

Broadening the Boardroom: Corporate Governance and Company Performance in Sri Lanka

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Whilst there have been many studies carried out to investigate to determine whether there is a link between corporate governance and company performance in developed nations , the empirical evidence on this area is very thin in Sri Lanka being a developing nation. Hence this study was undertaken with the intension of fulfilling the gap. The study was carried out by selecting a sample of 86 companies which had a turnover of more than US\$ 5 .5 million during the period of 2001 and 2002 out of the 232 listed companies in Colombo Stock Exchange. The governance element being the independent variable and performance variable being the dependent variable is initially tested under Simple Linear Regression model to identify any relationships. There after the variables were tested under Multiple Linear Regression model, introducing three controllable variables. The results indicate that there is a positive relationship between the board size and company performance but the contribution of an additional director decreases when there is an increment in the board size and the company performance. Tobin q being one of the performance variables does not indicate any significant relationship with the governance variable in this study. This may be due to the fact that in Sri Lanka, the market prices of shares are not yet heavily affected by the governance practices followed by the companies. The findings of the study indicate mixed results which are in consistent with empirical evidence of developed nations. It is suggested by Securities and Exchange Commission of Sri Lanka (SEC) and Colombo Stock Exchange (CSE) to make the compliance of rules of corporate governance mandatory among the listed companies with effect from April 2008.

Field of Research: Corporate Governance, Developing Nation

1. Introduction

The issue of corporate governance arises because of the separation of ownership from control in modern corporations. The separation of ownership and control has had profound consequences for the nature of corporate governance.

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The positive theory of agency argues that the managers may behave opportunistically to maximize their own welfare (Arrow, 1984; Strong and Waterson, 1987 as cited by Merrett and Houghton, 1999). Merrett and Houghton, (1999) state that the central issue in the growing body of theoretical and empirical literature on corporate governance is whether the actions of the managers-the agents-are consistent with the realization of the interests of the shareholders-the principals.

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. Effective governance is critical to all economic transactions, especially in emerging and transitioning economies (Judge and et al, 2003). As a developing and emerging nation the empirical research on the importance of corporate governance towards company performance is very thin in Sri Lanka. This paper aims to fulfill this gap.

In Sri Lanka the main bodies, which are concerned about practices of corporate governance, are Securities and Exchange Commission of Sri Lanka (SEC), Colombo Stock Exchange (CSE) Institute of Chartered Accountants of Sri Lanka (ICASL) and The Institute of Chartered Secretaries and Administrators of Sri Lanka (ICSASL). The ICASL published their first report on "The Code of Best Practice" on matters relating to financial aspects of Corporate Governance, in 1997. Thereafter taking into account the changes occurring in the subject of Corporate Governance in other parts of the world, the Council of the Institute appointed a committee in January 2000, to revise, enlarge and expand the existing code to cover all aspects of Corporate Governance. Two exposure drafts titled "Code of best practice on Board Room Governance and Audit Committee" were developed with the help of some other institutes such as The Ceylon Chamber of Commerce, CIMA Sri Lanka Division, ICSASL, Sri Lanka Banks (Guarantee) Associations Ltd and Sri Lanka Institute of Directors. In October 2001 a National Committee on Corporate Governance was constituted and the ICASL as member organization under a task force, appointed by this committee initiated the development of the Code of Best Practice on Corporate Governance. It strongly recommended that all public companies, whose share capital has been contributed by public subscriptions, not only observe the principles and guidelines but also to include in the company's audited annual report a Corporate Governance report, setting out the manner and extent to which the company has complied with the established principles and practices of good Corporate Governance and in the event of non compliance setting out reasons for such non compliance.

In Sri Lanka a public company which is established under the Companies Act No: 17 of 1982 or any other statutory corporation, incorporated or established under the laws of Sri Lanka or established under the laws of any other State (subject to Exchange Control approval) may apply to the Colombo Stock Exchange for admission to the official list. According to the definition of CSE the Annual Report means the Audited Financial Statements of the entity, directors' report and the other disclosures required by Listing Rule 8.7. The company shall prepare and circulate the Annual Report to the CSE and to all holders of

quoted securities before the expiry of 6 months from the close of the financial year (The financial year in Sri Lanka being the period between 1st April to 31st March). The audited accounts shall be prepared and presented in accordance with the Sri Lanka Accounting Standards.

In April 2007 The Securities and Exchange Commission of Sri Lanka and Colombo Stock Exchange introduced Section 06 of the Listing Rules as “Rules on Corporate Governance” indicating six rules of governance to be complied by the listed companies. Currently though it is not mandatory for the listed companies to comply these rules, still they need to publish the reasons why they are not complying in the annual reports. It is suggested by these bodies to make the compliance of rules of corporate governance mandatory with effect from April 2008.

