
The Effect of Board Composition on Corporate Financial Performance: Evidence from Listed Companies in Sri Lanka

P.P.S.U. Pathmasiri ^{a,*}, W.Y.M.M.N. Ekanayake ^a

^a Faculty of Management and Finance, University of Ruhuna

A B S T R A C T

Corporate governance plays a vital role in strengthening accountability and transparency in emerging economies, particularly Sri Lanka. Despite extensive studies on the Board composition-performance nexus, the association remains in the conceptualization stage, and limited empirical attention has been paid to the Sri Lankan context. Therefore, this study examines the effect of board composition on the financial performance of non-financial firms listed on the Colombo Stock Exchange. A quantitative, explanatory research design was applied, using secondary data from 55 sample companies over the period from 2015 to 2024. Return on assets and return on equity were used as proxies for financial performance, while board size, board independence, CEO duality, gender diversity, and non-executive directors were employed as proxies for board composition. The natural logarithms of firm size and leverage were used as control variables to improve the robustness of the study. The study comprises 550 firm-year observations and analyses the data using SPSS. The descriptive statistics and multiple regression analysis were employed to examine the association between corporate governance and financial performance. The results of the study indicate that board composition, as a whole, has a notable positive influence on financial performance. In particular, positive relationships can be observed between gender diversity and CEO duality and financial performance, even though there seems to be a negative relationship between board independence and leverage and financial performance. More interestingly, board size and the number of non-executive directors do not indicate any significant association. These findings underscore the importance of sound board design in enhancing financial performance while offering significant implications for managers, investors, and policymakers in formulating robust corporate governance practices.

Keywords: Board composition, Colombo Stock Exchange, Corporate governance, Firm performance, Gender diversity

1. Introduction

Corporate governance refers to the mechanisms by which corporations are directed, managed and held accountable, while ensuring corporate transparency (Hillman et al., 2000). The fundamental objective of corporate governance is to improve the trust of stakeholders that

* Corresponding author: ppsup31@gmail.com

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managers are working towards the success of the corporation instead of their own well-being (Azeez, 2015). Corporations with inadequate governance procedures have to cope with more agency problems, and their managers receive too large compensation (Monks & Minow, 2011). Therefore, corporate governance is crucial to building market trust and drawing customers to the company (Zahra & Pearce, 1989). The board not only seeks oversight of management (Monks & Minow, 2011), but it also gives strategic advice, which lowers agency conflicts and makes decisions better (Zahra & Pearce, 1989). Since sound board composition reduces investor risk, attracts investment capital, and improves firm performance, it generally fosters economic growth (Dilrukshika & Senarathne, 2022). However, the application of board composition differs from nation to nation due to political and economic disparities (Chang et al., 2014; Eisenhardt, 1989; Martynov, 2009).

There have been several corporate failures worldwide, despite the fact that the relationship between corporate governance, particularly board composition and firm performance has been extensively studied in the context of emerging economies. For example, the two largest corporate failures in existence were the bankruptcies of Enron Corporation on 2nd December 2001 and Lehman Brothers on 18th September 2008 (Samaraweera et al., 2021). Two recent failures in Sri Lanka include Edirisinghe Trust Investment Finance Limited (ETI) and Swarnamahal Financial Services PLC (Samaraweera et al., 2021). As a result, these mistakes have highlighted the necessity of governance changes to avoid corporate failures (Samaraweera et al., 2021).

Despite the availability of numerous studies on this association, the board composition-performance nexus is still in the conceptualization state, particularly in emerging economies (Dharmadasa et al., 2021). For example, certain studies indicate a positive influence of board composition on firm performance (Affes & Jarboui, 2023; Bhatt & Bhatt, 2017), whereas others revealed detrimental or negligible effects (Al-Matari et al., 2012; Haniffa & Hudaib, 2006), leaving a notable gap in the extant evidence. These inconsistencies may stem from variations in governance frameworks, institutional contexts, and research methodologies (Arora & Sharma, 2016; Dharmadasa et al., 2021). Moreover, the studies conducted in the Sri Lankan context remain limited and even in the available studies, they often concentrate only on a few components using particular sectors instead of encompassing the majority of listed companies (Ntim & Soobaroyen, 2013). Consequently, there exists no definitive consensus regarding its effect, underscoring a notable research deficiency (Gupta, 2012). Therefore, the study examines the effect of board composition on the financial performance of firms, based on the purposively selected 55 companies on the Colombo Stock Exchange in Sri Lanka during 2015-2024. The researcher aims to fill the existing knowledge gap using the most recent data and a board composition index, covering key indicators demonstrating the significance of the study.

