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The Impact of Being Compliant with Best Practices of Corporate Governance on the Financial Performance of Listed Companies in Sri Lanka (With special reference to the Dominant Industry Sectors)

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Abstract

Code of Best practice on Corporate Governance and Rules on Corporate Governance were introduced in 2008 and many companies are being taking actions to comply with these conventions from 2008. The main objectives of the study are to measure the level of compliance with the best practices of corporate governance and to examine its impact on the financial performance of Listed Companies in Sri Lanka. A Sample of 60 companies is selected randomly based on probability proportionate sampling technique and secondary data are collected for the years of 2009/10 & 2012/13. The level of compliance of companies which is measured through descriptive statistics is found to be around 56% and 75% in 2009/10 & 2012/13 respectively. The results derived through multiple regression analysis reveal that being compliant with board effectiveness and accountability & audit have significant positive impact on financial performance of listed companies in Sri Lanka in 2012/13, whereas that is absent in 2009/10. Hence, it is concluded that the level of compliance with best practices is being continuously improved after the introduction of the Codes whereas the improved level of compliance directly influences the performance of the corporates in Sri Lanka.

Key words: ***Best Practices, Compliance level, Corporate Governance, Financial Performance.***

1. INTRODUCTION.

1.1 Background of the study.

Many of the corporates were collapsed and many were affected by financial distress with the great depression taken place in 1930s. Thus, the scholars were very keen in searching the causes for the failures of corporates. Berley and Means (1932) reveal that one of the major causes for the corporate failures occurred due to the bad governance of the corporates. Therefore, it is considered as the starting point of the concept of Corporate Governance (CG) discussed in the modern corporations. During 1980s and 1990s, failures and insolvencies of financial Institutions emerged all over the world, both in developed and developing / transition countries. Similarly, the Economic Crisis in 1997-1998 that hit South- East Asian Stock Markets was due to a certain extent attributed to weak corporate governance (Haniffa and Hudaib, 2006). Failures such as Enron in 2001 and World Com in 2002 and together with other high profile corporate collapses have resulted in calling for better CG systems. As far as Sri Lankan context is concerned, scandals in Pramuka Savings and Development Bank Ltd. and Vanik Incorporation Ltd. occurred mainly under the background of misconduct, unsound and imprudent practices of the management.

As consequences of these kinds of bad governance practices, several institutions took some initiatives to establish a proper CG structure in Sri Lanka. Major significant initiations to establish a better CG system in Sri Lanka were taken place with the introduction of Section 06 of the Listing Rules by Colombo Stock Exchange (CSE) in 2008 under the heading of "Rules on Corporate Governance" and the "Code of Best Practice on Corporate Governance" (CBPCG), which was issued jointly by the Institute of Chartered Accountants of Sri Lanka and the Securities and Exchange Commission in 2008. With the introduction of these codes, listed companies in Sri Lanka took necessary actions to comply with it since they believe it provides many benefits to the company itself and to the shareholders as well.

There have been many discussions recently about whether the CG structures make a difference to the bottom line, that is, does good CG structure improve the company performance? Thus, a growing number of empirical studies have been conducted to examine the CG structures and effectiveness of CG structures towards company performance and found mixed results in most of the cases due to the differences in countries and different contexts. Evidence suggest that improving performance and value can be achieved by paying greater attention to the elements of CG (Millstein

& MacAvoy, 1998). However, it seems that very few studies have been conducted to examine whether the CG structure effects to the financial performance in corporate sector in Sri Lanka. Hence, the problem of the study can be identified as **Does the corporate Governance Structure affect the performance of listed companies in Sri Lanka?**

1.2 Research questions and objectives of the study

This study is focused to answer two research questions as: (1) What is the level of compliance of Sri Lankan listed companies with corporate governance best practices (CGBP) and (2) Is there an impact of being compliant with CGBP on performance of listed companies in Sri Lanka (with special reference to the dominant industry sectors)?