These indicate though adopting practices of corporate governance are not mandatory in Sri Lanka the relevant bodies are concerned whether companies follow these principles and guide lines so that there will be more transparency and accountability which would finally enhance the wealth of the share holders through high company performances. 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. And the compliances of governance rules are crucial in terms of attracting foreign investment to a developing nation. 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 paper whether the listed companies under CSE adopt the practices of corporate governance.

Sir Cadbury in his Corporate Governance Agenda (2000) states that “...I would not have spent the time I have on matters of corporate governance, were I not convinced that it helps companies to meet their business objectives, in sum that good governance is an aid to good corporate performance.”

This paper is focused on **“the degree of effectiveness of adopting corporate governance practices when achieving higher company performance in Sri Lankan listed companies”**.

2. Literature Review

2.1 The link between corporate governance and corporate performance

A survey carried out by MC Kinsey and Company in conjunction with Institutional Investor Inc., found that investors pursuing a growth strategy did not worry about corporate governance, while investors who pursued a value strategy and invested in undervalued or stable companies were willing to pay for good governance (Agrawal *et al.*, 1996 as cited by Kakabadse *et al.*, 2001)

According to them, these investors hold the belief that a company with good governance will perform better over time and/or that good governance can reduce risk and attract further investment. Also they insist that good corporate governance, can apparently serve as a tool for attracting certain types of investors as well as influencing what will be paid for stock; the average premium which investors are willing to pay for good governance being between 11 and 16 per cent.

Although there is a growing literature linking corporate governance to company performance, there is, equally, a growing diversity of results. For example a Meta analysis of 54 empirical studies of board composition and 31 empirical studies of board leadership structure and their relationship to financial performance by Dalton *et al* (1998) concluded by saying, "relying on firm size, the nature of the financial performance indicators and various operationalisations of board composition, provide little evidence of a systematic governance structure and financial performance relationships".

2.2 Relationship between Board Size and Company Performance

According to Jensen (1993) "... As groups increase in size, they become less effective because the coordination and the process problem overwhelm the advantage from having more people to draw on." Yermack 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. Mintzberg (1983) as cited by Dalton *et al* (1999) suggests that board members' assessments of top management are more easily manipulated when boards are large and diverse and it might be reasonably expected, that large boards would tend to be more diverse, more contentious, and more fragmented than small boards.

Board size may be a measure of an organization's ability to form environmental links to secure critical resources (Goodstein *et al* 1994 as quoted by Dalton *et al*). Proven (1980) as cited by Dalton *et al* (1999) demonstrate that board size was associated with a firm's ability to extract critical resources such as amount of budget, external funding and leverage from an environment. Resource dependence theory has been the primary foundation for the perspective that larger boards will be associated with higher levels of firm performance. (Alexander, Fennell & Halpern (1993) as cited by Dalton *et al* (1999).

Keeping boards small can help improve their performance. When board get beyond seven or eight people they are less likely to function effectively and are easier for the CEO to control (Jensen 1993). In contrast, research in the area suggests that as groups increase in size, they become less effective because of coordination and process problems outweighing the advantages gained from having people of diverse background (Steiner, 1972; Hackman 1990 as quoted by Kathuria and Dash 1999). Lipton and Lorsch (1992) quoted by Jensen (1993) states that "... the norms of behavior in most boardrooms are dysfunctional, because the directors rarely criticize the policies of top managers or hold candid discussions about corporate performance." Believing that these

problems increase with the number of directors, Lipton and Lorsch (1992) recommend limiting the membership of boards to ten people, with a preferred size of eight or nine. The Cadbury committee (Cadbury 1992) also recommends that the ideal size of the board should be between eight and ten members.

3. Research Methodology

3.1 Sample design and variables

The sample for this paper is drawn from firms listed in the Colombo Stock Exchange (CSE) during year 2001 and 2002 period which published their audited annual reports and had an annual minimum turnover of Rs.500 Million(US\$ 5.5 Million). At the time the research was carried out there were 241 companies listed in the CSE, (nine of these companies are in the default board) representing twenty business sectors. After satisfying the above criteria only 86 companies belonging to 15 Trading Sectors were included in the sample which is only 37% of the of the companies listed in the CSE. The study was mainly done by using secondary data which were collected from audited annual reports and Hand Book of listed companies-2003, Fact Book- 2002 issued by CSE.

