

Do Firms With Better Corporate Governance Yield Higher Stock Returns? Evidence From Firms Listed in the Colombo Stock Exchange

WANNIARACHCHIGE, M.K.

*Faculty of Management and Finance, University of Ruhuna
manjula@mgt.ruh.ac.lk*

DE SILVA, L.D.¹

*Faculty of Management and Finance, University of Ruhuna
dinukee@gmail.com*

Abstract

Corporate governance received enormous attention from researchers and policymakers following a series of corporate scandals. Nonetheless, the effectiveness of prevailing governance best practices in achieving intended objectives remains a puzzle. Therefore, this study assesses the association between corporate governance and stock returns using data for the five years from 2016 to 2020 from a sample of 100 firms listed in the Colombo Stock Exchange. Four corporate governance sub-indices were formulated to measure the level of corporate governance compliance by classifying 18 board-related best practices into four sub-indices where each best practice was given the same weight. Capital gain, dividend, and total return were used as proxies for stock return. The nine random-effects panel regression models used in this study to analyze the data did not show adequate evidence to claim a positive association between stock returns and corporate governance compliance. Only the basic board-related best practices showed a weak positive impact on stock returns. The main reason behind this finding could be the concentrated and family ownership structure prevailing in a large number of smaller firms in Sri Lanka. More precisely, the Sri Lankan firms have maintained satisfactory levels of stock returns even when they do not comply with the corporate governance best practices. These indications highlight the necessity of formulating contextually relevant best practices instead of encouraging firms to comply with irrelevant practices. More precisely, what constitutes best practices of corporate governance need to be defined more contextually than globally. Moreover, future research can focus on the formulation of a contextually relevant corporate governance compliance index.

Keywords: *agency theory, corporate governance, stock return, Sri Lanka*

1 Corresponding Author

1. Introduction

A positive association between corporate governance and firm performance is well-established in the literature. If this positive association is material and fully integrated into the stock market, any favorable change in corporate governance compliance of a firm should be reflected in a favorable change in share prices (Gompers, Ishii, & Metrick, 2003). Moreover, as per popular belief, firms with better corporate governance should perform better. Therefore, in general, firms with better corporate governance should be associated with higher stock returns.

Some studies have suggested that better corporate governance enhance stock returns (Black, 2001; Gompers et al., 2003), while others deny the existence of such effect (Bhagat & Black, 2001; Hermalin & Weisbach, 2003). Conflicting empirical evidence raises concerns about the effectiveness of prevailing best practices. According to Bhagat and Black (2001) and Hermalin and Weisbach (2003), existing codes of best practices on corporate governance have been formulated mainly based on the claims made in agency theory concerning organizations with dispersed ownership such as the ones observed in more developed capital markets.

Nevertheless, most of the listed firms in emerging markets such as Sri Lanka are characterized by concentrated or family ownership (Manawaduge, 2012). However, legal protection for minority shareholders is limited in such markets, given the weak rules and regulations and poor institutional and organizational quality. Hence, there is more room for principal-principal conflicts (i.e., between larger and smaller shareholders) than the conventional agency conflict between owners and managers. Therefore, such conflicts in empirical evidence are inevitable (Black, 2001). These contextual settings make emerging markets such as Sri Lanka unique contexts for corporate governance studies. However, only a handful of studies in Sri Lanka have examined the effect of corporate governance on stock returns. Hence, this study assesses the impact of corporate governance on stock returns using a more recent panel dataset on 100 firms listed in the Colombo Stock Exchange (CSE) using four sub-indices to measure corporate governance.

2. Literature Review

Modern organizations are like republics; the shareholders with ultimate authority elect agents to manage the firm on their behalf (Gompers et al., 2003). Nevertheless, this separation of control and ownership, given the self-interested nature of agents, creates a potential conflict of interest between shareholders and managers, which is well-known as the agency conflict (Jensen & Meckling, 1976). The absence of adequate monitoring mechanisms and incentives encourages managers to abuse the shareholders' funds to satisfy their own interest at the expense of the firm's wellbeing (Anderson & Reeb, 2004; Shleifer & Vishny, 1997). In addition to this

agency conflict, a conflict of interest between family and external shareholders or between minority and controlling shareholders can emerge in firms with concentrated or family ownership, creating a potential risk of expropriating weaker shareholders by influential shareholders (Shleifer & Vishny, 1997). The resulting agency costs generally lead to poor firm performance. Hence, corporate governance has emerged as a mechanism to control the opportunistic behaviors of managers and ensure accountability towards all the investors (Azeez, 2015).

