CORPORATE GOVERNANCE AND FIRM PERFORMANCE OF FINANCE SECTOR IN SRI LANKA: EVIDENCE FROM LISTED FINANCIAL COMPANIES IN COLOMBO STOCK EXCHANGE

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Abstract

The Securities and Exchange Commission in Sri Lanka prescribes corporate governance regulations, yet research indicates disparities between actual practices and mandated standards, particularly in listed companies excluding the financial sector. This underscores the necessity for robust governance frameworks to safeguard investor interests, prompting regulatory reforms. This study explores the nexus between corporate governance and financial performance in Sri Lanka's financial sector from 2015 to 2022, utilizing Return on Assets, Return on Equity, and Tobin's Q as performance metrics. Independent variables include Board Committee, Independence, Ownership, and Size, with financial leverage as a control variable. Findings demonstrate a strong positive correlation between ROA and Tobin's Q, with board size significantly enhancing ROA. Conversely, board independence negatively impacts ROA, indicating a decline in performance with more independent directors. Both board size and financial leverage positively influence Tobin's Q, necessitating a balance between leverage and market performance. This underscores the pivotal role of board size in shaping financial and market performance within Sri Lanka's financial sector, suggesting implications for governance reforms to optimize performance outcomes.

Keywords: *corporate governance, finance sector, return on asset, return on equity, tobin's q*

1 Introduction

Corporate governance encompasses the regulatory frameworks, institutional mechanisms, and procedural guidelines governing the operations of corporations, with the overarching aim of enhancing various economic indicators. As elucidated by Njegomir and Tepavac (2014), the adoption of high-quality corporate governance practices assumes paramount importance in mitigating risks for investors, optimizing organizational performance, and catalyzing the inflow of

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investment capital. The structural arrangement of corporate governance mechanisms varies across nations, contingent upon the prevailing economic, social, and political landscapes. For instance, enterprises situated in developed economies typically operate within robust financial infrastructures, stable political contexts, and efficacious regulatory frameworks. In contrast, entities domiciled in developing nations contend with inherently volatile political climates and are frequently beset by economic and financial turmoil. The dearth of effective corporate governance mechanisms stands as a prominent causative factor contributing to the failure of numerous well-managed enterprises, as asserted by Heenetigala (2011). Extant scholarly inquiries consistently underscore the salutary effects of sound corporate governance practices on organizational performance. Tornyeva (2012) delineates corporate governance as a multifaceted process encompassing the facets of direction, control, and accountability within organizational frameworks. This conceptualization underscores the integral role of governance structures in orchestrating the authority, leadership, directional clarity, accountability mechanisms, and control measures inherent in organizational management processes. In Sri Lanka, regulatory frameworks governing corporate governance are established and overseen by the Securities and Exchange Commission (SEC). Nonetheless, scholars have discerned variations between the operational practices of corporate governance and the stipulated regulatory mandates applicable to publicly listed companies, excluding banking institutions, within the Sri Lankan context. This observation underscores the imperative for robust corporate governance mechanisms and has spurred retrospection within governance frameworks aimed at forestalling the recurrence of such disparities to safeguard the interests of investors, particularly within emerging economies. Notably, Achchuthan, Kajananthan, and Sivathaasan (2013) delineate the historical evolution of corporate governance initiatives in Sri Lanka, highlighting the inception of a voluntary code of optimal practices concerning financial transparency in 1997, succeeded by the issuance of Voluntary Codes of Best Practices in Corporate Governance in 2003. Additionally, Heenetigala and Armstrong (2012) underscore subsequent advancements in 2008 and 2013, wherein collaborative efforts between the Securities and Exchange Commission and the Institute of Chartered Accountants of Sri Lanka culminated in the publication of the "Code of Best Practices on Corporate Governance," aimed at fostering robust corporate governance standards within the Sri Lankan capital market. Moreover, the Securities and Exchange Commission, although without a specified date, has also been instrumental in shaping corporate governance guidelines within the Sri Lankan context.

