
Corporate Governance Compliance in Firms Listed in Colombo Stock Exchange: Does Size Matter?

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A B S T R A C T

Since corporate governance acts as a monitoring mechanism in reducing agency issues, firms with higher corporate governance compliance are often associated with higher firm value, investor confidence, and stock liquidity. Recently, firms seem to comply more with corporate governance practices due to the increased awareness of these benefits and various policy initiatives. Nevertheless, literature provides conflicting evidence on the determinants of corporate governance, particularly relating to emerging financial markets. Therefore, this study examined whether firm size affects corporate governance compliance based on a firm-level panel data set during the period from 2016 to 2020 for a sample of 100 firms listed in Colombo Stock Exchange selected using the systematic random sampling technique. Firm size was measured using the natural logarithm of total assets. A corporate governance index was formulated to measure compliance with 18 board-related corporate governance best practices while assigning them equal weights. Results of three random-effects panel regression models indicated that firm size has a statistically significant positive effect on the level of corporate governance compliance. This implies that larger firms are better motivated or capable of complying with corporate governance since they can benefit from the reduced agency cost and increased attractiveness for investors with their more extensive resource base. In contrast, smaller firms might have considered compliance with corporate governance less beneficial given the higher cost of compliance. This study makes three implications. First, one size fits all governance practices can be ineffective in Sri Lanka. Second, the findings highlight the necessity of formulating appropriate policies flexible enough in the application based on the firm-specific characteristics, such as the firm size. Finally, the literature suggests that a contextually relevant corporate governance index for Sri Lanka is still missing. Therefore, further research is required to formulate such an index with a broader perspective.

Keywords: agency conflict, Colombo Stock Exchange, corporate governance, firm size

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1. Introduction

Owners appoint experienced agents to run the businesses on their behalf in modern firms. This separation of ownership and control can result in a potential conflict between the interests of owners and managers, which is referred to as agency conflict (Jensen, 1986). Given the extent of information asymmetry, managers of the firms may use firms' assets for their interests instead of maximizing owners' wealth. Corporate governance spells out the rights and responsibilities of different stakeholders, including managers, board of directors, and shareholders to streamline the corporate decision-making and ultimately assist in attaining corporate objectives (Manawaduge, 2012). Codes of best practices on corporate governance offer self-regulated provisions as a monitoring mechanism to mitigate these inherent principal-agent conflicts (Pritchett, 1983). As a result, a reduction in information asymmetry between managers and shareholders and agency costs are generally expected (Chang, 2018). Moreover, compliance with corporate governance practices also leads to increased investor trust, better performance, and higher market value (Brown & Caylor, 2006; Senthuran & Velnampy, 2015).

The first code relating to corporate governance in Sri Lanka was introduced in 1997 based on the British governance code in 1992. Subsequently, this code was amended with the consultation of various stakeholders in 2003, 2008, 2013, and 2017. Despite the vast differences in institutional settings, Sri Lanka still uses corporate governance practices adopted from developed countries (Manawaduge, 2012). As argued by Castelluccio (2005), these codes have ignored the concerns of small firms. Hence, as Hertig (2005) argued, requiring smaller firms to comply with governance practices designed for larger firms can be ineffective.

In Sri Lanka, there is a considerable diversity of the listed firms in terms of firm size, even though most of the listed firms are relatively small. For example, the average market capitalization of the 299 entities listed in the Colombo Stock Exchange (CSE) as of 10th May 2021 was LKR 10.6 billion. However, only 60 firms (i.e., 20 percent of the total firms) had a market capitalization above the average, while there are 18 firms (6 percent) with a market capitalization above LKR 50 billion. In this context, as argued in the next section, one size fits all type of corporate governance best practices may be ineffective. Nevertheless, despite the large number of Sri Lankan corporate governance studies and the studies which used firm size as a control variable, any study has not been carried out primarily to investigate the size effect. Therefore, this study investigates whether firm size affects corporate governance compliance in Sri Lanka.

1.1. Research problem

In firms characterized by concentrated family ownership, like in Sri Lanka, the central conflict of interest occurs between the majority shareholders and the minority shareholders (La Porta et al., 1998) than between owners and managers. Since corporate governance in Sri Lanka is based on voluntary codes, the extent to which a firm is implementing corporate governance depends on the decisions of influential shareholders (Aluchna & Kuszewski, 2020). Previous literature emphasizes corporate governance as a way of attracting investors (Chang, 2018). Nevertheless, the controlling shareholders in firms with concentrated ownership may perceive corporate governance as a mechanism that dilutes their power (Chen et al., 2010). This may lead to lower compliance. For example, as Manawaduge (2012) stated, the level of corporate governance compliance in Sri Lanka is unsatisfactory despite the given benefits.

