
The Impact of Corporate Governance on Firm Performance in Listed Firms in Sri Lanka

Isurika, M.D.C.*^a & Wanniarachchige, M.K.^b

^a Department of Accountancy, Faculty of Management and Finance, University of Ruhuna, Sri Lanka

^b Department of Finance, Faculty of Management and Finance, University of Ruhuna, Sri Lanka

^aisurika_5175@umgt.ruh.ac.lk

^bmanjula@mgt.ruh.ac.lk

Abstract

The literature is conflicting on the impact of corporate governance on firm performance. Hence, this study examined the effect of corporate governance compliance on the firm performance based on the annual data from 2017 to 2022 for a purposively selected sample of 40 firms listed on the Colombo Stock Exchange. A corporate governance index was constructed based on 29 codes of the best practices in Sri Lanka to measure corporate governance compliance. Firm performance was measured using EPS and ROE. Further, two control variables, i.e., firm size measured in terms of total assets and firm age calculated as the number of years since the establishment, were included in the model. The regression results suggest that corporate governance has a statistically significant positive effect on firm performance. Thus, these findings highlight the necessity of persuading firms to comply with the best practices of corporate governance to improve firm performance.

Keywords: Codes of best practices, Corporate governance, Corporate governance index, Earning per share, Return on equity

01. Introduction

Corporate governance is referred to the mechanism by which corporations are managed, directed, and held accountable. The primary objective of corporate governance is to build confidence among shareholders that management is working toward the shareholders' best interest (Shleifer & Vishny, 1997). Firms with poorer governance mechanisms must deal with more agency issues, and their managers obtain unnecessarily high personal rewards (Core et al., 1999). Therefore, corporate governance is essential to fostering market confidence and attracting clients to the firm (Guo & Kga, 2012). Generally, corporate governance promotes the economic growth since good corporate governance mitigates investor risks, draws in investment capital, and enhances firm performance (Spanos, 2005). Nevertheless, due to economic and political reasons, corporate governance implementation varies from country to country (Chan & Cheung, 2012).

**isurika_5175@umgt.ruh.ac.lk*

Even though the link between corporate governance and firm performance has been a frequently investigated subject in the context of developed countries, there have been several corporate failures globally as well. For instance, the Enron Corporation's bankruptcy on December 2, 2001, and the Lehman Brothers' bankruptcy on September 18, 2008, were the most prominent corporate failures in history (Samaraweera et al., 2021). In the Sri Lankan context, Swarnamahahal Financial Services PLC and Edirisinghe Trust Investment Finance Limited (ETI) are two recent collapses (Samaraweera et al., 2021). So, these failures have emphasized the need for governance reforms to prevent business failures (Arora & Sharma, 2016).

There are many studies conducted to investigate the effect of corporate governance on firm performance. For example, some studies, such as Guo and Kga (2012) and Yermack (1996), observed a negative relationship between firm performance and corporate governance. On the other hand, some studies, such as Sami et al. (2011) and Farooq et al. (2022), found a positive association between corporate governance and firm performance. In contrast, studies such as Kawshalya and Aruppala (2014) and Velnampy (2013) did not find a statistically significant association between corporate governance and firm performance. These pieces of evidence reveal that the findings are inconsistent. One reason could be the differences in corporate governance practices across some countries (Ali et al., 2022). Moreover, studies conducted on this topic in the Sri Lankan context are limited, and even in the available studies, corporate governance has been measured using only a few practices. Therefore, this study reinvestigates the impact of corporate governance on firm performance based on a purposively selected sample of 40 firms listed on the Colombo Stock Exchange. The use of the most recent data and the use of a broad index covering 29 best practices to measure corporate governance can be considered as the key significances of this study.

02. Literature Review

Agency theory, coined by Jensen and Meckling (1976), indicates a relationship between shareholders and managers. In this agency relationship, the managers are expected to work in the best interest of the shareholders. However, managers seem to act out of self-interest and prioritize on fulfilling their demands over maximizing the shareholders' wealth (Eisenhardt, 1989). This conflict of interest indicates that the manager acts as an agent while seeking personal goals that differ from the shareholders' objectives if they are not appropriately supervised (Farooq et al., 2022). Further, Shleifer and Vishny (1997) stated that managers might misuse the owners' wealth by wasting the firm's resources and disclosing internal information to outside parties for undue benefits.

