Hermalin & Weisbach, 2003; Hossain et al., 2000; John & Senbet, 1998; Khatab et al., 2011; La Porta et al., 1999; Lee et al., 1992; Lipton & Lorsch, 1992; Mitton, 2001; Rehman & Hussain, 2013; Rosenstein & Wyatt, 1990; Saravanan, 2012; Shleifer & Vishny, 1997; Weisbach, 1988).

Mitton (2001) research carried out on 'A cross-section analysis of the impact of CG on the East Asian crisis' firms include Korean, Malaysian, Indonesia, Philippines and Thailand found that the firm-level differences in variables are related to CG has strong impact on firm performance during East Asian crisis in 1997 and 1998. Brown and Caylor (2004) studies on 'Corporate governance and firm performance' findings indicated that high profit, more value creation and growing shareholder wealth are associated with better governed firms. Adjaoud et al. (2007) completed study on 'the effect of board's quality on performance of Canadian firms' to observe the relationship between firm performance and the governance scores and results have been discovered having significant relationship between the governance scores and measures of value created such as market value added and economic value added.

Brown and Gorgen (2009) conducted a study using the ASX CG principle to create a CG measure for the top 300 Australian listed companies and related this measure to the financial performance such as EPS and ROA of each company. Researchers found that companies with better CG outperform poorly governed companies, particularly in relation to EPS and ROA. Furthermore, they find that companies that are fully compliant with the ASX CG principals perform better than companies that are only partially compliant. Khatab et al. (2011) have concluded that firms having good CG measures perform well as compared to the firms having no CG practice or less. Saravanan (2012) study conducted on 'CG and company performances' aiming at analyzing the significant differences in the CG characteristics between 51 manufacturing firms and non-manufacturing firms in India found that the firm value is significantly affected by the CG variables for manufacturing firms.

The study of Rehman and Hussain (2013) directed on 'Impact of CG on overall FP of the leading banks of Pakistan, and investigated the effects of elements of CG practices on FP of different companies with different governance styles and how much SHs affect the FP of the firm as SHs are normally interested in higher share price. Findings showed that tested independent variables of attitude of senior management, SHs vs. senior management performance ratings and attitude of employees do have a strong impact on the overall FP. The study was mostly qualitative in nature because of the data were gathered mainly on the perception of respondents. Hence the researchers view is, different employees might have different perceptions that could boost their individual performances, but in the study, researchers have included the above three variables examples that seems to have maximum impact on the overall FP.

Heenetigala (2011), study examined the relationship between CG practices and firm performance of PLCs in Sri Lanka as a result of the adoption of a code of best practice on CG in 2003 and the extent of changes to CG practices denotes that the agency theory propositions that good CG practices enhance board's accountability to shareholders and improve a company's performance. Further, the researcher concludes that even in adverse economic and political conditions good CG practices are important to the performance of firms operating in Sri Lanka. Manawaduge (2012) stated that higher levels of compliance have a positive impact on financial performance and by the side of stakeholder perceptions on eight aspects of CG system in Sri Lanka, analysis of results showed the majority of stakeholders are in agreement that sound CG practices improve corporate financial, market and social performance. The researcher's overall results suggest that compliance with CG practices by respondent firms is closely associated with ownership structure and that better governance seems to correlate with higher financial performance of the firms.

In the existing literature some researchers have offered counterarguments against to the above findings. Although, a common situation is CG enhances firm performance, some of the researchers have pointed out the negative relationship between CG and firms' performance (Bathala & Rao, 1995; Hutchinson, 2002). Adjaoud et al. (2007) engaged in the study on 'the effect of board's quality on performance of Canadian firms' to observe the relationship between firm performance and the governance scores and results have been discovered that relationship between accounting-based measures of performance such as ROI, ROE, EPS, and MBR and governance scores was not significant.

Khatab et al. (2011) study conducted on the CG and firm performance of twenty firms listed on Karachi Stock Exchange and performance of CG has been analyzed using Tobin's Q and results have shown that firms of the emerging markets are not so healthy and they did not create value for shareholders. The researchers have given possible explanations to claim for these ostensible discrepancies. Some researchers have asserted that aforesaid inconsistencies could happen on the method of data collection for the study either publicly available data or survey data collected on the sources are generally restricted in scope. Dalton et al. (1998) explicated that meta-analytically reviewed show negative relationship and no statistically significant relationship was revealed at all between variables of interest and firm performances. Gani and Jermias (2006) stated another reason for above inconsistencies as the nature of restrictive use of accounting



based performance measures, ROA, ROE, ROCE, or restrictive use of market based performance measures such as the market value of equities.

Guo and Kumara (2012) study carried out on 'CG and firm performance of listed firms in Sri Lanka', study results found that the relationship between board size and ROA and TQ has shown marginal negative value. However, the researchers predicted that the regression run model value for ROA on considered independent variables cannot be relied upon as a good way of explaining the impact because of the low explanatory power of the model. Guo and Kumara (2012) stated that the relationship between proportion of NEDs and TQ has shown marginal negative value. The researchers have concluded that all the recommendations made in Code of Best Practice (2008) with regard to the composition of the board have a negative impact on the value of firm measured by TQ. Danoshana and Ravivathani (2013) study found that meeting frequency is negatively impacted on the firm's performance and researchers supported this finding by depicting that increasing meeting frequency results in poor financial performance because of increases in cost of management.

Some researchers have not found any relationship between CG determinants and FP measures in the studies (Dalton et al., 1998; Park & Shin, 2003; Prevost et al., 2002; Singh & Davidson, 2003; Young, 2003). Bino and Tomar (2012) have revealed that board size has no effect on bank performance. Lokuwaduge and Armstrong (2014) study conduct on 'The impact of governance on the performance of the higher education sector in Australia' found that no significant relationship between the board size and the FP of the universities and finding rejected the arguments of high monitoring costs of larger board size negatively relates with organizational performance. Attains and Ocal (2014) study results have shown that the dimensions of the environment do not moderate the relationship between the rate of change in top management teams and FP.