2. Literature Review

Existing debate on the association between board composition and corporate financial performance stems from a few major theories, namely agency theory, stewardship theory and stakeholder theory. According to agency theory, ownership (shareholders) and control (managers) are distinct in companies, which can lead to conflicts of interest since managers may act in their own best interests instead of maximizing the wealth of shareholders (Jensen & Meckling, 1976). By effectively monitoring and supervising management operations, the existence of independent and non-executive directors on the board, in particular, contributes to reducing these agency conflicts (Eisenhardt, 1989). Transparency, accountability, and effective decision-making are all improved by a well-organised board, and these factors may contribute to firm performance. Accordingly, agency theory contends that strong board structures are crucial for safeguarding the interests of shareholders and enhancing the

profitability and efficiency of businesses (Brown et al., 2011; Dahya et al., 2008; Farinha, 2003). Empirical evidence generally shows that higher board independence strengthens governance and aligns managerial decisions with shareholder interests.

In contrast, stewardship theory emphasizes that managers are reliable stewards who place the company's and shareholders' best interests over their own (Davis et al., 1997). This perspective emphasises trust and collaboration, suggesting that supportive and cohesive boards improve strategic decision-making and long-term performance (Nicholson & Kiel, 2007). Similarly, the theory emphasises that stimulating executives and empowering a supportive board may strengthen firms' effective decision-making. For instance, leadership unity can be enhanced through the CEO duality, effective, strategic coordination, and faster decision-making, which contribute to greater performance (Debnath et al., 2021). Consequently, stewardship theory offers validity to the concept that a company's overall performance and profitability can be enhanced by management and the board working together effectively.

Furthermore, stakeholder theory states that rather than concentrating on the wealth of shareholders, companies should take into account the interests of numerous stakeholders, such as shareholders, employees, customers, suppliers, creditors, and the general public (Hillman et al., 2000). This idea strengthens the development of broad-based governance and long-term values. Boards that are more autonomous and diverse are better able to represent the perspectives of different stakeholders, and promote moral decision-making, leading to improved company stability (Edward Freeman & Phillips, 2002). Accordingly, board independence and gender diversity are essential for coordinating shareholder interests with company objectives. Therefore, this theory supports the belief that governance practices promoting stakeholder representation enhance financial performance and long-term organizational value (Harrison & Wicks, 2013).

The literature reveals an inconsistency in the effect of board composition on corporate financial performance. For instance, Kor and Yasemin (2008) discovered a positive correlation between board composition and corporate financial performance, possibly due to board size. Moreover, Lynall et al. (2003) also argued that the board must be large enough to effectively oversee the company since larger boards have greater access to information. Yermack (1996b) underlined that smaller boards lack the necessary managerial skills. However, an effective board should include no more than eight or nine members since larger boards would be ineffective due to director free-riding and coordination problems (Dharmadasa et al., 2021; Rashid, 2018). This is due to the fact that large boards of directors lower the firm's value and increases monitoring costs, according to numerous studies (Alam et al., 2015).

According to Fama and Jensen (1983), the board of directors director board is an essential internal control mechanism for directing upper management. An effective board must have independence, which is based on several independent directors. Since they are not regular staff members of the company, these independent directors solely have supervisory responsibilities (Weisbach, 1988). As a result, they are not actively involved in how the company is operated. Naimah and Hamidah (2017) discovered a lower connection between company performance measures such as return on assets, return on equity and independent director boards with a higher proportion of outsiders.

CEO duality would be a violation of the distinction between management and decision-making, according to Jensen (1993). In reality, CEO duality would provide one individual with excessive decision-making power. Therefore, separate individuals should serve as the

company's CEO and chairperson since this avoids control from being concentrated in one person and enhances the functioning of the company (Bogamuwa & Perera, 2022). In addition, studies indicate that the CEO paradox could be detrimental to company success. For example, CEO duality and company performance are negatively correlated, according to Yu (2022).

