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CORPORATE GOVERNANCE ON FINANCIAL PERFORMANCE: EVIDENCE FROM LISTED COMMERCIAL BANKS IN SRI LANKA

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ABSTRACT

Corporate governance is a widely accepted governing mechanism that is followed by a majority of organizations believing that it would help to improve the financial performance of the organization. Based on this scenario, this study examines the impact of corporate governance on the financial performance of listed commercial banks in Sri Lanka. Financial performance has been considered as the dependent variable while return on assets and return on equity have been considered as the proxies for the dependent variable. Corporate governance has been considered as the independent variable while board size, board balance, female directors, board meetings, and board ownership have been considered as the proxies to measure the independent variable. A deductive approach has been employed using secondary data which is obtained from listed commercial banks in Sri Lanka. Descriptive and inferential statistics such as Pearson correlation and panel data regression have been used for the analysis purpose. The results of the Pearson correlation revealed that board size has a positive correlation with banks' financial performance while female directors show a negative relationship with banks' financial performance. Panel data analysis recommended the random effect model as the best-fitted model for ROA and ROE. The result of the Robust specification test at a 95% significant level confirmed that, in panel A for ROA, only the number of executive directors shows a significant relationship while in panel B for ROE, both independent variables of a number of executive directors and board ownership show a significant relationship. The empirical findings of this study are helpful for any individual, institutional decision-makers, managers, academics, and any other parties who are interested in corporate governance.

KEYWORDS: *Board balance, Corporate governance, Financial performance*

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1. INTRODUCTION

Corporate governance is about putting in place the structure, processes and mechanisms that ensure that the firm is being directed and managed in a way that enhances long term shareholder value through accountability of managers while enhancing firm performance. In other words, through such structure, processes and mechanisms, the well-known agency problem may be addressed such that the interest of managers can be associated with those of the shareholders.

There is no universally accepted definition for corporate governance. What is more representative of the concept is the statement that "corporate governance refers to a set of rules and incentives by which the management of a company is directed and controlled. Good corporate governance maximizes the profitability and long-term value of the firm for shareholders", which views corporate governance as a set of mechanisms through which outside investors protect themselves against expropriation by insiders. Then they give specific examples of the different forms of expropriation. The insiders may simply steal the profits; sell the output, the assets or securities of the firm they control to another firm they own at below-market prices; divert corporate opportunities from firms; put unqualified family members in managerial positions; or overpay managers. This expropriation is central to the agency problem described by Jensen and Meckling (1976) as cited by Shah and Hussain (2012).

Organizational performance changes reasonably, as the company changes the corporate governance process that influences the long-term decision and day-to-day activity. These corporate governance changes may influence the firm's performance level. When the corporate governance practices change, the companies change their performance in a favourable manner, while also changing financial leverage in a favourable manner for the shareholders.

In this case, the company should identify the main dimension to inflate the firm's performance. Further the financial manager or CFO should know how to maintain a proper performance level (ROE, ROA, P/E Ratio) by changing profit margin and share valuation. Therefore, the relationship between corporate governance system and the bank performance should be identified to make the appropriate financial decision. In order to become pioneer in the banking sector, it is vital to comply with corporate governance within organizations. Otherwise, company cannot manage their decision based on the performance when companies face bad conditions.

As per the compliances of the Sri Lankan Institute of Chartered Accountants (ICASL) and the Securities and Exchange Commission (SEC), code of best practices on corporate governance are mandatory requirements for the Sri Lankan banks. It revealed that corporate governance practices have an ability to influence on bank performance. Previous empirical studies such as Tandelilin, Kaaro and Mahadwartha (2007), Velnampy (2015), Anandasayanan and T. Velnampy (2018), Danoshana and Ravivathani (2019) stated the impact of corporate governance mechanism on financial performance of the corporations. Besides, Mohammed (2011) found that weak corporate governance practices and agency problems influence to reduce the bank performance in Nigeria. Although the scholars found a significant impact of corporate governance on financial performance, a divergence of the results can be identified related to the corporate governance practices which they employed. As examples, board gender diversity is an important factor to determine the firm performance (Boyle & Jane 2011; Bathula 2008). However, some scholars such as Rose (2007), BeleteZegeye (2015) identified gender diversity as an insignificant factor to determine the firm performance. A mixed result can be also identified related to the frequency of board meetings (Karamanou et al. 2005; Danoshana & Ravivathani 2013; Akpan 2015). Further, the same scenario can be also identified as related to the board ownership (Kibrysfaw Getahun 2013; Harun 2017). As existing knowledge generates puzzling results related to the areas of corporate governance and financial performance and moreover, as per the researchers' knowledge, in Sri Lankan context, few studies have

