Impact of Corporate Governance on Insider Dealing: An Empirical Examination in the Context of Companies Listed on The Colombo Stock Exchange

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Abstract

This research will principally provide an insight in to the relationship between corporate governance & insider dealing and ascertain whether the existence of corporate governance practices will have an impact on the occurrence of insider dealing based on the behaviour of the return abnormality of shares of the different categories of the corporate governance samples. Further, the information content of earnings announcement of Sri Lankan public listed companies will also be statistically quantified whilst providing a test in the semi strong form of efficient market hypothesis (EMH) relating to the Sri Lankan market.

In this study, the standard Event Study Method (ESM) is applied to estimate the abnormal returns of shares. The overall sample period of the research covers consecutive eight years between 2001 and 2008 (inclusive of both years) encompassing 152 events in respect of 22 companies and the estimation period as well as the event period comprise of 261 market days. The overall sample consists of the companies included in the Milanka Price Index of the Colombo Stock Exchange during the sample period subject to the elimination criteria of the study. There are eight sub-samples namely, two sub-samples of companies relating to the years 2001 and 2008 as well as six sub-samples in respect of the level of corporate governance i.e. corporate governance high, medium and low categories pertaining to the same years.

A detailed questionnaire covering the selected key elements pertaining to corporate governance is applied to assess the level of governance practices existent the sample companies based on the disclosures made in the annual reports of such entities and the sample companies are categorized into three groups according to the markings obtained by them in the above mentioned corporate governance rating assessment, namely, the governance high, medium and low categories for the years 2001 and 2008. The abnormal returns pertaining to each sub-sample are then estimated in order to ascertain as to whether the level of corporate governance practices has any impact on the return abnormality of the respective shares and thereby to draw an inference whether the degree of governance practices has any impact on the occurrence of insider dealing.

The findings relating to the overall as well as the sub-samples of the study clearly demonstrate that the market reacts positively to the earnings announcements and support clearly the information content of such announcements. As far as the overall sample as well as the sub-sample of 2001 are concerned, abnormal returns begin much prior to the event date (i.e.as far back as from day -20) whilst according to the sub-sample of 2008, abnormal returns are much closer to the event date starting from the day -5. Further, the abnormal returns pertaining to the corporate governance high samples begin much closer to the event date whilst it is longer in respect of the governance low samples. Furthermore, the return abnormality of the samples relating to the year 2001 is greater and longer in comparison to 2008. In this context, the findings also show that the level of the existence of corporate governance practices in listed companies has an impact on the the return abnormality of shares and thereby an inference could be drawn that there exists an inverse relationship between corporate governance and insider dealing. As such, when the governance practices are high, it appears to have a negative effect on insider dealing and vice versa. The findings further suggest that the improvements in the area of governance in listed entities by the year 2008, as depicted in the results of the corporate governance rating assessment, has had a negative impact on the occurrence of insider dealing. Further, the results also do not support the semi-strong form of EMH in the context of the Sri Lankan stock market.

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