It is observed that, with the introduction of the CBPCG, many of the companies started to comply with number of components included in the code. Hence, the main objective of the study is to investigate the compliance level of CG best practices of listed companies in Sri Lanka for the years of 2009 and 2012 which are considered as the first and the fourth year after the introduction of the CBPCG respectively. This study uses the CBPCG (2008) as the base to measure the compliance level of the corporate. Further, the four main components stated in CBPCG namely (i) Board Effectiveness, (ii) Directors' Remunerations, (iii) Accountability & Audit and (iv) Relations with Shareholders are used as the main four governance components (independent variables) in the study. The secondary objective is to examine the impact of being compliant with CGBP on financial performance of listed companies in Sri Lanka?

2. REVIEW OF LITERATURE

2.1 What is corporate Governance?

The whole responsibility for establishing a proper governance system is rest with the board of directors and top-level management who are considered as the Agents of the Principal-Agent relationship discussed under the Agency Theory. The overwhelmingly dominant theoretical perspective applied in CG studies is agency theory (Dalton and Daily,1993). Jensen and Meckling (1976) define this agency relationship as a "contract under which one or more persons (the principal/s) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent". The cornerstone of agency theory is the assumption that the interests of principals and agents diverge. According to Hovey et al. (2003), the corporate directors of the company (Being the Agent) are working as the formal representatives of the company's stockholders and therefore they are expected to supervise the performance of the management and thereby protecting interests of the stockholders (The Agents).

It is evident that the concept of CG has already become a major theme among the dynamic academics and policy debate all over the world. The literature on the theory of the firm, the term "Corporate Governance" attributes different meanings and nuances to a number of words in common usage. The Cadbury Committee Report (CCR) (1992) defines the term CG as "the system by which companies are directed and controlled" whereas Demb and Neubauer (1992) try to relate the organizational purpose directly to the term CG, defining as "a process by which corporations are made responsive to the rights and wishes of stakeholders". As far as the definitions and for the term CG is concerned, it is apparent that there is no one common definition and there are some disputes among the active academics regarding this burning issue. One of the main reasons for why various views on the term CG has aroused is that different scholars scrutinize firms from different points of views. As an example, Turnbull (1997) argues that the differences are due to the different cultural contexts, intellectual backgrounds and different interests of scholars and another reason is the divergence of the definition to the concept of "firm".

2.2 Association between CG structure and performance.

Having understood the major reasons for the different definitions for the concept of CG, the author tries to recognize whether there are differences in findings related to the CG structures and performance. Thus, the author finds blend of results in different contexts when the association between CG structures and performance are examined. Hermalin and Weisbach (1991) argue that different CG structures are optimal for different firms, due to the simple reason that each firm faces its own management problems and finds its own solutions. Therefore, the performance will depend upon the different CG structures in organizations. Hence, empirical evidence on the relationship between corporate performance and various CG characteristics stated under CG structures, such as board size, CEO duality, performance evaluation of the boards, directors' remunerations, and types of directors in the board, show mixed results. Thus, it is difficult to design and specify any ideal model in advance and there is no way to fix as a "once-and-for-ever" solution for a one best definition for the CG structure. Fligstein and Freeland (1995, p.39) note that "there is no universal governance structure ever found throughout the world and there is also little evidence that relations between firms are converging towards markets, hierarchies, networks, or strategic alliances as the dominant form of governance". By supporting this argument, proponents of government intervention in CG argue that there is a positive relationship between the use of effective CG structure and firm performance (Vafeas & Theodorou, 1998). Therefore, according to them, a proper governance structures should be mandated through the law. Opponents of government intervention argue that it is difficult to have a one single governance structure since each firm has different governance needs depending on its economic and regulatory environments. However, Allen (2001), highlights that a better CG structure may lead to better long-term corporate financial performance. He further states that "CG functions only through human action, which itself are affected by a high number of changing and interacting variables" (Allen 2001, p.2). Therefore, it is emphasized that both structures and its operations are indispensable to achieve better performance from the governance structure. Letza, Sun and Kirkbride (2004) reveal that CG is completely changeable and transformable; hence, it is difficult to formulate an everlasting or universal principle which is suitable and adoptable for all societies, cultures, and business environments. As a result of that, they admit that CG structures are being developed around the world from their own unique, cultural, historical, and social state of affairs. Therefore, it is noted that each model and structure related to CG are being evolved continuously throughout the world with unique characteristics to each country or sub-continent. Further, Letza, Sun and Kirkbride (2004) argue that the model for the CG should be dynamic and flexible and it continually weighs and adjusts the method of governing in practice. They further demonstrate that any single model for the structure of CG cannot work well for all firms at all times and therefore, CG needs to be flexible, adaptable, and innovative. It is evident that large numbers of studies have been carried out in order to examine the relationship between CG and performance of the corporates throughout the world and the empirical results provide with mix results related to CG structure and firm performance.