Corporate governance element being the independent variable is determined by the number of total board of directors in the organization (**BS**). In this study the performance of the company is measured by Return on Equity (**ROE**) and Tobin Q ratio (**TOBIN Q**). Return on Equity is measured by Profit after interest and taxation divided by number of ordinary share issued. Tobin Q, the ratio of market value of the firm's equity and debt to the current replacement cost of assets. The literature generally recognizes three additional independent variables that have explanatory power when examining firm performance and corporate governance (Hovey and *et al.*, 2003). Therefore in addition to the above dependent and independent variables the author includes three controllable variables: average gross turnover (**TOVER**), average growth rate of turnover (**TGROW**) and ordinary shares held by the corporate sector -corporate holding (**COHOLD**).

3.2 Hypothesis and the Model

The following three hypotheses were developed for testing and the linear regression was used to examine the relationship between governance variables and the performance variables. **Hypothesis 1 (H1)**: Companies with higher number of directors in the board are likely to have a higher company performance.

Models used to test **H1**

$$\text{ROE} = \beta_0 + \beta_1 \text{BS} + \varepsilon \quad (1a)$$

$$\text{TOBINQ} = \beta_0 + \beta_1 \text{BS} + \varepsilon \quad (1b)$$

$$\text{ROE} = \beta_0 + \beta_1 \text{BS} + \beta_2 \text{TOVER} + \beta_3 \text{TGROW} + \beta_4 \text{COHOLD} + \varepsilon \quad (1c)$$

$$\text{TOBINQ} = \beta_0 + \beta_1\text{BS} + \beta_2\text{TOVER} + \beta_3\text{TGROW} + \beta_4 \text{COHOLD} + \varepsilon \quad (1d)$$

Where β_0 = Interception

ε - Standard error of the sample

These hypotheses were tested using the Pearson correlation coefficient, which gives the measure of association between two variables. Then the Simple Linear Regression (SLR) model was used to assess how well the dependent variables could be explained by knowing the independent variables. Further more the hypotheses were tested under the Multiple Linear Regression (MLR) model by introducing three controllable variables for all three hypotheses on Entry method. (Two independent variables are regressed separately accompanying the three controllable variables).

4. Results and Empirical Analysis

4.1 Descriptive Statistics for Study Variables

Table 4.1 summarizes the descriptive statistics, for the variables employed in the study.

Table 4.1
Descriptive Statistics for study variables

N=86

Variables Statistics	BS	TOVER	TGRO W	COHOLD	ROE	TOBINQ
Mean	8.16	3016775803	16.2920	77.2736	10.9048	2.8716
Std. Deviation	2.22	4048817391	62.8197	19.5585	7.89873	2.5411
Skewness	.506	3.457	7.541	-1.717	1.204	1.898
Minimum	4	531342970	-45.07	12.24	.110	.000
Maximum	15	24604679000	551.98	98.07	40.140	12.952

TOVER- In Sri Lankan Rupees

The above table shows the number of directors in the board (BS) have a wide range from 4 to 15. The mean of the size of the board (BS) is 8.16, with a standard deviation of 2. This is in par with many studies undertaken previously. The Cadbury Committee report (1992) also recommends the size of the board to be between 8 and 10 members. Kathuria and Dash (1999) in their study have found that the size of the board as 9.83. Mak and Li (2001) in their research on determinants of corporate ownership and board structure: evidence from Singapore found the mean of the board size to be 8.04 and the board size ranges from 4 to 14. Carter and et al (2003) in their research on board diversity and firm value (sample is drawn from Fortune 1000) found a mean of 10.986 on number of directors with a standard deviation of 3.105.

An empirical study on corporate governance and firm performance carried out in Russia by Judge and et al (2003) got a 9.6 mean on size of the board with a standard deviation 4.2 while range being 5 to 17.

When looking at the number of non-executive directors in the board, the table shows a mean of 4.55 with a standard deviation of 2.61 and it ranges between 0 to 9 non-executive members. This indicates that from the board size approximately 50% of them are non-executive directors. Cadbury Committee Report (1992) suggests if the board to become effective the non-executive directors should have a sufficient representation.

4.2 Empirical Analysis

4.2.1 Correlation Analysis

Table 4.2 presents the Pearson correlation coefficients between dependent variables and independent variables separately. There is a significant relationship between board size and ROE at 0.05 levels. But there is no significant relationship between BS and TOBINQ. Thus, the null hypothesis has been rejected only in terms of TOBINQ (Model 1).

