

# Institutional Adoption of Principle-Based Corporate Governance Practices: Study on the Listed Food, Beverage and Tobacco Industry in Sri Lanka

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## Abstract

Corporate scandals and failures in the past primarily demanded the necessity for a regulated corporate governance structure. To mitigate such scandals and to safeguard investors, the Institute of Chartered Accountants of Sri Lanka (ICASL), together with the Central Bank of Sri Lanka (CBSL) and the Colombo Stock Exchange (CSE), have declared a Code of Best Practice of Corporate Governance (CBCG) which includes several reforms. This study investigates the impact of principle-based corporate governance practices on firm performance. The sample consists of 46 listed companies classified under the Food, Beverage and Tobacco sector in the CSE from 2015 to 2019. The performance is measured by Return on Assets (ROA), Return on Equity (ROE) and Tobin's Q. The level of compliance is measured using an index based on board meetings, board composition, board committees, board size and CEO duality. Insider ownership, block-holding, firm maturity, directors' proportion, firm size, board size and board diversity were used as control variables. Diagnostic tests, descriptive statistical analysis, Spearman's rank correlation and fixed effect panel regression were used to analyze the data. The results revealed that compliance with the CBCG has a significant negative relation with ROA and ROE and positive relation with Tobin's Q. Further, other corporate governance practices such as insider ownership, board size and audit committee correlate significantly with firm performance. This investigation sets a framework for companies to identify the corporate governance variables of practical interest.

**Keywords:** *corporate governance, firm performance, panel data regression analysis*

## **1. Introduction**

Significant corporate failures in the twenty-first century highlighted the importance of good Corporate Governance (CG) practices. It is a system that utilizes the corporate power for the goodness of the community while ensuring fair and equal distribution of wealth among the shareholders. Corporate governance primarily emphasizes the transparency of the operations (Monks, 2007). Prior research revealed that poor CG may result in an adverse impact on the financial performance of the companies (Azim, 2012; Bauwhede, 2009; Klein et al., 2005; Love, 2011; Shleifer & Vishny, 1997). This is due to the poor CG practices, which create the opportunity to misuse the organizational resources for their own benefit by the management, major shareholders etc. (Jensen & Meckling, 1976). This conflict of interest demands the good CG to safeguard the investors and other interested stakeholders while minimizing the possible risk of scandals. This study is based on the reforms of 2017, and hence this would be a novel synthesis of existing knowledge with the latest reforms in the field. This investigation sets a framework for companies to identify the corporate governance variables of practical interest which drive the corporate performance.

The major limitation of this study is the dependency upon the secondary data because the primary data could not be collected via open interviews due to the Covid-19 pandemic. Future research can focus on the heterogeneity among various sectors and capture the period of study under varying policy changes and economic conditions.

Corporate governance practices can be studied from several aspects. This is not limited to the board characteristics, including audit committee and remuneration committee independence (Mapitiya, 2015). Therefore, this study extends the knowledge by counting several aspects of corporate governance such as board diversity, block-holding and insider ownership. This study examines the level of compliance with the principle-based CG practices by the listed firms in the Food Beverage and Tobacco (FB&T) sector in Sri Lanka and then assesses the relation between effective CG practices compliance and financial performance.

## **2. Methodology**

The population of the study is all listed firms in the CSE, and the sample was drawn from the population, based on best representation to generalize the results of the study i.e., the Food, Beverage, and Tobacco sector. This study employs the secondary data collected from the CSE website and the Lanka Monthly Digest (LMD 50), and company-specific websites and publications. The years of study are from the 2014/15 to the 2018/19. The CG data such as board size, board committees, CEO duality, and board composition are considered as measures of level of compliance.

Its effect on performance is measured using Return on Assets (ROA), Return on Equity (ROE) and Tobin's Q. The study uses eight control variables, namely, block-holding, insider ownership, board size, non-executive/independent directors, board diversity, audit committee and firm size. The study adopts a panel data model, notably the fixed-effects model, with control variables and time effects. Fixed effects model was selected given the Hausman test results. The regression model of the study is shown in equation (1).

$$FP_{it} = \beta_1 CGI + \beta_2 IOWN + \beta_3 BLHD + \beta_4 BSZ2 + \beta_5 NED + \beta_6 BDIVE + \beta_7 LnTA + \beta_8 FMMA + \beta_9 ACOM + \pi_i + Y_t + \varepsilon_{it} \text{ ----- (1)}$$

Where FP is a vector of firm performance variables, namely ROA, ROE and Tobin's Q. CGI is CG index. IOWN is insider ownership. BLHD is block-holding. BSZ2 is board size. NED is non-executive/independent directors. BDIVE is board diversity. LnTA is natural log of total assets which measures firm size. FMMA is firm maturity. ACOM is audit committee.  $\pi_i$  denotes individual firm-specific effects,  $Y_t$  are the dummy variables representing the time effect,  $\varepsilon_{it}$  is the error term,  $i$  are cross-sectional units and  $t$  denotes the time.

### **3. Findings and Discussion**

The results revealed that the CG index has a statistically significant negative relation with ROE at 90 percent confidence level. Compared to the correlation coefficient of ROA and CGI, it is a much lower value as ROA has a statistically significant negative relation with CGI ( $p < .05$ ). There is also a statistically significant positive relation between CGI and Tobin's Q which is a measure of the firm's value ( $p < .10$ ). This implies that the level of compliance does not positively impact the firm performance but can positively impact the firm's value.