Velnampy (2013), a study carried out on 'CG and firm performances' of manufacturing companies in Sri Lanka, found that determinants of corporate governance such as board structure, board committee, board meeting and board size including EDs, INEDs, and NEDs; are not correlated to the performance measures of ROE and ROA; of the organization. The researcher suggests that sampling companies have still not properly put into practice CG guidelines. Therefore, companies should pay attention on the role of corporate governance measures. Further, researcher indicates that selected four variables as the determinants of corporate governance has the least ability to predict performance (i.e. ROE and ROA 17.1% and 16.1%, respectively).

#### *1.4. Hypotheses of the study*

The testable hypotheses for the study developed in the theoretical framework discussed above and the developed hypotheses measure whether there is a possible relationship between the considered corporate governance variables which are vital to the area of corporate governance with financial performance or not. The good corporate governance helps to attract investor confidence in capital markets. The shareholders and other stakeholders are the persons who are

impressively affected by the firm activities and the board is functioning to monitor the activities of the top managers for their stewardship and their accountability towards interested parties referred to above. The B&D (H<sub>01</sub>), C&CEO (H<sub>02</sub>), BBAP (H<sub>03</sub>), DRD (H<sub>04</sub>), SH (H<sub>05</sub>), AA (H<sub>06</sub>), IIOI (H<sub>07</sub>), and DSR (H<sub>08</sub>) are represented to investigate the corporate governance impact on financial performance.

*The Board & Directors and Firm Performance*

The conceptual framework considers the role of the board, board directors, and, financial acumen is an important mechanism of corporate governance and it results in growing financial performance. The following hypotheses have been developed to test the argument referred to above considering Sri Lankan context.

H<sub>a1a</sub>: There is an association between B&Ds' index scores and AP

H<sub>a1b</sub>: There is an association between B&Ds' index scores and MP

*Chairman & CEO and Firm Performance*

The study considers the leadership structure as an important dimension which has an impact on FPs (Cadbury, 1992; Hampel, 1998). The empirical research evidence suggests the importance of separating the positions for an effective mechanism (Abdullah, 2004; Baxt, Ramsay & Stapledon, 2002; Boyd, 1994; Coles, McWilliams et al., 2007; Daynton, 1984; Dobrzynski, 1991; Fazel & Louie, 1990; Finkelstein & D'Aveni, 1994; Jensen, 1993; Jensen & Meckling, 1976; Kosnik, 1987; Lorsch & MacIver, 1989; Mallette & Fowler, 1992; Millstein, 1992; Morck, Shleifer & Vishney, 1989; Singh & Harianto, 1989; Suryanarayana 2005). The following hypotheses are developed to test the argument referred to above considering Sri Lankan context.

H<sub>a2a</sub>: There is an association between duality CEO index scores and AP

H<sub>a2b</sub>: There is an association between duality CEO index scores and MP

*Board Balance & Appraisal of Performance and Firm Performance*

The researchers have identified board composition as an important component of CG which effects on FP in Sri Lanka. The percentage of the proportion of inside and outside directors functioning attached to the board is referred as the board composition related to the study. It is said that there should be a clear division between the inside and outside directors' roles as it results in conveying some specific gains and losses. Appointment of both inside and outside directors is similarly important as the inside directors are having the permission on the access of inside information and the outside directors are having the expertise and objectivity in evaluating the decisions of managers (Barnhart et al., 1994; Beasley, 1996; Brickley, 1994; Byrd & Hickman, 1992; Daily & Dalton, 1992; Ellingson, 1997; Fosberg, 1989; Gibbs, 1993; Li, 1994; Mace, 1971; Matolcsy, Stokes & Wright, 2004; Schellenger et al., 1989). The following hypotheses are developed to test the argument referred to above considering Sri Lankan context.

H<sub>a3a</sub>: There is an association between BBAP index scores and AP

H<sub>a3b</sub>: There is an association between BBAP index scores and MP

*The Directors Remuneration & Disclosure and Firm Performance*

Researchers claimed that the companies which established Remuneration Committee to the board structure have performed much better than those without them, and companies

Remuneration Committees' have shown a significant improvement in financial performance (David, 2001; Keong, 2002; Klein, 1998; Spira & Bender, 2004; Weir, Laing & McKnight, 2002; Laing & Weir, 1999). Furthermore, some researchers have evidenced that RC has no effect on financial performance (Theodorou, 1998; Weir et al., 2002). The appointment of the RC on the given recommendation of the Code of Best Practices (2013) has been done with the expectation that it has a positive impact on financial performance. The following hypotheses have been developed to test the argument referred to above considering, Sri Lankan context.

H<sub>a4a</sub>: There is an association between DRD index scores and AP

H<sub>a4b</sub>: There is an association between DRD index scores and MP

#### *Shareholders and Firm Performance*

The conceptual framework considers that the constructive use of the annual general meeting and conduct of general meetings; communication with shareholders; and, major and material transactions is an important mechanism of corporate governance and it results in growing financial performance. The following hypotheses have been developed to test the argument referred to above considering, Sri Lankan context.

H<sub>a5a</sub>: There is an association between SH index scores and AP

H<sub>a5b</sub>: There is an association between SH index scores and MP

#### *Accountability & Audit and Financial Performance*

The researchers have claimed that the companies which established board committees to the board structure have performed much better than those without them, and companies with AC have shown a significant improvement in FP (Laing & Weir, 1999; Wild, 1994). Furthermore, some researchers have evidenced that AC has no effect on FP (Theodorou, 1998; Weir et al., 2002). The following hypotheses are developed to test the argument referred to above considering, Sri Lankan context.