Researchers have argued that policymakers consider larger corporations when developing governance codes as governance failures of larger corporations are likely to have a stronger effect on the investors and markets (Hertig, 2005). Hence, smaller firms are facing difficulties in complying with such corporate governance practices. Previous literature also evidenced that firm size affects the level of corporate governance compliance (Haniffa & Cooke, 2002; Samaha et al., 2012). In CSE, most firms are far smaller than the firms in the top 20% in terms of market capitalization. Hence, examining whether the firm size affects the level of corporate governance compliance in Sri Lanka is necessary.

2. Review of the relevant literature

Jensen and Meckling (1976) have introduced the first theory relating to agency conflict. They have defined a firm as a nexus of contracts. Agency contract can be identified as one of these contracts in which principals engage agents to manage the firm. Agency theory argues that conflict of interest between owners and managers can emerge due to the separation of ownership from the firm's control. Managers may tend to misuse the owners' wealth for their benefits by revealing insider information of the firm (Jensen, 1986), rewarding themselves with excessive salaries and bonuses (Ntim & Oseib, 2011; Shleifer & Vishny, 1997), and wasting corporate resources by unnecessary consumption of perquisites (Jensen & Meckling, 1976).

Managing these opportunistic behaviors of agents involves a cost to the firms. These costs are known as agency costs. Agency costs consist of monitoring costs, bonding costs, and residual losses (Manawaduge, 2012). By incurring monitoring and bonding costs, principals try to make sure agents take all the decisions in the best interest of principals. On the other hand, residual losses occur when monitoring and bonding costs fail to discipline the management behavior. Agency theory explains how to mitigate agency costs and prevent the misappropriation of shareholders' wealth by aligning the interests of agents and principals. Here, corporate governance acts as a mechanism to reduce these opportunistic behaviors of managers, thereby reducing agency costs.

Fremond and Capaul (2002) argued that corporate governance spells out how shareholder property rights are protected, especially in the context of dispersed ownership structure. However, in Sri Lanka, the primary concern that corporate governance should address is the potential expropriation by controlling shareholders at the expense of minority shareholders and corporate objectives (Chen et al., 2010). Controlling shareholder expropriation can occur in the forms of appointing unqualified and overpaid family members or friends as managerial persons, advancing political, personal, and familial agendas that hinder company performance, or engaging in self-beneficial trading (Claessens et al., 2002). In developed countries, controlling shareholder expropriation can be offset by legal mechanisms. However, with weak legal and institutional settings of emerging countries, minority shareholders often rely on voluntary corporate governance practices (Claessens et al., 2002).

Chen et al. (2010) have stated that corporate governance mechanisms like an active board of directors, separation of the roles of Chief Executive Officer (CEO) and Chairman, and having a majority of outside directors in the board are crucial in protecting the interest of minority shareholders against the controlling shareholder expropriation. For example, Lee et al., (1999) have found that firms with a higher number of non-executive directors on the

boards result in higher firm performance, particularly in smaller firms characterized by less financial expertise and constrained resources. Similarly, Beasley (1996) has also identified that boards dominated by non-executive directors fulfill their monitoring role more effectively and reduce financial fraud significantly. Fama and Jensen (1983) found that separating the roles of Chairman and CEO separates the decision management and decision control and eventually leads to control the agency problem and enhanced firm performance.

Investors often seek companies with better monitoring mechanisms for investing to ensure their investment is safeguarded (AlHares, 2020). For example, Mudalige and Ekanayake (2015) stated that higher agency costs resulted from controlling shareholder expropriation reduces external financing. Further, AlHares (2020); Gompers et al., (2003); Haque (2015); La Porta et al., (1998); Shleifer and Vishny (1997) have stressed the importance of corporate governance compliance in increasing investor confidence and access to external finance at a lower cost. Hence, substantial compliance with corporate governance leads to reduced financing costs. Therefore, smaller firms heavily reliant on equity financing can benefit through increased compliance with corporate governance (Atanasova et al., 2015). However, smaller firms still pay less attention to comply with corporate governance practices (Chen, 2019). Atanasova et al., (2015) have claimed that this is due to the constrained resources of smaller firms.