been conducted related to corporate governance and financial performance with reference on listed commercial banks in Sri Lanka, it is necessary to conduct research with further investigating the relationship between corporate governance and financial performance in listed commercial banks in Sri Lanka.

Based on relevant literature and empirical findings in other countries, this paper contributes to the bank performance literature in Sri Lanka by investigating the relationship between financial performance and corporate governance mechanism in the Sri Lankan banking industry. Thus, this study provides an opportunity to look at various parts of the bank governance framework and the financial incentives that influence managers and owners long term & short-term financial decisions. Further, the study can serve as a reference material for future researchers who need to make research on this area. Moreover, the empirical findings of this study would also be useful for regulators, policy makers, managers of the commercial banks for crafting policies.

Literature Review

Corporate governance is a relationship between shareholders (stockholders), board of directors and managers (top management) in shaping the direction of the company in order to achieve a sustainable performance. Corporate governance consists of external corporate governance and internal corporate governance. The principal objective of business enterprises is to enhance economic value for all shareholders by making the most efficient use of resources. A company that meets this shareholder value creation objective will have greater internally generated resources, improving its prospects for meeting its environmental, community, and social obligations, which is a lead indicator of corporate success of bank. As well as bank performance represented mainly through profitability. Profitability is measured by return on equity and return on assets.

Concerning the significance of the corporate governance and its nature, three dominant theories can be identified related to the corporate governance, namely, agency theory, stakeholder theory, and resource dependency theory. Agency theory is based on a principle-agent relationship. This theory identifies corporate governance as a controlling mechanism to control the agency cost and specially to resolve the conflict-of-interest issue between owners and managers. The stakeholder theory is an extension of the agency theory. Although the agency theory more focuses on the board of directors' accountability to the shareholders, stakeholder theory expanded this accountability not only to the shareholders but also in different sub-groups in the business environment such as suppliers, employees, business partners and so on (Freeman et al., 2004). As per resource dependency theory, board of directors are considered as a provider of the resources such as information, skills, business expertise, access to key constituents such as suppliers, buyers, public policymakers, and social groups as well as legitimacy to the business (Harun, 2017). According to the stakeholder theory, directors play an advisory and counseling role to the firm management. Thus, a dual role related to the board of directors can be identified as per the above-explained three theories. Finally, agency theory and stakeholder theory have seen corporate governance as a mechanism to minimize agency conflict while recourse dependency theory has seen corporate governance as a mechanism to interact the business organization with different resources (Harun, 2017).

Here onwards, scholars' special attention is adverted towards a variety of models, analytical tools and methodologies related to this studied area and key findings of the previous empirical studies.

Khatib and Nour (2021) have conducted a study to find out the impact of corporate governance on firm performance during Covid 19. The authors have collected secondary data from 188 non-financial firms in the Malaysian market for the period from 2019 to 2020. The results of the study have found that firm performance, governance structure, dividend, liquidity and leverage level do not have any significant change in pre and post crisis period. Furthermore, the results revealed that board size has a positive impact on firm performance and board

meetings while the audit committee has a significant negative impact on the firm performance.

Zukaa et al. (2018) have conducted a study to examine the effect of corporate governance on firm performance by collecting pieces of evidence from Syria. Data have been obtained from all firms listed at Damascus Securities Exchange (DSE) for the period between 2011 and 2015 and multiple linear regression has been used to analyze the collected data. Board of directors, audit, disclosure, and ownership structure have been used to measure corporate governance. The study's results revealed a significant impact of ownership structure on firm performance proxies.

Mashayekhi and Bazaz (2010) studied the relationship between certain corporate governance aspects such as board size, independence of the board, board leadership and institutional board investors on firm performance in Iranian economics. This research found that small boards are more efficient as the monitoring purpose, as well as a positive relationship, was identified between independent directors and the firm performances.

