Corporate Governance and Firm Performance: *"A Study of Selected Listed Companies in Sri Lanka"*

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***Abstract* - Corporate governance is considered as the significant implications for the growth of an economy. Good corporate governance practices are important in reducing risk for investors, attracting investment capital and improving the performance of companies. Good corporate governance plays a vital role in enhancing performance of companies. Board structure and corporate report are used to measure the corporate governance whereas returns on assets, return on equity and net profit are used to measure the firm's performance. The data of ten manufacturing companies in Sri Lanka representing the period of 2006 to 2010 were used for the study. The multiple regression analysis was applied to test the impact of corporate governance on firm performance. The results show that there is an impact of corporate governance on ROE and ROA. However the impact of corporate structure on ROE and ROA is higher than the board structure while the impact of board structure on net profit is higher than the corporate reporting. Further the study found a positive relationship between the variables of corporate governance and firm's performance.**

Index Terms — **Board structure, Corporate Governance, Corporate report, and Firm Performance**

I. Introduction

Corporate governance has become a popular discussion theme in developed and developing countries. The widely held view that corporate governance determines firm performance and protects the interests of shareholders has led to increasing global attention (1997). However, the way in which corporate governance is organized differs between countries, depending on the economic, political and social contexts. For example, firms in developed countries have dispersed shareholders and operate within stable political and financial systems, well developed regulatory frameworks and effective corporate governance practices. However, firms that operate in developing countries such as Sri Lanka may be affected by political instability resulting in severe economic dislocation and sharp escalation in defense expenditure, which result in a widening fiscal deficit.

In Sri Lanka, apart from weak regulatory and institutional frameworks, increasing oil prices, overvalued exchange rates and rising inflation have been growing macroeconomic problems global finance crisis (GFC), which in turn affected the performance of firms. Remarkably, despite all these setbacks, the stocks in Sri Lanka have generally continued to perform well, and the value of firms increased. The important issue in this case is to understand why, in such a volatile environment as Sri Lanka, the stock markets have managed to perform well. Referring to this situation, Bloomberg (---) pointed out that as the capital market in Sri Lanka does not reflect its political situation, its corporate governance requires investigation to provide an understanding of why its corporate sector has remained resilient to adversity in the business environment.

To investigate the reasons for the effectiveness of corporate governance in the context of Sri Lanka, this study will firstly examine on the relationship between board structure, corporate reporting and firm performance. It will then examine the accountability to shareholders and other stakeholders through corporate reporting mechanisms

II. Literature Review

Weisbach (1988) Firms with a higher proportion of outside directors are likely to replace the CEO after a period of poor performance of the company. Similarly, outside directors are likely to join boards after a poor performance or leave when a shift in strategy requires new or additional outside guidance (Hermalin & Weisbach 1988). Some studies find that there is a positive link between firm performance and board composition. Lee et al. (1992) and Rosentein and Wyatt (1990), state that boards dominated by independent outside directors are associated with substantially higher abnormal returns. There are others which state that having more outside directors on the board, increases performance (Barnhart, Marr & Rosenstein 1994; Daily & Dalton 1992; Schellenger, Wood & Tashakori 1989). There is also evidence which indicates that the percentage of inside directors is high on boards of declining firms (Pfeffer 1972). Studies by Valenti et al (2011) reports that during the periods of declining performance a number of outside directors would be affected. Conversely, when performance improves firms were able to add more outside directors. According to Baysinger and Butler (1985), the degree of financial health is affected by the board composition. They also found that boards with a higher percentage of outside directors have an above average performance compared to firms with a lower number of non-executive directors.

Alternatively, the studies show a negative relationship between the proportion of outside directors and corporate performance (Bhagat & Black 1998). Weir and Lang (2001) state that there are a number of reasons why empirical evidence may not support the positive relationship between non-executive directors and performance. Non-executive directors are only employed on a part-time basis and are likely to have other work commitments, which may result in devoting insufficient time to the company. They may lack the expertise required to understand certain technical issues in the business and they may not possess sufficient information when called upon to make key decisions.

Studies by Lorsch and MacIver (1989), Daily (1994, 1996) and Kesner (1988) explain that most critical processes and decisions are derived from a board subcommittee such as audit, remuneration and nomination committees, rather than boards-at-large. These committees enable the boards to cope with the limited time factor and the complexity of information that they need to deal with (Dalton et al. 1998).

