IMPACT OF CORPORATE GOVERNANCE PRINCIPLES ON FINANCIAL PERFORMANCE: EVIDENCE FROM LISTED FINANCIAL COMPANIES IN SRI LANKA

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ABSTRACT

This study aims to examine the impact of corporate governance (CG) principles on financial performance of listed financial companies in Sri Lanka. This study is based on quantitative approach and using a panel data of 32 listed financial companies for the period of 2012-2016 and Return On Asset (ROA) and Return On Equity (ROE) as proxies to financial performance, the hypotheses were tested to investigate the influence of compliance of the corporate governance on the financial performance of Sri Lankan listed financial companies. Secondary data for the compliance of corporate governance principles were extracted. CG Score was constructed to measure the degree of compliance of corporate governance and panel data regression analysis and Pearson's correlation analysis were employed to test the hypothesis. The results reveal that CGS which is an aggregate of the compliance requirements of the corporate governance principles positively impact on financial performance which is measured by ROA and ROE whereas only directors' remuneration and relations with shareholders have a significant positive impact on financial performance of listed financial institutions while the size of the company, sales volume, number of years the company has operated in the market are keeping as the controlling factors. These results are useful to corporate governance regulators, boards and policymakers to improve corporate governance practices in Sri Lanka.

Keywords: *Corporate Governance Principles, Corporate Governance Score, Directors' Remuneration, Sri Lanka*

1 INTRODUCTION

1.1 Background

Corporate finance scandals enlighten the companies that the reason behind this is basically the corporate governance issues. As the companies look for a secured economics to diversify their investment portfolio to maximize the returns they equally pay the attention towards the corporate governance practices. Among the companies, financial companies understood that the investors reluctant to invest in these companies as they feel insecurity in their investments. So finance companies bias towards the corporate governance factors to build up a security in the minds of investors. The competition among Sri Lankan finance companies is very high and strong. All of them try to put a step further and before their competitors and through it maximize the wealth of shareholders. As well as want to show a strong image & higher financial performance in their annual financial figures. This research evaluates the impact of corporate governance variables on firm's financial performance in the Sri Lankan context and also tries to find out whether there is any significant relationship between corporate governance policy disclosures & financial performance of the companies.

1.2 Research Problem

In this Research, the research problem is defined and confined as do the publicly listed non-bank financial companies comply with corporate governance policies and practices have better financial performance in the Sri Lankan context?

1.3 Research Objectives

Overall research objective is to review the Sri Lankan experience concerning the relationship between board characteristics such as size and composition and corporate performance using a sample of publicly listed non-bank finance companies in the finance sector. However following specific aims help to identify the main objective.

1. To examine how board of directors has influenced on financial performance of the publicly listed non-bank finance companies in Sri Lanka.
2. To see whether remuneration scheme of the company has affected to the financial performance of the publicly listed non-bank finance companies in Sri Lanka.

3. To see whether there is a relationship between shareholders and financial performance of the publicly listed non-bank finance companies in Sri Lankan context.
4. To see whether there is a relationship between accountability and audit practices and financial performance of the publicly listed non-bank finance companies in Sri Lankan context.
5. To see whether there is a relationship between institutional & other investors and financial performance of the publicly listed non-bank finance companies in Sri Lankan context.
6. To examine how sustainability performance and financial performance of the publicly listed non-bank finance companies in Sri Lankan context.

1.4 Significance of the Study

The researcher identified three main significances of studying the financial companies' performance on practicing of corporate governance.

i. Identifying the relationship between corporate governance and financial performance

   Corporate governance is a practice which is not a mandatory regulation to the companies but most of the companies are eager to use corporate governance practices. So by conducting this study the researcher try to find out whether there is a relationship between corporate governance and financial performance and whether there is an advantage of using the corporate governance on financial performance.

ii. Find out the impact of corporate governance on firm performance.

   Financial indicators are the most critical measurements for a company. By conducting this research the researcher is able to identify how corporate governance can impact on financial indicators of the company such as ROA, EPS and ROE and how board composition, separation of Chairman and CEO (duality role), existence of the committees (Audit committee, Remuneration committee, and nomination committee) affect to increase performance of financial companies.

iii. Suggest the financial organizations to adapt good governance practices towards the performance.

