



CORPORATE GOVERNANCE AND FIRM PERFORMANCE: EMPIRICAL EVIDENCE FROM EMERGING MARKET



 Saseela Balagobei¹

¹Senior Lecturer, Department of Financial Management, University of Jaffna, Sri Lanka

Email: saseelab@univ.jfn.ac.lk Tel: +94779687100



ABSTRACT

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Corporate governance (CG) has become a dominant theme in developed and developing countries. This study aims to investigate the impact of CG on firm performance of listed companies in Sri Lanka. Fifty listed companies were selected as a sample by using proportion random sampling method. Apart from that secondary data were collected from the annual report of listed companies in Sri Lanka from 2010 to 2015. This study considers the CG which is measured by board size, board independence, CEO duality, director's ownership and audit committee as the independent variable while firm performance which is measured by ROA and Tobin's Q as a dependent variable. Multiple regressions and Pearson's correlation analyses were employed as the main tool of analyzing data. The results reveal that the board size and audit committee have significant impact on ROA and board size has significant impact on Tobin's Q, whereas board independence, CEO duality and director's ownership have insignificant impact on both firm performance measures such as ROA and Tobin's Q. Furthermore the board size and audit committee have negative relationship with firm performance. This study suggests that small boards are associated with higher firm performance, possibly through closely monitored managements.

Contribution/ Originality: This study investigates the impact of corporate governance on firm performance of listed companies which are included in all business sectors in Colombo Stock Exchange.

1. INTRODUCTION

This study focuses on the impact of CG on firm performance of firms listed in Sri Lanka. CG refers to the system an organization is directed, administrated or controlled. It consists of rules and regulations that influence on the manager's effective decision and contributes to the way firm is perceived by the existing and potential stakeholders. The CG structure recognizes the distribution of rights and responsibilities among several stakeholders in the firm such as; boards, managers, investors and other stakeholders and spells out the rules and procedures and also decision making assistance on business affairs. CG is concerned with the ways in which stakeholders involved in the prosperity of the firms strive to ensure that managers and other insiders take measures or adopt mechanisms that safeguard the interests of the stakeholders.

As a result of the process of globalization and the rising complications of business, there is more reliance on the private sector as the engine of growth of all countries. Corporations are legal bodies created by the people because

they are well-organized form of organization and society welfares from their survival. Companies provide their contribution to economic expansion and social development, which improve the living standard and reduce the poverty of the people.

The firm performance consists of financial and nonfinancial indicators which provide the information for the achievement of objectives and results (Kaplan and Norton, 1992; Lebars and Euske, 2006). Financial ratios are used by various stakeholders for making their effective financial decisions such as investing, and performance appraisal decisions. However, the financial ratios still kept its classical and fund a mental power either as part of these financial and accounting models or as another important supportive analysis with it.

In this study CG is measured by number of the directors on the board, number of independent directors, CEO duality, director's ownership and audit committee; and firm performance measured by ROA and Tobin's Q. Good CG practices play a significant role in reducing the risk for shareholders, expanding the investment capital and increasing the performance of the companies.

Despite a lot of research works have been done to investigate the effect of CG on firm performance in emerging market, it is observed that only a few have been conducted in the context of Sri Lanka. Moreover, there are no studies which included all business sectors in Colombo Stock Exchange during the period of 2010 to 2015. Apart from that, there is no consensus related to the association between CG and firm performance. For instance, Guo and Kga (2012); Smirat and Sharif (2014); Guritno *et al.* (2016); Khan and Ali (2017) indicated that board size is negatively associated with firm value and effect of the proportion of outside directors on operating performance of a firm. In contrast, Velnampy and Pratheepkanth (2013) highlighted that board structure and corporate reporting as the determinants of CG are positively correlated with the firm performance variable of ROA.

Similarly, Vo and Phan (2013) indicated that board size is negatively correlated with firm performance, further CEO duality negatively affects firm performance, Director's ownership is positively related to a firm's performance. Under this scenario, the study is needed of carrying out an empirical study in emerging market in order to address the highlighted gaps. The present study is initiated to examine that; To what extent CG impacts on firm performance of listed companies in Sri Lanka? Hence, the objective of this study is to investigate the impact of CG on firm performance of the companies listed in Sri Lanka for the period of 2010 to 2015.

