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Corporate Governance Practices and Its Impact on firm Performance : Special Reference to Listed Banking Institutions in Sri Lanka

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Received: 12 December 2011 Accepted: 2 January 2012 Published: 15 January 2012

Abstract

Background of the Study : The term "corporate governance" came into popular use in the 1980's to broadly describe the general principles by which the business and management of companies were directed and controlled. Further, Governance may be said to be all about effective, transparent and accountable administration of affairs of an institution by its management, while protecting the interests of its stakeholders including shareholders, creditors, regulators and the public.Objective : The objectives of the study are to find out the relationship between corporate governance practices firm performance; to examine the impact of corporate governance on firm performance in listed banks,

Index terms— corporate governance practices and firm performance

1 Introduction

orporate governance has become a popular discussion topic in developed and developing countries. The widely held view that corporate Author : University of Jaffna. E-mail : k.r.kaja@gmail.com the interests of shareholders has led to increasing global attention. Today corporate governance has become a worldwide issue and the development of corporate governance practices has become a prominent issue in all countries in the world. Sri Lanka too is not immune from these developments and problems relating to corporate governance. Further, many financial regulations and supervision systems were established in order to control banking activities and ensure the safety of investors. In Sri Lanka, attempts to improve corporate governance in the past have been through the adoption of voluntary codes. Several years ago the Central Bank published a voluntary code for banks to adopt (Kumudini, 2011).

According to the Sivesan, Achchuthan, Manusuthan and Piriyatharsan (2012), the banks are fighting with each other to gain a great slice of the market share with a globalization effect. Therefore, the banks have to face difficulties to meet the high growth of customer expectations. Velnampy and Nimalathasan (2008)says according to their study on association between organizational growth and profitability: a study of commercial bank of ceylon ltd srilanka in developing countries like Sri Lanka, banking organizations provide fund for other organizational developments. Financial System of a country is broadly the mechanism in the financial market which deals with the Business or transactions in money. The financial sector in every country has become the deciding factor of the economy. The banking organisations, today, is moving towards the goal of integrated financial services because of the strong competition and quick changes of technology (Velnampy and Nimalathasan). In srilanka, banking sector is considered as main recipient in recent economic downturn. Therefore, better formation of strategies in banking sector is the most needed one especially in the recent information technology era. Furthermore, in Srilanka, the rapid growth of banking and other financial services provide the financial infrastructure facilities to the economic expansion and structural transformation .this is clearly reflected in the growth of assets in the financial sector and the contribution of the financial sector to gross national product in last ten years. In this context, Bank governance determines firm performance and protects

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Objective : The objectives of the study are to find out the relationship between corporate governance practices & firm performance; to examine the impact of corporate governance on firm performance in listed banks, SriLanka in the years of ??006, 2007, 2008, 2009, and 2010. Design/methodology/approach : In an empirical study, leadership structure, board composition, board committees, board size and board meeting in the corporate governance dimensions to predict the firm performance were examined. A sample of 11 listed banks were selected from database of Colombo stock exchange for the during the period 5years from 2006 to 2010. The selection was determined by the availability of data for years. Data was obtained from annual reports. The data was analyzed with SPSS to obtain quantitative measures of descriptive statistics, Spearman's correlation, regression analysis and analysis of variance.

Findings : This study provided evidence in support of a positive relationship for separate leadership, board composition, board committees and firm performance. In this study, the positive relationship between corporate governance structures, separate leadership, board composition, board committees and firm performance indicated that firms had implemented corporate governance strategies, which had resulted in higher profitability. Further the corporate governance practices have a significant impact on firm performance.

Practical implications : 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.

represent machines of economic growth. For this reason, Corporate Governance of banks plays important role in the global financial scene. Further, as the development of the capital markets in Sri Lanka is a result of the liberalization of the economy in 1977, among other things, the country has experienced good performance and increased investor confidence in listed companies. In order to attract foreign direct investment, organizations such as the World Bank and International Monetary Fund (IMF) are promoting better governance for their member countries and wider networks. As a result, corporate governance initiatives in Sri Lanka commenced in 1997 with the introduction of a voluntary code of best practice on matters relating to the financial aspects of corporate governance. The Bank is required to mandatorily comply with the Corporate Governance rules of the Code of Best Practice of Corporate Governance laid down as per Central Bank Direction No. 11 of 2007 as amended as aforesaid and also the Colombo Stock Exchange rules of Corporate Governance for listed entities which became mandatory for banks with effect from the financial year January 2009.before that compliance with the ICASL/SEC code of best practice on corporate governance was on a voluntary basis.