Non-executive directors contribute to corporate governance by providing independent judgment and external expertise (Fama & Jensen, 1983). They improve monitoring and reduce managerial bias, leading to better decision-making. Empirical evidence generally supports a positive relationship between NEDs and firm performance (Habtoor, 2020; Kalsie & Shrivastav, 2016; Mitra Bose & Chakraborty, 2022). A balanced mix of executive and non-executive directors is associated with improved governance and firm value in emerging markets, particularly Sri Lanka (Baysinger & Butler, 1985; Core et al., 1997). However, simply increasing the number of NEDs does not ensure better performance if governance systems are weak (Core et al., 1997).

Gender diversity has become an important aspect of board composition, as diverse boards enhance perspectives, innovation, and decision-making (Terjesen et al., 2009a). Arenas-Torres (2021) and Adams and Ferreira (2009) indicate that gender diversity is positively correlated with the performance of firms, their profitability, and corporate reputation. In Sri Lanka, increased female representation is often linked with improved governance and financial outcomes. However, some findings are mixed, suggesting that diversity may also create challenges in decision-making (Ahern & Dittmar, 2011). Accordingly, a well-composed board is critical in the aspects of corporate accountability, strategy, and performance. Therefore, the effect of gender diversity depends on organizational and institutional contexts (Post & Byron, 2015).

Three observations can be drawn from the extant literature discussed here. First, the existing literature is inconsistent and still in the conceptualization stage (Bogamuwa & Perera, 2022). Second, different studies employ quite different methods to measure board composition and financial performance (Ahern & Dittmar, 2011). Finally, very few studies have been conducted in Sri Lanka on how board composition affects firms' performance and the majority of the studies are conducted in developed countries (Dharmadasa et al., 2021). Thus, the findings of such studies cannot be applied to the Sri Lankan context due to contextual disparities Naimah and Hamidah, (2017). Most importantly, these studies have measured board composition using narrow-based indexes (Rashid, 2018). Therefore, the current study aims to fill the existing knowledge gap by measuring board composition using a broad-based index.

3. Methodology

This study investigates the association between board composition and the financial performance of listed companies in the CSE during 2015-2024 using a quantitative method. The banks and insurance companies are not included as they have different rules and ways for board composition. A sample of 55 firms was selected based on a purposive sampling technique. Accordingly, the study includes 550 firm-year observations over the last ten years. Secondary data was extracted from the audited annual financial reports of the listed companies over the study period. This study combines descriptive and explanatory research approaches to describe patterns of data and to investigate the relationships between two variables.

Table 1: Dimension, Proxies, and Measures

Dimension	Proxies	Measurement	Literature
Independent variable	Board Size	Total number of directors	Affes and Jarboui (2023) and Guluma (2021)
	Board Independent	Ratio of Independent Directors $\times 100$	Al-Faryan (2024) and Kallamu (2016)
	CEO Duality	Dummy (1 = duality; 0 = no duality)	Al-Saidi and Al-Shammari (2013) and Richard et al. (2020)
	Gender Diversity	Percentage of female directors $\times 100$	Simionescu et al. (2021) and Terjesen et al. (2009b)
Dependent variable	Non-Executive Directors	NEDs/total board members	Pathirawasam and Wickremasinghe (2013)
	Return on Assets	(Net income/Total assets) $\times 100$	Affes and Jarboui (2023) and Al-Matari et al. (2014)
	Return on Equity	(Net income/Shareholders' equity) $\times 100$	
Control variable	Log Firm Size	Natural logarithm of total assets	Akbar et al. (2017) and Li and Dang (2013)
	Leverage	(Total debt/Total assets) $\times 100$	Salim and Yadav (2012)

The study measured board composition using five key indicators, including board size, board independence, CEO duality, gender diversity, and non-executive directors. Board size was measured by considering the total number of directors serving on the board of a company. Board independence was measured as the ratio of independent directors to the total number of board members multiplied by 100, representing the percentage of independent directors on the board. CEO duality was measured using a dummy variable, where a value of 1 indicates that the Chief Executive Officer simultaneously serves as the chairperson of the board, while a value of 0 indicates the separation of these two positions. Gender diversity was measured as the percentage of female directors relative to the total number of board members multiplied by 100. Non-executive directors were measured by dividing the number of non-executive directors by the total number of board members to identify the proportion of non-executive representation on the board. Overall, the board composition index was then calculated considering the average of these five dimensions following the approach applied by Abdullah (2004).