3. METHODOLOGY OF THE STUDY

The sample for the empirical examination of the study was derived from the listed companies registered in the CSE for the period of two years; 2009 and 2012. As at 31st of August 2009, a total of 232 companies were listed on the main board of CSE representing twenty sectors. Following industries and companies were excluded in selecting the sample due to the specified reasons stated. 32 companies representing Banks, Finance and Insurance sector was exempted since their governance practices and specially the disclosures on CG have considerable differences with the companies in other industries. Haniffa and Cooke (2002) and Haniffa and Hudaib (2006) have excluded aforesaid sector from their sample due to the availability of different statutory requirements on CG. 15 Companies which were in the Default Board for two or more consecutive years were excluded due to the non-availability and insufficiency of data. Further, 11 companies under the "Diversified Holdings" sector and nine (09) Holding companies which are coming under other sectors were exempted due to the possibility of double counting error of the data with a individual companies. Finally, 22 companies in non-dominant industry sectors were excluded since this study is focused on the dominant industry sectors. Author of this study defined the dominant sector if that industry sector has more than five companies in the relevant sector. Hence the total number of companies qualified for the selection of the sample is 152 companies and a sample of 60 companies was selected from eleven industry sectors to represent 40% of the qualified sample. As far as literature on CG is concerned related to the sample selection, it is observed that 40%t sample is a well-qualified and representative sample (Collett & Hrasky, 2005). The sample for the study was selected randomly based on the probability proportionate sampling technique.

The study was mainly conducted by using secondary data collected through annual reports of each company. Data related to CG variables were mainly extracted from the statement of CG and other CG related disclosures provided in annual reports by using a composite index which was constructed purely based on the CBPCG (2008) whereas the data on performance, Return on Assets (ROA) and Return on Equity (ROE) were gathered from the audited financial statements of the related companies. ROA and ROE are being extensively used by many scholars in governance related studies (Weir & Laing, 2000 ; Haniffa & Hudaib, 2006). The index consists with 13 scores to measure board effectiveness, 06 scores to measure directors' remunerations, 09 scores to measure accountability & audit and 03 scores to measure relations with shareholders and finally, the whole concept of CG was measured by using 31 dichotomous scores.

Descriptive statistics namely (i) Mean values, (ii) Maximum values and (iii) Minimum values were used to analyze the level of compliance of Sri Lankan listed companies and correlation, and multiple regressions analysis which was stated as follows used to analyze the impact of compliance with CGBP on financial performance.

$$ROA = \beta_0 + \beta_1 BODEF + \beta_2 DIRREM + \beta_3 RELSHS + \beta_4 ACCAUD + \beta_5 COHOLD + \varepsilon \quad (1)$$

$$ROE = \beta_0 + \beta_1 BODEF + \beta_2 DIRREM + \beta_3 RELSHS + \beta_4 ACCAUD + \beta_5 COHOLD + \varepsilon \quad (2)$$