3. Methods

This study examines the effect of firm size on corporate governance compliance based on the annual report data from 2016 to 2020. The sample consists of 100 firms selected using systematic random sampling technique out of 283 firms listed in CSE as of 30th April 2021. Corporate governance compliance was assessed using a Corporate Governance Index (CGI) which was constructed through equally weighting 18 board-related best practices¹ of the Sri Lanka Code of Best Practice on Corporate Governance 2017 (Bebchuk et al., 2004). A value of one was assigned if a firm has complied with a particular best practice and a value of zero otherwise. The CGI is the sum of all the scores obtained for each best practice. Firm size was measured using the natural logarithm of total assets (Dogan, 2013). Leverage and firm age were used as the control variables. Here, leverage was measured using the debt-to-equity ratio, and firm age was measured as the number of years since the firms' shares were listed in CSE, similar to Azeez (2015).

$$CGI_{it} = \alpha + \beta_1 FSIZE_{it} + \beta_2 LEV_{it} + \beta_3 AGE_{it} + u_i + \varepsilon_{it} \text{ ----- (1)}$$

Based on the literature cited under the research problem, this study hypothesizes that the larger firms comply more with corporate governance best practices. Many studies seem to rely on the Hausman test for determining whether a fixed effect model or a random-effect model needs to be selected. However, based on the extensive discussions made by Bell et al., (2019) on this issue, a random-effects panel regression model was chosen in this study to assess the association between firm size and corporate governance compliance as specified in

¹ CEO chair duality, at least 33% of the board is NEDs, at least 66% are INEDs, board met at least once every quarter, Presence of RC, chairman is an INED, entirely consists of NEDs, comprised minimum of three NEDs, majority is INEDs, Presence of AC, chairman is an INED, entirely consist of NEDs, comprised minimum of three NEDs, majority is INEDs, Presence of NC, chairman is an INED, majority are NEDs, at least 33% is INEDs.

equation 1. This is mainly because the primary focus of this study is to observe whether firms with different sizes comply differently with the best practices rather than study whether a firm complies more with best practices when it grows in size. In equation 1, α and β stand for the intercept and regression coefficients. Moreover, u and ε respectively denotes individual random effects and residuals, respectively. Further, i denotes individual firms, and t denotes time. CGI denotes the level of corporate governance compliance, which can vary from zero to 18. FSIZE, LEV, and AGE respectively denote firm size, leverage, and firm age. Since the data set contained serial correlation and heteroscedasticity, the same random-effects panel regression model was estimated using robust standard errors and bootstrapping. Hence, altogether three models were estimated. Since panel data analysis can largely eliminate the omitted variable bias (Bell et al., 2019), this study assumes that the effects of other factors are adequately controlled.

4. Data analysis

The results of the Breusch and Pagan Lagrangian multiplier test for random effects ($\chi^2 = 460.37, p < 0.001$) indicated that the random-effects model is suitable for the data set over the OLS model. Wooldridge test for autocorrelation in panel data ($F(1, 99) = 15.622, p < 0.001$) suggests the presence of first-order autocorrelation. Therefore, as indicated in the previous section, three random-effects panel-regression models were estimated using STATA 15: Model 1 with default standard errors, Model 2 with robust standard errors, and Model 3 with bootstrapping using 50 samples. The descriptive statistics and the results of these models are shown in Tables 1 and 2, respectively.

As illustrated in Table 2, all the models were statistically significant. All three models suggest a statistically significant positive association (either at 5% or 1% significance levels) between firm size and the level of corporate governance compliance. This result is consistent with the findings of Chen (2019); Hertig (2005); Madhani (2016). Moreover, models 1 and 2 provide weak evidence to suggest that the levered firm tends to comply less with corporate governance best practices even though this coefficient is not significant under Model 3. Nevertheless, any significant association between firm age and compliance level was not detected.

Table 1: Descriptive Statistics

Variable	Symbol	n	Mean	SD	Min.	Max.
Corporate Governance Index	CGI	488	13.43	2.39	6.00	18.00
Firm Size	FSIZE	488	21.97	1.52	12.68	25.86
Leverage	LEV	487	0.35	0.26	0.00	1.63
Firm Age	AGE	488	28.99	16.57	0.00	71.00

Table 2: Random Effects Panel Regression Results

Dependent Variable: Corporate Governance Index (CGI)				
Variable	Symbol	Model 1	Model 2	Model 3
Firm Size	FSIZE	0.320 *** (2.95)	0.320 ** (2.41)	0.320 *** (2.56)
Leverage	LEV	-0.966 * (-1.80)	-0.966 * (-1.72)	-0.966 (-1.47)
Firm Age	AGE	0.006 (0.52)	0.006 (0.53)	0.006 (0.54)
Constant	α	6.531 *** (2.72)	6.531 ** (2.18)	6.531 ** (2.40)
χ^2 (3)		12.491 ***	9.902 **	9.036 **
n		487	487	487
R^2 Within		0.003	0.003	0.003
R^2 Between		0.123	0.123	0.123
R^2 Overall		0.093	0.093	0.093

Notes: t -statistic is within parentheses; *, **, *** respectively indicate statistical significance at 0.1, 0.05, and 0.01 levels.