This paper studies the impact of corporate governance on the firm performance of the financial sector in Sri Lanka. Although there is a lot of research in the global context on the impact of corporate governance on the performance of organizations, very little research has been done in the Sri Lankan context by focusing financial sector. Although Sri Lanka has a large number of laws designed to assure shareholders' rights and maintain good corporate governance, effective implementation of existing laws and regulations is a major challenge for improving and practicing corporate governance. Corporate governance can truly address problems and challenges faced by companies that have important implications for investors, management of the company, policymakers, industry regulators and decision makers.

According to the 2017 World Bank report, financial sector plays a vital role in the Sri Lankan economy. In Sri Lankan context, some research has been done focusing on financial institutions but insurance firms have been excluded or randomly selected due to the difficulties in accessing data during the period. Hence it is necessary to focus on all types of financial companies such as banks, diversified financial companies as well as insurance companies covering the entire financial sector. Therefore, the purpose of this research is to identify the impact of corporate governance on the firm performance of the financial sector in Sri Lanka.

2 Literature Review

This section encapsulates both the theoretical frameworks and empirical reviews pertinent to this study.

2.1 Theoretical Review

The inception of corporate governance literature can be traced back to the seminal Cadbury Report, released in December 1992, following the directives of the UK Cadbury Committee. This initiative was prompted by concerns regarding the perceived lack of transparency within publicly traded companies, aiming to bolster investor confidence. However, it is noted by Khatib et al. (2022) that corporate governance models may exhibit flaws or discrepancies due to researchers' divergent interpretations and conceptualizations of the subject matter.

2.1.1 Agency Theory

Agency theory posits that without adequate governance mechanisms, managers may prioritize their interests over shareholders' wealth maximization. Directors, acting as agents, oversee managerial decisions to ensure alignment with owners' objectives (Padmanabha & Bhatt, 2017; Munga, 2018). This theory, articulated by Jensen and Meckling (1976), highlights the principal-agent relationship between shareholders and managers, wherein managers act on behalf of absentee shareholders, potentially leading to conflicts of interest. Consequently, agency costs arise, necessitating governance systems to mitigate such conflicts (Munga, 2018). Non-executive directors play a pivotal role in monitoring management performance, ensuring financial integrity, and managing risks, thereby enhancing corporate governance effectiveness (Jensen & Meckling, 1976).

2.1.2 Stewardship Theory

Stewardship theory, as contrasted with agency theory, emphasizes the alignment of interests among shareholders, directors, and executives (Donaldson & Davis, 1991). Executives, acting as stewards, prioritize collective firm interests over personal gains, driven by intrinsic rewards (Donaldson & Davis, 1991). This perspective suggests that external independent directors may not be essential (Obermann et al., 2020). Stewards, characterized as high-level managers, exhibit behaviors conducive to the firm's well-being rather than self-serving actions (Sama, Stefanidis, & Casselman, 2022). Stewardship advocates for managerial autonomy based on trust, facilitating efficient decision-making (Donaldson & Davis, 1991). Key tenets of stewardship theory include empowerment, trust, open communication, performance enhancement, and long-term focus (Davis, Schoorman, & Donaldson, 1997). Managers, motivated by intrinsic satisfaction, strive for organizational success to maintain their reputation and secure positions (Shleifer & Vishny, 1997).

2.1.3 Resource Dependency Theory

Resource dependence theory underscores the significance of resources in driving firm success, complementing the focus of agency theory on managerial behavior (Farooq, Noor, & Ali, 2022). It emphasizes a firm's need to maximize control over essential resources to ensure operational efficiency. Directors play a crucial role in securing these resources through external linkages, including political and financial capital, and stakeholder influence (Hillman & Dalziel, 2003). By providing resources and monitoring managers, directors help the firm cope with uncertainty, crucial for survival (Hillman, Cannella, & Paetzold, 2000). Diverse board compositions enhance information gathering and networking, contributing to effective resource allocation and firm performance (Wernerfelt, 1984; Zahra & Pearce, 1989).