Financial performance was measured using return on assets and return on equity. The return on assets was calculated by dividing net income by total assets and multiplying the result by 100 to get the percentage values (Affes & Jarboui, 2023). Similarly the return on equity was computed by dividing net profit from total equity and taking the percentage value into account (Samaraweera et al., 2021). Moreover, the study employed two firm-specific control variables such as firm size and leverage. Firm size was measured using the natural logarithm of total assets. The logarithmic transformation was applied because the data were not normally distributed (Ahmed & Gujrathi, 2024). Leverage was measured by dividing total debt by total assets and multiplying the result by 100 (Peiris et al., 2020).

The OLS regression model illustrated in equation 1 was used to estimate the effect of board composition on corporate financial performance of listed companies in Sri Lanka. Additionally, multicollinearity issues were detected using variance inflation factors. The independence assumption was tested using the Durbin-Watson test.

$$FP_{it} = \alpha + \beta_1 BS_{it} + \beta_2 BI_{it} + \beta_3 CD_{it} + \beta_4 GD_{it} + \beta_5 NED_{it} + \beta_6 L_FS_{it} + \beta_7 LEV_{it} + \varepsilon_{it} \text{-----} (1)$$

In equation 1, FP indicates the vector of financial performance measures, in terms of return on assets and return on equity. Therefore, two models, namely, model 1 and model 2, were constructed, considering each performance measure as the dependent variable. BS, BI, CD, GD and NED denote board size, board independence, CEO duality, gender diversity and non-executive directors, respectively. Moreover, L_FS indicates the bank size which was log transformed, and LEV denotes the leverage. Moreover, i denote individual firms and t denotes time. Finally, intercept, regression coefficients, and random errors are denoted by α , β , and ε , respectively. The model permits the overall analysis of the board composition effect on the performance of the firm with regard to firm-specific traits.

4. Findings and Discussion

Table 2 indicates the fluctuations of the selected variables over the study period. A comparatively low dispersion in board independence and non-executive directors indicates that these governance systems are generally uniform across companies. This is possibly due to the mandatory corporate governance requirements of the Colombo Stock Exchange and the Securities and Exchange Commission of Sri Lanka as it encouraged companies to maintain comparable board structures. Conversely, financial performance exhibits significantly greater deviation, indicating the economic instability experienced between 2015 and 2024, especially the detrimental effect of the COVID-19 outbreaks, economic crisis, currency depreciation, and interest rate fluctuation, affected businesses differently across industries. Additionally, governance factors, in terms of CEO duality and gender diversity, show inconsistent adoption patterns among organizations. Overall, the fluctuations indicate that while financial performance and leverage show significantly more sample-wide variation, governance factors are generally more consistent.

Figure 2 shows notable shifts in the selected variables over the study period. Even though ROA did not vary considerably, ROE and LEV exhibited notable changes. The decline in ROE in 2020 suggests a drop in profitability, probably due to the adverse impact of the COVID-19 pandemic and the associated economic shocks. Similarly, the rising trend in LEV before 2020 suggests that companies increasingly relied on debt financing during adverse financial conditions. The further reduction in LEV suggests that financing strategies became more conservative as economic conditions improved. Overall, the identified changes in ROE and LEV are largely explained by macroeconomic shocks that shaped corporate profitability and financing choices among CSE-listed companies.