According to Gompers et al. (2003), the actual power-sharing relation between managers and shareholders depends on the specific governance rules and distribution of property rights. Fremond and Capaul (2002) state that property rights of shareholders need to be well established through corporate governance regulations in order for a company to function efficiently. Accordingly, better corporate governance practices enhance access to outside capital, reduce the cost of capital and susceptibility to crises, and reduce the corruption and looting of firm resources by the management. In contrast, proponents of stewardship theory claim that managers are not necessarily opportunistic but are motivated to manage the firm in the best interest of shareholders owing to intrinsic rewards (Donaldson & Davis, 1991). Further, some studies show that firms with concentrated or family ownership experience lower agency costs due to lowered information asymmetry (Jiang & Peng, 2011). Hence, the owner-managers in these firms are intrinsically motivated to act in the firm's best interest because of their aligned interests (Anderson & Reeb, 2004).

Nevertheless, the effect of corporate governance on firm performance should be reflected in stock returns: dividends and capital gain. Two contrasting theories, namely outcome theory and substitution theory of dividend, explain the association between corporate governance and dividend. Proponents of the outcome hypothesis claim that the quality of corporate governance positively affects dividend payments as shareholder rights are solid, and in turn, they can pressure the management to pay higher dividends while preventing the misuse of free cash flows for their own benefits (Jensen & Meckling, 1976; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998). In contrast, the substitution hypothesis recognizes corporate governance as a substitute for dividends (Suhadak, Kurniaty, Handayani, & Rahayu, 2019) because higher investor protection reduces investor risk perceptions. Hence firms with sound corporate governance practices tend to pay low dividends (Chae, Kim, & Lee, 2009).

This literature review shows that neither the theoretical association between corporate governance and stock returns nor the empirical evidence are consistent. Some studies support the agency theory, while others support the stewardship theory. For example, some studies have found a positive association between

corporate governance and stock returns (Black, 2001; Gompers et al., 2003). Some studies have reported a negative impact (Kurniati, 2019), while others found no significant association between corporate governance and stock returns (Fernando & Dissabandara, 2018). Therefore, examining whether compliance with corporate governance best practices affects a firms' stock returns is necessary.

3. Methodology

This study examines the association between corporate governance and stock returns using data for five years from 2016 to 2020. A sample of 100 firms was selected out of 282 firms listed in the Colombo Stock Exchange as of 31st March 2021 using the systematic random sampling technique. Corporate governance compliance was measured using four sub-indices formulated considering 18 board-related best practices of the 2017 Sri Lanka Code of Best Practice on Corporate Governance. These best practices were organized into four corporate governance sub-indices, namely: Basic Board (BB), Remuneration Committee (RC), Audit Committee (AC), and Nomination Committee (NC).² If a firm complies with a particular best practice, a value of one was assigned, or else a value of zero was assigned. The value of each sub-index was determined by taking the sum of the best practices falling under the relevant sub-index where each best practice received the same weight. Stock returns represent three measures: capital gains (CGain), dividends (Div) and total stock returns (TSR). Firm size (SIZE) measured using the natural logarithm of total assets, and leverage (LEV) measured as debt-to-assets ratio were used as control variables (Azeez, 2015).

$$SR_{it} = \alpha + \beta_1 BB_{it} + \beta_2 RC_{it} + \beta_3 AC_{it} + \beta_4 NC_{it} + \beta_5 SIZE_{it} + \beta_6 LEV_{it} + \lambda_t + \mu_{it} \text{ --- (1)}$$

Based on the Hausman test, data were analyzed using a random-effects panel regression model specified in equation (1). In the equation, SR denotes a vector of stock return variables, where three separate models were fitted, each taking one of the stock return variables: CGain, Div and TSR. Further, since the data indicated serial correlation and heteroscedasticity, the same random-effects models were fitted using robust standard errors and bootstrapping. Therefore, altogether nine models were estimated. Since time fixed-effects were present, a vector of year dummies, denoted by λ , were also added to each model to account for time-variant characteristics. Error term and constant are indicated respectively by μ and α .