Where,

β_0 = Intercept BODEFV=Board Effectiveness

RELSHS = Relations with Shareholders

DIRREM = Directors' Remunerations

ACCAUD= Accountability & Audit ε - Standard error of the sample

COHOLD= Corporate Holding (a controlling variable)

4. FINDINGS AND DISCUSSIONS

4.1 The Level of Compliance with CG Best Practices of Listed Companies

Table.1**: Descriptive Statistics for the whole Industry Sectors in the Sample**

Index	Mean Value		Maximum Value		Minimum Value	
	2012/13	2009/10	2012/13	2009/10	2012/13	2009/10
overall C G Scores(out of 31)	**25.5 (82.2)**	**17.7(57.1)**	**31 (100)**	**31 (100)**	**15(48.3)**	**11(35.4)**
Board Effectiveness Scores(out of 13)	10.5 (80.8)	07.5 (57.7)	13 (100)	13 (100)	06(46.1)	04(30.7)
Directors' Remunerations Scores(out of 6)	04.4 (73.3)	03.5 (58.3)	06 (100)	06 (100)	03(50.0)	02(33.3)
Accountability & Audit Scores (out of 9)	08.3 (92.2)	05.6 (62.2)	09 (100)	09 (100)	04(44.4)	04(44.4)
Relations with Shareholders Scores (out of 3)	02.3 (76.7)	01.6 (53.3)	03 (100)	03 (100)	01(33.3)	01(33.3)

Source: Author constructed based on information from Annual Reports of Sampling Companies- 2009/10 and 2011/12
N.B. Percentage values are in parentheses

According to table 01, the level of overall compliance has been drastically improved to 25.5 scores averagely (25.5/31*100 = 82.2%) in 2012/13 with an improvement of 7.8 attributes (25.5-17.7) in average with compared to 2009/10 by reporting 44% improvement (7.8/17.7*100). Further, an improvement of 04 scores (15-11) has been demonstrated in 2013/14 compared with 2009/10 with respect to the overall CG scores by showing a considerable improvement in the minimum compliance level. Even though the overall index shows a higher level of compliance, it is significant that, there is a huge difference of 20 (31-11) scores (64.5%) in 2012/13 and 16 (31-15) scores (51.6%) in between the maximum and minimum values of the compliance level. It demonstrates that there are some companies which show the highest/maximum level of compliance (100%) whereas some of the companies reflect a minimum level of compliance (48.3%). It is interesting to reveal that, this finding is same for both years of 2013/14 and 2009/10, but it is observed that the gap between maximum and minimum scores have been significantly decreased in the year 2013/14. Table 01 further exhibits the compliance levels related to the four main individual variables in addition to the overall CG. scores. Board effectiveness demonstrates considerably a higher level of compliance of 80.8% (10.5/13*100) with CGBP in 2012/13 when compared with 57.1% in 2009/10. It is noted that the level of compliance with respect to directors' remunerations is in a moderate level due to the compliance level of 73.3% and 58.3% in 2012/13 and 2009/10 respectively. It is emphasized that accountability & audit has been reached to the maximum level of compliance for both years where there is a significant improvement in compliance level. Relations with shareholders depict a clear improvement of mean scores from 53.3% to 76.7% in the year of 2009/10 with compared to 2012/13 respectively even though minimum and maximum scores have indicated the same value in both years.