2. LITERATURE REVIEW

The previous studies discuss the issues on CG from different perspectives and with the view of giving empirical foundation to the study.

Padmanabha and Rathish (2017) analyses the effect of Malaysian Code on Corporate Governance (MCCG) on performance by using the sample of 113 listed companies in Malaysia. The study incorporates endogenous relationship between CG, firm performance and leverage and findings reveals that the performance of the firm is positively and significantly related with CG measured by corporate governance index. Secondly, CG of sample firms shows marked improvements after implementation of MCCG 2012 as compared to MCCG 2007.

Siddiqui (2015) examines the relationship between CG and firm performance by conducting a meta-analysis of 25 previous studies. The results are that the external governance mechanisms measured by anti-takeover provisions and market value of firm performance measured by Tobin's Q and market to book value are the key moderators of this relationship.

Arora and Sharma (2016) indicate that larger boards are associated with a greater depth of intellectual knowledge, which in turn helps in improving decision-making and enhancing the performance. On the other side, the results indicate that return on equity and profitability is not related to CG indicators. The results also suggest that CEO duality is not related to any firm performance measures for the sample firms.

Zukaa *et al.* (2018) show that ownership structure is the only significant CG provision in determining performance of Syrian firms, as it loads positively and significantly on firm performance proxies (ROA and EPS). This result is robust for both measures of firm performance and in the presence of political stability indicator.

Dalwai *et al.* (2015) create a focus for future research of measuring the impact of CG mechanism on firm performance. The regulators will be encouraged to focus on more research studies for the Gulf Cooperation Council sector development in the field of CG of the banking sector.

Ahmed *et al.* (2013) find out that board size is positively, whereas outside directors and managerial ownership are negatively related to the return on assets, earnings per share, and market-to-book ratio. Further internal CG mechanisms have material effects on firm performance. Alix *et al.* (2011) that negative change in firm performance was significantly related to a decrease in the overall number of directors and a decrease in the number of outside directors.

Guo and Kga (2012) investigate the impact of CG on firm performance of listed firms in Sri Lanka. Findings found that board size is negatively correlated with the firm value and proportion of non-executive directors in a board has negative relation with financial performance of firm.

Yermack (1996) finds that a statistically significant negative relationship between board size and firm performance as measured by Tobin's Q with sample of 452 large U.S. industrial corporations for the period of 1984 to 1991. In the same study Yermack also exhibits that companies with small boards have more favorable values for financial ratios. Similarly Eisenberg *et al.* (1998) conclude the negative relationship between firm board size and performance measured by ROA for a sample of 879 small private firms in Finland.

Fratini and Tettamanzi (2015) investigate the impact of CG on performance of 182 Italian listed companies by using both accounting and non-accounting performance measures. The study found that only board size kept its positive relation with performance. Audit committee and leverage lost their relevance in 2007 sample in which the presence of a compensation committee showed a positive impact on performance.

3. METHODOLOGY

Data was collected from secondary sources such as annual reports of listed companies published by Colombo Stock Exchange. Specifically, the financial statements of the listed companies were collected for the period of 2010 to 2015. The Colombo Stock Exchange has 295 companies representing 20 business sectors with a Market Capitalization of Rs. 2, 701.6 Bn. Fifty companies were selected as sample by using random sampling method.

The following measurements of the variables in this study are as follows.