Table 2: Descriptive Statistics

Variable	Min	Max	Mean	SD	CV%
Board size	.000	.462	.226	.079	28.61
Board Independence	.000	.462	.226	.079	34.95
CEO Duality	.000	1.000	.701	.458	65.33
Gender Diversity	.000	6.000	.274	.364	132.84
Non-Executive Directors	.000	.909	.462	.136	29.43
Return on Assets	-2.897	.684	.064	.153	239.06
Return on Equity	-15.606	13.789	.142	.906	638.03
Log Firm Size	7.477	12.122	10.113	.708	7.001
Leverage	.000	23.653	.287	1.086	378.39

Notes: Min, Max, SD and CV stand for minimum, maximum, standard deviation, and coefficient of variance, respectively

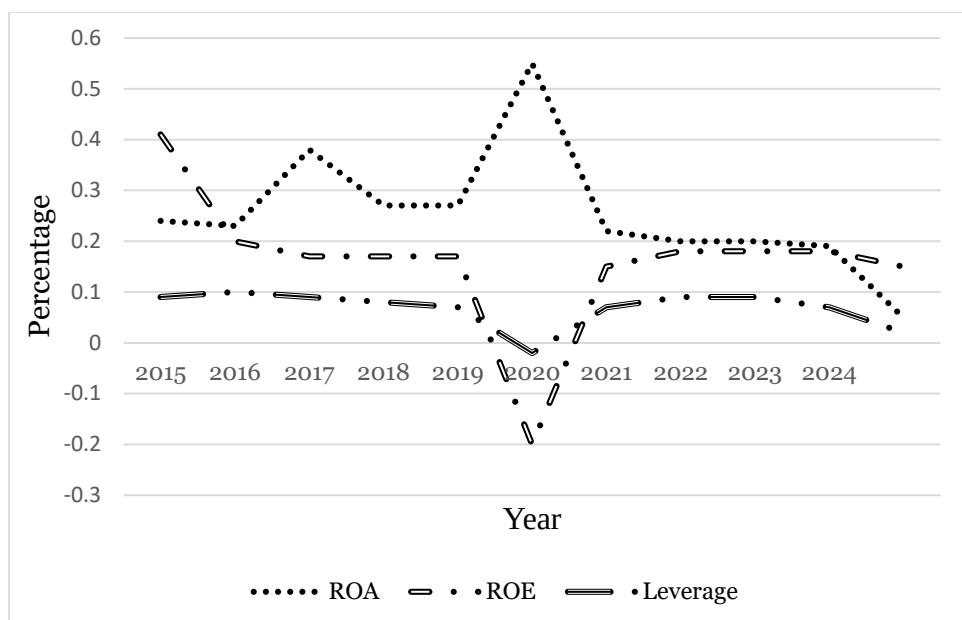


Figure 2: Fluctuations of the Financial Performance during 2015–2024

Several diagnostic tests were performed before regression analysis to ensure that the data met key statistical assumptions. Boxplot analysis was used to identify and remove extreme outliers to ensure the robustness of the analysis. A histogram of the standardized residuals was used to assess normality, which indicated that the data were approximately normal. Furthermore, the independence assumption is fairly satisfied in model 2 in terms of return on equity ($DW = 1.809$), despite not being satisfied ($D-W = 1.003$) by the observations in model 1 in terms of return on assets. The Variance Inflation Factor (VIF) and tolerance were also analyzed to detect the multicollinearity issues. The VIF values ranged from 1.044 to 1.570, well below five, and tolerance values were close to one. These findings confirm that there are no serious multicollinearity issues and justify the use of these variables in regression analysis.

The OLS regression model specified in equation 1 was used to assess the effect of board composition on corporate financial performance of non-financial companies in Sri Lanka over the study period from 2015 to 2024. Two regression models in terms of model 1 and model 2 were estimated using each performance dimensions as the dependent variable since the financial performance is assessed using two different indicators. Table 3 shows the regression results.

Two regression models were statistically significant in predicting their respective performance dimensions. As indicated in Table 3, the results of OLS regression models demonstrate that 59.4 per cent of the variation in return on assets and 45.1 per cent of the variation in return on equity can be attributed to the explanatory variables included in model 1 and model 2, respectively. Even though board size does not indicate a significant association with any performance measures, board independence demonstrates that the strong negative correlation with financial performance in terms of return on assets ($\beta = -.230, p < .001$) and return on equity ($\beta = -1.254, p = .008$), indicating that a higher percentage of independent directors may result in more cautious and conservative decision-making within the firms. Monitoring, compliance,

and risk management are frequently prioritized by independent boards over aggressive profit-seeking tactics. Consequently, businesses might pass up chances for expansion or high-risk expenditures that could stimulate profitability in line with Yermack (1996).