Further, Mohammed (2012) examined the impact of corporate governance on bank performance in the Nigerian context and results revealed that in any financial sector stability depends on the superiority of the code of corporate governance practices. Adegbemi, Ofoegbu and Fasanya (2011) studied the impact of corporate governance on bank performance in the same context and the results revealed that there is a negative impact on bank performance when there is a poor corporate governance practice. In the same context, Olayiwola (2018) examined the influence of corporate governance on the performance of ten listed companies over the period from 2010 to 2016 and panel data regression results revealed that corporate governance significantly influences on firm performance.

Ahmed et al. (2020) conducted a study to examine the importance of corporate governance on firm profitability by collecting cross-sectional data from 50 non-financial firms of OMAN. The secondary data have been collected from annual reports in the year 2018 and partial least squares have been used to analyze the collected data. The findings of the study revealed that there is a significant impact from board size, ownership, gender, and audit committee, and on firm profitability. Markonah and Prasetyo (2022) studied the effect of good corporate governance (GCG) on financial performance at banks in Indonesia over the period from 2011 to 2020 and the results indicates that GCG has a direct or indirect impact on banking financial performance.

In the Sri Lankan context, Guo and Kga (2012) examined the relationship between corporate governance and the financial performance of listed companies in CSE and the results revealed that there is a significant relationship between corporate governance and financial performance. Further, scholars found that the share of non-executive directors has negatively influenced on ROA. Anandasayanan and Velnampy (2018) also conducted a study in the Sri Lankan context based on diversified holding companies listed in CSE and the results confirmed that there is a significant impact of corporate governance on corporate profitability. Similar results to the previous findings were also confirmed by the scholars such as Siriwardhane (2008), Heenetigala (2011) as cited by Danoshana and Ravivathani (2019).

Danoshana and Ravivathani (2019) have conducted a study to examine the effect of corporate governance on firm performance by collecting secondary data from 25 listed financial institutions for the period 2008 to 2012. Return on Equity (ROE) and Return on Assets (ROA) have been used to measure the firm performance and board size, meeting frequency and audit committee of the company have been used to measure the corporate governance. The authors have used descriptive statistics, correlation and multiple regression to analyze the collected data and have found that corporate governance significantly impacts on firm's performance and board size while audit committee size has a positive impact on a firm's performance. Moreover, the authors have found that

meeting frequency has a negative impact on a firm's performance.

Velnampy (2015) conducted a study related to corporate governance and firm performance by using selected Sri Lankan banks. The results revealed that the board size, independence of boards, gender and education qualifications of directors are not significantly related to company performance.

However, Perera and Aruppala (2017) revealed that there is a positive relationship between financial performance and the number of board meetings and the education levels of the board of directors. Further, scholars found a negative relationship between financial performance and board size, the gender composition of the board of directors, outside directors, and CEO duality. Moreover, scholars conclude that there is no similarity in the disclosure of corporate governance practices of Sri Lankan banks.

2. METHODOLOGY

The hypothetical method is applied to understand the bank's financial performance response to corporate governance. Secondary data were gathered by following the convenience sampling technique and data were extracted from annual reports in ten listed commercial banks which are registered in CSE, Sri Lanka from 2007 to 2016. Organizational performance is a critical concept due to the existence of a large number of definitions for performance. However, performance may refer to the increase of the share price, profitability, or the present valuation of a company (Melvin & Hirt, 2005). In the Sri Lankan context, Corporate Governance practices (Independent Variable) are introduced by the Institute of Chartered Accountants of Sri Lanka and the Colombo Stock Exchange with the association of the Central Bank of Sri Lanka. Five corporate governance practices and two financial performance indicators are applied to achieve the objectives of the study. Figure 1 illustrates the conceptual framework of this study while Table 1 illustrates the operationalization of the variables.