- Board size: Number of the directors on the board
- Board independence: Number of independent directors / Board of directors on the board
- CEO duality: Coded "1" if Chairman also holds the position of CEO and "0" otherwise
- Director's ownership: The shares owned by directors / No of Equity Shares
- Audit committee: The number of the auditors during the year
- ROA: Net profit before tax / Total assets
- Tobin's Q: (Market capitalization + Total assets - Share holders funds) / Total assets

This study constructs regression model for carrying out empirical analysis to investigate the relationship between CG and firm performance.

$$ROA = \beta_0 + \beta_1 BS + \beta_2 BI + \beta_3 CEO + \beta_4 DO + \beta_5 AC + \varepsilon \dots\dots\dots(1)$$

$$TB = \beta_0 + \beta_1 BS + \beta_2 BI + \beta_3 CEO + \beta_4 DO + \beta_5 AC + \varepsilon \dots\dots\dots(2)$$

Where:

- $\beta_0, \beta_1, \beta_2, \beta_3, \beta_4, \beta_5$ –Regression coefficient
- BS – Board size
- BI – Board Independence

CEO	– CEO duality
DO	– Director Ownership
AC	– Audit committee
TB	– Tobin's Q
ε	– Error

4. DATA ANALYSIS AND DISCUSSION

4.1. Correlation Analysis

The Pearson correlation coefficient matrix is used to identify the direction and strength of the relationship between the CG and firm performance.

Table-2. Correlation Matrix

		ROA	Tobin's Q	BS	BI	CEO duality	DO	AC
ROA	Pearson Correlation	1						
	Sig. (2-tailed)							
Tobin's Q	Pearson Correlation	.532**	1					
	Sig. (2-tailed)	.000						
BS	Pearson Correlation	-.310**	-.210**	1				
	Sig. (2-tailed)	.000	.000					
BI	Pearson Correlation	.055	-.140*	-.069	1			
	Sig. (2-tailed)	.343	.015	.236				
CEO duality	Pearson Correlation	.052	.052	.042	.128*	1		
	Sig. (2-tailed)	.373	.366	.472	.026			
DO	Pearson Correlation	-.057	-.030	.260**	-.079	.227**	1	
	Sig. (2-tailed)	.325	.610	.000	.174	.000		
AC	Pearson Correlation	-.204**	-.215**	.334**	.389**	.134*	.012	1
	Sig. (2-tailed)	.000	.000	.000	.000	.020	.842	

** Correlation is significant at 0.01 levels (2-tailed), * Correlation is significant at 0.05 level (2-tailed).

Table 2 displays the Pearson correlation coefficient between CG and firm performance of the selected listed firms in Sri Lanka. According to this table the value of correlation coefficient between board size and ROA of the firm is -0.310^{**} , which is significant at 1% level; represents negative association between board size and ROA. At the same time audit committee is also negatively associated with ROA at 1% level of significant. Furthermore board independence, CEO duality and director's ownership are not associated with ROA. The value of correlation between board size and Tobin's Q of the firm is -0.210^{**} , which is significant at 1% level; represent negative association between board size and Tobin's Q. At the same time audit committee is also negatively associated with Tobin's Q at 1% level of significant and the value of correlation between board independence and Tobin's Q of the firm is -0.140^* , which is significant at 5% level; represents negative association between board independence and Tobin's Q. Furthermore CEO duality and director's ownership are not associated with Tobin's Q.

4.2. Multiple Regression Analysis

The multiple regression analysis quantifies the influence of CG on firm performance.

Table-3. Multiple regression analysis for ROA

Model	Un standardized Coefficients		t value	Sig.
	B	Std. Error		
(Constant)	.236	.035	6.643	.000
Boar size	-.013	.003	-4.061	.000
Board independence	.095	.062	1.520	.129
CEO duality	.029	.023	1.265	.207
Director ownership	.002	.100	.019	.985
Audit committee	-.022	.009	-2.563	.011
$R^2 = 0.121$				

Dependent Variable: ROA

The table 3 presents the results of multiple regression analysis. The Multiple regression analysis was carried out, in order to evaluate how well the firm performance (ROA) can be explained by knowing the values of CG. In this model the specification of five variables (board size, board independence, CEO duality, director's ownership and audit committee) revealed the ability to predict the ROA. Respective R^2 value of 0.121 denotes that 12.1 % of the observed variability in ROA can be explained by the differences in variables namely board size, board independence, CEO duality, director's ownership and audit committee. The remaining 87.9% is not explained which means that the remaining 87.9% of the variance in ROA is related to other variables not depicted in this model.