According to Gompers et al. (2003), an actual power-sharing arrangement among managers and shareholders can be determined depending on the precise governance regulations and allocation of property rights. Therefore, proper corporate governance practices would facilitate the establishment of shareholder property rights, which help the firm operations effectively. Accordingly, the best practices of corporate governance, such as independent boards, independent sub-committees of the board, and frequent board meetings, have evolved as tools to restrict managers' opportunistic behaviour and ensure accountability for investors (Azeez, 2015).

In contrast, the stewardship theory explains how executives behave while acting in their principles' best interest (Smallman, 2004). In this theory, instead of being viewed as an agent, the manager is considered a steward (Farooq et al., 2022). The most distinctive characteristic of this theory is that, in contrast to agency theory, it promotes greater trust in managers (Davis et al., 1997). In addition, this theory argues that the utility of stewards increases when the shareholder's wealth is maximized (Smallman, 2004). According to this theory, since both management and the owners aim to maximize the shareholders' wealth, the management will not focus on manipulation of earnings. However, the risk propensity of shareholders is the biggest obstacle to implementing stewardship methods of governance (Ali et al., 2022). Therefore, the most of the codes of the best practices seem to be found on the arguments made in the agency theory.

The literature reveals an inconsistency in the effect of these practices on firm performance. For example, Yermack (1996) found a positive association between financial performance and corporate governance's best practices like board size and audit committee's effort. For instance, Naimah and Hamidah (2017) also advocated that the board must be large enough to successfully supervise the corporation because larger boards have more access to information. Yermack (1996) further emphasized that smaller boards do not have the required managerial capabilities. However, an effective board size should not exceed eight or nine members, and larger boards would not be effective owing to free-riding by directors and coordinating issues (Dharmadasa et al., 2021). This is because several studies have shown that having a large board of directors raises monitoring costs and it lowers the firm's value (Cho & Kim, 2007).

The director board is a crucial internal control mechanism for overseeing top management (Fama & Jensen, 1983). Independence is an essential characteristic of an effective board, which depends on the number of independent directors. These independent directors only serve in a supervisory capacity since they are not a part of the regular staff of the firm. Thus, they are not involved with the way the firm is managed. Naimah and Hamidah (2017) found less correlation between independent director boards, with a larger percentage of outsiders, and firm performance indicators like ROA, Tobin's Q, and asset turnover.

According to Fama and Jensen (1983), the separation of decision-making and management would be violated if CEO duality existed. In fact, CEO duality would result in one person having too much authority to make decisions. Hence, the CEO and the chairperson of the firm should be held by different people since it prevents the concentration of control in one person and improves the firm performance (Javaid, 2015). Furthermore, the literature suggests that CEO duality could have a detrimental effect on firm performance. For instance, Kijkasiwat et al. (2022) stated that the link between CEO duality and firm performance is negative.

Sri Lankan firms have implemented board committees because board committees mostly perform the board's oversight duties (Heenetigala & Armstrong, 2011). These subcommittees can be considered as the tools for enhancing corporate governance by assigning board duties such as board appointments, compensation for the board, and financial reporting to smaller groups and effectively utilizing the inputs of non-executive directors (Spira & Bender, 2004). Further, Heenetigala and Armstrong (2011) stated that there is a strong link between board committees and firm performance.

The nomination committee aims to prevent appointing individuals with a conflict of interest and select qualified persons as directors who have the abilities (Heenetigala & Armstrong, 2011). Accordingly, the primary duty of this committee is to act as independent monitors to reduce agency issues (Klein, 1998), to maximize shareholders' wealth. The remuneration committee aims to determine and evaluate the compensation packages of senior officers of the firm. However, Weir and Laing (2001) did not find any evidence that the remuneration committee affects firm performance. Nevertheless, Klein (1998) discovered evidence that remuneration committees enhance the firm performance.