5. Results and discussion

The positive association between corporate governance compliance and firm size can be attributed to few factors. First, the cost of implementing corporate governance best practices may not be affordable to smaller firms given their lack of financial and human resources (Haniffa & Cooke, 2002). Firms should have independent directors who possess a balanced set of expertise and skills to exercise unbiased judgments on corporate matters. Hence, corporate governance codes place great emphasis on board independence and board subcommittees in monitoring management. Larger firms are likely to allocate more resources to comply with these practices as they have relatively higher access to resources given their well-established reputation (Hossain et al., 1994). However, hiring a director with adequate competence but remain independent of controlling shareholders and management can be relatively expensive for smaller firms (Chen, 2019). Especially, outside directors are likely to be reluctant to join as an independent director of a smaller firm with few directors given the higher responsibility than in a larger firm with many outside directors. Hence, the potential for hiring a well-qualified independent director is less for a smaller firm if the candidate is vigilant about the potential responsibilities.

Second, the agency problems of larger firms can be greater compared to smaller firms due to the greater complexity of their capital structures and business operations (Chung & Zhang, 2011; Haniffa & Cooke, 2002). Further, information asymmetry in larger firms is also higher than in smaller firms leading to higher agency costs (Nguyen et al., 2020). Larger firms may have a higher number of minority shareholders, and hence, protecting the rights of these minority shareholders is complicated than in smaller firms (Chen, 2019). Therefore, larger firms are better motivated to mitigate agency problems even at a higher cost (Laidroo, 2009).

Third, larger firms use corporate governance compliance as a tool to attract investors and to finance their operations through external funding at a lower cost (AlHares, 2019) because investors prefer firms with higher market liquidity (Falxenstein, 1996). Shleifer and Vishny (1997) stated that in the context of concentrated family ownership, block holder expropriation of minority shareholders increases the agency costs of companies. Hence, investors perceive a higher risk in firms with block holders and are less likely to invest because block holders tend to aggravate information asymmetry (AlHares, 2020). As legal protection to investors is low in emerging countries like Sri Lanka, to attract investors at lower cost, firms have to exercise strong corporate governance practices to show investors that insiders are not exploiting outside funds (Abdullah et al., 2012; Claessens et al., 2002). Gompers et al., (2003) claim that investors require a higher premium for investing in companies with poor governance as they have to tolerate higher risk. In other words, lower compliance with corporate governance best practices indicates a higher potential for opportunistic behaviors by managers and controlling shareholders. As a result, it reduces the amounts that investors are willing to invest in firms (Grossman & Hart, 1986). Hence, larger corporations adhere to corporate governance best practices to increase market liquidity and reduce the cost of capital (Chung et al., 2010).

6. Conclusion

Corporate governance practices act as a monitoring mechanism to protect investors and thereby lower the cost of capital. Hence, despite the voluntary nature of the corporate governance codes, firms are willing to comply with corporate governance practices to demonstrate that they discharge their accountability towards all the investors and act in a socially responsible manner. However, since firms comply with corporate governance practices at their discretion, vast differences can be seen in the level of corporate governance compliance among firms. This study found that compliance with corporate governance practices is greater when the firm size increase. This implies that the larger the firm, the greater the compliance with corporate governance best practices. This can be basically because the larger firms can afford the cost of compliance with corporate governance best practices better than smaller firms.

Therefore, on the one hand, the findings suggest that one size fits all governance practices can be ineffective in Sri Lanka since smaller firms comply less with them. On the other hand, the findings highlight the necessity of formulating appropriate policies flexible enough in the application based on the firm-specific characteristics, such as the firm size. However, the compliance index used in this study considers only 18 best practices while assigning equal weights. Moreover, the literature suggests that a contextually relevant corporate governance index for Sri Lanka is still missing. Therefore, further research is required to formulate such an index with a broader perspective.

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