Through the outcome of this study, the researcher is able to say whether there is a positive or negative impact on financial performance while complying with the corporate governance. If the results expressed a positive relationship companies can comply with similar corporate governance practices and develop and sustain in the industry.

2 LITERATURE REVIEW

Corporate Governance is the system of rules, practices and processes by which a company is directed and controlled. It involves balancing the interests of the stakeholders. This study tests the relationship between corporate governance practices and the firm financial performance. Board of directors, Directors remuneration, Relation with shareholders, Accountability and audit, Institutional Investors and other investors and sustainability reporting are the corporate governance mechanisms while the performance measures are ROA, ROE, and Net Interest Income. This chapter attempts to provide the view of different scholars/researchers based on their researches conducted on the relationship between corporate governance and firm performance.

With time, different authors began to use more comprehensive measures for corporate governance rather than a single governance mechanism. Studies mentioned before showed that not all elements of corporate governance, in isolation, have effectiveness in aspects regarding performance and agency issues. One of the first authors that examined the relationship between corporate governance and performance using multidimensional variable was (Labelle, 2002). The author used in his research the ratings from a statement of corporate governance practice (SCGP) developed by the Canadian Institute of Chartered Accountants (CICA) regarding disclosure quality of corporate governance, while performance was measured by ROE. The period of the study was 1996-1997. The results suggested no significant relationship between firm performance and disclosure quality of corporate governance. The first authors to build a complex index regarding all corporate governance aspects are (Gompers, P., Ishii, J., Metrick, A. (2003). Their index, G-index, is composed of 24 distinct Corporate Governance variables grouped in 5 categories. Their study regarding a 10 years period (1990-1999) found a strong correlation between G-index and the following financial indicators: stock performances, Tobin's Q, net profit margin and sales growth. In 2008 (Bhagat, S., Bolton, B., 2008) using G-index confirmed the results obtained by (Gompers, P., Ishii, J., Metrick, A. (2003), 2003). In 2008 (Bassen, A., Pridge, S., Zollner, C, 2008) found that between firm performance, measured by Tobin's Q, and compliance with Germany Corporate Governance Code is a negative correlation, for a period of one year and using publicly available date. (Bauer, G., Gunster, N., Otten, R, 2004) Used in their analysis Domino Corporate Governance Ratings

(DCGR), an index formed by 300 criteria grouped into 4 categories: rights and duties of shareholders; range of takeover defenses; disclosure of corporate governance and board structure and functioning". The results of their study conducted for 2000-2001 showed an insignificant negative relation between firm performance (net profit margin, ROE) and corporate governance standards.

3 METHODOLOGY

The study was conducted among the selected finance companies which were listed in Colombo Stock Exchange and data were collected by referring to the Annual reports published by the companies, CSE website, and corporate governance practices through corporate governance code of best practice published by ICASL. Data analysis part was done through spread sheet, developing an index based on the collected data and statistical technique which was multiple regression analysis was used to test the relationship between corporate governance variables and firm's financial performance.

