THE IMPACT OF CORPORATE GOVERNANCE CHARACTERISTICS ON FIRM FINANCIAL PERFORMANCE: EVIDENCE FROM LISTED NON-FINANCIAL COMPANIES IN SRI LANKA

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INTRODUCTION

Corporate Governance (CG) ensures fairness, transparency, and effective company management. According to Tarurhor and Olele (2020), a statistically significant nexus between a firm's success measures, including financial performance and CG characteristics, is available. According to Goel (2018), the long-term advantages of effective CG systems in enhancing the performance of firms and sustainability have been reaffirmed by the global financial crisis, including significant corporate scandals. These incidents led to a massive scandal and raised serious concerns about the company's financial practices and governance. Moreover, CG simplifies business oversight and promotes justice, transparency, and improved disclosures to protect stakeholders' interests (Arora & Bodhanwala, 2018).

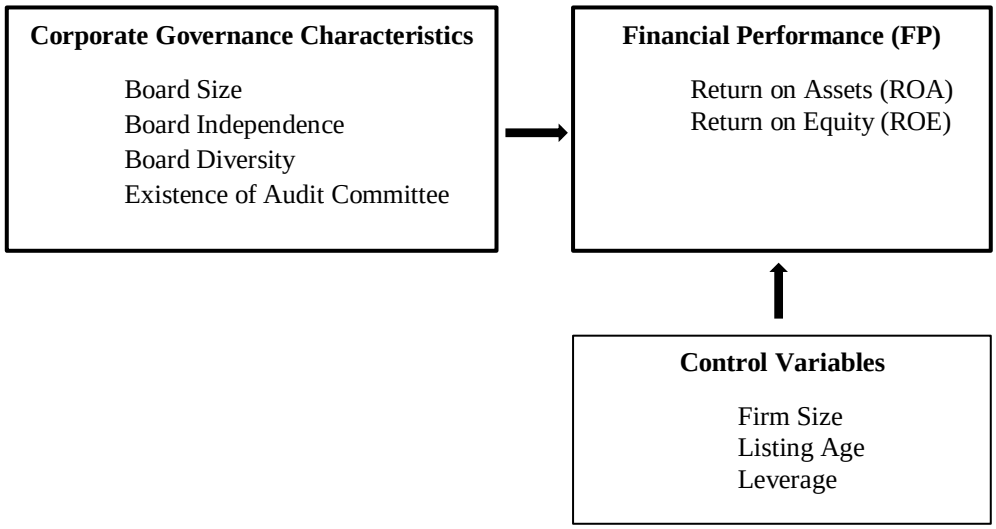
Several corporate failures in Sri Lanka, such as Galadari Hotels (Lanka) Ltd., ETI Finance Ltd., Vanik Incorporation Ltd., Ceylinco Group, Golden Key Credit Company, and the Finance Company PLC, recently highlighted the importance of an effective CG system for any organization. However, the previous empirical studies have produced conflicting results on the nexus between CG and firms' financial performance, highlighting the need for further research to investigate the relationship between CG characteristics and firm financial performance (Guluma, 2021). The association between CG characteristics and firm financial success has drawn the attention of numerous scholars. Numerous international studies have explored the link between corporate governance traits and a company's financial performance. However, these studies have yielded conflicting results, indicating a lack of consensus in existing literature. While there has been research on corporate governance in Sri Lanka, it has primarily centered on board diversity, particularly gender diversity, with limited attention to other characteristics. Most empirical evidence has been focused on publicly listed companies, leaving other sectors relatively unexamined. This study seeks to address this gap by investigating non-financial sectors. However, after conducting rigorous analyses on this topic, the researchers knew they could contribute to the existing knowledge on CG and its impact on firm financial performance. Consequently, this study intends to examine the significant impact of CG on firm financial performance with particular reference to listed non-financial companies in Sri Lanka. The study has the potential to contribute to existing knowledge on CG and provide valuable insights for academia and practical implementation in various aspects.

METHODOLOGY

As depicted in Figure 1, CG characteristics were measured by four proxies, whereas two measurements were used to measure the financial performance of the sample firms. Additionally, three control variables, namely, firm size, listing age, and leverage, were used as the control variables.