² BB - CEO chair duality, at least 33 percent of the board is NEDs, at least 66 percent are INEDs, board met at least once every quarter; RC - Presence of RC, chairman is an INED, entirely consists of NEDs, comprised minimum of three NEDs, majority is INEDs; AC - Presence of AC, chairman is an INED, entirely consist of NEDs, comprised minimum of three NEDs, majority is INEDs; NC - Presence of NC, chairman is an INED, majority are NEDs, at least 33 percent is INEDs.

4. Findings and Discussion

The Hausman test indicates the suitability of the random-effects model over the fixed-effects model ($\chi^2(10) = 1.400, p = .999$). The presence of the first-order autocorrelation was evidenced from the Wooldridge test for autocorrelation ($F(1,98) = 14.790, p < .001$) and the presence of group-wise heteroskedasticity was evidenced from Modified Wald test ($\chi^2(99) = 9.7e+06, p < .001$). Therefore, in addition to the model with default standard errors, the regression model for each of the three stock return measures was estimated using robust standard errors and bootstrapping. This approach yielded nine regression models. As shown in Table 1, out of the nine models, eight models were statistically significant except for the model-5 fitted using robust standard errors with *Div* as the dependent variable.

The first three models with *CGain* as the dependent variables indicated a statistically significant positive association (either at 5 or 10 percent significant levels) between basic board index and capital gains. None of the other corporate governance sub-indices showed a statistically significant association with capital gains. Moreover, none of the models showed evidence to claim any association between corporate governance sub-indices and dividends. Two models with *TSR* as the dependent variable indicated a statistically significant positive association (at 5 percent significant level) between basic board-related best practices and total stock returns. Since *BB* was not associated with dividend, this positive association with *TSR* probably represents the positive association between *BB* and *CGain*. The presence of time-variant factors having a substantial influence on the stock returns was evidenced in all models except dividend models. These time effects can be an indication of the highly volatile economic and political environment in Sri Lanka. Further, firm size did not show any association with stock returns in any of the models.

In summary, therefore, sufficient evidence is not available in this study to claim that better corporate governance leads to higher stock returns as generally expected in the corporate governance literature based on agency theory. This disassociation can be due to the lack of awareness about the benefits of corporate governance among Sri Lankan investors. Investors in Sri Lanka are generally attracted to firms with well-established asset bases without considering governance quality and easily influenced by large investors (Fernando & Dissabandara, 2018). Even though the findings contradict the predictions based on the agency theory, they are consistent with the findings of Black, Jang, and Kim (2006), Fernando and Dissabandara (2018), and Malik (2012).

Table 1: Random Effects Panel Regression Results

Variable	(Model) and Dependent Variable								
	(1) CGain	(2) CGain	(3) CGain	(4) Div	(5) Div	(6) Div	(7) TSR	(8) TSR	(9) TSR
BB	0.026**	0.026*	0.026**	-0.684	-0.684	-0.684	0.031**	0.031**	0.031
RC	0.006	0.006	0.006	-1.686*	-1.686	-1.686	0.015	0.015	0.015
AC	0.007	0.007	0.007	1.692	1.692	1.692	0.012	0.012	0.012
NC	0.001	0.001	0.001	0.540	0.540	0.540	0.002	0.002	0.002
LEV	-0.041	-0.041	-0.041	6.916**	6.916	6.916	-0.023	-0.023	-0.023
2017.Year	0.078**	0.078***	0.078***	2.311**	2.311	2.311	0.084***	0.084***	0.084**
2018.Year	0.013	0.013	0.013	0.301	0.301	0.301	0.000	0.000	0.000
2019.Year	0.060**	0.060**	0.060**	-0.630	-0.630	-0.630	0.048	0.048	0.048
2020.Year	0.109***	0.109***	0.109***	-1.347	-1.347*	-1.347*	0.094***	0.094***	0.094***
SIZE	0.011	0.011	0.011	0.591	0.591	0.591	0.013	0.013	0.013
α	-0.247**	-0.247**	-0.247**	2.930	2.930	2.930	-0.293**	-0.293***	-0.293**
$\chi^2(10)$	24.906***	25.936***	27.098***	24.504***	15.644	18.814**	25.434***	25.061***	23.097***
N	474	474	474	461	461	461	458	458	458
R ² Within	0.046	0.046	0.046	0.072	0.072	0.072	0.049	0.049	0.049
R ² Between	0.089	0.089	0.089	0.000	0.000	0.000	0.100	0.100	0.100
R ² Overall	0.052	0.052	0.052	0.008	0.008	0.008	0.054	0.054	0.054

Notes: BB - Basic Board index; RC - Remuneration Committee Index; AC - Audit Committee Index; NC - Nomination Committee Index; LEV - Leverage; SIZE - Firm size (Total Assets); α - constant.