H<sub>a6a</sub>: There is an association between AA index scores and AP

H<sub>a6b</sub>: There is an association between AA index scores and MP

#### *Institutional Investors & Other Investors and Financial Performance*

The conceptual framework considers that the SH's rights, evaluation of governance disclosures, investing/ divesting decisions, and SHs' voting are an important mechanism of CG and, results in growing FP. The following hypotheses are developed to test the argument referred to above considering, Sri Lankan context.

H<sub>a7a</sub>: There is an association between IIOI index scores and AP

H<sub>a7b</sub>: There is an association between IIOI index scores and MP

#### *Disclosure of Sustainable Reporting and Firm Performance*

Firm performance in Sri Lanka is also affected by capital market reactions to mandatory and voluntary disclosures, which is provided in the annual report of a company. Mandatory reporting is required by the regulation and sustainable reporting is voluntary. Information content of voluntary reporting provided by the companies varies. However, disclosure of additional information reduces the cost of capital by reducing information asymmetry in the market, and

reduces estimated risks associated with expected future returns and therefore the transaction costs (Ghazali & Mohd, 2008). According to Healy and Palepu (2001), empirical research on the economic consequences of voluntary disclosures asserts three types of capital market effects for firms that make extensive disclosures. The following hypotheses have been developed to test the argument referred to above considering Sri Lankan context.

H<sub>a8a</sub>: There is no association between DSR index scores and AP

H<sub>a8b</sub>: There is an association between DSR index scores and MP

The study is based on that the level of compliance to CG best practices would improve overall management efficiency and thereby the overall performance of the company. The AP measures are employed to capture the impact of overall performance of the company. Further, the level of CG will have a positive impact on investors' expectation of market share prices. Therefore, MP measures are applied to capture the impact of compliance with CG practices on the MV of the shares. Based on the assumed causal relationship, the following hypotheses are developed to examine the relationship between CG variables and the performance variables.

H<sub>a9a</sub>: There is an association between CG index scores and AP

H<sub>a9b</sub>: There is an association between CG index scores and MP

## **2. Methodology**

### *2.1. Development of Conceptual Framework of the Study*

The illustrated Conceptual Framework of this study encompasses internal CG variables of the board and directors (B&D), chairman and CEO (CCEO), board balance and appraisal of performance (BBAP), directors' remuneration and disclosure (DRD), shareholders (SH), accountability and audit (AA), institutional investors and other investors (IIOI), and disclosure of sustainability reporting (DSR) in the annual reports on CG principles which are having an impact on FP. The researcher has identified these variables with reference to the SLCGC (2013) and UK CG Code (2014). The relevancy of these identified variables is evidenced in the reviewed literature of past researchers.

### *2.2. Research Design and Approach*

In order to measure the research objective which was set out in the chapter one, this study has employed methodologies which have been adopted in prior researches in this subject area. The same studies on this title which investigated aforesaid relationships have utilized a positivist research paradigm of a deduction method and data collected from secondary sources have been analyzed using quantitative techniques (Perera, 2008). The aim of descriptive research is to provide information regarding the current status and the characteristics of a particular phenomenon and to verify the formulated hypotheses that refer to the present situation. This is usually exploratory in nature and attempts to determine the status of a particular area (Hepprer et al., 2008).

The researcher also aims to follow the same practice to conduct the study as this method can be used either with qualitative or quantitative data or both, giving flexibility in accommodating quantitative analysis of data gathered through secondary sources. It is useful in describing the occurrence and characteristics of the phenomena that are being studied, and therefore it is useful

for developing remedial actions. Thus, the findings are useful in managerial decision-taking (Creswell, 1994). Hence, the research is oriented in a positivist theoretical perspective and the descriptive method of research is used in the empirical investigations of the study. The use of a particular method for a research project depends on the scope, purpose and target population of the study, as well as the resources available to the researcher (Gill & Johnson, 2002). As depicted in the overall research framework of the study, an empirical investigation for a survey of compliance with corporate governance best practices and its impact on FP of Sri Lankan public listed companies is carried out in this study.

### *2.3. Selection of the Sample*

The population for the study comprises PLCs incorporated under the Companies Act No.7 of 2007 or any other statutory corporation, incorporated or established under the laws of Sri Lanka or established under the laws of any other state (subject to Exchange Control approval) are eligible to seek a listing on the CSE to raise debt or equity. All the 291 CSE listed companies representing 20 business sectors as of 30<sup>th</sup> September 2017, excluding delisted companies per the listing schedule of the CSE website, have been selected as the study population. Although 291 companies are listed on the CSE, for the study purpose to be considered those should have been listed before the 2007/08 financial year. 215 companies were eligible for the sample selection compliance to the above criteria, and out of these companies 96 elements were selected based on market capitalization  $\geq 0.1$  as a % of TMC as the final sample ([www.cse.lk](http://www.cse.lk), 2007). This is a representative rate of 44.65 percent of the population. The sample has been spread across 19 sectors of the 20 sectors as per the sector categorization of the CSE and in most industry sectors the sample elements rate is above 30 percent.

### *2.4. Data Collection and Measurement of Variables*

The study used secondary data for the analysis purpose. Collection of secondary data in relation to compliance with CG practices was carried out through a prepared check list. Secondary data in relation to accounting performance, market price data and additional governance information were obtained from two source namely the annual reports of the relevant companies and the CSE database. Items of interest to this were relevant financial statements of the companies and other annual report disclosures. Development of the checklist was completed in two stages. In the first stage main attributes of CG practices were identified by referring to the national and international codes, regulations and guidelines (SLCGC 2013, UK CG Code 2014). These attributes were classified under eight dimensions of CG, which form the basis of the questionnaire. In the second stage specific questions were developed by referring to prior research studies covering these attributes (Balasubramanian et al. 2007, Ho 2005, Jongsuregapat 2006, Manawaduge 2012, Nam & Nam 2004). Additional questions were also developed suitable to the control of the research study. All questions are shown in closed form and 'yes' and 'no' answers were used as it surveys level of compliance of company's existing CG best practices. The checklist consists of 93 questions, classified in eight parts, namely the B&D, CCEO, BBAP, DRD, SH, AA, IIOI and DSR. The checklist was developed by covering the areas on the CG compliance with the annual reports of the companies.