The audit committee is the most common corporate governance mechanism for protecting investors' interests, which reduces information asymmetry and provides reliable information about the firm (Saha et al., 2018). Since financial reporting is the most crucial method of informing stakeholders about a firm's financial performance, the audit committee may be pretty helpful in avoiding information asymmetry among stakeholders (Heenetigala & Armstrong, 2011). Naimah and Hamidah (2017) found a positive correlation between dividend yield and audit committee independence. Moreover, Saha et al. (2018) observed a positive relationship between the frequency of audit committee meetings and the board of directors' independence. Table 1 illustrates the key findings of selected literature on the impact of corporate governance on firm performance.

Table 1: Findings of Related Studies

Study	Dependent Variable(s)	Measurements of CG	Effect on FP
Farooq et al. (2022)	ROE ROA Tobin's Q	CG Index based on 29 governance provisions	Positive
Azam et al. (2011)	ROA ROE NPM	Ownership Concentration Board's Independence Audit Committee	Positive
Velnampy and Pratheepkanth (2012)	ROE ROA NPM	Board Structure Corporate reporting	Positive
Kawshalya and Aruppala (2014)	ROA ROE EPS	Board Structure Board Size Board Meeting Board Committee	No relationship
Heenetigala and Armstrong (2011)	ROA ROE Tobin's Q	Leadership Structure Board Composition Board Committees	Positive

The literature reviewed here indicates three things. First, the findings of the literature are inconstant. Second, the approaches used to measure corporate governance vary significantly across studies. Finally, only a handful studies have been conducted in Sri Lanka to investigate this association. Importantly, these studies have used narrow-based indices to measure corporate governance. Therefore, the impact of corporate governance on firm performance remains relatively understudied in Sri Lanka. This study aims to fill this gap by conducting a study using a broad-based index to measure the corporate governance.

03. Methodology

This study assesses the association between corporate governance and firm performance based on the data during 2017 and 2022 collected from the annual reports published by firms. Of the 294 firms listed on the Colombo Stock Exchange as of September 30, 2022, 40 firms were purposively selected for the sample. Nevertheless, some data was unavailable in some firms for some years, and some data had to be removed since they were outliers. Hence the final dataset used for the analysis comprised 206 firm-year observations.

A Corporate Governance Index (CGI) was constructed to assess compliance using 29 corporate governance best practices extracted from the 2017 Code of best practices on corporate governance in Sri Lanka. If a firm has complied with a particular best practice, the value 1 was given; otherwise, the value 0 was assigned. Then CGI was calculated as the total score obtained for all best practices by a single firm in a particular year (Silva & Wanniarachchige, 2022). A higher CGI denotes higher compliance with corporate governance and vice versa (Farooq et al., 2022). Further, firm performance was measured using EPS and ROE. Table 2 illustrates the measurements of the variables used for analysis in this study.

Error! Reference source not found.04. Findings and Discussion

Table 3 illustrates the descriptive statistics related to the key variables used in the study. A substantial variation in the level of corporate governance compliance can be identified. For instance, CGI in some firms is as low as 15, while some have scored 29. This index implies that some firms have followed all the best practices considered in the study. Further, high variation in firm age can also be observed over the sample period.

Both regression models were statistically significant. For example, as illustrated in Table 4, the results of the regression indicated that the three predictors, namely, corporate governance index, firm size, and firm age explained 8.5% of the variation in Earnings Per Share ($R^2 = .085$, $F(3, 202) = 6.254$, $p < .001$). Concurrently, the three predictors, namely, corporate governance index, firm size, and firm age explained 7.9% of the variation in Return on Equity ($R^2 = .079$, $F(3, 202) = 5.762$, $p = .001$).

Investors pay more attention to a firm's compliance with the best practices of corporate governance, as they serve as a way to safeguard and attract investors. According to the results of the study, the impact of corporate governance on EPS was positive and statistically significant ($\beta = .157$, $p = .047$). This finding is consistent with the findings of Azeez (2015). Moreover, the results indicate that Corporate Governance Index ($\beta = .006$, $p = .006$) significantly predicted ROE. This finding is also consistent with Azeez's (2015) and Javaid's (2015) findings. Hence, firms comply more with the best practices of corporate governance to enhance their performance.