2.2 Empirical Review

This section presents a condensed summary of the empirical review relevant to the current study.

2.2.1 Global Context

The study of corporate governance and its implications on financial performance in emerging markets has garnered increasing attention. Research conducted in

Pakistan by Farooq, Noor, and Ali (2022) suggests that corporate governance positively affects accounting returns and market indices, with larger firms benefiting more from effective governance implementations. Tornyeva (2012) finds in her research on Ghanaian insurance companies that various governance factors like board skill, audit committee size, and ownership positively impact financial performance. Mahmood, Khan, and Mahmood (2023) studied firms in Pakistan, identifying reduced board dimensions, moderate leverage, and CEO participation in multiple boards as contributors to improved performance. Silpachai (2023) reveals the significance of internal governance mechanisms like board size and institutional ownership in determining firm performance, highlighting a nonlinear relationship between board size and performance. Dawood et al. (2023) investigate the Pakistani banking sector, indicating that strong governance enhances profitability, with factors like board size and CEO tenure positively correlating with bank performance. Ben and Chouaibi (2023) explore European financial institutions, noting positive associations between board diversity, CEO ownership, and firm valuation, while larger board size and ownership concentration negatively impact firm value. Islami, Setiawan, and Mai (2020) analyze German non-financial firms, finding adverse effects of certain governance attributes on financial performance. Al Muhaissen and Alobidyeen (2022) study Jordanian banks, revealing that larger board sizes negatively affect bank performance. Finally, Mititean (2022) examines Romanian companies, identifying positive influences of board size, gender diversity, and CEO duality on firm performance, with the level of board independence showing no significant impact. These studies collectively underscore the intricate relationship between corporate governance mechanisms and firm performance across various emerging markets.

2.2.2 Local Context

The relationship between corporate governance and stock market returns was examined by Wanniarachchige and De Silva (2022) in a study of 100 listed firms in the Colombo Stock Exchange. The findings suggest that adherence to board-related governance practices has limited effectiveness in enhancing stock returns, with only best practices concerning the board showing a positive impact due to the concerns of minority shareholders. Guo and Kga (2012) explored the impact of corporate governance mechanisms on firm performance in Sri Lanka, focusing on 174 listed firms excluding those from the financial sector. Their findings reveal a non-significant relationship between certain governance practices and firm performance, contradicting some previous findings. Danoshana and Ravivathani (2019) evaluated the influence of corporate governance on financial institutions in Sri Lanka, finding significant effects of board and audit committee size on firm performance, although meeting frequency had a negative impact. Pathiraja et al. (2023) identified positive correlations between certain governance attributes and firm performance, although interlocked directorates were associated with decreased performance. Arachchi et al. (2022) investigated the extent of digital corporate governance adoption during the COVID era, revealing varied effectiveness among firms. Nagendrakumar et al. (2022) highlighted the significance of corporate governance on integrated firm performance across multiple domains, emphasizing ethical operations and stakeholder relations. Balagobei (2018) found significant impacts of board size and audit committee presence on firm performance, while Azeez (2015) revealed an inverse relationship between board size and firm performance but a positive correlation between CEO-chairman separation and firm performance. Heenetigala (2011) observed a surge in corporate governance practices between 2003 and 2007, with significant associations between governance practices and firm performance, particularly concerning board composition and committees.

3 Methodology

The study adopts a positivist research philosophy, positing an external reality that is objective and easily apprehended. It contends that this reality consists of quantifiable attributes that remain constant regardless of the observer's viewpoint. Within this framework, humans are presumed rational, and research focuses on establishing factual information and causal relationships. The methodology entails a comprehensive literature review to establish relevant theories and formulate hypotheses, which are subsequently tested against empirical data to discern connections or causations. Primary data, collected firsthand through surveys, questionnaires, and experiments, as well as secondary data, sourced from pre-existing information such as annual reports and published statistics, are employed. In this study, evidence is predominantly drawn from secondary sources. The research employs a positivist paradigm, employing deductive logic and quantitative methods to analyze social phenomena. This approach involves formulating hypotheses prior to data collection, and facilitating the verification or falsification of the proposed statements through empirical evidence. Overall, the study aligns with the positivist perspective due to its emphasis on factual information and causal relationships within social contexts, utilizing deductive reasoning to confirm or refute hypotheses.