Table 3: Regression Results

Variables	Description	Model 1: ROA	Model 2: ROE
α	Constant	-.027 (-.242)	-.407 (-.522)
BS	Board Size	.009 (1.497)	.014 (.359)
BI	Board Independence	-.230*** (-3.356)	-1.254** (-2.650)
CD	CEO Duality	.033** (3.036)	.156** (2.106)
GD	Gender Diversity	.082*** (6.844)	.383*** (4.659)
NED	Non-Executive Directors	.046 (1.141)	.211 (.758)
L_FS	Log of Firm Size	.000 (.036)	.050 (1.019)
LEV	Leverage	-.111*** (-27.198)	-0.573*** (-20.333)
R^2		.594	0.451
<i>F-statistic</i>		110.057***	61.904***
<i>Durbin-Watson</i>		1.003	1.809

Note **, *** indicates significant levels 5% and 1% respectively

T statistics are indicated within parentheses

Gender diversity has a statistically significant positive effect on financial performance in terms of ROA ($\beta=.082$, $p<.001$) and ROE ($\beta=.383$, $p<.001$), suggesting that well-organised boards promote strategic decision-making and monitoring, which strengthens managerial effectiveness and improves financial performance according to the findings of Simpson (2003). Similarly, CEO duality has also indicated a positive correlation with financial performance stemming from ROA ($\beta=.033$, $p<.003$) and ROE ($\beta=.156$, $p=.036$). This suggests that CEO duality enhances the efficiency of decision-making and leadership cohesion, enabling fast strategic decisions and improved management-board collaboration, all of which can boost company performance according to Donaldson (1991). Nevertheless, non-executive directors do not denote any significant association with return on assets ($\beta=.046$, $p=.255$) and return on equity ($\beta=.211$, $p=.449$). Overall, the results show that the board composition index has a statistically significant positive impact on financial performance ($\beta=.604$, $p=.031$) in terms of return on assets and return on equity, despite the negative relationships indicated by several factors. This suggests that good governance frameworks improve financial performance even though higher debt obligations and excessive monitoring mechanisms may hinder profitability.

Moreover, leverage denotes a statistically significant negative relationship with return on assets ($\beta=-.111$, $p<.001$) and return on equity ($\beta=-.573$, $p<.001$), suggesting that greater leverage raises financial risk and interest obligations, which hinder profitability. However, board size does not show a significant relationship with financial performance, indicating that it might have more qualitative influences on performance, including expertise and effectiveness of the board, according to Guest (2009).

The findings of this study are in line with Kor and Misangyi (2008) and Lynall et al. (2003), whereas they contradict Yu (2022). This indicates that a higher percentage of independent, non-executive directors may hinder decision-making, leading to over-monitoring, which can reduce managerial flexibility and have a detrimental impact on profitability. Nevertheless, this

contradiction may show how performance dynamics change over time and in different contexts.

6. Conclusion

This study analyses the relationship between the board composition and financial performance of listed firms in the CSE in Sri Lanka during 2015-2024. The regression results indicate that board independence negatively correlates with financial performance, whereas CEO duality and gender diversity positively associate with financial performance. This underscores the significance of leadership structure and board diversity in corporate governance. However, the size of the board structure and the presence of non-executive directors do not have a significant effect on the performance of the company. This means that just adding more board members does not make things better. Overall, the board composition has a statistically significant positive effect on firms' financial performance. This suggests that the effects of each board member may be varied, but the effects of all of them together are stronger.

This study provides two significant implications. First, the findings highlight the importance of an effective board structure with appropriate board independence and gender diversity to enhance corporate governance practices and improve financial performance. These insights are valuable for corporate managers, investors, and regulators in strengthening governance systems. Second, the recent empirical evidence presented in this study is added to the existing body of knowledge on board composition and financial performance, addressing the limited research on this association in emerging markets. Nevertheless, the sample size can be expanded in future studies since this study covers ten years from 2015 to 2024, considering the companies operating in the financial sector as well. Moreover, further studies can implement both qualitative and mixed-method designs to have a better understanding of how board dynamics affect corporate financial performance.

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