Table 3: Descriptive Statistics

Symbol	Variable	Min	Max	Mean	SD
CGI	Corporate Governance Index	15.00	29.00	22.330	2.836
EPS	Earnings Per Share	-4.51	10.99	2.982	3.289
ROE	Return on Equity	-0.14	0.31	0.076	0.089
FS	Firm Size (natural log. of total assets)	20.00	25.00	22.180	1.102
FA	Firm Age (years)	1.00	113.00	45.670	31.242

Notes: N = 206

Table 4: Regression Results

Symbol	Variable	Coefficient	VIF	t
Dependent Variable: EPS [$R^2 = .085$, $F(3, 202) = 6.254$, $p < .001$, $DW = .90$]				
α	Constant	-16.669 ***		-3.449
CGI	Corporate Governance Index	0.157 **	1.002	2.003
FS	Firm Size (natural log. of total assets)	0.699 ***	1.006	3.471
FA	Firm Age (Years)	0.014 **	1.009	1.980
Dependent Variable: ROE [$R^2 = .079$, $F(3, 202) = 5.762$, $p = .001$, $DW = 1.19$]				
α	Constant	-0.116		-0.882
CGI	Corporate Governance Index	0.006 ***	1.002	2.767
FS	Firm Size (natural log. of total assets)	0.004	1.006	0.704
FA	Firm Age (Years)	-0.001 ***	1.009	-2.816

Note: N = 206. *, **, *** respectively indicate statistical significance at 0.1, 0.05, and 0.01 levels.

Evidence of this study suggests that the firm size ($\beta = .699$, $p = .001$) has a statistically significant positive impact on EPS. This finding is consistent with the results of Azeez (2015) and Mashayekhi and Bazaz (2008). Nevertheless, a statistically significant effect of firm size on ROE could not be found ($\beta = .004$, $p = .483$). This is consistent with Ahmed and Hamdan (2015), Arora and Sharma (2016), and Farooq et al. (2022).

As per the test results of this study, firm age has a statistically significant positive impact on EPS ($\beta = .014$, $p = .049$). This finding is also consistent with Azeez (2015). Nevertheless, similar to the results of Arora and Sharma (2016), firm age shows a statistically significant negative impact on ROE ($\beta = -.001$, $p = .005$). This finding implies that the older firms perform comparatively better than the new firms in terms of EPS while the new firms become more profitable in terms of ROE.

05. Conclusion

This study investigated the association between corporate governance and firm performance based on the data from 2017 to 2022 which was collected from the annual reports published by 40 purposively selected firms. The results suggest that higher compliance with corporate governance enhances firm performance. This result is consistent with the findings of Azeez (2015). Compliance with corporate governance best practices enhances decision-making effectiveness, as the agency theory claims. Consequently, higher compliance, on the one hand, ensures adequate returns and, on the other hand, provides the firm's solvency. Concurrently, firms can lose competitive advantage and collapse if effective corporate governance practices are absent.

This study has two significances. First, the findings will help the corporate sector, investors, and policymakers determine future trends in corporate governance. As the results suggest, the firms can enhance their performance by complying more with the best practices. Second, the recent empirical evidence presented in this study is added to the body of knowledge on corporate governance and firm performance. Nevertheless, the period used in the study is

only six years (2017 - 2022). This period can be expanded in future research to observe the relationship in a more extended period. Moreover, the number of best practices considered to estimate the Corporate Governance Index can be further expanded.