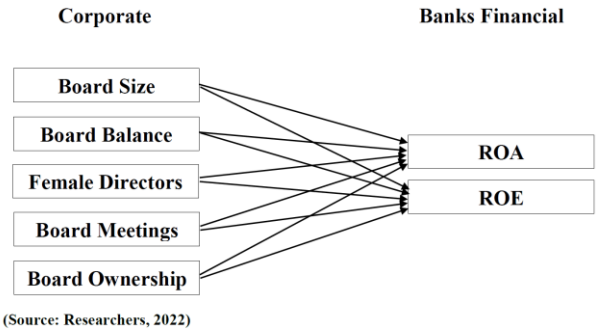

Figure 1: Conceptual Framework

Table 1: Measurement of the Variable

Independent Variable	**Measurement**	**Notation**
Board Size	Number of directors on board	BS
Board Balance	Number of executive directors	EX
	Number of non-executive director in the board	NEX
Female Directors	Number of female directors on board divided by total number of directors	FD
Board Meetings	Board meeting frequency is measured by the total number of meetings held per in a year	BM
Board Ownership	The percentage of the firm's outstanding shares owned by members of board of directors excluding the CEO	BO
Dependent Variable	**Measurement**	**Notation**
Return on Equity	Banks Net Income plus Depreciation divided by its book value of shareholder's Equity.	ROE
Return on Assets	Banks Net Income plus Depreciation divided by its book value of Total Assets	ROA

(Source: Researchers, 2022)

The Variance Inflation Factor (VIF) is used for identifying the multi-collinearity issue of the independent variables and it indicates a strong linear association among independent variables. According to Montgomery and Peck (1982), if the VIF value is greater than 5-10, then the regression coefficients are poorly estimated.

Correlation analysis and panel data regression analysis are used for identifying the relationships, model building and hypothesis testing. The entire analysis was done by using Stata software as it is the most appropriate software for panel data analysis. Panel data (also known as longitudinal or cross-sectional time-series data) is a dataset in which the behaviour of entities is observed across time. The following two models are built for measuring the impact of corporate governance on banks' financial performance.

$ROE_{it} = \beta0 + \beta1\ BS_{it} + \beta2\ EX_{it} + \beta3\ NEX_{it} + \beta4\ FD_{it} + \beta4\ BM_{it} + \beta4\ BO_{it} + e_{it}$ --------- (1)

$ROA_{it} = \beta0 + \beta1\ BS_{it} + \beta2\ EX_{it} + \beta3\ NEX_{it} + \beta4\ FD_{it} + \beta4\ BM_{it} + \beta4\ BO_{it} + e_{it}$--------- (2)

Where, β0, β1, β2, β3, β4, are the regression coefficient, "e" represents the error term, "*it*" represents the "i" company at time "t" and other notations are explained in Table 1.

The panel data regression analysis will suggest three types of models, namely, the random effect model, fixed effect model, and ordinary least squares model. Out of above-stated models, the best model will be selected by using the specimen tests of Breusch and Pagan Lagrangian multiplier test, Fisher (F) tes,t and Hausman Specification test.

3. RESULTS AND DISCUSSION

Descriptive Statistics

Table 2 comprises the descriptive statistics for the variables that investigate the effect of different corporate governance elements on a bank's financial performance.

Table 2: Descriptive Analysis

Variable	Obs	Mean	Std. Dev.	Min	Max
ROA	100	1.7	1.32	0.1	12.27
ROE	100	15.58	7.39	0.69	44.69
BS	100	11.1	1.74	6	18
EX	100	0.17	0.04	0.01	0.03
Nex	100	0.82	0.1	0.05	0.16
FD	100	0.14	0.11	0	0.04
BM	100	13.78	2.74	7	25
BO	100	0.02	0.032	0	0.22

(Source: Stata Output for Sample Data Set)

The maximum value of the ROA amount is 12.27 while the minimum amount is 0.1. As well as the maximum value of the ROE amount is 44.69 while the minimum amount is 0.69. The average value of ROA is 1.7 while ROE is 15.58. Average of 0.17 executive directors include in the board while representing a maximum of 3 and minimum of 1. Board has met average times of 13.78 and this ratio is also agreed with the guide line issued by CA Sri Lanka (minimum requirement is at less 12 time met the directors). Frequency of board meeting signifies minimum of 7 and maximum of 25 per one accounting period. Board ownership variable indicates 0.02 of average value in banking sector. According to above table, zero (0) minimum ownership and 0.22 maximum ownership represent the banking sector. When considering the board size, it will split within the 6 (minimum) to 18 (maximum). The variables of female directors and non-executive directors show 0 to 0.04 and 0.05 to 0.16 minimum and maximum values respectively.