It has been predicted that corporate governance systems which promote corporate transparency and accountability are significantly associated with voluntary disclosures (Huafang & Jianguo 2007). Examination of the impact of board composition on corporate disclosures, as measured by the ratio of independent directors, is positively associated with mandatory disclosures (Chen & Jaggi 2000) and increases in the number of independent directors improves voluntary disclosures (Donnelly & Mulcahy 2008; Huafang & Jianguo 2007). Studies also report that combined leadership structure is associated with a lower level of voluntary disclosures (Gul & Leung 2004; Huafang & Jianguo 2007).

Firm performance in the literature is based on the value of the firm. Studies show that corporate governance affects firm value as a result of reduced expropriation by insiders and improvement in the expected cash flows that can be distributed to investors (Black, Jang & Kim 2006; Claessens & Fan 2002; Gomper, Ishii & Metrick 2003; Klapper & Love 2004). Four different approaches to firm value have been identified in the corporate finance literature (Qureshi 2007). They are: the financial management approach which focus on the estimation of cash flows and investment levels before identifying and evaluating the impact of financing sources on firm value; the capital structure approach which studies the impact of capital

There are many measures of firm performance. Financial measures of firm performance used in empirical research on corporate governance fit into both accounting-based measures and market-based measures (Kiel & Nicholson 2003). Most commonly used accounting based-measures are return on assets (ROA) (Kiel & Nicholson 2003), return on equity (ROE) (Baysinger & Butler 1985) and earnings per share. The most commonly used market-based measures are market to book value ratio and Tobin’s Q (Barnhart, Marr & Rosenstein 1994). There is criticism about accounting as opposed to market-based measures. Accounting-based measures can be easily manipulated by the management through changes to accounting methods or accruals and are difficult to interpret across industries. They are historical and report a more backward focus on past success (Kiel & Nicholson 2003), and exclude risks and investment requirements, and time value of money (Rappaport 1986). Market-based measures are based on the value of companies common stock and are often affected by factors beyond the control of the leaders of the firms. They reflect risk adjusted performance and are not adversely affected by multi-industry or multinational contexts (Daily & Dalton 1998). They are considered forward looking and reflects current plans and strategies (Kiel & Nicholson 2003).

Results of the study by Haniffa and Hudaib (2006) indicate that a significant relationship exists between the accounting based measures of performance and combined leadership structure. Irrespective of the type of performance measures used, whether accounting-based or the market-based measures, Daily and Dalton (1998) found no systematic relationship between board composition and firm performance.

Various studies have been done on corporate governance but no any detail study has been made in Sri Lankan context. So the present study is initiated on corporate governance and firm performance of selected Companies in Sri Lanka.

III. Objectives

The focus of this study is to find out the association between Corporate Governance and Firm Performance, and other objective is to find out the impact of Corporate Governance on Firm Performance.

IV. Research Design

A. Data Collection

Data on corporate governance and performance were collected from secondary sources. Financial data on performance were extracted from the CSE, which reports data on all the financial information relevant to the performance of the 10 manufacturing companies. Fact and figures relating to corporate governance and performance were extracted from annual reports and the Handbook of Listed Companies from CSE.

B. Conceptual Frame Work

Based on the Literature, the following conceptual model is constructed.

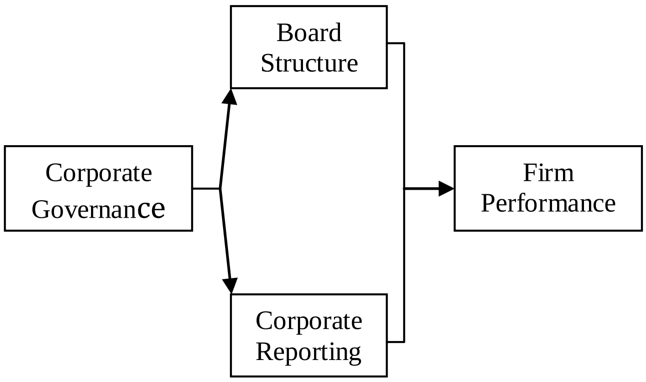

Figure 01: Conceptual Model

C. Hypotheses

The following hypotheses are formulated for the study
H1: Boards structure is positively associated with firm performance.
H2: Corporate reporting is positively associated with r firm performance.
H3: Board structure and corporate reporting have impact on firm performance