3.1 Conceptual Diagram

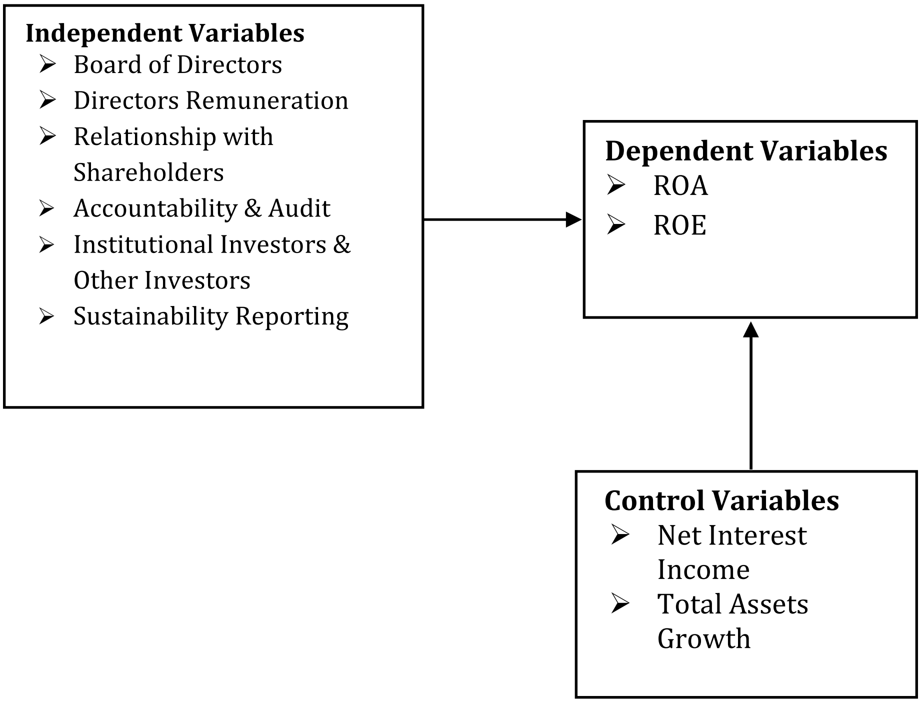

Figure 1: Conceptual Diagram

3.2 Operationalization of Variables

Operationalization is given in Table 1.

Table 1: Operationalization

Variable name	Measurement Type	Measurement scale
	Independent Variables	
Board of Directors	Quantitative/Qualitative	Assigning "1" point if the practice is complied, otherwise "0"
Directors Remuneration	Quantitative/Qualitative	Assigning "1" point if the practice is complied, otherwise "0"
Relationship with Shareholders	Quantitative/Qualitative	Assigning "1" point if the practice is complied, otherwise "0"
Accountability & Audit	Quantitative/Qualitative	Assigning "1" point if the practice is complied, otherwise "0"
Institutional Investors & Other Investors	Quantitative/Qualitative	Assigning "1" point if the practice is complied, otherwise "0"
Sustainability Reporting	Qualitative	Assigning "1" point if the practice is complied, otherwise "0"
	Dependent Variables	
ROA	Quantitative	Net income divided by total assets
ROE	Quantitative	Net income divided by equity
	Control Variables	
Net Interest Income	Quantitative	Interest Income-Interest Expense
Total Assets Growth	Quantitative	Total Assets$_{(t)}$ -Total Assets$_{(t-1)}$ /Total Assets$_{(t-1)}$

3.3 Sample and Data Analysis Techniques

There are 43 finance companies in Sri Lanka and the researcher considered 32 companies among them since 11 out of them are private limited companies. As the researcher collected data through annual reports PLC only were taken as this sample study. The research was conducted on 32 finance companies (excluding banks) listed in the Colombo Stock Exchange (CSE) which was the population of this research. Since the researcher have accessibility for all 32companies' annual reports the researcher collected data for the population.

Whole population was taken for the study since the researcher had accessibility to all 32 non-banking listed finance companies by considering 5 years from 2012 to 2016.

There are three different types of approaches to a research, Quantitative, Qualitative and Mixed methods. These approaches should be in line with the research question. Content analysis was the main data collection method which the researcher used in quantitative research. The researcher used secondary data collection methods (Refer the public listed finance companies websites, Colombo Stock Exchange web site (CSE).Further; the researcher referred to the code of best practice & corporate governance published by ICASL and Central Bank. In addition the researcher interviewed professionals in finance industry in Sri Lanka to search for voluntary disclosures.

Spreadsheets were used to prepare indices as the data analysis strategy and Statistical Package for Social Sciences (SPSS) and Econometric Views (EViews) were used to assess and analyze the collected data to examine the relationship between corporate governance practices and firm performance. There were two methods of analysis used in this study, which are descriptive and correlation analysis.

4 DATA ANALYSIS AND DISCUSSION

4.1 Correlation Analysis

In this section the researcher measured the degree of association between the governance variables and profitability variable i.e. if the governance proxies (board size, director remuneration, relations with shareholders, accountability and audit, institutional investors and sustainability). Decision rule is based on the significances of the t-statistics which are represented by the p-values flagged by the statistical packages used. This is based on the fact that the existence of a significant relationship can be inferred from a significant t-statistic.

Based on the fact that more significant relationships are noticed between the governance variables and ROA than in ROE.