*, **, *** respectively indicate statistical significance at 0.10, 0.05 and 0.01 levels.

5. Conclusions and Implications

Despite the widespread expectation, this study did not find any positive association between compliance with corporate governance best practices and stock returns. This lack of association can be attributed to three reasons. First, a substantial variation in corporate governance compliance among Sri Lankan firms may not be present to observe a substantial difference in stock returns. Second, a possible lack of awareness among Sri Lankan investors on implications of corporate governance who usually behave like a herd influenced by giant investors may make the signals sent by corporate governance compliance less relevant in investment decisions. Third, conventional corporate governance best practices aimed at firms with dispersed ownership may be relatively ineffective since most Sri Lankan firms are characterized by concentrated or family ownership. This study does not grossly deny favorable effects of better corporate governance but raises concerns about current corporate governance definitions. More precisely, what constitutes best practices of corporate governance need to be defined more contextually than globally.

References

- Anderson, R. C., & Reeb, D. M. (2004). Board composition: Balancing family influence in S&P 500 Firms. *Administrative Science Quarterly*, 49(2), 209-237.
- Azeez, A. A. (2015). Corporate governance and firm performance: Evidence from Sri Lanka. *Journal of Finance and Bank Management*, 3, 180-189.
- Bhagat, S., & Black, B. (2001). The non- correlation between board independence and long term firm performance. *Journal of Corporation Law*, 27, 231-274.
- Black, B. (2001). The corporate governance behavior and market value of Russian firms. *Emerging Markets Review*, 2, 89-108.
- Black, B., Jang, H., & Kim, W. (2006). Does corporate governance predict firms' market values? Evidence from Korea. *Journal of Law, Economics & Organization*, 366-413.
- Chae, J., Kim, S., & Lee, E. J. (2009). How corporate governance affects payout policy under agency problems and external financing constraints. *Journal of Banking & Finance*, 33(11), 2093-2101. doi:10.1016/j.jbankfin.2009.05.003
- Donaldson, L., & Davis, J. H. (1991). Stewardship theory or agency theory: CEO governance and shareholder returns. *Australian Journal of Management*, 16(1), 49-65.
- Fernando, P., & Dissabandara, H. (2018). *Corporate governance in determining the stock price in Colombo Stock Exchange*. Paper presented at the 11th International Research Conference, General Sir John Kotelawala Defence University.
- Gompers, P. A., Ishii, J. L., & Metrick, A. (2003). Corporate governance and equity

- prices. *Quarterly Journal of Economics*, 118(1), 107-155.
- Hermalin, B. E., & Weisbach, M. S. (2003). Boards of directors as an endogenously determined institution: A survey of the economic literature. *Economic Policy Review*, 7-26.
- Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, 3(4), 305-360.
- Jiang, Y., & Peng, M. W. (2011). Are family ownership and control in large firms good, bad, or irrelevant? *Asia Pacific Journal Management*, 28, 15-39. doi:10.1007/s10490-010-9228-2
- Kurniati, S. (2019). Stock returns and financial performance as mediation variables in the influence of good corporate governance on corporate value. *Corporate Governance: The International Journal of Business in Society*, 19(6), 1289-1309. doi:10.1108/cg-10-2018-0308
- La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R. W. (1998). Law and finance. *Journal of Political Economy*, 106(6), 1113-1155.
- Malik, S. U. (2012). Relationship between corporate governance score and stock prices: evidence from KSE- 30 index companies. *International Journal of Business and Social Science*, 3(4), 239-249.
- Manawaduge, A. S. P. G. (2012). *Corporate governance practices and their impacts on corporate performance in an emerging markets: The case of Sri Lanka*. (Doctor of Philosophy), University of Wollongong, Research Online.
- Shleifer, A., & Vishny, R. W. (1997). A survey of corporate governance. *The Journal of Finance*, 52(2), 737-783.
- Suhadak, S., Kurniaty, K., Handayani, S. R., & Rahayu, S. M. (2019). Stock return and financial performance as moderation variable in influence of good corporate governance towards corporate value. *Asian Journal of Accounting Research*, 4(1), 18-34.