One of the major causes to record the minimum compliance in 2009/10 is the absence of the remuneration committee due to the inadequacy of independent directors in the board. Several committees such as remunerations committee, performance evaluation committee were affected by inadequate number of independent directors in their boards. If the mandatory listing rules were not satisfied, a clear justification has to be given to the CSE in order to be deserved further on the main list. Further, there is a clear tendency and a rationale to improve the level of compliance for the mandatory rules with the time factor. Weir and Laing (2002) demonstrate that the U.K board-related governance mechanisms are to a larger degree, "prescriptive" due to the fact that the London Stock Exchange requires a full compliance to the recommended code of best practice whereas a clear rationale had to be given to shareholders in the absence of the compliance to that. Therefore, they have the opinion that there should be a higher level of compliance to the recommendations of the CCR with the time factor. Meanwhile, Weir and Laing (2000) studied the compliance effect and the performance effect prior (1992) and after (1995) the introduction of the CCR and found out that the level of compliance to the aforesaid CCR have been improved in a significant manner in U.K corporate sector in case of post introduction to the Cadbury Recommendations rather than prior recommendations of the CCR. Another plausible reason which might have had an impact on such an improved level of compliance in 2012/13 might be the better and peaceful environment of the country after finishing the 30-year aged war in May 2009. It is acceptable that peaceful and harmonic conditions in the country might have a positive impact for the economic development of the country which in turn improves the organizational set ups in the corporate sector. Weir and Laing (2000) confirm that the positive impact of economic conditions for a higher level of compliance for governance practices. U.K was coming out of the recession in 1995 and it was in the upswing phase of the cycle and therefore they argue that this economical condition might have a considerable effect for the improved level of compliance with CCR in 1995 with compared to that of 1992. Further, fiscal policy executed by the Central Bank of Sri Lanka (CBSL) after the year 2009 would be another major factor for such a higher level of compliance in 2012/13. CBSL suddenly deduced the interest rates from 25% to 12% at the end of 2010 and it was further reduced up to 8% at the first quarter in 2011. As results of these reasons, the investments in share market were significantly improved and it was reported that share market in Sri Lanka has positioned at a higher place not only in the Asia but also in the world context. Therefore, it is not irrational to expect a higher level of compliance with best practices in the corporate sector with such an improvement in the economy as well as in the better share market conditions. Another reason for the improvement of the C.G. Scores might be due to the "Nature" and Nature- related factors of the industry sectors. Due to this, profitability, growth, size of the companies in some of the industry sectors recorded a significant improvement. For instance, industry sectors such as Hotels & Travels, Investments and Land & Property grew in a significant pace in the years of 2010 to 2013 compared with 2009/10 mainly due to the present calm and peaceful environment of the country after ending the war.

4.2 Impact of compliance of CGBP towards financial performance of corporate

Under the correlation analysis, it is expected to understand the association in which each independent variable has with each dependent variable and direction & strength of that association for the two years of 2009/10 and 2012/13. According to the results of Partial Correlation Analysis in table 2, it is emphasized that there is an average size, but definite positive relationships existed between all the governance variables and performance (for both ROA and ROE) except relations with shareholders at .05 and .01 significant levels for the year 2012/13 whereas no significant association is found for the year 2009/10 with financial performance.

Table.2**: Results of Pearson Correlation Analysis- Partial *2009/10 and 2012/13*.**

Control Variables - COHOLD		BODEFV	DIREMU	ACCAUD	RELSHS	ROA
DIREMU	2009/10	.685***				
	2012/13	.689***				
ACCAUD	2009/10	.545***	.364***			
	2012/13	.551***	.375***			
RELSHS	2009/10	.114	.135	-.003		
	2012/13	.354***	.422***	.474***		
ROA	2009/10	.215	.147	.204*	.207	
	2012/13	.578***	.535**	.641**	.293*	
ROE	2009/10	.255*	.186	.285*	.191	.352***
	2012/13	.620***	.541**	.624***	.178*	.861***