The researcher used the self-developed questionnaire with the review of existing literature (Balasubramaniam et al. 2010, Manawaduge 2012) consisting with 93 closed-ended statements to collect, study data by referring to the annual reports of the selected sample companies with the compliance to the existing corporate governance practice of the particular company. The checklist was completed by marking the level of response of Likert scale on the each statement related to the corporate governance practice on above mentioned eight dimensions.

### *2.5. Methods of Data Analysis*

The analytical techniques used in the study were quantitative in nature. The quantitative data analysis included percentage analysis, frequency analysis and other statistical analysis. The level of compliance to CG best practices was determined based on the scores of the CGI and the sub-indices. A statistical analysis was carried out using the SPSS version 21.0 & EViews 9.0 in order to examine the impact of levels of corporate governance compliance on financial performance.

### *2.6. Impact of CG Compliance on Firm Performance*

In order to examine the performance implications of CG compliance, the sample was divided into two sub-samples, as high and low compliance companies based on the CG scores obtained. The maximum possible value of the OI is 93. Based on the variance of the index score, a company that has scored 75 for the OI was defined as a high compliance company, whereas an OI scored 53 was considered as a low compliance company. With this objective, the sub-samples of high and low compliance companies were analyzed in relation to both FP and MP, based on correlation analysis and t-tests for the Paired sample as indicated above. The analysis addressed two issues first, whether high CG compliance improves the FP of the companies, and second whether high CG compliance improves the MP of the companies.

## **3. Results**

### *3.1. Correlation Analysis and t-test Results*

#### *3.1.1. Correlations:*

The results presented in Table 3.1 indicate the extent of correlation between the OIS and performance variables used in this study. It shows the correlation of firm performance and the OI & sub-indices identified based on compliance to governance practices.

Table 3.1: Correlation matrix for firm Performance and CGI Scores

	BD	CCEO	BBAP	DRD	SH	AA	IIOI	DSR	OI	ROA	ROE	TQ	MBR
BD	1.000												
CCEO	.330**	1.000											
BBAP	.383**	.547**	1.000										
DRD	.302**	.492**	.750	1.000									
SH	.180	.338**	.361**	.311**	1.000								
AA	.234*	.493**	.644**	.649**	.326**	1.000							
IIOI	.234*	.237*	.517**	.589**	.198	.451**	1.000						
DSR	.283**	.419**	.531**	.403**	.209*	.421**	.218*	1.000					
OI	.508**	.678**	.859**	.825**	.505**	.783**	.649**	.666**	1.000				
ROA	.007	.012	.016	-.014	-.018	-.040	-.118	-.085	-.054	1.000			
ROE	.945	.904	.875	.894	.859	.702	.252	.408	.602	.038	1.000		
TQ	-.016	.002	-.176	-.148	.056	-.138	-.054	.004	-.088	.038	.113	1.000	
MBR	.876	.987	.087	.150	.588	.179	.602	.966	.397	.715	.577**	.020	1.000
	.072	-.022	.037	.044	-.070	.022	.002	.077	.034	.050	.113	.020	1.000
	.486	.831	.720	.673	.498	.835	.986	.455	.741	.628	.274	.843	1.000
	.030	.091	-.017	-.031	.011	-.037	.088	.113	.049	-.042	.577**	.020	1.000
	.773	.377	.871	.762	.912	.720	.393	.272	.639	.686	.000	.843	1.000

Source: Survey Data

Note: \* Correlation is significant at the 0.05 level (2-tailed)

\*\* Correlation is significant at the 0.01 level (2-tailed)

The Table 3.1 shows that in the overall sample, there is no significant relationship between the overall governance scores and ROA. This indicates that it is difficult to explain the relationship of level of corporate governance with ROA values. In the case of ROE, there is no significant relationship between the level of compliance of CG and ROE. It means the level of compliance does not explain the direct relationship with the ROE. There is no significant relationship between the overall governance scores and Tobin's Q. Further, results show that there is no significant relationship of MBR to the overall corporate governance scores. The correlation values of ROA, ROE, Tobin's Q and MBR with sub-indices of BD, BBAP, CCEO, DRD, SH, AA, IIOI and DSR do not show significant relationship in the correlation analysis.

*3.1.2. The t-test for independence samples*

The correlation analysis of the OIS and performance measures indicate that there is no significant relationship between ROA, ROE, TQ and MBR on CG compliance. In order to provide robust evidence on these issues, a t-test for independent sample was undertaken based on high compliance and low compliance sub samples. The main purpose of the test was to discover whether there is a statistically significant difference in performance between these sub samples.

Table 3.2 Results of t-test on Performance and Index Scores

P&I	Mean		Std. Deviation		MD	t	df	p-value
	HCF	LCF	HCF	LCF				
ROA	.097	.098	.059	.059	.001	.080	33	.444
ROE	.163	.158	.047	.073	-.005	-.244	33	.074
TQ	.381	.752	.256	1.444	.371	1.073	33	.062
MBR	.058	-.606	.122	.360	-.118	-1.320	33	.263

Source: Survey Data

Note: significant at (0.05) level

The mean difference of ROA is positive but statistically insignificant at 0.05 level. There was no significant difference in average ROA between high level of compliance and low level of compliance listed firms. Results further show that average ROA for high level compliance firms was .001 higher than the average ROA of low level firms. This concludes that compliance to CG best practices has no systematic relationship with the financial performance measure of ROA of Sri Lankan listed firms. On the contrary to the expected value implications of CG, the mean differences for ROE is negative. There was no significant difference in average ROE between high level of compliance and low level of compliance listed firms. Results further show that average ROE for high level compliance firms was lesser (-.005) than the average ROE of low level firms, suggesting that high CG compliance do not always generate positive financial performance measure of ROE.