D. Methodology

Manufacturing Companies listed under Colombo Stock Exchange are the sampling organizations, Thus Ten Companies such as Royal Cerimics PLC, Singer Ceylon Plc, Chevron Plc, Bogala Graphite Lanka Plc ,lanka aluminium industries PLC, Lanka Walltile PLC, Acme Printing & Packaging PLC, Central Industries PLC, Diamonds Jewellery, KELANI TYRES PLC are selected for the present study. Board structure and corporate reporting were used to measure the corporate governance while ROE, ROA and NP were used to measure the firm performance of selected companies. Using above determinants, the following models were formulated.

$ROE=\beta_o+\beta1(bs)$………………………………….(1)
$ROA=\beta_o+\beta1(bs)$……………………………….. (2)
$NP=\beta_o+\beta1(bs)$………………………………….. (3)
$ROE=\beta_o+\beta1(cr)$…………………………………. (4)
$ROA=\beta_o+\beta(cr)$………………………………… (5)
$NP=\beta_o+\beta1(cr)$………………………………… (6)

Where
$\beta_o + \beta1$ =Co- effeients
ROE = Return on Equity
ROA = Return on Assets
NP= Net Profit
bs= Board Structure
cr= Corporate reporting

With these models data were analyzed by using the appropriate statistical tools such as descriptive statistics, correlation and regression.

V. Data Analysis and Findings

A. Descriptive Statistics:

Descriptive statistics for 2006 and 2010 were calculated for corporate governance variables and firm performance variables in the study. Descriptive statistics compared the compliance by the companies with corporate governance best practice recommendations in 2006 and 2010. They also described the characteristics of board structure and corporate reporting prevalent among listed companies in Sri Lanka and the variables used to measure firm performance.

Table 01: Descriptive statistics

Variables	**2006**			**2010**		
	Minimum	Maximum	Mean	Minimum	Maximum	Mean
Board Structure	4	14	8.43	4	15	9.27
Corporate Reporting	0	1	51	0	1	76
Return on Equity	-14	45	14.43	3	97	21.73
Return on Assets	-4	23	4.58	1	37	7.38
Net Profit	7.66	17.34	6	11.92	26	9.93

Board structure, shows that there is a large variation in the percentage of directors on the boards in both years. In 2006, the number of directors ranged from a minimum mean of4% to a maximum mean of 14%, and in 2010 it ranged from a minimum mean of 4% to a maximum mean of 15% the mean of proportion of the directors on the boards increased from 8% in 2006 to 9.27 % in 2010, which is a relatively small increase.

Corporate reporting presents reporting on corporate social responsible activities by the companies in Sri Lanka. Corporate reporting by the firms in the sample increased from 51% in 2006 to 76% in 2010. Further it was observed that an increase on return on equity and return on assets as well as the net profit in the year 2010 as compared to the year of 2006.

B. Spearman's Correlation:

Correlation analysis was carried out to find out the relationship between the variables of corporate governance and firm' performance.

Table 02: Multiple correlation matrix for companies

	BS	CR	ROE	ROA	NP
Board structure (BS)	1				
Corporatereporting (CR)	0.16	1			
Return on equity (ROE)	0.497**	0.643**	1		
Return on assets (ROA)	0.234**	0.324**	0.342*	1	
Net profit (NP)	0.352**	0.243*	0.205	0.242*	1

Table 02 shows the relationship between the variables. Accordindly board structure is correlated with ROE and NP with the r-values of 0.497, and 0.352 which are significant at 0.01 levels where as the board structure is correlated with ROA with the r-value of 0.234 which is significant at 0.05 levels. Similarly the correlation value between corporate reporting and net profit is 0.243 which is significant at 0.05 levels. These indicate that board structure and corporate reporting are associated with determinants of firms' performance. So the hypothesis one and two are accepted.