Table 4.2

Results of Pearson Correlation Analysis

Variables	BS
ROE	.221** (.049)
TOBINQ	.009 (.933)

Two tailed probabilities are given within parentheses

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

* Correlation is significant at the 0.1 level (2-tailed)

Table 4.3 shows the relationships between the independent variable and the two dependent variables. There is a significant positive correlation between the Board Size (BS) and the ROE and also a positive relationship between ROE and TOBIN Q.

Table 4.3**Results of Pearson Correlation Analysis II**

	BS	ROE	TOBINQ
BS	1.00		
ROE	.248*** (.026)	1.000	
TOBINQ	.009 (.933)	.413*** (.000)	1.000

Two tailed probabilities are given within parentheses
 ***Correlation is significant at the 0.01 level (2-tailed)
 **Correlation is significant at the 0.05 level (2-tailed)
 *Correlation is significant at the 0.1 level (2-tailed)

Table 4.4 indicates the correlation between the independent and dependent variables after introducing the three controllable variables. Turnover (TOVER) and Growth Rate of Turnover (TGROW) are positively correlated with Board Size (BS).

Table 4.4**Results of Pearson Correlation Analysis III**

	BS	TOVER	TGROW	COHOLD	ROE	TOBINQ
BS	1.000					
TOVER	.263** (.014)	1.000				
TGROW	.234** (.030)	.225** (.037)	1.000			
COHOLD	-.028 (.807)	.113 (.327)	-.314*** (.005)	1.000		
ROE	.248** (.026)	.329*** (.003)	.009 (.940)	.086 (.477)	1.000	
TOBINQ	.009 (.933)	.234** (.030)	-.035 (.752)	.244** (.032)	.413** * (.000)	1.000

Two tailed probabilities are given within parentheses
 ***Correlation is significant at the 0.01 level (2-tailed)
 **Correlation is significant at the 0.05 level (2-tailed)
 *Correlation is significant at the 0.1 level (2-tailed)

4.2.2 Regression Analysis

A simple linear regression was carried out, in order to assess how well the company performance (ROE and TOBINQ) can be explained by knowing the value independent variables. Table 4.5 shows the coefficients. The coefficient of BS and ROE are significant at 0.05 indicating the positive role played by the board of directors.

Table 4.5
Simple Regression Analysis

Performance Variables	Governance variables
	BS (Model 1a, 1b)
ROE	
Intercept (Constant)	4.371
t	1.295
p value	.199
Slope	.814
t	2.004**
p value	.049
Adjusted R square	.037
TOBINQ	
Intercept (Constant)	2.786
t	2.635***
p value	.010
Slope	1.048E-02
t	.084
p value	.933
Adjusted R square	-.012

***Correlation is significant at the 0.01 level (2-tailed)

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

*Correlation is significant at the 0.1 level (2-tailed)

The variables in this study were regressed under the Multiple Regression Model introducing three controllable variables. Table 4.6 reports the regression results with respect to all the variables where ROE being the dependent variable (Model 1c).

Table 4.6

Multiple Regression Analysis I

Dependent Variable: ROE

Variables	Model (1 c)	
	Coefficient	t-value
BS	.198	1.681
NONEX		
CEO		
TOVER	.343	2.872***
TGROW	-.117	-.941
COHOLD	.006	.050
Adjusted R Square		.125

***Correlation is significant at the 0.01 level (2-tailed)

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

*Correlation is significant at the 0.1 level (2-tailed)

Under Model 1c Board Size is related with ROE positively ($t=1.681$, $p<0.1$). This is in consistent with Correlation Analysis and Simple Regression Model although the above contribution is weaker than the previous results. This further supports the acceptance of H1.

Table 4.7

Multiple Regression Analysis II

Dependent Variable: TOBINQ

Variables	Model (1d)	
	Coefficient	t-value
BS	.010	.090
NONEX		
CEO		
TOVER	.263	2.229
TGROW	-.031	.247
COHOLD	.205	1.733*
Adjusted R Square		.077

***Correlation is significant at the 0.01 level (2-tailed)

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

*Correlation is significant at the 0.1 level (2-tailed)

The above table 4.7 presents the results when Model 1d is run under the Multiple Regression Model where TOBINQ is the dependent variable. It reports that the dependent variable and the independent variable is not related significantly either positively or negatively. It shows that only TOVER and

COHOLD, the two controllable variables positively contributes towards TOBINQ. The following Table 4.8 reports how all the governance variable is regressed with the two performance variables separately. This indicates that the Board Size contributes to ROE.