II.

2 Objectives

The Bank is required to mandatorily comply with the Corporate Governance rules of the Code of Best Practice of Corporate Governance laid down as per Central Bank Direction No. 11 of 2007 as amended and also the Colombo Stock Exchange rules of Corporate Governance for listed entities which became mandatory for banks with effect from the financial year January 2009.before that compliance with the ICASL/SEC code of best practice on corporate governance was on a voluntary basis. Corporate governance research has also evolved along a similar trajectory. The purpose of this study was to examine the relationship between corporate governance practices & firm performance; to examine the impact of corporate governance on firm performance in listed banks, SriLanka in the years of ??006, 2007, 2008, 2009, and 2010.

3 III.

4 Review of Literature

In order to understand corporate governance in Sri Lanka, a review of relevant literature is fundamental one to discussing corporate governance practices and firm performance in the organization perspective. According to the Organization for Economic Cooperation and Development (??004), the corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets. Further, today corporate governance is complex and mosaic, consisting of laws, regulations, politics, public institutions, professional associations and a code of ethics. However, in the emerging markets of the developing countries many details of these structures are missing. For them developing a system of good corporate governance is difficult because such governance is complex and vague due to the confusing relationships between state and financial sectors, weak legal and judicial systems, absent or underdeveloped institutions, corrupt political systems, and scarce human resource capabilities (Chowdary 2003), which can negatively affect the return on investment (Dallas & Bradley 2002).

Corporate governance comprises several elements of the structure of the government, which includes capital, labour, market, organisation along with their regulatory mechanisms. It also involves the processes that connect the structures with agents, including management control and accountability, as well as rules, regulations, laws and institutionalized procedures and norms (Alawattage & Wickramasinghe 2004). However, governance is more than board processes and procedures, involving relationships between management, boards, shareholders and other stakeholders such as employees and the community (Bain & Band 1996; ??howdary 2002). Shleifer and Vishny (1997) view corporate governance as a set of mechanisms which ensures that potential providers of external capital receive a fair return on their investment, because the ownership of firms is separated from their control. And also corporate governance promotes efficient use of resources within the firm and the larger economy. It also helps firm's to attract low cost investment capital through improved investor and creditor confidence, both nationally and internationally. It also increases the firms' responsiveness to the need of the society and results in improving long-term performance (Gregory & Simms 1999). Following key points help to emphasis the significance of corporate governance especially in the banking sector as Banking system stability is important for economic growth; Good corporate governance (CG) is required in banks to achieve good CG in other firms; Banks have wider stakeholders-government, regulators and most importantly depositors ; Promotes market confidence; helps to attract additional capital and fosters market discipline through good disclosure and transparency; Helps ensure that company takes into account the interest of not only of a group of people but also of the communities within which they operate; Those actions in turn help to ensure that FIs are operating for the benefit of society as a whole and Good corporate governance practices can strongly contribute to financial market development and financial stability etc. Based on the relevant literatures, we have pointed that, there is a significant relationship between corporate governance and firm performance in developing and developed countries. in the Malasiyan context, Abdul Rahman (2006) has approached on the corporate governance practices, the findings revealed that, most Malaysian companies are controlled by foreigners from European countries, particulary the U.K. According to Gomez (2004), most of the small and medium enterprises (SMEs) owners prefer their heirs to become professionals and do not encourage passing business to them. Indeed, previous studies in several other countries also find a negative relationship between board size and firm performance. ??elnampy

5 H1b

A majority of non-executive directors on the board is associated with firm performance.

6 H1c

Boards committee structures composed of audit, remuneration and/or nomination committees are positively associated with firm performance.

7 H1d

Board size is associated with firm performance.

8 H1e H2

Board meeting is associated with firm performance There is a significant impact of corporate governance on the firm performance c) Sample Selection

The objective of the study was to conduct an investigation of the corporate governance practices of listed banking institutions in Sri Lanka and their effect on firm performance. The following section discusses the method of data collection and types of data that were collected to conduct the study. The study assessed the relationship between corporate governance practices and firm performance of listed companies in Sri Lanka. The data and information required for the study were collected from the Colombo Stock Exchange (CSE) websites, annual reports, journals and the Colombo Stock Exchange publication e) Data Collection Methodology Data on corporate governance practices and firm performances were collected from secondary sources.