3.1 Conceptual Framework

Figure 3.1 visually depicts the interconnection between the theoretical framework and the practical application of corporate governance factors and firm performance metrics in this study. Empirical evidence highlights various variables influencing this relationship, including board leadership structure, composition, and the roles of audit, remuneration, and nomination committees. Corporate governance literature identifies measures like Tobin's Q, Return on Assets (ROA), and Return on Equity (ROE) to assess firm performance. This research examines the correlation between corporate governance and overall company performance, focusing on internal governance factors such as board ownership, committees, independence, and size. Leverage serves as a control variable. Firm performance is evaluated using accounting metrics (ROE, ROA) and market-based indicators (Tobin's Q).

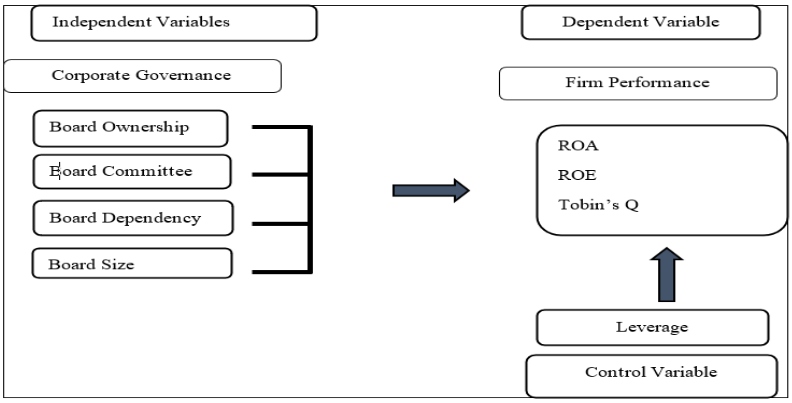

Figure 1: Conceptual Framework

3.2 Hypothesis Development

The conceptual framework delineated earlier establishes the groundwork for crafting testable hypotheses in this study. These hypotheses will center on the proposition that the implementation of effective corporate governance principles, specifically focusing on board ownership, committees, independence, and size, will significantly influence the firm performance of financial sector companies in Sri Lanka. The integrity of capital markets in inspiring investor trust hinges upon robust corporate governance practices. The board plays a pivotal role in supervising senior management and ensuring accountability to shareholders and stakeholders affected by the company's operations. In light of the research objectives, the subsequent hypothesis was scrutinized.

H1a: Board Ownership significantly influences the firm performance of financial institutions in Sri Lanka.

H1b: The number of board committees significantly affects the firm performance of financial companies in Sri Lanka.

H1c: The firm performance of financial institutions improves with the presence of board dependency.

H1d: Board size significantly impacts the firm performance of financial companies in Sri Lanka.

3.3 Target Population, Sample and Data Collection Instrument

The research was conducted using a comprehensive census survey of selected listed financial institutions in Sri Lanka spanning from 2015 to 2022. To conduct this analysis, a cluster sampling technique was used, wherein all the publicly listed financial institutions were categorized into three clusters: banks, diversified financial entities, and insurance firms. Subsequently, the selected sample is comprised of 09 banks, 09 diversified financial companies, and 09 insurance companies.

This study was conducted using secondary data, which was sourced from both the annual reports of financial institutions and their internal records. In the process of data analysis, E-views software was used. The research employed Descriptive analysis, Pearson correlation analysis and multiple regression analysis separately for ROA, ROE and Tobin's Q to ascertain the connection and impact between Corporate Governance and Firm Performance.

4 Findings

In this section, the empirical findings are presented after data was collected from listed companies on the CSE.