Table 03: Regression Analysis

Model	Variable	R	R^2	Adjusted R^2	Std error of the estimate	F
1	Boad Structure/ROE	0.497	0.247	0.244	2.469	0.000
2	Boad Structure/ROA	0.234	0.054	0.05	1.143	0.000
3	Boad Structure/NP	0.352	0.123	0.12	1.698	0.000
4	Corporate reporting/ROE	0.643	0.413	0.256	0.274	0.000
5	Corporate reporting/ROA	0.324	0.104	0.175	0.285	0.000
6	Corporate reporting/NP	0.329	0.108	0.90	0.3034	0.000

The regression analysis was carried out to find out the impact of corporate goverence (Board Structure and Corporate Reporting) on firm performance (ROA, ROE and NP) and the result are furnished by the Table 03. The models 1, 2, and 3 show the impact of the board structure on the return on the equity, return on assets and net profit respectivily where as models 4, 5 and 6 show the impact of corporate reporting on return on the equity, return on assets and net profit respectivily. Accordingly, R^2 values of 0.247, 0.054 and 0.123 indicate that the board structure of the selected companies is contributing to the ROE, ROA, and NP by 24.7%, 5.4% and 12.7% respectivily and the remaining 75.3%, 94.6% and 87.3% can be attributed by other factors which are not studied, because they are outside the scope of the study. Similarly R^2 values of 0.413, 0.104, and 0.108 which are denoted by the model 4,5 and 6 reveal that the corporate reporting of the selected companies is contributing to the ROE, ROA and NP by 41.3% 10.4% and 10.8 respectively, and the remaining 58.7%, 89.6% and 89.2% can be attributed by the other factors. It can be noted that the impact of corporate structure on ROE and ROA is higher than the board structure., but the impact of board structure on net profit is higher than the corporate reporting. Anyhow the management of the companies should be specifically concerned on both board structure and corporate reporting inorder to enhance the performance of the above companies.

Table 04: Co-efficient of corporate governance

Model	Unstandard co-efficients		Standise Co efficients	t	Sig
	B	Std error	Beta		
1	20.143	1.926		14.092	0.000
Constant Bs	2.339	0.620	0.811	19.476	0.000
2	21.042	2.333		13.305	0.000
Constant Bs	2.057	0.143	0.715	14.390	0.000
3	32.421	2.974		10.902	0.000
Constant Bs	1.973	0.183	0.609	10.804	0.000
4	6.120	0.387		15.834	0.000
Constant Cr	0.415	0.098	0.521	4.231	0.000
5	6.146	0.492		12.499	0.000
Constant Cr	0.428	0.127	0.438	3.372	0.000
6Constant	6.063	0.651		9.311	0.000
Cr	0.370	0.153	0.329	2.416	0.000

The table 04which deals with the coefficient analysis shows the beta value of corporate governance which are determined by the board structure and corporate reporting. Using the above values the following formula can be constructed.

ROE = 20.143+2.339 (Bs)
ROE=6.120+0.415 (Cr)

ROA=21.042+2.057 (Bs)
ROA=6.146+ 0.428 (Cr)

NP=32.421+1.973(Bs)
NP=6.063+0.370 (Cr)

t-values for all variables are significant Hence the board structure and corporate reporting have a significant impact on ROA, ROE and NP as the measurements of firm performance. Hence the hypothesis 03 is also accepted.

VI. CONCLUSION

Board structure and corporate reporting as the determinants of corporate governance are positively correlated with the variables of ROE, ROA and NP as the measurements of firm performance. Regression analysis shows that the board structure and corporate reporting have impact on the variables of ROE, ROA, and NP.

VII. SUGGESTIONS

As a result of the above study, the corporate governance code should include following:

a. Include a risk management committee.

d. Recognize the various stakeholders relevant to the business that will add value to the organization, and,

i. Consider aligning the CR strategy with the objectives of the firm.

ii. Define the CR policies that determine the long-term value of the firm and supervise their implementation.

It is expected that these recommendations to the code will have an impact on firm performance in relation to corporate governance practices in Sri Lanka.

In Sri Lanka, the business environment is dominated by the private sector. The findings of this study show that implementing good governance practices increases firm performance. As a result, this study has significant implications for the corporate sector, investors, policy makers, international agencies, government and stakeholders, due to the importance of the corporate success to the economy of the country.

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