Figure 1

Conceptual Framework of the Study



The population of the study is non-financial entities listed in the Colombo Stock Exchange (CSE) as of March 31, 2022. Banking, Finance, and Insurance companies were excluded due to their distinct financial statement structures and strict corporate governance regulations. However, the sample size was confined to the top 100 companies based on market capitalization. Data was collected from five consecutive financial years (2018-2022), resulting in 500 firm-year observations. The data source for the study's analyses was the CSE's published annual reports, which underwent initial data cleaning and screening to identify missing data. Diagnostic tests were then conducted to ensure the suitability of the data for primary analyses. The collected data were analyzed using the STATA statistical package. Initially, descriptive statistics and correlation analysis were conducted, while regression analysis on panel data was executed to investigate the effects of independent and control variables on dependent variables. Further, Hausman tests were conducted to select the appropriate effect on each proposed model. Two models were developed and tested as below by aligning with the conceptual framework.

Model 01

$ROA_{it}=\beta 0+\beta 1\text{BODSIZE}_{it}+\beta 2\text{BODIND}_{it}+\beta 3\text{BGENDIV}_{it}+\beta 4\text{ACZ}_{it}+B5SIZE_{it}+B6\text{AGE}_{it}+B7\text{LVE}_{it}+\varepsilon$..... (1)

Model 02

$ROE_{it}=\beta 0+\beta 1\text{BODSIZE}_{it}+\beta 2\text{BODIND}_{it}+\beta 3\text{BGENDIV}_{it}+\beta 4\text{ACZ}_{it}+B5SIZE_{it}+B6\text{AGE}_{it}+B7\text{LVE}_{it}+\varepsilon$..... (2)

A hypothesis is essential for concluding, particularly when establishing relationships between two variables. These hypotheses are derived from the existing literature review.

H_{1a}: Board size has a positive impact on ROA, H_{1b}: Board size has a positive impact on ROE, H_{2a}: Board independence has a positive impact on ROA, H_{2b}: Board independence has a positive impact on ROE, H_{3a}: Board diversity has a positive impact on ROA, H_{3b}: Board diversity has a positive impact on ROE, H_{4a}: Audit committee size has a positive impact on ROA, H_{4b}: Audit committee size has a positive impact on ROE.

RESULTS AND DISCUSSION

As indicated in Table 1, the mean value of the ROA variable is negative, indicating that most companies did not perform well in terms of ROA and ROE during the COVID-19 pandemic and the economic crisis in Sri Lanka. The preliminary analyses, namely multicollinearity and tolerance values, were tested and confirmed the appropriateness of the data for the primary analyses. The sample's ROA values range from -0.06 to 15.7, with an average value of 0.16. The ROE values range from -0.7 to 17. The mean board size is 4, with a minimum of 3 and a maximum of 14. Board independence ranges from 1 to 19, and board gender diversity is from 0 to 7. The audit committee size is the number of members. Firm size, financial leverage, and listing age are the control variables. The skewness of return on assets, return on equity, board size, board independence, board gender diversity, audit committee size, firm size, listing age, and financial leverage are typically distributed. The kurtosis of ROA, ROE, board size, board independence, board gender diversity, audit committee size, firm size, listing age, and financial leverage is less than 5, indicating that data is usually distributed.

Table 1

Result of the Descriptive Analysis

Variables	Mean	Std. Dev.	Min	Max	Skewness	Kurtosis
ROA	0.067	0.168	-0.212	15.720	1.864	4.646
ROE	-0.349	3.663	-0.742	16.924	-1.260	3.430
BODSIZE	4.008	5.738	3.000	14.000	-0.033	2.699
BODIND	3.766	1.309	1.000	19.000	0.228	2.548
BGENDIV	1.206	1.267	0.000	5.000	0.909	3.118
ACZ	2.994	1.243	0.000	7.000	0.412	3.440
Size	5.306	7.22	-0.938	13.033	-0.033	2.699
AGE	1.865	2.978	2.000	37.000	0.006	1.960
LVE	2.919	2.366	0.000	3.278	1.309	1.494

Relationships between the selected variables are illustrated in Table 2. The coefficient's distance from zero determines the fit and correlation. Perfect fits indicate perfectly connected variables, allowing inference from matched values. The connection weakens as it approaches zero, resulting in no linear link. The modest degree of positive/negative correlation between the variables is depicted in Table 2.

Correlation analysis indicates a weak positive correlation between ROA and board size, board independence, audit committee size, and listing age. In contrast, a strong positive correlation exists between ROA and board gender diversity. However, negative correlations exist between ROA and firm size and financial leverage. ROE has a weak positive correlation with board size, board independence, audit committee size, and listing age, while a strong positive correlation with board gender diversity is observed. However, there are two negative relationships with ROE: firm size (-0.0159) and leverage (-0.0204). These variables tend to rise in different relation to each other.