Further, this model reveals that the co-efficient of board size is -0.013. It indicates board size has negative significant impact on ROA because its significant value is less than significant level 0.05. The coefficient for board independence, CEO duality and director's ownership are not significant at 0.05 levels. It means that these variables are not contributing to the firm performance measure of ROA. The co-efficient of regression is -0.022 for audit committee. It also indicates audit committee has negative significant impact on ROA.

Table-4. Multiple regression analysis for Tobin's Q

Model	Un standardized Coefficients		t value	Sig.
	B	Std. Error		
(Constant)	6.659	.884	7.534	.000
Board size	-.224	.080	-2.815	.005
Board independence	-2.909	1.551	-1.875	.062
CEO duality	.917	.567	1.618	.107
Director ownership	-.526	2.483	-.212	.833
Audit committee	-.402	.216	-1.860	.064
$R^2 = 0.085$				

Dependent Variable: Tobin's Q

The table 4 presents that specification of five variables (board size, board independence, CEO duality, director's ownership and audit committee) and reveals that ability to predict the Tobin's Q. Respective R^2 value of 0.085 denotes that 8.5 % of the observed variability in Tobin's Q can be explained by the differences in variables namely board size, board independence, CEO duality, director's ownership and audit committee. The remaining 91.5% is not explained which means that the remaining 91.5% of the variance in Tobin's Q is related to other variables not depicted in this model.

Further, this model reveals that the co-efficient of regression is -0.224 for board size. It indicates board size has negative significant impact with Tobin's Q, because its significant value is less than significant level 0.05. The coefficient for board independence, CEO duality, director's ownership and audit committee are not significant and these variables are not contributing to the firm performance measure of Tobin's Q.

5. CONCLUSION

This study investigates the impact of CG on firm performance of listed companies in Sri Lanka during the period of 2010 to 2015. Based on multiple regressions analysis this study has found that board size and audit committee has significant impact on ROA. This is corroborated by the findings of other works such as [Guo and Kga \(2012\)](#); [Fratini and Tettamanzi \(2015\)](#) and [Azeez \(2015\)](#). Further board size has significant impact on Tobin's Q. This is corroborated by the findings of other works such as [Fratini and Tettamanzi \(2015\)](#). Board independence, CEO duality and director's ownership have insignificant impact on both firm performance measures. Therefore some variables of CG have significant impact on firm performance of listed companies in Sri Lanka, whereas some other variables have little impact.

Based on the correlation analysis this study has found that board size and audit committee has significant relationship with both firm performance measures at 1% significant level. This is corroborated by the findings of

other works such as Guo and Kga (2012); Azeez (2015) and Eisenberg *et al.* (1998). There is significant relationship between board independence and Tobin's Q, at 5% significant level.

6. RECOMMENDATION AND SUGGESTIONS

The researcher has collected relevant data of listed companies in Sri Lanka and analyzed to find out the impact of CG on firm performance. From the detailed study about the CG variables, the researcher has some suggestions to improve the firm performance of listed companies in Sri Lanka. From this study it is observed that the increasing board size has negative impact on the firm performance. The main reason is that with the increasing number of board members may cause the conflicts among the directors when making the effective decision and suitable actions cannot be taken on time, thus affects the firm performance. Therefore, smaller board size is much more efficient and preferred. The same thing applies to the size of the audit committee of an organization. Smaller the size, the firm performance is better. Similar findings are obtained using the agency theory as well.

However presences of board independence directors are not associated with firm performance of listed companies in Sri Lanka suggesting that mere presence of board independence directors would not ensure the stakeholders that the firm is running in fair and smooth manner reducing agency conflicts between shareholders and the management.

During the course of this study several ideas and potential research areas have been identified. The purpose of this section is to serve as a source of inspiration for further researchers. In this manner the followings are the suggestions for further researches.

- There are 295 listed companies in Sri Lanka. But this study selected only fifty companies as sample.
- Only six years data were taken for the study. So the data is not sufficient to take correct finding.
- There are so many CG variables are available. But this study considers only five variables: those are board size, board independence, CEO duality, director's ownership and audit committee.
- Only financial performance was considered in this study. In future non-financial performance should consider by the researcher.
- Secondary data was used in this research. Primary data may be considered in future research.

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