**Table 4.8
Multiple Regression Analyses III**

Variables	ROE		TOBINQ	
	Coefficient	t-value	Coefficient	t-value
BS	.222	1.743*	.034	.269
R Square	.083		.008	
Adjusted R Square	.043		-.031	

*Correlation is significant at the 0.1 level (2-tailed)

The Table 4.9 shows the regression results when run with all the study variables. With respect to ROE the table indicates the most important variable is TOVER. Then it is the Board Size, the governance variable followed by COHOLD. And other variables contribute negatively but not significantly. Then with respect to TOBINQ the most contributing variable is again the TOVER. COHOLD also impacts as TOVER.

**Table 4.9
Multiple Regression Analyses IV**

Variables	ROE		TOBINQ	
	Beta	t-value	Beta	t-value
BS	.198	1.434	.074	.573
TOVER	.368	2.927***	.313	2.605***
TGROW	-.120	-.881	-.034	-.261
COHOLD	.046	.359	.279	2.316***
R Square	.207		.198	
Adjusted R Square	.125		.123	

***Correlation is significant at the 0.01 level (2-tailed)

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

*Correlation is significant at the 0.1 level (2-tailed)

From all the above analyses it shows the Broad Size (BS) and ROE always have a positive significant relationship (Model 1a and 1c) under the correlation analysis, simple and also under multiple regression. Although under all three analyses BS and TOBINQ are positively related they are not significant (Model

1b and 1d). Therefore we can accept the Hypothesis H1. Also it is found that the contribution of an additional director is decreased when the Board Size and company performance is increased. This is supported by the results of the research carried out by Kathuria and Dash (1999) where they suggest that the size of the board has a significant impact on the corporate performance with a *t* statistics of 2.155. The analysis in this study also suggests that a corporation's performance improves by increasing the board size and contribution of an additional board member decreases as the size of the corporation decreases.

But in contrast Xie and et al (2003) find in their study that the coefficient for board size is negative and significant at 0.005. And this is shown in some prior research; smaller boards are more effective monitors than larger boards. Dalton and et al (1999) in their Meta – analysis of 131 samples provide systematic evidence of nonzero, positive, true population estimates of board size and firm performance relationships. Yermack (1996) finds a negative relationship between Board Size and Tobin Q.

5 Conclusion, Limitations and Further Research

In the analysis it was investigated whether there were relationships between the element of corporate governance and company performance among listed companies in Sri Lanka. The data for the analysis was collected mainly from company annual reports and the Hand Book of Listed Companies, which is published by the Colombo Stock Exchange (CSE). The sample for the data collection was selected from the listed companies in the CSE from 12 trading sectors, which had a turnover of more than Rs. 500 million (US\$5.5 MILLION) per annum for 2001 and 2002 periods. The element of corporate governance examined in the study is board size while performance of the company is investigated from average ROE and average Tobin Q over the two-year period. Apart from the correlation analysis the data was regressed introducing three controllable variables namely, turnover, growth rate of turnover and corporate holding of ordinary shares.

The findings indicate that Board Size and Company Performance is positively related with respect to ROE (correlation as well as regression) hence H1 is accepted. 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. TOBINQ being one of the performance variables did not report any positive relationship with the governance variable in the study. This may be due to the fact that in Sri Lanka, still the share market prices are not heavily affected by the governance practices followed by the companies.

When considering the introduced controllable variables it reveals that the Turnover has a positive significant relationship with the company performance, both with the ROE and Tobin Q. The corporate holding of the ordinary share has a direct impact on the Tobin Q, which may have been influenced by the market price of the shares. The sample in this study consisted only 86 companies out of 232 companies, which indicates the sample is relatively small. Larger sample

size would contain more “power” and may have revealed the hypotheses to be significant. And this would limit the generalisability of the findings.

Few Annual reports of the companies in the sample did not present governance information required for the study. Even when the author accessed the company secretaries in person to get the same, they were reluctant to reveal the information although information carries no confidentiality. But all these information should have published in the Annual Report for the reference of the stakeholders though it is not a mandatory requirement in Sri Lanka yet. However this was not a major limitation but the author would like to emphasize on this since the study concerns about the transparency and accountability.

The study does not consider all the elements of corporate governance, which impact the performance of the company. In using the findings of this research these conceptual limits are needed to be considered. Finally this study is cross-sectional in nature, while the company performance is the dependent variable; it may be the other way around as well. It is clear that much has still to be done in terms of understanding the role and impact of governance structures in Sri Lankan companies. It is also important to recognize that an appropriate structure for one firm may not be appropriate another. Greater flexibility in acceptable governance structures may therefore be necessary if shareholder interests are to be promoted. Hence further research is significantly recommended.

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