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Full Length Research Paper

The impact of the corporate governance on firm performance: A study on financial institutions in Sri Lanka

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Abstract

Now corporate governance issues have received wide attention of researchers for more than three decades due to the increasing economic crisis around the world. This research study consider the impact of corporate governance on the performance of listed financial institutions in Sri Lanka as main objective and recommend a suitable corporate governance practices for improving performance of listed financial institutions. To achieve these objectives, the researcher use Return on equity, Return on assets, as the key variables that defined the performance of the firm. On the other hand, Board size, Meeting frequency and audit committee of the company are used as variables to measure the corporate governance. Twenty five listed financial institutions were selected as sample size for the sample period of 2008-2012. The data will be collected by using the secondary sources. According to the analysis, variables of corporate governance significantly impact on firm's performance and board size and audit committee size have positive impact on firm's performance. However, meeting frequency has negatively impact on firm's performance.

Keywords: Corporate Governance, Performance, Sri Lanka

INTRODUCTION

Corporate governance has been generally defined as the system by which companies are directed and controlled. (The Cadbury Committee 1992).Sri Lanka has made a progress of corporate governance toward adoption of code of best practice on corporate governance (2007) with the other OCED countries and the developed world by introducing mandatory corporate governance compliances through the new listing rules (2009). There has been much discussion recently about whether corporate governance makes a difference to the bottom line that is, does good corporate governance improve company performance? A growing number of empirical researches have examined the structure and effectiveness of corporate governance towards company performance mainly in developed nations.

The purpose of this study was to investigate the impact of corporate governance on firm's performance in listed financial institutions in Sri Lanka as a result of after the adoption of corporate governance practices. Reason for the selection of listed financial institution is in Sri Lanka the financial sector has been one of the fastest growing segments of the economy, with the overall growth being manifested in the expansion of the institutional structure and developments in money and capital markets, infrastructure, facilities and products.

Further corporate governance is not something of domestic concern only, but also a matter that warrants international co-operation, especially at this time of economic and financial globalization which are vital for a developing nation like Sri Lanka. These compliances will be normally examined in the companies, which are listed under a Stock Exchange: in Sri Lanka, the Colombo Stock Exchange (CSE). CSE is an economic indicator of the country with a market capitalization of 262 billion rupees (over US $ 2.7 billion) as at 31st December 2003, which correspond to approximately, 16% of the Gross Domestic Product of the country. Hence it is important to examine through this study relationship between corporate governance and firm performance of listed financial institution in Sri Lanka. Research Question is *whether the corporate governance that has an impact on firm's performance*?

Objectives of this study

- To examine the relationship between corporate governance and firm's performance on listed financial institutions in Sri Lanka.
- To analyze the impact board size, number of board meeting and audit committee size on the listed financial institution.
- To suggest appropriate level of corporate governance mechanism to improve the firm's performance to the financial institutions

Review of literature

In Sri Lanka number of researchers has done study on corporate governance. Based on that most resent research that conducted by Kumudini Heenetigala in 2011 April, said that corporate governance practices to have a full impact on firm performance, strategies of the board should include CSR initiatives that are in the interest of all stakeholders and are relevant to business performance.

Pavithra Siriwardhane (2008) reported that Board Size and Company Performance is positively related with respect to ROE and also it is found that the contribution of an additional director is decreased when the board size and company performance is increased. In other words, high performing corporations, which already have a high average board size, do not gain much if an additional board member is joined.

According to the Chitra Sriyani De Silva Loku Waduge research, corporate governance represents institutional structures and incentive mechanisms that are implemented in order to mitigate the principal- agent problem and to thus promote the long-term competitiveness of the firm. Best practice corporate governance emphasizes accountability, transparency, shareholder rights, efficiency, and the performance of the firm.