Table 3: Correlation Analysis

Pearson's Correlation Matrix

	BS	EX	NEX	FD	BM	BO
ROA	-0.112	0.193	0.107	*-0.037	0.082	-0.087
ROE	*0.056	0.28	-0.109	0.123	0.205	-0.199

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

Source: Strata Output Sample Data set

As per Table .3 Pearson's correlation matrix, board size and female directors show a significant relationship between Return on assets and Return on Equity variables under the significant level at 0.05. Board size is positively correlated with ROE which means regularity of board meeting has higher performance and have an expansionary impact. However, the female director shows a negative association with bank performance.

Unit-Root Test

All the variables of corporate governance and financial performance are tested to check whether they are stationary or not stationary. Harris-Tzavalis unit-root test is conducted to test the stationarity of all variables. As per the results of Table 4, the alternative hypothesis is accepted which indicates that the panel is stationary. It means the null hypothesis of panels containing unit roots are rejected since the P value is significant.

Table 4: Harris-Tzavalis Unit-Root Test Results

Variable	Statistic	P - Value
ROA	0.1071	0.0000
ROE	0.1225	0.0000
BS	0.0791	0.0000
EX	0.1309	0.0000
NEX	0.1309	0.0000
FD	0.8024	0.0000
BM	0.1004	0.0000
BO	0.4637	0.0000
(Source: Stata Output for Sample Data Set)		

Collinearity Statistics

The multi-collinearity is an essential requirement to check in multiple regression analysis. In this study, VIF test is used to identify the multi-collinearity issue among independent variables. If the VIF value is more than 10, it indicates a collinearity problem (Myers & Myers 1990). As per the test results of Table 5, all independent variables' VIF values are below 10. Hence, it provides evidence that there is no possibility to have multi-collinearity issues in selected independent variables.

Table 5: Results of the Multi-Collinearity Test

Variable	**BS**	**EX**	**NEX**	**FD**	**BM**	**BO**
VIF value	2.85	2.23	1.46	1.28	1.26	1.18
Mean VIF Value	1.71					
(Source: Stata Output for Sample Data Set)						

Panel Data Analysis

There are three models tested in this study, namely Ordinary Least Squares (OLS), Fixed Effect Model (FEM), and Random Effect Model (REM). For the objective of finding out the most appropriate model to estimate and represent the results, F test, LM test and Hausman test are performed. All the models are conducted towards each data panel which represents the ROA and ROE. Panel A represents (Table 6) the models with ROA Panel B (table 7) represents the models with ROE.

Table 6: Results of Panel Data Analysis (Panel A)

Test	**Panel A – ROA**			
Specification Test	**Tested**	**Statistic**	**P-value**	**Model Selection**
F-test	OLS/Fixed	1.09	0.00	Fixed
LM test	OLS/Random	6.17	0.00	Random
Hausman	Random/Fixed	1.40	0.96	Random
(Source: Stata Output for Sample Data Set)				

Initially, F test is conducted to select the most suitable model between the Classical regression model and the Fixed effect model. Coming to a conclusion based on Table 5 and 6 results, the Fixed effect model is suggested rather than the Classical regression model (Pooled OLS) for both ROA and ROE because F statistics are significant at 0.05 levels. Subsequently, researchers try to identify either one way or two-way fixed model fitted for further consideration. At the significant level of 5%, a One-way fixed model is recommended for both panels. However, Fixed time effect models for both panels are not significant at this level. It means time impact is not significant for ROA and ROE, hence, researchers selected the One-way fixed model for future considerations.

Table 7: Results of Panel Data Analysis (Panel B)

Test	**Panel A – ROE**			
Specification Test	**Tested**	**Statistic**	**P-value**	**Model Selection**
F-test	OLS/Fixed	0.17	0.00	Fixed
LM test	OLS/Random	10.76	0.00	Random
Hausman	Random/Fixed	0.24	0.98	Random

(Source: Stata Output for Sample Data Set)