Further, market performance measure of TQ has positive mean difference in between higher level of compliance listed firms and lower level of compliance listed firms. Results further show that average TQ for high level compliance firms was .371 higher than the average TQ of low level compliance listed firms. On the contrary to the expected value implication of CG, the mean difference for MBR was negative (-.118). This concludes that compliance to CG best practices has no significant relationship with market performance measure of MBR of Sri Lankan listed firms.

*3.1.3. Panel Regression Analysis*

Regression analysis was carried out based on the sample data and the results are provided in the Table 3.3. The control variables of leverage, size, sales, age and industry are represented by the TD/TA ratio, changes of total assets, sales growth change, operational years and Dummy sectors respectively.

Table 3.3 Panel regression matrix for ROA and CG Variables

Correlated Random Effects - Hausman Test

Equation: Untitled

Test period random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Period random	7.323979	9	0.6034

Period random effects test equation:

Dependent Variable: ROA

Method: Panel Least Squares

Sample: 2008 2017

Sample: 1 960 Periods included: 10

Cross-sections included: 96

Total panel (balanced) observations: 960

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-1.226651	1.282692	-0.956309	0.3392
BD	-0.846876	1.528848	-0.553931	0.5798
CCEO	-0.994153	1.540702	-0.645260	0.5189
BBAP	-0.699242	1.549091	-0.451389	0.6518
DRD	-1.029980	1.531661	-0.672459	0.5015
SH	-0.954773	1.531982	-0.623227	0.5333
AA	-0.936524	1.534513	-0.610307	0.5418
IIOI	-0.853164	1.528118	-0.558311	0.5768
DSR	-0.811458	1.526148	-0.531703	0.5951
OI	0.900864	1.526396	0.590190	0.5552
AGE	0.031495	0.029352	1.073021	0.2836
SALES_GROWTH_CHANG				
E	-0.007725	0.074646	-0.103486	0.9176
TOTAL_ASSET_CHANGE	-0.399962	0.078312	-5.107261	0.0000
LEVERAGE	-0.000347	0.001665	-0.208590	0.8348

Effects Specification

Cross-section fixed (dummy variables)

R-squared	0.664713	Mean dependent var	0.389708
Adjusted R-squared	0.622162	S.D. dependent var	2.922563
S.E. of regression	1.796457	Akaike info criterion	4.116072
Sum squared resid	2746.396	Schwarz criterion	4.668672
Log likelihood	-1866.714	Hannan-Quinn criter.	4.326514
F-statistic	15.62151	Durbin-Watson stat	1.711241
Prob(F-statistic)	0.000000		

Source: Survey Data

The probability value of Hausman test is 0.6034 which means that result is not significant. The null hypothesis is not rejected. The statement of null hypothesis of Hausman test is that the random effect regression is appropriate. Based on the result of Hausman test random effect regression is appropriate. The Table 3.3 shows panel regression analysis model summary and the overall fit statistics for ROA. The researcher found that the adjusted  $R^2$  of the model is .622 with the  $R^2 = .664$ . This model shows that linear regression explains 66 percent variation in the data. The Durbin- Watson  $d = 1.711$ , which is between the two critical values of  $1.5 < d < 2.5$ . Therefore, it can be assumed that there is no first order linear auto-correlation in the panel regression analysis data. The next output variable is the F-test. The linear regression's F- test has the null hypothesis that the model explains zero variance in the dependent variable (in other words  $R^2 = 0$ ). The F- test is highly significant, thus, it can be assumed that the model explains a significant amount of the variance in ROA rate. The regression results indicate that there is no systematic relationship of governance scores & ROA. Further, results show a significant negative coefficient between the control variable of Total Assets and ROA.

Table 3.4 Panel regression matrix for ROE and CG Variables

Correlated Random Effects - Hausman Test  
Equation: Untitled  
Test period random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Period random	2.498237	9	0.9809

Sample: 1 960 Periods included: 10  
Cross-sections included: 96  
Total panel (balanced) observations: 960

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.089131	0.128633	-0.692913	0.4886
BD	-0.339287	0.153318	-2.212962	0.0272
CCEO	-0.307419	0.154507	-1.989684	0.0469
BBAP	-0.329314	0.155348	-2.119845	0.0343
DRD	-0.341515	0.153600	-2.223404	0.0265
SH	-0.364469	0.153632	-2.372348	0.0179
AA	-0.310257	0.153886	-2.016148	0.0441
IIOI	-0.317963	0.153245	-2.074871	0.0383
DSR	-0.331010	0.153047	-2.162795	0.0308
OI	0.329279	0.153072	2.151139	0.0317
AGE	0.005857	0.002943	1.989956	0.0469
SALES_GROWTH_CHANG				
E	-0.002044	0.007486	-0.273057	0.7849
LEVERAGE	-0.002005	0.000167	0.093655	0.9254
TOTAL_ASSET_CHANGE	-0.000558	0.007853	-0.071016	0.9434



Effects Specification

Cross-section fixed (dummy variables)

R-squared	0.734235	Mean dependent var	0.168417
Adjusted R-squared	0.700507	S.D. dependent var	0.329194
S.E. of regression	0.180155	Akaike info criterion	-0.483440
Sum squared resid	27.61981	Schwarz criterion	0.069160
Log likelihood	341.0510	Hannan-Quinn criter.	-0.272997
F-statistic	21.76921	Durbin-Watson stat	1.493828
Prob(F-statistic)	0.000000		