Brown and Caylor (2006) provide evidence that only one exchange reform (board guidelines are in each proxy statement) is associated with a higher Tobin's Q, a market based measure of firm value, suggesting that regulators did not act as if they enacted corporate-governance related exchange reforms to improve firm performance. Yermack(1996) in his analysis of 452 large US corporations for the period 1984 to 1994 finds that the negative relation between board size and corporation value attenuates as the board become large.

Velnampy.T and Pratheepkanth.P state 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.

Conceptual model

Based on the literature following conceptual model is developed by the researcher. (Figure 1)

Hypotheses of the study

In this study based on above conceptual framework following hypotheses are formulated to test:

H_0: The corporate governance practices have no impact on the firm's performance.
H_1: The corporate governance practices have an impact on the firm's performance.
H_{1A}: The size of the board has a negative impact on firm performance.
H_{1B}: The number of board meeting has a negative impact on firm performance.
H_{1C}: The size of audit committee has a positive impact with firm performance.

METHODOLOGY

Data sources and sampling design

To accomplish above mentioned objectives and hypotheses, the data for this study are extracted from audited annual reports of the firm's and the Colombo Stock Exchange publications and website. Listed financial institutions (33 companies in Sri Lanka) are the population for this study. For this analysis *cluster sampling* method is used. Here all listed financial institutions are divided into four clusters such as banking, financing, leasing and insurance industries. Then 10 companies from banking and 5 companies from

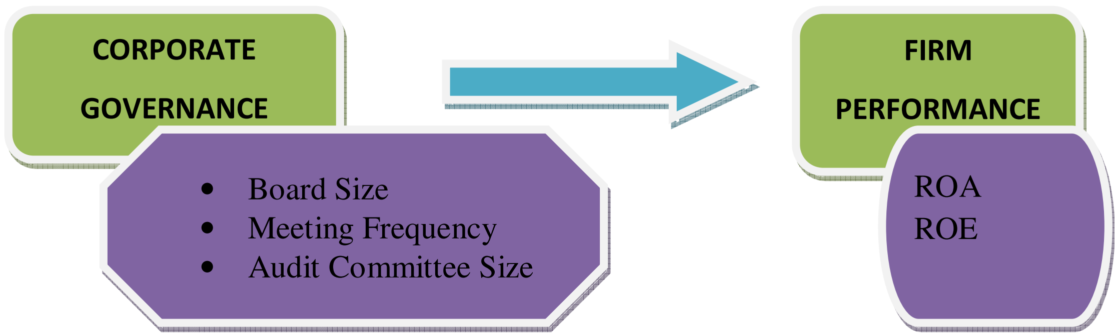

Figure 1. Author constructed

financing, leasing and insurance industry is randomly selected as sample (25 companies out of 33companies) due to the difficulty in accessibility of data.

Periods of study

In Sri Lanka code of best practices of corporate governance was introduced in 2007.Therefore, this study utilize secondary data that collected over the sample period of five years (2008, 2009, 2010, 2011and 2012).

Mode of analysis

In this study, different methods of statistical processing have been applied. SPSS software programmed exclusively applicable to statistical processing is used for processing the data. Here, Correlation, Regression, and descriptive statistics are used to analyze the data. In this study the researcher use Board size, Meeting frequency and audit committee of the company as independent variable and Return on assets and Return on equity are the dependent variable.

RESULTS AND DISCUSSIONS

Descriptive Statistics of the Variables

Average value of ROE and ROA over the five year periods are 15.37% and 5.01% (nearly 5%) in that order. That demonstrates a not notable performance of the financial in Sri Lanka under study period because minimum ROE and ROA are -123.2 and 8.6 respectively. Mean value of Board Size is 9.05 and which indicates that most of financial institutions have moderate Board Size as 9 or 10. The average value of Meeting Frequency is 11.89 (nearly 12) and which point towards normally board meets at least once a month .But when observing maximum and minimum value of Meeting Frequency, results more deviation between them and very few firms make this deviation as wide. Average value of Audit Committee Size is 3.5 (nearly 4) means that most of financial institutions in Sri Lanka have 3 to 4 members as its audit committee size. (Table 1)