Table 2

Result of Correlation Analysis

Variables	ROA	ROE	BODSIZE	BODIND	BGENDIV	ACZ	Size	AGE	LVE
ROA	1.000								
ROE	0.212	1.000							
BODSIZE	0.137	0.016*	1.000						
BODIND	0.092	0.038*	0.537	1.000					
BGENDIV	0.005**	0.010**	0.463	0.469	1.000				
ACZ	0.027*	0.029*	0.241	0.239	-0.086	1.000			
Size	-0.037	-0.015	-0.015	-0.009	0.078	0.023*	1.000		
AGE	0.061	0.054	-0.093	0.036*	-0.252	0.352	-0.143	1.000	
LVE	-0.139	-0.020*	0.007**	-0.034*	0.079	-0.097	0.065	-0.153	1.000

N = 500, * $P< 0.05$, ** $P< 0.01$

Table 3 summarizes the findings of regression on panel data analyses. The Hausman test confirmed the suitability of random effect for each model.

Table 3

Results of Regression Analyses

Variables	Model- 1 – ROA (Random-effect)			Model- 2 ROE (Random-effect)		
	Coef.	Std. Err.	P>|z|	Coef.	Std. Err.	P>|z|
BODSIZE	0.013	0.004	0.004	-0.000	0.024	0.979
BODIND	0.002	0.007	0.792	0.022	0.041	0.584
BGENDIV	-0.006	0.007	0.383	0.007	0.042	0.850
ACZ	-0.011	0.007	0.123	0.001	0.040	0.972
Size	-0.004	0.006	0.508	-0.006	0.041	0.867
AGE	0.000	0.000	0.233	0.004	0.003	0.301
LVE	0.016	0.006	0.009	-0.008	0.035	0.803
Cons	-0.011	0.038	0.756	-0.058	0.204	0.775
R^2			0.046			0.004
Sig. value			0.006			0.944
Hausman test chi2			0.000			1.620
Prob>chi2			0.983			0.977

As per Table 3, board size and leverage significantly impact ROA, while none of the other variables impact ROA. Ahmad et al. (2018) also confirmed that board size positively impacts financial performance by providing effective monitoring, stakeholder representation, and resource access. As a result of the investigation, a substantial impact was identified between board size and ROA. Surprisingly, all the variables selected in the study did not indicate an impact on ROE. Based on the results, it can be concluded that CG characteristics have no statistically significant association with ROE. Most previous scholars reported similar findings (Nesma & Ali, 2017), although there are a few dissimilar findings.

The study rejects the null hypothesis (H_{1a}) that board size does not significantly affect financial performance, citing previous evidence indicating a positive relationship between board size and ROA. There is a positive relationship between board size and firm performance, suggesting that larger boards may lead to increased firm performance (Vafeas, 2003). Additionally, it accepts the null hypothesis for the second (H_{2a}), third (H_{3a}), fourth (H_{4a}), fifth (H_{1b}), sixth (H_{2b}), seventh (H_{3b}), and eighth (H_{4b}) hypotheses. Jackson and Nakajima (2019) found no significant correlation between board independence and firm performance metrics like return on assets and sales. Therefore, it is observable that the regression results confirm

the null hypothesis. According to Cucinelli (2013), there is no significant association between the number of female directors and financial performance. It was unable to detect any relationship between the attributes of the audit committee and firm performance (Zhou et al., 2018).

CONCLUSION AND IMPLICATION

The study concludes that corporate governance characteristics do not substantially influence the financial performance of listed non-financial companies in Sri Lanka. The results show that BGENDIV and ACZ have a negative impact on ROA, indicating their insignificant effect. On the other hand, BODSIZE and BODIND positively impact ROA, with BODSIZE having a significant positive impact. Regarding ROE, BODSIZE has a negative relationship, while BODIND, BGENDIV, and ACZ positively influence it. Nevertheless, the results show that BODSIZE, BGENDIV, BODIND, and ACZ have an insignificant impact on ROE. As well as firm size and financial leverage have a negative relationship with ROE. The study focuses on financial reports from listed non-financial companies at the CSE in Sri Lanka, ignoring other CSE sectors. It suggests expanding the research area through future studies and using appropriate independent, dependent, control, and moderate variables to understand firm performance better. It highlights the potential influence of control variables on firm performance estimates, providing a new perspective on control factors' impact on firm performance.

***Keywords*:** Corporate governance, non-financial listed companies, return on assets, return on equity.

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