Source: Survey Data

The probability value of Hausman test is 0.9809 which means that result is not significant. The null hypothesis is not rejected. Based on the result of Hausman test random effect regression is appropriate. The Table 3.4 shows the panel regression analysis model summary and the overall fit statistics for the ROE. The researcher found that the adjusted R<sup>2</sup> of the model is .700 with the R<sup>2</sup>= .734. This model shows that panel regression explains 73 percent variation in the data. The Durbin- Watson d= 1.493, which is a value closer to the value of 1.5. Therefore, it can be assumed that there is no first order linear auto-correlation in the panel regression data. The next output variable is the F-test. The linear regression's F- test has the null hypothesis that the model explains zero variance in the dependent variable (in other words R<sup>2</sup>= 0). The F- test is significant, thus, it can be assumed that the model explains a significant amount of the variance in ROE rate. The variable of OGS has a positive coefficient on ROE variable. Further, variables of BD, CCEO, BBAP, DRD, SH, AA, IIOI and DSR have shown a significant negative coefficient with ROE. The control variable of Age has a significant positive coefficient on the ROE variable. Further, results show that there is no significant probability relationship exit among the control variables of sales growth, leverage and TAs on ROE.

Table 3.5 Panel Regression matrix for Tobin’s Q and CG Variables

Dependent Variable: Tobin’s Q  
 Method: Panel Least Squares  
 Sample: 1 960  
 Periods included: 10  
 Cross-sections included: 96  
 Total panel (balanced) observations: 960

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	3.298367	8.292556	0.397750	0.6909
BD	3.308609	9.883940	0.334746	0.7379
CCEO	2.219710	9.960575	0.222850	0.8237

BBAP	4.162517	10.01481	0.415636	0.6778
DRD	3.507305	9.902129	0.354197	0.7233
SH	4.285575	9.904205	0.432703	0.6653
AA	2.604124	9.920565	0.262498	0.7930
IIOI	3.614634	9.879220	0.365882	0.7145
DSR	2.903898	9.866487	0.294319	0.7686
OI	-3.250319	9.868088	-0.329377	0.7420
AGE	-0.037425	0.189758	-0.197224	0.8437
SALES_GROWTH_CHA				
NGE	0.026347	0.482584	0.054596	0.9565
TOTAL_ASSET_CHANG				
E	-0.262539	0.506287	-0.518557	0.6042
LEVERAGE	-0.001020	0.010763	-0.094775	0.9245

Effects Specification

Cross-section fixed (dummy variables)

R-squared	0.646656	Mean dependent var	3.156573
Adjusted R-squared	0.601813	S.D. dependent var	18.40514
S.E. of regression	11.61402	Akaike info criterion	7.848866
Sum squared resid	114787.6	Schwarz criterion	8.401466
Log likelihood	-3658.456	Hannan-Quinn criter.	8.059308
F-statistic	14.42053	Durbin-Watson stat	1.061894
Prob(F-statistic)	0.000000		

Correlated Random Effects - Hausman Test

Equation: Untitled

Test period random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Period random	4.085339	9	0.9057

Source: Survey Data

The probability value of Hausman test is 0.9057 which means that result is not significant. The null hypothesis is not rejected. The statement of null hypothesis of Hausman test is that the random effect regression is appropriate. Based on the result of Hausman test random effect regression is appropriate. The Table 3.5 shows the panel regression analysis model summary and overall fit statistics for Tobin's Q. The researcher found that the adjusted R<sup>2</sup> of the model is .601 with the R<sup>2</sup>= .646. This model shows that linear regression explains 65 percent variation in the data. The next output variable is the F-test. The F- test is significant, thus, can be assumed that the model explains a significant amount of the variance in Tobin's Q rate. The variables of BD,

CCEO, BBAP, DRD, SH, AA, IIOI, DSR and OI scores and all the control variables have not systematically related with Tobin's Q variable.

Table 3.6 Panel Regression matrix for MBR and CG Variables

Dependent Variable: MBR  
 Method: Panel Least Squares  
 Sample: 1 960  
 Periods included: 10  
 Cross-sections included: 96  
 Total panel (balanced) observations: 960

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	9.734397	4.299757	2.263941	0.0238
BD	-3.332114	5.124902	-0.650181	0.5158
CCEO	-2.766349	5.164638	-0.535633	0.5924
BBAP	-3.164203	5.192760	-0.609349	0.5425
DRD	-2.284588	5.134334	-0.444963	0.6565
SH	-3.125905	5.135410	-0.608696	0.5429
AA	-3.638665	5.143893	-0.707376	0.4795
IIOI	-3.062351	5.122455	-0.597829	0.5501
DSR	-2.590483	5.115853	-0.506364	0.6127
OI	3.180746	5.116683	0.621642	0.5343
AGE	-0.242907	0.098391	-2.468795	0.0138
SALES_GROWTH_CH				
ANGE	0.205546	0.250224	0.821450	0.4116
TOTAL_ASSET_CHA				
NGE	0.193349	0.262514	0.736527	0.4616
LEVERAGE	0.002312	0.005581	0.414365	0.6787

Effects Specification

Cross-section fixed (dummy variables)

R-squared	0.389131	Mean dependent var	2.019105
Adjusted R-squared	0.311606	S.D. dependent var	7.258044
S.E. of regression	6.021965	Akaike info criterion	6.535266
Sum squared resid	30860.71	Schwarz criterion	7.087866
Log likelihood	-3027.928	Hannan-Quinn criter.	6.745709
F-statistic	5.019417	Durbin-Watson stat	2.059963
Prob(F-statistic)	0.000000		