References

- Ahmed, E., & Hamdan, A. (2015). The impact of corporate governance on firm performance: Evidence from Bahrain bourse. *European Journal of Business and Innovation Research*, 3(5), 25-48.
- Ali, A., Alim, W., Ahmed, J., & Nisar, S. (2022). Yoke of corporate governance and firm performance: A study of listed firms in Pakistan. *Indian Journal of Commerce & Management Studies*, 13(1), 08-17. <https://doi.org/10.18843/ijcms/v13i1/02>
- Arora, A., & Sharma, C. (2016). Corporate governance and firm performance in developing countries: Evidence from India. *International Journal of Business in Society*, 16 (2), 420–436. <https://doi.org/10.1108/CG-01-2016-0018>
- Azam, M., Uumani, S., & Abassi, Z. (2011). The impact of corporate governance on firm's performance: Evidence from oil and gas sector of pakistan. *Australian Journal of Basic and Applied Sciences*, 2(5), 2978-2983.
- Azeez, A. A. (2015). Corporate governance and firm performance: Evidence from Sri Lanka. *Journal of Finance and Bank Management* 3(1), 180-189. <https://doi.org/10.15640/jfbm.v3n1a16>
- Chan, A. W. H., & Cheung, H. Y. (2012). Cultural dimensions, ethical sensitivity and corporate governance. *Journal of Business Ethics*, 110(1), 45–59. <https://doi.org/10.1007/s10551-011-1146-9>
- Cho, D.-S., & Kim, J. (2007). Outside directors, ownership structure and firm profitability in Korea. *Corporate Governance: An International Review*, 15(2), 239–250. <https://doi.org/10.1111/j.1467-8683.2007.00557.x>
- Core, J. E., Holthausen, R. W., & Larcker, D. F. (1999). Corporate governance, chief executive officer compensation and firm performance. *Journal of Financial Economics* 51(3), 371-406. [https://doi.org/10.1016/S0304-405X\(98\)00058-0](https://doi.org/10.1016/S0304-405X(98)00058-0)
- Davis, J. H., Schoorman, F. D., & Donaldson, L. (1997). Toward a stewardship theory of management. *The Academy of Management Review* 22 (1), 20-47. <https://doi.org/10.2307/259223>
- Dharmadasa, P., Gamage, P., & Herath, S. (2021). Corporate governance, board characteristics and firm performance: Evidence from Sri Lanka. *South Asian Journal of Management*, 21(1), 7-31.
- Eisenhardt, K. M. (1989). Building theories from case study research. *The Academy of Management Review* 14 (4), 532-550. <https://doi.org/10.2307/258557>
- Evans, D. S. (1987). The relationships between firm growth, size and age: estimates for 100 manufacturing industries. *Journal of Industrial Economics*, 35(4), 567-581.
- Fama, E. F., & Jensen, M. C. (1983). Separation of ownership and control. *Journal of Law and Economics*, 26(2), 301-325.
- Farooq, M., Noor, A., & Ali, S. (2022). Corporate governance and firm performance: empirical evidence from Pakistan. *International Journal of Business in Society*, 22(1), 42–66. <https://doi.org/10.1108/CG-07-2020-0286>
- Gompers, P. A., Ishii, J. L., & Metrick, A. (2003). Corporate governance and equity prices. *Quarterly Journal of Economics* 118(1), 107-156. <https://doi.org/10.1162/00335530360535162>
- Guluma, T. F. (2021). The impact of corporate governance measures on firm performance: the influences of managerial overconfidence. *Future Business Journal*, 7(1), 1-18. <https://doi.org/10.1186/s43093-021-00093-6>
- Guo, Z., & Kga, U. K. (2012). Corporate governance and firm performance of listed firms in Sri Lanka. *Procedia - Social and Behavioral Sciences*, 40 (1), 664-667. <https://doi.org/10.1016/j.sbspro.2012.03.246>