9 f) Types of Data collection

For the purpose of this study data were collected for the period between 2006 and 2010. The data required for the study included board leadership (if the positions of chairman and the CEO were held by single person or two separate persons), composition of the board (number of non-executive directors), board committees (details of the audit, remuneration and nomination committees) board size (no of directors) and board meeting (no of meetings). Performance data used in the study were return on investment (ROE), and return on assets (ROA). g) Data analysis method Preliminary analysis of the data was carried out for the years ??006, 2007, 2008, 2009 and 2010. At this stage, firms with missing information were excluded from the study to test the relationships suggested in the hypotheses stated in the conceptual framework, the SPSS statistical program was employed. The analysis included descriptive statistics, Spearman's correlation, and regression analysis.

V.

10 Results and Analysis

a) Correlation analysis Table 3. Presents Spearman's correlation for all the variables in the study. It examined the association between the corporate governance variables and firm performance variables. Overall, the correlations were low. But there are a number of statistically significant relationships.

Further, there is a significant relationship between corporate governance dimensions as composition of board, board committee, board size, board meeting, and firm performance.

And also all the correlation values are in the lowest level expect composition of board and firm performance.

11 Year b) Regression Analysis

The purpose of regression analysis is to find out the significant impact or influence of independent variable on dependent variable. In this study, corporate governance is considered as independent variable or predictor variable, and the firm performance is considered as dependent variable. [1] [2]

Figure 1:

1

and

Figure 2: Table 1 :

2

NO

Figure 3: Table 2 :

[1]

[2] Corporate Governance Practices and Its Impact on Firm Performance : Special Reference to Listed Banking Institutions in Sri lanka

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2012 ear Y 2 and Business Research Volume XII Issue XXI Version I	COB BC BZ BM	Sig. (2-tailed) Pearson Correlation Sig. (2-tailed) Pearson Correlation Sig. (2-tailed) Pearson Correlation Sig. (2-tailed) Pearson Correlation Sig. (2-tailed)	COB . 1 .000 .671 * .024 - .657 * .028	BC . .000 1.000 1 .289 .389 - .122 .721	BZ . .671 * .024 .289 .389 1 - .744 ** .009
Global Journal of Management	a. Cannot be computed because at least one of the variables is constant. *. Correlation is signifi				
	BM: BOARD MEETING FP: FIRM PERFORMANVCE				

Figure 4: Table 3 :

4

a. Predictors: (Constant), BOARD MEETING, BOARD COMMITEE, COMPOSITION OF BOARD, BOARD SIZE

Figure 5: Table 4 :

5

Figure 6: Table 5 :

6

a. Predictors: (Constant), BOARD MEETING, BOARD COMMITEE, COMPOSITION OF BOARD, BOARD SIZE

b. Dependent Variable: FIRM PERFORMANCE

a. Dependent Variable: FIRM PERFORMANCE

According to the

Figure 7: Table 6 :

4

Model		R	R Square	Adjusted R Square	Std. Error of the Estimate
1	. 616 a		.480	.203	3.39541

	Model	Sum of Squares	df	Mean Square	F	Sig.
1	Regression	42.397	4	10.599	9.19	.000
	Residual	69.173	6	11.529		
	Total	111.570	10			

	Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig
		B	Std. Error	Beta		
1	(Constant)	63.750	28.359		2.248	.066
COMPOSITION OF BOARD		.037	.579	.330	.064	.001
BOARD COMMITEE		2.326	2.237	.364	1.040	.008
	BOARD SIZE	1.648	1.534	.595	1.074	.905
BOARD MEETING		1.391	1.322	.536	1.053	.003

Figure 8: Table 4 .

c) Hypotheses testing Summary of the data analysis is given below through the hypotheses testing.

.1 Rejected Correlation

.2 H1b

A majority of non-executive directors on the board is associated with firm performance.

.3 Accepted correlation

.4 H1c

Boards committee structures composed of audit, remuneration and/or nomination committees are positively associated with firm performance.

.5 Accepted Correlation

.6 H1d

Board size is associated with firm performance. Accepted Correlation H1e H2

Board meeting is associated with firm performance There is a significant impact of corporate governance on the firm performance Accepted Accepted

.7 Correlation Regression

Note : All are significant at 0.05 levels.

.8 VI. Recommendations and Conclusion

This study proposed that the code of best practice should include the boards to have at least fifty percent of non-executive directors, not one third as stated in the code. It was also proposed to select the directors from a register kept by the institute of directors. In order to have a clear understanding of the risk, and manage the risks identified in a satisfactory manner, it was proposed to appoint risk management committees. Lastly, as a result of the importance of accountability to other stakeholders, this study recommended the inclusion of interests of other stakeholders in the code of best practice, which would result in share prices responding to CSR practices of firms in Sri Lanka.

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