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

By Rajendran Kajananthan
University of Jaffna

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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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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 2006, 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.
Keywords : corporate governance practices and firm performance.

I. Introduction

Corporate governance has become a popular discussion topic 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. 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

Author : University of Jaffna. E-mail : k.r.kaja@gmail.com

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institutions in developing and developed countries 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. 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 2006, 2007, 2008, 2009, and 2010.

III. 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 Co-operation and Development (2004), 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; Chowdary 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

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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. Velnampy and Pratheepkanth in a study, entitled "Corporate Governance and Firm Performance: A Study of Selected Listed Companies in Sri Lanka" for corporate governance practices during the year between 2006 to 2010 in Selected Listed Companies in Sri Lanka, showed a positive relationship between the variables of corporate governance and firm's performance. According to the studies of Black, jang and kim, 2006; Drobetz, Schillhofer and Simmermann (2004); Ong, Wan and Ong (2003), and Gedajlovic and Shapiro (2002), there was the positive significant relationship between corporate governance practices and firm performance in various countries, in contrast, based on the studies of Guler, Mueller and Yurtoglu (2001), Hovey, Li, and Naughton (2003) and Alba, Claessens And Djankov (1998), there was no significant relationship between corporate governance and firm performance.

IV. Methodology

a) Operationalization

Table 1 : Variables used to study the corporate governance practices

Variables	Measures	Symbols
Corporate Governance		
Separate leadership	Dummy variables 0 for combined leadership and 1 separate leadership	LDS
Board composition	Non-executive directors to number of directors	COMP
Board committees	Dummy variables 0 if less than two committees are represented and 1 if all three committees are represented	COMM
Board size	Number of directors	BSIZE
Board meeting	Number of meetings	BM
Firm performance		
Return on equity	Profit after tax / shareholders funds	ROE
Return on total assets	Profit after tax / book value of total assets	ROA

b) Hypotheses

Table 2 : Development of Hypotheses

NO	Hypotheses
H1a	Separate leadership structure is positively associated with firm performance.
H1b	A majority of non-executive directors on the board is associated with firm performance.
H1c	Boards committee structures composed of audit, remuneration and/or nomination committees are positively associated with firm performance.
H1d	Board size is associated with firm performance.
H1e	Board meeting is associated with firm performance
H2	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 sample was selected from the 11 banking companies listed in the Colombo Stock Exchange for the period 2006,2007,2008,2009 and 2010.

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d) Data Collection

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.

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 2006, 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. 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.

Table 3 : Correlation matri

		COB	BC	BZ	BM	FP
	Sig. (2-tailed)	.	.	.	.	.
COB	Pearson Correlation	1	.000	.671*	-.657*	.077
	Sig. (2-tailed)		1.000	.024	.028	.002
BC	Pearson Correlation	.000	1	.289	-.122	.470
	Sig. (2-tailed)			.389	.721	.05
BZ	Pearson Correlation	.671*	.289	1	-.744**	.321
	Sig. (2-tailed)	.024	.389		.009	.005
BM	Pearson Correlation	-.657*	-.122	-.744**	1	.029
	Sig. (2-tailed)	.028	.721	.009		.003
FP	Pearson Correlation	.077	.470	.321	.029	1
	Sig. (2-tailed)	.002	.05	.005	.003	

a. Cannot be computed because at least one of the variables is constant.

*. Correlation is significant at the 0.05 level (2-tailed).

WHERE:

LS : LEADERSHIP STYLE
COB: COMPOSITION OF BOARD
BC: BOARD COMMITEE
BZ: BOARD SIZE
BM: BOARD MEETING
FP: FIRM PERFORMANVCE

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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.

Table 4 : Model Summary

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

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

Table 5 : Anova table in Regression analysis

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			

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

b. Dependent Variable: FIRM PERFORMANCE

Table 6 : Coefficients table in the Regression analysis

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

a. Dependent Variable: FIRM PERFORMANCE

According to the Table 4. Model Summary, Adjusted R square is 0.203. It means that there is a 20.3 % of the impact of the independent variable (corporate governance) on the dependent variable (firm performance). From the table 5. Anova table in the regression analysis, Significant P value is 0.000. It is less than the significant level 0.05. Therefore, we can conclude that 20.3 % of the impact is in the significant level.

From the Table. 6. Coefficients table in the Regression analysis, Beta value between firm performance and other predictor variables as composition of board, board committee, board size, board meeting, is 0.330, 0.364,0.595 and 0.536 respectively. These are in significant level, expect the board size. The P values of these dimensions are less than the 0.05 levels, expect the board size.

Finally, In terms of the Multiple Regression analysis, we can come to the conclusion that the predictor power of the corporate governance is in the weak level. The results of the regression analysis summarized in above tables show that corporate governance contributes significantly to the firm performance ($F= 9.19$; $P< 0.05$) and predicts 20.3 percent of the variation found.

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c) Hypotheses testing

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

Table 7 : Hypotheses testing

NO	Hypotheses	Results	Tools
H1a	Separate leadership structure is positively associated with firm performance.	Rejected	Correlation
H1b	A majority of non-executive directors on the board is associated with firm performance.	Accepted	correlation
H1c	Boards committee structures composed of audit, remuneration and/or nomination committees are positively associated with firm performance.	Accepted	Correlation
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	Correlation Regression

Note : All are significant at 0.05 levels.

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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