- Heenetigala, K., & Armstrong, A. (2011). The impact of corporate governance on firm performance in an unstable economic and political environment: Evidence from Sri Lanka 2012 *Financial Markets & Corporate Governance Conference*, 1-17. <https://doi.org/10.2139/ssrn.1971927>
- Javaid, F. (2015). Impact of corporate governance index on firm performance: Evidence from pakistani manufacturing sector. *Journal of Governance and Regulation* 4(3-1), 163-174.
- Jensen, M. C. (1986). Agency costs of free cash flow, corporate finance and takeovers. *The American Economic Review*, 76(2), 323-329.
- Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: managerial behavior, agency costs and ownership structure. *Journal of Financial Economics* 3(4), 305-360. [https://doi.org/10.1016/0304-405X\(76\)90026-X](https://doi.org/10.1016/0304-405X(76)90026-X)
- Kawshalya, P., & Aruppala, D. (2014). Corporate governance and firm performance: A study of Sri Lankan beverage, food and tobacco companies. *Proceedings of the 5th International Conference on Business and Information, University of Kelaniya*, 108-115. (<https://www.researchgate.net/publication/280722196>)
- Kijkasiwat, P., Hussain, A., & Mumtaz, A. (2022). Corporate governance, firm performance and financial leverage across developed and emerging economies 10(10), 1-20. <https://doi.org/10.3390/risks10100185>
- Klein, A. (1998). Firm performance and board committee structure. *Journal of Law and Economics*, 41(1), 275-304 <https://doi.org/10.1086/467391>
- Mashayekhi, B., & Bazaz, M. (2008). Corporate governance and firm performance in Iran. *Journal of Contemporary Accounting and Economics*, 4(2), 156-172
- Naimah, Z., & Hamidah. (2017). The role of corporate governance in firm performance. *SHS Web of Conferences*, 34, 1-6. <https://doi.org/10.1051/shsconf/20173413003>
- Saha, N. K., Moutushi, R. H., & Salauddin, M. (2018). Corporate governance and firm performance: The role of the board and audit committee. *Asian Journal of Finance & Accounting*, 10(1), 210. <https://doi.org/10.5296/ajfa.v10i1.12933>
- Samaraweera, A. S. A., Thilakerathne, P. M. C., & Pathirawasam, C. (2021). Impact of failures: A review in the perspective of Sri Lankan corporates. *International Journal of Research in Commerce and Management Studies*, 3(4), 01-11. <https://doi.org/10.38193/ijrcms.2021.3401>
- Sami, H., Wang, J., & Zhou, H. (2011). Corporate governance and operating performance of Chinese listed firms. *Journal of International Accounting, Auditing and Taxation*, 20(2), 106-114. <https://doi.org/10.1016/j.intaccudtax.2011.06.005>
- Shleifer, A., & Vishny, R. W. (1997). A survey of corporate governance. *Journal of Finance*, 52(2), 737-783. <https://doi.org/10.1111/j.1540-6261.1997.tb04820.x>
- Silva, L. D. D., & Wanniarachchige, M. K. (2022). Corporate governance compliance among the listed firms in colombo stock exchange: Does size matter? *South Asian Journal of Business Insights*, 2(1), 33-50. <https://doi.org/10.4038/sajbi.v2i1.32>
- Smallman, C. (2004). Exploring theoretical paradigms in corporate governance. *Int. J. Business Governance and Ethics*, 1(1), 78-94.
- Spanos, L. (2005). Corporate governance in Greece: developments and policy implications. *Corporate Governance*, 5 (1), 15-30. <https://doi.org/10.1108/14720700510583430>
- Spira, L. F., & Bender, R. (2004). Compare and contrast: perspectives on board committees. *Corporate Governance: An International Review*, 12 (4), 489-499. <https://doi.org/10.1111/j.1467-8683.2004.00389.x>
- Subedi, S. D. (2018). Role of corporate governance on the performance of insurance companies of Nepal. *Journal of Business and Social Sciences Research (JBSSR)*, 3 (2), 151-164. <https://doi.org/10.3126/jbssr.v3i2.28131>
- Velnampy, T. (2013). Corporate governance and firm performance: A study of Sri Lankan manufacturing companies. *Journal of Economics and Sustainable Development* 4(3), 228-235. (<https://www.researchgate.net/publication/249341798>)
- Velnampy, T., & Pratheepkanth, P. (2012). Corporate governance and firm performance: A study of selected listed companies in Sri Lanka. . *Research Journal of Accounting and Finance*, 1-11. (<https://www.researchgate.net/publication/231590032>)

- Weir, C., & Laing, D. (2001). Governance structures, director independence and corporate performance in the UK. *European Business Review* 13 (2), 86-94. <https://doi.org/10.1108/09555340110385254>
- Yasser, Q. R. (2016). Corporate governance and firm performance: An analysis of family and non-family controlled firms. *The Pakistan Development Review*, 50(1), 47-62.
- Yermack, D. (1996). Higher market valuation of companies with a small board of directors. *Journal of Financial Economics*, 40(2), 185-211. [https://doi.org/10.1016/0304-405X\(95\)00844-5](https://doi.org/10.1016/0304-405X(95)00844-5)