Table 1: Descriptive Statistics of Variables

	Independent Variable				**Control Variable**	**Dependent Variable**		
	Board Committee	Board Independence	Board Ownership	Board Size	Leverage	ROA	ROE	TOBIN_S_Q
Mean	5.653	4.250	0.046	9.236	0.815	0.034	0.110	1.272
Median	5.000	4.000	0.001	9.000	0.838	0.016	0.111	0.973
Maximum	11.000	10.000	0.468	17.000	9.331	1.000	1.201	34.835
Minimum	3.000	2.000	0.000	4.000	0.003	-0.197	-2.512	0.349
Std. Dev.	1.886	1.739	0.104	2.656	0.805	0.089	0.230	2.478
Skewness	1.004	0.840	2.826	0.349	8.987	6.806	-6.259	12.0005
Kurtosis	3.188	3.191	10.452	3.054	90.895	71.852	81.179	158.650
Jarque-Bera	36.585	25.755	787.302	4.415	72437.36	44333.51	56418.53	223227.9
Probability	0.000	0.000	0.000	0.109	0.000	0.000	0.000	0.000
Sum	1221.000	918.000	9.880	1995.000	176.173	7.299	23.897	274.930
Sum Sq. Dev.	764.958	650.500	2.337	1516.958	139.414	1.694	11.459	1320.587
Observations	216	216	216	216	216	216	216	216

The research analyzed financial performance metrics and board characteristics of listed finance companies over an eight-year period. Return on Assets (ROA) was found to have a mean of 3.37% and a median of 1.61%, with a distribution skewed towards positive values. Return on Equity (ROE) exhibited a mean of 11.06% and a distribution skewed negatively. Tobin's Q, measuring market performance, had a mean of 1.27, indicating favorable investment prospects, but with a wide range and high standard deviation.

Board characteristics such as Board Committee, Board Independence, Board Ownership, and Board Size were examined. The Board Committee had a mean of 5.65, positively skewed. Board Independence had a mean of 4.25, also positively skewed. Board Ownership showed a mean of 0.0457, positively skewed. Board Size had a mean of 9.24, positively skewed. Leverage, with a mean of 0.8156, was also positively skewed. Jarque-Bera tests indicated that the distributions of these variables deviated from normality. These findings provide insights into the financial and governance dynamics of finance companies, highlighting areas of strength and potential concern.

4.1 Table 2: Correlation Matrix

	BC	BI	BO	BS	FL	ROA	ROE	TQ
BC	1.000							
BI	0.490*	1.000						
BO	-0.135*	-0.185*	1.000					
BS	0.253*	0.491*	0.073	1.000				
FL	0.231*	0.143*	0.044	0.138*	1.000			
ROA	-0.160*	-0.143*	-0.028	0.090	-0.031	1.000		
ROE	-0.023	-0.151*	-0.005	-0.018	0.003	0.457*	1.000	
TQ	-0.032	0.014	0.017	0.266*	0.267*	0.718*	-0.023	1.000

Sources: Generated from e – Views 8

Notes: *Indicates statistical significance at a 5% level of significance.

The correlation matrix illustrates relationships among various variables within financial companies in Sri Lanka. A strong positive correlation (71%) is observed between Return on Assets (ROA) and Tobin's Q, indicating a robust link between profitability and market performance. Weak positive correlations are found between financial leverage and both board committee (23%) and board independence (14%). Similarly, board size exhibits weak positive relationships with board committee (25%) and board independence, while displaying a moderate correlation with the latter. Financial leverage weakly correlates positively with board size (13%). Tobin's Q, as a market performance indicator, weakly correlates positively with board size and financial leverage (26% each). ROA and Return on Equity (ROE) demonstrate a moderate relationship (45%). Board ownership exhibits weak negative correlations with board committee (13%) and board independence (18%). Furthermore, ROA shows weak negative correlations with board committee (16%) and board independence (14%), whereas ROE weakly correlates negatively with board independence (15%). These findings provide insights into the interplay between financial metrics and governance structures within Sri Lanka's financial sector.