The level of CG compliance as an index was measured using board meetings, board composition, board committees, board size and CEO duality. It is evident that, as indicated by CGI, listed FB&T firms adhere to more than 50 percent of the major corporate governance practices discussed in this study (M = 3, Min = 1, Max = 5). Companies are moving towards adopting the good governance mechanisms stipulated in the code issued in 2013 by the ICASL and Securities and Exchange Commission of Sri Lanka (SEC).

When determining the strength of the relation between effective CG practices compliance and financial performance of the listed FB&T companies, the study uses several CG practices and examined the impact of these governance practices towards firm performance. According to the observations, the proportion

of shares held by the board of directors, including the chairman, was around 4 percent. In contrast, a study conducted by a sample of 100 listed firms covering all the sectors showed that this proportion was around 26 percent (Andradi et al., 2012). Therefore, FB&T sector has lower insider ownership allowing more external shareholder proportion. Insider ownership shows a statistically negative coefficient with ROA and ROE and a positive relation with Tobin’s Q.

In the FB&T sector, the insider ownership proportion is low and negatively related to performance. However, it is positively related to firm’s potential value, which will be more critical than short-term performance measures. Despite the block-holding proportion, the percentage of shares held by the 20 largest shareholders is 93 percent, and there is a lower possibility of minority issues as insiders themselves represent only 4 percent. Block-holding is negatively correlated with ROA, but it is positively correlated with ROE in which the block-holders can affect the equity than the firm’s assets. Again, it is negatively related with value creation, and a positive relation is better to eliminate the majority- minority issues (Reddy & Sharma, 2014). The block-holding coefficients are insignificant with ROA, ROE and Tobin’s Q at 95 percent confidence..

**Table 1: Regression Model Summary (Fixed Effects Model)**

Variable	ROE		ROA		Tobin’s Q	
	Coefficient	Prob.	Coefficient	Prob.	Coefficient	Prob.
C	34.221	.865	-10.240	.842	1290.765	.000
CG INDEX	-10.880	.095	-1.088	.012	1.349	.051
IOWN	-98.337	.078	-15.419	.044	26.809	.062
BLHD	0.012	.892	-0.008	.721	-0.008	.086
BSZ2	4.456	.043	0.851	.083	0.291	.657
NED	-62.720	.063	-3.403	.847	-4.875	.681
BDIVE	55.368	.532	8.521	.707	-2.840	.852
ACOM	70.691	.003	19.112	.001	2.195	.591
FMMA	-2.568	.381	0.300	.089	3.067	.000
LnTA	0.475	.956	-0.198	.929	-61.678	.000

This study also proved that board size is positively related to ROA, ROE and Tobin’s Q ( $p < .05$ ). However, the CBCG issued in 2013 by the ICASL specifies that the board should consist of a minimum of two directors. This condition has been satisfied by the listed FB&T sector firms (Min = 2, Max = 12). Furthermore, board size may adversely affect the companies trying to have a larger board without

considering the effectiveness (Reddy & Sharma, 2014).

Non-Executive/independent director proportion that measures the board independence may also enhance the firm performance (Andradi et al., 2012). However, in this study, board independence depicted a statistically significant negative relation with ROE, and the relation is insignificant with ROA and Tobin's Q (Table 1). This would indicate that the firms have not achieved the boards' optimum independence under FB&T sector. Board diversity of the sector epitomized by the female participation is not at a satisfactory level as the proportion of females in the board is at 6 percent. However, board diversity was not statistically significant with the measures of the firm performance.

An audit committee was available in 93 percent of the firms in the FB&T sector. Furthermore, firm maturity also impacts firm value measured using Tobin's Q. Assets of the firm representing the firm size in this study are negatively correlated with Tobin's Q.

Effective governance mechanisms can be identified as a strength of the organization as they can impact the risk reduction of the investments while safeguarding the investors, ultimately enhancing the firm's long-term value and performance (Rezaee, 2009). In some countries such as Saudi Arabia, it is necessary to adopt CG practices for effective financial, operational and market performance. In Sri Lanka, it is the discretion of the firm to adopt CG code as it is principle-based. However, the mandatory adherence to CG code is built into listing rules, thus directly applicable for listed companies. Firms have identified the importance of adopting the code requirements for the sake of the benefits (Manawaduge, 2012). However, some of the governance practices had negatively impacted firm performance, indicating practical issues in adopting certain practices. As a result, such practices should be revisited and necessary amendments be made to the code itself.

#### **4. Conclusion**

CG is a mechanism of governing or the controlling body of any organization to ensure that all the stakeholders' interests are secured. The agency problem, which demanded a CG framework, can minimize CG practices via effective adaptation of CG practices. The findings suggest that better corporate governance practices may lead to higher performance, and some practices have not been adequately adopted by the FB&T firms in Sri Lanka. Hence, the policymakers and regulatory bodies in the country such as the SEC, ICASL and CBSL can consider the findings of this study to bring further reforms into CG code to enhance firm performance while ensuring good governance and stakeholder interests at large.

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