Table 8: Results of the One-way Random Effect Model

Panel A					Panel B			
Variable	**Coefficient**	**Robust Standard Error**	**Z –stat.**	**P-value**	**Coefficient**	**Robust Standard Error**	**Z-stat.**	**P-value**
BS	0.08	0.08	0.96	0.33	0.12	0.49	0.24	0.80
EX	6.51	2.52	2.58	0.01*	26.91	13.82	1.95	0.05**
NEX	-0.31	2.30	-0.14	0.89	-9.90	12.07	-0.82	0.41
FD	-2.04	1.85	-1.1	0.27	-2.14	6.12	-0.35	0.72
BM	0.05	0.05	1.01	0.31	0.48	0.43	1.1	0.27
BO	-3.11	2.52	-1.23	0.22	-32.64	6.84	-4.77	0.00*
Constant	-0.53	2.68	-0.2	0.84	12.06	13.54	0.89	0.373
P		0.00			P	0.00		
Sigma e		0.94			Sigma e	5.30		
Sigma u		1.14			Sigma u	5.66		
Rho		0.40			Rho	0.46		

(Source: Stata Output for Sample Data Set)

Second, Breusch and Pagan Lagrangian multiplier test is used to identify the best model between Classical regression model (Pooled OLS) and Random effect model. This test was also conducted for the dependent variables of ROA and ROE individually. As per the test results indicated in table 4.5 and 4.6, P values of the Breusch and Pagan Lagrangian multiplier tests' statistic for both panel A and panel B are significant at the level 5%. It implies that Random effect models for both panel A and panel B are suitable models than Classical regression model (Pooled OLS). However, the researchers cannot come to the final conclusion based on these results because, before that, it is necessary to verify whether the separate company specific characteristics follow the one-way time random effect model or not. The "rho" ratio indicated null value and time random effect model is not appropriate for both panels. Hence, One-way firm random effect model is suggested for panel A and B.

Finally, Hausman test is used for identifying whether the fixed effect model or the random effect model is more suitable to interpret the relationship between the firm performance and the corporate governance variables. As per the crosswise of the firm level, Hausman statistic is not significant at the significant level of 5%. Hence, the researchers can accept the null hypothesis that the difference in coefficients is not systematic. Thus, it can be concluded that the firm random effect model is the best fitted model for ROA and ROE.

Table 8 presents the results of the one-way random effect model analysis which covers the two dependent variables. (Panel A-ROA and Panel B-ROE). Return on assets and return on equity are dependent variables and Board Size, Executive Directors, Non-Executive Directors, Female Directors, Board Meetings, Board Ownership are taken as independent variables.

It is recommended to compute Robust standard error correcting for the possible occurrence of heteroscedasticity and hence, this study calculates robust standard errors to the ROA and ROE, random effects regression models to estimate the efficient regression coefficients. As per the results of Robust specification test at the 95% significant level, in panel A, only the number of executive directors shows a significant relationship with ROA. Simultaneously, in panel B, both of the independent variables of number of Executive directors and Board ownership shows a significant relationship with ROE. As per the agency theory, there exists a positive link between board independence and firm performance

(Krivogorsky, 2006). Hence, it can be explained that if the directors have shares, they are not independent. So, the negative relationship between Board ownership and ROE is acceptable based on the agency theory. However, board size, non-executive directors, female directors, and board meetings do not reveal any significant relationships with both ROA and ROE panels. These findings agree with the findings of scholars such as Rose (2007), Jenson (1976) as cited by Harun (2017), Effiok et al. (2012).

4. CONCLUSION

The authors have conducted the study to examine the impact of corporate governance on financial performance of Listed Commercial banks in Sri Lanka. Financial performance has been considered as the dependent variable while return on assets and return on equity have been considered as the proxies for the dependent variable. Corporate governance has been considered as the independent variable while board size, board balance, female directors, board meetings and board ownership have been considered as the proxies to measure the independent variable. Descriptive and inferential statistics such as Pearson correlation and panel data regression have been used for the analysis purpose. The results of the Pearson's correlation revealed that board size has a positive correlation with banks' financial performance while female directors show a negative relationship with banks' financial performance. The result of the Robust specification test revealed that, in panel A for ROA, only the number of executive directors shows a significant relationship while in panel B for ROE, both independent variables of the number of executive directors and Board Ownership shows a significant relationship. Ultimately, future researchers are suggested to identify if there is any divergence in corporate governance practices and financial performances between state-owned commercial banks and private commercial banks. Further, it is suggested to compare this relationship with international commercial banks and domestic commercial banks.

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