4.2 Table 3: Regression Analysis

Variable	ROA		ROE		TOBIN'S Q	
	Coefficient	Probability	Coefficient	Probability	Coefficient	Probability
C	0.047	0.088	0.153	0.094	-0.457	0.506
BC	-0.006	0.152	0.009	0.427	-.0.154	0.121
BI	-0.011	0.019	-0.037	0.007	-0.199	0.097
BO	-0.083	0.194	-0.027	0.897	-1.450	0.369
BS	0.007	0.010	0.007	0.434	0.305	0.000
FL	0.002	0.784	-0.003	0.852	0.857	0.159
R-Squared		0.059	0.035			
Adjusted R-Squared		0.037	0.012		0.139	
F-Statistic		2.658	1.537		7.943	
Prob(F-Statistic)		0.023	0.179		0.000	

The study rigorously assessed the assumptions of multiple regression analysis, including normality, linearity, multicollinearity, and homoscedasticity, all of which supported the model's validity. Employing a hierarchical multiple regression approach, separate analyses were conducted for three dependent variables: Return on Assets (ROA), Return on Equity (ROE), and Tobin's Q. Random effects were applied to all models, with the Hausman test conducted using E-views confirming model validity. Board size demonstrated a significant positive impact on ROA, aligning with prior research by Danoshana and Ravivathani (2019) and Yasser, Mamun, and Rodrigs (2017). Conversely, Board Independence exhibited a significant negative impact on ROA and ROE, reflecting the ambiguity noted by Azeez (2015) regarding non-executive directors' autonomy in the Sri Lankan context. However, the model for ROE was deemed insignificant, despite a significant negative effect of Board Independence. In contrast, the model for Tobin's Q was found to be highly significant, with both Board size and financial leverage exerting a highly significant positive impact on Tobin's Q. These results provide robust insights into the relationship between board characteristics and financial performance metrics within the context of Sri Lankan finance companies.

5 Conclusion

This study examines the relationship between corporate governance and the performance of financial sector companies in Sri Lanka. It employs variables including corporate governance attributes (board size, board ownership, number of committees, and board independence), with financial leverage as a control variable, and performance proxies (Return on Assets, Return on Equity, and Tobin's Q). Secondary data from financial reports and regulatory bodies spanning 2015 to 2022 were analyzed using descriptive statistics, correlation analysis, and multiple regression. The findings reveal a strong positive correlation (71%) between ROA and Tobin's Q, weak positive relationships (ranging from 13% to

25%) between financial leverage and governance attributes, and a moderate relationship (45%) between ROA and ROE. Notably, board ownership exhibits weak negative relationships (13% and 18%) with governance attributes. These results contribute to understanding governance-performance dynamics in Sri Lankan financial firms.

The study provides empirical evidence on the impact of corporate governance mechanisms on the performance of financial firms. Through regression analysis, it is established that board size significantly and positively affects Return on Assets (ROA) in Sri Lankan financial companies, indicating that an increase in board size enhances firm performance. Conversely, board independence is found to have a significant negative impact on ROA, suggesting that an increase in the number of independent directors correlates with a decrease in firm performance. Additionally, both board size and financial leverage are identified to exert significant and positive influences on Tobin's Q, indicating the importance of balancing financial leverage with market performance. These findings underscore the crucial role of board size in shaping the financial and market performance of financial firms in Sri Lanka.

The findings from this study underscore the need for robust corporate governance frameworks within financial institutions in Sri Lanka. Effective governance mechanisms, such as board independence, has been shown to positively influence firm performance. This reinforces the importance of regulatory bodies enforcing stringent governance standards to ensure transparency and accountability.

Future research should maintain consistency in sector selection and sample choice. While quantitative methods dominate, integrating qualitative approaches like interviews with managerial personnel can deepen insights into corporate governance dynamics. Mandating public disclosure of corporate governance statements for all financial firms, aligning with stock exchange requirements, would enhance transparency and governance practices, especially among unlisted entities lacking such reporting standards.

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