*,**,*** denote significance 10%, 5% and 1% respectively

The results in table 3 below indicates that the most important variable towards ROA and ROE is the board effectiveness by reporting the highest beta values of .320 and .317 at .05 significant level respectively ((t=2.102, β=.320, p<0.05 on ROA) and (t=2.068, β=.317, p<0.05 on ROE)) . It further reveals that accountability and audit too have significant impact for the corporate financial performance ((t=2.094, β=.317, p<0.05 on ROA) and (t=2.001, β=.309, p<0.05 on ROE)). Thus, results conclude that being compliant with CGBP on board effectiveness and accountability & audit have strong impact on financial performance of listed companies in dominant industry sectors in Sri Lanka for the year of 2012/13. In addition to that, directors' remuneration and relations with shareholders as well positively impact, but not significantly on the corporate performance in Sri Lanka. As far as adjusted multiple R^2, which gives more accurate information about the fitness of the model is concerned, it is observed that 28.6% variation on ROA and 27.5% variation on ROE have been explained from the independent variables in 2012/13. Further, the significance of the model was examined and it is noticed that the regression model is statistically significant ((F-ratio=5.715, p<.001 with respect to ROA) and (F-ratio=5.469, p<.001 with respect to ROE)). This type of mixed results are supported by the Weir and Laing (2000) on the study of Public Quoted Companies in London Stock Exchange in U.K.

Table 3**: Results of Multiple Regression Analysis - 2012/13 and 2009/10**

Variables	ROA		ROE	
	Beta Coefficient		Beta Coefficient	
	2012/13	**2008/09**	**2012/13**	**2008/09**
BODEFV	0.320** (2.102)	0.128 (.643)	0.317** (2.068)	0.231 (1.185)
DIREMU	0.002 (0.017)	0.143 (.916)	0.019 (0.142)	0.088 (0.577)
ACCAUD	0.317** (2.094)	0.018 (.103)	0.309** (2.001)	0.074 (.422)
RELSHS	0.054 (0.402)	0.196 (1.489)	0.133 (0.975)	0.246* (1.903)
COHOLD	-.066 (-.569)	-.084 (-.643)	-.024 (-.204)	-.081 (-.629)
R^2	0.346	0.096	0.336	0.129
Adjusted R^2	0.286	0.012	0.275	0.048
F-Value	5.715***	1.143	5.469***	1.598

N.B: T-Values are in the parentheses with*,**,*** denoting significance 10%, 5% and 1% respectively.

5. CONCLUSIONS, IMPLICATIONS AND LIMITATIONS OF THE STUDY

It is concluded that the listed companies with reference to the dominant industry sectors in Sri Lanka have complied with CGBP is at "significantly higher" level in 2012/13 compared with that of year 2009/10. Under the partial correlation Analysis, significant positive correlations were found between all the governance variables except Relations with Shareholders in 2012/13 with ROA and ROE whereas that of correlation did not exist in the year 2008/09 with any of the governance variables. It is further concluded that being compliant with best practices of board effectiveness and accountability & audit demonstrate a significant impact on corporate financial performance when the compliance level increased in the year 2012/13. Therefore, final conclusion of the study could be presented as "corporate governance structure and financial performance show mixed results with respect to the dominant industry sectors of listed companies in Sri Lanka".

As far as the limitations of the study are concerned, this study considers only the financial performance measurements/variables of ROA and ROE whereas market and social performance measurements are not considered. Further, primary sources such as physical observations, interviews with the employees and management, secretary of the companies and with internal auditors were not occurred since the study based on the secondary data. Thus, as a result of that, a complete understanding of the implementation of the CBPCG was not taken into the consideration.

It is highly recommended to do further studies by using both primary and secondary data which would then provide a better result and understanding to the reader. Further, it is highly recommended to use all the elements of the concept of Corporate Governance and to use social and market performance measurements as well in addition to the financial measurements. One of the major implications of the study is that the findings are very much useful for the top-level decision makers in corporations as well as for the investors in Sri Lanka for the efficient and effective allocation of their resources. Further, directors of the companies are in a position to measure their level of compliance with the help of composite index and it would be a better implication for them to enhance their compliance level and to improve the financial performance of their corporates.

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