1. There is a significant relationship between board of directors and financial performance of the publicly listed non-bank finance companies in Sri Lanka.

From the analysis of ROE, the Correlation is positive (0.036547), with a p-value of 0.6464.This indicates a positive effect of board of directors on the financial performance of the financial companies. Based on these results, the researcher accepts the alternate hypothesis. From the analysis of ROA, the Correlation is positive (0.037217), with a p- value of 0.6403. This indicates a positive effect of board of directors on the financial performance of the financial companies. Based on these results, the researcher accepts the alternate hypothesis.

2. There is a significant relationship between remuneration scheme of the company and financial performance of the publicly listed non-bank finance companies in Sri Lanka.

From the analysis of ROE, the Correlation is positive (0.158877), with a p-value of 0.0448.This indicates a positive effect of directors remuneration on the financial performance of the financial companies. Based on these results, the researcher accepts the alternate hypothesis which states that there is a significant relationship between directors' remuneration and ROE. From the analysis of ROA, the Correlation is positive (0.197826), with a p- value of 0.0122.This indicates a positive effect of directors' remuneration on the financial performance of the financial companies. Based on these results, the researchers accept the alternate hypothesis.

3. There is a significant relationship between shareholders and financial performance of the publicly listed non-bank finance companies in Sri Lankan context.

From the analysis of ROE, the Correlation is positive (0.126998), with a p-value of 0.1095.This indicates a positive effect of shareholders on the financial performance of the financial companies. Based on these results, the researchers accept the alternate hypothesis which states that there is a significant relationship between relations with shareholders and ROE. From the analysis of ROA, the Correlation is positive (0.061525), with a p- value of 0.4396.This indicates a positive effect of shareholders on the financial performance of the financial companies. Based on these results, the researchers accept the alternate hypothesis which states that there is a significant relationship between relations with shareholders and ROA.

4. There is a relationship between accountability and audit practices and financial performance of the publicly listed non-bank finance companies in Sri Lankan context.

From the analysis of ROE, the Correlation is positive (0.107428), with a p-value of 0.1763. This indicates a positive effect of accountability and audit practices on the financial performance of the financial companies. Based on these results, the researchers accept the alternate hypothesis which states that there is a significant relationship between accountability and audit practices and ROE. From the analysis of ROA, the Correlation is positive (0.092289), with a p- value of 0.2458. This indicates a positive effect of accountability and audit practices on the financial performance of the financial companies. Based on these results, the researchers accept the alternate hypothesis which states that there is a significant relationship between accountability and audit practices and ROA.

5. There is a relationship between institutional & other investors and financial performance of the publicly listed non-bank finance companies in Sri Lankan context.

From the analysis of ROE, the Correlation is positive (0.114705), with a p-value of 0.1486. This indicates a positive effect of institutional & other investors on the financial performance of the financial companies. Based on these results, the researchers accept the alternate hypothesis which states that there is a significant relationship between institutional & other investors and ROE. From the analysis of ROA, the Correlation is positive (0.064804), with a p-value of 0.4156. This indicates a positive effect of institutional & other investors on the financial performance of the financial companies. Based on these results, the researcher accepts the alternate hypothesis which states that there is a significant relationship between institutional & other investors and ROA

6. There is a relationship between sustainability reporting and financial performance of the publicly listed non-bank finance companies in Sri Lankan context.

From the analysis of ROE, the Correlation is positive (0.123888), with a p-value of 0.1186. This indicates a negative effect of sustainability reporting on the financial performance of the financial companies. Based on these results, the researchers accept the alternate hypothesis which states that there is a significant relationship between institutional & other investors and ROE.

From the analysis of ROA, the Correlation is positive (0.007195), with a p-value of 0.9281. This indicates a positive effect of sustainability reporting on the financial performance of the financial companies. Based on these results, the researchers accept the alternate hypothesis which states that there is a significant relationship between sustainability reporting and ROA.

4.2 Regression Analysis

4.2.1 Regression Analysis for Independent Variables and ROE

Coefficient of BOD is -0.408419 representing a negative relationship between board of directors and ROE and the probability is 0.5999 which means that it is statistically insignificant (P Value is less than .05)

Coefficient of DSR is 1.171138 representing a positive relationship between directors' remuneration and ROE and the probability is 0.0151 which means that it is statistically significant.