Analysis of Significant of Independent Variable

In order to test the hypotheses, considering the probability of t test of profitability is significant at 5%.In the case of ROA and ROE t test of p-values are 0.0000 < 0.05for Board Size. Coefficients are 0.489 and 1.51 respectively on ROA and ROE. It illustrate that, Board Size has significant positive impact on ROA and ROE of financial institutions. ROA will be increased by 49% and ROE will be increased by 151%, when one board member increases. So Board Size has significantly positive impact on the firm performance of financial institutions in Sri Lanka. Therefore H_{1A} is not accepted and it means that increasing board size will result high financial performance because of more knowledge gathering. (Table 2 and 3)

Further, in the case of ROA with Meeting Frequency, coefficient is -0.271, test of p-value is 0.0001< 0.05. This result depicts that, Meeting Frequency has a significant negative impact on ROA and an increasing in meeting frequency will reduce the ROA by 27%. Meantime, in the case of ROE, Coefficient is -0.977, test of p-value is 0.0000< 0.05. Significant negative impact relationship exists between Meeting Frequency and ROE and ROE will have 98% negative impact due to the increases in Meeting Frequency. So meeting frequency has significant impact on the firm performance of financial institutions. H_{1B} is accepted and means that, increasing Meeting Frequency will result poor financial performance, because of increases in cost of management.

Result shows that, a significantly positive impact exists between Audit Committee Size and ROA. Because, in the case of ROA, Coefficient is 1.357, test of p-value is 0.0000< 0.05. It means that, if Audit Committee Size is increased by one member, that will give 137% increases to the ROA. At the same time, in the case of ROE,

Table 1. Descriptive Statistics of the Variables

Determinants	Mean	Maximum	Minimum	Std.Dev
BS	9.056000	18	3	2.709910
MF	11.89600	27	4	4.766861
ACS	3.504000	8	2	1.222267
ROE	15.36696	117.4000	-123.2000	24.91752
ROA	5.012000	28.32000	-30.50000	8.607987

Table 2. ROA as a Dependent Variable

Variable	Coefficient	Std. Error	t-statistic	Probability
BS	0.488606	0.083557	5.847594	0.0000
MF	-0.27107	0.065234	4.155350	0.0001
ACS	1.356824	0.207289	6.542782	0.0000

Table 3. ROE as a Dependent Variable

Variable	Coefficient	Std. Error	t-statistic	Probability
BS	1.509843	0.242007	6.238849	0.0000
MF	-0.976525	0.184917	-5.280874	0.0000
ACS	3.939413	0.611740	6.439690	0.0000

Coefficient is 3.940, test of p-value is 0.0000< 0.05. It explains that, if Audit Committee Size is increased by one member, that will give 394% increases to the ROA. So Audit Committee Size has significantly positive impact on the firm's performance. Therefore H_{1C} is accepted and means that, increasing Audit Committee Size will result high financial performance, because detailed discussion on the financial statement of the companies will lead to get more ideas regarding the reports and it will guide to increase the firm's performance.

Based on the results, that researcher found, there is a significant relationship between the corporate governance mechanism and firm performance. Meanwhile, Board Size, Meeting Frequency and Audit Committee Size have significant impact on the performance of financial institution in Si Lanka. Increases in Board Size and Audit Committee Size give positive impact to the firm's financial performance and Meeting Frequency negative impact. So H_0 is rejected and H_1 is not rejected.

CONCLUSION AND RECOMMENDATION

This study examined the whether the corporate governance factors have any significant impact on the firm performance of financial institutions in Sri Lanka after the adoption of corporate governance best practices.

On the basis of findings, it is documented that corporate governance practices of Board Size, Meeting Frequency and Audit Committee Size have significant impact on firm performance and Board Size and Audit Committee are positively related with firm's performance but Meeting Frequency has negative relation. Further, researcher can conclude that, corporate governance can be improved in Sri Lanka by companies maintain their board size to nine directors, meetings to once a month and audit committees to four members.

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