Correlated Random Effects - Hausman Test

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Period random	11.365675	9	0.2515

Source: Survey Data

The probability value of Hausman test is 0.2515 which means that result is not significant. The null hypothesis is not rejected. Based on the result of Hausman test random effect regression is appropriate. The Table 3.6 shows the panel regression analysis model summary and the overall fit statistics for MBR. Researcher found that the adjusted  $R^2$  of the model is .311 with the  $R^2 = .389$ . This model shows that panel regression explains 39 percent variation in the data. The Durbin- Watson  $d = 2.059$ , which is between the two critical values of  $1.5 < d < 2.5$ . Therefore, it can be assumed that there is no first order linear auto-correlation in the panel regression analysis data. The next output variable is the F-test. The F- test is significant, thus, it can be assumed that the model does explain a significant amount of the variance in MBR rate. The variable of AA scores and control variable age scores have a significant negative coefficient on the MBR variable. Further, the control variables of sales growth change and TAs change have positive coefficient on MBR variable.

*3.1.4. Testing Hypotheses*

This section is designed for testing the constructed hypotheses on the variables of conceptual framework which is shown in the section 1.4. Table 3.7 shows the developed hypotheses and testing results of the hypotheses.

Table 3.7: Testing of Hypotheses

Hypothesis	Sub Hypothesis	Results
H1	H <sub>01a</sub> : H <sub>a1a</sub> :	Alternative hypothesis is not supported ROA (P= .579) Alternative hypothesis supported ROE (P= .027)
	H <sub>01b</sub> : H <sub>a1b</sub> :	Alternative hypothesis is not supported Tobin's Q & MBR (p=.690, .515)
H2	H <sub>02a</sub> : H <sub>a2a</sub> :	Alternative hypothesis is not supported ROA (P= .518) Alternative hypothesis supported ROE (P= .046)
	H <sub>02b</sub> : H <sub>a2b</sub> :	Alternative hypothesis is not supported Tobin's Q & MBR (p=.823, .592)
H3	H <sub>03a</sub> : H <sub>a3a</sub> :	Alternative hypothesis is not supported ROA (P= .651) Alternative hypothesis supported ROE (P= .034)
	H <sub>03b</sub> : H <sub>a3b</sub> :	Alternative hypothesis is not supported Tobin's Q & MBR (p=.677, .542)
H4	H <sub>04a</sub> : H <sub>a4a</sub> :	Alternative hypothesis is not supported ROA (P= .501) Alternative hypothesis supported ROE (P= .026)
	H <sub>04b</sub> : H <sub>a4b</sub> :	Alternative hypothesis is not supported Tobin's Q & MBR (p=.723, .656)
H5	H <sub>05a</sub> : H <sub>a5a</sub> :	Alternative hypothesis is not supported ROA (P= .533) Alternative hypothesis supported ROE (P= .017)
	H <sub>05b</sub> : H <sub>a5b</sub> :	Alternative hypothesis is not supported Tobin's Q & MBR (p=.665, .542)
H6	H <sub>06a</sub> : H <sub>a6a</sub> :	Alternative hypothesis is not supported ROA (P= .541) Alternative hypothesis supported ROE (P= .044)
	H <sub>06b</sub> : H <sub>a6b</sub> :	Alternative hypothesis is not supported Tobin's Q & MBR (p=.793, .479)
H7	H <sub>07a</sub> : H <sub>a7a</sub> :	Alternative hypothesis is not supported ROA (P= .576) Alternative hypothesis supported ROE (P= .038)
	H <sub>07b</sub> : H <sub>a7b</sub> :	Alternative hypothesis is not supported Tobin's Q & MBR (p=.714, .550)
H8	H <sub>08a</sub> : H <sub>a8a</sub> :	Alternative hypothesis is not supported ROA (P= .595) Alternative hypothesis supported ROE (P= .030)
	H <sub>08b</sub> : H <sub>a8b</sub> :	Alternative hypothesis is not supported Tobin's Q & MBR (p=.768, .612)
H9	H <sub>09a</sub> : H <sub>a9a</sub> :	Alternative hypothesis is not supported ROA (P= .555) Alternative hypothesis supported ROE (P= .031)
	H <sub>09b</sub> : H <sub>a9b</sub> :	Alternative hypothesis is not supported Tobin's Q & MBR (p=.742, .534)

Source: Survey Data



#### **4. Discussion**

The findings show that, the majority of the companies have a separate chairman and CEO, ensuring a clear division of responsibilities at the head of the company. Non- appointment of SIDs at the non-duality of chairman is a lack of compliance with CG practice. Cadbury Committee (1992), Report on the Financial Aspects of CG has recommended that chairman's role should be separated from that of CEO. This recommendation has been empirically evidenced by a few researchers that firms are more effective with the duality of these two positions (Yermack, 1996; Brow et al., 2004). Rechner and Dalton (1991) examined that firms with separate leadership structures outperformed joint structures when measured on ROE, ROI and profit margins.

Laing and Weir (1999) mentioned that companies that have combined leadership may have an individual who has too much power and is able to make decisions that do not maximize SH wealth. Abdullah (2004) stated that the reason for separation of the top two positions of the board is that when both the monitoring and implementation roles are vested in a single person (combined leadership) the monitoring role will be severely impaired. Contrary to this finding a few researchers have argued that the FP improved by combining these two roles rather than separating them (Donaldson & Davis, 1991; Coles, McWilliams & Sen, 2001). Abdullah (2004) has counter argued that when one person is in charge of both tasks, favorable decisions are reached faster provided that person is well aware of the decisions needed to improve the performance of the firm.