Coefficient of AA is 0.751723 representing a positive relationship between Accountability & audit and ROE and the probability is 0.0823 which means that it is statistically insignificant.

Coefficient of RWS is 1.479742 representing a positive relationship between relationship with shareholders and ROE and the probability is 0.0183 which means that it is statistically significant.

Coefficient of III is 0.158048 representing a positive relationship between institutional investors & other investors and ROE and the probability is 0.3786 which means that it is statistically insignificant.

Coefficient of SR is -0.196385 representing a negative relationship between sustainability reporting and ROE and the probability is 0.5631 which means that it is statistically insignificant.

R-squared (0.396710) implies that independent variables explain 39.6710 percent of the variance in the dependent Variable. F statistic is significant since the P value is 0.000861. It signposts the insignificance of the independent variables towards dependent variable.

4.2.2 Regression Analysis for Independent Variables and ROA

Coefficient of BOD is -0.020376 representing a negative relationship between board of directors and ROE and the probability is 0.8548 which means that it is statistically insignificant (P Value is less than .05)

Coefficient of DSR is 0.158779 representing a positive relationship between directors' remuneration and ROE and the probability is 0.0210 which means that it is statistically significant.

Coefficient of AA is 0.088846 representing a positive relationship between Accountability & audit and ROE and the probability is 0.1504 which means that it is statistically insignificant.

Coefficient of RWS is 0.158310 representing a positive relationship between relationship with shareholders and ROE and the probability is 0.0761 which means that it is statistically significant.

Coefficient of III is 0.034680 representing a positive relationship between institutional investors & other investors and ROE and the probability is 0.1778 which means that it is statistically insignificant.

Coefficient of SR is 0.011283 representing a positive relationship between sustainability reporting and ROE and the probability is 0.8163 which means that it is statistically insignificant

R-squared (0.597203) implies that independent variables explain 59.7203 percent of the variance in the dependent Variable. F statistic is significant since the P value is 0.00000. It signposts the insignificance of the independent variables towards dependent variable.

4.2.3. Regression Analysis for Corporate Governance Index and ROE.

Coefficient of CGI is 2.558931 representing a positive relationship between relationship with shareholders and ROE and the probability is 0.0278 which means that it is statistically significant.

R-squared (0.357514) implies that independent variables explain 35.7514 percent of the variance in the dependent Variable. F statistic is significant since the P value is 0.001011. It signposts the insignificance of the independent variables towards dependent variable.

4.2.4 Regression Analysis for Corporate governance index and ROA.

Coefficient of CGI is 0.399003 representing a positive relationship between relationship with shareholders and ROA and the probability is 0.0153 which means that it is statistically significant.

R-squared (0.582183) implies that independent variables explain 58.2183 percent of the variance in the dependent Variable. F statistic is significant since the P value is 0.000000. It signposts the insignificance of the independent variables towards dependent variable.

5 CONCLUSION

This study was interested in finding whether there is a significant relationship between selected corporate governance practices and firm financial performance based on the 32 publicly listed financial companies in Sri Lanka. Scope of the study limited to the selected corporate governance practices for the Board of directors, Director Remuneration, Relations with shareholders, Accountability and audit, Institutional Investors and other investors and Sustainability reporting while the size of the company, sales volume, number of years the company has operated in the market are keeping as the controlling factors

This research carries out to explore the relationship between corporate governance policies and practices and financial performances of the publicly listed non-bank finance companies in Sri Lanka. This research was run on secondary data.

Index was created based on the collected data to identify the degree of compliance of corporate governance. Multiple regression analysis will be employed to test the relationship between firm's financial performances.

The study was conducted among the selected finance companies which were listed in Colombo Stock Exchange and data were collected by referring to the Annual reports published by the companies, CSE website, and corporate governance practices through corporate governance code of best practice published by ICASL

According to the analysis, the researcher has found, there is no relationship between corporate governance policies and practices and financial performances of the publicly listed non-bank finance companies in Sri Lanka. But there is a relationship between Directors' Remuneration and financial performances of the publicly listed non-bank finance companies in Sri Lanka.

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