Evidencing mixed result on board leadership structure and company performances Dalton et al. (1998) noted that there is no relationship between leadership structure and financial performance. Braun and Sharma (2007) study conducted on 'Should the CEO Also Be Chair of the Board? An Empirical Examination of Family-Controlled Public Firms' and their findings explained that duality by itself does not influence firm performance and relationship between duality and performance is contingent on the family's ownership stake in the firm. In non-dual firms, performance is inversely related to the family ownership level. Researchers further state that dual FCPF's do not exhibit any changes in performance depending on family ownership levels, and when family ownership is low; the separation of CEO and board chair roles is beneficial in terms of shareholder returns.

The size of the BODs of sample companies ranged from five to sixteen members. Findings show that sixteen of the selected companies have seven board members while fifteen of the two groups of companies each have nine board members and eleven board members respectively. The overwhelming tendency is for the boards to have six to twelve members (87.5 percent). The finding that majority of boards consists of six to twelve members could have positive implications for adherence to best CG practices. Furthermore, this tendency could improve the board efficiency as well as the firm's performance. This finding is supported by Chugh, Meader and Kumar (n.d) and they found that 'a Governance structure incorporating largest board size creates better opportunities and more resources, thus enhancing the Financing Performance. Kathuria and Dash (1999) support the above to find that FPs increase if the board size increased

but the contribution of an additional board member decreases as the size of the board increases. Anderson et al. (2004) finding of their study revealed that the cost of debt is lower for larger boards because creditors view these firms as having more effective monitors of their financial accounting process. Linck et al. (2008) claimed evidence that smaller boards are not necessarily better than larger boards. Siriwardhana (2008) denoted that there is a positive relationship between board size and FP and further researcher evidences that when the board size and FP increased similarly the contribution of an additional director is also diminished. Lokuwaduge and Armstrong (2014) found that no significant relationship exist between the board size and the FP of the universities and the finding rejected the arguments of high monitoring costs of larger board size that negatively relates with organizational performance. The results further did not agree with the argument of Yermack (1996) that larger boards provide a better knowledge base and networking which positively influence the performance.

The maximum number of IDs observed in the study firms is nine. The majority of the companies have at least two IDs on the board. The highest representation of NEDs is notable in Sri Lankan Companies. In addition, 20 percent of firms have less than 30 percent of IDs on their boards. Principle A.5.1 discloses, that in the event the chairman and CEO is the same person, NEDs should comprise the majority of the board. Although the majority of companies have more than 60 percent of NEDs on their boards, 43 percent of companies have less than 40 percent of IDs on their boards. This evidence signifies that half of the companies maintain a low level of independence on their boards. However, most of the companies comply with the requirements for NEDs. Baysinger and Butler (1985) claimed that companies perform better if boards include more outsider directors on the board and had a greater ROE than the inside directors. Zahra and Pearce (1989) supported above to find that an effective board comprised of a greater proportion of outside directors is significant to FP. Rosensten and Wyatt (1990) denoted that 'a clearly identifiable announcement of the appointment of an outside director led to an increase in SH wealth'. Ezzamel and Watson (1993) found a positive association between outside directors and profitability of UK Firms. Dalton et al. (1998) declared that according to agency theory, the outside NEDs are able to provide superior performance as a result of their independence from firm management. Dare (1998) further supported the findings that NEDs are effectively monitored when firm's strategy related questions are asked. They are able to provide independent judgment when dealing with the EDs in areas such as pay awards, EDs' appointments and dismissals. In the extant literature, some researchers have offered a counterargument against the above findings.

Chaganti et al. (1985) found that there was no difference in the proportion of NEDs on the boards of failed and non-failed firms. More researchers have empirically found that there is no relationship between board composition and FP (Abdullah, 2004; Daily & Dalton, 1992, 1993a; Kesner, Victor & Lamont, 1986). Kesner (1987) found a positive and significant relationship between the proportion of inside directors and returns to investment with the consistent of the stewardship theory. Some researchers view is, the dominance of outsider directors' performances determine on the method of measures of performance that have been applied in academic

research. Agrawal and Knoeber (1996) and Coles, McWilliams and Sen (2001) found a negative impact of greater representation of outside directors on FP.

Yermack (1996) and Bhagat and Black (1999) demonstrated a negative relationship between the proportion of outside directors and corporate performance. Laing and Weir (1999) found that there is no relationship between the proportion of NEDs and corporate performance. The basic reasons that can be attributed to that are part-time employment on NEDs, lack of highly technical issues and not getting sufficient information while taking key decisions. Bino and Tomar (2012) revealed that board composition has a strong impact on bank performances. Lokuwaduge and Armstrong (2014) found that board composition has a highly significant negative relationship with FP.

The study findings show that in the overall sample, there is a negative relationship ( $p=.977$ ) between the OGS and ROA. This indicates that the level of compliance does not improve the ROA. In the case of ROE, there is a negative relationship ( $p=.445$ ) between the level of compliance of CG and ROE. It means the level of compliance does not improve the ROE. The study findings are supported by some of the researchers who have pointed out the negative relationship between corporate governance and firms' performance (Bathala & Rao, 1995; Hutchinson, 2002). Adjaoud et al. (2007) study results have discovered a negative relationship between accounting-based measures of performance such as ROI, ROE and CG. Guo and Kumara (2012) study carried out on 'Corporate governance and firm performance of listed firms in Sri Lanka' and study results found that the relationship between board size and ROA has shown marginal negative value. However, the researchers predict that the regression run model value for ROA on considered independent variables cannot be relied upon as a good way of explaining the impact because of the low explanatory power of the model. Further, study findings denoted that there is no relationship ( $p=.282$ ) between the overall governance scores and Tobin's Q. Khatab et al. (2011) study conducted on the corporate governance and firm performance of twenty firms listed on Karachi Stock Exchange and performance of corporate governance has been analyzed using Tobin's Q and results have shown that firms of the emerging markets are not so healthy and they did not create value for shareholders.

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